

MEMO# 13401

April 11, 2001

APPEALS COURT RULING THAT SECTION 36(B) UNDER THE INVESTMENT COMPANY ACT DOES NOT PREEMPT STATE LAW

[13401] April 11, 2001 TO: CLOSED-END INVESTMENT COMPANY MEMBERS No. 12-01 DIRECTOR SERVICES COMMITTEE No. 4-01 SEC RULES MEMBERS No. 31-01 RE: APPEALS COURT RULING THAT SECTION 36(b) UNDER THE INVESTMENT COMPANY ACT DOES NOT PREEMPT STATE LAW The Court of Appeals for the Third Circuit recently found that Section 36(b) of the Investment Company Act of 1940, which creates a private right of action for breach of fiduciary duty by an investment adviser to an investment company with respect to compensation for services, does not preempt state law claims for breach of fiduciary duty and deceit.¹ The plaintiffs in this action are shareholders in seven closed-end investment companies (the "Funds"). The Funds make use of leverage to increase return to shareholders. Calculation of the advisory fee, according to the plaintiffs, created a strong financial incentive for the investment adviser to keep the Funds fully leveraged, even when it may not be in the best interest of shareholders. They allege that the conflict of interest created by the fee arrangement, as well as the issuance of preferred stock in connection with the leveraging strategy, was not disclosed. As a result, the plaintiffs claim, they were misled with respect to the advisory fees paid by the Funds. The Appeals Court's finding reverses the district court decision dismissing plaintiffs' state law claims.² The district court had concluded that the plaintiffs' claims for breach of fiduciary duty and deceit were preempted by Section 36(b) under the theory of "conflict preemption", i.e., the state laws stood as an obstacle to the realization of Congress's intent in passing the Investment Company Act. The Court of Appeals determined, however, that there was no evidence that Congress intended Section 36(b) to displace state common law actions. Neither the language of Section 36(b) itself nor the accompanying legislative history demonstrate an intent to preempt state law. The court acknowledged that the relevant history makes clear that Congress enacted Section 36(b) "because it determined that existing remedies for improper compensation arrangements were inadequate to protect mutual fund investors." Nevertheless, it concluded that the mere existence of a federal remedy does not necessarily eradicate the state law remedy or require that the federal remedy be exclusive. Accordingly, the 1 *Green v. Fund Asset Management, L.P., et al.*, No. 99-5734 (3d Cir. March 16, 2001). 2 *Green v. Fund Asset Management, L.P., et al.*, Civ. No. 97-3502 (DRD)(D.N.J.)(June 14, 1999). 2 Court of Appeals reversed the district court's grant of judgment and remanded the case to the district court. A copy of the Appeals Court opinion is attached to this memorandum. A petition for rehearing has been filed in the case. Marguerite C. Bateman Associate Counsel Attachment Note: Not all recipients receive the

attachment. To obtain a copy of the attachment to which this memo refers, please call the ICI Library at (202) 326-8304 and request the attachment for memo 13401. ICI Members may retrieve this memo and its attachment from ICINet (<http://members.ici.org>). Attachment (in .pdf format)

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