The Investment Lawyer
Covering Legal and Regulatory Issues of Asset Management
VOL. 27, NO. 3 • MARCH 2020

Fund Advisers Face Another Class of Plaintiffs Bringing Section 36(b) Lawsuits

By Gary O. Cohen

Mutual fund investment advisers, beset by mutual fund shareholder lawsuits[1] challenging investment advisory fees, face another class of plaintiffs—owners of variable annuity contracts and variable life insurance policies (insurance contract owners).

This stems from a decision of the US Court of Appeals for the Third Circuit (Third Circuit)[2] in a case where a District Court had earlier ruled[3] that an insurance contract owner had standing to sue the investment adviser of a mutual fund underlying a life insurance company separate account, even though the insurance contract owner was not a record shareholder of the fund.

In its opinion, the Third Circuit found against plaintiff's claim under Section 36(b) of the Investment Company Act of 1940 (1940 Act),[4] based on an assessment of the process that the underlying fund board followed in evaluating and approving the investment advisory agreement. The process put an insurance spin on traditional *Gartenberg* factors that could prove protective against any future Section 36(b) lawsuits brought by insurance contract owners.

SEC Two-Tier Structure

The issue of standing arises from an SEC-created two-tier structure where life insurance company separate accounts[5] invest in shares of underlying mutual funds.

Life insurance companies (life companies) allocate purchase payments for variable annuity contracts and variable life insurance policies (variable insurance contracts) to legally segregated separate accounts. The separate accounts are registered with the Securities Exchange Commission (SEC) as unit investment trust investment companies under the 1940 Act. The separate accounts and related life companies co-offer units of interests in the separate accounts, which units are registered with the SEC as securities under the Securities Act of 1933.

The life companies invest the assets of the separate accounts in shares of mutual funds (underlying funds) registered with the SEC as management, open-end investment companies, whose shares are registered with the SEC as securities.

The Investment Company Institute shows that there is a total of about 8,000 mutual funds with total net assets of more than $17.7 trillion[6] and a total of more than 1700 underlying funds with total net assets of more than $1.6 trillion.[7] So, underlying funds represent more than 21 percent of all mutual funds, and life companies account for more than 9 percent of total mutual fund assets.

Under this two-tier structure, insurance contract owners own units of interest in the separate accounts, but not shares of the underlying funds.

Issue of Standing

Section 36(b)[8] grants an express private right of action to a mutual fund shareholder to sue the fund's investment adviser for breach of its fiduciary duty in charging excessive compensation[9] for services to the fund.

The statutory language provides that "[a]n action may be brought by . . . a security holder of [a] registered investment company on behalf of such company." However, the 1940 Act does not define the term "security holder."

So, the issue raised is whether an insurance contract owner, who does not own shares of an underlying fund, is a "security holder" of an underlying fund with standing to sue under Section 36(b).[10]

The District Court in *Sivolella* ruled[11] that an insurance contract owner does have standing to sue. Plaintiff was an owner of a certificate under a group variable annuity contract issued by AXA Equitable Life Insurance Company (Equitable) suing on behalf of eight series of an underlying fund.

Equitable moved to dismiss, arguing that plaintiff was a "security holder" of the separate account, a registered investment company, but not a "security holder" of the underlying fund, which was a different registered investment company.

Equitable also argued that the two-tier structure was essentially the same as a fund-of-funds structure.

A District Court, in a fund-of-funds case involving the Principal Life Insurance Company (*Principal*), had ruled[12] that a shareholder of the top fund-of-funds did *not* have standing to sue under Section 36(b) on behalf of the underlying funds whose shares the fund-of-funds owned. The basis of that Court's ruling was that plaintiff did not own any "security" as expressly defined in the 1940 Act's definition of "security," did not own an "interest or instrument commonly known as a 'security,'" and did not own "an investment contract."[13]

The District Court in *Principal* had *originally* held[14] that plaintiff *did* have standing, because (1) the term "security holder" should be read broadly to effectuate the purposes of the 1940 Act and (2) the legislative history of Section 36(b) showed that Congress substituted the broad term "security holder" for the narrow term "shareholder."[15] The District Court flip-flopped from this position on a motion for reconsideration.

Principal was involved in a similar lawsuit a few years later. Plaintiff argued that it had standing, because (1) the advisory fee paid by the underlying funds reduced the net asset value of the fund-of-funds and (2) the SEC required disclosure of acquired fund fees and expenses. The District Court held[16] that plaintiff did not have standing, because the acquired fund fees and expenses were not compensation for services within the meaning of Section 36(b).

On appeal, plaintiff made the head-scratching argument that the fund-of-funds and the underlying funds were not "distinct companies," but rather "a single registered investment company" in which plaintiff was a "security holder," so that payment of the advisory fee by the underlying funds was payment by the fund-of-funds.[17] The Circuit Court found that the-fund-of- funds and underlying funds were "separate investment companies," so that plaintiff had no standing with the underlying funds.[18]

Plaintiff also argued that a ruling of no standing would render the investment advisory fees immune from any challenge under Section 36(b). But the Circuit Court said that there were other shareholders of the underlying fund who could sue the investment adviser.

The District Court in *Sivolella* refused to follow the holding of no standing in the fund-of-funds situation. Instead, that court found that plaintiffs had standing, because they had the "economic interest or stake"[19] in the underlying funds. They paid the advisory fee, bore the full risk of poor investment performance, and had the right to instruct Equitable how to vote the shares that the separate account owned in the underlying funds.[20]

In a later Section 36(b) lawsuit involving Great-West Life and Annuity Insurance Company, plaintiff asserted that he had standing, because fees paid

by the underlying funds "are simply passed through to the [fund-of-funds]."[21] Defendants moved to dismiss, arguing the precedent of the *Principal* decisions that a shareholder in a fund-of-funds did not have standing. Surprisingly, the District Court denied the motion to dismiss, distinguishing the *Principal* decisions on the ground that plaintiff was alleging payment by the fund-of-funds, rather than by the underlying funds.[22]

So, now there is something of a split, with a court at odds with previous *Principal* fund-of-fund decisions and consistent with the *Sivolella* decision. (*See* Sidebar.)

Protection of Section 15(c) Process

As explained above, despite the difficulties that courts have had with the SEC's two-tier and fund-of-funds structures, a District Court has ruled that insurance contract owners have standing to sue investment advisers of underlying funds, under Section 36(b), for breach of fiduciary duty based on excessive compensation.

Life companies and their affiliated investment advisers can protect themselves against these claims through the evaluation and approval process for continuing investment advisory agreements under Section 15(c) of the 1940 Act. *Sivolella* shows how that Section 15(c) process for underlying funds can differ from the process for mutual funds sold directly to the public and how life companies and affiliated investment advisers can take advantage of those differences.

In 2010, the US Supreme Court upheld[23] the six *Gartenberg* factors for determining whether a fund's investment adviser had breached its fiduciary duty under Section 36(b). The factors are: (1) nature and quality of services provided; (2) investment adviser profitability; (3) economies of scale; (4) fall-out

Standing of Variable Insurance Contract Owner to Bring Derivative Action on Behalf of Underlying Fund Against Excessive Investment Advisory Fees under Section 36(b) of the Investment Company Act of 1940

Insurance Company	**Equitable**	**Equitable**	**Principal**	**Principal**	**Great West**
Case Name	Sivolella v. AXA Equitable	Levy v. Alliance Capital Mgmt. LP	Curran v. Principal Mgmt. Corp.	Am. Chem. & Equip. v. Principal Mgmt. Corp	Obeslo v. Great-West Capital Mgmt. Co.
Date Decided	2012/2018	1998	2010/2011	2017	2018
Plaintiff	Certificate owner under group variable annuity	Individual variable annuity owner	Fund shareholder	401(k) plan shareholder	401(k) plan shareholder
Structure	Two-Tier	Two-Tier	Fund-of-Funds	Fund-of-Funds	Fund-of-Funds
Claim	Section 36(b)	Section 36(b)	Section 36(b)	Section 36(b)	Section 36(b)
Standing	Yes	Yes[1]	Yes/No[2]	No	Yes[3]
[1] Issue of standing not raised.					
[2] Court reversed itself upon reconsideration.					
[3] In the context of a motion to dismiss.					

benefits; (5) fee comparability; and (6) director independence and conscientiousness.

The District Court in *Sivolella* set out an analysis of two of the *Gartenberg* factors: (1) economies of scale and (2) fall-out benefits.

Economies of Scale

Plaintiff contended that the investment adviser had not shared economies of scale.[24]

The court looked at breakpoints and other conventional steps an investment adviser can take to share economies of scale. However, there was contradictory testimony regarding breakpoints, and consideration of other steps was inconclusive.

But the court did consider a circumstance peculiar to some variable insurance contracts, namely "*product* cap reimbursements"—a ceiling on expenses under the contract at the separate account level.[25]

The court, for *Gartenberg* purposes, looked above the underlying fund level to the life company level and the expense limitation imposed there and deemed that expense limitation to constitute the sharing of economies of scale at the underlying fund level.

Fall-Out Benefits

Plaintiff contended[26] that the board of the underlying fund had not considered three fall-out benefits.

Contract Charges.[27] The first alleged fall-out benefits were the charges that Equitable imposed under a variable insurance contract at the separate account level, such as the mortality and expense risk assumption charge, administrative charge, and surrender charge.

The court said that plaintiff had not provided any information about the contract charges. So, the court made no determination on whether they are fall-out benefits.

At the same time, the court expressed the view that variable insurance contract charges probably would not be a fall-out benefit unless an insurance contract owner bought a contract in order to participate in the *particular* underlying fund—a possibility that, in reality, is not very likely.

General Account Spread.[28] Plaintiff contended that the second fall-out benefit that the underlying fund board failed to consider was the "general account spread."

Plaintiff noted that the variable insurance contract provided a fixed benefit investment option through the life company's general account where the owner could earn a guaranteed fixed rate of interest every year. Plaintiff argued that the life company could earn a higher rate of return than that promised to the insurance contract owner and that the difference—the excess earned over the guarantee—would be retained by the life company and, therefore, was a fall-out benefit.

Equitable argued that the fixed benefit option was available only through the life company and not the underlying fund. The court agreed with Equitable, finding that the general account spread was not a fall-out benefit.

Fees to Affiliates.[29] Plaintiff contended that the third fall-out benefit that the board of the underlying fund failed to consider were the fees that the underlying fund paid to affiliates of Equitable providing services.

Plaintiff argued that a subsidiary of Equitable received sub-investment advisory fees from the underlying fund and that a subsidiary of the subsidiary received commissions for handling portfolio trades for the underlying fund.

Equitable agreed that the fees and commissions were fall-out benefits, but told the court that the underlying fund board considered them during its Section 15(c) process for evaluating and approving the sub-investment advisory agreement and administrative agreement. The court found that this was the equivalent of treating the fees and commissions as fall-out benefits.

Conclusion

Investment advisers of mutual funds underlying life company separate accounts face potential lawsuits

challenging excessive fees brought by insurance contract owners under Section 36(b). Investment advisers can find protection through the evaluation and approval process for continuing investment advisory agreements under Section 15(c). This process for underlying funds differs, in significant respects, from the process for mutual funds that sell shares directly to the public.

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NOTES

1 For a general review of Section 36(b) lawsuits with particular reference to life insurance companies, *see* Christopher E. Palmer, Michael K. Isenman, and Mac M. Laban, Mutual Funds and Advisers: Key Regulatory and Litigation Developments, ALI CLE Life Insurance Company Products 2019, Course Materials 693 (Nov. 6-8, 2019) and Jeffrey S. Puretz, Nicholas S. Di Lorenzo, Shayna Gilmore and Ari Abramovitz, Excess Litigation: Developments in Mutual Fund Fee Litigation, ALI CLE Life Insurance Company Products 2018: Featuring Current SEC, FINRA, Insurance, Tax, and ERISA Regulatory Compliance Issues, Course Materials 675 (Nov. 7-9, 2018).

2 Sivolella v. AXA Equitable Life Ins. Co., No. 16-4241, 2018 WL 3359108 (3d Cir. July 10, 2018) ("This disposition is not an opinion of the full Court and pursuant to I.O.P. 5.7 does not constitute binding precedent") [hereinafter Sivolella Circuit Court Section 36(b) Opinion], upholding Sivolella v. AXA Equitable Life Ins.Co., No. 11-cv-4194, 2016 WL 4487857 (Aug. 25, 2016) [hereinafter Sivolella District Court Section 36(b) Decision].

3 Sivolella v. AXA Equitable Life Ins. Co., No.11-cv-04194 (PGS)(DEA), 2012 WL 4464040 (D.N.J. Sept. 25, 2012) [hereinafter Sivolella District Court Standing Decision]. The issue of standing was addressed in the context of a motion to dismiss filed by Equitable against a complaint brought by Mary Ann Sivolella on July 21, 2011 and amended on November 4, 2011. Sivolella v. AXA Equitable Life Ins. Co., No. 3-11-cv-04194 PGS-DEA, 2011 WL 10501140 (D.C.N.J. Nov. 4, 2011) (amended complaint and jury demand). The District Court denied Equitable's motion to dismiss on two of three counts, and the case proceeded to trial, culminating in the District Court and Circuit Court opinions regarding Section 36(b) cited *supra* n.2.

4 All references below to "Sections" are to Sections of the 1940 Act.

5 The first separate accounts were registered as management open-end investment companies, but the life insurance industry later registered separate accounts as unit investment trusts investing in investment companies (SEC's two-tier structure).

6 Investment Company Institute, 2019 Investment Company Fact Book, at Table 1 at 192 (59th ed 2019), available at *https://www.ici.org/research/stats/factbook*.

7 *Id*. Table 58 at 249.

8 Section 36(b) provides, 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.

9 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].

10 The District Court in Sivolella addressed the issue in terms of "legal or record owner" versus "equitable or beneficial owner." Sivolella District Court Standing Decision, *supra* n.3, at 4.

11 *Id*. at 5.

12 Curran v. Principal Mgmt. Corp., No. 4:09-cv-00433 RP-CFB, 2011 WL 223872 (S.D. Iowa Jan. 24, 2011).

13 *Id*. at 3.

14 Curran v. Principal Mgmt. Corp., No 4:09-cv-00433, 2011 WL 2889752 (S.D. Iowa June 8, 2010).

15 *Id*. at 5-6.

16 Am. Chem. & Equip., Inc. 401(k) Ret. Plan v. Principal Mgmt. Corp., No. 4:14-cv-00044-JAJ, 2016 WL 7155791 (S.D. Iowa Feb 3, 2016).

17 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 864 (8th Cir. July 24, 2017).

18 *Id*.

19 Sivolella District Court Standing Decision, *supra* n.3, at 4.

20 *Id.*

21 Obeslo v. Great-West Capital Management, LLC, and Great-West Life and Annuity Ins. Co., Civil Action No. 16-cv-00230-CMA-SKC, 2018 WL 6246464 at 7 (D.C. Col. Sept. 11, 2018).

22 *Id*. at 7-8.

23 Jones, *supra* n.9.

24 The court's analysis summarized in this section is set out in the Sivolella District Court Section 36(b) Decision, *supra* n.2, at 48-51.

25 *Id.* at 50.

26 *Id.* at 51-52.

27 The court's analysis summarized in this section is set out in *id*. at 52-54.

28 The court's analysis summarized in this section is set out in *id*. at 54.

29 The court's analysis summarized in this section is set out in *id*. at 55.