K&L GATES

2017 BOSTON INVESTMENT MANAGEMENT CONFERENCE

Registered Fund Board of Directors and Fund Governance Issues

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AGENDA

- Overview of Issues Facing Registered Fund Boards of Directors
- Valuation Developments
- Excessive Fee Litigation - Section 36(b) Suit Updates

Overview of Issues Facing Registered Fund Boards of Directors

ROLE OF A REGISTERED FUND BOARD OF DIRECTORS

- Unlike boards of operating companies, the 1940 Act and SEC rules and pronouncements assign a number of specific duties to mutual fund boards
  - Approval of advisory agreements
  - Approval of underwriting agreements
  - Approval of Independent Auditors
  - Fair valuation
- Primary purpose is to monitor and manage conflicts with outside service providers—especially the sponsoring investment adviser
- Secondary purpose is to supervise various compliance functions, such as:
  - Brokerage and soft dollars, securities lending, valuation, annual advisory contract reviews, approval of fund compliance program, and affiliated transactions

ROLE OF A REGISTERED FUND BOARD OF DIRECTORS *(CONTINUED)*

- Additional corporate duties of the board include:
  - Election of officers, approval of material service contracts, approval of share issuance, interaction with auditors and declaration of dividends
- Despite the specific duties imposed, fund boards are not expected to manage or supervise most day-to-day operations of the adviser and manager
  - Difficult balance to strike, particularly with respect to valuation

SEC REQUIREMENTS

- Board practices formally mandated by the SEC include:
  - Nomination of independent directors by independent directors
  - Annual self-assessments
  - Fair valuation of portfolio securities
  - “Independent Counsel” requirement
  - Approval of compliance policies and procedures

FIDUCIARY DUTY, BUSINESS JUDGMENT, AND THE ROLE OF INDEPENDENT DIRECTORS

- Directors must meet fiduciary standards under state law:
  - Duty of loyalty
  - Duty of care
- Business judgment rule
  - Protects the board, but requires extensive process and documentation to be effective
- Independent directors
  - Common issues regarding independence include:
    - Material business relations with the adviser
    - Relationships with subadvisers
    - Updating questionnaires

SIGNIFICANT CURRENT TOPICS

- Valuation matters
- Oversight of intermediaries and distribution payments
- Liquidity risk management
- Use of Rule 38a-1 in the examination and enforcement process

Valuation Developments

OVERVIEW

- Investment Company Act of 1940 (1940 Act) requires that mutual funds offer and redeem their shares at a price based on a fund's current NAV
- Rule 38a-1 of the 1940 Act requires funds to adopt policies for fair valuing a fund's securities, which include:
  - Monitoring for circumstances that may necessitate the use of fair value pricing
  - Establishing criteria for determining when market quotations are not reliable for a portfolio security
  - Providing methodology to determine the current fair value of a portfolio security
  - Regularly reviewing the appropriateness and accuracy of the method used for valuation

OVERVIEW *(CONTINUED)*

- Role of the board in valuation
  - Approving fund valuation policies and procedures
  - Monitoring valuation policy implementation
  - Reviewing fair valuation decisions made by valuation committees
- Valuation practices continue to be an SEC examination and enforcement priority

RECENT SEC ENFORCEMENT ACTIONS: PIMCO

- In December 2016, PIMCO entered into a settlement with the SEC to pay $20 million and retain an independent compliance consultant to review its valuation policies
- The PIMCO Total Return Bond ETF outperformed a similar bond and its benchmark index (by 477 bps) during the four months after it launched by purchasing odd lot positions of non-agency MBS that were then marked up in value by a third-party pricing vendor
- The SEC alleged that PIMCO marked up 43 non-agency MBS positions despite numerous indications that the third-party prices may not have reflected their fair value
- The SEC alleged that PIMCO's policies and procedures were not reasonably designed to address odd lot purchases, which resulted in neither the Valuation Committee nor the Pricing Committee reviewing the valuations

RECENT SEC ENFORCEMENT ACTIONS: PIMCO *(CONTINUED)*

SEC Staff Messages From PIMCO:

- Pricing service prices are not the equivalent of market prices and cannot be relied upon in the same way as market prices
- Misleading overstatements of performance played a role in the enforcement action
  - Traders were provided incentives to puff up performance through trading strategies
  - Importance of Disclosure - PIMCO's performance disclosures never mentioned the odd lot strategy
- Adviser personnel must elevate investment strategies/pricing practices that result in aberrant performance to boards for review

RECENT SEC ENFORCEMENT ACTIONS: CALVERT INVESTMENTS

- In October 2016, Calvert agreed to pay a $3.9 million penalty to the SEC and to reimburse shareholders after a civil suit with the SEC
- The settlement order alleged that Calvert relied on a third-party analytical tool and that Calvert failed to adequately monitor:
  - Prices paid for purchases of bonds
  - Values assigned by another institution that owned the bonds
  - “Other market data” not specified in the order
- The settlement order also alleged that Calvert failed to back test the prices, and that Calvert failed to reflect market transaction prices
- Calvert continued for a number of years to rely on prices that were inflated because the third-party had incorrect input data

RECENT SEC ENFORCEMENT ACTIONS: CALVERT INVESTMENTS *(CONTINUED)*

SEC Staff Messages From Calvert Investments:

- Advisers must take into account other data when valuing securities, as independent pricing services are just one data point
- Advisers must be able to document and provide proof if they ignore the price of a market trade because it was a "distressed sale"
- SEC Staff may object to the settlement of a mispricing claim that does not involve recalculation of NAV and payments to affected individual shareholders

Excessive Fee Litigation - Section 36(b) Suit Updates

SECTION 36(b) DESIGNED TO ADDRESS EXCESSIVE FEE CONCERNS

- Less than arm's-length relationship
- Existing fund governance not effective
- Market not effective
- Shareholders tend not to move
- State corporate law ineffective
- Difficult substantive standard
- Demand required

OVERVIEW OF SECTION 36(b)

- For purposes of this subsection, 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.
- The Result:
  - Fiduciary duty of adviser
  - Fiduciary standard of compensation
    - Fiduciary may not charge an “excessive” fee
    - Fee must have the “earmarks of an arm’s-length bargain”

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
  - Fall-out 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*

SECTION 36(b) LITIGATION OVERVIEW

- Approximately seven cases now pending (twenty total cases have been filed)
- Defendant investment advisers are increasingly either winning suits or settling with plaintiffs
- Legislative interest in 2017
  - Financial CHOICE Act would have heightened pleading standards and the burden of proof for plaintiffs in 36(b) litigation (the bill is currently in hearings)

CURRENT WAVE OF SECTION 36(b) CASES

- Traditional 36(b) cases (approximately 1 currently in process)
- Manager of managers cases (approximately 1 currently in process)
  - Adviser/manager contracts with fund
  - Adviser subcontracts portfolio management services
- Subadviser cases (approximately 3 currently in process)
  - Manager contracts to sub-advise other funds
  - Fees as subadviser are lower
- Fund of fund cases (approximately 2 currently in process)
  - Adviser receives fees from underlying fund
  - Adviser receives “Acquired Fund Fees”
  - Adviser acts as manager of managers
- Administration fee claims

SECTION 36(b) SCORECARD

- Defendants are increasingly prevailing on pretrial motions and standing grounds
  - Defendants won three cases in 2016 and 2017:
    - *Sivolella v. AXA Equitable Life Insurance Company* (dismissed with prejudice, appeal in progress)
    - *Kasilag v. Hartford Investment Financial Services, LLC*
    - *American Chemicals & Equipment 401K Retirement Plan v. Principal Management Corporation*
- Increasing number of settlements
  - Four voluntary dismissals in 2017
    - Including *Kennis Trust v. First Eagle Investment Management, LLC* (voluntarily dismissed with prejudice)

NOTABLE RECENT SECTION 36(b) ACTIONS

- *Kennis Trust v. First Eagle Investment Management, LLC* (voluntarily dismissed with prejudice on August 9, 2017)
  - Plaintiffs alleged in 2014 that First Eagle charged excessive advisory fees compared to the fees it charged to provide similar services as a subadviser for other mutual funds
  - Plaintiffs stipulated to a dismissal with prejudice after reviewing 750,000 pages of First Eagle's documents during the discovery process
- *Sivolella v. AXA Equitable Life Insurance Company* (class action suit dismissed with prejudice on August 25, 2016; appealed)
  - Plaintiffs alleged in 2011 that AXA charged excessive fees for management and administrative duties and then delegated the duties to subadvisers for nominal fees
  - After a bench trial, the judge dismissed the case with prejudice based on the lack of credibility of expert witnesses and lack of testimony by Plaintiffs

SECTION 36(b) DEFENSE STRATEGY

- Focus on the “fee as a whole”
  - Are the shareholders paying a fair or reasonable price for what they are receiving notwithstanding how fee is divided?
- Overall profitability
  - Is profit appropriate in light of risks borne by adviser?
- Integrity of 15(c) process
  - How much do directors see?
  - How robust is the 15(c) process?
- Focus on independent directors
  - Can they explain their decision as an appropriate judgment?
  - Understanding the issues
  - Oversight of multiple funds

SECTION 36(b) DEFENSE STRATEGY *(CONTINUED)*

- Business judgment of independent directors
  - Were they informed?
  - Did they act in good faith?
  - Is the decision reasonable?
- Preparation starts with process
- Back to *Gartenberg*
  - Reasonable relation to services rendered
  - Within the range of negotiated fees


Questions?