LOSS CAUSATION, MUTUAL FUNDS, AND SECURITIES ACT CLAIMS: AN UNCERTAIN FUTURE FOR SHAREHOLDERS

INTRODUCTION

Imagine you are an investor in a mutual fund portfolio. Your mutual fund's prospectus states that it will invest in "low-risk products with steady growth." For the purpose of this example, the fund invests half of its portfolio in apples priced at $5 per share and the other half in oranges priced at $6 per share. The fund owns 100 shares total in its portfolio, with $250 worth of apples and $300 worth of oranges. Then the fund manager deviates from the investment strategy in the prospectus, and instead invests three-quarters of the 100 shares in an extremely high-risk apple market, the price of which has recently dropped from $10 to $5 per share, and one-quarter of the fund's shares in oranges. Now the fund owns $375 worth of apples and $150 worth of oranges.[1] At first glance, it would seem like you should be able to recover any loss that might have resulted from the change in investment strategy. Some courts, however, would not allow mutual fund shareholders to recover for misrepresentations made on a registration statement or prospectus.[2] These courts would find that, whether you discovered the misstatement before a drop in value or after, the price would have remained the same.[3] That would make it impossible for investors who purchase shares of a mutual fund[4] to recover for any misstatements or omission of material fact in a registration statement or prospectus. On the other hand, some courts would reach the opposite outcome and find that the misstatement or omission "touched upon" the loss (if any) and allow mutual fund shareholders to recover.[5]

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1 The totals added together, minus the liabilities (none in this example), and divided by the number of outstanding shares, equals a value of $5.25 per share. *See* discussion *infra* Part I.B.

2 *See* discussion *infra* Part IV.

3 The price per share would remain the same because it is calculated based on what the fund *actually* holds as assets at the time the net asset value is calculated. *See* discussion *infra* Part I.B.

4 For the purposes of this Note, all references to mutual funds are limited to registered open-end management investment companies. *See* Mercer E. Bullard, *Insider Trading in Mutual Funds*, 84 OR. L. REV. 821, 823–26 (2005) (defining "mutual fund" and discussing operation and pricing of mutual funds). This Note also excludes reference to exchange-traded funds, which are a kind of mutual fund that trades on an exchange.

5 In the example above, recovery would be the difference in value between the price per share before the misstated investment ($5.50) and the price per share after the misrepresented investments became known ($5.25).

This Note discusses the current state of the law regarding fund shareholder claims for misstatements or omissions of material fact in a registration statement or prospectus. Part I provides a brief history of the importance of mutual funds as an investment tool in the United States, as well as a basic understanding of how mutual funds are valued under a statutory formula to calculate the fund's price per share or net asset value ("NAV"). Part II of this Note addresses the parties that are liable under Section 11 and Section 12(a)(2), lists the procedural steps to bring a claim, and introduces the concept of loss causation as an affirmative defense, which may prevent recovery for fund shareholders. Part III discusses the differences between transactional causation and loss causation. Part IV discusses the different conclusions courts have reached when analyzing loss causation for Section 11 and Section 12(a)(2) claims brought by mutual fund shareholders. Part V proposes a congressional amendment to the Securities Act of 1933 ("Securities Act") to provide mutual fund shareholders with a remedy for Section 11 and Section 12(a)(2) claims.

I. BRIEF BACKGROUND ON MUTUAL FUNDS

A. Mutual Fund Investment in U.S. Markets

Investment in mutual funds has grown considerably over the last thirty years. In 1980, only 5.7% of U.S. households owned mutual funds.[6] By 2000, that number skyrocketed to 44.5%.[7] In 2010, the number of households owning mutual funds held steady despite an economic downturn, dipping only slightly to 43.9% or a total of 51.6 million U.S. households.[8] In fact, by 2010, "an estimated 90 million individual investors owned mutual funds and held 87 percent of total mutual fund assets,"[9] with households making up the largest group of investors.[10] Furthermore, at year-end in 2010, the U.S. mutual fund market had $11.8 trillion in assets under management.[11] Needless to say, mutual funds are a very important investment tool for Americans, especially

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6 INV. CO. INST., 2011 INVESTMENT COMPANY FACT BOOK 80 (51st ed. 2011), *available at* http://www.ici.org/pdf/2011_factbook.pdf; *see also* Ali Hortaçsu & Chad Syverson, *Product Differentiation, Search Costs, and Competition in the Mutual Fund Industry: A Case Study of S&P 500 Index Funds*, 119 Q.J. ECON. 403, 403 n.1 (2004) (noting mutual fund investment statistics in the United States over the last thirty years).

7 INV. CO. INST., *supra* note 6, at 80.

8 *Id.*

9 *Id.* Investor demand for mutual funds is influenced by a variety of factors, including diversification of assets, steady long-term growth, and low-risk investing, which assist investors in achieving their investment objectives.

10 *Id.* at 8.

11 *Id.* at 23.

those who seek to diversify their investment portfolios and pursue low-risk investments in preparation for retirement.

B. Calculating the Net Asset Value

To calculate damages under Section 11 and Section 12(a)(2), it is important to understand the way a mutual fund's price per share is valued. When most people first encounter mutual funds, they believe that mutual fund shares are "subject to the same market forces as shares of stock."[12] This is incorrect, however, because the number of shares outstanding will vary depending on the amount of sales and purchases that are made by the fund and its investors,[13] making the traditional rules of supply and demand not applicable.[14] Whereas the value of a typical security is determined on an exchange market where buyers and sellers engage in transactions to form a price at which an investor is willing to purchase the security, mutual funds are valued differently and are not subject to market forces.

Mutual funds are generally regulated under the Investment Company Act of 1940.[15] A key difference between mutual funds and other securities is that the per-share price of a mutual fund is calculated by a statutory formula called the "net asset value" ("NAV").[16] To calculate a fund's NAV, its underlying assets (securities, cash, and other assets) must be valued at current market price.[17] Then the fund will take its total underlying assets—at market price—subtracted by the total liabilities—including management fees and other fees—divided by the total number of shares outstanding for that particular day to reach its NAV or price per share.[18] Each day, a fund will price its shares according to this formula.[19]

For example, suppose a fund's portfolio contains four investments—apples, oranges, bananas, and mangos—with each investment

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12 *Changes in NAV*, YOUR COMPLETE GUIDE TO INVESTING IN MUTUAL FUNDS, http://www.investing-in-mutual-funds.com/changes-in-nav.html (last visited Mar. 8, 2013) [hereinafter *Changes in NAV*].

13 *Id.*

14 *Id.*

15 LARRY D. SODERQUIST & THERESA A. GABALDON, SECURITIES LAW 14 (3d ed. 2007).

16 Bullard, *supra* note 4, at 824; *see also* David M. Geffen, *A Shaky Future for Securities Act Claims Against Mutual Funds*, 37 SEC. REG. L.J. 20, 23–24 (2009) (discussing how a mutual fund's NAV is calculated).

17 Bullard, *supra* note 4, at 824.

18 Geffen, *supra* note 16.

19 Funds may choose the time or times during the day at which to value their shares. However, most funds value their shares at 4:00 p.m. eastern standard time. Bullard, *supra* note 4, at 824.

representing 25% of the total assets of the portfolio. The total outstanding shares of the fund are 100, and the liabilities are set at $100. The total market value of the fund's assets (apples, oranges, bananas, and mangos) is $1,025 each or $4,100 total. The fund's per-share NAV would be the total market value of the underlying assets, $4,100, minus the fund's liabilities, $100, to equal $4,000, divided by the number of outstanding shares, 100, to equal $40 per share. That per-share NAV is determined each day based solely on the assets the fund holds in its portfolio at the time the value is calculated. Moreover, unlike stocks, which are traded on an exchange, shares in a mutual fund do not have a secondary market, and instead are continuously offered for sale by the fund and may be redeemed by the fund when a shareholder desires.[20]

II. AN OVERVIEW OF SECTION 11 AND SECTION 12(A)(2)

While mutual funds are generally regulated under the Investment Company Act of 1940,[21] most courts have denied mutual fund shareholders relief for private causes of action based on sections 12(b), 12(d)(1), 17(j), 22, 26(f), 27(i), 34(b), 36(a), and 48(a) of that Act.[22] Additionally, several courts have also expressly required that claims under sections 13(a)(3), 17(d), 17(e), 17(j), 18(f), 34(b), and 36(a) of that Act must be brought derivatively, because the harm alleged is to the fund and not to individual shareholders.[23] Therefore, to obtain relief for

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[20] Geffen, *supra* note 16, at 24.

[21] *See supra* note 15 and accompanying text.

[22] Mercer E. Bullard, Dura, *Loss Causation, and Mutual Funds: A Requiem for Private Claims?*, 76 U. CIN. L. REV. 559, 559 n.4 (2008); *see, e.g.*, Olmsted v. Pruco Life Ins. Co. of N.J., 283 F.3d 429, 431 (2d Cir. 2002) (finding no private cause of action under sections 26(f) and 27(i)); *In re* Eaton Vance Mut. Funds Fee Litig., 380 F. Supp. 2d 222, 233 (S.D.N.Y. 2005) (finding no private right of action under sections 34(b), 36(a), and 48(a)); DH2, Inc. v. Athanassiades, 359 F. Supp. 2d 708, 714–15 (N.D. Ill. 2005) (finding no private cause of action under Section 17(j)); Strigliabotti v. Franklin Res., Inc., No. C 04-00883 SI, 2005 WL 645529, at *7 (N.D. Cal. Mar. 7, 2005) (finding no private cause of action under Section 12(b)); MEVC Draper Fisher Jurvetson Fund I, Inc. v. Millennium Partners, L.P., 260 F. Supp. 2d 616, 622 (S.D.N.Y. 2003) (finding no private cause of action under Section 12(d)(1)); White v. Heartland High-Yield Mun. Bond Fund, 237 F. Supp. 2d 982, 986 (E.D. Wis. 2002) (finding no private cause of action under sections 22 and 34(b)). *But see In re* Nuveen Fund Litig., No. 94 C 360, 1996 WL 328006, at *4–6 (N.D. Ill. June 11, 1996) (acknowledging a private right of action under sections 34(b) and 36(a)).

[23] Bullard, *supra* note 22, at 560 n.4; *see, e.g.*, Lapidus v. Hecht, 232 F.3d 679, 684 (9th Cir. 2000) (holding that a Section 18(f) claim must be brought derivatively, but that direct claims under sections 13(a)(2) and 13(a)(3) are permitted); Rohrbaugh v. Inv. Co. Inst., No. Civ.A. 00 1237, 2002 WL 31100821, at *7 (D.D.C. July 2, 2002) (holding that claims under Section 17(d) must be derivative); *In re* Dreyfus Aggressive Growth Mut. Fund Litig., No. 98 Civ. 4318(HB), 2000 WL 10211, at *4 (S.D.N.Y. Jan. 6, 2000) (holding

false or misleading statements made in a fund's registration statement or prospectus, mutual fund investors have turned to Section 11 and Section 12(a)(2) of the Securities Act.

To maintain public confidence in the marketplace, Congress enacted, *inter alia*, Section 11 and Section 12(a)(2) of the Securities Act to provide investors with a private right of action to recover for losses in investments caused by misstatements in a registration statement or prospectus.[24] The Securities Act lays out a basic framework in which "a security must be sold in a registered offering, unless the security or the transaction is exempt from registration."[25] A registered offering generally requires a significant amount of disclosure in the form of a registration statement, which contains a prospectus.[26] Section 11 and Section 12(a) provide a civil remedy to investors who have been misled by a material misstatement in either the registration statement or the prospectus.[27]

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that claims under sections 13(a)(3), 17(e), 17(j), 34(b), and 36(a) must be brought derivatively).

24 MARC I. STEINBERG, UNDERSTANDING SECURITIES LAW § 1.02, at 1 (5th ed. 2009). In response to the stock market crash of 1929, Congress enacted the Securities Act and the Securities Exchange Act of 1934 ("Exchange Act"), both of which gave private investors a right of action against fraudulent sales of securities. These two Acts have become the principal bodies of law regulating the securities markets. *Id.*

25 Allan Horwich, *Section 11 of the Securities Act: The Cornerstone Needs Some Tuckpointing*, 58 BUS. LAW. 1, 5 (2002).

26 *Id.* "A key policy underlying this requirement is to enable prospective purchasers to make informed investment decisions based upon the disclosure of adequate and truthful information regarding the issuer, its associated persons, and the offering." STEINBERG, *supra* note 24, § 7.02, at 206.

27 *See* STEPHEN J. CHOI & A.C. PRITCHARD, SECURITIES REGULATION: THE ESSENTIALS 256, 287 (2008). The purpose of these sections is to protect investors who purchase securities pursuant to registration statements that contain false or materially misleading information. When the Securities Act was enacted by Congress, many believed that Section 11 would be the driving force of inducement for officers and directors to comply with disclosure requirements of securities for sale on primary markets. Horwich, *supra* note 25, at 1. Section 11 provides a civil remedy for a registration statement that contains "an untrue statement of a material fact or omit[s] to state a material fact required to be stated therein or necessary to make the statements therein not misleading." Securities Act of 1933 § 11, 15 U.S.C. § 77k(a) (2006). Liability extends to registration statements for traditional securities sold on a market as well as to a mutual fund's registration statement. Geffen, *supra* note 16, at 21–22. Similarly, Section 12(a)(2) provides recovery for any investor who purchases shares pursuant to a prospectus that includes a material misstatement of fact or omission of fact when the omitted fact is necessary to make the statements not misleading. *Id.* at 22.

A. Procedural Advantages

Both Section 11 and Section 12(a)(2) provide an express private right of action for investors[28] who have purchased securities on a primary market.[29] Moreover, Section 11 liability is not associated with trading on a secondary market.[30] This means that an investor must have purchased a security in the initial offering itself or must be able to trace the specific shares purchased to that offering.[31] This standing requirement is important because mutual funds, by definition, do not trade on a secondary market.[32]

Section 11(a)(1)–(5) provides a straightforward list of those who could potentially be liable.[33] Similarly, Section 12(a)(2) may subject to

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[28] A private right of action also exists under Securities and Exchange Commission ("SEC") Rule 10b-5 for purchasers of securities on a secondary market; however, that private right of action is implied through judicial interpretation. *See* W. Barton Patterson, Note, *Defining the Reach of the Securities Exchange Act: Extraterritorial Application of the Antifraud Provisions*, 74 FORDHAM L. REV. 213, 216 (2005); *see, e.g.*, Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 730 (1975) (affirming that there is "an implied private right of action under" Rule 10b-5); Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6, 13 n.9 (1971) ("It is now established that a private right of action is implied under § 10(b)."). *Kardon v. National Gypsum Co.* was the first case to hold that a private right of action exists under Section 10(b) based on the broad purposes of the Exchange Act. 69 F. Supp. 512, 514 (E.D. Pa. 1946).

[29] CHOI & PRITCHARD, *supra* note 27, at 256, 288. Primary market transactions are sales by an issuer (generally a corporate issuer) to investors. *Id.* at 13. Primary market transactions generally take the form of a public offering or initial public offering (IPO) to "raise capital to fund business operations and expansion." *Id.* These offerings carry a disclosure requirement in which companies must complete annual Form 10-K and quarterly Form 10-Q filings. *Id.* at 14. The disclosure requirements are strict because primary transactions pose a large amount of risk and uncertainty to investors. *Id.* In an offering, the issuers seek to convince investors to pay top dollar for the offered securities, thereby maximizing the proceeds received. Additionally, in IPOs, the stock being sold is generally from companies that are unknown to the market, making investors highly susceptible to attempts to inflate the value of the offered securities. *Id.*

[30] *Id.* at 257.

[31] Horwich, *supra* note 25, at 7. Therefore, investors who purchase directly from underwriters in an offering have standing, but a party who purchases shares (through brokers generally) on a secondary market will not be able to sufficiently trace their claim under Section 11 and must turn to Rule 10b-5 to impose liability. CHOI & PRITCHARD, *supra* note 27, at 259.

[32] Bullard, *supra* note 4, at 822.

[33] Securities Act of 1933 § 11, 15 U.S.C. § 77k(a)(1)–(5) (2006) (explaining that potential defendants include: (1) those who signed the registration statement (which under Section 6(a) includes each issuer, principle executive officer (or officers), principal financial officer, comptroller, principal accounting officer, and a majority of the board of directors or persons performing similar functions); (2) every director or partner at the time the registration is challenged; (3) experts who certified or prepared all or part of the registration statement; and (4) the underwriters). Thus, Section 11 only imposes liability on a seller if it is among those listed.

liability any person who offers or sells a security by way of a prospectus or oral communication.[34] Section 12(a)(2) also suggests that a claimant cannot recover if he or she knew about the misstatement complained of before investing.[35]

Therefore, every person who signs a fund's registration statement[36] and any person who offers or sells a security by means of a prospectus may be liable to purchasers.[37] Additionally, a shareholder bringing a claim under Section 11 or Section 12(a)(2) does not need to prove reliance to prevail,[38] and the shareholder need not prove scienter.[39] Instead, the issuer is strictly liable provided a plaintiff can prove that the registration statement contained a material misstatement or omission. At that point, the burden shifts to the defendants to provide an affirmative defense, such as due diligence or loss causation.[40] The burden-shifting provision increases a plaintiff's chances of prevailing on motion for summary judgment or dismissal, which also increases the settlement value of the case.[41]

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[34] *Id.* § 12(a)(2), 15 U.S.C. § 77*l*(a)(2) (2006). The Supreme Court has defined "prospectus" as "a term of art referring to a document that describes a public offering of securities by an issuer or controlling shareholder." Gustafson v. Alloyd Co., 513 U.S. 561, 584 (1995); *see also* SODERQUIST & GABALDON, *supra* note 15, at 112.

[35] § 12(a)(2); *see also* SODERQUIST & GABALDON, *supra* note 15, at 112.

[36] The methods of registration are provided in Section 6(a). Securities Act of 1933 § 6(a), 15 U.S.C. § 77f(a) (2006).

[37] Additionally, there is no privity requirement between the purchaser and the seller. Pinter v. Dahl, 486 U.S. 622, 647 & n.23 (1988); CHOI & PRITCHARD, *supra* note 27, at 281–82.

[38] Penn Mart Realty Co. v. U.S. Fin., Inc. (*In re* U.S. Fin. Sec. Litig.), 64 F.R.D. 443, 455 (S.D. Cal. 1974). The only exception is when the plaintiff "has acquired the security after the issuer has made generally available to its security holders an earning statement covering a period of at least twelve months beginning after the effective date of the registration statement." Securities Act of 1933 § 11(a), 15 U.S.C. § 77k(a) (2006); Horwich, *supra* note 25, at 10.

[39] *See* Securities Act of 1933 §§ 11, 12(a)(2), 15 U.S.C. §§ 77k, 77*l*(a)(2) (2006). In contrast, to prevail on a Rule 10b-5 claim, a plaintiff has the burden of proving "'a strong inference'" of scienter. *See* Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 308, 321 (2007) (quoting 15 U.S.C § 78u-4(b)(2) (2006)). This hurdle requires a showing of "'intent to deceive, manipulate, or defraud.'" *Id.* at 319 (quoting Ernst & Ernst v. Hochfelder, 425 U.S. 185, 194 (1976)).

[40] Due diligence defenses are also provided in Section 11(b)(3). Securities Act of 1933 § 11(b)(3), 15 U.S.C. § 77k(b)(3) (2006). However, due diligence defenses are only available to persons liable under Section 11(a) other than the issuer. *Id.* § 11(b). Generally, the issuer is strictly liable and may avoid liability only by establishing "the purchaser's knowledge of the misstatement or omission, lack of materiality, lack of causation, equitable defenses . . . , and expiration of the statute of limitations." STEINBERG, *supra* note 24, § 7.02[C][1], at 209.

[41] *See* Geffen, *supra* note 16, at 22. This means that, because a plaintiff does not have to show scienter, claims under Section 11 and Section 12(a)(2) are not subject to the

B. The Statutory Damages Formula

The measure of recovery under Section 11 and Section 12(a)(2) is statutorily defined by a price depreciation formula. For Section 11 claims, a plaintiff may only recover

> [s]uch damages as shall represent the difference between the amount paid for the security (not exceeding the price at which the security was offered to the public) and (1) the value thereof as of the time such suit was brought, or (2) the price at which such security shall have been disposed of in the market before suit, or (3) the price at which such security shall have been disposed of after suit but before judgment if such damages shall be less than the damages representing the difference between the amount paid for the security (not exceeding the price at which the security was offered to the public) and the value thereof as of the time such suit was brought . . . .[42]

This language can be read to serve as a cap on the damages that can be recovered by a plaintiff in a Section 11 claim.[43]

This makes sense because the Securities Act, particularly Section 11 and Section 12(a)(2), is designed to provide adequate means of disclosure in the primary market of a public offering.[44] The price of a new issue or security may increase in the secondary market or aftermarket after the initial offering.[45] Those who purchase at the initial offering price may sell their holdings for three or four times more than what they paid for them.[46] But, under Section 11(e), these original purchasers who sell a security above the offering price do not suffer any damages and are therefore barred from recovery even if the registration statement contained a misstatement that inflated the initial price.[47] Additionally, damages are not recoverable to the extent that "the defendant proves that any portion or all of such damages represents other than the depreciation in value of such security *resulting from* such part of the

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heightened pleading standards required by Federal Rule of Civil Procedure 9(b), which requires a party to plead "with particularity the circumstances constituting fraud or mistake," FED. R. CIV. P. 9(b), as opposed to Federal Rule of Civil Procedure 8(a), which merely requires "a short and plain statement of the claim showing that the pleader is entitled to relief," FED. R. CIV. P. 8(a)(2).

42 Securities Act of 1933 § 11(e), 15 U.S.C. § 77k(e) (2006).

43 This measure of damages is distinct from that found in Rule 10b-5, which does not have a statutorily determined price-depreciation formula. Instead, Rule 10b-5 is meant to be a catch-all provision that, because of its more stringent burden of proof, is more flexible in the amount of damages that may be recovered. Geffen, *supra* note 16, at 38–39.

44 *Hochfelder*, 425 U.S. at 195; Matt Silverman, Note, *Fraud Created the Market: Presuming Reliance in Rule 10b-5 Primary Securities Market Fraud Litigation*, 79 FORDHAM L. REV. 1787, 1793 (2011).

45 Horwich, *supra* note 25, at 12.

46 *Id.*

47 *Id.* at 12–13.

registration statement, with respect to which his liability is asserted."[48] This means that if the defendant can show that any recoverable loss suffered by the plaintiff *resulted from* factors other than a misstatement in the registration statement, then the damages will be reduced by the amount attributable to other factors that did not result from the misstatement.

Similarly, the Private Securities Litigation Reform Act of 1995 ("PSLRA") amended the Securities Act to include Section 12(b),[49] which allows a defendant to avoid liability in Section 12(a)(2) claims for "any portion or all of the amount" of depreciation in value of the subject security that resulted from factors other than the misstatement or omission.[50]

Together, these provisions provide a negative causation or loss causation affirmative defense.[51] Under these defenses, the defendant has the burden of proving that the loss in value of the security resulted from factors other than the misstatements or omission of material facts.

C. A Rescission Option for Section 12(a)(2) Claims

Section 12(a)(2) provides that a plaintiff "may sue either at law or in equity . . . to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if he no longer owns the

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48 Securities Act of 1933 § 11(e), 15 U.S.C. § 77k(e) (2006) (emphasis added).

49 Section 12(b) provides that,

> [I]f the person who offered or sold such security proves that any portion or all of the amount recoverable under subsection (a)(2) of this section represents other than the depreciation in value of the subject security resulting from such part of the prospectus or oral communication, with respect to which the liability of that person is asserted, not being true or omitting to state a material fact required to be stated therein or necessary to make the statement not misleading, then such portion or amount, as the case may be, shall not be recoverable.

Id. § 12(b), 15 U.S.C. § 77*l*(b) (2006).

50 Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, § 105, 109 Stat. 737, 757 (codified at 15 U.S.C. § 77*l*(b) (2006)); *see also* STEINBERG, *supra* note 24, §7.09[G], at 236.

51 Under Section 12(a)(2), the defendant may also avoid liability by proving that he or she did not know of the material misrepresentation or, through the use of reasonable care, could not have known. The standard of reasonable care, however, may be higher than similar standards in other areas of law such as torts. *See* Dannenberg v. Painewebber Inc. (*In re* Software Toolworks Inc.), 50 F.3d 615, 621 (9th Cir. 1994) (holding that the standard of reasonable care under Section 12(a)(2) is similar to the standard of a reasonable investigation under Section 11).

security."[52] Therefore, a plaintiff has two options: either sell the security and sue for damages, or keep the security and sue for rescission.[53]

Rescission is an equitable remedy that serves to undo the sale of the security and place the buyer in the same position as if no transaction occurred.[54] The general principle is that an investor suing for rescission must be put, as close as possible, in the same position as before the transaction occurred. The rescission action in Section 12(a)(2) serves "'to prevent further exploitation of the public'" and "'to place adequate and true information before the investor.'"[55] The theory of rescission in securities fraud dates back to an 1890 decision by the Court of Appeals of New York in *Vail v. Reynolds*.[56] The court held that "[a] person who has been induced by fraudulent representations to become the purchaser of property . . . may rescind the contract absolutely, and sue in an action at law to recover the consideration parted with upon the fraudulent contract."[57] By enacting Section 12(a)(2) of the Securities Act, Congress sought to put the common law rescission remedy in statutory form.[58] Further, "Congress shifted the risk of an intervening decline in the value of the security to defendants, whether or not that decline was actually caused by the fraud."[59]

Congress did, however, add Section 12(b) in the PSLRA which requires a causal link between a misstatement under Section 12(a)(2) and a rescission action, thereby creating a loss causation affirmative

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[52] Securities Act of 1933 § 12(a)(2), 15 U.S.C. § 77*l*(a)(2) (2006).

[53] This Note does not address the full scope of rescission suits. Specifically, this Note does not analyze the timing of a rescission suit, interest for rescission, tax benefits, or calculation of consideration. This portion of the Note merely serves to provide a brief background of rescission actions and to show that defendants have a loss causation affirmative defense for rescission actions. *See* Securities Act of 1933 § 12(b), 15 U.S.C. § 77*l*(b) (2006).

[54] *See* Jordan v. Duff & Phelps, Inc., 815 F.2d 429, 440 (7th Cir. 1987) ("Rescission entails the undoing of the deal, the return of the parties to the position they occupied before."); Burgess v. Premier Corp., 727 F.2d 826, 837 (9th Cir. 1984) (citing Prescott v. Matthews, 579 P.2d 407, 409 (Wash. Ct. App. 1978)) ("Rescission voids the transaction and returns to both parties the consideration they paid.").

[55] Randall v. Loftsgaarden, 478 U.S. 647, 659 (1986) (quoting S. REP. NO. 73-47, at 1 (1933)).

[56] 23 N.E. 301 (N.Y. 1890); *see also* Michael L. Bell, Casenote, *Securities Law—Rescissionary Recovery Under Federal Securities Law—Tax Offset Rule Struck Down.* Randall v. Loftsgaarden*, 106 S.Ct. 3143 (1986)*, 17 CUMB. L. REV. 275, 278–79 (1986–1987) (tracing the history of rescissionary remedies for securities fraud actions).

[57] *Vail*, 23 N.E. at 302–03.

[58] Bell, *supra* note 56, at 282.

[59] *Randall*, 478 U.S. at 659.

defense for defendants.[60] By adding this provision, Congress specifically rejected the traditional theory of rescission that courts had been applying previously and noted that the traditional approach created "an unfair windfall to shareholders who have not in any way been harmed by the misstatement or omission."[61] Therefore, since Congress has enacted the PSLRA, defendants can use loss causation as an affirmative defense in actions both for damages and for rescission.

III. DISTINGUISHING BETWEEN TRANSACTIONAL CAUSATION AND LOSS CAUSATION

As noted above, loss causation is an element of recovery[62] or an affirmative defense in private securities fraud claims. Recovery under Section 11 and Section 12(a)(2) is based on a tort formula for damages, whereby a plaintiff can recover losses that are proximately caused by fraud or a misstatement.[63] Specifically, to overcome a defendant's loss causation defense, a plaintiff must prove "a causal connection between a defendant's misstatements and the plaintiff's harm."[64] However, it is important to distinguish between the two types of causation that are required in securities fraud claims: loss causation and transactional causation.[65] While loss causation is rooted in the tort concept of proximate cause, transactional causation is essentially the same concept as traditional tort "but for" causation.[66] Distinguishing between the two types of causation is critical because there can be no legal liability absent loss causation.[67]

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60 Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, § 105, 109 Stat. 737, 757 (codified at 15 U.S.C. § 77*l*(b) (2006)).

61 S. REP. NO. 104-98, at 23 (1995), *reprinted in* 1995 U.S.C.C.A.N. 679, 702; *see also* H.R. REP. NO. 104-369, at 42 (1995) (Conf. Rep.), *reprinted in* 1995 U.S.C.C.A.N. 730, 741 (noting the windfall effect that can take place when calculating damages for securities fraud cases); ALAN R. PALMITER, SECURITIES REGULATION: EXAMPLES & EXPLANATIONS 249 (4th ed. 2008).

62 Although Rule 10b-5 has a heightened scienter requirement unlike Section 11 and Section 12, a plaintiff under Rule 10b-5 must also prove loss causation as an element of recovery.

63 Geffen, *supra* note 16, at 23; *see also* Elizabeth Chamblee Burch, *Reassessing Damages in Securities Fraud Class Actions*, 66 MD. L. REV. 348, 360 (2007) (noting that modern day securities fraud claims share some of the same elements of traditional common law fraud or deceit claims).

64 Geffen, *supra* note 16, at 23.

65 First Nationwide Bank v. Gelt Funding Corp., 27 F.3d 763, 769 (2d Cir. 1994) (noting that a securities fraud plaintiff "must prove both transaction and loss causation").

66 Geffen, *supra* note 16, at 23.

67 *Id.*

A. Transactional Causation

Transactional causation "is akin to reliance and requires only an allegation that 'but for the claimed misrepresentations or omissions, the plaintiff would not have entered into the detrimental securities transaction.'"[68] This requirement "(merely) means that the misstatement caused the plaintiff to engage in the transaction for which the plaintiff seeks redress."[69] Transactional causation is essentially the same thing as the tort law concept of "but for" causation, meaning that the plaintiff must establish that he or she would not have entered into the transaction "but for" the misstatement.[70] In a famous loss causation case, *Huddleston v. Herman & MacLean*, the United States Court of Appeals for the Fifth Circuit illustrated the difference between transactional causation and loss causation:

> [A]n investor might purchase stock in a shipping venture involving a single vessel in reliance on a misrepresentation that the vessel had a certain capacity when in fact it had less capacity than was represented in the prospectus. However, the prospectus does disclose truthfully that the vessel will not be insured. One week after the investment the vessel sinks as a result of a casualty and the stock becomes worthless. In such circumstances, a fact-finder might conclude that the misrepresentation was material and relied upon by the investor but that it did not cause the loss.[71]

In sum, transactional causation is analogous to reliance or "but for" causation and is fairly easy to establish and rarely ever contested.

B. Loss Causation

In *Dura Pharmaceuticals, Inc. v. Broudo*, the Supreme Court of the United States defined loss causation for securities fraud litigation.[72] In that case, investors that purchased stock in a pharmaceutical company brought a 10b-5 claim[73] against the company for false statements

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68 Lentell v. Merrill Lynch & Co., 396 F.3d 161, 172 (2d Cir. 2005) (quoting Emergent Capital Inv. Mgmt., LLC v. Stonepath Group, Inc., 343 F.3d 189, 197 (2d. Cir. 2003)). Courts analogize transactional causation to reliance and require it for securities fraud claims, yet, under Section 11 and Section 12(a)(2), reliance is not required to recover. CHOI & PRITCHARD, *supra* note 27, at 263, 291–92.

69 Geffen, *supra* note 16, at 23.

70 *Lentell*, 396 F.3d at 172.

71 640 F.2d 534, 549 n.25 (5th Cir. 1981), *aff'd in part, rev'd in part on other grounds*, 459 U.S. 375 (1983).

72 544 U.S. 336, 338, 345–46 (2005).

73 Rule 10b-5 is a regulation that "forbids, among other things, the making of any 'untrue statement of a material fact' or the omission of any material fact 'necessary in order to make the statements made . . . not misleading.'" *Id.* at 341 (quoting 17 CFR § 240.10b-5 (2004)). The courts have read into the regulation an implied private right of

regarding approval of a new asthmatic spray device by the Food and Drug Administration ("FDA").[74] The investors alleged that the purchase price was artificially inflated because the pharmaceutical company had falsely claimed that the FDA would approve of the new asthmatic spray, which could cause drug sales, and thus profits, to increase.[75] The Court held that the investors failed to adequately allege loss causation[76] because they did not "claim that Dura's share price fell significantly after the truth became known."[77] The Court noted that "securities fraud actions resemble in many (but not all) respects common-law deceit and misrepresentation actions."[78] Thus, loss causation is similar to a standard of proximate cause in traditional tort actions in that (1) the alleging party must have suffered an actual economic or pecuniary loss, (2) the fraud or misrepresentations must have been the proximate cause of the loss suffered, and (3) simply purchasing shares of stock at an inflated price does not meet this standard.[79]

Similarly, in *Lentell v. Merrill Lynch & Co.*, the Second Circuit noted that the analogy to "the tort-law concept of proximate cause" is imperfect because, unlike a foreseeable injury proximately caused by a defendant, "it cannot ordinarily be said that a drop in the value of a security is 'caused' by the misstatements or omissions made about it, as opposed to the underlying circumstance that is concealed or misstated."[80]

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action "which resembles, but is not identical to, common-law tort actions for deceit and misrepresentation." *Id.*

74 *Id.* at 339.

75 *Id.*

76 *Id.* at 346.

77 *Id.* at 347.

78 *Id.* at 343.

79 *See id.* at 342; Bullard, *supra* note 22, at 565 ("The Court explained that merely purchasing shares at an inflated price did not satisfy the common law standard of proximate cause in which the loss causation element is rooted."). Some academics have criticized *Dura* as ambiguous and overly complex. *See, e.g.*, Larry E. Ribstein, *Fraud on a Noisy Market*, 10 LEWIS & CLARK L. REV. 137, 155 (2006) ("*Dura* did not address the problems of applying the [fraud on the market] theory in noisy markets. When markets are irrational, it may not be clear how much, if any, damages connect to defendants' misstatements."); John C. Coffee, Jr., *Loss Causation After 'Dura': Something for Everyone*, N.Y. L.J., May 19, 2005, at 5, 8 (claiming that the court's ambiguous dicta leaves the door open for "phantom losses," which are those "that have no corroboration in actual market movements"). *But see* Matthew L. Fry, *Pleading and Proving Loss Causation in Fraud-on-the-Market-Based Securities Suits Post-*Dura Pharmaceuticals, 36 SEC. REG. L.J. 31, 31 (2008) (noting that the *Dura* court clarified the broad application of proximate cause for securities fraud claims by "requiring that the defendant's fraud caused the plaintiffs' economic loss").

80 396 F.3d 161, 172–73 (2d Cir. 2005); *see also In re* Vivendi Universal, S.A. Sec. Litig., 634 F. Supp. 2d 352, 363 (S.D.N.Y. 2009) ("[S]tock prices decline in reaction to

The court went on to state that the loss must be foreseeable and "be caused by the materialization of the concealed risk."[81] The materialization of the risk deals with the relationship between the misstatement and its subsequent disclosure to the public, and it is similar to what is known as the "corrective disclosure-price drop" paradigm whereby the price of the security is "corrected" by the disclosure of a misstatement to the market causing the price to drop.[82]

For example, suppose an investor purchases a security for $20. Later, it becomes known that the price of that security is inflated because of a misstatement or misrepresentation. The misstatement is then disclosed to the market and the price of the security drops from $20 to $5. The market "corrected" the inflated price of the security and returned it to its true market value. The investor is then able to prove a causal connection between the misstatement and the loss in economic value (price) of the security that he or she purchased. Accordingly, the investor is able to recover the difference in the price paid for the security ($20) and the price of the security after the disclosure of the misstatement ($5). Therefore, a misstatement alone is not sufficient to establish legal liability for a securities fraud claim. The misstatement must conceal information from the market, which when disclosed or materialized would "cause" the price of the security to drop.[83] This concept generally requires a secondary market or aftermarket to disclose the fraud whereby the price of the share will be corrected. However, in the context of mutual funds, there is no secondary market or aftermarket for shareholders to prove loss causation.[84]

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information released into the market rather than in reaction to the fraudulent statements themselves.").

81 *Lentell*, 396 F.3d at 173. Under this theory, liability on a securities fraud claim can extend if

> the decline in a security's price is not caused by the market's reaction to a corrective disclosure revealing precisely the facts concealed by the fraud, as they existed at the time of the defendant's misstatements. Under the theory, the plaintiff may prove loss causation by showing, instead, that the materialization of a fraudulently concealed risk caused the price inflation induced by the concealment of that risk to dissipate.

Hubbard v. BankAtlantic BanCorp., Inc., 688 F.3d 713, 726 (11th Cir. 2012).

82 *Hubbard*, 688 F.3d at 726–27. Both the "materialization of the risk" and the "corrective-disclosure-price-drop" theories act as price-correction mechanisms whereby damages can be calculated.

83 *Dura*, 544 U.S. at 343 ("To 'touch upon' a loss is not to *cause* a loss, and it is the latter that the law requires."); *see also Lentell*, 396 F.3d at 173 (noting that the law requires "that the loss be foreseeable *and* that the loss be caused by the materialization of the concealed risk").

84 Bullard, *supra* note 4, at 822.

IV. THE SPLIT OF AUTHORITIES ON SECTION 11 & SECTION 12(A)(2) CLAIMS BROUGHT BY MUTUAL FUND SHAREHOLDERS

Since *Dura*, courts have interpreted loss causation requirements differently in cases involving Section 11 and Section 12(a)(2) claims brought by mutual fund shareholders. Some courts have found that a decrease in share price cannot be a direct result of the disclosure of a misrepresentation.[85] Other courts have applied a less stringent standard, which demands only a causal connection between the misrepresentation and the loss.[86] Three recent cases highlight the confusion over how to analyze loss causation for mutual fund shareholder claims.

A. In re Charles Schwab Corporation Securities Litigation

The United States District Court for the Northern District of California in *In re Charles Schwab Corporation Securities Litigation* ("*Charles Schwab*") interpreted loss causation broadly and found that it was adequately pleaded by mutual fund shareholders.[87] In that case, investors brought a putative class action suit under Section 11 and Section 12(a)(2), alleging that the defendants had misrepresented the fund's risk profile and mix of assets by changing investment policies and, specifically, had invested heavily in risky mortgage-backed securities which declined in value—thus, they overstated the value of the fund's holdings.[88] The defendants claimed that the court should follow precedent and find that the plaintiffs lacked loss causation.[89] Specifically, the defendants argued that the plaintiffs were investors in mutual funds rather than individual securities and, because the NAV is calculated by statutory formula, that it is impossible for the misrepresentations to cause a decline in the value of the portfolio's

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85 *See, e.g.*, D.E.&J. P'ship v. Conway, 133 F. App'x 994, 1001 (6th Cir. 2005) (finding that the plaintiffs had not adequately pled loss causation because they alleged only that prices were inflated and did not allege that the market's acknowledgement of the misrepresentation caused the price to drop); Semerenko v. Cendant Corp., 223 F.3d 165, 185 (3d Cir. 2000) ("In the absence of a correction in the market price, the cost of the alleged misrepresentation is still incorporated into the value of the security and may be recovered at any time simply by reselling the security at the inflated price.").

86 *See, e.g.*, Siemers v. Wells Fargo & Co., No. C 05-04518 WHA, 2006 WL 2355411, at *12 (N.D. Cal. Aug. 14, 2006) (finding that a plausible theory of causation exists when secret paybacks were made to broker-dealers from mutual fund assets); *In re* Mutual Funds Inv. Litig., 384 F. Supp. 2d 845, 864 (D. Md. 2005) ("Loss causation simply 'is the causal link between the alleged misconduct and the economic harm ultimately suffered by the plaintiff.'" (quoting Emergent Capital Inv. Mgmt., LLC v. Stonepath Grp., Inc. 343 F.3d 189, 197 (2d Cir. 2003))).

87 257 F.R.D. 534, 547–48 (N.D. Cal. 2009).

88 *See id.* at 542–44.

89 *Id.* at 546.

holdings.[90] The court rejected this defense as too narrow,[91] and determined that a plaintiff need only show "that the *subject* of the fraudulent statement or omission" caused the loss suffered.[92]

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[90] *Id.*

[91] *Id.* at 547 ("Defendants' narrow formulation of loss causation would effectively insulate mutual fund companies from claims for a wide range of material misrepresentations regarding fund policies, risks and investment decisions. Defendants would immunize a scheme that purported to invest in low-risk government bonds but in fact invested in legitimate but high-risk treasure-hunting expeditions. Loss causation, however, is not limited to the common 'corrective disclosure-price drop' scenario.").

[92] *Id.* (quoting Lentell v. Merrill Lynch & Co., 396 F.3d 161, 173 (2d Cir. 2005)). The court cited *In re Morgan Stanley & Van Kampen Mutual Fund Securities Litigation*, No. 03 Civ. 8208(RO), 2006 WL 1008138, at *9 (S.D.N.Y Apr. 18, 2006), *Merrill Lynch & Co. v. Allegheny Energy, Inc.*, 500 F.3d 171, 183 (2d. Cir. 2007), *In re Mutual Funds Investment Litigation*, 590 F. Supp. 2d 741, 748 (D. Md. 2008), and *Lentell*, 396 F.3d at 173, 177, yet came to the opposite conclusion. *Charles Schwab*, 257 F.R.D. at 546–48. In fact, the court quoted *In re Merrill Lynch & Co., Research Reports Securities Litigation*, 568 F. Supp. 2d 349, 359 (S.D.N.Y. 2008), which also cited *Lentell*, to support its reasoning:

> [T]he Second Circuit has made clear that in order "[t]o plead loss causation, the complainant must allege facts that support *an inference* that [defendants'] misstatements and omissions concealed the circumstances that bear upon the loss suffered such that plaintiffs would have been spared all or an ascertainable portion of that loss absent the fraud."

Charles Schwab, 257 F.R.D. at 547 (emphasis added) (quoting *In re Merrill Lynch*, 568 F. Supp. 2d at 359). Furthermore, the court went on to state that other theories, such as a "run on the fund" scenario (analogous to a fraud-on-the-market theory), would be conceivable. "[A]s losses mounted, more an[d] more investors sought to withdraw their investments, forcing the fund to liquidate assets at low prices, which in turn contributed to the share-price decline." *Id.* at 547–48. Similarly, in *Rafton v. Rydex Series Funds*, the Northern District of California reiterated its broad interpretation of loss causation. No. 10 CV 01171 LHK, 2011 WL 31114, at *10 (N.D. Cal. Jan. 5, 2011). In that case, plaintiffs brought claims under Section 11 and Section 12(a)(2). *Id.* at *6. The defendants presented the same (almost exact) argument as was brought in *Charles Schwab*: that mutual funds and exchange traded funds are valued according to their NAV, not a public market. *Id.* at *10. The court rejected the argument stating that it "would lead to the absurd result that such funds could even *intentionally* misrepresent material facts with impunity." *Id.* at *11. The court relied heavily on *Charles Schwab* and *In re Daou Systems, Inc.*, 411 F.3d 1006, 1025 (9th Cir. 2005), to reach its conclusion. *Rafton*, 2011 WL 31114, at *11 ("'[A] plaintiff is not required to show that a misrepresentation was the sole reason for the investment's decline in value in order to establish loss causation'" (quoting *In re Daou*, 411 F.3d at 1025)). *In re Evergreen Ultra Short Opportunities Fund Securities Litigation* is a similar case out of the District of Massachusetts in which the fund shareholders alleged that the defendants made misrepresentations about the riskiness of the fund's investments, that they artificially inflated the NAV, and that, when the misrepresentations were revealed, the NAV declined in value. 705 F. Supp. 2d 86, 89–90 (D. Mass. 2010). The court noted that these claims "are sufficient to demonstrate that there is a colorable claim of loss causation which is all that is required to survive a motion to dismiss." *Id.* at 95. The *Evergreen* conclusion stretched the *Charles Schwab* conclusion to the limits.

B. In re State Street Bank & Trust Co. Fixed Income Funds Investment Litigation

In contrast, in *In re State Street Bank & Trust Co. Fixed Income Funds Investment Litigation* ("*State Street*"), the Southern District of New York dismissed the shareholders' claim for insufficiently pleading loss causation.[93] In that case, the shareholders alleged that their fund managers misrepresented the nature, extent, and potential consequences of the fund's investments in mortgage-backed securities.[94] In defense of these allegations, the defendants made the same argument that was used in *Charles Schwab*; however, in this case, it was successful. The court "somewhat reluctantly" agreed with the analysis the defendants provided (the same as in *Charles Schwab*) and drew support for that argument by looking to the text of Section 11(e).[95] The court noted that the statutory scheme "envisions material misrepresentations in the prospectus inflating the market price of the security at the time of the statement" and that when the misrepresentation is revealed, the market "corrects the price."[96] The court relied on *Dura*, *Lentell*, and the specific language of the statute to apply the corrective disclosure-price drop test.[97] The court did note that the plaintiff's theory of the case was substantially similar to the theories relied on in *Charles Schwab*, yet it rejected those conclusions.[98]

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93 774 F. Supp. 2d 584, 595–96 (S.D.N.Y. 2011).

94 *Id.* at 585. Specifically, the plaintiffs alleged that (1) the prospectus's statement claiming a "diversified portfolio" was misleading; (2) the prospectus's statement that the fund sought liquidity was misleading because the fund abandoned its objective of liquidity; and (3) the prospectus's statement that it would only invest in high quality debt securities was misleading. *Id.* at 586–87.

95 *Id.* at 592–93. Section 11(e) reads:

> The suit . . . may be to recover such damages as shall represent the difference between the amount paid for the security (not exceeding the price at which the security was offered to the public) and (1) the value thereof as of the time such suit was brought, or (2) the price at which such security shall have been disposed of in the market before suit, or (3) the price at which such security shall have been disposed of after suit but before judgment if such damages shall be less than the damages representing the difference between the amount paid for the security (not exceeding the price at which the security was offered to the public) and the value thereof as of the time such suit was brought . . . .

Securities Act of 1933 § 11(e), 15 U.S.C. § 77k(e) (2006).

96 *State Street*, 774 F. Supp. 2d at 593.

97 *Id.* (noting that "the statute awards as damages the difference between the two prices—the purchase price reflecting the inflation associated with the material misstatement and the latter reflecting the market correction after disclosure").

98 *Id.* at 591–92. The theories were also similar to those asserted in *Rafton* and *Evergreen*. As in *Charles Schwab*, the court relied on *Lentell* to reach its conclusion. *Id.* at 588–90; *see also In re* Morgan Stanley & Van Kampen Mut. Fund Sec. Litig., No. 03 Civ.

Specifically, the court used a simple example to show why the plaintiffs' theories were incorrect:

> Suppose two individuals, P1 and P2, purchase shares of a mutual fund for $50 a share at the same time. The fund's prospectus contains a material misrepresentation. P1 sells his shares on Tuesday for $55 a share. On Wednesday, the shares of the fund fall to $25. On Thursday, P2 sells his shares for $25 a share. P1 and P2 are analytically indistinct, except that P2 suffered a loss and P1 did not. If we say that the material misrepresentation "caused" P2's losses, this leads to a paradox: both P1 and P2 are subject to the same "proximate cause," yet one has a legal cause of action and one does not. Indeed, the measure of P1's damages under Section 11 would result in a negative number.[99]

How is this paradox solved? It is solved by noting the difference between transaction causation and loss causation.[100] Both P1 and P2 share the same transaction causation, but they do not share the same loss causation.[101] By requiring the price of the share to be corrected by the revelation of the misrepresentation (corrective-disclosure price drop) P1 and P2 become distinct. When the misrepresentation was revealed on Wednesday, the price dropped to $25 a share. Thus, the misrepresentation has proximately caused P2's loss; it is the revelation of the misrepresentation that creates the difference in P1 and P2's selling prices and marks the measure of damages awarded to P2.[102]

This example marks the distinction between mutual funds and ordinary stock traded on a market. Using the same example, in the mutual fund context, both P1 and P2's shares would be valued according to their NAV at the end of the day on Tuesday. But, on Wednesday, after the misrepresentation, the value of the shares would still be the value of the underlying assets that the mutual fund holds minus liabilities and divided by the number of outstanding shares. A misrepresentation in the nature, extent, and mix of the fund cannot correct the value of the shares. Whether the disclosure of the misrepresentation would have happened on Wednesday (when the NAV is calculated) or not, the fund

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8208(RO), 2006 WL 1008138, at *9 (S.D.N.Y. Apr. 18, 2006) (holding that the value of a mutual fund is calculated by a statutory formula and that "[p]laintiffs explain[ed] no mechanism by which a mutual fund share's price could differ from its objective 'value'"). The Southern District of New York in *In re Salomon Smith Barney Mutual Fund Fees Litigation* came to its conclusion based on reasoning similar to *In re Morgan Stanley*. 441 F. Supp. 2d 579, 589–90 (S.D.N.Y. 2006) (holding that the loss suffered is the "diminution of value of the mutual fund share" and that it was impossible to show that the misstatements, in that case, affected the NAV).

99 *State Street*, 774 F. Supp. 2d at 593.

100 *Id.* at 593–94.

101 *Id.*

102 *Id.* at 594.

still holds the same shares which are used to calculate the per share price. The *State Street* court noted this complex distinction, and, despite the obvious reluctance to rule in favor of the defendants, the court stated "that it is bound by the text of sections 11 and 12"[103] and made a plea to the legislature to correct this problem:

> It seems likely that Congress never considered that it might be creating a loophole for fraudulent misrepresentations by mutual fund managers when enacting these provisions. But if this is so, closing the loophole requires legislative action. Here, where the NAV does not react to the any [sic] misstatements in the Fund's prospectus, no connection between the alleged material misstatement and a diminution in the security's value has been or could be alleged.[104]

This distinction makes a mutual fund that misleads or omits statements on its registration statement or prospectus potentially immune from suit for damages or rescission under Section 11 and Section 12(a)(2) of the Securities Act.[105]

C. In re Oppenheimer Rochester Funds Group Securities Litigation

In *In re Oppenheimer Rochester Funds Group Securities Litigation* ("*Oppenheimer*"), the District of Colorado denied the defendants' motion to dismiss[106] and criticized the *State Street* opinion as "dense and provocative."[107] In *Oppenheimer*, the shareholders brought thirty-two class action claims against the defendants,[108] alleging that the "Fund Prospectuses and offering statements were materially misleading and rendered investors' capital extremely vulnerable to changing market conditions."[109] The defendants relied heavily on *State Street* to assert the

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103 *Id.* at 595.

104 *Id.* at 595–96 (internal citation omitted).

105 *But cf.* Operating Local 649 Annuity Trust Fund v. Smith Barney Fund Mgmt. LLC, 595 F.3d 86, 92–93 (2d. Cir. 2010) (holding that investors can adequately plead loss causation when bringing a 10b-5 claim when the investment advisors and their affiliates (1) failed to disclose to investors that a transfer agent would perform limited services, and instead, a subcontractor would perform a majority of transfer agent functions, but (2) still charged a fraction of the transfer agent fees while the subsidiary would pocket the difference).

106 838 F. Supp. 2d 1148, 1180 (D. Colo. 2012).

107 *Id.* at 1176.

108 *Id.* at 1152. It should be noted that the court dismissed the plaintiffs' claims under Section 13(a) of the Investment Company Act because it found that Section 13(a) did not provide a private right of action. *Id.* at 1159; *see* Investment Company Act § 13(a), 15 U.S.C. § 80a-13(a) (2006).

109 *Oppenheimer*, 838 F. Supp. 2d at 1152. The shareholders claimed that "[a]ll of the Funds pitched themselves as vehicles for generating high yields of tax-free interest income from municipal bond portfolios that would be carefully assessed and monitored," when in fact they engaged in risky strategies, "relying on low quality, unrated, and/or illiquid bonds, or on highly-leveraged derivative instruments known as 'inverse floaters,'" which

same loss causation defense[110] and argued that the "absence of loss causation [was] apparent on the face of the complaint."[111] The court, however, emphatically rejected the *State Street* analysis as "both hypertechnically narrow and sweepingly broad" because it focused "too narrowly" on the NAV as an objective valuation of a mutual fund's long-term holdings.[112] Instead, the court looked at the underlying assets and noted that they had "taken a hit" only when the holdings had to eventually be liquidated.[113] Thus, "the Funds' unconventional and negatively-leveraged holdings moved both *with* and *counter to* market forces resulting in rapid and accelerated declines . . . and declines in NAV that *were* related to Fund disclosures that obscured or misrepresented these risks."[114] The court stated that "*State Street* neither supports the assertion that diminution in mutual fund asset value can 'never' be causally related to fund registration statements" and noted that the "[p]laintiffs' claims are not premised on 'the common "corrective disclosure-price drop" scenario' in which a security's value declines after negative or corrective disclosures unrelated to misrepresentations or omissions in offering statements."[115] Rather, their claims were premised on "the price-volatility and risk associated with aggressive and highly leveraged investment strategies"—risks that they did not know they were undertaking due to misleading statements—"that resulted in" devaluation of the fund's NAV,[116] thus making the

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made their investments vulnerable to changing conditions in the market. *Id.* Specifically, when the credit crisis of 2008 occurred, the plaintiffs' NAVs fell 30–50%, while other similar funds fell only 10–15%. *Id.* at 1155.

[110] *Id.* at 1174–75. The defendants argued that a decline in mutual fund value is "*always* the result of things 'other than' prospectus representations because open-end mutual funds are not traded on secondary markets." *Id.*

[111] *Id.* at 1174; *see also In re* DoubleClick Inc. Privacy Litig., 154 F. Supp. 2d 497, 508 (S.D.N.Y. 2001) ("[A] court may properly dismiss a claim on the pleadings when an affirmative defense appears on its face."). *But see In re* Giant Interactive Grp., Sec. Litig., 643 F. Supp. 2d 562, 572 (S.D.N.Y. 2009) (refusing to dismiss Section 11 and Section 12(a)(2) claims because "the affirmative defense of negative causation is generally not properly raised" at the pleading stage); Levine v. AtriCure, Inc., 508 F. Supp. 2d 268, 272–73 (S.D.N.Y. 2007) (observing that a loss causation affirmative defense is generally raised at the summary judgment stage due to the fact-intensive nature of the defense).

[112] *Oppenheimer*, 838 F. Supp. 2d at 1175.

[113] *Id.*

[114] *Id.* (first and second emphases added).

[115] *Id.* at 1175; *see also In re* Mut. Funds Inv. Litig., 384 F. Supp. 2d 845, 866–67 (D. Md. 2005) (noting that the only damages that are recoverable under Section 11 and Section 12(a)(2) are based on the price difference damages formula in the statute).

[116] *Oppenheimer*, 838 F. Supp. 2d at 1175.

"[p]laintiffs' losses . . . plausibly linked to those misleading statements and omissions."[117]

D. Analysis

To recover on a Section 11 or Section 12(a)(2) claim, the statutory language requires some kind of price-correction mechanism whereby damages directly caused by the misrepresentation can be calculated. The lack of a secondary market in mutual fund cases necessarily means that it is impossible for traditional methods of calculation such as "materialization of the risk" or "corrective disclosure-price drop" to apply to calculate damages. The revelation of a misrepresentation would not affect the NAV because it is only calculated by what the fund actually holds at the time of valuation.[118] Therefore, under the statutory damages formula of Section 11 and Section 12(a)(2), it is impossible for any misrepresentation in a fund's holdings to cause a decline or loss in the fund's NAV. Specifically, because of the unique way in which a fund's NAV is calculated, the requirement of a corrective-price mechanism or materialization of the risk to show that a misrepresentation has caused the loss complained of is impossible for mutual fund shareholders to prove to overcome a defendant's affirmative loss causation defense.

Accordingly, the *State Street* court determined "that it is bound by the text of sections 11 and 12"[119] and that it would be up to the legislature to correct the problem.[120] In contrast, the *Oppenheimer* court took a different view of interpreting the statutory language, noting that "the argument that purveyors of mutual funds . . . are immune from suit under [Sections] 11 or 12(a)(2) because NAV is a rote mathematical calculus that cannot be impacted" by misstatements or omissions "is sweepingly broad," and it is "one for lawmakers to make express as a matter of policy, not for trial courts to declare on motions to dismiss."[121]

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117 *Id.*

118 Geffen, *supra* note 16, at 23–24 (noting the distinction between NAV and market valuation); *see also* Bullard, *supra* note 22, at 560–61 ("Because of the way that funds are priced, there is no public disclosure of information that could ever affect a fund's net asset value.").

119 *In re* State St. Bank & Trust Co. Fixed Income Funds Inv. Litig., 774 F. Supp. 2d 584, 595 (S.D.N.Y. 2011); *see also In re* Mut. Funds Inv. Litig., 384 F. Supp. 2d 845, 866 (D. Md. 2005) (noting that the only damages that are recoverable under Section 11(a) and Section 12(a)(2) are based on the price difference damages formula in the statute).

120 *State Street*, 774 F. Supp. 2d at 595–96.

121 *Oppenheimer*, 838 F. Supp. 2d at 1176; *see also* Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 511 U.S. 164, 188 (1994) ("Policy considerations cannot override our interpretation of the text and structure of [an act], except to the extent that they may help to show that adherence to the text and structure would lead to a result 'so bizarre' that Congress could not have intended it.").

The court went on to state that "[u]nless and until Congress defines mutual fund offering statements out of the category of registration statements . . . [it] will take the statute's language at face value and consider Defendants' loss causation arguments within its confines."[122] To provide support for its position, the *Oppenheimer* court noted that "*State Street* is the only decision to date that stands for the sweeping proposition that open-end mutual funds are categorically excluded from Congress's reach under the [Securities Act],"[123] and that the "restrictive view of liability" in *State Street* "is simplistic" and runs counter to the much broader common view of liability.[124]

However, "if the language of a provision of the securities laws is sufficiently clear in its context and not at odds with the legislative history, it is unnecessary 'to examine the additional considerations of "policy."'"[125] Under Rule 10b-5, courts generally afford plaintiffs more flexibility in proving loss causation.[126] But Rule 10b-5 does not contain a statutory damages formula.[127] As the Northern District of California in *In re Worlds of Wonder Securities Litigation* recognized, the measure of

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122 *Oppenheimer*, 838 F. Supp. 2d at 1176.

123 *Id.* The court called the *State Street* decision "dense and provocative." *Id.*

124 *Id.* The court criticized *State Street*, stating,

> As intriguing as I may find the *State Street* court's persistence in testing plaintiffs' pleadings and in contrasting pleading requirements in 1934 and 1933 Act cases, I am unconvinced by its holding that misrepresentations in open-end mutual fund prospectuses are categorically excluded from investors' reach under the 1933 Act or that Plaintiffs' allegations in this case fall outside its purview. If I am ultimately persuaded *State Street* applies and constitutes the better-reasoned of the various decisions reaching Defendants' loss-causation argument, it will be after Plaintiffs have had an opportunity to marshal evidence to counter an affirmative defense premised upon it. I will not follow the *State Street* court's lead and apply its holding preemptively.

Id. at 1176–77.

125 Aaron v. SEC, 446 U.S. 680, 695 (1980) (quoting Ernst & Ernst v. Hochfelder, 425 U.S. 185, 214 n.33 (1976)); *see also* Versyss Inc. v. Coopers & Lybrand, 982 F.2d 653, 657 (1st Cir. 1992) (noting that Section 11's "very stringency suggests that, whatever the usual rule about construing remedial securities legislation broadly, some care should be taken before section 11 is extended beyond its normal reading" (internal citation omitted)).

126 *See, e.g.*, Robbins v. Koger Props., Inc., 116 F.3d 1441, 1447 (11th Cir. 1997) (stating that "'the plaintiff need not show that the defendant's act was the sole and exclusive cause of the injury he has suffered; "he need only show that it was 'substantial,' i.e., a significant contributing cause"'" (quoting Bruschi v. Brown, 876 F.2d 1526, 1531 (11th Cir. 1989))).

127 *Compare* Rule 10b-5, 17 C.F.R. § 240.10b-5 (2012) (providing no statutory damages formula), *with* Securities Act of 1933 § 11, 15 U.S.C. § 77k(e) (2006) (outlining a specific damages formula), *and* Securities Act of 1933 § 12(a)(2), 15 U.S.C. § 77*l*(a)(2) (2006) (outlining a specific damages formula).

damages for Section 11 and Rule 10b-5 are different for a reason.[128] Rule 10b-5 is meant to be a "catch-all" to protect investors from fraud.[129] In contrast, Section 11 is not an anti-fraud provision; rather, it attempts to balance its own strict liability provisions. Therefore, Congress expressly implemented a damages formula to limit damages directly caused by the misleading conduct. Thus, the damages formula must be followed by the court to achieve the purposes of liability under Section 11 and Section 12(a)(2).

Furthermore, a fund's NAV is the most reasonable reflection of "value" for purposes of determining damages in Section 11 and Section 12(a)(2) cases. The theory that a fund's NAV is "a *substitute* for the actual sale or purchase 'price' of a security that trades individually on secondary markets on a daily basis and no more,"[130] and that the value of the underlying assets can still be affected by the "materializations of risk" which have misled fund shareholders,[131] does not take into account the dynamics of market forces or the role of the NAV in limiting investment risks from market forces.

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[128] 814 F. Supp. 850, 876–77 (N.D. Cal. 1993), *aff'd in part, rev'd in part*, 35 F.3d 1407 (9th Cir. 1994) ("[I]t is no accident that the measures of damages for Section 11 violations and Rule 10b-5 violations are different. Rule 10b-5 is a catch-all provision that provides a remedy for any misleading conduct made in connection with the purchase or sale of securities, provided that the defendant possessed fraudulent intent, or scienter. The broad 'loss causation' standard applied in the Rule 10b-5 cases cited by plaintiffs is judicially created to deter fraudulent conduct. The measure of damages, the difference between the price paid for the security and its 'true value', is similar to any misleading statements that appear in a prospectus. Section 11 does not require the plaintiff to prove fraudulent intent, or even negligence, on the part of the defendant. In order to balance the harsh, strict liability features of Section 11, Congress expressly has limited the damages to those directly caused by the defendant's misleading conduct. The remedy and the loss causation defense are provided by statute, and stand in stark contrast to the judge-made remedy for Rule 10b-5 violations.").

[129] *See, e.g.*, Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 511 U.S. 164, 174 (1994) ("Section 10(b) is aptly described as a catchall provision, but what it catches must be fraud."); Herman & MacLean v. Huddleston, 459 U.S. 375, 382 (1983) ("Although limited in scope, § 11 places a relatively minimal burden on a plaintiff. In contrast, § 10(b) is a 'catchall' anti-fraud provision . . . ."); Chiarella v. United States, 445 U.S. 222, 226 (1980) ("Section 10(b) was designed as a catchall clause to prevent fraudulent practices.").

[130] *In re* Oppenheimer Rochester Funds Grp. Sec. Litig., 838 F. Supp. 2d 1148, 1176 (D. Colo. 2012) (emphasis added).

[131] *Id.* However this argument runs counter to what some scholars and observers have noted in the mutual fund context. *Compare* Bullard, *supra* note 22, at 561 (noting that loss causation requires a corrective price-drop after disclosure of the misstatement), *and* Geffen, *supra* note 16, at 22 (same), *with* Jill E. Fisch, *Cause for Concern: Causation and Federal Securities Fraud*, 94 IOWA L. REV. 811, 821 (2009) (arguing that loss causation is difficult to determine in securities fraud cases because there are many factors that affect the value of a security).

While it may be correct that the NAV acts as a substitute for a secondary market, it does not take into consideration the differences between a statutorily calculated formula and the dynamics of an open secondary market as a price-correction mechanism.[132] In other words, statutorily calculated values are different than values determined on an open market. As noted above, on a traditional open market, "stock prices decline in reaction to *information* released into the market."[133] However, in the mutual fund context, the fund's underlying assets are affected by market forces, but the information released about the make-up of the fund itself does not affect the underlying assets that determine the NAV. Therefore, while the NAV might be a "substitute" for a secondary market, it does not have the same effect on the price per share of a mutual fund as a secondary market.[134] However, as the case law illustrates, some courts are reluctant to follow this analysis. That reluctance leaves mutual fund shareholders in an uncertain position and could serve as a deterrence from bringing claims under Section 11 and Section 12(a)(2).

V. A PROPOSED SOLUTION FOR MUTUAL FUND SHAREHOLDERS

It is unlikely that Congress intended to create a loophole for mutual fund managers to be immune from suit for making false or misleading statements on a registration statement and prospectus. To remedy this situation, Congress should amend Section 12(b) of the Securities Act to provide an exception—from the loss causation defense—for mutual fund shareholders who have purchased shares in a fund based on false or misleading statements in a fund's registration statement or prospectus to rescind absolutely and recover the consideration paid for the shares in

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[132] *See In re* Direxion Shares ETF Trust, 279 F.R.D. 221, 233 (S.D.N.Y. 2012) (distinguishing *State Street* on the grounds that exchange-traded funds can be traded in a secondary market); *Changes in NAV*, *supra* note 12.

[133] *In re* Vivendi Universal, S.A. Sec. Litig., 634 F. Supp. 2d 352, 363 (S.D.N.Y. 2009) (emphasis added).

[134] Additionally, calling the NAV a "substitute" for a secondary market does not take into consideration the unique objectives and role the NAV plays in valuing mutual funds. Mutual funds are meant to provide a low-risk, diversified investment with the value not determined directly by the market forces (like an ordinary security) but instead by the NAV to assume a portion of the investment risk. Furthermore, the court fails to take into consideration the unique objectives of calculating the value of mutual funds shares. Mutual funds are meant to assume a portion of the risk of changing market forces. A traditional secondary market and the statutory formula for calculating the NAV have different objectives and perform different functions for investors.

the fund.[135] The author suggests that Section 12(b) be amended to read as follows:

> In an action described in subsection (a)(2) of this section, if the person who offered or sold such security proves that any portion or all of the amount recoverable under subsection (a)(2) of this section represents other than the depreciation in value of the subject security resulting from such part of the prospectus or oral communication, with respect to which the liability of that person is asserted, not being true or omitting to state a material fact required to be stated therein or necessary to make the statement not misleading, then such portion or amount, as the case may be, shall not be recoverable, *except for the person who sues in equity to recover the consideration paid for such securities as valued according to their net asset value as defined by 17 C.F.R. § 270.2a-4(a)(1)–(5).*[136]

As noted above, because of the lack of a secondary market, a price-correction mechanism is not present, and, therefore, a rescission remedy should be available for shareholders. Under the PSLRA, Congress amended the Securities Act to include Section 12(b), requiring plaintiffs to prove loss causation in claims for rescission, thus rejecting the pure rescission theory of recovery for traditional fraud claims. Congress added Section 12(b) to avoid windfalls, in rescissionary actions, to shareholders who were not directly harmed by the misstatement.[137] However, in a mutual fund context, the problem of windfalls to shareholders is outweighed by the dangers of a potential windfall going to fund managers. Specifically, without a method of recovery, fund managers in violation of Section 12(a)(2) would get an unfair windfall because managers could potentially have misstatements in a prospectus, which cause an investor to purchase shares, and then receive management fees even though an investor may not have purchased shares "but for" the misstatement. Because there is no price-corrective mechanism for fund shareholders under the statutory damages formula, shareholders should be provided a rescissionary remedy (the value originally paid for the securities) to avoid a windfall to fund managers. Admittedly, this solution potentially creates a windfall in favor of the shareholders, which is what Congress sought to avoid.[138] The distinction, however, is that a shareholder of traditional securities would still have the option to collect damages under the price depreciation formula in Section 12(a)(2). But,

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[135] Rescission would be subject to a three-year period provided by Section 13 of the Securities Act. *See* Securities Act of 1933 § 13, 15 U.S.C. § 77m (2006) (showing that the statute of limitations is virtually the same for both Section 11 and Section 12(a)(2) claims).

[136] *See id.* § 12(b), 15 U.S.C. § 77*l*(b) (author's alterations in italics); 17 C.F.R. § 270.2a-4(a)(1)–(5) (2012).

[137] *See* sources cited *supra* note 61.

[138] *See* sources cited *supra* note 61.

as explained above, mutual fund shareholders do not have that option. Therefore, while mutual fund shareholders may receive a windfall, the effect would be capped at the price that was initially paid for the funds, whereas shareholders of traditional securities traded on a market have two options: damages or rescission.

Additionally, because both Section 11 and Section 12(a)(2) already provide a private right of action, courts should interpret Section 11(e) and Section 12(b) to allow shareholders to recover the management fees paid to a fund manager[139] under a common law unjust-enrichment or disgorgement theory.[140] If a shareholder can prove transactional causation, a shareholder could argue that the manager has received a measurable benefit that has been unjustly retained because of a misstatement.[141] Specifically, the manager would not have received the management fees awarded without the misstatement because the shareholder would not have invested in the fund "but for" a material misstatement or omission. These damages are measureable and not subject to the above loss causation analysis because management fees are calculated after the value of the underlying assets is calculated and are subsequently subtracted from the value of the underlying assets, making the fees measurable and directly related to a misstatement in a registration statement or prospectus.[142] Therefore, a shareholder can claim that all fees awarded to a fund manager unjustly enriched the manager by way of a misstatement that caused the shareholder to invest in the fund.

Furthermore, shareholders should be able to elect to either rescind (under the proposed congressional amendment) or keep their shares in the fund. To avoid any unfair windfalls[143] to shareholders or excessive

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[139] *See* George P. Roach, *How Restitution and Unjust Enrichment Can Improve Your Corporate Claim*, 26 REV. LITIG. 265, 294 (2007) (noting the distinctions between unjust enrichment claims brought in equity and at law, and stating that unjust enrichment for a defendant's profits is a claim at law).

[140] *See* Great-West Life & Annuity Ins. Co. v. Knudson, 534 U.S. 204, 217 (2002) (acknowledging unjust enrichment as a distinct cause of action in equity).

[141] *See generally* JAMES F. HOGG ET AL., CONTRACTS: CASES AND THEORY OF CONTRACTUAL OBLIGATION 116–19 (2008) (discussing the theory of restitution and unjust enrichment).

[142] *See* Operating Local 649 Annuity Trust Fund v. Smith Barney Fund Mgmt. LLC, 595 F.3d 86, 93 (2d. Cir. 2010) (noting a distinction in damages when shareholders' claims are based on misrepresentations with regard to management fees); Geffen, *supra* note 16, at 23–24 (describing how to calculate the NAV).

[143] This scenario could create a windfall whereby shareholders would be able to keep their shares at a lower risk and then sue for rescission if the price falls. Admittedly, this creates a complex problem; however, when balancing the equities, a free ride for a short period—before the statute of limitations runs—is not as problematic as a fund manager receiving management fees by way of a misrepresentation.

punishment to a fund manager, if a shareholder elects to keep their shares in the fund, the manager should be allowed to keep all the fees that would normally be paid once the misstatement or omission becomes known to the shareholders. The manager should be able to keep those fees because, at that point, the shareholders know of the misstatement and have—from that point on—consciously elected to continue their investment in the fund and receive benefit of the services of the fund manager, who should be fairly compensated for the services provided. This solution also follows the purposes of the existing statutory language because the shareholders are not receiving a windfall for damages not caused by the misstatement, and the shareholders are able to use unjust enrichment claims as insurance to avoid the risk of prior investments because the damages are simply the fees awarded and not the difference in value of the price per share of the fund.[144]

Alternatively, if a shareholder elects to pursue an unjust enrichment or disgorgement claim combined with a rescission action (under the proposed congressional amendment), the shareholder would be placed as close as reasonably possible to the position the shareholder was in before investing in the fund. Therefore, an equitable outcome would be achieved for shareholders without having an onerous negative impact on fund managers, while also providing a deterrence against false or misleading statements made in a mutual fund's registration statement or prospectus.

CONCLUSION

In sum, mutual funds are an important and popular investment tool for individual investors and many U.S. households. Section 11 and Section 12(a)(2) of the Securities Act provide broad legal recourse for shareholders trading on a primary market. However, under the damages formula in Section 11(e) and Section 12(b), mutual fund shareholders are barred from recovery because a fund's price per share is calculated by statutory formula, the NAV, and not traded on a secondary market. Because of the way the NAV is calculated, the damages formula under Section 11(e) and Section 12(b) or rescission under Section 12(b) makes it impossible for fund shareholders to overcome a defendant's loss causation defense. Therefore, Congress should amend Section 12(b) to allow shareholders a rescissionary action for false or misleading statements in a fund's prospectus. Additionally, courts should interpret

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[144] *See* Dura Pharmaceuticals, Inc. v. Broudo, 544 U.S. 336, 345 (2005) ("[T]he statutes make these . . . actions available, not to provide investors with broad insurance against market losses, but to protect them against those economic losses that misrepresentations actually cause.").

Section 11(e) and Section 12(b) to allow shareholders to recover fees paid to a fund manager based on an unjust enrichment or disgorgement theory so that mutual fund shareholders are provided with an equitable outcome.

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