

HOW TO COMPENSATE MUTUAL FUND INVESTORS FOR LATE TRADING AND MARKET TIMING

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Introduction

On September 3, 2003, New York Attorney General Eliot Spitzer announced a \$40 million settlement with the hedge fund Canary Capital in connection with abusive trading practices in mutual fund shares of four fund groups.¹ Specifically, Canary had allegedly engaged in market timing and late trading and had obtained material nonpublic information about fund holdings that it used in connection with hedging transactions.² The Canary Capital case was only the tip of the iceberg. As it turns out, it was common among hedge funds and other sophisticated investors to engage in such practices with the acquiescence and indeed cooperation of mutual fund advisers. Thus, 176 actions against six fund families were consolidated on February 20, 2004, for trial in the U.S. District Court in Baltimore as Multidistrict Litigation (MDL) 1586, with four judges assigned to the cases.³ At the time, an additional 170 cases were pending around the country.⁴

The problem with these practices is that they reduce the returns for other, long-term investors. This is fairly intuitive in the case of late trading, which involves buying or selling fund shares after the market has closed and when new information indicates that the closing price of fund shares is too low or too high.⁵ Market timing is similar though less obviously abusive.⁶ In this Article, I explain why these practices harm individual fund investors, why it matters, and what to do about it. First, in order to analyze the current controversies, I describe fund structure and the mechanics of buying and selling fund shares. Second, I describe the abusive trading practices that are at the center of the controversy and explain in detail how they affect ordinary fund investors in terms of how such practices work and how much harm they are likely to cause. Third, I discuss a variety of reforms that have been suggested as ways to prevent such abusive

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¹ Thomas R. Smith, Jr., Mutual Funds under Fire: Developments since January 1, 2003 4 (Oct. 8, 2004) (unpublished manuscript, on file with the *Journal of Business and Technology Law*, University of Maryland School of Law), available at: <http://www.sidley.com/db30/cgi-bin/pubs/TRS%20Chronology%20-%20VERSION%2012%20070105.pdf>

² Jay G. Baris & Alexandra K. Alberstadt, *Fund Managers Face Enforcement Actions and Regulatory Reforms*, 12 Metropolitan Corp. Couns. No. 4, Apr. 2004, at 12; Richard M. Phillips, The Mutual Fund Market Timing Scandal—The Impact on Independent Directors 3 (unpublished manuscript, on file with the *Journal of Business and Technology Law*, University of Maryland School of Law).

³ *In re Janus Mut. Funds Inv. Litig.*, 310 F. Supp. 2d 1359, 1360-62 (J.P.M.L. 2004).

⁴ *Id.* at 1360 n.5.

⁵ Roberto M. Bracerias, *Late Trading and Market Timing*, 37 SEC. & COMMODITIES REG. 61, 62 (2004).

⁶ *Id.* at 64.

trading practices. Finally, I discuss the immediate problem of how to resolve the multitude of claims pending against the mutual fund industry. In particular, I address the difficult questions of whether these claims should be seen as direct claims or derivative claims and why the distinction matters. I conclude that because of the inherent nature of a mutual fund as a pooled investment vehicle, there is little choice but to treat such claims as direct claims of individual investors, but I offer a plan for handling investor claims that should minimize the expenses of administration as well as the dangers of opportunistic buy-in that would go with derivative recovery. Although the plan involves recovery by the fund in the first instance, and thus may appear to be inconsistent with treating investor claims as direct, the plan works through the issuance of additional fund shares to investors with claims and thus uses the forces of dilution to ensure that these investors are fairly compensated.

I. FUND STRUCTURE AND TRADING

To understand the abusive mutual fund trading strategies that came to light in 2003, one must first understand how mutual funds are structured and how they trade. There are two major types of investment companies in the United States. The term *mutual fund* usually refers to an *open-end fund*, that is, a fund that trades with investors in its own stock:⁷ it sells its own stock to investors who want to invest and buys (redeems) its own stock from investors who want to cash out.⁸ Thus, with an open-end fund, the number of shares outstanding changes continuously—hence the name. A *closed-end fund* is one that issues some fixed number of shares in a public offering.⁹ Those shares trade just like shares in any other corporation and may be listed on an exchange.¹⁰ Thus, an investor who wants to buy into a closed-end fund must buy shares from another investor in an ordinary exchange-executed trade.¹¹ The current controversies relate exclusively to open-end companies. Accordingly, in this Article I use the term *mutual fund* in its strict sense to refer to open-end investment companies only.

As for structure, most funds (of both types) consist of two separate entities. The fund itself is a corporation or business trust or similar entity that holds the securities and cash that constitute the investment portfolio.¹² Although the fund has a board of directors and nominal officers, it usually employs no active managers. Rather, the fund contracts with a separate entity, the fund adviser, to manage the fund. In exchange for managing the fund, the adviser is typically

⁷ INVESTMENT COMPANY INSTITUTE, 2004 MUTUAL FUND FACTBOOK 12 (44th ed. 2004).

⁸ *Id.*

⁹ *Id.*

¹⁰ Comm. On Fed. Reg. of Sec., ABA Section of Business Law, *Fund Director's Guidebook*, 59 BUS. LAW. 201, 206 (2003).

¹¹ *Id.* at 254–55. As of 2005, there are 480 closed-end funds listed on the New York Stock Exchange (NYSE), or about one of every six companies listed there. New York Stock Exchange, *Closed-End Funds*, available at: <http://www.nyse.com/Frameset.html?displayPage=/marketinfo/1069181586532.html> (last visited Oct. 6, 2005).

¹² Comm. on Fed. Reg. of Sec., *supra* note 10, at 208.

paid some specified percentage of fund assets annually.¹³ The fund is regulated under the federal Investment Company Act of 1940 (ICA) (and to some extent by the state law under which the entity is organized).¹⁴ The adviser is regulated under the Investment Advisers Act of 1940, which also regulates investment advisers who deal with individual clients.¹⁵

As for trading, unlike stocks that trade continuously during the day (and indeed twenty-four hours a day), mutual fund shares are priced once a day at 4:00 p.m. (New York) on the basis of the fund's net asset value (NAV) per share.¹⁶ In theory, NAV is the actual value of the stocks and cash in the fund—less fund liabilities—divided by the number of shares outstanding, all as priced at market close in New York.¹⁷ Anyone who wants to buy or sell mutual fund shares must place an order before 4:00 p.m.¹⁸ The fund itself fills all such orders at the NAV (deducting any fees for the transaction). In other words, an investor who buys fund shares buys new shares issued by the fund directly from the fund, and an investor who sells fund shares sells them directly to the fund, which has agreed to buy back its own shares once a day at NAV. Thus, investing in a mutual fund is clearly different from investing in a normal business corporation.

This is a simple system for investors who place orders directly with the fund. But most funds also market their shares through brokerage firms in order to reach the largest possible market. The problem is that brokers need time to convey their customer orders to the fund itself. In order to accommodate this relay of orders, it was standard practice, before the Canary Capital incident, to permit brokers to place orders as late as 5:30 p.m.¹⁹ The alternative would have been to require brokerage customers to place fund orders before some cutoff time earlier than 4:00 p.m. in order to give the broker the time to relay the order by the 4:00 p.m. deadline. Of course, this procedure would mean that brokerage customers were at a distinct disadvantage compared with customers who dealt directly with the fund. Thus, in order to make the rules at the retail level consistent for all investors, brokers were given extra time to relay orders to the funds, presumably with the understanding that their customers would place their orders by the 4:00 p.m.

¹³ Some closed-end funds are unmanaged. That is, the fund invests in a fixed portfolio at inception and refrains from trading thereafter. Such a fund is often called a *unit investment trust* (“UIT”). Other closed-end funds may engage in more or less active trading during the life of the fund. Many closed-end funds and all UITs have limited lives. In other words, they must be dissolved and liquidated after a specified number of years. INVESTMENT COMPANY INSTITUTE, *supra* note 7, at 12.

¹⁴ The Investment Company Act is also known as the *1940 Act* and is codified at 15 U.S.C. §§ 80a-1 to 80a-64. *See generally* 15 U.S.C. §§ 80a-1 to 80a-64 (2000 & Supp. 2002).

¹⁵ The Investment Advisers Act is codified at 15 U.S.C. §§ 80b-1 to 80b-21. *See generally* 15 U.S.C. §§ 80b-1 to 80b-21 (2000).

¹⁶ INVESTMENT COMPANY INSTITUTE, *supra* note 7, at 17.

¹⁷ *Id.* at 16.

¹⁸ *Id.* at 17.

¹⁹ *See* Christopher Oster & Tom Lauricella, *Making the Case to Defend Trading Practices*, WALL ST. J., Apr. 12, 2004, at C1.

deadline. It is difficult to believe that brokers would need until 5:30 p.m. to complete this mechanical task, but the idea of allowing extra time at least makes some sense.

II. ABUSIVE TRADING PRACTICES

Accommodations for brokers begat trading opportunities for hedge funds. NAV is calculated as of 4:00 p.m. But a lot can happen between 4:00 p.m. and 5:30 p.m.²⁰ One obvious example is that many companies wait until the market closes to make significant announcements. The idea is that the market will have time to digest the information and will react more rationally the following morning.

Suppose that Acme Fireworks Corporation closes at \$30.00. Immediately after the closing bell, Binford Tools Company announces that it is making a tender offer for Acme at \$50.00. It seems clear that Acme shares will rise substantially when the market opens on the following day. If PrettyBig Fund is known to own a significant number of Acme shares, and if the fund's shares are priced solely according to NAV calculated on the basis of closing market prices, then those shares are under-priced. An unscrupulous broker may thus place an order to buy fund shares after hearing the news, knowing for certain that NAV is too low.

The effect of the tender offer on the NAV of PrettyBig Fund shares is likely to be small. Assuming that Acme accounts for one percent of fund holdings and assuming that Acme stock rises (say) to \$45.00 as a result of the tender offer, NAV should be one-half of one percent higher. In other words, if fund shares are priced at \$20.00 per share based on closing prices, the correct price should be \$20.10. Nevertheless, one could make a substantial profit by buying a large number of shares. For example, by purchasing \$20,000,000 worth of fund shares and selling them on the following day, one could expect a gain of \$100,000. On the other hand, if fund shares fall by 0.5% on the following day (because of other factors), the entire gain will be wiped out. One may even suffer a loss. It may of course be possible to lock in today's selling price by means of a short sale, put option or some other similar device.²¹ But it is not clear that such devices are commonly available in connection with mutual fund shares. Nevertheless, even if one cannot hedge away the risk that the market may fall on the following day, it seems almost certain that the ability to enter late trades will be quite profitable over time. After all, it is equally possible on any given day that the market will rise on the following day. Thus, over the long haul and over many such trades, one would expect market movements to net out so that profits from late trading would almost certainly come close to the aggregate discrepancies between calculated NAV and true NAV.

To be sure, one must know what stocks are held in a fund portfolio in order for this strategy to work. The problem is that funds typically keep their holdings secret, because to disclose holdings may reveal investment and trading strategies to competitors. Accordingly, Securities & Exchange Commission (SEC) rules do not require disclosure of *current* fund holdings in prospectuses or periodic reports to investors. Rather, SEC rules permit funds to

²⁰ INVESTMENT COMPANY INSTITUTE, *supra* note 7, at 17.

²¹ See generally Robert W. Hamilton & Richard A. Booth, Business Basics for Law Students §§ 14.19, 15.1-15.2; Henry T. C. Hu, *Faith and Magic: Investor Beliefs and Government Neutrality*, 78 TEX. L. REV. 777, 812 (2000).

disclose their holdings as of sixty days before the date of the prospectus or report.²² SEC rules do not prohibit disclosure of fund holdings, but disclosure may nonetheless be a breach of the funds' own rules or representations.²³

To see how ordinary investors are harmed by late trading, consider the following example. PrettyBig Fund holds \$2,000,000,000 in stocks and has 100,000,000 shares outstanding at a NAV of \$20.00 per share. PrettyBig's investments are spread equally over 100 stocks. That is, PrettyBig has \$20,000,000 invested in each stock in its portfolio. One of those stocks is Acme Fireworks, which becomes the target of a tender offer as in the example above. Thus, although PrettyBig's calculated NAV is \$20.00 per share, its true value is \$20.10 per share. HedgeHog Investors buys 1,000,000 fund shares for \$20,000,000 in a late trade. As a result, the value of the fund immediately increases to \$2,020,000,000. The next day, the value of the fund further increases by \$10,000,000 because of the run up in the value of Acme stock held in the portfolio. The fund is now worth \$2,030,000,000. Each fund share is worth $\$2030 / 101$ or \$20.0990 per share (assuming no other changes in market prices and assuming that NAV is calculated to four decimals). HedgeHog now sells its shares and in effect withdraws \$20,099,000 from the fund. Assuming that no other fund investors trade, the fund is now worth \$2,009,900,000 and each remaining share is worth $\$2009.90 / 100$ or \$20.099 instead of \$20.10. Each fund investor has lost one-tenth of a cent per share compared to the NAV that would have obtained in the absence of late trading. HedgeHog has made \$99,000 on the trade (which is equivalent to an annual

²² This time lag is the result of rules that permit registration statements and periodic reports to include information that is no more than sixty days old. See 17 C.F.R. § 270.30e-1(d) (2004). Many funds voluntarily provide information that is more current. See *Survey of Fund Groups' Portfolio Disclosure Policies Summary of Results*, at: http://www.ici.org/statements/cmltr/01_sec_port_disclos_surv.html# (last visited Oct. 6, 2005).

²³ It is worth noting that if one knows which stocks are held in a fund's portfolio, it may also be possible to use the fund portfolio as part of various hedging strategies such as program trading. Indeed, Canary Capital reportedly engaged in hedging strategies using information about fund holdings, in addition to late trading and market timing. These strategies are quite distinct from late trading and market timing and arguably are less harmful to non-trading fund investors (at least in any direct way). There is, however, a definite advantage in using mutual fund shares for this purpose in that fund shares can be traded without incurring any fees. Ordinary investors often must pay a fee either up front or on the back end if they sell too soon. On the other hand, shares often may be traded fee-free with a fund family, and institutional shares may often be traded fee-free within a large group of funds (a fund supermarket). Therefore, it is unclear that permitting frequent trading is technically a breach of fund rules, though quite clearly it violates the spirit of the rules that are intended to permit trading primarily in retirement accounts. Ironically, firms that engage in program trading sometimes see themselves as providing a service to mutual funds by cleaning up or eliminating (technical) price discrepancies that may be caused by large volume trades made by mutual funds. Thus, one could even argue that the use of fund shares for hedging is part of the cost of running a fund, or indeed that funds benefit because such arbitrage had the effect of muting the price effects of the fund's own trading. Thus, it has been argued by some commentators that market timing should not be seen as an abuse. *E.g.*, Henry G. Manne, *What Mutual Fund Scandal?*, WALL ST. J., Jan. 8, 2004, at A22. On the other hand, to the extent that there is money to be made from such strategies, one could argue that the funds have a duty to capture the profit for the benefit of fund investors if only as a way of supplementing adviser compensation and possibly reducing fees. The problem is that if funds themselves engage in the business of arbitrage, there would be a danger that funds would engage in trading as a way of creating arbitrage opportunities, which would probably constitute manipulation. Thus, arranging with an outside firm in effect to make a capital contribution to the fund in exchange for arbitrage privileges may be the second best solution. See generally Holman W. Jenkins, Jr., *Also Stalking the Fund Industry: Obsolescence*, WALL ST. J., Dec. 10, 2003, at A19.

return of 124%). Investors are unlikely to notice the difference because they do not know how many Acme shares were in the PrettyBig portfolio.²⁴ Moreover, if the fund manager is compensated at the annual rate of one percent of fund assets, the manager stands to make an additional \$200,000 in fees.²⁵ The following table shows the effect of HedgeHog's late trading.

	TOTAL ASSETS	SHARES OUT	NAV / SHARE
Begin	\$2,000,000,000	100,000,000	\$20.00000000
HEDGEHOG BUYS	+ 20,000,000	1,000,000	
Subtotal	2,020,000,000	101,000,000	20.00000000
ACME OFFER ANNOUNCED	+ 10,000,000		
Subtotal	2,030,000,000	101,000,000	20.09901000
HEDGEHOG SELLS	- 20,099,010	-1,000,000	
Subtotal	2,009,900,990	100,000,000	20.09900990
WITHOUT HEDGEHOG TRADES	2,010,000,000	100,000,000	20.10000000
Difference	99,010		.00099000

Market timing is less clearly abusive than late trading, although it probably causes just as much harm to non-trading fund investors. Market timing depends on finding stocks that will be mispriced when NAV is calculated. For example, the Tokyo Stock Market closes at 1:00 a.m. and reopens at 7:00 p.m. (EST).²⁶ Most funds that invest in Japanese stocks base NAV on actual closing prices even though the prices are fifteen hours old and even though it may be quite clear that the price is inaccurate. For example, it may be well known that Japanese auto stocks are

²⁴ The strategy works equally well in the case of bad news about a portfolio company, except that the late-trading fund investor sells fund shares in the first instance.

²⁵ Advisory fees and 12b-1 fees (if any) are accrued daily on the basis on NAV (which makes it doubly important that NAV is accurately calculated). *See* Comm. on Fed. Reg. of Sec., *supra* note 10, at 233.

²⁶ The Tokyo Stock Exchange is open for trading from 9:00 a.m. to 3:00 p.m. (Japanese standard time) (with a break for lunch), which converts to 7:00 p.m. to 1:00 a.m. (EST). *See* Nikkei Net Interactive, *Company Watch*, available at: <http://www.nni.nikkei.co.jp/FR/SERV/help/hlpinvst.html> (last visited Oct. 6, 2005).

likely to rise if U.S. auto stocks rise. Thus, if U.S. auto stocks rise dramatically during the day, one could invest in a fund known to include Japanese auto stocks. Although there is no gain from the run-up in U.S. prices because U.S. stocks will be accurately reflected in NAV, a savvy trader can capture the gain from the likely run-up in Japanese stocks. This strategy does not depend on late trading. It works simply because the fund uses stale prices for its Japanese stocks. Market timing is a particular problem with country funds—that is, funds that invest more or less exclusively in the stocks of particular foreign countries—where the entire stock market can often be expected to rise or fall in reaction to broad movements in the U.S. market. Still, market timing (like late trading) can also be profitable in connection with domestic funds that hold some foreign stocks if one knows what stocks are held in what amount in the fund portfolio. In any event, the harm to non-trading investors is the same as with late trading.

It is not clear that there is anything particularly reprehensible about trading on such knowledge. Arguably, it is the funds that should do something to prevent such strategies. The real problem is stale pricing.²⁷ Indeed, in the 1990s many funds did attempt to prevent market timing by engaging in so-called *fair value pricing*, that is, by calculating NAV on the basis of what foreign stocks and some other securities were *likely* to be worth according to pricing models designed to adjust for known relationships.²⁸ Oddly enough, many investors objected to fair value pricing, presumably because of worry that such models could be manipulated. Most funds abandoned the practice (possibly because advisers discovered coincidentally that they could woo hedge fund investors with such opportunities).²⁹

III. REGULATORY FIXES

The obvious solution for late trading is to require all orders to buy or sell fund shares to be submitted to the fund itself by 4:00 p.m. Indeed, this solution—known as a *hard close*—was the primary regulatory fix that was proposed in the wake of the mutual fund scandals.³⁰ The obvious problem with this solution is that it creates difficulties for honest investors who trade through brokers and in particular for investors whose retirement savings are typically captive to such arrangements. It is not clear, however, that such investors—who are in the market for the long haul—should care much about the requirement that they submit orders by noon or 2:00 p.m. Presumably few such investors engage in active trading. Arguably none *should* do so, although it is quite clear that the fund supermarket model is designed to maximize choice and facilitate switching. On the other hand, even long-term investors may prefer to wait until as late in the day as possible to place an order so as to avoid the risk that the market will move against them after

²⁷ See Andy Kessler, *Get Real (Time)*, WALL ST. J., Nov. 13, 2003, at A18. Some have even argued that market timing serves a useful purpose by arbitraging away discrepancies between NAV and FMV and thus that fund investors suffer no real harm from the practice. See Henry G. Manne, *What Mutual Fund Scandal?*, WALL ST. J., Jan. 8, 2004, at A22.

²⁸ See *Barbash Says Rules for Share Pricing Not Likely to See Basic Changes*, 29 Sec. Reg. & L. Rep. (BNA) 1714, 1709, 1714–15 (1997).

²⁹ See *SEC Staff Calls for Greater Use of Fair Value Pricing in NAV Calculation*, 33 Sec. Reg. & L. Rep. (BNA) 709, 709–10 (2001).

³⁰ Phillips, *supra* note 2, at 5–6.

an order is placed but before it is actually executed.³¹ At the very least, one can imagine that an investor would be irked to know that after placing an order to buy, the market rose during the next few hours and the order was executed at a higher than expected price. Such an investor might think that she had effectively lost the difference. Therefore, permitting trading until the bitter end may maximize investor faith in the system even if ultimately there is no rational basis for any such effect.³²

Although the hard close may be a good idea, it does nothing to address market timing. And it does not ultimately address the fundamental reasons for the abusive trading practices that have come to light since September 2003. Without more basic reforms, these forces are likely to manifest themselves in some other way in the future. As it turns out, mutual fund managers apparently knew about these practices. Historically, funds had dealt harshly with market timing and other forms of active trading. Such investors were barred by many funds when they were discovered, while other funds engaged in fair value pricing in order to eliminate trading opportunities, at least until investors shouted down such pricing practices. By 2003, however, many fund managers did little, if anything, to stop active traders. Indeed, fund managers may have encouraged these practices because of the compensation system. In effect, the opportunity to engage in market timing and late trading seems to have been used as an inducement to attract large investments from hedge fund investors so as to increase the size of the fund and the

³¹ It is not clear that an investor would know or care about how market swings would affect alternative funds with the same focus as in the case of two different large cap funds. But, an investor might well know from readily available market indices that large cap funds are up or down versus small cap funds and may reallocate funds accordingly.

³² In addition to the proposed hard close, the SEC proposed a rule imposing a two percent fee in connection with the purchase and sale of fund shares within a five day period and also proposed additional disclosures in connection with market timing policies, fair value pricing, and disclosure of portfolio information. See Phillips, *supra* note 2, at 7–8. As for the redemption fee, it seems unlikely to have much impact because there is no need to sell fund shares immediately in order for the strategy to be successful. See Mark Hulbert, *Why an SEC Hurdle Won't Stop Fund Speculators*, N.Y. TIMES, Mar. 7, 2004, at B6. Ultimately, the SEC adopted a rule permitting funds to impose such fees (over and above normal redemption charges depending on fund class) together with a rule that requires funds to have agreements with intermediaries that permits monitoring of market timing as well as enforcement of redemption fees if any. See Rachel McTague, *SEC Gives Funds Redemption Fee Option, But Requires Contracts with Intermediaries*, 37 Sec. Reg. & L. Rep. (BNA) 393, 393–94 (2005). Proposals regarding additional disclosure of fund holdings met with skepticism. See Letter from Craig S. Tyle, General Counsel, Investment Company Institute, to Jonathan G. Katz, Secretary, U.S. Securities and Exchange Commission (Feb. 5, 2004), available at: http://www.ici.org/statements/cmltr/2004/04_sec_mkt_timing_com.html (last visited Oct. 6, 2005). But, some funds have voluntarily undertaken to disclose holdings more often and more quickly. See, e.g., *Janus to Pay Fund Shareholders \$31 Million for Harm from Market Timing*, 36 Sec. Reg. & L. Rep. (BNA) 1, 6 (2004). Ultimately, the SEC adopted a rule requiring fund disclosure of policies regarding disclosure of holdings. See Rachel McTague, *SEC Adopts Rule to Boost Disclosure by Funds on Timing, Portfolio Holdings*, 36 Sec. Reg. & L. Rep. (BNA) 701, 705–06 (2004). In addition to these reforms, the SEC has proposed a variety of reforms relating to director independence and sales and distribution practices. Phillips, *supra* note 2, at 17, 19. Many of these reforms address long-standing issues that are not obviously related to late trading and market timing, but it is arguable that distribution of funds through brokers ultimately gave rise to trading opportunities either directly in the case of late trading or indirectly in the case of both late trading and market timing (by permitting funds to cover their tracks with legitimate orders).

compensation of the fund adviser. In short, fund managers may have been in cahoots with late traders.³³

It seems unlikely that late trading would have been a problem if it had not been for the practice of selling fund shares through brokers. Although it seems only natural for a fund to want to reach the largest possible market, the most powerful reason for seeking broad distribution is that fund managers are invariably compensated by a percentage of fund assets. The bigger the fund, the bigger the paycheck, other things being equal.³⁴ Selling through brokers also gives rise to a wide variety of other potentially abusive practices. For example, a fund manager may in effect bribe brokers to sell his fund by paying large commissions, which in turn may color the judgment and advice of the broker in making recommendations to his clients. In addition, selling through brokers exacerbates the use of *soft dollar* compensation arrangements. For example, a fund manager may agree to pay higher than necessary brokerage fees to a broker that sells more of the fund shares. Such practices are prohibited by statute except in exchange for services that are not commercially available from other sources.³⁵

Trading abuses are also due in part to the peculiar fact that funds are separate from their advisers. Again, technically speaking, a mutual fund is a corporation that is separate from the fund adviser. The fund is simply a corporation formed to hold a portfolio of stocks. The adviser is a separate entity that contracts with the fund to provide management services. The fund pays the manager some specified percentage of assets per year as a management fee. If a mutual fund were one with its adviser, it seems unlikely that fund management would sit idly by while some opportunistic investor siphons off profits. Moreover, and more basically, it is difficult to see how the adviser could be compensated in the standard way with a percentage of fund assets. To be sure, individual managers could be paid a percentage of fund assets or a salary with a bonus based on the growth of the fund, or managers might be paid with options on fund shares as is common among other types of corporations. This would have been a powerful incentive to monitor late trading and market timing.

The problem is that federal securities law and SEC rules effectively dictate the current structure on the theory that the fund ought to be able to change management if the board of directors becomes dissatisfied with management performance. Of course, that never happens. Instead, most investors seem to view mutual funds as products created and offered by the

³³ In all fairness, once these practices became common, it may have been necessary for reluctant funds to go along simply in order to avoid losing large investors. That, too, may explain the remarkable shift from the hostility to active trading that was standard in the early 1990s.

³⁴ Interestingly, active trading strategies have not been a problem in the European Union, possibly because funds are viewed as a product of the adviser, who, accordingly, has a financial interest in the performance of the fund. Remarks of Margaret Bancroft. Presumably, a fund company can justify higher fees if the fund performs better, and that may induce fund managers to be more vigilant about such practices as late trading and market timing. But U.S. law prohibits fees based directly on performance. See 15 U.S.C. § 80b-5. Which system is preferable is open to debate. Fund expenses appear to be about fifty percent higher in the E.U., but U.S. funds bear significant expenses in addition to advisory fees that E.U. funds may not incur.

³⁵ 15 U.S.C. § 78bb(e) (2000).

adviser, and investors choose their funds accordingly.³⁶ To be sure, there have been attempts in the past to wrest control of funds from their advisers—without much success—but it seems more efficient for investors to vote with their feet. After all, investors can effectively force the progressive dissolution of a fund simply by redeeming their shares and investing the proceeds elsewhere.³⁷

In addition, federal securities law severely restricts compensation of fund managers on the basis of investment performance.³⁸ The rationale for this prohibition is not entirely clear, but it may have been that the framers of federal securities law thought that such compensation arrangements might induce fund managers to undertake too much risk on behalf of the fund. It may also be that the prohibition has persisted because of the efficient market theory.³⁹

In theory, funds could be limited to direct sales, but such a rule might make it difficult for smaller funds to gain access to a wide market. It is also important to note that brokers must agree under NASD rules not to maintain a secondary market in mutual fund shares. Although this may seem to be an odd restriction, it is presumably designed to prevent avoidance of sales and redemption fees.⁴⁰

IV. SORTING OUT PRIVATE CLAIMS

Whether or not regulators manage to fix the problems with mutual fund structure and practices that gave rise to abuses, the courts must sort out the avalanche of private claims made by fund investors. It should be clear at this point that late trading and market timing reduce returns for non-trading fund investors. Thus, the private civil actions arising as a result of these abuses seek (1) compensation for losses suffered by non-trading fund investors or recoupment of gains extracted by hedge funds and others who engaged in abusive trading and (2) disgorgement of fees collected by fund advisers as a result of increases in fund assets under management that came from facilitating abusive trading practices.⁴¹ There is little doubt that there is a private

³⁶ Remarks of Frank Partnoy. See Karen Damato, *et al.*, *Do Mutual Funds Really Need Directors?* Wall Street Journal, June 7, 2004, at R1.

³⁷ There is a limit to this process, though. As a fund is forced to sell its holdings in order to redeem its own shares, it is likely to sell the most liquid holdings first. As fund holdings become less liquid, sales by the fund have a greater effect on the primary market for the shares the fund holds, thus driving down NAV faster and faster. In other words, as with a run on the bank, the first few investors are likely to get out without much difficulty, but other investors may be induced to get out purely for strategic reasons.

³⁸ See 15 U.S.C. § 80b-5 (2000).

³⁹ Moreover, with recent doubts that have been raised about the use of stock options as compensation, it seems unlikely that reformers would favor the use of options as compensation in the fund industry.

⁴⁰ See *United States v. Nat'l Ass'n of Sec. Dealers*, 422 U.S. 694, 697, 708–09, 711 (1975) (finding no violation of antitrust law in this arrangement). See also Rachel McTague, *SEC Gives Funds Redemption Fee Option, but Requires Contracts with Intermediaries*, 37 Sec. Reg. & L. Rep. (BNA) 393, March 7, 2005.

⁴¹ If the increase in fees is attributable solely to additional fund assets under management, the increase in fees is effectively paid by the traders and should not result in any reduction in value for ordinary fund investors. That would seem to suggest that actions based on such claims should be dismissed for lack of any allegation of damages.

cause of action for these claims.⁴² But it is not clear whether the claims belong to individual investors or to the funds themselves -- that is, whether these claims are direct or derivative.⁴³

A. Distinguishing Direct and Derivative Claims

The characterization of claims as direct or derivative is important. If an action is classified as direct, the stockholders should ordinarily recover individually and recovery may be limited to those stockholders who sold their shares at depressed prices. Also, their recovery might be at the expense of the fund itself, which would cause further harm to non-selling fund stockholders, as in the case of an ordinary securities fraud class action.⁴⁴ If an action is classified as derivative, the corporation should ordinarily recover, and its recovery should extend to all of the illicit profits and fees. Thus, the potential for recovery (and the potential for attorney fees) is much greater under a derivative theory than it is under a direct theory, other things being equal. On the other hand, if an action is treated as derivative, it is subject to a variety of procedural hurdles and may ultimately be captured and possibly even dismissed by the fund board of directors.⁴⁵

(It is difficult to believe that traders did not profit in excess of the fees they paid, although it is possible that they figured out some way to escape paying fees by timing purchases and sales of fund shares.) On the other hand, if the fund adviser is seen as a fiduciary, extra fees may be recouped as secret profits.

⁴² See *Strougo v. Bassini*, 282 F.3d 162, 175 (2d Cir. 2002). *The financial claims made in these cases are primarily claims based on familiar principles of securities fraud or breach of fiduciary duty or contract.*

⁴³ Interestingly, the actions consolidated in MDL 1586 were divided almost evenly between direct actions and derivative actions. In other words, about half of the actions sought recovery on behalf of the fund, and about half of the actions sought recovery on behalf of individual investors. It is unclear which characterization is correct. Each of the four tracks to which the cases have been assigned has a lead plaintiff attorney for the direct actions and a lead plaintiff attorney for the derivative actions. See *In re Mutual Funds Investment Litigation* (MDL 1586), Case Management Order No. 1: http://www.mdd.uscourts.gov/MDL_Litigation/MDLDocs/mfcmo1reorgstructure.pdf. See also *In re Janus Mut. Funds Inv. Litig.*, 310 F. Supp. 2d 1359 (J.P.M.L. 2004). On August 25, 2005, Judge J. Frederick Motz dismissed the state and federal derivative claims except for the federal claim relating to excessive fees under ICA § 36(b) in one of the several subtracks under MDL 1586 on the grounds that the plaintiffs had failed to make a demand on the board of directors of the subject funds. *In re Mutual Funds Investment Litigation* (Janus Subtrack) (MDL-1586), 384 F.Supp.2d 873 (D.Md. 2005). As the decision notes, demand is not required for claims under ICA § 36(b). As I discuss further below, Judge Motz did not decide whether the claims were direct or derivative.

⁴⁴ See Richard A. Booth, *Who Should Recover What in a Securities Fraud Class Action?* available at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=683197

⁴⁵ See *Burks v. Lasker*, 441 U.S. 471, 485 - 86 (1979). This would seem to be a particular danger in connection with the instant cases, because by law, fund boards comprise a majority of independent directors. As the Delaware Supreme Court stated:

Determining whether an action is derivative or direct is sometimes difficult and has many legal consequences, some of which may have an expensive impact on the parties to the action. For example, if an action is derivative, the plaintiffs are then required to comply with the requirements of Court of Chancery Rule 23.1, that the stockholder: (a) retain ownership of the shares throughout the litigation; (b) make presuit demand on the board; and (c) obtain court approval of any settlement. Further, the recovery, if any, flows only to the corporation. The decision whether a suit is direct or derivative may be outcome-

The determination whether an action is direct or derivative is one for the court. The characterization of the action by the parties is not binding.⁴⁶ Moreover, the determination whether an action is direct or derivative is generally governed by the law of the state of incorporation of the fund.⁴⁷ Thus, although the mutual fund actions are pending in federal court, it is likely that state law will govern the characterization of these actions except to the extent that a cause of action involves an overriding federal policy.⁴⁸ Still, even if the rules relating to the choice of law are clear, classification of the actions as direct or derivative can present difficult questions.

In an archetypical derivative action, the stockholder is injured because the corporation suffers some injury that causes the stock price to fall or otherwise causes a loss in the value of the corporation.⁴⁹ For example, the corporation may have suffered a loss through mismanagement or self-dealing on the part of a director or officer. The primary injury is one to the corporation. The injury to the stockholder is *derivative*. The injury does not flow directly to the stockholder. Rather, the stockholder suffers the injury as a result of the market's *reaction* to the injury to the corporation, usually in the form of a decrease in market price.

In contrast, in a direct action the stockholder suffers injury in connection with some right that the stockholder possesses as against the corporation, such as the right to vote, the right to receive a dividend, or a contractual right.⁵⁰ Indeed, the corporation itself need not suffer any injury. For example, the stockholder may have been forced in the context of a merger to sell or trade his shares for too little consideration.⁵¹ Arguably, the corporation is unharmed except in some vague reputational sense.

determinative. Therefore, it is necessary that a standard to distinguish such actions be clear, simple and consistently articulated and applied by our courts.

Tooley v. Donaldson, Lufkin, & Jenrette, Inc., 845 A.2d 1031, 1036 (Del. 2004). Moreover, there are procedural requirements unique to *both* types of claims that need to be satisfied early on in the litigation in order to reach a result that will stick on appeal. For example, in a class action, the class must be certified and all members must be notified. *See* FRCP 23.

⁴⁶ *Tooley*, 845 A.2d at 1035.

⁴⁷ *See* *Kamen v. Kemper Fin. Servs., Inc.*, 500 U.S. 90, 108–09 (1991); *Strougo*, 282 F.3d at 167.

⁴⁸ *See* *Kamen*, 500 U.S. at 108; *Strougo*, 282 F.3d at 169. Although the law varies from jurisdiction to jurisdiction, most of the funds involved in MDL 1586 are incorporated in Delaware, Maryland, or Massachusetts. The law in these states, as well as federal law, is largely consistent. *See* *In re Mutual Funds Investment Litigation (Janus Subtrack)* (MDL 1586), 384 F.Supp.2d 873 (D.Md. 2005).

⁴⁹ A.L.I., *PRINCIPLES OF CORPORATE GOVERNANCE* § 7.01 (1994).

⁵⁰ *Id.*

⁵¹ *See, e.g.,* *Smith v. Van Gorkom*, 488 A.2d 858, 864–70 (Del. 1985).

Some cases are difficult to categorize because they fall in the middle or may have elements of both types of claims. For example, if a stockholder has been deprived of value because of dilution resulting from the improper issuance of stock by the corporation, the claim could be characterized either as direct or derivative. Suppose that the corporation issues a large block of shares at a bargain price. The corporation is harmed because it receives less for the shares than it should have received. The old stockholders are harmed because their percentage of ownership and voting rights are reduced (in addition to the fact that the price has probably declined from dilution). Although this latter form of harm may at first seem to be the same sort of reduction in value that comes from a mismanagement or self-dealing claim, it is somewhat different in that different shareholders are in different positions. The old stockholders suffer dilution, but the new stockholder who buys at a bargain price does not.

Most courts have ruled that dilution claims are derivative.⁵² But some courts have suggested that a suit should be regarded as direct rather than derivative if various classes of shareholders suffer different sorts of harm.⁵³ For example, in the dilution case above, one might argue that old stockholders suffer harm while new stockholders enjoy a benefit. On the other hand, one might argue that this distinction is illusory in that only those who were stockholders at the time of the harm to the corporation have standing to sue.⁵⁴ The problem, however, is that with a derivative action, the corporation recovers and all stockholders (new and old) benefit even though the plaintiff must be an old stockholder. All will end up treated equally if the corporation recovers from the new stockholder—but that is unlikely to happen in a dilution case.⁵⁵ One way

⁵² See *Kramer v. W. Pac. Indus., Inc.*, 546 A.2d 348, 349 (Del. 1988); *Elster v. Am. Airlines, Inc.*, 100 A.2d 219, 223 (Del. Ch. 1953).

⁵³ See *In re Tri-Star Pictures, Inc., Litig.*, 634 A.2d 319, 330 (Del. 1993); *Lipton v. News Int'l, PLC*, 514 A.2d 1075, 1078 (Del. 1986); *Bokat v. Getty Oil Co.*, 262 A.2d 246, 249 (Del. 1970); *Moran v. Household Int'l, Inc.*, 490 A.2d 1059, 1070 (Del. Ch. 1985) (specifying that a special injury is a wrong that "is separate and distinct from that suffered by other shareholders, or a wrong involving a contractual right of a shareholder, such as the right to vote, or to assert majority control, which exists independently of any right of the corporation") (citation omitted), *aff'd*, 500 A.2d 1346 (Del. 1985).

⁵⁴ It is also arguable that the wrong occurs at the time the decision is made to issue the new stock. One can easily conceive of cases in which existing stockholders are treated differently. For example, suppose that a fund offers to sell new shares to existing stockholders at a bargain price. Fund stockholders who fail to buy additional shares will suffer dilution but those who buy will not. Thus, some fund stockholders suffer harm while others enjoy a benefit. Although it might be argued that all stockholders are in the same position but for their own choice in how to respond to the offer, it might also be argued that the harm consists in making a coercive offer to fund stockholders and thereby threatening them with unequal treatment, both of which claims appear to be direct. Moreover, the corporation suffers no harm in such a case and arguably enjoys a benefit. For a discussion of these issues, see *Strougo v. Bassini*, 282 F.3d 162, 174–75 (2d Cir. 2002). One nice question in such a case is whether the stockholders have standing to sue the board of directors directly for a breach of fiduciary duty or whether the board of directors owes its duty to the corporation. Delaware seems to regard such a claim as direct and actionable. See *Blasius Indus. v. Atlas Corp.*, 564 A.2d 651, 652 (Del. Ch. 1988).

⁵⁵ In a dilution case, the new buying stockholder will likely be protected by statute. See MODEL BUS. CORP. ACT § 6.30 (2002). Thus, if anyone is held liable, it is likely to be the board of directors that issued the stock on the cheap, in which case the new buying stockholders will enjoy a windfall.

to deal with this problem is for the court to order individual recovery for the benefit of old stockholders only.⁵⁶ Many courts, however, are reluctant to resort to this.⁵⁷

The Delaware Supreme Court in *Tooley v. Donaldson, Lufkin, & Jenrette, Inc.*, rejected the special injury rationale as unduly confusing.⁵⁸ Rather, the court held that “[t]he analysis must be based solely on the following questions: [w]ho suffered the alleged harm—the corporation or the suing stockholder individually—and who would receive the benefit of the recovery or other remedy [the corporation or the stockholders, individually]?”⁵⁹ As the court itself noted, this is essentially the test set forth in the American Law Institute, Principles of Corporate Governance (PCG):⁶⁰

A direct action may be brought in the name and right of a holder to redress an injury sustained by, or enforce a duty owed to, the holder. An action in which the holder can prevail without showing an injury or breach of duty to the corporation should be treated as a direct action that may be maintained by the holder in an individual capacity.⁶¹

The court also emphasized that unless the plaintiffs can show a separate right in the nature of a contractual right, the action should be characterized as derivative.⁶² Thus, although the decision in *Tooley* may have clarified the law, it may also have set up a strong presumption in favor of characterizing doubtful cases as derivative rather than direct. Specifically, *Tooley* seems to hold that an action can be classified as direct only if a claim can be established without reference to an injury to the corporation.⁶³ In other words, if a claim can be characterized as both derivative and direct, *Tooley* seems to require that it be characterized as derivative.

In contrast, the PCG quite clearly contemplates that some cases may give rise to both direct and derivative actions.⁶⁴ The PCG also states that in such cases, the rules relating to each type of action should be applied only to the claims so characterized.⁶⁵ The potential problem with

⁵⁶ PRINCIPLES OF CORPORATE GOVERNANCE § 7.18(e) (1994).

⁵⁷ *Id.* § 7.16. The Supreme Court rejects the possibility of individual recovery in a situation in which recovery by the corporation would result in gain by a party involved in wrongdoing (such as one involving dilution). *Bangor Punta Operations, Inc. v. Bangor & Aroostock R.R.*, 417 U.S. 703, 713 (1974). In sum, Delaware case law would seem to counsel treating doubtful cases as direct rather than derivative, but, if anything, the opposite seems to be true.

⁵⁸ *Tooley v. Donaldson, Lufkin, & Jenrette, Inc.*, 845 A.2d 1031, 1039 (Del. 2004).

⁵⁹ *Id.* at 1035.

⁶⁰ *Id.* at 1036 n.9.

⁶¹ PRINCIPLES OF CORPORATE GOVERNANCE § 7.01 (1994). See *Grimes v. Donald*, 673 A.2d 1207, 1213 (Del. 1996); *Agostino v. Hicks*, 845 A.2d 1110, 1122 (Del. Ch. 2004).

⁶² See *Tooley*, 845 A.2d at 1039.

⁶³ *Id.*

⁶⁴ PRINCIPLES OF CORPORATE GOVERNANCE § 7.01 (1994).

⁶⁵ *Id.*

the approach announced in *Tooley* is that Delaware does not appear to permit individual recovery in a derivative action under any circumstances.⁶⁶ In contrast, the PCG expressly contemplates individual recovery in appropriate circumstances.⁶⁷ As a result, the possibility that recovery by the corporation might lead to undercompensation of old stockholders and a windfall gain to new stockholders can be addressed when it arises under the PCG, but it may be ignored under Delaware law.

B. Application in the Mutual Fund Context

It is not self-evident how these principles should be applied in the context of claims by fund investors based on abusive trading of mutual fund shares by other investors. It is, however, clear that a decision must be made relatively early in a case because numerous procedural issues hinge on the outcome. Undoubtedly the most important implication of the decision is that if an action is deemed to be derivative, the subject fund may be able to take control of the litigation as the true plaintiff and possibly even to seek dismissal of the action as contrary to the best interests of the fund.⁶⁸

At first blush, one would think that claims in connection with abusive trading of mutual fund shares are derivative. Such trades have the effect of reducing the value of the fund. Fund shares are thus reduced in value, and fund investors suffer as a result -- much as they do in a

⁶⁶ *Tooley*, 845 A.2d at 1039. *See also* *Bangor Punta Operations, Inc. v. Bangor & Aroostock R.R.*, 417 U.S. 703, 716 (1974) (dismissing action by corporation under new management against former management on theory that recovery would amount to windfall for new stockholders and rejecting individual recovery by old stockholders as inconsistent with idea of derivative action).

⁶⁷ PRINCIPLES OF CORPORATE GOVERNANCE § 7.01 (1994).

⁶⁸ *See* PRINCIPLES OF CORPORATE GOVERNANCE §§ 7.05 - 7.13 (1994). As noted above, in MDL 1586 the court dismissed the state and federal derivative claims except for the federal claim relating to excessive fees under ICA §36(b) on the grounds that the plaintiffs had failed to make a demand on the board of directors of the subject funds. *In re Mutual Funds Investment Litigation (Janus Subtrack) (MDL 1586)*, 384 F.Supp.2d 873 (D.Md. 2005). In his decision dismissing the Janus derivative claims for failure to make demand, Judge Motz noted that if the derivative claims had not been dismissed, it would have been necessary to accelerate the decision as to whether the claims were properly characterized as direct or derivative. It is not clear, however, that it is not necessary to undertake such an inquiry as to the direct class action claims. After all, it may be such claims should be characterized as derivative. As noted, that is a decision for the court and not for the parties. Moreover, it seems at least arguable that one could treat the derivative complaint as a demand on the board. To be sure, that would effectively eliminate the demand requirement altogether, but presumably the board would be entitled to treat the complaint as a demand rather than as a complaint and to exercise its own judgment accordingly. The same result could be achieved by dismissing the derivative complaint without prejudice. Thus, the court was probably correct in ruling as it did. *Cf. Kamen v. Kemper Fin. Servs., Inc.*, 500 U.S. 90 (1991) (Rule 23.1 should be interpreted literally and by its terms does not require demand if demand would be futile). The defendants also argued that the derivative actions should be dismissed, because the defendants were actively pursuing the same claims by virtue of their cooperation in various regulatory actions. The plaintiffs argued that the fund trustees' participation in the regulatory settlement process was immaterial because "the regulators have not asserted any claim to recover any damages caused to any Funds by the faithless fiduciaries." *Derivative Plaintiffs' Omnibus Opposition Memo*. at 36. Although the court did not reject either argument, Judge Motz noted that recovery by the fund would be problematic.

dilution case. In the case of an ordinary business corporation, such circumstances clearly give rise to a derivative claim. But for the reasons pointed out by Judge Motz in MDL 1586 (among other reasons), this characterization of the claim does not fit well in connection with a mutual fund:

Plaintiffs take the position that they are seeking recovery for the funds as entities, and they reject the concept of distributing the proceeds of any recovery to persons who held mutual fund shares during the period that late trading and market timing activities were occurring. Rather, plaintiffs contend that this is like any other derivative action in which any recovery becomes the asset of the corporate entity on behalf of which the action is instituted. Mutual funds, however, are quite different from other corporate entities. They do not have assets of their own but merely hold in trust securities (and cash) for the benefit of the mutual fund shareholders. Therefore, any recovery made by a mutual fund in a derivative action would merely increase the proportionate value of the investment of the persons who hold shares in the fund at the time of the recovery.

That result would be, at best, paradoxical because it would compensate persons who were not harmed at all by late trading or market timing activities (current shareholders who did not own shares when these activities were occurring) while failing to compensate others who were injured (persons who owned shares when late trading and market activities occurred but later sold them). Likewise, there would be no just or logical relationship between the compensation paid and the harm suffered as to persons who are current shareholders but who owned shares for different periods of time (or in amounts different from their present holdings) while late trading and market timing activities occurred.

Plaintiffs respond by saying this is always the case when a derivative action is filed. However, in the usual circumstance, the stock of a corporate entity on whose behalf the derivative recovery is made is valued on the basis of a wide variety of factors (many of which are intangible), and the entity does not serve simply as a pass-through of net asset value to its shareholders.

Furthermore, even to the extent that a recovery made in a derivative action filed on behalf of an ordinary corporate entity may (by increasing share price) indirectly redound to the benefit of its then current stockholders (as distinct from the stockholders at the time of the occurrence of the wrongs giving rise to the recovery), the disconnection between those who were harmed and those who were benefitted is less dramatic (and, as a matter of economic theory, does not exist at all). That is because a potential recovery in a derivative action is itself an asset of the corporation. Therefore, when a person, who owned stock in a corporate entity when wrongful acts giving rise to a derivative action or potential derivative action occurred, sells that stock before the derivative action is resolved, he makes the decision to accept a market price for the stock that presumably takes into account the value of the potential recovery. In contrast, the net asset value of a mutual fund is based entirely upon the underlying securities (and cash) in which the fund is invested and not upon the value of any chose in action held by the fund itself as an independent entity. Therefore, when a mutual fund shareholder sells his shares prior to the resolution of a derivative action, the price he receives includes no component for any potential recovery in that action.⁶⁹

Despite this cogent analysis, Judge Motz did not actually rule on the question whether the claims were direct or derivative. Rather he dismissed the derivative claims (with one minor exception) because the plaintiffs had failed to make the required demand on the various boards of directors of the funds involved.

⁶⁹ In re Mutual Funds Investment Litigation (Janus Subtrack) (MDL1586), 384 F.Supp.2d 873 (D.Md. 2005).

The Case for Direct Action

The considerations outlined by Judge Motz in MDL 1586 would seem to suggest that the claims should be seen as direct in nature. Indeed, he may have understated the case a bit. There are additional good arguments for that position.

First, as Judge Motz points out, there is a vital difference between an investment in a mutual fund and an investment in an ordinary business corporation. With an ordinary business corporation, an investor who wants to cash out must sell his shares in the market. With a mutual fund, an investor who wants to cash out sells his shares back to the fund, which has promised to buy them daily at NAV. Indeed, industry rules effectively block the investor from access to any other market for the shares.⁷⁰ There is no market price.⁷¹ The obligation to buy back the shares is a matter of contract with the fund. The harm that comes from selling at too low a price is one that comes, in effect, from a breach of that contract between the fund and the investor. That is a classic direct claim.⁷²

Second, if an action is treated as derivative, it could ultimately lead to speculative trading in fund shares. Because funds must be sold at NAV, the value of an award or settlement will not be included in fund shares until the cash is received. Thus, newcomers might be able to capture a share of the gain by buying fund shares when the award or settlement is announced but before the money is actually transferred to the fund.⁷³

Finally, a mutual fund is in essence a pass-through entity. Each investor has rights that a partner would have in connection with a claim of a partnership against a wrongdoer. Although the partnership can sue as an entity, the recovery is ultimately added to the partnership account

⁷⁰ See *United States v. Nat'l Ass'n of Sec. Dealers, Inc.*, 422 U.S. 694, 709 (1975) (finding no violation of antitrust law in this arrangement).

⁷¹ In contrast, exchange traded funds (ETFs) trade throughout the day and their prices vary from NAV as a result of market forces. See Hamilton & Booth, *Business Basics*, *supra*, § 16.6.

⁷² For example, a controversy relating to the rights of a particular class of stock as against other classes of stock and whether the corporate action has inappropriately favored one class over the other is classically a direct in nature. See PRINCIPLES OF CORPORATE GOVERNANCE § 7.01, comment (c) (1994). (To be sure, such an action may also be seen as one in which different stockholders suffer different injuries, but notwithstanding *Tooley*, the claim is still direct in nature.) The law relating to closely held corporations is also instructive in this connection. The essential feature of a closely held corporation is the lack of a market for shares. See *Donahue v. Rodd Electrotypes Co.*, 367 Mass. 578 (Mass. 1975). Because of the lack of a market, and because there is little danger of duplicative actions by multiple stockholders, the courts have ruled that minority stockholders have a direct right of action against the corporation and other stockholders in connection with claims arising as a result of improper unequal treatment. See PRINCIPLES OF CORPORATE GOVERNANCE § 7.01, comment (e) (1994). See also *Merola v. Exergen Corp.* 423 Mass. 461 (Mass. 1996) (holding that policy of closely held corporation to repurchase shares of exiting employees does not constitute a market). Cf. *Jones v. H.F. Ahmanson & Co.*, 460 P.2d 464, 475–76 (Cal. 1969) (exclusion of minority stockholders from access to public market for their shares constitutes breach of fiduciary duty).

⁷³ To be sure, this problem can be avoided by ordering individual recovery even though the action is derivative. Although there is substantial authority for such a solution, many courts are reluctant to order individual recovery in a derivative action as a matter of principle that such a remedy is simply inconsistent with the idea of a derivative action. See note 66 *supra*.

of each partner. Arguably, the distinction between direct claims and derivative claims breaks down in the context of a partnership.⁷⁴ Similarly, the value of mutual fund shares is that they constitute a direct claim on fund assets. Thus, to award any portion of the recovery to the fund without allocating it in some way to individual investors is nonsense. Moreover, an award to the fund will end up in the accounts of individual investors in any event because of the nature of mutual fund shares. Thus, the best reason for treating these claims as direct is that a derivative recovery will become a direct recovery one way or the other. Although one must pay homage to the distinction between direct and derivative claims, it does not follow that the distinction makes any real sense in this context.

The Case for Derivative Action

Notwithstanding the foregoing arguments, there are also problems with treating these claims as direct.

First, it is not clear that holdover fund investors have a valid claim under Rule 10b-5, because they did not trade.⁷⁵ To be sure, the court in MDL 1586 ruled that in the context of claims based on abusive trading of mutual fund shares, the requirement that one be a buyer or seller in order to have standing to sue under Rule 10b-5 does not apply.⁷⁶ But it is far from clear that that position will stand up on appeal.

Second, if the claims are direct, they are presumably claims directly against the fund. In other words, it would seem that the fund should pay in the first instance (although it would presumably have a claim over against those who participated in the abusive trading). It is not at all clear that a fund investor has standing to maintain a direct action against other investors, the fund adviser, third party brokers, or fund directors and officers without joining the fund as a

⁷⁴ Compare UNIF. PARTNERSHIP ACT § 405, cmt. n.2 (1997), with UNIF. LIMITED PARTNERSHIP ACT § 1001 (2001). In addition, § 1101 of the Uniform Limited Liability Company Act provides that a member "may maintain an action in the right of the company if the members or managers having authority to do so have refused to commence the cation or an effort to cause [them] to commence the action is not likely to succeed. Delaware law is similar. Del. Ltd. Liab. Act § 1001. In other words, the general rule in connection with pass-through entities is that in appropriate circumstances beneficial owners may enforce claims of the entity directly for the benefit of the entity and fellow beneficial owners. Moreover, as a technical matter, a mutual fund may opt to distribute a pro rata share of its assets in kind rather than paying a selling stockholder in cash. Finally, mutual funds are treated essentially as pass-through entities for federal income tax purposes. See Boris I. Bittker & James S. Eustice, *Federal Income Taxation of Corporations & Shareholders*, ¶ 1.06[1]. See also I.R.S., *Publication 17*, at 209 (2004) (addressing non-publicly traded funds).

⁷⁵ See *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 730–31 (1975) (only buyers and sellers have standing sue under Rule 10b-5).

⁷⁶ On the same day that the MDL 1586 court dismissed the derivative claims (save one), the court denied a motion to dismiss the (direct) class claims arising under Rule 10b-5 and ICA § 36(b) while dismissing various claims based on the 1933 Act, other sections of the ICA, and fiduciary duty under state law. *In re Mutual Funds Investment Litigation (Janus Subtrack)* (MDL 1586), 384 F.Supp.2d 845 (D.Md. 2005). The court held that the surviving claims could proceed under Rule 10b-5 even as to investors who held (but did not trade) fund shares during the fraud period, *citing* *In re Alger, Columbia, Janus, MFS, One Group, and Putnam Mutual Fund Litigation*, 320 F. Supp. 2d 352, 355 (D. Md. 2004).

defendant. Indeed, it is not altogether clear that fund investors have any claim against third parties even if the fund is joined.⁷⁷

Third, one major disadvantage of treating these claims as direct rather than derivative is that it may result in the distribution of thousands of checks for small amounts of money -- checks that may never be cashed. A derivative recovery, on the other hand, would likely take the form of a significant contribution of cash to the fund that the fund would then be able to invest. In short, it would presumably be much cheaper for the action to proceed as a derivative action.

Clearly, it would make more sense for selling fund investor plaintiffs to recover directly against the wrongdoers, but it is not clear that they have standing to do so. The fund itself clearly does have standing to recover against the wrongdoers. Moreover, the fund itself may recover the entire amount of the ill gotten gains, including amounts extracted from both sellers and holders of fund shares. Thus, it would seem preferable for the fund to seek recovery. But that suggests that the action should be characterized as derivative. We have now come full circle.⁷⁸

A Hybrid Solution

No matter how these actions are classified, there are significant logistical difficulties in managing recovery. If the action is treated as derivative and the fund recovers, those who sold their shares during the fraud period will recover nothing even though they would seem to have the strongest claims. Moreover, recovery by the fund (rather than individual recovery which seems to be disfavored by the courts) could lead to speculative purchases of fund shares before the recovery is reflected in NAV and could significantly dilute the effective recovery of holdover investors. Even in the absence of speculation, the effect of the recovery will be diluted by the normal advent of new investors, at least if the fund is growing. On the other hand, if the action is treated as direct, it may be argued that only investors who sold during the fraud period may

⁷⁷ If the claim is characterized as one involving participation in a fraud, it is presumably cognizable, but if it is more in the nature of aiding and abetting, it cannot be maintained as a private cause of action. See *Central Bank v. First Interstate Bank*, 511 U.S. 164 (1994). See also *Munford v. Valuation Research Corp.*, 98 F.3d 604 (11th Cir. 1996) (questioning whether there exists a cause of action for aiding and abetting breach of fiduciary duty under state law).

⁷⁸ It is also possible that a court may decide that some claims are direct and other claims are derivative. For example, claims relating to late trading and market timing, both of which dilute the shares of other investors, may be classified as direct, given that they have a direct effect on fund value (and certainly so for those who sold during the fraud period). Claims relating to additional fees paid to advisers as a result of investments made by offending traders may be classified as derivative in that they relate to expenses of running the fund and not directly to the value of the asset pool. (The analysis would seem to be the same whether the action is against the offending traders, the fund adviser, or the fund directors.) Undoubtedly, such a compromise solution is attractive precisely because it is a compromise, but that is no argument in itself. Moreover, the argument that because of the peculiar structure of mutual funds, management fees are paid out of the fund and represent a drain on asset value rather than some form of dilution simply proves too much. To be sure, most investors think of a fund and the fund company adviser as one. Indeed, commentators have noted that investors tend to view funds as products rather than services and that this perception has had a significant effect on investor attitudes toward fund governance. Remarks of Alan Palmiter; Remarks of Frank Partnoy. But the reality is that adviser compensation reduces the value of the fund in the same way that trading losses do so. Moreover, one might argue by the same logic that a stockholder action challenging option-based executive compensation as excessive is direct, whereas an action challenging an excessive cash bonus is derivative.

recover, as is the normal rule in an ordinary securities fraud class action. That would deprive more conservative buy-and-hold investors of any recovery even though their shares will forever be damaged as a result of the earlier diversion of fund assets. Again, one might appeal to the ultimate pass-through character of mutual funds as a rationale for granting all investors standing as class members.⁷⁹

There is, however, an elegant middle solution. The above problems can all be avoided if the fund recovers cash from the wrongdoers and then creates new fund shares in some number that would exactly offset the recovery so that it would have no effect on then current NAV. The new shares would then be divided into daily portions equal to the losses from abusive trades on each day during the fraud period. Finally, the daily portions would be allocated to individual fund investors in proportion to the number of shares owned on each day during the fraud

⁷⁹ It is not clear, however, that it is necessary to do so if one proceeds on a state law theory of breach of fiduciary duty owed directly to fund stockholders by the fund board of directors. *See* *Malone v. Brincat*, 722 A.2d 5, 14–15 (Del. 1998); *Blasius Indus., Inc. v. Atlas Corp.*, 564 A.2d 651, 652 (Del. Ch. 1988). The court also dismissed state law fiduciary duty claims relating to failure to disclose material facts on the grounds that such claims were not limited to non-trading fund investors and were thus preempted by the Securities Litigation Uniform Standards Act (SLUSA). The court gave leave to the plaintiffs to file an amended complaint on behalf of non-trading investors but cautioned that such claims would be improper if they involve fraud or misrepresentation. *See* *Rowinski v. Salomon Smith Barney, Inc.*, 398 F.3d 294, 300 (3d Cir. 2005); *Dabit v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 395 F.3d 25, 34 (2d Cir. 2005); *Dudek v. Prudential Securities, Inc.*, 295 F.3d 875, 879–80 (8th Cir. 2002). Despite the warning from the court, it would seem that the non-trading plaintiffs might well have a claim sounding in contract that should survive preemption under SLUSA. Indeed, it is the fact that mutual fund investors have a direct contractual right to sell their shares back to the fund corporation that ultimately justifies treatment of these claims as direct rather than derivative. *See* *Tooley v. Donaldson, Lufkin, & Jenrette, Inc.*, 845 A.2d 1031 (Del. 2004). The same theory might well save the claims of non-trading plaintiffs from ultimate dismissal for lack of standing to sue. As holders of shares in a mutual fund they are entitled to cash out on demand at NAV. Thus, although a given holder might not realize the harm until he sells his shares, it is certain that he will do so when he does sell. This would seem to distinguish the instant situation from that in *Blue Chip Stamps* where the plaintiffs claimed that they had been induced not to buy in the first place, thus giving rise to serious doubts about whether they would have bought had they known the truth. This duty need not conflict with federal law relating to fraud. For example, the failure to disclose late trading and market timing arguably prevented plaintiffs from seeking injunctive relief to enforce their contractual claims. The question remains, however, whether the state law duty of candor gives rise to a direct or derivative claim, that is, whether it is a duty that is owed directly to the stockholders. Intuitively, it is difficult to see how the duty of candor could not be one that is owed to the stockholders. It makes little sense as a duty running to the corporation. The Second Circuit faced a similar issue in *Strougo v. Bassini*, 282 F.3d 162 (2d Cir. 2002). *Strougo* involved a closed end fund that had issued to its existing investors non-transferable rights to purchase additional shares at a discount from then current share value. The plaintiff sought to maintain a class action against the fund board of directors on the theory that the board of directors owed a fiduciary duty directly to the investors (as well as to the corporation). Holding that the claims were properly characterized as direct (even though based on the issue of shares at a discount), the court addressed the question whether (under Maryland law) there exists an actionable fiduciary duty running from the board of directors to the stockholders of a corporation. Clearly, there must be some duties that run directly to stockholders. Otherwise there would be never be occasion for any direct action. On the other hand, one might characterize many such duties (such as those involving voting rights) as contractual in nature. Thus, the narrow question before the court was whether such duties are properly characterized as fiduciary. Ultimately, the court found that a direct duty does in fact exist, *citing* *Toner v. Baltimore Envelope Co.*, 304 Md. 256, 268–69, 498 A.2d 642, 648 (1985) and *Waller v. Waller*, 187 Md. 185, 194, 49 A.2d 449, 454. The court also held that the duty is actionable, noting that it would be peculiar for a legal duty to be non-actionable. But see Richard A. Booth, *Stockholders, Stakeholders, and Bagholders (Or How Investor Diversification Affects Fiduciary Duty)*, 53 Bus. Law. 429 (1998) (discussing supposed duty to maximize stockholder value).

period.⁸⁰ Holdover investors will presumably see a slight increase in the number of shares they own at the end of the process. Investors who cashed out during the fraud period will have their accounts constructively reopened to receive their allocation of the new shares. Presumably the shares in those accounts will then be redeemed, and the former fund investors will receive the cash value of their award.

The procedure would serve both holders and sellers and would have no effect on NAV. And it would avoid the danger of speculation that might go with derivative recovery.⁸¹ The expense of administering the recovery would be minimal, because it would all be handled by a simple journal entry crediting each account with a few additional shares or fractions thereof. And the costs associated with the distribution many small checks would be kept to a minimum. Finally, the funds themselves should favor this procedure because the recovery would effectively be reinvested in the fund.

The remaining question is how to achieve this solution. Is this remedy one that goes with a direct class action? Or is it one that goes with a derivative action? Or is there some other procedure by which this remedy is possible? Note that one of the factors to be considered in deciding whether an action is direct or derivative is the nature of the recovery at stake. Thus, although it is a bit odd to formulate a remedy before making a decision on the nature of an action, there is some authority for doing so.

The simplest procedure would be for the fund to sue the wrongdoers and then to allocate the proceeds by issue of new shares without outside interference. Of course, the fund is under no obligation to do so, although one might argue that fiduciary duty requires it. Moreover, in the absence of pending litigation against the fund, this solution would probably require a vote of the fund investors. On the other hand, a fund could presumably undertake some such plan in connection with a settlement agreement and probably without a fund investor vote because under the FRCP, court approval is required for settlement of both class actions and derivative actions.⁸² Thus, under this alternative it makes no difference how the action is characterized.

A second alternative is to treat the action as derivative.⁸³ With a derivative action, the plaintiff can direct the litigation against the entire array of potential defendants (including other investors, brokers, the fund adviser, and the directors and officers of the fund itself). But it is not clear that the derivative plaintiff can seek to compel the fund to allocate the recovery according

⁸⁰ Needless to say, one would need to make appropriate adjustments for the shares involved in abusive trading schemes by excluding such shares from the allocation. In addition, the allocation should proceed day to day from beginning to end of the fraud period, because investors who held during the entire period would have seen compounded gains and losses during the fraud period.

⁸¹ It would be important to announce the plan as early as possible during the course of the litigation in order to prevent speculation in fund shares.

⁸² FRCP 23(e); FRCP 23.1.

⁸³ The problem is that in MDL 1586 the derivative actions have been dismissed or are likely to be dismissed consistent with the decision of August 25, 2005. *See In re Mutual Funds Investment Litigation (Janus Subtrack)* (MDL 1586), 384 F.Supp.2d 873 (D. Md. 2005).

to the plan. In other words, it is not clear that one has standing as a derivative plaintiff to compel the fund to issue new shares as a way of distributing the recovery. Such a remedy seems more direct than derivative, in that the fund itself has no interest in how its own shares are allocated. On the other hand, as noted previously, many courts treat claims arising in connection with dilution as derivative, and the remedy proposed is one that is similar in many ways to a remedy one might imagine in such a connection. Moreover, a derivative action has traditionally been seen as one at equity, because (in effect) it amounts to an action to compel the corporation to sue some wrongdoer.⁸⁴ A court of equity has the power to fashion any necessary remedy. Thus, it would seem that a derivative plaintiff could seek to compel the issue of new shares to allocate the recovery.

A third alternative is to treat the action as a direct class action against the fund. The problem with this alternative is that it suggests -- by analogy to ordinary securities fraud class actions -- that the fund itself is a defendant and might in theory be held liable to fund investors who sold during the fraud period. After all, that is the normal remedy in a run of the mine securities fraud class action involving a publicly traded corporation that withholds bad news while innocent investors buy the stock. But the situation is different in a case involving abusive trading of mutual fund shares. In such a case, fund investors already own the shares. They realize the loss when they sell shares because the value of the shares has been reduced by abusive trading schemes. And holdover investors suffer a loss that is equally real because their investment going forward is effectively reduced as a result of the extraction of fund value by abusive trading. To hold the fund itself liable to sellers would compound the injury to holders. On the other hand -- and again by analogy to ordinary securities fraud class actions -- it would seem odd for fund investors to sue the primary wrongdoers without also suing the fund itself. Fund investors have no direct relationship with the wrongdoers. An action by fund investors against third parties without joining the fund itself would seem to be nothing but a closet derivative action.⁸⁵

There is, as it turns out, a simple solution to this problem as well. Although most class actions seek money damages and proceed under FRCP 23(b)(3), there is an alternative procedure available under FRCP 23(b)(2), which provides that an action may be maintained as a class action if "the party opposing the class has acted or refused to act on grounds generally applicable to the class, thereby making appropriate final injunctive relief or corresponding declaratory relief with respect to the class as a whole." This provision would seem tailor-made for cases involving abusive trading in mutual fund shares. Simply put, it permits a class action against a fund for injunctive relief, including presumably an injunction requiring a defendant fund to pursue claims based on abusive trading and to allocate recovery by means of issuing new shares. It is difficult to imagine a better example of a case in which the defendant has acted or refused to act on grounds generally applicable to the class. It is also worth noting that § 27 of the Exchange Act provides that the federal courts have jurisdiction over "all suits in equity and actions at law

⁸⁴ See *Ross v. Bernhard*, 396 U.S. 531 (1970).

⁸⁵ In the one case in which the issue has been addressed, the court dismissed the claims against two funds, precisely on the grounds that holding them liable would compound the harm to holdover investors. See *In re Mutual Funds Investment Litigation (Janus Subtrack)* (MDL 1586), 384 F.Supp.2d 845, 852, n.3 (D. Md. 2005). The court did not address the question whether the plaintiffs could maintain the action in absence of the fund defendants.

brought to enforce any liability or duty created [under the act] or the rules and regulations thereunder."⁸⁶

The bottom line is that it does seem to matter much whether mutual fund stockholder actions in connection with late trading and market timing are characterized as direct or derivative. What matters most is the remedy. And the ideal remedy -- recovery by the fund combined with the distribution of new shares (rather than cash) to injured investors -- can be achieved under either procedure. If the actions are characterized as derivative, the court sitting as a court of equity can fashion a remedy that includes the issue of new shares, and can do so without resorting to individual recovery. If the actions are characterized as direct, they can proceed as actions for injunctive relief under FRCP 23(b)(2), by which the fund itself is in effect compelled to seek recovery and to distribute new shares to injured stockholders.

Conclusion

The abusive trading strategies that came to light beginning in September 2003 have shaken the faith of the investing public in mutual funds. This is a serious development because it is vital for investors to diversify, and mutual funds are the primary way by which investors do so. Although one might argue that securities fraud in connection with the pricing of individual stocks is a zero sum event for diversified investors, fraud in connection with the pricing of mutual funds constitutes real financial harm for investors. Although it is irrational for an individual investor to keep all of her eggs in one basket, there is nothing the least bit imprudent about keeping all of one's eggs in a single well-diversified mutual fund. Accordingly, mutual fund advisers should be seen as fiduciaries of the highest order and held to the punctilio of an honor most sensitive. Thus, it is crucial that we get it right in addressing the harms suffered by mutual fund investors in connection with late trading and market timing. Although it may take some time and further thought to institute the necessary reforms in connection with mutual fund structure, the way to remedy the financial harms suffered by fund investors seems fairly clear.

⁸⁶ Admittedly, this argument suggests that all derivative actions could be prosecuted as direct actions under FRCP 23(b)(2) rather than under FRCP 23.1 thereby avoiding all sorts of procedural problems such as the need to make demand on the board of directors. On the other hand, given that FRCP 23(b)(2) permits only actions for injunctive or declaratory relief it is subject the full array of equitable limitations, including presumably the imposition of a pre-suit demand requirement.