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Francis J. Facciolo

*St. John's University School of Law*

Leland S. Solon

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## Sub-Adviser Fee Litigation: Will Section 36(b) Acquire Teeth?; Outside Counsel

Francis J. Facciolo and Leland S. Solon

Section 36(b) of the Investment Company Act establishes a private breach of fiduciary duty cause of action for shareholders in an investment company, or mutual fund, to challenge the fees charged by the mutual fund's investment adviser, in recognition of the fact that the adviser or one of its affiliates customarily creates the mutual fund and has a great deal of influence over the composition of the mutual fund's board of directors or trustees, which negotiates the fees paid to the investment adviser. Under the Gartenberg standard, which was substantially adopted by the Supreme Court in *Jones v. Harris Associates*, succeeding on an excessive fee claim is difficult, however, because Section 36(b) is violated only when the adviser charges 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."<sup>1</sup>

In the last several years, creative plaintiffs have looked to the fees paid by mutual funds to advisers and sub-advisers of mutual funds as a measuring tool to argue that fees are excessive. The plaintiffs have focused on the services provided to a mutual fund by the adviser and sub-advisers and have argued that the services are largely duplicative. If this is so, the logic goes, then why is the adviser paid such a large fee?

This argument gained traction in *Kasilag v. Hartford Investment Financial Services*,<sup>2</sup> where the plaintiffs survived a motion to dismiss. As we predicted in a prior article,<sup>3</sup> a large number of new Section 36(b) actions against mutual fund advisers have followed the *Kasilag* ruling, at least 11 as of today.<sup>4</sup> We based our prediction in large part on the fact that section 36(b) litigation has been characterized by the entrepreneurial activities of plaintiffs' law firms that develop legal theories that are then more broadly adopted, leading to waves of litigation each characterized by different legal theories.<sup>5</sup> This article examines the current state of this litigation, focusing in particular on two additional motions to dismiss that have been decided in plaintiffs' favor.

### Importance of the 'Spread'

Many of the lawsuits highlight the "spread" between what the defendants charged their sponsored funds, on the one hand, and what defendants paid to their sub-advisers to perform the actual investment services, on the other. In a new wrinkle, some plaintiffs have highlighted defendants who acted as sub-advisers to other, non-sponsored funds, contrasting what the defendants charged their own sponsored funds to act as investment managers with what those defendants charged independent, sophisticated parties to act as investment manager/sub-advisers to those independent funds. The spreads alleged by plaintiffs between what the defendants charge their sponsored funds for the "investment management services" and what they paid sub-advisers are summarized in the accompanying table.

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### Allegations of Spreads Between Defendants' Charges and Payments to Sub-Advisers

	Adviser Paid Sub-Adviser	Adviser Charged Fund	Spread	Spread as% Of Entire Fee
Cox v. ING Investments, LLC	\$12.1m	\$27.6m	\$15.5m	56.2%
Curd v. SEI Investments Management Corporation	\$16m	\$27m	\$11m	40.7%
Davidson v. Blackrock Advisors, LLC	\$235.2m	\$412.5m	\$177.3m	43%
Foote v. Blackrock Advisors, LLC	\$235.2m	\$412.5m	\$177.3m	43%
Fox v. Blackrock Advisors, LLC*	\$106.5m	\$144m+	\$37.6m	26.1%
McClure v. Russell Inv. Management Co.	\$57m	\$164m	\$107m	65.2%
Sanford v. AXA Equitable Funds Management	from \$1.1m to \$7.2m	from \$3m to \$22.7m	from \$263k to \$21.5m	from 109% to 2017%
Zehrer v. Harbor Capital Advisors	\$125m	\$225m	\$100.5m	44.7%

\* The four Blackrock Advisory, LLC cases were consolidated into In re Blackrock Mutual Fund Advisory Fee Litigation, Case 3:14-cv-01165-JAP-DEA, with the defendants' motion to dismiss pending as of Jan. 20, 2015.  
SOURCE: Authors

In addressing the spread, plaintiffs have compared the language in the fund advisory or investment management agreement (IMA) between the defendant and the fund with the subadvisory agreement between the defendant and the sub-adviser (or the agreement between the defendant and a third-party client, when the defendant is acting as the adviser or sub-adviser to a third party). The language in many of the advisory, IMA and sub-advisory agreements involved in the sub-adviser cases appears virtually the same, with responsibility for investment decision-making belonging to the sub-advisers.

In *Foote v. Blackrock Advisors*, for instance, the IMA between plaintiff's funds and the defendant adviser provided that the defendant adviser would "act as investment adviser for and supervise and manage the investment and reinvestment" of the funds' assets, "arrange ... for the purchase and sale of the securities," "provide investment research," and "supervise continuously the investment program" of the fund. The sub-advisory agreement between the defendant and its third-party sub-advisers was essentially the same, the plaintiff argued, as it stated in pertinent part that the sub-adviser would act "as investment adviser for and managing the investment and reinvestment of" the fund's assets "in its complete discretion," "arrang[e] ... for the purchase and sale of securities and other assets," and "provid[e] investment research and credit analysis."

With the spread as the overarching theme, the plaintiffs' complaints also typically argue, as a matter of "economies of scale," that the fee "breakpoints" that defendants offer as the size of their assets under management increase are in effect illusory and/or non-meaningful. This situation is exacerbated by the fact that, as some plaintiffs have alleged, defendants had agreed at arm's-length to act as advisers (or sub-advisers) to similar but independent third-party funds, and granted them much more beneficial fee reductions.

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The procedures followed by the board of directors or trustees of the funds who approve the defendants' compensation arrangements are also attacked in the complaints. Several plaintiffs allege, inter alia, that the directors/trustees meet only a few times every year to review and approve the IMAs for hundreds of funds, and that the directors/trustees, who often receive six-figure compensation, are not truly independent because they have an incentive to remain on good terms in order to be reappointed by these fund sponsors, who are the defendants in these sub-adviser cases.

### Denying Motion to Dismiss

In *Zehrer v. Harbor Capital Advisors*,<sup>6</sup> the plaintiff alleged that its fund adviser's fee was excessive, in light of the fact that, over the period in question, the adviser took \$225 million in advisory fees from the fund, while paying its sub-advisers \$125 million to provide the investment management services. The U.S. District Court for the Northern District of Illinois denied the adviser's motion to dismiss, remarking that "[a]lthough it is far from clear that [Terrence] Zehrer will be able to meet the high standard for liability under §36(b), he has alleged sufficient facts specific to the fees paid to Harbor Capital to survive a motion to dismiss."

The plaintiff's allegation "that a substantial portion of the tasks assigned to Harbor Capital in the Advisory Agreement are actually performed by the fund's sub-advisor, Northern Cross and that Harbor Capital's services 'are minimal compared to the day-to-day responsibilities of managing [the fund's] portfolio' performed by Northern Cross" was the first allegation cited in its main Section 12(b)(6) discussion by the court, which remarked that the adviser's counter-contention "that it retains significant responsibility for the fund's management is better suited for summary judgment."

In an immediately following footnote, the court further rejected the adviser's argument that the plaintiff's delegation claim was "clearly rebutted by the advisory agreements," asserting that "[t]he court has reviewed the agreements and believes that Zehrer's allegation that Northern Cross is responsible for almost all the investment management of the fund is not clearly rebutted by the agreements." In its main discussion that the complaint had sufficiently stated a Section 36(b) claim, the court also acknowledged the plaintiff's contention that the adviser "received 'economies of scale' benefits as the fund grew that were not passed on to the fund."

The Zehrer decision cited, among other cases, *Kasilag*, in asserting that defendant's argument that it "performed extensive services that were not delegated to the subadvisor ... was more appropriately addressed at summary judgment," as well as *Millenco v. MEVC Advisors*,<sup>7</sup> a 2002 decision that featured sub-adviser allegations but that has not been previously cited in the new wave of sub-adviser cases.

The second case that resulted in the denial of a motion to dismiss a Section 36(b) breach of fiduciary duty fee claim is a fund-of-funds case, *American Chemicals & Equipment 401(k) Retirement Plan v. Principal Management Corporation* (the ACE case), decided by the District Court for the Southern District of Iowa on Sept. 10, 2014.<sup>8</sup> There, the fund-of-funds plaintiff alleged that, in the relevant time periods, the defendant advisers charged plaintiff's funds, in addition to a three-basis-point investment management fee, a separate "acquired fund fee" (AFF) of \$120 million in 2012 and \$154 million in 2013. It was alleged that the defendants retained

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approximately two-thirds of the AFF for themselves while giving the other one-third to the underlying affiliated funds' investment advisers, which the complaint called "sub-advisers."

In denying the defendants' motion to dismiss, the court first ruled that the plaintiff satisfied Section 36(b)'s standing requirement that an action for breach of fiduciary duty for adviser's receipt of compensation for services may only be brought by a "security holder" of the investment company that paid the challenged fee. Defendants had argued that, because the fund-of-fund plaintiff was not a shareholder of any of the underlying funds, it did not meet 36(b)'s definition of "security holder," and thus lacked standing to challenge the fees of the underlying funds they invested in.

In support, they cited to a 2011 36(b) decision also featuring one of the same defendants, *Curran v. Principal Management Corporation*, No. 4:09-cv-00433, 2011 WL 223872 (S.D. Iowa Jan. 24, 2011), which held that because the fund-of-fund plaintiffs did not hold any "securities" in the underlying funds, they did not qualify as "security holder[s]" and thus were not entitled to bring claims regarding the fees charged by the underlying funds; however, the plaintiffs still had standing to challenge fees charged by the main adviser, of the fund in which they were shareholders. But the court in the ACE case rejected this argument and distinguished *Curran*, explaining: "Plaintiff alleges that the defendants, as advisers to the principal funds, first 'pocket the entire acquired fund fee from the principal funds as investment money' before distributing a portion of the fee to sub-advisers for managing the underlying funds," and thus seek "recovery only of the fees charged to plaintiff as a principal funds shareholder and kept by defendants as advisers to that fund."

Turning to the sufficiency of the complaint, the court recited the *Gartenberg/Janes* standard and remarked that "[a]t the heart of a 36(b) claim is the relationship between the fees charged to the fund and the services rendered to the fund." The court found that the plaintiff's complaint sufficiently alleged such a relationship, noting, among other allegations, plaintiff's assertions that "the sub-advisers provide virtually all daily management services to" plaintiff's funds, yet "receive only half the amount" of the AFF as defendants; and that "defendants provide no additional services beyond those for which they charge the investment management fee justifying their retention of the AFF."

The authors believe that the ACE case was incorrectly decided as an AFF is a regulatory requirement imposed by the Securities and Exchange Commission to represent the underlying expenses that a fund-of-funds pays to invest in the underlying funds in which it invests. This allows a shareholder in a fund-of-funds to understand both the indirect as well as direct expenses to which she is subject. The expenses are underlying fund expenses, not fund-of-fund expenses. This argument was raised and extensively briefed by the defendants in the ACE case in their motion to reconsider, which was denied on Dec. 2, 2014.

Regardless of whether the ACE case was correctly decided, there is now significant precedent at the motion to dismiss stage. While many defendants argue that they have not delegated many services to their sub-advisers, whether and to what extent the additional services justify the spreads will be a strong consideration in the outcome of these cases on the merits. In the authors' view, without being able to quantify the costs of such services, the defendants in those cases that rely on the additional services they provide seem unlikely to prevail, especially on a motion to dismiss. Looking forward from these motions to dismiss decisions, the next benchmark decisions to look for would be those arising from summary judgment motions, which no Section 36(b) plaintiff has

ever won.

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- <sup>1</sup> Factors to be considered include: (1) the adviser-manager's cost in providing the service, (2) the extent to which the adviser-manager realizes economies of scale as the fund grows larger, (3) the volume of orders which must be processed by the manager, as well as the nature and quality of the services provided to the fund and shareholders; (4) the profitability of the fund to the adviser; (5) any "fall-out financial benefits," those collateral benefits that accrue to the adviser because of its relationship with the mutual fund; (6) comparative fee structure (meaning a comparison of the fees with those paid by similar funds); and (7) the independence, expertise, care, and conscientiousness of the board in evaluating adviser compensation." See e.g., *Gartenberg v. Merrill Lynch Asset Management, Inc.*, 694 F.2d 923 (2d Cir. 1982); *Jones v. Harris Associates*, 130 S. Ct. 1418, 1426 (2010).
- <sup>2</sup> 2012 WL 6568409 (D.N.J. Dec. 17, 2012).
- <sup>3</sup> "New Wave of Cases Involving Investment Adviser Fees," NYLJ, Oct. 10, 2013.
- <sup>4</sup> The best source for following the ongoing litigation involving sub-adviser fees is <http://investorscoalition.com/litigation-tracker>.
- <sup>5</sup> See Quinn Curtis and John Morley, "The Flawed Mechanics of Mutual Fund Fee Litigation" at 12, available at <http://www.ssrn.com/abstract=2405307> (pointing to three prior waves of section 36(b) litigation involving, respectively, two South Carolina law firms, Milberg LLP and Baron & Budd). Several sub-adviser cases discussed in this article have been brought by two law firms: Robbins, Arroyo, in San Diego, has brought four, and Zwerling, Schachter & Zwerling, in New York, has brought three.
- <sup>6</sup> 2014 WL 6478054 (N.D. Ind. Nov. 18, 2014).
- <sup>7</sup> 2002 WL 31051604 (D. Del. Aug. 21, 2002).
- <sup>8</sup> Order denying motion to dismiss, Case 4:14-cv-00044-JAJ-HCA, (S.D. Iowa Sept. 10, 2014).