Note: These articles were published under my former name, having been written before my transition.

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Schwab faces uphill battle in court over fund losses

Firm seeks appeal of precedent-setting ruling against the Schwab Total Bond Fund

By David Hoffman

Charles Schwab & Co. Inc. is likely to lose this week when a California federal judge hears a motion appealing a ruling in a class action that, if left standing, would give mutual fund investors a new line of attack against underperforming funds, fund industry attorneys said.

The original ruling, handed down Feb. 19 by Judge Susan Illston of the U.S. District Court of the Northern District of California in San Francisco, said that investors have the right to sue an investment company under the Investment Company Act of 1940 for deviating from the fund's stated investment objectives.

"I'd say it's precedent-setting," Sean M. Murphy, a litigation partner at Milbank Tweed Hadley & McCloy LLP of New York, said about the ruling, in which investors are suing Schwab over losses they suffered in the Schwab Total Bond Fund.

The case is the first to find a right to sue an investment company under the 1940 Act since 2002 when the 2nd U.S. Circuit Court of Appeals in New York ruled that the act didn't give investors the express right to sue investment companies. The Supreme Court ruled in 2001 that acts of Congress need to have such language if suits alleging violations of the acts are to go forward.

But that doesn't mean that units of Schwab associated with the Total

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Schwab faces uphill battle in suit

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Bond Fund are going to succeed in getting the judge to revisit her own decision.

Schwab filed a motion March 26 asking Ms. Illston to allow an appeal, and a hearing is set for Friday.

She is unlikely to revisit the decision, especially since the 9th District is a busy one, said a fund attorney, who asked that neither he nor his firm be identified, as Schwab is a client.

Attorneys for Schwab referred questions to David Weiskopf, a spokesman for the company, who declined to comment.

The attorney for Northstar Financial Advisors Inc., the lead plaintiff, wouldn't comment on how he thinks the judge will rule. The advisory firm, which is based in North Caldwell, N.J., has more than $30 million in assets under management, according to federal filings.

"What courts do sometimes is that they do justice," was all Robert C. Finkel, a partner with Wolf Popper LLC of New York, would say.

In the case of Northstar v. Schwab, however, justice is complicated.

Northstar alleges that the Schwab Total Bond Fund was allowed to deviate from its investment strategy in violation of the Investment Company Act.

According to the fund's documents, it tracks the performance of the Lehman Brothers U.S. Aggregate Bond Index. The suit, however, alleges that the fund improperly invested in mortgage-backed securities that were riskier than those in the index.

The fund also invested more than 25% of its assets in mortgage-backed securities despite its own policy prohibiting it from investing more than 25% in any single industry, the suit claims.

The fund's deviations from its stated investment objectives caused it to lose 1.09% from Sept. 4, 2007, to Aug. 27, compared with a gain of 5.29% for the index, according to the suit.

Ms. Illston found that the allegations were sufficient to survive a motion to dismiss.

Her decision has fund attorneys worried.

"In refusing to dismiss a class action case alleging a fund harmed investors by investing in high-risk mortgage-backed securities, some plaintiffs may claim that the court has opened a new front in the plaintiff's bar's efforts to capitalize on the subprime crisis through investor class actions," said a client alert released this month by Paul Hastings Janofsky & Walker LLP of Los Angeles.

More lawsuits are almost a certainty, according to a March alert from Milbank Tweed Hadley & McCloy. "Historically, when courts found [or suggested] that the securities laws provide a potential cause of action, the class action plaintiff's bar has tried to stretch the limits of those findings," the alert said.

LIMITED DAMAGE

Attempting to stretch Ms. Illston's ruling, however, may prove especially difficult. The ruling is very narrow, applying only to Section 13(a) of the Investment Company Act, which says a fund can't deviate from its stated investment objectives without a vote of its shareholders.

"We don't see it spreading to other sections of the Investment Company Act," Mr. Murphy said. Furthermore, it isn't clear if other courts would adopt Ms. Illston's reasoning, he said. Rulings by judges in U.S. District Courts do not hold precedent in other jurisdictions.

Ms. Illston reasoned that investors could sue under the section of the Investment Company Act in question because it was amended by Congress as part of the Sudan Accountability and Divestment Act of 2007 to restrict the rights to bring actions against a fund or an adviser for divesting from securities issued by those conducting operations in Sudan.

"If there were no private right of action under Section 13(a), there would be no need to restrict the actions that could be filed under Section 13," Ms. Illston wrote in her opinion.

The judge's reasoning, however, is awkward at best, said one fund attorney, who asked not to be identified, because he has cases pending before her. It doesn't mesh with what the Supreme Court has said is required to bring a suit under an act of Congress — that there be language specifically in the act allowing for suits to go forward, he said.

Mr. Finkel, however, holds a different view.

"I do think that Schwab is using this perhaps as a way to end a lot of potential litigation, because they want to be able to deviate from a fundamental investment policy without holding themselves responsible to their investors," he said. "They are looking for a loophole in the law."

Whether such a loophole exists will most likely be decided by another court.

"Regardless of the result [of Schwab's appeal], this issue is likely to be revisited by a court in the 9th District or another court in the not-too-distant future," said James Cavoli, a partner in Milbank Tweed Hadley & McCloy.

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Fund industry likely to face wave of suits over risk disclosure

Economic downturn may spur more investors to seek legal remedies for their losses

By David Hoffman

The dismal performance of mutual funds could result in a wave of lawsuits alleging that funds failed to disclose the true risk of their investments, according to several industry lawyers.

Class actions that hinge on disclosure claims related to underperforming bond funds have already been filed against The Charles Schwab Corp. of San Francisco; Memphis, Tenn.-based Morgan Keegan & Co., a subsidiary of Regions Financial Corp., and OppenheimerFunds Inc. of New York (see related story on Page 22).

As plaintiff's attorneys look for additional cases, more such suits are inevitable, said Robert Skinner, a partner with Boston-based lawfirm Ropes & Grey LLP.

'FOLLOWING THE MONEY'

"My sense is that the plaintiff's bar is doing what they normally do: following the money, targeting funds that have investment losses and finding a theory to fit the facts," he said.

And the theory that funds should be on the hook for losses because they didn't disclose how risky their investments were may prove to be a winner.

However, "the history of disclosure suits in the mutual fund area is

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Risk disclosure lawsuits likely

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not great," said Barry Barbash, a partner in the Washington office of New York law firm Willkie Farr & Gallagher LLP. He is a former director of the Securities and Exchange Commission's Division of Investment Management.

But in a sour market in which complicated derivatives are being blamed for so much investor misery, the argument that "this or that was not disclosed" could find a receptive audience, Mr. Barbash said.

Much depends on the nature of the losses incurred by funds, said Bruce Leto, chairman of the investment management/mutual funds practice group at Stradley Ronon Stevens & Young LLP, a law firm based in Philadelphia.

"With what's happened in last six months, some of these funds are down by dramatic amounts," he said. "It's a question of, were funds following in line with the market, or was something else wrong?"

If a fund's poor performance was the result of risky investments that weren't disclosed, then a suit based on that claim may have a shot at succeeding, Mr. Leto said.

If such suits are successful, it would be a major blow to the fund industry, said Tamar Frankel, a professor at the Boston University School of Law who specializes in mutual fund law.

Disclosure cases are akin to "an atomic bomb," she said.

DIRE CONSEQUENCES

Successful cases would result in judgments ordering the repayment of investor losses, payments which could potentially wipe out a fund, Ms. Frankel said.

It seems unlikely, however, that such cases would be successful, Mr. Skinner said.

"What [plaintiff's attorneys] are really trying to do is to fit disclosure theories around investment losses," he said.

But investment losses by themselves aren't "actionable," Mr. Skinner said.

Even if they never make it to court, disclosure cases could end up costing fund companies a lot of money.

> "THE HISTORY of disclosure suits in the mutual fund area is not great."
>
> **Barry Barbash**
> Partner
> Willkie Farr & Gallagher

"If there are plaintiffs able to get past dismissal and into discovery … the defense cost is in the many millions," Mr. Skinner said.

"I think this is what [plaintiff's attorneys] are banking on," he said. "If they can put together a complaint that passes muster, they can impose costs and receive a quick settlement."

Such a scenario would be an added burden to fund advisers, but it wouldn't harm fund investors, said Jeff Keil, president of Keil Fiduciary Strategies LLC, a Littleton, Colo.-based industry adviser.

"From some of the suits I've been involved with, most funds aren't so bold as to flow through legal costs to the shareholders," he said.

A flood of lawsuits isn't a given.

"We have not witnessed a specific correlation between past economic downturns and a substantial increase in fund industry litigation," said Daniel Steiner, general counsel for the ICI Mutual Insurance Co. in Washington, the non-profit mutual fund insurance company owned by the fund industry.

There was just one federal class action related to mutual funds filed at the end of 2001 — months after the technology bubble burst — according to the Stanford Law School Securities Class Action Clearinghouse in Palo Alto, Calif. It was eventually dismissed.

Shortly thereafter, however, there was a dramatic increase in the number of mutual fund class actions filed. Eighteen suits were filed in 2003 and 22 in 2004, largely as a result of illegal market timing and late trading that came to light in 2003.

The database maintained by Stanford, however, isn't a complete picture of all litigation filed against mutual funds, as it covers federal class actions only.

GREATER VULNERABILITY

And even if it were, the market's decline has been so steep this time around that several industry observers said mutual funds are more vulnerable to litigation now than they have ever been.

The prospect of disclosure-related suits is a break from the past when the plaintiff's bar favored suits against mutual funds related to excessive fees.

VINCENT RICARDEL

Barry Barbash: Blame mentality could lead to risk-disclosure lawsuits.

Those cases, however, have proven nearly impossible to prosecute successfully.

That may change when the Supreme Court rules on an excessive-fee case that could change the standards by which such cases are tried.

The case, filed in 2004, involves a lawsuit against Harris Associates LP, the Chicago-based adviser to the Oakmark Funds. A ruling is expected soon.

But until then, plaintiff's attorneys are tilting toward disclosure-related suits, observers say. That approach has much in common with the slew of litigation still making its way through the courts that alleges tobacco companies knew of the dangers of smoking, but never disclosed those dangers to customers, Mr. Skinner said.

As a result, the fund industry may see lawsuits brought by deep-pocketed firms that don't typically get involved in mutual fund litigation, he said.

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TARP to the rescue

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tributes to confidence and gives them some flexibility," Ms. Vaughan said.

SEEKING CONFIDENCE

TARP, other opportunities for capital relief still exist, though they may be hard for insurers to find. For example, if a carrier had a maturing debt, it could refinance it, perhaps through commercial-paper offer-

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Is the bloom off the rose for American Funds?

In current market, firm's fixed-income aversion makes its products a harder sell, advisers say

By David Hoffman

The love affair financial advisers have enjoyed with American Funds has cooled.

Although advisers once made American Funds the biggest mutual fund family by long-term fund assets, driving assets to more than $1.19 trillion in October 2007, growing adviser discontent threatens to push the fund group into third place. Funds from American Funds are generally sold through advisers.

American Funds' total long-term fund assets stood at $880 billion at the end of September, placing it second behind The Vanguard Group Inc., with $1.01 trillion, and ahead of Fidelity Investments, with $709 billion.

During the third quarter,

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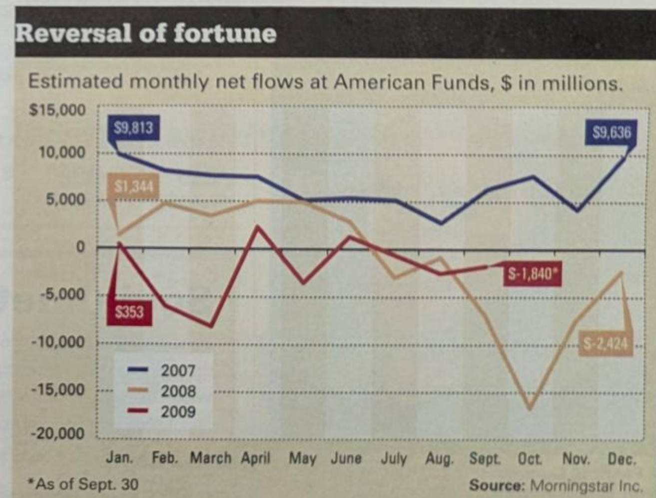

American faced with outflows

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investors yanked $5.1 billion out of American Funds, according to Morningstar Inc.

Year-to-date through September, the firm had outflows of $19.3 billion.

Meanwhile, Vanguard and Fidelity have seen inflows.

During the third quarter, Vanguard had $27.5 billion in net new flows, while Fidelity had $8.6 billion.

Year-to-date through September, Vanguard had $74.6 billion in net new flows, while Fidelity had $17.09 billion.

WHO IS WORRIED?

American Funds, which is advised by Capital Research & Management Co., however, sees no need to panic.

"Our outflows have lagged the overall industry," said Chuck Friedhoff, a spokesman for the firm. "What we're seeing is, American Funds are retaining assets at a higher rate than the overall industry."

That may be true, but not against Vanguard and Fidelity, which with American control more than 39% of long-term mutual fund assets.

American's fund mix is at least partly to blame, said Sonya Morris, associate director of fund analysis at Morningstar.

Vanguard and Fidelity have a more diversified menu of funds, while American's mutual fund lineup is significantly skewed toward equities, she said.

That hurt American as investors fled equities for the relative safety of bonds during the recession, Ms. Morris said.

"The overriding story, and the main factor behind American's outflows, has been investors' overwhelming preferences for bond funds," she said.

It isn't hard to see why such a preference hurt American.

The firm's taxable bond funds, which account for 9.73% of its total long-term fund assets, receive a fund family score — an asset-weighted average of a group's Morningstar ratings — of 2.3. A score below 2.5 is an indication that the firm has met with little success in that asset class.

American's municipal bond funds, which account for 1.9% of its assets, receive a 2.8 from Morningstar. A score between 2.5 and 3.5 indicates the group is about average.

Given American's relative lack of focus on fixed income at a time when bonds are king, it may be difficult for advisers to continue to persuade clients to buy them, said Reuben Gregg Brewer, director of mutual fund research at Value Line Inc. of New York.

"It might be an easier sell to get a customer into a [Pacific Investment Management Co. LLC] fund than try to convince them that American Funds, known for stocks, is good for bonds," he said.

Working in American's favor, however, is the fact that advisers still hold it in high regard.

Capital Research & Management received the Most Respected Fund Company Award and the Long-Term Achievement Award in *InvestmentNews*' Adviser's Choice competition in September.

Some advisers, however, said that they aren't even all that impressed with American's domestic-equity-fund performance.

The firm's domestic-stock funds, which account for more than 38% of its assets, receive a fund family score of three from Morningstar, indicating that the group is about average.

American has let some funds — most notably the $149.3 billion American Funds Growth Fund of America (AGTHX) — grow to such a size that it is hard for them to be anything more than closet index funds, said Lou Stanasolovich, president of Legend Financial Advisors Inc. The firm has $350 million in assets under management.

"They're not doing anything to justify the cost" of investing in such funds, Mr. Stanasolovich said.

The Growth Fund of America has a relatively low expense ratio of 0.65%, not counting sales loads, but investors can do better in a low-cost index fund, he said.

The performance numbers, however, only partially back him up.

Year-to-date through Oct. 28, the fund was up 24.80%. It was up 22.05% for the one-year period, down 4.66% for the annualized three-year period, and up 2.84% for the annualized five-year period, according to Morningstar.

The S&P 500 was up 17.76% for the same year-to-date period, up 13.83% for the one-year period, down 6.82% for the annualized three-year period and up 0.50% for the annualized five-year period.

Such numbers are why some advisers think that performance alone doesn't explain why American has been far less successful at stanching outflows than its chief rivals.

Some suspect that advisers have pulled back on exposure to American because the group offers a relatively limited number of funds that don't offer targeted exposure to certain hot segments of the market.

"I suspect that the outflows from American really speak more to a changing adviser as opposed to changes within the funds," said Malcolm Makin, whose practice, Professional Planning Group of Westerly, R.I., is affiliated with Raymond James Financial Services Inc.

Other advisers — particularly fee-only advisers — suspect American has had trouble stopping outflows because its mutual funds come with loads that they view as an unnecessary extra cost.

"My clients have become very, very cost-conscious in this past year," said Katie Weigel, the founder and managing director of LongPoint Financial Planning LLC, a firm with $20 million under management.

American Funds' offerings are "generally very good," but because they come with loads, it isn't hard to find better funds for less money, said Ms. Weigel.

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