The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

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Illinois Appellate Court Rules that SLUSA Precludes Class Actions Alleging Negligence Based on Market Timing

[24066]

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TO: BOARD OF GOVERNORS No. 1-10
SEC RULES MEMBERS No. 5-10
SMALL FUNDS MEMBERS No. 3-10
BROKER/DEALER ADVISORY COMMITTEE No. 1-10 RE: ILLINOIS APPELLATE COURT RULES THAT SLUSA PRECLUDES CLASS ACTIONS ALLEGING NEGLIGENCE BASED ON MARKET TIMING

We are pleased to inform you that an Illinois appellate court has held that, in addition to precluding class actions alleging fraud in connection with the purchase or sale of mutual funds, the Securities Litigation Uniform Standards Act (SLUSA) also precludes class actions alleging negligence. [1] The background of this case and the court's holding are briefly summarized below.

SLUSA

SLUSA was enacted by Congress in 1998 to curb vexatious litigation by establishing uniform national standards for securities class actions. It sought to accomplish this by preempting state class actions alleging a misrepresentation or omission of a material fact or a deceptive device or contrivance in connection with the purchase or sale of certain securities, including mutual fund shares, and requiring that such suits proceed only in the federal courts.

The Case

The plaintiffs filed a class action in state court alleging that the defendant mutual funds and their investment advisers acted negligently or recklessly in their pricing of mutual fund shares, to the detriment of the plaintiffs, who were shareholders of the funds. The plaintiffs' core contention was that the defendants permitted market timers to engage in abusive market timing to the detriment of the plaintiff shareholders.

Before this case could be heard on the merits, the defendants sought dismissal arguing that – though the plaintiffs styled their claim as one involving negligence or recklessness – the essence of their claim is that the defendants engaged in fraudulent conduct. As such, the defendants argued that the plaintiffs' claims were preempted by SLUSA and should be dismissed by the trial court.

The trial court denied the defendants' motion for judgment on the pleadings, but agreed to certify an interlocutory appeal to the appellate court on the issue of whether SLUSA precludes the plaintiffs' action.

In July 2008, the Institute filed an amicus brief supporting the defendants' view that SLUSA should be read to preempt class actions that are filed in state court alleging negligence or recklessness in connection with securities covered by SLUSA. [2] Our brief sought to impress upon the court the harm to mutual fund investors – and the flight of class actions to state court – that could result if SLUSA were read narrowly to preempt only those class action expressly alleging fraud.

The Appellate Court's Holding

According to the court, "the plaintiffs' allegations of stale pricing are, in essence, allegations of a negligent or willful and wanton misrepresentation of value." It rejected the plaintiffs' argument that, because the market-timing traders place their orders for shares before the day's price is published, the misrepresentation is not the basis of the plaintiffs' injury. In the view of the court:

> If the defendants had disclosed to the plaintiffs the fact that mutual fund shares are valued only once a day and that this once-a-day valuation creates opportunities for market-timing arbitrage, or if the defendants had stated in their prospectuses or otherwise disclosed to investors that a daily valuation left the defendants' funds exposed to short-swing trading strategies, the plaintiffs would be unable to claim that the negligent or willful and wanton valuation of the funds caused them damage. For these reasons, we find that the plaintiffs' complaint alleges a misrepresentation or omission of material fact for purposes of Securities Litigation Act preclusion.

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Attachment

endnotes

[1] *See Kircher et al. v. Putnam Funds Trust, et al.,* Gen. No. 5-08-0260 (Madison County No. 03-L-1255; Jan. 6, 2010), which is attached. As the court noted in its opinion, SLUSA does not preempt any state law cause of action but simply denies plaintiffs the right to use the class action device to vindicate certain claims.

[2] *See* Institute Memorandum No. 22711 (July 18, 2008). The 2008 brief was the second amicus brief the Institute filed involving SLUSA. Our first brief was filed in the U.S. Supreme Court on the issue of whether SLUSA preempted class actions brought by "holders" of securities or, instead, was limited to class actions brought by purchasers or sellers of securities. The U.S. Supreme Court held that SLUSA preempted class actions brought by holders, which was the position advocated by the Institute. *See Merrill Lynch, Pierce, Fenner & Smith Inc. v. Dabit,* 547 U.S. 71 (2006).