The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

MEMO# 2065

July 27, 1990

DISTRICT COURT DISMISSES 36(B) CLAIMS IN KALISH V. FRANKLIN ADVISERS INC.

July 27, 1990 TO: SEC RULES MEMBERS NO. 55-90 RE: DISTRICT COURT DISMISSES 36(b) CLAIMS IN KALISH v. FRANKLIN ADVISERS, INC.

_____ The United States District Court for the Southern District of New York has dismissed a suit brought by shareholders in a GNMA fund claiming excessive advisory fees pursuant to Section 36(b) of the Investment Company Act. A copy of the court's opinion in the case, Kalish v. Franklin Advisers, Inc., is attached. In dismissing the plaintiffs' suit, the court stressed four factors, in reliance on the Gartenberg and Krinsk cases. The four factors were (1) the nature and quality of the services provided by the fund's adviser, (2) the profitability of the fund to the adviser, (3) whether economies of scale were realized by the adviser and shared with the shareholders and (4) the role played by the fund's independent directors. The court also stated that some consideration could be given to fees charged by similar advisers. Plaintiffs had argued that the adviser had misallocated certain costs, including promotional and advertising expenses, thereby understating profits earned from the fund and misleading the directors. While the court expressed some doubts about the allocation, it concluded that the directors were fully aware of the rationale underlying the allocation, which was deemed reasonable by an independent auditing firm. The court did state, however, that the directors' duty to prevent the indirect use of fund assets for distribution purposes "forms an integral part of evaluating the fairness of the manager-adviser's fee". (The fund had no 12b-1 plan.) The court noted that even if expenses had been misallocated, the fund's profitability to the adviser did not appear to exceed 35%, which was comparable to the profitability found in the Schuyt and Krinsk cases. The court stated that "[profitability] alone does not violate the Act" and gave no weight to the plaintiffs' comparison of the fund's profitability with that of different types of financial service firms. As in prior decisions involving Section 36(b) claims, the court placed heavy emphasis on the role of the independent directors, noting, among other things, their education and professional experience, the advice received from independent counsel and the fact that the directors did not act passively, but requested a product-line analysis of cost and revenues and questioned the allocation of expenses contained in the resulting report. The court stated that the fact that counsel to the directors also served as counsel to the fund did not disqualify him "from performing the important function as counsel to the independent directors". With respect to the nature and quality of the services provided by the adviser, the court noted that the fund generally had high total returns and low expense ratios as compared to similar funds. The court also held that the burden of proof was on the plaintiffs to show that the fund realized economies of scale and

could not rely simply on the fact that the fund increased in size. The court concluded that the plaintiffs had failed to show that economies were realized or that, if they were, they were not shared with investors. Craig S. Tyle Associate General Counsel Attachment

---