MEMO# 13477

May 3, 2001

FEDERAL APPEALS COURT DISMISSES CASE ALLEGING BREACH OF FIDUCIARY DUTY UNDER SECTION 36(B) OF THE 1940 ACT

[13477] May 3, 2001 TO: BOARD OF GOVERNORS No. 21-01 CLOSED-END INVESTMENT COMPANY MEMBERS No. 15-01 DIRECTOR SERVICES COMMITTEE No. 6-01 SEC RULES MEMBERS No. 38-01 RE: FEDERAL APPEALS COURT DISMISSES CASE ALLEGING BREACH OF FIDUCIARY DUTY UNDER SECTION 36(b) OF THE 1940 ACT The U.S. Court of Appeals for the Fourth Circuit has upheld a decision of a lower court dismissing a complaint alleging a breach of fiduciary duty under Section 36(b) of the Investment Company Act of 1940 (the "Act").1 The original complaint, which was filed in the U.S. District Court for the District of Maryland, alleged that the investment adviser defendants breached their fiduciary duty under Section 36(b) by (1) receiving excessive fees from the funds they advised and (2) failing to negotiate their advisory agreements with the funds at arm's- length. This later allegation was based on the plaintiffs' claim that the independent directors of the funds were not disinterested because of their level of compensation and the fact that they served on multiple fund boards within the fund complex. The lower court dismissed the case, finding that the plaintiffs had failed to plead sufficient facts to maintain their claims. As discussed below, the appellate court upheld the lower court's dismissal. THE CLAIM OF EXCESSIVE ADVISORY FEES The plaintiffs' allegation that the defendants breached their fiduciary duty under Section 36(b) of the Act by receiving excessive compensation was based on the following: the amount of fees charged by the two funds; the fact that two or three similar funds offered lower fee rates than the funds in this case, while simultaneously outperforming them; the fact that the two funds in question did not meet their preselected benchmark performance standards; and, the fact that despite the funds' underperformance, the defendant investment advisers' earnings increased by more than 20%. 1 Migdal v. Rowe Price Fleming, et al., Case No. 00-1420 (May 1, 2001). 2Employing the Gartenberg analysis,2 the court noted that "to violate Section 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.'" As such, "in order to determine whether a fee is excessive for purposes of Section 36(b) a court must examine the relationship between the fees charged and the services rendered by the investment advisers." Because the plaintiffs "failed to allege any facts pertinent to this relationship between fees and services," the appellate court found that the plaintiffs . . . failed to allege sufficient facts about the services the defendants offered in return for those fees. For example, plaintiffs' comparisons between the two underlying funds and three other mutual funds is not particularly meaningful precisely

because it does not address the particular services offered by the defendants in this case. Similarly, the court did not find persuasive the plaintiff's allegations that the fees were excessive based upon the funds' performance. "While performance may be marginally helpful in evaluating the services which a fund offers, allegations of underpeformance alone are insufficient to prove that an investment adviser's fees are excessive."3 THE CLAIM CHALLENGING THE DIRECTORS' INDEPENDENCE The court next considered the plaintiffs' claim that the disinterested directors of the funds were, in fact, interested parties because: (1) they served on the boards of between 22 and 38 other funds within the same complex; (2) they received aggregate compensation of either $65,000 or $81,000; (3) their obligations to so many funds meant that they could not spend enough time on each particular fund; and (4) they were dependent on the investment advisers for information and for their positions on the boards. In considering these allegations, the court noted that Section 36(b) of the Act "is sharply focused on the question of whether the fees themselves were excessive, and not on the status of the directors who approved them." Notwithstanding this, the court addressed the plaintiffs' evidence on this issue and found that: neither the Act nor the SEC proscribes the use of multi- board members within mutual fund complexes; membership on the boards of several funds within a complex is the prevailing practice in the industry; the SEC has recently reaffirmed its position that "a director of a fund who also is a director of another fund managed by the same adviser generally would not be viewed as an interested person . . . solely as a result of this relationship;" several courts have likewise held that the fact that a director serves on multiple boards within a fund complex is insufficient to demonstrate control; the fact "that directors of the funds might be busy does not suggest that they were in any way 'interested';" the Act approves the practice of directors requesting information from management and staff on the day-to-day operations for which they are responsible; and "[t]here is a presumption under the [Act] that natural persons are disinterested." 2 See Gartenberg v. Merrill Lynch Asset Management, 649 F.2d 923 (2d Cir. 1982). 3 On the issue of the funds' performance the court added: "[I]nvestment results are themselves cyclical. An underachieving fund one year may be an overachieving fund the next. Accepting plaintiffs' invitation to permit discovery here because the funds underperformed would make it possible for other plaintiffs to state a claim in limitless actions filed under Section 36(b)." See pp. 7-8 of the attached decision. 3Accordingly, the court held that the plaintiffs failed to allege any facts that, if true, would support a claim that the disinterested directors were actually interested. In affirming the lower court's dismissal of the plaintiffs' complaint the court concluded: The Investment Company Act balances the tension between protecting mutual fund investors from overly generous charges by investment advisers, and shielding fund management from an outbreak of harassing lawsuits. Any change in this balance will have to come from Congress. A copy of the court's decision is attached. Tamara K. Reed Associate Counsel Attachment Note: Not all recipients receive the attachment. To obtain a copy of the attachment to which this memo refers, please call the ICI Library at (202) 326-8304 and request the attachment for memo 13477. ICI Members may retrieve this memo and its attachment from ICINet (http://members.ici.org). Attachment (in .pdf format)