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INVESTMENT COMPANIES

# Fund Boards in the Cross Hairs — Increased Litigation and Enforcement Activity Relating to Advisory Fees

BY WILLIAM F. SULLIVAN, DOMENICK PUGLIESE AND JOHN DURRANT

Among the myriad of responsibilities imposed on mutual fund boards of directors and trustees (''Boards''), none is more important than the decision to engage an investment adviser to manage the assets of a fund. Under current law, Boards are not only required to make the initial determination to engage an adviser and establish an advisory fee, but must also review these determinations annually. This annual ''15(c)'' review, named after the section of the Investment Company Act of 1940 (the ''1940 Act'') that mandates the process, has long been an area that has attracted the interest of regulators and the plaintiff's bar. While the 1940 Act itself provides minimal guidance to Boards as to how they are to conduct the 15(c) process, most Boards have developed processes to fulfill their responsibilities in this area, relying upon court decisions and regulatory actions over the years concerning mutual fund advisory fees. This process has generally worked well, as Securities and Exchange Commission (''SEC'') enforcement actions relating to the 15(c) process have been rare and litigation challenging allegedly excessive fees, while always prevalent, has generally been unsuccessful.

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However, the times they are a-changing. Through enforcement actions and public pronouncements, the SEC has indicated that mutual fund advisory fees and the 15(c) processes are areas of renewed focus for the SEC's Office of Inspections and Examinations (''OCIE''), its Division of Enforcement and the Division of Investment Management. This renewed regulatory focus is taking place alongside a new breed of private lawsuit against funds alleging excessive advisory fees. This recent enhanced regulatory and litigation activity in the 15(c) area is occurring in the context of the increasing popularity of funds using either a ''manager of managers'' or a ''multi-manager'' structure. In a ''manager of managers'' structure, an adviser seeking to provide diversification in the context of an asset allocation offering will supervise and oversee a number of different sub-advisers, each of whom has responsibility for the day-to-day management of a fund within the asset allocation offering. In a ''multi-manager'' structure, an adviser will engage one or more sub-advisers with particular expertise in specific asset classes to manage dis-

crete portions of a particular fund's portfolio. The use of these structures can raise the question as to the appropriateness of the fee split between advisers and subadvisers.

For many Boards, this increase in litigation and regulatory focus may cause a reexamination of the 15(c) process, particularly as the use of sub-advisers continues to expand. We examine this changing regulatory and litigation landscape and suggest best practices Boards may wish to consider in this area.

## 15(c) Overview

While it is not the purpose of this article to provide an in-depth review of the 15(c) process, a review of the current legal framework will provide helpful background to our discussion of the changing landscape in this area. First, it is important to remember that all funds are organized under state law, typically in Maryland, Massachusetts or Delaware, and therefore Boards are subject to the requirements of state law when performing their duties.[1] These requirements are generally expressed as the duties of care and loyalty owed by a director to a fund and its shareholders. These duties are reflected in a well-known corollary, the business judgment rule. As the American Bar Association's Fund Director's Guidebook states:

> ''The business judgment rule, well-established in case law, protects a disinterested director from personal liability to the corporation and its shareholders, even though a corporate action approved by the director turns out to be unwise or unsuccessful. The business judgment rule presumes that, in making a business decision, directors acted in good faith and in the honest belief that the action was taken in the best interests of the corporation. In reviewing directors' conduct, the court will look to determine whether the directors making the decision were disinterested in the matter, became appropriately informed before deciding and acted with a good faith belief that the decision was in the best interests of the corporation.''[2]

In addition to these overarching fiduciary duties, there are specific responsibilities that directors must fulfill in order to comply with the requirements of the 1940 Act. Courts and regulators have noted that the independent directors occupy a unique position in the structure of an investment company and should operate as the ''independent watchdogs'' over their mutual funds and ''furnish an independent check'' upon the management.[3] While it is not the duty of a director to undo the basic contract a shareholder makes when investing in a fund, or to seek the lowest competitive bid for advisory services, the director must exercise reasonable judgment at arm's length from the fund's investment adviser and any other service providers and must act solely in the best interests of the shareholders.[4]

Specifically, Section 15(c) of the 1940 Act requires that the terms of any investment advisory agreement (or sub-advisory agreement), or renewal thereof, be approved by the vote of a majority of directors who are not ''interested persons'' of the investment company or the investment adviser, cast in person at a meeting called for the purpose of voting upon such approval.[5] Additionally, Section 15(c) of the 1940 Act states that ''[i]t shall be the duty of the directors of a registered investment company to request and evaluate, and the duty of an investment adviser to such company to furnish, such information as may reasonably be necessary to evaluate the terms of any contract whereby a person undertakes regularly to serve or act as investment adviser of such company.''[6]

With respect to advisory fees, directors are charged with the responsibility to determine the appropriateness of the compensation paid to the advisers and subadvisers under all the facts and circumstances involved. Directors have an ongoing obligation to see that the compensation received by the advisers and sub-advisers does not result in a breach of their fiduciary duty by reason of its excessiveness. The Supreme Court in *Jones* recently described this test as follows:

> The 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. . . . To be guilty of a violation of § 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.[7]

The 1940 Act provides little guidance as to the factors that Boards should consider when applying this test. However, through litigation and regulatory pronouncements, a generally recognized set of factors has devel-

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[1] For convenience, we use the terms ''trustee'' and ''director'' and ''trust'' and ''fund'' interchangeably in this article.

[2] *ABA Fund Director's Guidebook* (2006, 3rd Ed. at 99-100.) *See Navellier v. Sletten*, 262 F.3d 923, 946 n.12 (9th Cir. 2001) (applying business judgment rule in investment company context, the Ninth Circuit upheld a jury verdict that independent directors did not breach their fiduciary duties when they voted not to renew an advisory contract based on the adviser's refusal to provide certain financial information about the adviser and its affiliated companies. In so doing, the Court noted that the rule protects directors' conduct provided they ''acted on an informed basis, in good faith, and in the honest belief that the action taken was in the best interests of the company.'') (citations omitted). The business judgment rule continues to evolve in the courts, and the nature and scope of its application is highly dependent on the context of the directors' decision-making. *See In re Citigroup Inc. S'holder Derivative Litig.*, 964 A.2d. 106 (Del. 2009); *Lyondell Chem. Co. v. Ryan*, 970 A.2d 235 (Del. 2009).

[3] The ''watchdog'' formulation for independent directors of an investment company was set forth as early as *Burks v. Lasker*, 441 U.S. 471, 485 (1979), and was recently reaffirmed in *Jones v. Harris Assocs.*, 130 S.Ct. 1418, 1428 (2010). For regulators' views, see the speech by former SEC Chairman William H. Donaldson, America's Need for Vigilant Mutual Fund Directors (Mutual Fund Directors Forum, Jan. 7, 2004); and speech by Paul F. Roye, former Director, SEC Division of Investment Management, Enhancing the Fund Director's Tool Box (Mutual Fund Directors Forum, Jan. 8, 2004).

[4] As discussed below, the Supreme Court in *Jones v Harris Assocs. L.P.*, 559 U.S. 335, 130 S.Ct. 1418 (2010) has stated, in the context of litigation alleging excessive advisory fees, that ''. . .the standard for fiduciary breach under § 36(b) does not call for judicial second-guessing of informed board decisions. . . .[P]otential conflicts [of interests] may justify some restraint upon the unfettered discretion of even disinterested mutual fund directors, particularly in their transactions with the investment adviser, but they do not suggest that a court may supplant the judgment of disinterested directors apprised of all relevant information, without additional evidence that the fee exceeds the arm's-length range.'' *Jones* at 352.

[5] 15 U.S.C. § 80a-15(c).

[6] *Id.*

[7] *Jones*, 559 U.S. at 344-45.

oped over time. The most well know delineation of these factors was made by the U.S. Court of Appeals for the Second Circuit in *Gartenberg v. Merrill Lynch Asset Management, Inc.*[8] A unanimous U.S. Supreme Court in *Jones* essentially adopted the ''*Gartenberg* factors'' as appropriate, although nonexclusive, factors for Boards to consider during the 15(c) process. These *Gartenberg* factors are as follows:

(1) the nature and quality of the services provided by the adviser;

(2) the profitability of the mutual fund to the adviser;

(3) the extent to which ''fall-out'' benefits inured to the adviser;

(4) the economies of scale realized by the adviser;

(5) the fee structures of comparable funds; and

(6) the independence and conscientiousness of the trustees. [9]

However, these factors are not exclusive and the Supreme Court has stated that the independent directors in evaluating an investment adviser's compensation must take into account ''all relevant circumstances.''[10] It stands to reason that, as advisory structures evolve, so to should the factors that Boards consider during the 15(c) process. This is particularly germane in this period of enhanced scrutiny and evolving advisory structures, such as the recent growth in ''multi-manager'' and ''manager of manager'' structures.

Directors should be prepared to defend the process used in their considerations regarding approval of such contracts. They may be called as witnesses and have to explain under oath the process used, the relevance of factors considered, the rationale for not considering other potential factors, all in the context of justifying the fees a fund is paying its adviser and sub-advisers.

## SEC Steps Up Enforcement Activity Regarding Advisory Fees

### The SEC's Legal Toolkit

The SEC has several legal avenues available to it in bringing enforcement actions against funds in the advisory fee arena. Section 36(b) of the 1940 Act provides that the SEC can sue a fund for excessive fees as a private plaintiff.[11] In addition, under Section 36(a) of the 1940 Act, the SEC is broadly empowered to sue for equitable relief and civil penalties regarding any practice that amounts to a breach of fiduciary duty. Potential defendants in such enforcement actions include: ''any officer, director, member of any advisory board, investment adviser, or depositor.''[12] Accordingly, unlike in private lawsuits discussed below, which can only be brought against a recipient of fees (*i.e.*, the adviser), the SEC can directly sue fund directors for breach of duties related to fees. The SEC may move for an injunction of the practice that amounts to a breach of fiduciary duty or ''for other relief against such person as may be reasonable and appropriate in the circumstances.''[13]

The SEC may also bring enforcement actions claiming violations of various Section 15(c)-related rules, such as the Advisory Contract Disclosure Rule discussed above. Section 15(c) operates alongside a panoply of related regulations that also provide bases for SEC actions. Rule 31a-2(a)(6), for instance, requires preservation of records concerning Section 15(c) processes for a time period not less than 6 years. Rule 38a-1(a) requires that funds establish policies and practices that allow for effective oversight of advisers and board approval of policies and procedures of both the fund and its adviser.

## A Renewed Focus on Advisory Fees and the 15(c) Process

Historically, the SEC has rarely brought actions against Boards, funds or advisers pursuant to Section 36(a) or (b) of the 1940 Act. In fact, in the 43 years since its enactment, the SEC has pursued only a small handful of cases under Section 36(b).[14]

However, recent actions and pronouncements from officials at the SEC indicate that the appetite to use section 36 may be increasing. In 2010, in the aftermath of the Bernie Madoff scandal, the SEC created a dedicated ''Asset Management Unit'' within its Enforcement Division with the express purpose, among other things, to ''tak[e] a widespread look into the investment advisory contract renewal process and fee arrangements in the fund industry'' and particularly the role of fund directors in negotiating the renewal or adviser contract and the agreement to fees.[15] The Asset Management Unit also announced that through its ''Fund Fee Initiative'' it is using analytical tools to identify funds that are outliers in terms of fees and/or performance. For example, in December 2011, in a speech by Robert Khuzami, then SEC Director of Enforcement and then head of the Asset Management Unit stated that the Unit was ''focusing on analyzing databases to identify mutual funds that exhibit poor performance, have relatively high fees arrangements, and sub-advisers—all of which may suggest excessive fee arrangements.''[16]

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[8] *Gartenberg v. Merrill Lynch Asset Mgmt., Inc.*, 694 F.2d 923, 928 (2d Cir. 1982).

[9] *Id.* at 928. The SEC closely followed the reasoning of the *Gartenberg* line of cases in adopting rule amendments under the 1940 Act (the ''Advisory Contract Disclosure Rule''). The Advisory Contract Disclosure Rule requires funds to discuss in their shareholder reports the material factors and conclusions with respect thereto that formed the basis for the board of trustees' approval of any investment advisory agreement. In adopting the Advisory Contract Disclosure Rule, the SEC catalogued the factors mentioned in the *Gartenberg* case law, and the Rule requires that the disclosure address each factor as appropriate.

[10] *Jones*, 559 U.S. at 347.

[11] 15 U.S.C. § 80a-35(b).

[12] *Id.* § 80a-35(a)(1).

[13] *Id.* § 80a-35(a).

[14] *See, e.g.*, *SEC v. Fundpack Inc.*, Civil Action No. 79-0859 (D.D.C. 1979); *SEC v. Am. Birthright Trust Mgmt. Co.*, Civil Action No. 80-3306 (D.D.C. 1980); *SEC v. AMMB Consultant Sendirian Berhad*, Civil Action No. 12-01052 (D.D.C. 2012).

[15] *See* Press Release, Secs. & Exchg. Comm'n., SEC Charges Gatekeepers of Two Mutual Fund Trusts for Inaccurate Disclosures about Decisions on Behalf of Shareholders (May 2, 2013).

[16] Robert Khuzami, Director, Div. of Enforcement, Secs. & Exchg. Comm'n., Remarks before the Consumer Federation of America's Financial Services Conference (Dec. 1, 2011).

## The SEC Takes Action—The Morgan Stanley Investment Management and Northern Lights Examples

Since the creation of the Asset Management Unit, two significant enforcement actions have caught the attention of the Fund industry. The first enforcement action was brought in 2011 against Morgan Stanley Investment Management (''MSIM'').[17] In the Morgan Stanley case, the SEC alleged that sub-advisory fees paid by MSIM to a sub-adviser for The Malaysia Funds were excessive because the sub-adviser did not actually provide meaningful sub-advisory services. The SEC brought action against MSIM, as the adviser to the Fund, for allegedly misrepresenting to shareholders and to the Board the scope of sub-advisory services that were actually performed by the sub- adviser. In bringing this action, Mr. Khuzami stated, ''We want to take the advisory fee setting process out of the shadows by scrutinizing the role of investment advisers and fund board members in vetting fee arrangements with registered funds''.[18]

According to the SEC's order settling administrative proceedings (pursuant to which MSIM agreed to pay a $3.3 million fine), despite presentations to the Board to the contrary and disclosure in the prospectus and shareholder reports, the scope of actual sub-advisory services performed by the sub-adviser allegedly consisted of two monthly reports based on publicly available information that MSIM neither asked for nor used in its management of the fund.[19] Further, the Order noted that MSIM's oversight and involvement with the sub-adviser was allegedly inadequate and that MSIM had no written procedures specifically governing is oversight of sub-advisers nor a procedure in place for reviewing the work done by the sub-adviser.[20]

The second enforcement action was brought in 2013 against the Trustees of the Northern Lights Fund Trust and the Northern Lights Variable Trust (the ''NL Trusts''), the NL Trusts' fund administrator, Gemini Fund Services (''GFS''), and the Trusts' chief compliance officer, Northern Lights Compliance Services (''NLCS''), in connection with disclosure, reporting, and recordkeeping, stemming from the Trusts' advisory contract approval process.[21] Pursuant to the settlement of this action, GFS and NLCS each agreed to pay a $50,000 penalty and agreed to engage an independent compliance consultant to address the violations found in the SEC's order.[22]

In this action, the SEC objected to what it characterized as ''boilerplate'' disclosures of the 15(c) process that was included in shareholder reports. The disclosures were characterized as ''boilerplate'' largely because, for some funds, the disclosure contained statements that were not accurate with respect to that specific fund. For example: i) one disclosure claimed that the Trustees had considered advisory fee peer group information, however no such data had been provided for that Fund, and ii) other disclosures indicated that a fund's advisory fee was not materially higher than its peer group range, when in fact the fee was nearly double the peer group's mean fee or even higher.[23]

The SEC also cited GFS for recordkeeping violations for failing to maintain and preserved the information supplied to the Trustees in the 15(c) process. More specifically, on three occasions written financial information provided by the advisers as part of their 15(c) submissions were discarded by GFS or returned to the advisers after the board meeting due to the advisers' confidentiality concerns. On four other occasions, certain series failed to maintain written management fee peer group comparisons as submitted by advisers. In addition, certain series failed to maintain written 15(c) summaries that were prepared by the Trusts' outside counsel.[24]

## A New Generation of Private Litigation Concerning Fund Advisory Fees

### A Historical Perspective

Funds and their advisers have long contended with lawsuits concerning excessive fees. A 2012 study found that, between 2000 and 2009, about a quarter of funds had faced at least one lawsuit for excessive fees.[25] Over that time, there were some 91 lawsuits regarding 2,770 funds under section 36(b).[26] Curiously, according to that study, the fee level actually charged by advisers did not seem to correlate strongly to the filing of lawsuits against funds regarding fees. However, the size of a fund family correlated much more strongly with filings, likely indicating that plaintiffs' attorneys have focused their attention on larger funds where the total amount of fees charged is greater (and the potential bounty for a successful settlement is presumably greater).

In discussing private lawsuits regarding fees, commentators often note that no plaintiff has successfully tried a Section 36(b) case to verdict before a jury.[27] Though true, it would be a mistake to conclude that such lawsuits do not warrant concern for funds, directors, and advisers, as a result. The lack of victories at trial is reflective more of the fact that few of the cases make it to trial, indicating that defendants are often able to get such matters dismissed, but—when they are not able to do so—the parties settle cases.[28]

### The Plaintiff Lawyers' Toolkit

Challenges to excessive fees brought by private parties are typically brought under Section 36(b) of the 1940 Act, which allows shareholders and the SEC to sue

[17] Press Release, Secs. & Exchg. Comm'n., SEC Charges Morgan Stanley Investment Management for Improper Fee Arrangement (Nov. 16, 2011).

[18] *Id.*

[19] *In re Morgan Stanley Inv. Mgmt., Inc.*, Investment Advisers Act Release No. 3315, Investment Company Act Release No. 29862, at ¶ 14 (SEC Nov. 16, 2011).

[20] *Id.* at ¶ 16.

[21] *In re Northern Lights Compliance Servs. et. al.*, Investment Company Act Release No. 30502 (SEC May 2, 2013).

[22] *Id.* at Section IV, ¶¶ D-E.

[23] *Id.* at ¶¶ 23(a)-(b).

[24] *Id.* at ¶ 25.

[25] *See* Curtis & Morley, *An Empirical Study of Mutual Fund Excessive Fee Litigation: Do the Merits Matter?* Sept. 18, 2012 at p. 1, *available at* http://www.law.yale.edu/documents/pdf/LEO/Morley_MutualFundExcessiveFeeLitigation.pdf (''Curtis'').

[26] *Id.* at p. 5.

[27] *See id.*; *see also* Volz, ''Axa Loses Bid to Quash Excessive-Fee Suit,'' *Ignites*, Oct. 1, 2012.

[28] *See* Curtis, *supra* note 25, at p. 12 (56 of the 91 cases references were settled or voluntarily dismissed).

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fund advisers based on the theory that a fund's fees are so high that they constitute a breach of fiduciary duty, even if the fees have been fully and accurately disclosed. Section 36(b) suits, which may only be brought in federal court,[29] are neither class actions nor derivative actions, in a conventional sense. While they may be brought as ''derivative'' claims against the fund advisers, the shareholder bringing the claims is not required to make a demand on the board to sue in the fund's name (as they would for typical derivative claims).[30]

Monetary recovery is limited to disgorgement of the portion of fees charged in violation of the fiduciary duty. No money is recoverable for fees paid prior to one year before a complaint is filed. Section 36(b) does not allow recovery of sales loads. According to the plain language of Section 36(b), only the individuals or entities that actually received a fund's fees may be sued. In addition, any such recovery is limited to the amount received by the recipient attributable to the breach of fiduciary duty in setting the fee.[31]

Accordingly, the defendant in a typical section 36(b) suit for recovery of excessive fees is an adviser, rather than a fund or fund directors. Nevertheless, fund directors should remain very concerned about the 15(c) process. First, as described above, directors have been the target of the SEC inquiry regarding allegedly excessive fees. Second, fee lawsuits can require directors to appear and testify as key witnesses, since litigation will concern the board's process in the negotiation of fees. Such testimony can be time consuming and stressful and in and of itself may result in subsequent SEC actions against directors if the 15(c) process is found wanting. Moreover, some directors and officers insurance policies may not cover the legal representation of directors to the extent they appear as witnesses, rather than defendants in litigation, and directors may have to seek indemnity from the fund for such costs.

## Recent Trends in Private Securities Litigation Concerning Advisory Fees

In addition to increased SEC attention, recent months have brought a new spate of private lawsuits against advisers concerning excessive fees. An appendix of recent lawsuits concerning advisory fees appears at the end of this article. In this new breed of cases, plaintiffs have brought fee claims in ''multi- manager'' and ''manager of managers'' complexes. The gravamen of plaintiffs' allegations are the assertions that advisers provide few actual services, delegating most duties to sub-advisers, but are retaining an excessive portion of the advisory fee. This allegedly results in a total fee that is excessive because the adviser portion of the fee should be less than the sub-adviser portion of the fee. There have been a number of lawsuits filed with similar allegations, and several have survived motions to dismiss. Of course, funds counter that the lawsuits discount the substantial amount of work done by the adviser in selecting, monitoring and overseeing the trading activity of the sub-adviser and also fails to recognize other substantial work done by the adviser, such as valuation and compliance work.

## So, What's a Fund Director to Do?

What lessons can directors learn from this renewed regulatory action and increased litigation surrounding advisory fees? While there is no surefire way to avoid litigation or regulatory attention, directors can protect themselves and their funds by developing and adhering to a rigorous and fully documented 15(c) process. In many respects, process is king in this area. In *Jones*, the Supreme Court discussed the appropriate level of deference which courts should give to decisions by Boards regarding advisory fees. The Supreme Court stated that if the 15(c) process employed by the Board is robust, great deference should be given by courts to the judgment of the Board:

> Where a board's process for negotiating and reviewing investment adviser compensation is robust, a reviewing court should afford commensurate deference to the outcome of the bargaining process. . . . Thus, if the disinterested directors considered the relevant factors, their decision to approve a particular fee agreement is entitled to considerable weight, even if a court might weigh the factors differently. This is not to deny that a fee may be excessive even if it was negotiated by a board in possession of all relevant information, but such a determination must be based on evidence that the fee ''is so disproportionately large that it bears no reasonable relationship to the services rendered and could not be the product of arm's-length bargaining.[32]

On the other hand, a deficient process, or a process tainted with misinformation, will result in less deference given by courts:

> In contrast, where the board's process was deficient or the adviser withheld important information, the court must take a more rigorous look at the outcome.[33]

This process must include a consideration by Boards of ''all relevant factors.'' While the Court stated in *Jones* that the framework set forth in *Gartenberg* was an appropriate way to conduct the 15(c) review, it did not explicitly endorse or reject any of the individual factors that have been the focus in the *Gartenberg* line of cases.[34] It is therefore important for Boards to ensure that the factors they consider during the 15(c) process evolve with the evolution of the investment advisory function.

In the context of a ''multi-manager'' or ''manager of managers'' structure, Boards may want to ensure that the following factors, in addition to the traditional *Gartenberg* factors, are considered, addressed, and documented:

- **Oversight services**—Advisers should have written oversight procedures that address the following issues:

- How does the adviser conduct oversight of the sub-adviser?

[29] *See* 15 U.S.C. § 80a-35(b)(5).

[30] *See Id.* § 80a-35(b).

[31] Section 36(b)(3) states:

No such action shall be brought or maintained against any person other than the recipient of such compensation or payments, and no damages or other relief shall be granted against any person other than the recipient of such compensation or payments. Any award of damages against such recipient shall be limited to the actual damages resulting from the breach of fiduciary duty and shall in no event exceed the amount of compensation or payments received from such investment company, or the security holders thereof, by such recipient.

[32] *Jones*, 559 U.S. at 351.

[33] *Id.*

[34] *See id.* at 354 (Thomas, J., concurring).

■ What kind of interaction occurs between the adviser and sub-adviser and how often does it occur?

■ How well is the adviser performing its sub-adviser oversight and supervisory function?

■ If the sub-adviser is managing the entire portfolio, does the adviser continue to perform a valuable service?

■ What is the adviser's due diligence process in selecting new sub-advisers and when does the adviser recommend a change in sub-advisers?

■ **Other advisory related services**—Advisers should also have detailed statements of procedures concerning services that they provide in addition to oversight. For instance, advisers will provide significant services in areas such as valuations, risk management oversight, and compliance. Such services should be documented in detail.

■ **Assessment of advisory fee retention**—Since most sub-advisers are paid by the adviser from its advisory fee, the adviser will retain a portion of the advisory fee to compensate it for the oversight and other services it performs. In reviewing the reasonableness of the advisory fee, Boards should look at not only the total fee, but also at that portion of the fee retained by the adviser after payment of the sub-advisory fee (''advisory fee retention''). Determining the reasonableness of the advisory fee retention can be a challenging exercise. Boards must consider the actual oversight and other services provided by the advisor. While most Boards are familiar with the advisory fee review process, which typically includes industry comparisons against other similarly managed funds as well as comparisons with fees charged by the adviser for similarly managed accounts, similar comparisons may be difficult with advisory fee retention amounts. Furthermore, the nature of oversight and other services will differ with each adviser, making any available industry comparisons of limited utility. The review of the advisory fee retention is made even more difficult when the adviser also manages a portion of a portfolio. In these circumstances, the Board needs to consider the advisory fee and the retention amount in relation to both the portfolio management services and the portfolio supervisory services provided. Comparative fee data in this scenario, if it exists, may be particularly unhelpful.

■ **Assessment of subadvisory agreement**—Boards must also review and approve the sub-advisory agreement and the level of the sub-advisory fee, a process that has distinct considerations, apart from an advisory contract, including:

■ **Performance**—If the sub-adviser is solely responsible for managing the fund's portfolio, then the performance review will typically be similar to that conducted in a traditional adviser managed fund context, where fund performance is measured against appropriate indices and benchmarks. However, when a sub-adviser manages only a sleeve of a portfolio, it is important for the Board to understand the role that the sleeve is designed to play in the larger portfolio. Some sleeves may have pure performance objectives, in which case the sub-adviser's performance can be measured against traditional indices and benchmarks. Other times, however, the sleeve is designed to play a more nuanced role in the overall portfolio, such as reducing its volatility or leveraging its returns. In these cases, Boards need to develop with the adviser and sub-adviser appropriate performance objectives and means to measure whether the sub-adviser is achieving its objective.

■ **Profitability**—In the traditional advisory fee review, *Gartenberg* teaches that considerations of the level of profitability to the adviser from the advisory fee may be relevant in determining whether a shareholder may have a claim for an excessive advisory fee. However, in the sub-advisory fee context, profitability may be less relevant for a number of reasons. First, it is important to remember that the Board will be considering profitability at the advisory fee level. If the total advisory fee is not excessive and the sub-advisory fee is paid by the adviser, then the level of the sub-advisory fee will have no impact on the expenses paid by the shareholders. Therefore, regardless of the level of profitability of the sub-advisory fee, the level of the sub-advisory fee will not harm the shareholder. Second, the courts have held that considerations of profitability may be relevant in the advisory fee context because a typical advisory fee negotiation does not involve arm's-length negotiations. In this context, profitability serves as a sort of ''proxy'' for the arm's-length negotiation. But, in a sub-advisory context, the level of the sub-advisory fee does indeed involve an arms-length negotiation. The adviser is incented to negotiate as low a sub-advisory fee as possible in order to maximize the advisory fee retention. The fact of this arm's-length negotiation at the sub-advisory fee level may make unnecessary, and irrelevant, the ''proxy'' of profitability.

■ **Valuation and other support**—Boards should assess whether the sub-adviser is providing the necessary level of support to the adviser and the fund. For instance, such support is often needed in the area of valuation. It is often the responsibility of the adviser to identify fair value situations and to employ the fund's fair value procedures, but where a holding was purchased by the sub-adviser, it is the sub-adviser that is most likely to be aware of a potential fair value event and to have the information relevant to making a fair value determination. Proxy voting is another area where sub-adviser support is often required. The Board should determine those particular areas where sub-adviser support is required and annually assess whether the appropriate level of support is provided.

Sub-advisers can bring undeniable benefits to the management of funds. But, the use of sub-advisers complicates the 15(c) process and raises new issues for Boards to consider. Boards should work with counsel to make sure a fund has processes in place that enable a probing inquiry regarding the fees being paid in relation to the quality and nature of the services being provided. Boards should be sure to review the related Advisory Fee Contract Rule disclosures to make sure they are accurate and fully describe the factors considered by the Board in approving or renewing advisory or sub-advisory agreements. Finally, funds must document the process and retain records of this process.

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## Appendix of Recent Private Lawsuits Concerning Advisory Fees

| CASE | JURISDICTION | ALLEGATIONS | STATUS |
|---|---|---|---|
| *American Chem. & Equip., Inc. 401(K) Ret. Plan v. Principal Mgmt. Corp.* | U.S. Dist. Ct. (N.D. Ala.) | Excessive fees under ICA 36(b)—adviser fees (including adviser/sub-adviser division). | Jan. 24, 2014—case transferred to U.S. Dist. Ct. (S.D. Iowa). |
| *Clancy v. Blackrock Inv. Mgmt.* | U.S. Dist. Ct. (D. N.J.) | Excessive fees under ICA 36(b) (including adviser/sub-adviser division | Feb. 2014—complaint filed. |
| *Cox v. ING Invs. LLC* | U.S. Dist. Ct. (D. Del.) | Excessive fees under ICA 36(b)— adviser fees (including adviser/sub-adviser division). | Aug. 2013—complaint filed. |
| *Curd v. SEI Mgmt. Corp.* | U.S. Dist. Ct. (E.D. Penn.) | Excessive fees under ICA 36(b)— adviser fees (including adviser/sub-adviser division). | Dec. 2013—complaint filed. In Feb. 2014, defendant moved to dismiss the complaint. |
| *Curran v. Principal Mgmt. Corp.* | U.S. Dist. Ct. (S.D. Iowa) | Excessive fees under ICA 36(b)— adviser fees (including adviser/sub-adviser division), distributor fees under SEC Rule 12b-1. | June 2013—settled. |
| *Gallus v. Ameriprise Fin.* | U.S. Dist. Ct. (D. Minn.) | Breach of fiduciary duty under ICA 36(b). Allegations included that fee negotiation resulted in board over-relying on fee agreements of similar mutual funds, adviser gave comparable service to institutional clients at lower fees, & adviser misled the fund's directors. | March 2012—appealed to the 8th Circuit, where court affirmed summary judgment for the defendant. |
| *Kasilag v. Hartford* | U.S. Dist. Ct. (D. N.J.) | Excessive fees under ICA 36(b)—adviser fees (including adviser/sub-adviser division), distributor fees under SEC Rule 12b-1. | Dec. 2012—claim regarding distributor fees dismissed for lack of detail in allegations, standing, etc. Claim regarding adviser fees allowed. |
| *Korland v. Capital Research & Mgmt. Co.* | U.S. Dist. Ct. (C.D. Cal.) | Excessive fees under ICA 36(b); Rule 12b-1 fees. | Jan. 2012—case dismissed without prejudice via joint stipulation. |
| *McClure v. Russell Inv. Mgmt. Co.* | U.S. Dist. Ct. (D. Mass.) | Excessive fees under ICA 36(b)— adviser fees (including adviser/sub-adviser division). | Oct. 2013— complaint filed. Jan. 2014—answer filed. |
| *Reso v. Artisan Partners LP* | U.S. Dist. Ct. (N.D. Cal.) | Excessive fees under ICA 36(b). | Aug. 2012—case dismissed with prejudice via joint stipulation. |
| *Sanford v. AXA Equitable Funds Mgmt. Grp.* | U.S. Dist. Ct. (D. N.J.) | Excessive fees under ICA 36(b)—adviser fees (including adviser/sub-adviser division). | April 15, 2013 – first amended complaint filed. Consolidated with *Sivolella* (below). Plaintiffs' request for jury trial denied. |

**Appendix of Recent Private Lawsuits Concerning Advisory Fees – Continued**

| CASE | JURISDICTION | ALLEGATIONS | STATUS |
|---|---|---|---|
| *Sivolella v. AXA Equitable Life Ins. Co.* | U.S. Dist. Ct. (D. N.J.) | Excessive fees under ICA 36(b)—adviser fees (including adviser/sub-adviser division). | Sept. 2012—Court allowed claims for excessive fees to proceed past motion to dismiss. April 15, 2013—second amended complaint filed. Consolidated with *Sanford* (above). Plaintiffs' request for jury trial denied. |
| *Zehrer v. Harbor Capital Advisors* | U.S. Dist. Ct. (N.D. Ill.) | Excessive fees under ICA 36(b)—adviser fees (including adviser/sub-adviser division). Also alleges that fees prevent fund from taking advantage of economies of scale. | Feb. 4, 2014—Complaint filed. |


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