The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

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COURT DENIES ADVISEER'S MOTION TO DISMISS AMENDED COMPLAINT IN CASE CHALLENGING DIRECTOR INDEPENDENCE

1 Strougo v. BEA Associates, 98 Civ. 3725 (S.D.N.Y. Jan. 19, 2000). 2 Strougo v. BEA Associates, 98 Civ. 3725 (S.D.N.Y. Mar. 11, 1999). See Memorandum to Board of Governors No. 21-99, Closed-End Investment Company Members No. 11-99, Director Services Committee No. 12-99, and SEC Rules Members No. 22-99, dated March 26, 1999. [11572] January 24, 2000 TO: BOARD OF GOVERNORS No. 5-00 CLOSED-END INVESTMENT COMPANY MEMBERS No. 1-00 DIRECTOR SERVICES COMMITTEE No. 2-00 SEC RULES MEMBERS No. 4-00 RE: COURT DENIES ADVISER'S MOTION TO DISMISS AMENDED COMPLAINT IN CASE CHALLENGING DIRECTOR INDEPENDENCE

_____ The United States District Court for the Southern District of New York granted in part and denied in part an investment adviser’s motion to dismiss a shareholder’s amended complaint alleging breach of fiduciary duty under Sections 36(a) and (b) of the Investment Company Act of 1940 (the “Act”).1 Essentially, the plaintiff claimed that the advisory agreement between the closed-end fund and the adviser was not negotiated at arm’s-length because at least 40% of the directors on the fund’s board were not independent within the meaning of the Act. The plaintiff therefore contended that the advisory agreement could not have been properly approved as required by Section 15(c) of the Act, and any compensation paid to the adviser thereunder was wrongly received. In March, the court dismissed the shareholder’s initial complaint on the grounds that the mere assertion that there was no arm’s-length bargain between the fund and the adviser was insufficient to state a claim under Section 36(b).2 The court granted the shareholder leave to amend the initial complaint, indicating that his allegations would more likely present a claim under Section 36(a). The plaintiff amended his complaint to bring a shareholder derivative claim under Section 36(a) and added additional facts to support his Section 36(b) claim. In its motion to dismiss the amended complaint, the adviser objected to the Section 36(a) cause of action on three grounds: (1) failure to name the fund as a defendant; (2) failure to make pre-suit demand on the board of directors; and (3) failure to state a claim. Although the court granted the adviser’s motion to dismiss the Section 36(a) claim for failure to join the fund as a defendant, the court granted the plaintiff leave to amend his complaint in this regard. “In anticipation that [the plaintiff] will take this step,” the court proceeded to consider the adviser’s two other grounds for seeking dismissal of the Section 36(a) claim. In addressing the adviser’s second objection, the court determined, in reliance upon an earlier court decision, that “well-compensated service on multiple boards of funds managed by a single fund adviser can, in some circumstances, be indistinguishable in all relevant respects from 3 Strougo v. Bassini, 1 F. Supp. 2d 268, 273 (S.D.N.Y. 1998). 4 See Gartenberg v. Merrill

Lynch Asset Management Inc., 694 F.2d 923, 929-39 (2d Cir. 1982). employment by the fund manager, which admittedly renders a director interested." 3 Consequently, the court held that the plaintiff alleged facts "sufficient to maintain a course of action predicated on [the adviser's] control over the non-employee directors," which the court determined satisfied the demand futility requirement of Rule 23.1. Additionally, the court stated that the adviser's third objection was based on the assumption that the plaintiff had not adequately plead that the non-employee directors were "interested." The court indicated that it had directly rejected this point in its consideration of the adviser's second objection. In denying the adviser's motion to dismiss the Section 36(b) claim, the court noted that the six- factor test set forth in the Gartenberg case to determine whether fees charged by an adviser were disproportionate to the services rendered is not appropriately applied at the pleadings stage, but rather following trial when evidence can be weighed against the six factors.4 The court determined that the appropriate inquiry at this stage is whether the complaint alleges sufficient facts to show that the adviser charged a fee "that is so disproportionately large that it bears no reasonable relationship to the services rendered." The court found that the facts added to the amended complaint, namely that the net adviser fee equaled 42.3% of the fund's total investment income in a year when "by any objective standard" the fund performed poorly, made it "impossible to say, as a matter of law, that [the adviser's] fee was not disproportionately large enough to bear an unreasonable relationship to the service rendered by that adviser." The court held that the plaintiff's Section 36(b) claim stands, and gave him twenty days to add the fund as a defendant for the purposes of the Section 36(a) claim. Doretha VanSlyke Zornada Assistant Counsel Attachment Note: Not all recipients receive the attachment. To obtain a copy of the attachment referred to in this Memo, please call the ICI Library at (202) 326-8304, and ask for attachment number 11572. ICI Members may retrieve this Memo and its attachment from ICINet (http://members.ici.org).
