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Second Circuit Vacates Dismissal Of Securities Fraud Claims Holding That Mutual Funds' Alleged Misrepresentations Regarding Payment Of Transfer Agent Fees Were Material

In [*Operating Local 649 Annuity Trust Fund v. Smith Barney Fund Management LLC*](#), No. 07-5125-cv, 2010 WL 520896 (2d Cir. Feb. 16, 2010), the [United States Court of Appeals for the Second Circuit](#) vacated an order dismissing a securities fraud class action brought on behalf of investors against the manager of a family of mutual funds. The Court held, among other things, that the defendants' alleged misrepresentations regarding transfer agent fees paid by the funds were material under the "total mix" materiality test. This decision provides guidance regarding disclosures to be made by mutual funds concerning the details of transfer fee arrangements.

Plaintiff Operating Local 649 Annuity Trust Fund purchased shares in 105 mutual funds from the Smith Barney Family of Funds ("Funds") between September 11, 2000 and May 31, 2005. Plaintiff alleged that Smith Barney negotiated a contract for transfer agent services that subjected the Funds to excessive and misleadingly disclosed fees and that a portion of these excessive fees were essentially a kick back to a Smith Barney affiliate. From 1994 through 1999, an outside contractor named First Data Investor Services Group ("First Data"), provided transfer services for the Funds. In accordance with industry practice, the Funds paid First Data's fees through Fund assets, and this expense was publicly disclosed.

Plaintiff alleged that in 1997, with the contract between the Funds and First Data set to expire, Smith Barney asked Deloitte & Touche Consulting ("Deloitte") to opine as to whether their subsidiary Citigroup Asset Management ("CAM") could take over the transfer agent function from First Data. To accomplish this, Deloitte recommended that CAM create a subsidiary to provide the transfer services to the Funds using technology purchased from a First Data competitor. CAM rejected this recommendation and, instead, the Funds rehired First Data to provide transfer agent services for substantially the same fees previously paid.

Around this time, CAM created a transfer agent subsidiary called Citigroup Trust Banks ("CTB"). The Funds then entered into a contract with CTB to provide transfer agent services, and CTB subcontracted with First Data to provide essentially the same transfer agent services that First Data had previously provided, but at a much lower rate. Plaintiff alleged that even though First Data reduced the rate it charged for its services, and despite the fact that CTB's limited role as First Data's subcontractor was to run a call center, CTB

charged the Funds substantially more in transfer agent fees than it paid to First Data. In essence, a Smith Barney affiliate was allegedly “pocketing” savings on the cost of the transfer agent fees, rather than returning those savings to the Funds.

Finally, plaintiff alleged that CAM concealed this scheme from the Funds board of directors and from investors. Indeed, while the existence of the contracts between the Funds, First Data and CTB were disclosed, CAM allegedly did not disclose that First Data was still performing the same services it had previously performed at a substantially reduced rate. Nor did CAM disclose that CTB pocketed the difference between what it charged the Funds for its minimal services and what it paid First Data. Plaintiff alleged that the misrepresentations and omissions regarding the fees violated, among other things, [Rule 10b-5](#), 17 C.F.R. § 240.10b-5, promulgated thereunder.

The [United States District Court for the Southern District of New York](#) dismissed plaintiff’s claims, holding that the mischaracterization of the fees paid to CTB as transfer agent were not, as a matter of law, a material misrepresentation because if an investment adviser discloses the total amount of fees paid by a fund for services, neither the allocation of the fees nor the profit margin of the transfer agent is material. Instead, the district court held, only the actual amount of fees is material because, when deciding to invest, an investor who knows the amount of fees a fund pays can compare the fees to those of its competitors. Since defendants disclosed the amount of the fees paid by the Funds, the district court concluded that “Plaintiffs were in possession of all material information; *i.e.*, they knew the value of the Funds.” Plaintiff appealed.

On appeal, the Second Circuit reversed. In reaching its decision, the Court applied the well recognized “total mix” materiality test. When applying this test to determine whether a misrepresentation is material, courts look to whether there is a “substantial likelihood” that a reasonable investor would have viewed the disclosure of the omitted fact as having significantly altered the “total mix” of information made available to the investor. Put another way, a fact is deemed material if a reasonable person would consider that fact important when deciding whether to buy or sell shares of stock. Applying this “total mix” materiality test, the Second Circuit held that CAM’s alleged omissions were material. The Court reasoned that CAM, acting through investment adviser Smith Barney, owed a fiduciary duty to the Fund’s shareholders to negotiate the best possible arrangement for the Funds and, accordingly, a reasonable investor would be reluctant to deal with a fiduciary who allegedly “lined their pockets at the expense of investors whose interests they were obligated to protect.” The Court reasoned further that its holding also was supported by CAM’s alleged failure to follow the SEC’s disclosure requirements, which require mutual funds to detail the management fees payable to investment advisers. Accordingly, since CAM allegedly failed to disclose to investors its transfer agent service arrangement, and since a reasonable investor could find the arrangement important when deciding whether to buy or sell shares of stock, the Court concluded that CAM’s omissions were material.

In light of this ruling, investment advisers should be aware that in certain instances additional disclosures regarding the details of any transfer agent service arrangements, including amounts charged and amounts paid for transfer agent services, may need to be made in prospectuses and in SEC disclosures.

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