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Enhancing the Investment Advisory Contract Review Process Can Mitigate Recent Increased Litigation and Enforcement Risk of Sub-Advised Funds

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The US Securities and Exchange Commission (SEC) Staff has made it clear that it intends to focus its examination and enforcement efforts on mutual fund fees and expenses as part of a new mutual fund fee initiative, and it has rolled out new analytics designed to help it identify outlier funds for further investigation.[1] At the same time, the plaintiffs' class action bar is pursuing a new theory of liability against sponsors of sub-advised funds, alleging that they receive a disproportionately large portion of the investment advisory fee while the sub-adviser purportedly does most of the work.[2] In light of these developments, mutual fund boards and management companies should review and consider ways to enhance their investment advisory contract approval process pursuant to Section 15(c) of the Investment Company Act of 1940, as amended (the Act). This article will review these recent developments and discuss strategies to enhance the Section 15(c) process.

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Recent Litigation Focus on Sub-Advised Funds

Both the SEC and private plaintiffs' bar have focused recently on sub-advised fund fees. The SEC brought an enforcement action last year against an investment adviser that hired a sub-adviser to help it manage a Malaysian sector fund.[3] The Malaysian-based sub-adviser was supposed to provide various management and research services to the adviser. The SEC alleged that the adviser represented to the board that the sub-adviser was providing services to the fund and recommended that the board approve the sub-advisory contract, even though the sub-adviser provided no real services to the fund. The fund continued to pay the sub-adviser based on the adviser's recommendations for a period of 11 years. The SEC's enforcement action alleged violations of Section 15(c) and other provisions, but not Section 36(b).

While this case involved unusual facts, it received widespread attention as the SEC's first salvo in its much publicized mutual fund fee initiative. The SEC's strategy of focusing on a deficiency in the contract renewal process (a misrepresentation to the board by the adviser) may present a blueprint for its future efforts in this area. By suing to enforce the procedural and disclosure requirements under Section 15(c), the SEC may avoid the heavy evidentiary burden required in Section 36(b) actions under the *Gartenberg*[4] standard and significantly improve its chances of success in litigation.

The SEC has brought only two cases under Section 36(b) since its enactment by Congress in 1970, and both cases occurred over thirty years ago. One of the two cases involved a sub-advised fund in which the investment adviser allegedly paid the sub-adviser approximately six percent of the investment advisory fee, while keeping approximately 94 percent of the investment advisory fee for itself.[5] The SEC alleged that the fee was excessive in light of the fact that the sub-adviser performed most of the advisory services provided to the fund. Given the growth in popularity of sub-advised fund structures since the *American Birthright Trust* case, it would not be surprising if the SEC were to renew its enforcement efforts in this area as it prosecutes its mutual fund fee initiative. In some of the recently filed class actions, plaintiffs have alleged fee splits between the investment adviser and sub-adviser that, while not as favorable to the adviser as those in the *American Birthright Trust* case, were weighted in favor of the adviser.

Case law suggests that if the SEC can find deficiencies in the 15(c) process that undermine the ability of the board to properly evaluate the advisory contract, courts may be less inclined to defer to the business judgment of the mutual fund board.[6] Still, recent cases have held that a process deficiency by itself would not give rise to liability under Section 36(b), absent an excessive fee.[7] A fact pattern combining a process deficiency with "outlier" fees may thus present the most attractive case to bring from an SEC enforcement perspective.

The SEC is not constrained by the same economic forces that drive the litigation strategies of private plaintiffs' firms. It can bring cases against smaller mutual funds and fund families that the plaintiffs' bar has been reluctant to pursue because of the relatively small potential recovery. Unlike the private plaintiffs' bar, the SEC through its examination power has the capability to assess the adequacy of a potential defendant's 15(c) process, and thus the strength of its case, before it even files a complaint. The SEC may thus be better positioned to focus on fees of smaller funds that have previously avoided scrutiny by the private plaintiffs' bar. A recent academic study has suggested that regulators should focus more on smaller fund families for this very reason, and because in the author's view, smaller fund families have disproportionately higher fees than larger fund families, even though the latter are far more likely to be sued under Section 36(b).[8] Smaller fund families may therefore be at higher risk now than ever before.

Some boards of sub-advised funds may assess the reasonableness of the investment advisory fee from the standpoint of the total package of services provided to the fund, without giving much consideration to the fee split between the adviser and sub-adviser.

Under this approach, board approval turns on the reasonableness of the overall investment advisory fee in light of all of the services provided to the fund. It is not clear whether, as a legal matter, a board is required to devote attention to the question of the reasonableness of the fee split between the adviser and sub-adviser, which is a matter negotiated at arms' length between two parties to whom the board owes no duty. The language of Section 36(b), while broad, provides no definitive answer.[9] Plaintiffs or the SEC may argue that Section 36(b) imposes liability on an investment adviser that retains an outsize portion of the fee and performs insufficient services to justify that fee, even when the overall fee paid by the fund is reasonable in light of all of the services rendered by the adviser and sub-adviser together. Although no court we are aware of has interpreted Section 36(b) in this manner, it is possible that one might in the future.

Plaintiffs often combine their allegations of an excessive fee split between the adviser and sub-adviser with allegations that the overall fee itself was disproportionately large, or that the portion of the fee retained by the adviser was excessive because it was the result of economies of scale that should have been passed along to the shareholders. In order to avoid putting a court in the position of having to decide this legal issue, advisers should structure their 15(c) presentations to disprove the plaintiffs' primary factual premise: that the investment adviser performs little or no services in connection with the fee that it receives.

Investment advisers in fact perform a variety of functions in the course of overseeing sub-advisers. These services may include researching and selecting the sub-advisers; performing due diligence on the sub-advisers from an investment process, operational and compliance perspective; portfolio construction (that is, combining multiple sub-advisers, and allocating fund assets among them, in a manner designed to serve fund investment objectives); monitoring their ongoing performance; ensuring compliance with the investment objectives of the fund and consistency with the funds' disclosures; oversight of third party service providers; and reporting to the fund board, to name a few. If the investment advisory contract does not clearly delineate the responsibilities of the investment adviser, however, an adviser that finds itself in litigation under Section 36(b) may be left with an ambiguous record. If the description of services to be performed under the advisory contract is brief or vague, and does not reflect the reality of the work being performed by the adviser, the adviser should consider ways it can clarify the work it performs pursuant to its advisory contract.

There are several ways to improve the record when an investment advisory contract does not clearly delineate the responsibilities of adviser and sub-adviser. One way would be for management to clearly specify (for example, in the Section 15(c) meeting board materials) for the board the various services it actually performs for the funds, and differentiate these services from those performed by the sub-adviser. Another approach would be to amend the investment advisory agreement to specify the responsibilities of the investment adviser. Before undertaking such an amendment, however, it would be necessary to determine whether the amendment would be material and require a shareholder vote under Section 15(a). The SEC has distinguished amendments that involve an actual reallocation of functions as between the adviser and sub-adviser from other amendments which it has deemed to be non-material, such as a reallocation of fees between an adviser and sub-adviser where the overall investment advisory fee paid by shareholders does not increase.[10]

Enhancing the Contract Approval Process

Management and boards should consider ways that they can improve upon their process and address some of the concerns raised by the SEC and plaintiffs' bar about mutual fund fees in general and sub-advised fund fees in particular. The need for process improvements will vary from one fund group to another, and the suggestions discussed below will not be applicable to all fund groups. The case law under Section 36(b) and SEC disclosure rules in this area provide a framework for considering how to improve the 15(c) process.

Care and Conscientiousness of the Board

Both *Gartenberg* and *Jones v. Harris* focused on the role of the board, the care and conscientiousness with which the directors approached the contract review process, and their independence.[11] Section 36(b) itself states that in any action brought under that section, "approval by the board of directors of such investment company of such compensation or payments … shall be given such consideration as is deemed appropriate under all the circumstances."[12] Courts and the SEC are most likely to defer to the business judgment of boards where the record demonstrates that a thorough review process took place, the board reviewed all of the information necessary to evaluate the investment advisory contract, and the board asked relevant questions and received meaningful responses from management.

In *Jones v. Harris*, the court suggested that the degree of deference given by courts to board approval of the investment advisory contract will vary depending on the circumstances of a given case.[13] The Ninth Circuit applied this concept of a "sliding scale" of judicial deference in litigation under Section 36(b) in *Jelinek v. Capital Research and Management Co*.[14] The court noted that the district court had appropriately given the directors' approval "less deference than it would have given if they had diligently performed their 'watchdog' role."[15] It also agreed with the district court that the lack of conscientiousness was "not sufficient to rebut the substantial evidence that overall the conduct of the directors met the *Gartenberg* standard[.]"[16]

Section 15(c) places an affirmative obligation on the part of the board to request and evaluate such information as may reasonably be necessary to evaluate the terms of the investment advisory contract and requires that the investment adviser furnish such information to the board.[17] Boards typically fulfill their obligation in a written request prepared by board or fund counsel addressed to the management company. Boards should review this letter with counsel to make sure that their request is well-crafted to capture all of the relevant information based on each fund's particular circumstances. Boards and counsel should update the request to reflect developments during the year, including any performance, compliance or asset flow issues with particular funds. If the board of a sub-advised fund does not clearly understand the allocation of responsibilities between the investment adviser and the sub-adviser, they should ask the adviser for clarification.

Boards and management should consider the best way for their fund group to structure their 15(c) meetings, given the complexity of review and time and resource constraints on directors and management. For some fund groups, a single meeting may be sufficient, but other groups may prefer to spread the process over two or more meetings to allow for a more thorough discussion of issues requiring in-depth analysis. Having two meetings may be advantageous because it allows the board to ask follow up questions based on information it receives in the first meeting, and gives management sufficient time to provide well researched answers at the second meeting, at which time they can seek approval from the board. Another option is to create a contract review committee of the board that meets throughout the year and is able to delve more deeply into substantive questions. Other fund groups may allocate among the directors responsibility for more focused attention on particular funds, assigning each director responsibility for reporting on several funds at the contract approval meeting. This facilitates a greater focus on issues with individual funds, and can be an effective way of demonstrating diligence in a group with a large number of funds.

The independent directors should make sure the agenda for the meeting includes ample time to meet among themselves with their counsel to review management's presentation and identify issues for further inquiry. They should also make sure that they receive the board materials well in advance of the meeting to allow for a thorough review. The board should have a process for asking questions and communicating them to management through a single point of contact, such as a lead independent trustee or independent trustees' counsel.

Management can enhance the board's effectiveness by proactively identifying issues and raising them with the board. The *Gartenberg* standard calls for a multi-factor analysis: some factors are quantitative (performance, expenses, profitability, economies of scale), and others are qualitative (nature and quality of the services rendered, care and conscientiousness of the board). If the management company knows that a fund has challenges under one or more of the quantitative factors, for example comparatively high expenses relative to peers combined with poor relative performance, it should bring that to the attention of the board and provide an explanation that addresses the board's concerns, or it should explain what steps it is taking to address the issues. Although we do not know how the SEC plans to identify outlier funds for purposes of its mutual fund fee initiative, it is reasonable to expect that they will consider easily available quantitative metrics such as standardized performance and fund fee comparisons. Once they identify candidates for further scrutiny using publicly available information, we can expect that they will then consider more nuanced information such as profitability and economies of scale.

Nature, Extent and Quality of the Services Provided by the Adviser

Management should explain for the board how the services it performs add value to the sub-advised fund structure. If there are specific functions that the adviser performs, such as managing cash, allocating assets among multiple sub-advisers, or performing compliance testing for the portfolio, these should be explained. Management should maintain policies and procedures regarding the oversight of sub-advisers and other service providers, and keep records that demonstrate those services were actually performed during the year. This *Gartenberg* factor also gives management an opportunity to highlight for the board why shareholders choose to invest their money with the firm. Relevant information may include shareholder satisfaction surveys, industry awards, and other recognition from unbiased sources such as the media and independent mutual fund research firms such as Lipper and Morningstar.

Investment Performance of the Fund and Adviser

Boards should compare their fund's performance with that of an appropriate peer group and an appropriate benchmark. Boards often hire independent firms such as Morningstar and Lipper to prepare this information. Lipper recently looked at the question of performance of sub-advised funds compared to funds that were not sub-advised, but their conclusions were necessarily general. They found virtually no performance difference between sub-advised funds and funds that were not sub-advised, but acknowledged that given the broad viewpoint of their analysis, boards and fund companies should conduct more tailored analyses to their specific funds.[18] Lipper did note, however, that performance of sub-advised funds was strong, as reflected in their scores based on consistency of returns.[19]

Boards should focus on a comparison to a peer group specially tailored to their particular fund. The vendors that put together these peer groups are not infallible, and management should address with the board any peer funds that they believe should not be in the group and why. For example, two funds in the same peer group may have similar investment objectives, but may utilize strategies with very different risk profiles. The board and management should also consider what are the most appropriate performance time periods to consider (for example, one-, three-, five- or 10-years), based on their investment philosophy, investor time horizon, and other relevant considerations.

Costs of the Services Provided and Profitability of the Adviser

The courts have cautioned not to place too much emphasis on fund expense comparisons because mutual funds generally do not change investment advisers, and therefore competition to reduce fees may be lacking.[20] Still, this factor continues to receive attention, and a fund with higher expenses relative to peers should prompt further inquiry by the board. All else being equal, an outlier fund with higher expenses relative to peers is more likely to draw the attention of regulators and the plaintiffs' bar. Lipper recently conducted an analysis of sub-advised fund fees and expenses and concluded that the median management fee expense for sub-advised funds is generally higher than that for funds that are not sub-advised, although not significantly higher.[21]

There may be good explanations as to why a sub-advised fund may be more expensive than its peers, including the fact that high quality sub-advisers can command higher fees. Also, an investor in a sub-advised fund may be getting a better overall product, especially where the adviser is adept at researching and selecting the best sub-advisers or allocating assets among a group of sub-advisers that results in a portfolio with superior risk-adjusted performance. Management should explain to the board why higher than peer expenses are justified by superior services or better risk-adjusted performance.

In recently filed lawsuits against sub-advised funds, the plaintiffs compare the targeted fund's expenses to those of a fund offered by Vanguard. Some courts reject these comparisons as a matter of law,[22] while others reserve judgment at the motion to dismiss stage.[23] As with performance peer groups, if management believes that particular funds are not appropriately included in the expense peer group, or that relevant funds were inappropriately excluded from it, they should raise that with the board. In certain circumstances it may be appropriate for management, in consultation with the board, to create a custom peer group.

Profitability of the investment adviser has been extensively litigated in the cases since *Gartenberg*, and the courts acknowledge that cost accounting often is "an art rather than a science."[24] Cost accounting systems that management relies on for business planning and accounting purposes likely will be given more weight by courts than systems that are used solely to calculate profitability for Section 15(c) purposes. Cost allocation may be particularly challenging for investment advisory firms that are subsidiaries of larger financial services organizations. Management and the board should evaluate the cost allocation methodologies in order to satisfy themselves that cost allocations to the investment advisory business are appropriate. An internal review by the firm's accounting department may help the board understand the cost allocation process. Some firms hire outside accounting firms to perform an analysis of the cost allocation methodology.

It is also important when evaluating profitability to allocate revenues properly to the investment adviser's business. While this may be easy with respect to explicit revenue sources such as the investment advisory fee and administration fees, other sources of revenue may not be as readily apparent. Management is required to disclose and the board should evaluate any "fall-out" benefits that the adviser or its affiliates would not have earned but for the investment advisory relationship with the mutual fund.[25] For example, the courts have held that float revenue earned by investment advisory affiliates on free credit balances awaiting sweep into a money market fund should be considered as a fall out benefit of the adviser's contract with the money market fund.[26]

Extent to Which Economies of Scale Are Realized as the Fund Grows

As fund assets grow, the fund may experience economies of scale. These economies of scale ordinarily should be shared with investors, for example, through reductions in advisory fees as fund assets reach specified levels (breakpoints). The first question that needs to be answered, however, is whether the adviser is experiencing economies of scale as a fund increases in size. The courts have defined economies of scale for purposes of Section 36(b) to mean decreasing unit costs as fund assets increase in size.[27] The courts have also recognized that economies of scale that may arise in one area, such as the portfolio management function, may not arise in other areas, such as transfer agency.[28]

In order to address this *Gartenberg* factor, the adviser must determine what the appropriate drivers of cost are, and whether unit costs are actually decreasing as fund assets grow. An example of how unit costs might not decrease as fund assets grow is found in the money market fund context. If the number of accounts is increasing proportionately with the increase in fund assets, and the number of sweep transactions per account remains constant, the unit costs might not decrease if the primary driver of cost is the number of transactions in the fund. Conversely, the same fund may experience economies of scale in this area if the average account size increases as fund assets increase, because the average number of transactions per account may decrease in such a situation, leading to lower unit costs.

With respect to the portfolio management function, one would generally expect there to be economies of scale as fund assets increase. That may not always be the case, however. An example might be a fixed income fund that is forced to invest in a larger number of issuers as it grows, and that increasing number of issuers requires a larger number of research analysts to evaluate new issuers.[29] This is not an easy analysis, and like profitability, may involve as much art as science. Conducting this analysis may nonetheless be important for fund companies that experience significant asset growth. In the sub-advised model, there may be fewer opportunities for economies of scale depending on the ability of the adviser to negotiate fee reductions with the sub-adviser. Portfolio management is a variable, rather than fixed, cost.

Whether Fee Levels Reflect Economies of Scale for the Benefit of Investors

The courts have held that economies of scale can be reflected in fund fees in different ways. Breakpoints, or reductions in the investment advisory fee as assets reach specified levels, are a common way for fund managers to pass along economies of scale to investors. Alternatively, the manager may set fund fees low to begin with and not have breakpoints because the low fee incorporates economies of scale throughout the life of the fund.[30] Waivers of fees and contractual expense limitations are another way that managers may pass along economies of scale to investors. Fee waivers or expense reimbursements pursuant to contractual expense limitations are in effect a benefit that the management company provides to investors early in the fund's life, and it may be appropriate for fee levels to reflect management's ability to recoup some of that subsidy later on. The manager may pass along economies of scale to investors by increased investment in infrastructure and staffing, resulting in improved fund performance.

To the extent that the management company actually experiences economies of scale with respect to its management of a fund, it should disclose that to the board and explain how it has shared those benefits with shareholders. As discussed above, the management company can pass along these benefits to investors in a variety of ways, but given the requirements of the legal standard, management and the board should satisfy themselves that the benefits are reasonable in relation to the amount of economies of scale.

Comparable Products Analysis

Management and the board should make sure that they review the investment advisory fees of mutual funds managed by the investment adviser with any comparable products it manages. In *Jones v. Harris* the court made clear that to the extent that the nature of services provided to mutual funds is materially different from those provided to other products such as institutional managed accounts, nothing in the Act requires parity of fees between the two.[31] While the court said that lower courts should be "wary of inapt comparisons[,]" it refused to set forth a categorical rule that comparisons between mutual fund fees and institutional account fees are never relevant, and instead ruled that each case must be determined based on the facts and circumstances.[32]

The management company should identify any products that are arguably comparable and, if applicable, explain for the board how the services provided to institutional or other clients are materially different from those provided to mutual fund clients. Management companies have identified a number of differences in services and business expenses between managing retail mutual funds and institutional accounts, including: the heightened regulatory, compliance, and disclosure burdens for mutual funds; the need for managers to hire specialized personnel who are fully or substantially dedicated to mutual fund operations; the added burden of oversight of mutual fund service providers such as transfer agent, distributor, fund accountant, fund administrator, auditor and legal counsel; the greater class action litigation risk with respect to mutual funds as compared to institutional accounts; the added difficulty of managing a portfolio to be able to meet daily redemption requests from retail mutual fund investors as compared with the relatively stable asset base of institutional investors; and others.

Conclusion

While enhancing the contract renewal process will not ensure that a fund adviser or board will avoid scrutiny or litigation by the SEC or plaintiffs' attorneys, it may significantly improve the record that a court or regulator will be asked to review in the context of a lawsuit or investigation. If the board can demonstrate that it exercised appropriate diligence in evaluating all of the relevant information in approving the investment advisory contract, it will enhance the likelihood that a court or regulator will defer to the sound business judgment of the board. Management and the board should approach the process with equal care and conscientiousness, because their interests in a sound process are aligned.

Notes

1. *Investigating and Prosecuting Fraud after the Fraud Enforcement and Recovery Act: Hearing Before the S. Comm. on the Judiciary, 111th Cong.* (Sept. 22, 2010) (statement of Robert Khuzami, Director, Div. of Enforcement, SEC), available at *http://www.sec.gov/news/testimony/2010/ts092210rk.htm* (last visited Apr. 23, 2012).

2. *See, e.g.,* Sivolella v. AXA Equitable Life Ins. Co., No. 11-CV-4194(D.N.J. filed Jul. 21, 2011); Curran v. Principal Mgmt. Corp., No. 09-CV-433 (S.D. Iowa filed Oct. 28, 2009); Southworth v. Hartford Inv. Fin. Servs., LLC, No. 10-CV-878 (D. Del. Filed Oct. 14, 2010).

3. *In the Matter of Morgan Stanley Inv. Mgmt. Inc.*, Exchange Act Rel. Nos. 3315, 29862, 2011 WL 5562535 (Nov. 16, 2011).

4. Gartenberg v. Merrill Lynch Asset Mgmt., Inc., 694 F.2d 923 (2d Cir. 1982). Under the *Gartenberg* standard, a plaintiff must prove that the fee was so disproportionately large that it bore no relationship to the services rendered and could not have been the result of arms-length negotiation. Jones v. Harris Assocs. L.P., 130 S. Ct. 1418 (2010). Of the eight Section 36(b) cases that have gone to trial since *Gartenberg* was decided, defendants have prevailed in every instance.

5. SEC v. Am. Birthright Trust Mgmt. Co., No. 80-3306, 1980 WL 1479 (D.D.C. 1980).

6. *Jones*, *supra* n.4; Jelinek v. Capital Research & Mgmt. Co., No. 10-55221, 2011 WL 3701742 (9th Cir. Aug. 24, 2011) (not for publication).

7. Gallus v. Ameriprise Fin., Inc., No. 11-1091, 2012 WL 1058976 (8th Cir. Mar. 30, 2012).

8. Curtis, Quinn and Morley, John D., "An Empirical Study of Mutual Fund Excessive Fee Litigation: Do the Merits Matter?" (May 11, 2011) at 40.

9. Section 36(b) provides, in pertinent part, that:

> The investment adviser to 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. An action may be brought under this subsection by the [SEC], or by a security holder of such registered investment company on behalf of such company, against such investment adviser, or any affiliated person of such investment adviser, or any other person enumerated in subsection (a) of this section who has a fiduciary duty in respect of such compensation or payments paid by such registered investment company or by the security holders thereof to such investment adviser or person.

10. *See Am. Express Fin. Corp.*, 1998 SEC No-Action LEXIS 993 (Nov. 17, 1998).

11. *Jones*, supra n.4 (quoting *Gartenberg, supra* n.4 at 930).

12. 15 U.S.C. § 80a-35(b)(2).

13. *Jones, supra* n.4, at 1428.

14. *Jelinek*, supra n.6.

15. *Id.* at **1.

16. *Id.*

17. 15 U.S.C. § 80a-15(c).

18. Sasha Franger, "Lipper's 2011 Subadvisor Research Series - Part 2: Performance" (Nov. 2011).

19. *Id.* at 1.

20. *Jones*, *supra* n.4, at 1429.

21. Sasha Franger, "Lipper's 2011 Subadvisor Research Series - Part 1: Sub-Advisor Fees & Expenses" (Sept. 2011).

22. Amron v. Morgan Stanley Inv. Advisors, Inc., 464 F.3d 338, 345 (2d Cir. 2006).

23. Kasilag v. Hartford Inv. Fin. Servs. LLC, No. 11-1083(D.N.J. filed Sept. 13, 2011).

24. Krinsk v. Fund Asset Mgmt., Inc. 875 F.2d 404, 412 (2d Cir. 1989), *cert. denied*, 493 U.S. 919 (1989).

25. *Gartenberg*, supra n.4.

26. *Id*.

27. *Krinsk, supra* n.24; Kalish v. Franklin Advisers, Inc., 742 F. Supp. 1222, 1238-41 (S.D.N.Y. 1990), *aff'd*, 928 F.2d 590 (2d Cir. 1991), *cert. denied,* 502 U.S. 818 (1991).

28. *See Krinsk,* supra n.24.

29. *See Kalish*, *supra* n.27.

30. *Id.* at 1239.

31. *Jones*, supra n.4.

32. *Id*.

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