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MUTUAL FUNDS AND SECURITIES CLASS ACTIONS: A SQUARE PEG IN A ROUND HOLE

The authors describe securities class actions concerning mutual funds as "relatively sparse" and "often divergent." They discuss the cases focusing on three prominent issues: loss causation, control person liability, and reliance.

By Sean M. Murphy, Robert J. Liubicic, and Lisa M. Northrup *

The popularity and growth of mutual funds have made it an over $16 trillion industry, a fact not lost on the federal securities plaintiffs' bar.[1] But bringing class actions on behalf of mutual fund investors is not without significant obstacles. The primary federal statute governing mutual funds, the Investment Company Act of 1940 (the "ICA"), provides only a single, express, private right of action. That right of action under Section 36(b) of the ICA limits recovery to the amount of fees charged by a mutual fund's investment adviser, and the statute provides significant procedural safeguards for defendants.[2] Mutual funds are also subject to the Securities Act of 1933 (the "Securities Act") and the Securities Exchange Act of 1934 (the "Exchange Act"), the traditional vehicles of choice for securities class action plaintiffs' lawyers. But those statutes present unique issues when mutual funds are involved, and impose additional hurdles for plaintiffs that are more challenging than those plaintiffs face in a traditional securities class action against a corporate issuer of securities.

At the time the Securities Act and Exchange Act were enacted, mutual funds obviously were not in the forefront of the drafters' minds. In the wake of the Great Depression, Congress was focused on enacting legislation aimed at traditional corporate issuers and protecting shareholders of those types of securities (*e.g.*, shares of common stock). Moreover, almost all of the last 80 years of caselaw interpreting the relevant provisions of the Securities Act and Exchange Act has involved claims brought by shareholders of corporate issuers, not mutual funds. Only more recently have courts begun to address how these statutes apply to funds. The result has been a revelation that the unique legal and structural characteristics of mutual funds, and their very nature as pooled investment vehicles that hold a basket of many underlying investments, makes them fundamentally different from the individual securities

[1] Investment Company Institute, *2017 Investment Company Fact Book: A Review of Trends and Activities in the Investment Company Industry* (57th Ed.) at 9.

[2] Investment Company Act of 1940, § 36(b), 15 U.S.C.A. § 80a–35(b); *Jones v. Harris Assocs. L.P.*, 559 U.S. 335, 340 (2010).

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that are the subject of traditional securities class actions. Because of these fundamental differences, many standard concepts of liability under the securities laws do not fit mutual funds as naturally as they do individual securities, and the result is often confusion and uncertainty.[3]

Securities Act and Exchange Act claims involving mutual funds are typically filed as class action lawsuits by fund shareholders under Sections 11, 12(a)(2), and 15 of the Securities Act and Section 10(b), Rule 10b-5, and Section 20 of the Exchange Act. Plaintiffs typically name as defendants the mutual funds themselves, the funds' investment adviser, parent companies of the funds and investment adviser, officers of any of the aforementioned entities, and the funds' directors. Plaintiffs have targeted a wide range of conduct, including mutual fund market-timing and late-trading arrangements, mutual fund fee practices including revenue sharing and directed brokerage, sales practices with respect to different share classes, failure to adhere to a fund's stated investment objective, omission of relevant risks, and inaccurate valuation of the fund's assets. Plaintiffs most frequently allege misrepresentations and omissions in the fund's registration statement. The securities class action caselaw concerning mutual funds is relatively sparse and often divergent.

In this article, we examine the different approaches courts and litigants have taken with regard to three well-known concepts under the Securities Act and Exchange Act: (1) loss causation; (2) control person liability; and (3) reliance. In our view, the caselaw reflects both the difficulties of applying the securities laws to products for which they were not originally intended, and the judicial philosophies that are employed when attempting to adapt precedent to these products.

I. LOSS CAUSATION AND THE MEASURE OF A MUTUAL FUND'S "VALUE"

Loss causation is, in its broadest terms, "a causal connection between the material misrepresentation and the loss."[4] In securities class actions, proving loss causation often takes the form of a plaintiff attempting to show how either a corrective disclosure or the materialization of a concealed risk led to a negative market reaction.[5] For claims under Section 10(b) and Rule 10b-5 of the Exchange Act, plaintiffs must allege loss causation as an element of the claim.[6] For claims under Sections 11 and 12(a)(2) of the Securities Act, plaintiffs need not establish loss causation to prevail.[7] The absence of loss causation is an affirmative defense, however, and accordingly, courts will sometimes dismiss claims when it is apparent on the face of the complaint that plaintiffs will be unable to establish loss causation.[8]

A. *The View That a Mutual Fund's "Value" Is Not Limited to Its Net Asset Value*

For most individual securities, a secondary market — *e.g*., a stock exchange — typically determines the market value of a unit of that security. The market value of a common stock, for example, is set by buyers and sellers of that stock who make decisions about the issuer's fundamentals and future prospects. The price of shares of an open-ended mutual fund (its net asset value, or "NAV"),[9] by contrast, is not set by the perceived value of the mutual fund by buyers and seller — rather, it is simply the total value (assets minus liabilities) of the portfolio of the underlying individual securities held by the fund, calculated according to a statutory formula.[10]

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3 *Tannenbaum v. Zeller*, 552 F.2d 402, 405-07 (2d Cir. 1977).

4 *Dura Pharm., Inc. v. Broudo*, 544 U.S. 336, 342 (2005).

5 *Lentell v. Merrill Lynch & Co., Inc*., 396 F.3d 161, 173 (2d. Cir. 2005).

6 *Dura Pharm*., 544 U.S. at 342.

7 *See In re State Street Bank and Tr. Co. Fixed Income Funds Inv. Litig*., 774 F. Supp. 2d 584, 588 (S.D.N.Y. 2011).

8 *See In re Evergreen Ultra Short Opportunities Fund Sec. Litg*., 705 F. Supp. 2d 86, 94 (D. Mass. 2010); 15 U.S.C. § 77k(e); 15 U.S.C. § 77l(b).

9 Closed-end funds, as opposed to open-ended funds, are traded on a market and can trade at a discount or premium to NAV as the fund shares fluctuate like that of other publicly traded securities. Investment Company Institute, *supra* note 1, at 76.

10 *See* 17 C.F.R. §§ 270.2a–4, 270.22c–1; Investment Company Institute, *supra* note 1, at 242.

Dividing the fund's NAV by the total number of outstanding shares in the fund results in the fund's per-share NAV.

Seizing on this difference, defendants in securities class actions involving mutual funds have argued that plaintiffs cannot show loss causation with respect to alleged misrepresentations or omissions concerning a fund because the fund's NAV accurately reflects the underlying value of each of the many holdings in the fund's portfolio of securities. Any decline in the fund's NAV, the argument goes, is due to a decline in the value of one or more of the underlying securities in the fund's portfolio, not to alleged misrepresentations or omissions concerning the fund itself. Courts that have rejected this argument have taken a broader, more policy-based view of loss causation and the securities laws.

In *In re Charles Schwab Corp. Securities Litigation*,[11] plaintiff mutual fund shareholders claimed that defendants violated Sections 11 and 12(a)(2) of the Securities Act based on misrepresentations regarding the investment policies and risk profile of the fund in fund prospectuses, Statements of Additional Information ("SAIs"), and other written communications with investors. Defendants moved to dismiss, arguing that because the fund's NAV was based on the value of the underlying assets held by the fund, alleged misrepresentations about the fund itself could not have caused plaintiffs' losses. Any losses, according to defendants, would have been due only to the decline in the value of the fund's underlying assets. The court denied defendants' motion to dismiss, holding that defendants' NAV-based conception of loss causation was overly narrow and would "effectively insulate mutual fund companies from claims for a wide range of material misrepresentations."[12] The court explained that while the "loss causation inquiry often hinges on the timing of purchases and sales in relation to the typical inflation-disclosure-deflation cycle, loss causation is not limited to that scenario."[13] The court held loss causation is sufficiently established "where a plaintiff proves that 'it was the very facts about which the defendant lied which caused its injuries.'"[14] Thus, the court held that because plaintiffs alleged that the subject of the alleged misrepresentations and omissions — *i.e.*, risks relating to the fund's portfolio — caused the claimed losses, the plaintiffs had sufficiently established loss causation.

[11] 257 F.R.D. 534, 546-49 (N.D. Cal. 2009).

[12] *Charles Schwab*, 257 F.R.D. at 547.

[13] *Id.*

[14] *Id.*

The court also noted that other causation theories, such as a "run on the fund" theory, were conceivable.

Similarly, in *In re Evergreen Ultra Short Opportunities Fund Securities Litigation*,[15] the court denied defendants' motion to dismiss plaintiffs' Section 11 claim, in which defendants argued that plaintiffs could not establish loss causation because a mutual fund's NAV is not tied to misrepresentations or omissions regarding the fund itself.[16] Plaintiffs in *Evergreen* alleged that defendants made false representations about the riskiness of the fund's investments that artificially inflated the fund's NAV, that the NAV declined in value when the misstatements were ultimately revealed, and that this resulted in losses for fund shareholders. The court, primarily in reliance on *Charles Schwab*, held that these allegations constituted a sufficient showing of loss causation to survive defendants' motion to dismiss.

More recently, the court in *Youngers v. Virtus Investment Partners Inc. et. al.*,[17] denied defendants' motion to dismiss claims brought by mutual fund shareholders under Section 10(b) and Rule 10b-5 where defendants argued that plaintiffs failed to adequately allege loss causation. The two funds at issue in this case used an investment strategy called "AlphaSector," a strategy created in 2008. The funds' registration statements contained charts showing back-tested results of how the AlphaSector strategy would have performed against the S&P 500 index during the period from 2001 through 2008, while allegedly failing to sufficiently disclose that the chart represented only back-tested, rather than actual, results. The court in *Youngers* took a broader view of the measure of the value of a mutual fund, similar to the broader views taken by the courts in *Schwab* and *Evergreen*. The court, quoting language from the Second Circuit in *Lentell*, held that "[t]o establish loss causation, a plaintiff must allege . . . that the misstatement or omission concealed something from the market that, when disclosed, negatively affected the *value* of the security."[18] (emphasis added). The court acknowledged that statements about a mutual fund do not generally affect the fund's NAV, but it rejected the idea that NAV is the only way to measure a fund's

[15] 705 F. Supp. 2d at 94-96.

[16] *Evergreen*, 705 F. Supp. 2d at 94-95.

[17] 195 F. Supp. 3d 499, 511-14 (S.D.N.Y. 2016), *motion to certify interlocutory appeal denied*, 228 F. Supp. 3d 295 (S.D.N.Y. 2017).

[18] *Youngers*, 195 F. Supp. 3d at 511 (quoting *Lentell*, 396 F.3d at 173).

value. According to the court, mutual fund investors can look to other indicators of a fund's value, such as risk or performance history. Looking at those factors, the court concluded, meant that plaintiffs adequately pled loss causation by alleging that: (1) a key factor used to value the funds was performance history; (2) the history of the AlphaSector strategy was sufficiently alleged to be misleading because the registration statements failed to disclose that the claimed results of the strategy were back-tested; (3) the alleged misrepresentation of the funds' performance history caused the valuation of the funds to be inflated; and (4) when that valuation proved to be false, plaintiffs lost the difference between the inflated value of the funds' shares at the time of the purchase and the true value of the funds' shares.

The court also held that plaintiffs adequately alleged an alternative theory of loss causation pertaining to a direct loss in NAV based on fees. Plaintiffs alleged that they paid higher fees than they would have had they known the claimed performance history of the AlphaSector strategy was back-tested rather than actual, and that the higher fees resulted in a decrease in the net asset value of the funds, as the fees are deducted from the funds' assets.

B. The View That a Mutual Fund's "Value" Is Reflected in Its NAV and That Misrepresentations Concerning a Mutual Fund Do Not Affect Its NAV

Not every court has agreed with plaintiffs' side of this issue. In *In re State Street Bank and Trust Co. Fixed Income Funds Investment Litigation*,[19] the court granted defendants' motion to dismiss claims brought by mutual fund shareholder plaintiffs under Sections 11 and 12(a)(2) of the Securities Act for failure to adequately allege loss causation. The plaintiffs in *State Street* alleged that several statements in the fund's offering documents "misrepresented the nature of the securities or investments held by the [Fund] . . . , misrepresented the description and/or objectives of the Fund and misrepresented the Fund's exposure to risky mortgage-related assets and the risk of investing in the Fund."[20] Defendants argued that the fund's NAV accurately reflected the total value of the fund's investments at any given time, and thus the NAV was not artificially inflated by any statements about the fund itself that were contained in the fund's prospectus.

Plaintiffs, relying on *Charles Schwab* and *Evergreen* (*Youngers* had yet to be decided), made two arguments in support of loss causation.[21] First, plaintiffs argued that the "risk" allegedly hidden by the fund's prospectus was that the subprime mortgage market would collapse and that the fund's undisclosed overexposure to that market rendered the fund overly vulnerable to that collapse. Plaintiffs contended that when defendants ultimately wrote down the market value of the fund's mortgage-related investments, this risk had materialized and caused a decline in the fund's NAV — which in turn caused shareholders of the fund to lose money and abandon the fund. The court rejected this theory on the rationale that a fund's NAV is calculated according to a statutory formula and there is no secondary market for a mutual fund's shares. Second, plaintiffs argued that loss causation occurred in the form of a "run on the [f]und" — specifically, that the fund's undisclosed emphasis on mortgage-related securities caused a decline in the fund's NAV, which caused investors to liquidate their fund shares *en masse*, which ultimately caused the liquidation of the fund and losses for shareholders. The court rejected this theory as well, explaining that while the run on the fund may have pressured the fund to liquidate, the liquidation caused losses for fund shareholders because of the decreasing value of the underlying securities held by the fund.

The court stated that "[p]laintiff's position certainly has an appealing element to it."[22] The court, however, concluded that "*Evergreen*'s analysis . . . cannot be correct" and criticized *Charles Schwab* as well.[23] The court explained that these decisions "appear to be reasoning from effect to cause, as each begin their arguments about loss causation with a policy rationale . . . That is, because plaintiffs suffered a loss, and because defendants made some statement that is related to that loss, the statement must have caused the loss."[24] Ultimately, the court reasoned that it was constrained by the plain language of Sections 11(e) and 12(a)(2) "which requires a connection between the alleged material misstatement and a diminution in the security's value."[25] The court acknowledged that Congress likely never considered that it might have left a "loophole" in the Securities Act, but the court viewed closing the alleged loophole as a task for the legislature, not the courts.

[19] 774 F. Supp. 2d at 588-9.

[20] *State Street*, 774 F. Supp. 2d at 585.

[21] *Id.* at 594-95.

[22] *Id.* at 594.

[23] *Id.*

[24] *Id.* at 595.

[25] *Id.*

These cases reflect the tension between the plain statutory language, which makes it difficult for mutual fund plaintiffs to allege loss causation except in very narrow circumstances, and more policy-based rationales that support construing the securities laws broadly to afford more protections for shareholders. That tension remains unresolved, and is likely to continue until the circuit courts and Supreme Court address this issue.

II. CONTROL PERSON LIABILITY AND THE DISTINCTION BETWEEN A MUTUAL FUND AND ITS INVESTMENT ADVISER

A mutual fund is a registered investment company, and an investor in a mutual fund owns shares in that company. A mutual fund typically has no employees, and is created and operated by third parties that are separate legal entities. Those third parties typically include the fund's investment adviser, which is the entity that makes the decisions about the fund's investment strategy, and most often undertakes the buying and selling of the securities that make up the fund's portfolio of investments. While an investment adviser has certain fiduciary duties under the ICA to the fund it advises, the adviser is a legally distinct entity that provides its services to the fund pursuant to a contract and in exchange for a fee that is a portion of the total expense ratio paid by the fund's investors. The fact that an investment adviser is an entity legally separate from the funds to which it provides investment advisory services has significant potential implications in claims brought under the Securities Act and the Exchange Act, as detailed below.

A. The Supreme Court's Decision in Janus

In *Janus Capital Group., Inc. v. First Derivatives Traders*,[26] the Supreme Court, in a 5-4 decision, narrowed the scope of entities and persons liable in private actions brought under Section 10 and Rule 10b-5 of the Exchange Act. Specifically, the Court held that Rule 10b-5 liability may only be imposed on the "maker" of a statement alleged to be materially false or misleading. The plaintiffs in *Janus*, who were shareholders of Janus mutual funds, claimed that the investment adviser to the at-issue Janus funds, and the investment adviser's parent company, made misleading statements in fund prospectuses, including that the funds did not permit "market timing" (the practice of rapidly trading in and out of a fund to exploit inefficiencies) when they in fact did.

The Supreme Court held that the allegedly false statements in the mutual fund prospectuses, which were filed by *the funds*, were "made" by *the funds* and therefore the investment adviser and its parent company could not be held liable as "makers" of those statements under Rule 10b-5. The Court held that "[f]or purposes of Rule 10b-5, the maker of a statement is the person or entity with ultimate authority over the statement, including its content, and whether and how to communicate it."[27] The Court further explained that "[o]ne who prepares or publishes a statement on behalf of another is not its maker . . . This rule might best be exemplified by the relationship between a speechwriter and a speaker. Even when a speechwriter drafts a speech, the content is entirely within the control of the person who delivers it. And it is the speaker who takes credit — or blame — for what is ultimately said."[28] The Court relied on the fact that the funds and the investment adviser were separate legal entities, that while all of the officers of the funds were also officers of the investment adviser only one member of the funds' board of trustees was associated with the adviser, and that the funds (not the adviser) had the statutory obligation to file the prospectuses at issue with the SEC and was in fact the entity that did so.

*B. Post-*Janus *Decisions Regarding Control Person Liability*

Janus obviously places limits on who can be named as a defendant in an Exchange Act case involving a mutual fund. But plaintiffs have still tried to pursue Exchange Act claims against investment advisers and related entities, including parent companies, by alleging control person liability under Section 20. The statutory text of Section 20 provides that: "Every person who, directly or indirectly, controls any person liable under any provision of this chapter or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable . . . ." Generally, to plead a claim for control person liability, under Section 20, the plaintiff must establish: (1) a primary violation of the Exchange Act and (2) control over the primary violator.[29] Claims for control person

[26] 564 U.S. 135, 142-43, 148 (2011).

[27] *Janus*, U.S. 135 at 142.

[28] *Id.* at 142-43.

[29] *Youngers*, 195 F. Supp. 3d at 523.

liability under Section 15 of the Securities Act are generally treated analogously.[30]

Post-*Janus* decisions addressing Section 20 control person liability in the mutual fund context include *Youngers* and *In re Smith Barney Transfer Agent Litigation*.[31] In *Smith Barney*, the court dismissed a Section 20 control person claim against an individual officer of the investment adviser's parent company, where plaintiffs alleged that the defendant officer exercised control over other individuals who signed allegedly misleading SEC filings.[32] The court held that plaintiffs' allegations regarding the defendant officer's control of the funds were insufficient. The court explained that the defendant officer was not an officer of the funds and, citing *Janus*, noted that it was the funds, not the parent company of the investment adviser, that filed the allegedly misleading documents with the SEC. The court further explained that the defendant officer did not sign the SEC filings himself, and that when the officers of the funds signed the filings at issue they did not report to the defendant officer. Thus, the court concluded that the defendant officer's position at entities other than the funds did not demonstrate that he exercised control over the statements in the funds' SEC filings.

In *Youngers*, the court held that plaintiff mutual fund shareholders failed to adequately allege that the funds' investment adviser had control over the statements made in the funds' registration statements.[33] Plaintiffs alleged that the investment adviser controlled the funds "by virtue of their status" as adviser to the funds, and by causing the funds to adopt the AlphaSector investment strategy that the funds followed.[34] The court held that "status alone is not sufficient to establish control person liability."[35] The court further held that plaintiffs' allegations about the investment adviser's determination of the funds' investment strategy added nothing to plaintiffs' control-person claim because the alleged misstatements in the funds' registration statement and marketing documents did not relate to investment strategy. The court held that, at most, plaintiffs' allegations supported an inference that the investment adviser provided investment advice to the funds, which was also insufficient to plead control person liability.

The court in *Youngers* did, however, find that plaintiffs sufficiently stated that the parent company of the funds' investment adviser was a control person under Section 20. In reaching this conclusion, the court noted that the parent company and the funds operated from the same office, the parent company employed officers of the funds, the parent company's officers approved and signed the funds' registration statements, the parent company's management was responsible for eliminating statements about the track record of the AlphaSector strategy from fund filings after the SEC started investigating the funds' subadviser (and without providing a corrective disclosure), and the parent company's name was printed in bold on the front page of the registration statements.[36]

Janus is the definitive law on primary liability for mutual fund investment advisers and affiliated entities, and that law is obviously adviser-friendly. But the battle over secondary liability for investment advisers has only begun, and plaintiffs will undoubtedly continue to name advisers and their affiliates as defendants in Exchange Act claims based on control person theories. *Smith Barney* and *Youngers* suggest that control person liability for these types of entities will likely turn on the individual facts of each case.

III. RELIANCE

Generally, plaintiffs who bring claims under Section 10 and Rule 10b-5 of the Exchange Act must plead individual reliance, *i.e.* that an alleged misrepresentation or omission induced investors to do something different from what they would otherwise have done in making investment decisions.[37] The Supreme Court, however, has recognized two rebuttable presumptions of reliance that eliminate the need for plaintiffs to establish actual reliance. Class action plaintiffs often seek to utilize a presumption of reliance, as establishing actual reliance on behalf of numerous individual class members can present a significant challenge to, among other things, getting a class certified. The caselaw regarding whether a presumption of reliance applies to claims involving mutual funds is far from clear.

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[30] *See, e.g.*, *Durham v. Kelly*, 810 F.2d 1500, 1503 (9th Cir. 1987).

[31] 884 F. Supp. 2d 152, 165-67 (S.D.N.Y. 2012).

[32] *Smith Barney*, 884 F. Supp. 2d at 167.

[33] *Youngers*, 195 F. Supp. 3d at 524-25.

[34] *Id.* at 525.

[35] *Id.*

[36] *Id.* at 526.

[37] *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta*, 552 U.S. 148, 159 (2008).

A. The Affiliated Ute *Presumption*

The first presumption of reliance is based on the Supreme Court's decision in *Affiliated Ute Citizens of Utah v. United States*.[38] Under *Affiliated Ute*, there is a rebuttal presumption of reliance where a defendant fails to disclose material information that it was obligated to share. In *Kreek v. Wells Fargo & Co.*,[39] the court held that plaintiffs adequately pled reliance under the *Affiliated Ute* presumption where plaintiffs alleged that the mutual funds' investment adviser omitted from prospectuses and SAIs a supposed scheme, financed by purportedly hidden and excessive fees charged to investors, to provide brokers and selling agents revenue when they steered clients into the at-issue mutual funds.

But *Kreek* comes with a significant caveat: the case was decided before *Janus*, in which the Supreme Court, as discussed above, held that only a mutual fund — and not its investment adviser — bears the obligation to file documents such as fund prospectuses with the SEC. *Janus* therefore raises serious questions about whether investment advisers or any of the many other traditional defendants in mutual fund cases brought under the Exchange Act can be considered to have an obligation to disclose information to investors in a fund. Absent an obligation to disclose, the *Affiliated Ute* presumption does not apply.

Notably, in *Smith Barney*, the court cited *Janus* and concluded that the *Affiliated Ute* presumption was inapplicable because plaintiffs did not allege that the defendant investment adviser had a duty to disclose the information at issue.[40] While the plaintiffs in *Smith Barney* did not expressly invoke the *Affiliated Ute* presumption and the issue was therefore not fully litigated, the court's conclusion is telling.

B. The "Fraud-on-the-Market" Presumption

Under the second theory of presumed reliance, known as the "fraud-on-the-market" theory, there is a rebuttable presumption of reliance where a defendant is alleged to have made a public, material misrepresentation about securities that trade in an impersonal, well-developed market and investors rely on the price of that security having been set by an efficient market.[41] "The fraud-on-the-market theory is based on the hypothesis that, in an open and developed securities market, the price of a company's stock is determined by the available material information regarding the company and its business . . . . Misleading statements will therefore defraud purchasers of stock even if the purchasers do not directly rely on the misstatements."[42]

The application of the fraud-on-the-market presumption to mutual funds arguably presents issues similar to those discussed above in relation to loss causation. Specifically, since the price of a share of a mutual fund is calculated based on the fund's NAV, and the NAV reflects the value of the individual underlying securities held by the fund, the price of mutual fund shares is not set by an efficient market digesting information about the fund itself. Under this view, plaintiffs cannot avail themselves of the fraud-on-the-market presumption in connection with claims alleging misstatements or omissions about a fund.

The court in *In re Van Wagoner Funds, Inc. Securities Litigation*,[43] granted defendant Ernst & Young's motion to dismiss based on this rationale. Plaintiffs alleged that Ernst & Young participated in disseminating misleading information related to mutual funds' financials that aided the funds in artificially inflating their NAVs. Plaintiffs did not allege that they had read fund documents that contained statements or consents prepared by Ernst & Young, but rather generally alleged that they relied on the integrity of the market in making their investment decisions. The court held that because plaintiffs did not plead particular facts establishing an efficient market, and because a mutual fund's share price is not determined by a market for the fund, but rather by the underlying value of the individual securities in which the fund invests, plaintiffs had not sufficiently pled fraud on the market.

Similarly, in *Smith Barney* the court held that, while plaintiffs did not try to invoke the fraud-on-the-market presumption, the presumption would not apply because the "[f]unds' shares never traded in an efficient market."[44]

Other courts, however, have applied the fraud-on-the-market presumption to mutual funds. In *Bachow v.*

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[38] 406 U.S. 128, 153-54 (1972).

[39] 652 F. Supp. 2d 1053, 1063 (N.D. Cal. 2009).

[40] *Smith Barney*, 884 F. Supp. 2d at 162.

[41] *Basic Inc.* v. *Levinson*, 485 U.S. 224, 241–47 (1988).

[42] *Id*. at 241-42 (quoting *Peil v. Speiser*, 806 F.2d 1154, 1160–61 (3d Cir. 1986)).

[43] 382 F. Supp. 2d 1173, 1187-88 (N.D. Cal. 2004).

[44] *Smith Barney*, 884 F. Supp. 2d at 162.

Swank Energy Income Advisers, LP,[45] the court denied defendants' motion to dismiss with respect to plaintiffs' Section 10(b) claim and, despite the fact that defendants did not make an argument regarding reliance, held that plaintiffs' allegations were sufficient to be entitled to a rebuttable presumption. The plaintiffs in *Bachow* alleged that defendants, including the investment adviser, its general partner, officers of these entities, and the fund trustees, had made materially misleading statements in SEC filings that stated the fund was expected to realize the benefit of a tax deferred asset when, in reality, the realization of that benefit was exceedingly unlikely. Plaintiffs alleged that when the truth was disclosed, the fund's NAV fell 50 percent. Based on these allegations, the court concluded that plaintiff had sufficiently alleged that material misrepresentations or omissions about the fund were placed into the mix of market information and that plaintiffs were entitled to the fraud-on-the-market presumption.

Although plaintiffs may be able to successfully plead reliance without invoking either the *Affiliated Ute* or fraud-on-the-market presumption of reliance, the potential inapplicability of either of these presumptions to mutual funds would be a major limitation on the plaintiffs' bar's ability to bring class actions involving funds. However, as with loss causation and control person liability, these reliance issues have not been sufficiently litigated in the reported caselaw to predict exactly where the lines will be drawn.

IV. CONCLUSION

The treatment of loss causation, control person liability, and reliance in Securities Act and Exchange Act claims involving mutual fund remains relatively unresolved. The sparse caselaw to date reveals tensions that are often based between, on the one hand, strict interpretations of statutory language which would limit claims involving mutual funds and, on the other hand, policy-based rationales that favor broad relief for investors but that may be better addressed by Congress. We expect to see an increase in Securities Act and Exchange Act class actions involving mutual funds in the next significant market correction, which will lead to further development of the law in these areas. ■

[45] No. 3–09–CV–0262–K, 2010 WL 70520, at *7 (N.D. Tex. Jan. 6, 2010).