

Court Ruling Strikes Down Exercise of Self-Governance By Schwab YieldPlus Mutual Fund

Recently, a California federal district court judge granted a summary judgment motion filed by plaintiffs in class action litigation relating to the Schwab YieldPlus mutual fund. The decision is notable because it focuses on mutual fund governance – not the more typical disclosure issues. Let’s highlight the important aspects of the decision.

As background, Schwab characterized the YieldPlus fund as an ultra-short bond fund, and marketed the fund as a cash equivalent investment and as a safe alternative to money market funds with a higher yield and only slightly more risk. However, in an attempt to achieve higher returns, the YieldPlus fund’s managers increasingly invested in large amounts of uninsured mortgage backed securities. By February 29, 2008, more than 60% of the fund’s assets were concentrated in mortgage-backed securities as well as asset backed securities, the majority of which were tied to residential mortgage loans. As a result of the YieldPlus fund managers’ actions, YieldPlus investors suffered far greater losses than investors in other ultra-short bond funds or short-term fixed income funds. In 2008, the Schwab YieldPlus fund lost 35% of its value.

In response to those losses, investors filed scores of arbitration claims. Class action claims also were filed in court. Schwab has denied all liability and damages, blaming the market, and arguing that it properly had disclosed all of the fund’s activities. While most of the arbitration claims now have been arbitrated or have been settled (directly between the parties or through mediation), class action litigation is ongoing. The court’s ruling comes from one of the remaining class action cases.

The court held that the Schwab fund violated Section 13(a) of the Investment Company Act when, without a shareholder vote, it altered its express diversification policy with respect to investment concentration in uninsured mortgage backed securities. Specifically, the court wrote, “When a mutual fund attracts investors based on a diversification policy expressly limiting investments in uninsured mortgage backed securities or any other industry to 25 percent or less of the fund, this order holds that a shareholder vote is required before the fund may reverse field and concentrate more than 25 percent in uninsured mortgage backed securities or in any other industry.”

The court found that from at least November, 2001 until February, 2006, Schwab YieldPlus maintained an announced diversification strategy in its registration statement and statement of additional information filed with the SEC. That strategy was to treat mortgage backed securities (issued by private lenders and not federally guaranteed) as a stand-alone industry, thereby limiting investments in that “industry” to 25 percent. Nonetheless, after 5 years, the YieldPlus fund managers “reversed field and repudiated the 25 percent limitation.”

In a statement filed with the SEC as of September 1, 2006, the fund managers stated: “The funds have determined that mortgage-backed securities issued by private lenders do not have risk characteristics that are correlated to any industry and, therefore, the funds have determined that mortgage-backed securities issued by private lenders are not part of any industry for purposes of the funds’ concentration policies.”

The court characterized this change as a “phenomenal turnabout”, and was quite troubled by the process. It wrote that the change was done unilaterally by the fund managers, without any shareholder vote, and with no notice to investors of the reversal of policy. Only a majority vote by the shareholders would allow for such change. The court held, “To rule otherwise would allow the very abuse that led to the 1940 Act.” The court was referring to “funds that drew in savings based on supposed diversification policies only to be squandered in a single industry that collapsed.”

Schwab raised numerous arguments in its defense, which the court rejected. One argument was that Schwab YieldPlus had disclosed that the definition of what is an industry could be changed without a shareholder vote “unless otherwise noted.” But the court retorted that this was a “governance question”, not a “disclosure question”, and that “a fund promoter cannot proclaim self-serving reservations of power denied it by the 1940 Act.”

In sum, because the concentration limitation reversal “was not a mere clarification of an otherwise blurred line”, but instead “an entire repudiation of a clear-cut definition that had become a fixture of the fund on which shareholders were entitled to depend for the safety of their savings”, a shareholder vote was required. Let’s hope other mutual funds hear the court’s clear warning!

About the Author: *James J. Eccleston leads the Securities group at the Chicago law firm of Shaheen, Novoselsky, Staat, Filipowski & Eccleston, P.C., where he represents investors in recovering investment losses and financial services professionals in disciplinary, employment, and compliance matters. He has held numerous securities licenses and Chicago Bar Association leadership positions and serves as an arbitrator and mediator. He is a recipient of Martindale-Hubbell’s highest rating (AV) for legal ability and ethics and is named to the Illinois Super Lawyer and Leading Lawyer lists.*

JEccleston@snsfe-law.com, 312.621.4400, www.snsfe-law.com, www.financialcounsel.com