
Investors Permitted to Sue Adviser for Transfer Agent Fee Kickbacks

BY STEPHANIE FICHERA

The Second Circuit Court of Appeals recently reversed a district court's dismissal of claims that an investment adviser committed securities fraud and breached its fiduciary duties by failing to disclose kickbacks received in connection with a transfer agent services contract. In *Operating Local 649 Annuity Trust Fund v. Smith Barney Fund Management LLC*, investors sued Citigroup Asset Management (CAM), a provider of investment advisory and management services to Citigroup-sponsored mutual funds, alleging that CAM concealed from the funds' shareholders and boards of directors that it renegotiated a contract for transfer agent services in a manner that resulted in the funds being charged more in transfer agent fees and a substantial portion of those fees being pocketed by CAM.

The court ruled that CAM's misrepresentations were material, explaining that "the facts that shareholders were being grossly overcharged for transfer agent services and that CAM was reaping the benefits were ones that would have been viewed by the reasonable investor as having

significantly altered the total mix of information made available." CAM, the court concluded, was obligated to negotiate the best possible arrangement for the funds and to make clear to their boards and shareholders that it was benefitting from the agreement.

The court also found that the investors adequately alleged a causal connection between the material misrepresentation and their loss. The defendants contended that investors could not establish a diminution in the funds' values because the SEC had ordered defendants to disgorge transfer agent profits to the funds following an SEC investigation prior to the filing of civil suits by investors. The court rejected the defendants' argument because it was premature to conclude that investors were fully compensated by SEC-ordered restitution. Moreover, the court stated that CAM's misrepresentations resulted in the improper deduction of monies from the funds, which negatively and predictably impacted fund returns.

Privately Held Fidelity Entities Cannot Avoid Sarbanes-Oxley Whistleblower Suits

BY MICHAEL VALERIO

In a March 30, 2010 opinion addressing two separate cases brought against Fidelity, the United States District Court in Massachusetts denied Fidelity's motions to dismiss employment retaliation claims under Section 806 of the Sarbanes-Oxley Act (SOX). The court rejected Fidelity's argument that the SOX claims should be dismissed because the whistleblower plaintiffs were not employees of publicly held investment companies covered under SOX (i.e., the Fidelity mutual funds) but, rather, were employees of privately held Fidelity entities (i.e., Fidelity Brokerage Services and Fidelity Management & Research). The court's holding breaks with prior Department of Labor administrative decisions – as well as the rulings of other federal district courts – which concluded that the SOX whistleblower provision does not cover employees of non-public affiliates or agents of public companies.

The Massachusetts court acknowledged that "the statutory text is far from pellucid" regarding whose employees are covered. The court ultimately concluded, however, that Section 806 protects employees of "contractors, sub-contractors, or agents" of public companies, provided those employees establish the "protected activity" and retaliation prongs of the statute. In turn, the court found that the non-public Fidelity affiliates that employed the plaintiffs fell within this ambit in light of their operational relationships with the publicly held Fidelity investment companies.

In the end, the court appeared to be guided primarily by its view of the broader preventative, punitive, and remedial purposes of SOX. The court observed: "If Section 806 only protected employees of public companies, then any reporting of fraud involving a mutual fund's shareholders would go unprotected, for the very simple reason that no 'employee' exists for this particular type of public company." If the court's interpretation stands and is adopted elsewhere, it could have significant implications for privately held mutual fund complexes in the SOX arena.