MEMO# 14527

March 12, 2002

COURT GRANTS ADVISER'S MOTION TO DISMISS COMPLAINT ALLEGING VIOLATIONS OF SECTIONS 36(A) AND (B) OF THE 1940 ACT

[14527] March 12, 2002 TO: BOARD OF GOVERNORS No. 8-02 CLOSED-END INVESTMENT COMPANY MEMBERS No. 9-02 DIRECTOR SERVICES COMMITTEE No. 2-02 SEC RULES MEMBERS No. 17-02 RE: COURT GRANTS ADVISER’S MOTION TO DISMISS COMPLAINT ALLEGING VIOLATIONS OF SECTIONS 36(a) AND (b) OF THE 1940 ACT The United States District Court for the Southern District of New York has granted an investment adviser’s motion to dismiss a shareholder’s second amended complaint alleging breach of fiduciary duty under Sections 36(a) and (b) of the Investment Company Act of 1940 (the “Act”).∗ As discussed in more detail below, the plaintiff shareholder 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 pursuant to that agreement was wrongly received. In addition, the plaintiff claimed the adviser charged “excessive or inappropriate compensation” in violation of Section 36(b). Following discovery, the defendant filed a motion for summary judgment, which was granted. In dismissing the action, the court not only rejected the claims relating to Sections 36(a) and (b) but also rejected the plaintiff’s assertion that the motion for summary judgment should be denied because of discovery improprieties. A copy of the court’s order is attached. The Claim that the Adviser Controlled the Directors The plaintiff challenged the validity of the advisory agreement between the fund and its adviser on the basis that the fund failed to maintain the requisite number of independent directors needed to approve the agreement. He contended that the directors were “interested persons” because they were “controlled “ by the adviser. In support of this argument, he pointed to the directors’: 1) service on multiple boards advised by the defendant; 2) failure to terminate the adviser, oppose the adviser, or lower the fees; 3) insufficient attention to duty as a ∗ Strougo v. BEA Associates, 98 Civ. 3725 (RWS) (S.D.N.Y. Feb. 21, 2002). 2 result of other, full-time occupations; 4) insufficient information to monitor the adviser; and 5) dependency on the adviser for board positions as a result of staggered terms and re-election procedures. The court found that the specific circumstances presented by the plaintiff were insufficient to establish that the adviser “controlled” the independent directors or to raise factual issues with respect to such control. The court reiterated that service on multiple boards alone does not constitute control. The court went on to say that “no authority has held that full time occupations and two hour meetings

sufficiently state a claim of inattention to duty." In view of the outside employment of the directors, the fees they were paid as directors failed to overcome the presumption of independence. In this case, the court observed, the fees were found to be within the range for directors' fees that have been acceptable under the applicable law. The plaintiff cited a number of board actions as further evidence of control of the directors by the adviser – a rights offering that resulted in greater dilution than anticipated, a by-law change to give the board exclusive power to amend the by-laws, and an increase in the number of shares required to request a special shareholder's meeting. The court accepted the argument put forth by the defendant that these were issues of corporate governance resulting, in part, from changes in state law. The Claim of Excessive Advisory Fees The plaintiff further alleged that the adviser breached its fiduciary duty under Section 36(b) of the Act by charging "excessive or inappropriate compensation." To prevail on this claim, the plaintiff was required to demonstrate that the adviser's fee "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." Applying the factors found in the Gartenberg case, the court found that the plaintiff's evidence was insufficient on this claim as well. Specifically, the court noted that the performance of the fund, which the plaintiff had complained was poor in 1997 and 1998, must be viewed in light of all of the surrounding circumstances. Because of the circumstances negatively impacting performance in this case, such as the investment restrictions imposed on the fund and the overall performance of the foreign market in which the fund was required to invest, the court found that this factor did not support the plaintiff's claim. Further, the court found that the plaintiff had not submitted evidence to dispute the defendant's showing that the fund's fees and expenses were within the range of fees and expenses for similar funds. It also rejected the plaintiff's additional arguments relating to excessive fees. Accordingly, the Section 36(b) claim was dismissed. Marguerite C. Bateman Associate Counsel Attachment (in .pdf format) Note: Not all recipients receive the attachment. To obtain a copy of the attachment, please visit our members website (http://members.ici.org) and search for memo 14527, or call the ICI Library at (202) 326-8304 and request the attachment for memo 14527.