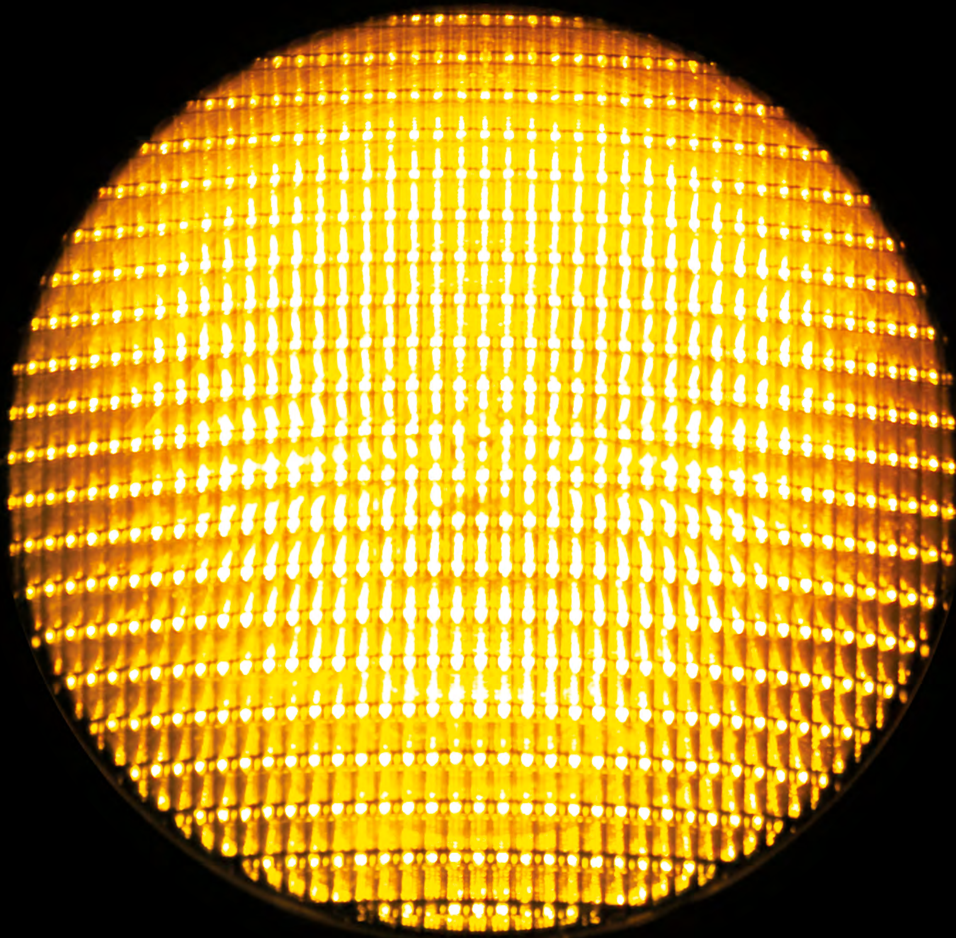

Fund Managers: Prepare for the next wave of Section 36(b) litigation and Section 15(c) enforcement

Perspectives

September 2022

Regulatory spotlight on advisory fees

As highlighted in recent comments by senior regulatory officials and industry publications[8,9], and evidenced by recently issued SEC sweep exam letters focusing on the Section 15(c) process, the Securities Exchange Commission's (SEC) Divisions of Enforcement and Examinations both appear to be magnifying their focus on mutual fund advisory fees as part of the SEC's investor protection mission.

Section 36(b) of the Investment Company Act of 1940 (the "Act") among other things, establishes a fiduciary duty on behalf of a registered adviser with respect to the receipt of compensation for services and other material payments from its registered fund clients (or its security holders) to the registered adviser or its affiliates. The Section also provides that fund shareholders or the SEC may bring suit against a registered adviser for breach of fiduciary duty relating to alleged "excessive" advisory fees being charged by a registered fund's investment adviser. Advisory fees charged pursuant to an investment advisory agreement, and certain other business arrangements that a fund's sponsor may have with a registered fund, such as acting as a principal underwriter, administrator or transfer agent, are ultimately evaluated by the fund's board, typically with the assistance of trustee counsel and other subject matter experts, during the board's annual Section 15(c) process to determine, amongst other things, whether the fiduciary standard set out in Section 36(b) are being met. During the 15(c) process, it is the responsibility of the independent directors of a registered fund to request and evaluate, and the duty of the registered adviser to provide, such information as may reasonably be necessary to evaluate the terms of any investment advisory contract.

Taken together, it is important for registered advisers, as well as registered fund boards, to confirm that they are taking the necessary steps to ensure that their Section 15(c) process is consistent with the SEC's current Section 36(b) leanings and emerging leading industry practices.

Brief case law history

Since the establishment of Section 36(b) in 1970, there have been numerous attempts (i.e., cases) by registered fund shareholders to hold registered advisers accountable for charging "excessive" advisory fees, as well as registered fund boards for approving such fees without sufficient basis. A number of these cases have offered some, albeit vague, guidance around what may constitute an "excessive" fee.

In *Jones v. Harris Associates L.P.* (2010)[1], for example, the US Supreme Court adopted the *Gartenberg*[2] test and held that an adviser does not breach its fiduciary duty by charging an "excessive" fee unless a shareholder proves that the fee 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." The *Gartenberg* test consists of the following six factors to be considered:

01 **The nature and quality of services provided to fund shareholders**

02 **The profitability of the fund to the adviser-manager**

03 **Fall-out benefits**

04 **Economies of scale**

05 **Comparative fee structures**

06 **The independence and conscientiousness of the trustees**

In both *In the Matter of Commonwealth Capital Management, et al.* (2015)[3] and *In the Matter of Kornitzer Capital Management, et al.,* (2015)[4], the SEC alleged deficiencies in the process that certain mutual funds used to renew advisory contracts with their investment advisers, as required by Section 15(c). In addition, the *Commonwealth* matter reflected the SEC naming individual board members, even where the underlying conduct did not necessarily warrant the imposition of a significant penalty.

In *Zehrer v. Harbor Capital Advisors, Inc.* (2018)[5], which was directed at least in part at a fund's board, a court rejected claims made by the plaintiff that the board was acting passively and held that "Although there is room to quibble about how little or much individual effort the trustees invested in preparation for their meetings, and whether the fees were the best that could have been negotiated, the court is not persuaded that plaintiffs' evidence is sufficient to create a triable issue of fact." In more recent years, plaintiffs have targeted manager-of-managers (i.e., excessive fees being retained by advisers based on services actually provided) and also sub-advisory arrangements (excessive fees received from an adviser's proprietary funds versus fees received in an adviser's role as sub-adviser to non-proprietary funds)[6,7].

Although there have been many cases since the enactment of Section 36(b), no plaintiff has won a single case. In a recent comment regarding Section 36(b) cases, however, an SEC representative said," if no adviser can ever lose one—and none has, so far—one wonders whether the duty enacted in the statute is truly being honored[8]." This comment (and others) may be signaling that the SEC intends to bring its own Section 36(b) actions to prevent "excessive" fees. Or perhaps, the current SEC sweep exam under Section 15(c) serves as an initial stage of a journey toward regulation via enforcement, a path that we've seen the SEC take before in related conflict of interest cases.

Key takeaways

After so many years of unsuccessful claims, it is not surprising that the SEC appears to be changing its approach on advisory fees. It is important for registered fund advisers to be on their toes and consider areas where changes may need to be made to align with current regulatory thinking and continued expected regulatory scrutiny. Fund managers should be in the process of conducting a comprehensive review on their 15(c) processes, including identifying revenue constituting fall-out benefits, tracking of allocation of expenses, and reviewing board reporting materials to determine if enhancements need to be made. Depending on the size and complexity of fund complexes, assessing for the following potential shortcomings may be appropriate:

- Lack of appropriate industry knowledge or conflicts of interest in employees or representatives with duties and/or responsibilities related to contractual relationships and fee negotiation
- Lack of transparency among sub-adviser, sub-transfer agents & intermediary payments (e.g., fees for little or no services)
- Lack of transparency or complete capture of fall-out benefits and their source
- Lack of cadence or depth in fund board self-evaluations and process related to 15(c) process
- Inadequate memorialization in minutes of discussions and/or actions taken
- Descriptions of services by adviser and sub-adviser provided to the fund board are unclear and/or inadequate
- Unclear, ambiguous, or contradictory policies and procedures
- Practices not aligned to policies and procedures
- Inconsistencies with documented allocation methodologies (e.g., expense misallocations)
- Fee schedules and allocations not administrated properly according to contracts/agreements/disclosures
- Misalignment in understanding of fee terms, fee splits, or allocations to internal to external entities
- Discrepancies in waivers/fee expense cap limits/reimbursements /recaptures
- General and administrative expenses accrued and booked improperly from an accounting, books and records and financial reporting perspective
- Unintentional disclosure omissions (i.e., offering documents)

Our experience

Deloitte's investment management and regulatory remediation team is bolstered by professionals who have a long history of serving investment management firms with process assessments to bring tangible, practical and scalable outcomes. We have helped organizations with regulatory and fund operational matters, including with board reporting and the Section 15(c) process. Our team also has extensive experience working with clients and mutual fund boards on various regulatory engagements and shareholder remediations.

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Endnotes:

1. Jones v. Harris Associates L.P., 559 U.S. 335 (2010)
2. Gartenberg v. Merrill Lynch Asset Mgmt., Inc., 694 F.2d 923, 928 (2d Cir. 1982)
3. In the Matter of Commonwealth Capital Management, et al., SEC Rel. No. IC-31678 (2015)
4. In the Matter of Kornitzer Capital Management, et al., SEC Rel. No IC-31560 (2015)
5. Zehrer v. Harbor Capital Advisors, Inc., (N.D. Ill. 2018)
6. N. Valley GI Medical Group v. Prudential Inv. LLC, No. 15-3268 (D. Md. filed Oct. 30, 2015)
7. Redus-Tarchis v. N.Y. Life Inv. Mgt., No. 14-cv-7991 (D.N.J. filed Dec. 23, 2014)
8. Remarks at the ICI Investment Management Conference. William Birdthistle. Director, Division of Investment Management (March 28, 2022)
9. Fund Critic Birdthistle to Take Reins at SEC's Division of Investment Management, Barron's, Dec. 23, 2021