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Second Circuit Affirms Dismissal of Mutual Fund Class Action, Applies SEC Guidance on Industry Concentration

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In a decision ratifying the mutual fund industry's long-standing treatment of portfolio concentration, the U.S. Court of Appeals for the Second Circuit affirmed the dismissal of a putative class action against the Sequoia Fund on September 9. In *Edwards v. Sequoia Fund, Inc.*, the shareholder-plaintiffs alleged that the Fund violated its industry concentration policy when healthcare stocks grew to comprise more than 25% of the Fund's assets in 2015, due to strong growth in the value of its holdings in Valeant Pharmaceuticals, Inc. The Fund's healthcare position grew to more than 25% due solely to increases in Valeant's share price, not because of any additional share purchases. Applying SEC guidance from 1983, the Second Circuit affirmed the trial court's holding that such "passive" increases in concentration cannot constitute a policy violation, defeating the plaintiffs' claims. The Fund is represented by a Ropes & Gray litigation team.

The Fund's policy regarding concentration of its holdings in a single industry was disclosed in its Statement of Additional Information ("SAI") on file with the SEC. It provided that the Fund would not concentrate investments in a given industry, as "concentration" may be defined in the Investment Company Act of 1940 (the "1940 Act") or in rules, regulations, guidance or interpretation published by the SEC. While neither the 1940 Act nor any rule or regulation thereunder defines "concentration," the SEC has provided guidance on concentration policies. In its 1983 release adopting Form N-1A for mutual fund registration statements, the SEC included Guidelines for Form N-1A, consisting of a compilation and adaptation of SEC releases and SEC staff positions and interpretations for use in the preparation and filing of registration statements. Guide 19 of the Guidelines stated that "investment … of more than 25 percent of the value of the [fund's] assets in any one industry represents concentration." Guide 19 went on to explain that "when securities of a given industry come to constitute more than 25 percent of the value of the registrant's assets *by reason of changes in value of either the concentrated securities or the other securities, the excess need not be sold.*"

The plaintiffs argued that Guide 19's passive increase guidance had been "rescinded" by the SEC's subsequent release in 1998 amending Form N-1A, and therefore that non-concentrating funds may not exceed 25% industry concentration under any circumstance. The Second Circuit rejected this view, concluding that the 1998 guidance incorporated by reference Guide 19's guidance allowing passive increases. The court reasoned:

> Nothing in the 1998 Guidance suggests a change in SEC policy regarding concentration such as rescinding the prior exception for passive increases. . . . If the SEC had indeed adopted such a change, non-concentrating funds would be required to constantly monitor for sudden increases and decreases in asset values, and adjust their investments in each industry to avoid exceeding the 25% threshold. It seems doubtful that the SEC would adopt such a major change without calling attention to it and without explanation.

The plaintiffs asserted their claims under a breach of contract theory, alleging that the Fund's prospectus and SAI constituted a contractual offer by the Fund to manage its investments according to the policies described therein, including the industry concentration policy. In the trial court proceedings, the U.S. District Court for the Southern District of New York rejected this contract formation theory, ruling that such mandatory disclosure documents do not form the basis for a contractual obligation. On appeal, the Second Circuit declined to take up the contract formation issue, instead affirming dismissal on the district court's alternative basis: even assuming the existence of a contract, the plaintiffs' passive-increase theory failed to show a breach of the contract, because the policy was not violated.

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The Sequoia Fund was represented in this matter by a Ropes & Gray litigation team led by partners Robert Skinner and Amy Roy. If you would like to discuss the decision or its implications, please contact Rob at 617-951-7560, Amy at 617-951-7445, or your regular Ropes & Gray contact.