

MEMO# 30212

September 7, 2016

District Court Rules for Defense in Section 36(b) Case

[30212]

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TO: CHIEF COMPLIANCE OFFICER COMMITTEE No. 18-16
CLOSED-END INVESTMENT COMPANY MEMBERS No. 14-16
ETF (EXCHANGE-TRADED FUNDS) COMMITTEE No. 20-16
ETF ADVISORY COMMITTEE No. 19-16
INVESTMENT ADVISER MEMBERS No. 16-16
INVESTMENT COMPANY DIRECTORS No. 24-16
SEC RULES MEMBERS No. 49-16
SMALL FUNDS MEMBERS No. 38-16
UNIT INVESTMENT TRUST MEMBERS No. 7-16
VARIABLE INSURANCE PRODUCTS ADVISORY COMMITTEE No. 19-16 RE: DISTRICT COURT
RULES FOR DEFENSE IN SECTION 36(B) CASE

On August 25, a federal judge ruled in favor of the defense in *Sivolella v. AXA Equitable Life Insurance Co.*, [\[1\]](#) the first section 36(b) “excessive fees” case to go to trial since the Supreme Court’s *Jones v. Harris* decision in 2010. [\[2\]](#) (The decision is attached.) The plaintiffs—investors in mutual funds through variable annuities—alleged that the funds’ adviser delegated nearly all its work to subadvisers, but retained fees out of proportion to the work it performed. In a 159-page opinion, the judge found that the plaintiffs “failed to meet their burden in demonstrating a breach of fiduciary duty in violation of § 36(b) of the Investment Company Act” and failed to show any actual damages.

At odds with that conclusion, the opinion stated, is that the filing of the lawsuit had been “the impetus to improve the quality of the Board’s decision-making, facilitating enhancements to the Board materials and changes in the Board’s composition.” The judge outlined the board improvements, including changes to the board composition and board presentations, in a section titled, “Benefits of the Lawsuit.”

The testimony of the witnesses shaped the judge’s conclusions. The judge found the defendants’ fact witnesses and experts to be credible. In particular, the judge found the testimony of the board’s lead independent director to be “credible and reliable” and “generally consistent, thorough, and accurate.” The lead independent director was the only board member to testify at the trial and provided the most significant information regarding the board’s contract and fee approval process. In contrast, the judge discounted the

testimony of most of the plaintiffs' expert witnesses. For example, the judge gave "little weight" to one expert due to "inconsistencies, oversimplifications, and his sarcastic demeanor."

The judge's opinion focused on the application of the *Gartenberg* factors to the specific facts of the case to determine whether plaintiffs met their burden of establishing that the adviser's fees "were so disproportionately large that they bore no reasonable relationship to the services rendered and could not have been the product of arms-length bargaining."

- *Independence and conscientiousness of the board.* The judge found that "the Board's makeup is sufficiently diverse and independent, and the procedures it followed demonstrates that the Board robustly reviewed [the adviser's] compensation."
- *Nature and quality of the services.* The judge found that the plaintiffs failed to meet their burden in demonstrating that the adviser delegated all of its duties. In particular, the judge found that the adviser "continued to perform significant administrative and investment management duties, despite the fact that some duties were delegated to [subadvisers]. The managerial role that [the adviser] plays in coordinating with sub-advisers and sub-administrators is extensive." The judge observed that while the contractual language was "generic and broad," the trial testimony made clear that the adviser performed a host of duties that may not have been explicitly enumerated in the contracts.
- *Profitability.* The judge found that the plaintiffs failed to demonstrate that the methodologies used by the adviser to determine profitability — e.g., to treat subadvisory and subadministration fees as an expense—were improper. The judge determined that the plaintiffs' expert in this area lacked credibility.
- *Economies of scale.* The judge found that the plaintiffs failed to meet their burden on this factor. The judge found the testimony of the defendants' witnesses—which showed that both breakpoints and other cost-saving methodologies had been used to share economies with shareholders—to be more credible than that of the plaintiffs' witnesses and that the board "conscientiously reviewed economies of scale."
- *Fall-out benefits.* The judge rejected the plaintiffs' contention that the board did not receive information as to certain fall-out benefits, finding that certain of the fees did not constitute fall-out benefits and others were reported to the board.
- *Comparative fees.* The judge found that the plaintiffs failed to demonstrate that the fees for the funds were excessive when compared to similar funds and that the board compared the fees on each fund against reliable sources.

The judge also addressed fund performance, which plaintiffs contended demonstrated that the nature and quality of services provided by defendants were inadequate. The judge found that the vast majority of the funds performed at or above expectations and, as such, plaintiffs did not demonstrate that the adviser's services were in any way inadequate based on fund performance.

Annette Capretta
Deputy Managing Director

[Attachment](#)

endnotes

[1] *Sivolella et al. v. AXA Equitable Life Insurance Company, et al.*, Civil Action No. 11-cv-4194 (PGS)(DEA) (D.N.J) (Aug. 25, 2016).

[2] *Jones v. Harris Associates L.P.*, 559 U.S. 335 (2010).

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