

Federal Court Rejects Mutual Fund Prospectus Liability Claims: Plaintiffs Cannot Prove Causation Because Alleged Misrepresentations Have No Effect on Fund Share Price

Applying reasoning that could sharply narrow the ability of plaintiffs' lawyers to bring prospectus liability claims against mutual funds and their advisers and directors, the United States District Court for the Southern District of New York on March 31, 2011 dismissed a class action complaint against State Street Corporation that alleged the SSgA Yield Plus Fund's prospectus misled investors about the Fund's "subprime" mortgage exposure in violation of Sections 11 and 12(a)(2) of the Securities Act of 1933. The court held that the plaintiffs could not establish a causal connection between the alleged misrepresentations in the prospectus and a drop in the fund's share price. Since the price of open-end mutual fund shares is always equal to net asset value, an alleged misstatement or omission in fund disclosures cannot artificially inflate or deflate the price at which investors buy or sell: plaintiffs simply cannot logically connect the dots between the document and any damages.

In *Yu v. State Street Corporation*, the plaintiffs alleged that the Yield Plus Fund's prospectus and Statements of Additional Information did not accurately describe the Fund's investment objectives or the extent of its holdings in mortgage-related securities. According to the complaint, the Fund's underperformance in 2007-2008 resulted from exposure to mortgage-related instruments. The plaintiffs claimed that their investment losses were "caused" by the "undisclosed risk" associated with the scope of the Fund's mortgage-related holdings.

The court rejected this theory of causation, basing its analysis primarily on the text of the Securities Act. Sections 11 and 12 explicitly measure damages in prospectus liability cases as the difference between the share purchase price and the price when suit is brought or the shares are sold. But the language also provides that those damages are not recoverable to the extent the difference represents amounts "other than the depreciation in the *value* of such security *resulting from*" the alleged prospectus misstatement. The *Yu* court held that "[t]his statutory scheme envisions material misrepresentations in the prospectus inflating the market price of the security at the time of the statement. When the nature of the misrepresentation is revealed, whether by the issuer or by other circumstances, the market corrects the price of the security to the value it would have had absent the misrepresentation." As a result, "it is crucial that there be a revelation of the concealed risk and that the revelation cause a depreciation in the value of the security." It is insufficient for the plaintiff merely to allege that he would not have purchased fund shares absent the alleged misstatements – that establishes only "transaction causation," not the required "loss causation." In the mutual fund context, because "NAV does not react to . . . any misstatements in the Fund's prospectus, no connection between the alleged material misstatement and a diminution in the security's value has been or could be alleged."

The *Yu* court specifically rejected the reasoning of other recent decisions that permitted mutual fund prospectus liability cases to proceed. The court observed that those decisions' rationale – that “because plaintiffs suffered a loss, and because defendants made some statement that is related to that loss, the statement must have caused the loss” – was untethered to the statutory text. The *Yu* court concluded that their “reasoning makes the policy rationale – *i.e.*, that mutual fund issuers ought to be subject to private securities fraud claims, and any other construction would be ‘absurd’ – guide the legal analysis.” But such outcome-driven results cannot be squared with the plain language of the Securities Act. Private shareholder claims for truly fraudulent misstatements in a mutual fund prospectus might still be available under Section 10(b) of the Securities Exchange Act of 1934, but any concerns about the limited availability of claims against mutual funds under Sections 11 and 12 of the Exchange Act must be addressed to Congress, not the courts.

Yu has the potential to have far-reaching impact. If the court's reasoning that open-end mutual fund shares are not susceptible to artificial inflation or deflation attributable to misrepresentations or omissions in prospectuses becomes more broadly accepted, Securities Act liability for mutual funds, advisers, distributors and directors or trustees could be sharply limited.

A team of Ropes & Gray litigators represented State Street in this action. For the full text of the court's decision in *Yu v. State Street Corporation*, please [click here](#).

CONTACT INFORMATION

If you have any questions or would like to learn more about the issues raised in the court's decision, please contact the Ropes & Gray lawyer who normally represents you or one of the following Ropes & Gray litigators involved in the case:

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