The Role of Investment Advisers in Client Class Action Claims

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What to do about class actions, settlements and related proofs of claim? This has been an issue begging for clarification for years and has been punctuated by recent class action complaints against mutual funds and their investment advisers and even more recent inquiries by the SEC's Office of Compliance Inspections and Examinations (OCIE). As we discuss, this needed clarification is not so much what *are* an adviser's responsibilities in this area, because we think an adviser should not be deemed lawfully responsible for these sorts of matters absent a contractual understanding to the contrary, but rather the desirability for advisers to clarify what role they do, or do not, play in these matters.

Class Action Lawsuits on Class Actions Settlements

In the past year, a large number of mutual fund advisers were sued in class actions alleging that the advisers failed to file claims on behalf of their funds in securities class action settlements. The complaints, filed in federal courts across the country, alleged that fund advisers and other fund fiduciaries violated their fiduciary duties to their mutual funds and their shareholders by failing to file class action claims. All the complaints are virtually identical and name mutual fund companies, individual fund directors or trustees, and fund advisers and sub-advisers as defendants. Each complaint alleges that the defendant funds held shares of companies that settled securities class action lawsuits, totaling more than 130 in the past four years, and that the funds failed to submit proofs of claim to collect settlement proceeds to which the funds (and indirectly the funds' shareholders) were entitled. The plaintiffs generally allege five causes of action and seek monetary damages, disgorgement of fees and compensation, punitive damages and attorney's fees.

The complaints ask the court to assume that the role of an adviser includes not only the authority, but the obligation, to submit proofs of claim. Citing a California district court decision (which was hardly on point),[1] the complaints allege that, "by virtue of their position as investment advisors to the Funds with complete control of Plaintiffs' investments, the Investment Advisor Defendants (and any sub-advisors and affiliates) directly owed Plaintiffs and other fund investors a fiduciary duty to act in their best interests,"[2] and that, "by failing to submit Proof of Claim forms, Defendants breached the fiduciary duty and standard of care that they owed directly to Plaintiffs and members of the Class."[3] Although the complaints cite no legal authority to support the position that an adviser's fiduciary duty encompasses the task of submitting proofs of claim, the complaints lump advisers in together with the other defendants

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and assume that such an obligation exists because "Plaintiffs entrusted Defendants to fulfill their fiduciary duties and not knowingly refuse to recover money rightfully belonging to the Fund investors at the time of settlement disbursement."[4] This position is similar to that taken by Professors James Cox and Randall Thomas in their 2002 article, discussed subsequently, which may have spurred the recent wave of lawsuits against mutual funds and their advisers.[5]

Of the 44 funds and firms targeted, at least 22 have had their cases voluntarily dismissed because the complaints were based on bad facts.[6] On June 8, a California court dismissed another of these lawsuits, finding that no private right of action exists under section 36(a) of the Investment Company Act, and refuting the plaintiffs' expansive interpretation of section 36(b). The court also dismissed the plaintiffs' state-law claims for breach of fiduciary duty, finding that such actions must be brought derivatively. Although this may signal the beginning of the end of the recent wave of class actions against large fund groups and their advisers on processing class action claims, recent inquiries by the SEC examination staff in the area still leave many advisers concerned about the lack of meaningful (let alone definitive) guidance in the area.

OCIE Enters the Fray

While mutual funds and their advisers clashed with plaintiffs lawyers on the class action settlements cases, OCIE contacted a number of advisers earlier this year, seeking information on the advisers' procedures for identifying, evaluating and pursuing legal class action claims for securities held in client accounts and related records. In these inquiries, apparently not coordinated with the staff of the SEC's Division of Investment Management, OCIE sought information on:

- The process the adviser uses to identify situations in which clients may be eligible to participate in a class action lawsuit and receive any resulting benefits, including the factors considered in deciding whether or not to participate;
- Written policies and procedures for the foregoing as well as the process for participating, filing proofs of claim, etc.; and
- The number of class action recoveries for the past two years in which the adviser's clients participated and the total amount of their recoveries, as well as the number of class action lawsuits for which clients were eligible but the adviser elected not to participate.

OCIE did not apparently ask whether the advisers had the responsibility, or indeed the authority, to act for or advise clients on these matters or whether someone else was charged with these tasks. Since its initial information request, OCIE has informed certain advisers, again, apparently without consultation with the staff of the SEC's Division of Investment Management, that they should "consider" implementing written policies and procedures relating to clients' participation in class action lawsuits, with the ominous tag line found in many OCIE letters, "we are bringing the issue to your attention for immediate corrective action."

It is easy to take potshots at OCIE for getting out ahead of the law while the courts and the Division of Investment Management try to figure it out. Part of OCIE's job is to respond quickly to emerging regulatory issues to help the industry get ahead of the curve. Yet, it is troubling when OCIE enters the fray, hinting at responsibilities of advisers that are not clearly established as a matter of law or SEC or SEC staff interpretation and are, in fact, subject to litigation in private lawsuits. To the extent that OCIE's view (and this is not clear) is that an adviser invariably has a legal responsibility to monitor for class actions involving their clients' portfolio securities and to decide whether to participate in such actions and file proofs of claim, we disagree for several reasons.

Acting on Class Actions Exceeds Typical Responsibility and Authority

The responsibility and authority for handling class actions and related claims rests with the client and does not flow down to an adviser by virtue of its appointment or being given discretionary authority unless such authority and responsibility is specifically conferred by contract. An adviser's customary mandate to manage client investments does not in-and-of itself confer on the adviser authority or responsibility for acting for the client in legal proceedings such as class actions.

Advisory agreements typically do not grant the type of broad power of attorney that would be necessary for an adviser to pursue litigation or file claims on behalf of a client in litigation. This includes submissions of proofs of claim in class action settlements that almost always include, among other provisions, a full release of claims against the defendants. Indeed, proofs of claim in class action settlements generally state that the form may only be executed by a person with the "authority to bind the person or entity on whose behalf they are acting to the Proof of Claim and Release" and, in many cases, that such authority, for example, "cannot be established by stockbrokers *only demonstrating that they have discretionary authority to trade stock in another's accounts.*"[7] Moreover, many advisory agreements expressly state (as we think they should) that the adviser is not responsible for advising or acting for clients in legal proceedings, including class actions and bankruptcies, involving securities purchased or held in client accounts. Consistent with this, and as Lemke and Lins observe in their treatise, "there is no accepted fiduciary duty [for advisers] to litigate or serve as lead plaintiff."[8]

Professors Cox and Thomas argue just the opposite in their 2002 article. The authors assert that institutional investors and their fiduciaries have an obligation to file proofs of claim in securities class actions unless they believe so doing would be futile or imprudent.[9] However, their analysis (and the analysis in their forthcoming 2005 article) seems primarily directed at the in-house managers of institutional investors and does not seek to parse the fine distinctions between the roles of different in-house and outside fiduciaries. Instead, Cox and Thomas lump all fiduciaries together and assert that anyone with a fiduciary duty to a fund, whether the fund's board or its adviser, has a duty to protect and maintain the trust's assets and, as such, submit proofs of claim. Cox and Thomas fail to address the fact that a fund's adviser is tasked only with providing investment management services and that the adviser's fiduciary duties are coextensive with this mandate. Significantly, though, they note in their forthcoming article that the vast majority of institutional investors surveyed relied on their bank custodians, not their investment advisers, to process and file proofs of claim. The remaining institutional investors surveyed had in-house departments, outside vendors or attorneys involved in the process.[10]

The need to recognize the distinct roles and responsibilities of different fiduciaries also comes up in the pension plan context. For example, the Department of Labor (DOL) has taken the position that a pension plan's "fiduciaries" (without differentiating between "named fiduciaries" and other fiduciaries, including those appointed as "investment managers") have an affirmative duty under the Employee Retirement Income Security Act of 1974 (ERISA) to determine whether the plan should serve as lead plaintiff in litigation.[11] This position does not invariably mean that this responsibility flows with the appointment of an investment manager down to an adviser responsible for making investment decisions for a plan's account. The DOL has in other contexts made clear what responsibilities flow from a plan fiduciary to an investment manager. Most notably in the proxy voting area, the DOL has stated that the "fiduciary act of managing plan assets that are shares of corporate stock includes the voting of proxies appurtenant to those shares of stock."[12] Even in this circumstance, the DOL has acknowledged that responsibility for proxy voting does not pass to an investment manager if the plan document or investment management contract expressly precludes the investment manager from voting proxies. In contrast, the DOL has not formally taken the position that the responsibility for making decisions on class actions or submitting proofs of claim invariably flows down to an investment manager.

Moreover, there is a good reason why class actions should be treated differently than proxy voting responsibilities in this regard. The voting of proxies on a company's management or other shareholder initiatives may have a direct bearing on the investment merits of a particular security. In contrast, while the initiation of a shareholder class action may be a factor an adviser might prudently consider when evaluating the investment merits of a security, issues of whether a client participates in the class action and the submission of proofs of claim do not, however, affect the analysis of whether an investment in a given security is prudent. Nor would an adviser's judgment or expertise about a security or its investment merits have any bearing on a decision by a plan fiduciary to participate in a class action or submit a proof of claim.

As discussed, proofs of claim in class action settlements generally state that the form may only be executed by a person with the authority to bind the person or entity on whose behalf they are acting. According to one large class action administrator, a claim cannot be submitted on behalf of another unless it is accompanied by a signed power of attorney or a notarized statement from the claimant indicating that the person signing the proof of claim has authority to do so. Other administrators require only that the party submitting the proof of claim certify that they have the authority to do so without any further documentation. Additionally, third party providers of class action monitoring and notification services require proof of authority, such as an executed power of attorney, before filing and executing claims.

Exceeds Current Abilities

As a general matter, advisers do not have the requisite expertise to advise clients with regard to participation in class actions,[13] but would have to subscribe to litigation monitoring services, engage outside lawyers to assist in evaluating potential claims and undertake other measures—functions far attenuated from an adviser's true job of managing client investments. The decision of whether to participate in a class action may involve facts beyond the scope of the adviser's dealings with the client, and participation in a class action is not always, as the mutual fund class action complaints presume, a prudent choice. Rather, a potential class member should first evaluate whether it is prudent to opt out of a class action. This might arise, at least theoretically, when the potential class member had direct claims against the defendants (*e.g.,* if the potential class member purchased shares in a private placement directly from the issuer) such that, if the potential class member failed to "opt" out of the class action, such direct claims would be foreclosed.

The decision to participate in a class action (or opt out) or to sign a release of claims when submitting a proof of claim may involve the exercise of legal judgment beyond the customary expertise of the adviser and touches on matters within the purview of the client. Even when an adviser is comfortable and qualified to provide advice or act for a client in these areas, they must wrestle with a variety of procedural and compliance quandaries. For example, an adviser would need to take appropriate steps to ensure that its claims notification system is accurate and reliable. In the absence of more simplified filing requirements and standardized forms, an adviser would have to establish a system to gather and compile necessary information to monitor and submit claims. Moreover, an adviser might need to determine whether the client should opt out from a class action (or has, in fact, already done so apart from the adviser), whether the client has other holdings of the securities subject to the class action that should be reflected in a proof of claim and whether the client (or another of the client's agents) is separately submitting a proof of claim in the proceeding. Many of these matters fall within the exclusive purview of the client. For example, where an institutional client receives money in a class action settlement, it is the client that should decide how such a recovery should be allocated (*e.g.,* to its current beneficial owners or to beneficial owners at the time the underlying claim arose).[14] Answers to these questions require knowledge and expertise beyond the knowledge and resources typically available to advisers. An adviser, after all, is not hired to provide legal advice, nor is it typically evaluated for its capabilities in this area.

Best Practices

Even though an adviser should not invariably be deemed to have the legal responsibility to act for a client in class actions, advisers nevertheless may wish to consider, and make clear to clients, the role they play in this area. Specifically:

1. An adviser should specify in its investment management agreement or Form ADV (or both) whether the adviser will advise or act for the client in legal proceedings, including class actions or bankruptcies, involving securities purchased or held in the client's account.
2. An adviser that specifically undertakes to provide services in these areas, should spell out the terms under which it will do so in a contract signed by the client that confers on the adviser the legal authority to submit proofs of claim on behalf of the client, obligates the client and its legal counsel to provide information and be reasonably available to consult with the adviser, and addresses such matters and fees, expenses and the standard of liability that will apply to the adviser's services. The contract should specifically disclaim any obligation on the adviser's part to provide legal services and enable the adviser to "bump" back to the client and its counsel any decision or matter the adviser deems appropriate.
3. An adviser that does not undertake to provide services in these areas, may still wish to confirm who is undertaking this responsibility for the client and receive direction from the client on whether the adviser should transmit copies of class action notices it receives to that person. In many cases, the person engaged by the client to handle class action matters should either be receiving such notices directly or be tracking the proceeding and related postings online or through outside vendors such that it should not be necessary for the adviser to forward copies of class action notices it receives. If the adviser is to forward class action notices, the adviser should make clear what level of efforts it is required to undertake (*e.g.,* commercially reasonable efforts) and seek to disclaim responsibility for reasonable delays in transmission.
4. An adviser should consider the extent to which the handling of class action claims should be reflected in its policies and procedures.
5. An adviser that undertakes to provide class action claim services, should review its insurance policies to ensure these activities are appropriately covered.

Notes

1. The plaintiffs cite McLaughlin v. Simon, 31 F. Supp. 2d 731, 737 (N.D. Cal. 1998), in which the court addressed the issue of whether a private right of action exists under Section 36 of the Investment Company Act of 1940 (Investment Company Act) for breach of a fiduciary duty in connection with a decision to not renew an investment advisory agreement.

2. Class Action Complaint for Damages at para. 27, Mutchka v. Harris (C.D. Cal. Jan. 13, 2005) [hereinafter Class Action Complaint]. Complaints filed in other jurisdictions contained virtually identical allegations.

3. *Id.* at para. 28.

4. *Id.* at para. 28.

5. James D. Cox & Randall S. Thomas, "Leaving Money on the Table: Do Institutional Investors Fail to File Claims in Securities Class Actions," 80 *Wash. U. L. Q.* 855 (2002).

6. Alison Sahoo, "Class Action Suit Loses Sting as Cases Dropped," Ignites, Mar. 24, 2005, available at *www.ignites.com*.

7. WorldCom, Inc. Securities Litigation Proof of Claim and Release (due August 26, 2005) (emphasis added); Bristol-Myers Squibb Securities Litigation Proof of Claim and Release (due January 31, 2005) (emphasis added).

8. Thomas P. Lemke & Gerald T. Lins, Regulation of Investment Advisers § 2:36, at 168 (2005 ed.); *see also* Steven W. Stone & Jennifer L. Klass, "Responsibilities of Advisers in Class Actions," *ICAA Newsl*. (Inv. Adviser Assoc., Wash., DC), Dec. 1999, at 9.

9. Cox & Thomas, *supra* n.5, at 860–867. Cox and Thomas have recently reiterated this position in the pending publication of another article addressing the same issue. *See* James D. Cox & Randall S. Thomas, "Letting Billions Slip Through Your Fingers: Empirical Evidence and Legal Implications of the Failure of Financial Institutions to Participate in Securities Class Action Settlements," 23 (unpublished manuscript), at *http://www.issproxy.com/pdf/LeavingMoneyontheTableII012805.pdf* [hereinafter Cox & Thomas, Letting Billions Slip] (stating that "[a]s we discussed in our earlier work, we believe that institutional investors have a legal duty to file claims in securities fraud class action settlements").

10. *See* Cox & Thomas, Letting Billions Slip, *supra* n.9, at 18–20.

11. Secretary of Labor's Memorandum of Law as Amicus Curiae in Support of FSBA's Motion for Appointment as Lead Plaintiff at 6–7, In re Telxon Corp., 67 F. Supp. 2d 803 (N.D. Ohio 1999).

12. DOL, Interpretive Bulletin 94-2, Interpretive Bulletin Relating to Written Statements of Investment Policy, Including Proxy Voting Policy or Guidelines (July 29, 1994), *http://www.dol.gov/dol/allcfr/Title_29/Part_2509/29CFR2509.94-2.htm.*

13. Indeed, advisers providing clients with advice on the merits of legal claims and the exercise of legal rights might be viewed as practicing law without a license.

14. Cox & Thomas, Letting Billions Slip, *supra* n.9, at 19–21 (asserting that such concerns were cited by respondents to their surveys).