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SEC Update

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SEC's Hesitancy to Intervene in Litigation to Correct Misstatements Regarding the Federal Securities Laws

Courts, from time to time, encounter misstatements by litigants regarding the federal securities laws. Courts also make such misstatements themselves.

The US Securities and Exchange Commission (SEC), which is charged with enforcing the federal securities laws, has been hesitant to intervene in litigation to correct such misstatements.

Addressed below is an example of a misstatement by a litigant and a misstatement by a court, each in the context of the Investment Company Act of 1940 (1940 Act).[1] The question arises why the SEC does not intervene to correct such misstatements, lest a court reach a conclusion at odds with the federal securities laws.

Section 36(b) Standing

Section 36(b) provides[2] that a "security holder" can sue the investment adviser of an investment company for excessive fees.

The SEC regulates two-tier investment company structures where a top investment company invests in shares of one or more underlying investment companies. Such a two-tier structure exists where (1) a fund-of-funds invests in shares of underlying mutual funds and (2) a life insurance company separate account, funding variable annuity contracts and variable life insurance policies, invests in shares of underlying mutual funds.

The courts have struggled mightily[3] to determine whether, under Section 36(b), an owner of a top-tier investment company is a "security holder" of an underlying fund who has standing to sue an investment adviser of an underlying fund. Generally speaking, the courts have determined that a fund-of-funds shareholder does not have standing, but that an owner of a variable insurance product does have standing.

In the process, courts have had to address patently false arguments by plaintiffs, such as the following claim that collapsed underlying funds into top tier funds:

> [Plaintiff] now argued that "because the [fund-of-funds] and the underlying funds in which they invest are *not distinct companies*, but are *part of a single registered investment company*" it is a "security holder" in the only "registered investment company" that [the investment adviser] manages . . .

> and therefore may assert this § 36(b) claim for [the investment adviser's] breach of fiduciary duty.[4]

This statement contravenes the regulatory scheme of the 1940 Act. Section 8 calls for the separate registration of individual investment companies, and Section 12 authorizes a registered investment company to invest in the shares of another investment company.

The SEC did not intervene in this litigation to so inform the court. However, the higher court reached the correct conclusion that the top-tier and underlying investment companies were "each a separate 'registered investment company'" and Plaintiff's "argument is without merit."[5]

Gartenberg Standards

The US Supreme Court, in 2010, upheld[6] the six so-called *Gartenberg* factors for determining whether a fund's investment adviser had breached its fiduciary duty under 36(b). The factors are: (1) nature and quality of services provided, (2) investment adviser profitability, (3) economies of scale, (4) fall-out benefits, (5) fee comparability, and (6) director independence and conscientiousness.

At least one court has struggled through the application of the *Gartenberg* standards in the context of an underlying fund. In doing so, the court made the false statement that fund investment performance is not a *Gartenberg* factor, as follows:

> Although *not a Gartenberg factor,* Plaintiffs contend that the Funds at issue performed poorly, demonstrating that the nature and quality of services provided by [the fund's investment adviser] were inadequate. Plaintiffs offered the testimony of Pomerantz and Goldstein in support of their claim that the at-issue Funds performed poorly.[7]

This statement of the court conflicts with the fund industry's reading of the *Gartenberg* opinion. Widespread industry practice considers fund investment performance to fall under the "*Gartenberg* factor" of "nature and quality of services provided." Fund investment performance metrics measure the "quality" of an investment adviser's services of managing a fund's portfolio assets. It is difficult to fathom how a court would expect fund boards to consider the "quality" of investment advisory services without considering fund investment performance.

The SEC did not intervene in this litigation to so inform the court. However, the higher court in the litigation, without reference to the lower court's misstatement, recognized that fund investment performance was a *Gartenberg* factor. The higher court stated that:

> [r]egarding the "nature and quality of the services provided" [that is, the first *Gartenberg* factor] . . . the Funds at issue performed well.[8]

No SEC Intervention

The court struggles noted above raise the question why the SEC doesn't intervene in such cases to assist the courts by explaining the federal securities laws and opining on the issues raised.

The author, over the years, has informally put this question to Commissioners and Staff officials.

The Commissioners and Staff officials have answered along the following lines:

- The SEC's Office of the General Counsel follows litigation involving the federal securities laws.
- However, the SEC has limited resources and generally believes that resources are better spent on direct regulation rather than intervening in litigation that can be time-consuming and extended.
- Occasionally, a court will ask the SEC for its view, and, of course, the SEC will respond. This happened, for example, in 2001, where a federal

court asked for the SEC's view on whether a private right of action lies under Section 26(f) or 27(i) of the 1940 Act concerning variable insurance products.[9]

In the two instances of misstatements addressed above, the courts eventually reached conclusions that are consistent with the federal securities laws. These outcomes tend to support the SEC's hesitancy to spend resources to intervene in litigation to correct misstatements regarding the federal securities laws.

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NOTES

1 All references below to "Section" are to Sections of the Investment Company Act of 1940.

2 Section 36(b) provides, in pertinent part with emphasis added, that

> the investment adviser of a registered investment company shall be deemed to have a fiduciary duty with respect to the receipt of compensation for services, or of payments of a material nature, paid by such registered investment company, or by the security holders thereof, to such investment adviser or any affiliated person of such investment adviser. *An action may be brought under this subsection by* the Commission, or by *a security holder of such registered investment company* on behalf of such company, against such investment adviser, or any affiliated person of such investment adviser, or any other person enumerated in subsection (a) of this section who has a fiduciary duty concerning such compensation or payments, for breach of fiduciary duty in respect of such compensation or payments paid by such registered investment company or by the security holders thereof to such investment adviser or person.

3 The courts' struggle is described in Gary O. Cohen, "Fund Advisers Face Another Class of Plaintiffs Bringing Section 36(b) Lawsuits," *The Investment Lawyer*, Vol 27, No. 3 at 34 (March 2020).

4 Am. Chem. & Equip., Inc. 401(k) Ret. Plan v. Principal Mgmt. Corp, Nos. 16-1576, 16-1580, and 16-1712, 864 F.3d 859 at 865 (8th Cir. July 24, 2017) (emphasis added).

5 *Id.*

6 The courts have held that the standard for assessing whether an investment adviser has breached its fiduciary duty regarding receipt of compensation for services is whether the investment adviser has charged "a fee that is so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been the product of arm's length bargaining." Jones v. Harris Assocs., L.P., 559 U.S. 335, 338 (2010), available at *https://supreme.justia.com/cases/federal/us/559/335/* [hereinafter Jones], relying on Gartenberg v. Merrill Lynch Asset Mgmt., Inc., 694 F.2d 923 (2d Cir. 1982), available at *casetext.com/case/gartenberg-v-merrill-lynch-asset-management* [hereinafter Gartenberg].

7 Sivolella v. AXA Equitable Life Ins.Co., No. 11-cv-4194, 2016 WL 4487857 at 133 (Aug. 25, 2016) (emphasis added).

8 Sivolella v. AXA Equitable Life Ins. Co., No. 16-4241, 2018 WL 3359108 at 7 (3d Cir. July 10, 2018) (footnote omitted) ("This disposition is not an

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opinion of the full Court and pursuant to I.O.P. 5.7 does not constitute binding precedent").

9 Brief for the Amicus SEC, Olmstead v. Pruco Life Ins. Co., 383 F.3d 429 (2d Cir. 2002), available at *https://www.sec.gov/litigation/briefs/olmsted.htm*, stating at 1: The Securities and Exchange Commission submits this brief in response to the Court's request that it address the issue "whether Sections 26 and 27 of the Investment Company Act (ICA) provide private rights of action."

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