

The logo for K&L GATES, featuring the text in white on an orange rectangular background.

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A blurred background image showing a grid of lights in shades of blue, purple, and yellow, resembling a digital display or data visualization.

2016 INVESTMENT MANAGEMENT CONFERENCE

Update on 36(b) Litigation

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Section 36(b) Litigation Overview

- Over 20 cases now pending
- New cases continue to be filed
- New plaintiffs' law firms appearing
- Core theories and strategies unchanged

Third Wave of Section 36(b) Cases

- Manager-of-managers cases
 - Adviser/manager contracts with fund
 - Adviser subcontracts portfolio management services
- Sub-adviser cases
 - Manager contracts to subadvise other funds
 - Fees as subadviser are lower
- Fund-of-fund cases
 - Adviser receives fees from underlying fund
 - Adviser receives “Acquired Fund Fees”
 - Adviser acts as manager of managers
- Administration fee claims

Manager-of-Manager Cases

- AXA (D.N.J)
- Hartford (D.N.J)
- ING/Voya (D. Del.)
- Russell (D. Mass.)
- SEI (E.D. Pa.)
- Harbor (N.D. Ill.)
- New York Life (D.N.J)
- Prudential (D. Md.)
- State Farm (C.D. Ill.)
- Principal (S.D. Iowa)
- Great-West (D. Col.)

Sub-adviser Cases

- BlackRock (D.N.J.)
- JP Morgan (S.D. Ohio)
- Davis (S.D.N.Y.)
- First Eagle (D. Del.)
- Calamos (S.D.N.Y.)
- Met West (C.D. Cal.)
- T. Rowe Price (N.D. Cal.)
- Harris Associates (Oakmark Funds)(N.D. Ill.)

Other “Traditional” Section 36(b) Cases

- Pimco (W.D. Wash.)
- Fiduciary Management (E.D. Wisc.)
- Prospect Capital (S.D.N.Y.)

Section 36(b) Scorecard

- Plaintiffs usually prevail on pretrial motions
 - Eight motions to dismiss denied
 - Two motions for summary judgment denied
- Cases are going to trial
 - Defendants prevail in first trial (AXA)
 - Second trial underway (Hartford)
 - Others anticipated in 2017
- Few settlements

The Gartenberg Standard

- *Gartenberg v. Merrill Lynch Asset Mgmt., Inc.*
 - To violate Section 36(b), “the adviser-manager must charge 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”
 - “[T]he test is essentially whether the fee schedule represents a charge within the range of what would have been negotiated at arm’s length in the light of all of the surrounding circumstances”
- Supreme Court adopts in *Jones v. Harris Associates LP*

Gartenberg Factors

- Consideration of “all facts in connection with the determination and receipt of such compensation,” including:
 - The nature and quality of services rendered
 - The profitability of the fund to the investment adviser
 - Economies of scale
 - Comparative fee structures
 - Fallout benefits
 - The independence of the unaffiliated directors and the care and conscientiousness with which they performed their duties
- Supreme Court endorses in *Jones v. Harris Associates*

Nature Of The Services

- You don't do very much
- What you do is largely duplicative
- What you do is the board's responsibility

Quality Of The Services

- It's not very good
 - Generally short-term performance
- Even if it's good, you're not responsible for it
- It really doesn't matter
 - Multi-fund cases have mixed performers
 - Single-fund cases have average performers

Profitability Analysis

- Total advisory fee = 100
- Total adviser costs = 60 (30 to sub-adviser)
- Profit = $\frac{100 - 60}{100} = 40\%$

Profitability Plaintiff Style – Step 1

- Total advisory fee = 100
- Sub-adviser's share of fee = 30
- Adviser's "retained" fee = 70
- Adviser's costs = 30
- Profit = $\frac{70 - 30}{70} = \frac{40}{70} = 57.1\%$

Profitability Plaintiff Style – Step 2

- Plaintiffs challenge expenses — including allocation of costs from outside the adviser
 - Total fee = 100
 - Sub-adviser fee = 30
 - Adviser’s “retained” fee = 70
 - Adviser’s costs = 10
- Profit = $\frac{70 - 10}{70} = \frac{60}{70} = 85.7\%$

Economies Of Scale

- Core staff and infrastructure constant as fund grows
- The same staff and infrastructure manage multiple funds
- The dollar numbers get very large
- Any breakpoints provide trivial benefits

Comparative Fee Structures

- Comparison of adviser fee to sub-adviser fee
- What do you do for your portion?
- “Admission” of value of services at arm’s length

Conscientiousness Of Directors/Trustees

- “House directors”
- Oversight of multiple funds
- “Conflicted counsel”
- Procedural flaws
- Papering the record
- Lack of understanding of issues

AXA Trial

- Twenty-five day trial
- Lengthy opinion (159 pages)
- Plaintiffs “failed to meet their burden to demonstrate”
 - a breach of fiduciary duty
 - actual damages
- Credibility determinations key
- Plaintiffs have moved to amend judgment

AXA Opinion – Board Independence

- Process and independence addressed conflicts
- Board “sufficiently diverse”
- Use of outside consultants
- Independent counsel
- Credibility of lead independent trustee

AXA Opinion – Adviser Services

- Court looked beyond contract terms to assess nature and quality of services
- “Enterprise risk” a valid consideration
- Funds performed at or above expectations

AXA Opinion – Profitability

- Sub-advisory fees are an “expense” not “contra revenue”
- Allocation of costs based on revenue was acceptable
- Plaintiffs’ experts inconsistent and not credible

AXA Opinion – Economies, Fallout And Fees

- Credible expert testimony demonstrated that AXA shared savings with shareholders using breakpoints, product caps, expense limitations and pricing to scale, securities lending
- Plaintiff did not prove that insurance wrapper fees, general account spreads, and fees of affiliated broker are fallout benefits
- Board appropriately considered data on comparative fees produced by Lipper

AXA Opinion – Damages

- Plaintiff did not meet burden of proof
- Comparison with “low cost” funds not credible
- No evidence services were comparable or what an arm’s-length fee would have been

AXA Opinion

- Plaintiff has asked court to amend its opinion to change findings on services and fees and to make additional findings
- Strategy appears to be to delay judgment while another case (Hartford) is tried, hoping to improve record for appeal

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