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2018 INVESTMENT MANAGEMENT CONFERENCE

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Current Topics in Investment Management Litigation

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TOPICS FOR TODAY

- Litigation Under Section 36(b) of the Investment Company Act
- “Proprietary Funds” ERISA Litigation
- Developments Under The Securities Litigation Uniform Standards Act (“SLUSA”)

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LITIGATION UNDER SECTION 36(b) OF THE INVESTMENT COMPANY ACT

THE RIGHT OF ACTION UNDER SECTION 36(b) OF THE INVESTMENT COMPANY ACT OF 1940

- Section 36(b) of the ICA imposes upon an investment adviser a fiduciary duty "with respect to…[its]…receipt of compensation for services, or of payments of a material nature" made by a registered investment company
- Standard: to incur liability, "an investment adviser 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." *Jones v. Harris Assocs. L.P.*, 559 U.S. 335, 346 (2010)
- *Gartenberg* factors

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THE RECENT WAVE OF SECTION 36(b) CASES

- 2010-Present: suits involving 26 funds groups have been brought under Section 36(b)
  - Vast majority of cases were brought by just 5 law firms (some of which collaborate)
  - Interlopers have been more active in recent years
- Filings peaked in 2014-2015
  - Only 2 new cases filed in 2017-2018

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THE RECENT WAVE OF SECTION 36(b) CASES (cont'd)

- Manager-of-Managers
  - Adviser contracts with fund
  - Adviser utilizes a subadviser for portfolio management services
  - Plaintiffs focus only on the portion of the advisory fee "retained" by the adviser after payment of subadvisory expense; plaintiffs contend that this "retained fee" is excessive in light of the services performed by the adviser itself
  - Plaintiffs re-compute adviser's profit margin by excluding from the calculation the revenue and expense attributable to subadvisory services

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THE RECENT WAVE OF SECTION 36(b) CASES (cont'd)

- Manager-As-Subadviser
  - Adviser contracts to subadvise other, unrelated funds
  - Fees received as subadviser are lower than advisory fees at issue
  - Plaintiffs contend that the subadvisory fee represents the "true value" of services
- More "traditional" *Gartenberg* factor-focused cases

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OVERVIEW OF SECTION 36(b) LITIGATION IN THE AFTERMATH OF THE *SIVOLELLA* RULING

- On August 25, 2016, following a 25-day bench trial, the District of New Jersey entered judgment for the defendant in *Sivollea v. AXA Equitable Life Ins. Co.*, subsequently affirmed by the Third Circuit Court of Appeals in a "non-precedential" opinion (*Sivolella v. AXA Equitable Life Ins. Co.* (3d Cir. July 10, 2018)
- Since the ruling in *Sivolella*, numerous rulings have come down, some at each critical stage of litigation
- Case law has turned decidedly against plaintiffs in the manager-of-managers and manager-as-subadvisor cases that fueled the explosion in Section 36(b) litigation

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OVERVIEW OF SECTION 36(b) LITIGATION IN THE AFTERMATH OF THE *SIVOLELLA* RULING

- Court rulings have placed increasing reliance on Board decision-making
- Flood of case filings has slowed to a trickle
- Plaintiffs have begun taking voluntary dismissals of actions, or foregoing the right to appeal adverse decisions

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RECENT RULINGS ON MOTIONS TO DISMISS

- Historically plaintiffs have, with rare exception, prevailed at the motion to dismiss stage due to the relatively low pleading standard applicable to Section 36(b) claims. But that is changing . . . .
  - Two post-*Sivolella* decisions denied motions to dismiss based, in part, on allegations that advisers performed only minimal services or performed essentially the same services, for lower fees, when serving as a subadviser:
    - *Zoidis v. T. Rowe Price Assoc., Inc.* (D. Md. Mar. 31, 2017)
    - *Ingenhutt v. State Farm Inv. Mgmt Corp.* (C.D. Ill. April 18, 2017)

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RECENT RULINGS ON MOTIONS TO DISMISS (cont'd)

- But two of the four motions to dismiss that have been decided since *Sivolella* have resulted in *dismissals* where the plaintiffs' fee comparisons showed that the challenged fees were within a range that could have been negotiated at arm's-length:
  - *Paskowitz v. Prospect Capital Mgmt LP* (S.D.N.Y. January 24, 2017)
  - *Pirunduni v. JP Morgan Inv. Mgmt, Inc.* (S.D.N.Y. February 14, 2018)

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RECENT RULINGS ON SUMMARY JUDGMENT

- Until 2018, no district court had granted full summary judgment in a Section 36(b) case since the district court decisions in *Jones v. Harris Associates* (N.D. Ill. Feb. 27, 2007) and *Gallus v. Ameriprise Financial, Inc*. (D. Minn. July 10, 2007)
  - Following the denial of summary judgment in *Sivolella*, summary judgment also was denied in *Kennis v. Metropolitan West Asset Management, LLC* (C.D. Cal. Sept. 22, 2017), a manager-as-subadviser case

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RECENT RULINGS ON SUMMARY JUDGMENT

- Summary judgment rulings have begun to change the dynamic in Section 36(b) litigation
  - In *Goodman v. J.P. Morgan Investment Mgmt, Inc.* (S.D. Ohio Mar. 9, 2018), the court granted summary judgment for the defendant in a manager-as-subadviser case
  - In *Zehrer v. Harbor Capital Advisors, Inc.* (N.D. Ill. Mar. 13, 2018), the court granted summary judgment for the defendant in a manager-of-managers case
  - In *Redus-Tarchis v. New York Life Inv. Mgmt, LLC* (D.N.J. Oct. 10, 2018), the court granted summary judgment for the defendant in another manager-of-managers case
  - In *In re BlackRock Mutual Funds Advisory Fee Litig.* (D.N.J. June 13, 2018) and *Chill v. Calamos Advisors LLC* (S.D.N.Y. Oct. 10, 2018), court granted partial summary judgment for the defendants in manager-as-subadviser cases

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POST-*SIVOLELLA* TRIALS

- *Kasilag v. Hartford Inv. Fin. Services, Inc.* (D.N.J. Feb. 28, 2017):
  - Following a four day trial, the court issued a *70 page* opinion finding for the defendant adviser in a manager-of-managers case, subsequently affirmed by the Third Circuit in a "non-precedential" opinion (*Kasilag v. Hartford Inv. Fin. Services, Inc.* (3d Cir. Aug. 15, 2018))
- *In Re BlackRock Mutual Funds Advisory Fee Litig*. (D.N.J.) trial recently concluded
  - 8-day trial
  - Post-trial briefing underway
- *Chill v. Calamos Advisors LLC* (S.D.N.Y.) to commence trial this month
  - Issues limited to comparative fee structures, profitability, nature and quality of services, and conscientiousness and care of the Trustees' evaluation of the advisory fees

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“PROPRIETARY FUNDS” ERISA LITIGATION

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FIDUCIARY DUTY CLASS ACTIONS

- In May 2015, the Supreme Court decided *Tibble v. Edison Int'l*, adopting a broad interpretation of the duties owed by Plan fiduciaries
- Since *Tibble*, there has been a large number of ERISA suits filed against Plan sponsors, administrators, and recordkeepers
  - In particular starting in 2016, there has been a significant increase in ERISA suits involving proprietary funds of financial services companies

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WHO REPRESENTS PLAINTIFFS

- Law firm driven putative class actions
- Common players: Schlichter, Bogard & Denton LLP; Nichols Kastor, PLLP; McTigue Law LLP; Bailey & Glasser, LLP
- 2010 to present: 33 “proprietary funds” lawsuits filed, involving 31 adviser-related entities
  - Most of these have been filed in the past three years

WHO IS A FIDUCIARY?

- Anyone who:
  - exercises discretionary authority or control over Plan or assets
  - renders investment advice for a fee or other compensation, direct or indirect, with respect to any moneys or other property of such Plan, or has any authority or responsibility to do so, or
  - has any discretionary authority or discretionary responsibility in the administration of such Plan

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INVESTMENT MANAGERS AS FIDUCIARIES

- ERISA Sections 3(21)(B) & 401(b)(1)
  - Operate to excludes mutual fund advisers from definition of Plan fiduciary in most instances where Plan owns shares in mutual fund
- No equivalent exclusion where adviser manages funds in separate account or CIT
- No exclusion where adviser or other fund affiliate is sued in its capacity as an employer sponsor of a plan for its own employees

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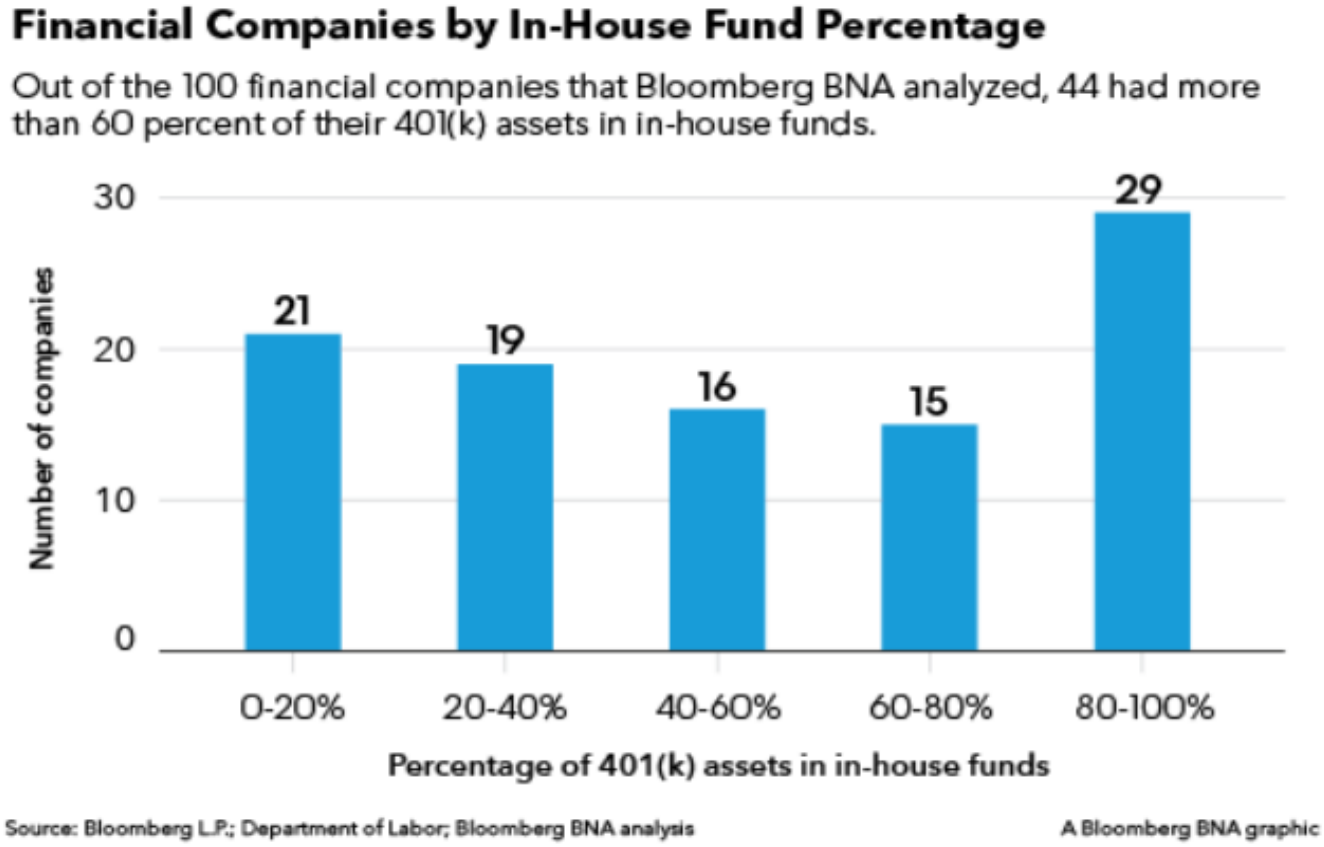
INVESTMENT MANAGERS AS FIDUCIARIES



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FIDUCIARY DUTIES

- Duty of Care
  - *Tibble v. Edison Int'l*: "trustee has a continuing duty to monitor trust investments and remove imprudent ones"
- Duty of Loyalty
  - Must discharge duties solely in the interest of participants and beneficiaries
  - Prohibited self-dealing transactions

FIDUCIARY DUTIES

- Standard:
  - Whether a prudent fiduciary in like circumstances would have acted differently
- Application:
  - To show prudent fiduciary would have selected different funds based on the cost or performance of the selected fund, a plaintiff must point to a meaningful benchmark for comparison
  - Not enough to allege that cheaper alternative investments exist in the marketplace

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COMMON ALLEGATIONS – PERFORMANCE

- Proprietary funds that have few other investors outside the 401(k) Plan--alleged to be a way to provide “seed money” for new investment funds
- High-fee proprietary index funds
- Offering proprietary funds to the exclusion of all competitor funds
- 401(k) plans that offer in-house funds not offered by any other large retirement plan
- Excessive administration or recordkeeping fees
- Failure to rebate revenue-sharing payments in a manner consistent with rebates paid to non-affiliated plans
- Failure to put recordkeeping out to bid periodically

SCORECARD

- Pleading challenges overwhelmingly unsuccessful in post-2016 wave
- Plaintiffs have won hundreds of millions of dollars in settlements over the last decade, ranging from $5 million to over $30 million
- Eighth Circuit recently affirmed a dismissal
- First trial judgment in defendants' favor
  - BUT it was recently vacated in part and remanded for trial on breach, loss, and causation

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RECENT DEVELOPMENTS

- *Patterson v. Capital Group Cos*., 2018 WL 748104 (C.D. Cal. Jan. 23, 2018)
  - Motion to dismiss granted in part because plaintiff had actual knowledge of prohibited transaction claims outside of the three year statute of limitations period
- *Meiners v. Wells Fargo & Co*., 898 F.3d 820 (8th Cir. Aug. 3, 2018)
  - District court correct in determining that Vanguard fund's performance was not a meaningful benchmark and in recognizing a "potential pattern of plaintiffs trying to convert failure to invest in Vanguard without more, into a breach of fiduciary duty"

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RECENT DEVELOPMENTS

- *Brotherston v. Putnam Investments, LLC*, 2018 WL 4958829 (Oct. 15, 2018 1st Cir.)
  - Vacated dismissal of plaintiff's breach of fiduciary duty claim and remanded for trial on:
    - Whether defendant breached the duty of prudence;
    - Whether plaintiffs have shown a loss to the Plan; and
    - Whether defendant can meet its burden by showing loss would have occurred even if defendant had been prudent in its selection and monitoring procedures
  - Recognized Circuit split on causation burden:
    - Fourth, Fifth, Eighth and (now) First Circuits: Burden shift
    - Sixth, Ninth, Tenth and Eleventh Circuits: Plaintiff's burden

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DEVELOPMENTS UNDER SECURITIES LITIGATION UNIFORM STANDARDS ACT OF 1998

THE SECURITIES LITIGATION UNIFORM STANDARDS ACT OF 1998 ("SLUSA")

- Legislative response to the significant trend of plaintiffs' attorneys shifting securities class actions from federal to state court
- Prohibits class action claims involving 50 or more persons from being brought based on state law if the claim involves misrepresentation in connection with the purchase or sale of a publicly traded security
- SLUSA mandates removal and immediate dismissal of an action when certain prerequisites are met

CYAN, INC. V. BEAVER CNTY. EMPLOYEES RETIRE. FUND

- In 2017, the Supreme Court made clear that SLUSA does not prohibit state courts from hearing class actions exclusively alleging violations of the ‘33 Act
- SLUSA does not authorize removing these cases from state to federal court
  - State and federal courts have concurrent jurisdiction over ‘33 Act claims

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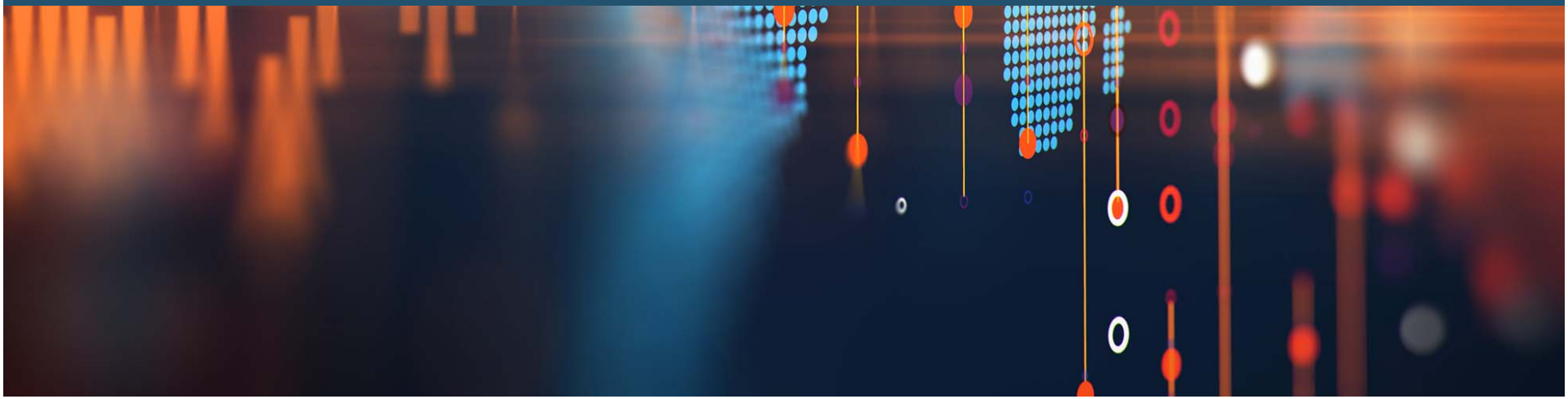
CYAN LEAVES UNRESOLVED QUESTION OF WHETHER ACTIONS ALLEGING '33 ACT CLAIMS ARE REMOVABLE

- *Coffey v. Ripple*, 2018 WL 3812076 (N.D. Cal. Aug. 10, 2018)
  - Held '33 Act class actions not involving nationally traded securities, but including both state law and '33 Act claims in the same complaint, can be removed under CAFA

Questions?



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