MEMO# 4467

January 29, 1993

ILLINOIS COURT FINDS PRIVATE RIGHT OF ACTION UNDER SECTION 17(J) OF THE 1940 ACT

1January 29, 1993 TO: SEC RULES MEMBERS NO. 16-93 COMPLIANCE COMMITTEE NO. 3-93 RE: ILLINOIS COURT FINDS PRIVATE RIGHT OF ACTION UNDER SECTION 17(j) OF THE 1940 ACT ____ In a recent case brought by a class of mutual fund investors against the investment adviser, sponsor and portfolio manager of two option income mutual funds, the Illinois Appellate Court found an implied private right of action under Section 17(j) of the Investment Company Act of 1940 and reversed the lower court's dismissal of several other counts. The lower court had dismissed the plaintiffs' complaint on the basis that they did not have standing to sue directly for their injuries and should have brought a derivative suit. A copy of the Appellate Court's decision in the case, Mann v. Kemper Financial Companies, Inc., is attached. The plaintiffs alleged that in connection with managing and marketing the funds, the adviser and sponsor failed to maintain and enforce internal trading controls, commingled financial futures transactions for public and in-house funds, improperly allocated financial futures trades after the close of trading, diverted profitable trades to an employee profit sharing plan while allocating unprofitable trades to the two mutual funds, and engaged in a pattern of speculative financial futures trading prohibited by the funds' prospectuses. They further alleged that the portfolio manager, who also managed a portion of the employee profit sharing plan, violated internal compliance procedures with respect to the completion of order tickets for futures trades, used the funds' financial resources to finance his trading for the profit sharing plan and improperly commingled and allocated trades. (According to the court, as a result of his actions, his portion of the profit sharing plan had a 400% return, while the mutual funds had losses in the tens of millions of dollars.) The court reversed the lower court's dismissal of the plaintiffs' claim alleging violations of Section 17(j) of the Investment Company Act and Rule 17j-1 thereunder (based on the 2portfolio manager's speculating, commingling of funds and wrongful allocation of trades), finding that a private right of 3action exists under Section 17(j). The court observed that federal courts previously have found a private right of action under Section 17(a), and concluded that there was no reason to permit a private right of action under one subsection and not the other. The court also reversed the dismissal of plaintiffs' claims seeking an accounting for all wrongfully obtained profits and misappropriated funds, and alleging (a) common law fraud, (b) breach of fiduciary duty, (c) violation of the Illinois Consumer Fraud and Deceptive Business Practices Act, (d) violation of Section 11 of the Securities Act of 1933 based on material misrepresentations in the funds' prospectuses, and (e) violation of Section 12(2) of the Securities Act through selling the funds by means of false and misleading prospectuses. In each case, the court found that only the individual plaintiffs, and not the mutual funds, had standing to bring these claims. Dismissal of the plaintiffs' Section 36(b) claim was upheld on appeal because that provision authorizes actions only in federal district court, not state court. In addition, the appellate court affirmed the lower court's dismissal of plaintiffs' claim under Section 37 for conversion of investment company funds, finding that that section establishes that certain conduct is criminal but does not provide for a civil cause of action or a civil remedy. The case was remanded to the trial court. Frances M. Stadler Assistant Counsel Attachment

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