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Investment Services Regulatory Update

Litigation and Enforcement Actions

U.S. District Court Rules for Defense in *Hartford* Section 36(b) Excessive Fee Case

On February 28, 2017, the U.S. District Court for the District of New Jersey issued its opinion in *Kasilag v. Hartford Investment Financial Services, LLC*, the second Section 36(b) "excessive fee" case to proceed to trial following the Supreme Court's 2010 decision in *Jones v. Harris Associates L.P.* The lawsuit was brought by shareholders of six mutual funds advised by defendants Hartford Investment Financial Services, LLC and Hartford Funds Management Company, LLP (collectively, Hartford). The plaintiffs alleged that the advisory fees retained by Hartford, after delegating "virtually all of the actual investment management services and activities" to an unaffiliated sub-adviser, were excessive in relation to the "woefully minimal" services performed by Hartford. Judge Reneé Marie Bumb determined that the plaintiffs failed to meet their burden to demonstrate that the defendants charged excessive fees in breach of their fiduciary duty under Section 36(b) of the 1940 Act and ruled in favor of the defendants. In so doing, the court rejected the plaintiffs' "retained fee theory," which sought to limit the court's consideration of the services provided to the funds to those performed directly by the defendants, separate and apart from the services performed by the sub-adviser. Under this theory, the plaintiffs also contended that the fees paid to the sub-adviser should be disregarded (rather than treated as an expense of Hartford) in calculating Hartford's profitability.

Section 36(b) imposes a fiduciary duty on investment advisers with respect to the compensation they receive for providing advisory services to mutual funds and provides fund shareholders with an express private right of action to enforce this duty against advisers and their affiliates that receive compensation from funds. In such cases, the burden of proof rests on the plaintiffs to show, by a preponderance of the evidence, that the advisory fee is excessive, i.e., that the fee is "so disproportionate that it does not bear a reasonable relationship to the service the defendant rendered and could not have been negotiated at arm's-length."

To determine whether an advisory fee is excessive, courts consider the fee in light of the factors set forth in the 1982 decision of the U.S. Court of Appeals for the Second Circuit in *Gartenberg v. Merrill Lynch Asset Management, Inc.*,

which was cited with approval by the Supreme Court in *Jones v. Harris*. These factors are:

- the nature and quality of the services provided by the adviser to the mutual fund;
- the profitability to the adviser of managing the fund;
- “fall-out” benefits;
- the existence of any economies of scale achieved by the adviser as a result of growth in fund assets under management and whether such savings are shared with fund shareholders;
- comparative fee structures with similar funds; and
- the independence and conscientiousness of the independent board members.

The court noted that this is a nonexclusive list of factors and that courts are to consider “all relevant circumstances.” The court further stated that Section 36(b) “does not call for judicial second-guessing of informed board decisions” and that courts are to give considerable, but not conclusive, weight to a decision to approve a particular advisory agreement made by independent board members in consideration of the foregoing factors. However, even if a fee is negotiated by a board in possession of all relevant information, the fee may still be excessive if it 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.”

In the *Hartford* case, the independence and conscientiousness of the independent board members were not in dispute at the trial stage. In addition, despite the court’s holding in its earlier denial of the defendants’ motion for summary judgment that the issues of fall-out benefits and economies of scale were among the *Gartenberg* factors that remained in “genuine dispute,” the plaintiffs did not address or present evidence regarding those factors at trial. The trial thus focused on questions regarding: (1) the nature of the services provided by Hartford; (2) the quality of the services provided by Hartford, as measured by fund performance; (3) the profitability of the funds, including the methodology of calculating fund profitability; and (4) a consideration of comparative fee structures. A few observations concerning the court’s consideration of these factors are as follows:

Nature of services provided. Noting that the advisory agreements expressly contemplated the possibility of Hartford’s hiring a sub-adviser, the court determined to consider all services provided under the advisory agreements in exchange for the advisory fee, “regardless whether Defendants performed them or hired others to fulfill their obligations.” The court stated that the plaintiffs did not offer evidence showing that the sub-adviser’s services were suspect or inadequate. The court also noted the testimony offered by the defendants concerning the services directly provided by Hartford under the advisory agreement, including Hartford’s obligation to select and oversee sub-advisers, as well as the entrepreneurial, reputational and legal and regulatory risks borne by Hartford in advising the funds.

Quality of Services Provided. A key consideration regarding the assessment of fund performance in the *Hartford* case

was determining the appropriate metrics. The defendants offered two analyses, one comparing fund performance to Lipper peer groups and another comparing fund performance to the performance of funds in peer groups selected by an expert witness. Based on these metrics, the court found that one fund had strong performance, four funds had generally average performance and another fund (with performance ranging between the 77th and 71st percentiles in its Lipper peer group) had below-average performance. While the plaintiffs attempted to impeach the Lipper comparison on grounds that Hartford had conversations with Lipper that influenced the selection of peer groups for certain funds and that Lipper data may include inaccuracies, the court determined that Lipper's data should not be discounted based on these arguments, noting in particular that Lipper did not simply rubber-stamp the defendants' proposed peer group changes, and found the Lipper data to be reliable. The plaintiffs argued that a proper comparison of fund performance should be a comparison to relevant benchmark indices. However, the court noted that the plaintiffs "presented little evidence that the failure to hit a benchmark is a strong indication of poor performance," noting that benchmark performance numbers do not include fees, and, "[a]s such, in going against a benchmark, a mutual fund begins in the hole."

Profitability and Methodology. As noted above, the plaintiffs in the *Hartford* case argued for the use of a "retained fee" theory to calculate fund profitability—a methodology that essentially excludes sub-advisory fees from both the numerator and denominator of the profitability calculation and can result in extremely high profit margins. The court rejected this theory, noting that plaintiffs presented no supporting accounting authority for this methodology. Rather, the court cited testimony from both plaintiff and defendant witnesses that generally accepted accounting principles would treat sub-advisory fees as an expense of the adviser. Additionally, the court noted that Section 36(b) has never required a "cost-plus" method of setting profits and, consistent with its inclusion of the services provided by the sub-adviser in assessing the nature of services provided, the court determined to consider profitability inclusive of the sub-adviser's fees.

The court also reviewed the profitability numbers as calculated by Hartford, under which annual adviser profitability with respect to the funds in question ranged as high as 80.3%. The court determined that the plaintiffs failed to meet their burden to establish that the funds were so profitable that their fees could not have been the result of an arm's-length negotiation, noting the testimony of the plaintiffs' expert witness to the effect that profits were "a little high, but could have resulted from an arm's length bargain."

Comparative Fees. Noting the importance of considering fees charged to other funds in determining whether an advisory fee is excessive, the court determined that the evidence presented weighed against a determination that the fees charged by Hartford were excessive. In this regard, the court noted that no fund's fee fell within the bottom tenth percentile of the Lipper peer group or the peer group assembled by the defendants' expert. In addition, while the court was sympathetic to the plaintiffs' argument that certain peer funds' fees may not have been negotiated at arm's length, the court stated that the plaintiffs' arguments did not undermine the generally median fee levels of the funds when compared to those of peers.

The opinion in the *Hartford* case was issued approximately six months after the opinion following the trial in *Sivolella*

v. AXA Equitable Life Insurance Company, another Section 36(b) case decided in the U.S. District Court for the District of New Jersey, in which the plaintiffs' claim also related to a "manager of managers" model (wherein an adviser relies on sub-advisers to provide investment management services). As in the *Hartford* case, the court in *AXA* determined that the plaintiffs had failed to meet their burden to demonstrate that the defendants breached their fiduciary duty in violation of Section 36(b).

The litigation was filed in the U.S. District Court for the District of New Jersey under the name *Kasilag et al. v. Hartford Investment Financial Services, LLC et al.*, Case No. 11-cv-01083.

Public Statements, Press Releases and Testimony

OCIE Issues Risk Alert Regarding Compliance Topics Frequently Identified in Deficiency Letters

On February 7, 2017, the SEC's Office of Compliance Inspections and Examinations (OCIE) issued a Risk Alert concerning the compliance topics most frequently identified in deficiency letters that OCIE has sent to SEC-registered investment advisers during the past two years.

The five most frequently identified deficiencies or weaknesses concerned the following Advisers Act rules and requirements generally: (1) Rule 206(4)-7 (the Compliance Rule); (2) required regulatory filings; (3) Rule 206(4)-2 (the Custody Rule); (4) Rule 204A-1 (the Code of Ethics Rule); and (5) Rule 204-2 (the Books and Records Rule). Within these general categories, the issues noted by OCIE included the following:

Compliance Rule:

- compliance manuals and/or programs were not reasonably tailored to the investment adviser's business; for example, by not taking into account important individualized business practices such as the adviser's particular investment strategies, types of clients, trading practices, valuation procedures and advisory fees;
- annual reviews were either not performed or failed to address the adequacy of the investment adviser's policies and procedures;
- the investment adviser did not follow compliance policies and procedures; and
- compliance manuals were not current; for instance, manuals included references to terminated investment strategies, departed personnel and stale information about the firm.

Regulatory Filings:

- Form ADV filings and amendments were untimely or contained inaccuracies, including inaccurate disclosures relating to custody, regulatory assets under management, disciplinary history, client types and conflicts; and
- Form PF and Form D filings were untimely or contained inaccuracies.

Custody Rule:

- the investment adviser did not recognize that it may have custody due to online access to client accounts or as a result of certain authority over client accounts; and
- the investment adviser with custody had surprise examinations that did not meet the requirements of the Custody Rule; for example, by failing to provide accountants with a complete list of accounts over which the investment adviser had custody or by having "surprise" exams conducted at the same time each year.

Code of Ethics Rule:

- the firm's list of "access persons" failed to identify certain employees, partners or directors;
- the code of ethics failed to include required information, such as the requirements for reporting and reviewing personal holdings and transaction reports;
- "access persons" made untimely submissions of personal holdings and transaction reports; and
- the investment adviser's Form ADV Part 2A brochure failed to include a description of the firm's code of ethics and that prospective clients may request a copy of such code of ethics.

Books and Records Rule:

- the investment adviser failed to maintain required records, such as trade records, advisory agreements and general ledgers;
- the investment adviser had errors or omissions in its books and records, including inaccurate fee schedules and outdated client records; and
- the investment adviser's recordkeeping was inconsistent, with contradictory information in separate sets of records.

The Risk Alert notes that the examinations within the scope of OCIE's review resulted in a range of actions. Among other things, investment advisers took remedial measures, such as enhancing written compliance procedures, policies or processes; changing business practices; or devoting more resources or attention to the area of compliance. In addition, the Risk Alert indicates that, where appropriate, the staff referred examinations to the Division of Enforcement for further action.

The Risk Alert is available at:[https://www.sec.gov/ocie/announcement/risk-alert-five-most-frequent-ia-compliance-topics.html.](https://www.sec.gov/ocie/announcement/risk-alert-five-most-frequent-ia-compliance-topics.html)

New Rules, Proposed Rules and Guidance

SEC Staff Publishes FAQ in Response to Questions Regarding Its Mutual Fund Fee Structure Guidance and "Clean Shares" Interpretive Letter

On February 15, 2017, the staff of the SEC's Division of Investment Management (the Staff) published Frequently Asked Questions (FAQs) concerning its December 2016 Guidance Update on mutual fund fee structures, including sales load variations (the Guidance Update), and its January 2017 interpretive letter issued to Capital Group, permitting brokers to charge commissions on sales of mutual fund "Clean Shares" (the CG Letter). The FAQs address six questions under three headings: (1) Variations in Sales Loads; (2) Template Filing Relief; and (3) the CG Letter.

Variations in Sales Loads

In the Guidance Update, the Staff noted that funds are considering "streamlined sales load structures to simplify costs for investors and to help address operational and compliance challenges that can exist for Intermediaries that sell shares of multiple Funds." The FAQs provide guidance on the following issues associated with implementing and disclosing these sales load variations:

- The Staff will not object if a fund that has received template filing relief includes disclosure regarding sales load variations by making a filing under Rule 497 and later including the disclosure in its next Rule 485(b) filing (thus avoiding the need for a second registration statement amendment, in addition to the annual update, in the same year), assuming that the fund would not have otherwise needed to amend its registration statement prior to implementing sales load variations. This option is not available for funds that are offering a new share class.

- Funds that choose to use a prospectus appendix to disclose sales load variations must disclose all variations for all share classes described in the prospectus in a single appendix. In other words, funds cannot use different appendices for different intermediaries and deliver to an investor only the appendix related to the investor's particular intermediary. Instead, the fund's prospectus must include a single, complete appendix.

- A variable annuity issuer may disclose sales load variations in an appendix to a variable annuity prospectus.

Template Filing Relief

The Staff explained that it generally would not grant template filing relief if a fund modifies the representations from the language set forth in the Guidance Update. Funds are directed to contact the Staff "[i]f exceptional circumstances require that the representations be modified." The representations include, among others, a statement that the disclosure changes in the template filing are substantially identical to disclosure changes that will be made in other filings.

CG Letter

In the CG Letter, the Staff expressed its view that the restrictions of Section 22(d) of the 1940 Act do not apply to a broker when the broker acts as an agent on behalf of its customers and charges its customers commissions for effecting transactions in "Clean Shares" of mutual funds. Clean Shares are a mutual fund share class "without any front-end load, deferred sales charge, or other asset-based fee for sales or distribution."

The FAQs explain that, to rely on the CG Letter, a fund should create a new Clean Share class, like any new share class, by making a filing under Rule 485(a), adding that a fund may seek template filing relief to add these classes to multiple funds within a fund complex. If a fund already offers a share class that meets the requirements of the CG Letter (such as an institutional class), the Staff advises that it does not believe a 485(a) filing is necessary solely to add the prospectus disclosure described in the CG Letter.

Finally, the FAQs advise that funds offering Clean Shares should include narrative fee table disclosure stating that investors may pay brokerage commissions on their transactions in Clean Shares.

The FAQs are available at: https://www.sec.gov/divisions/investment/guidance/frequently-asked-questions-mutual-fund-fee-structures.htm.

The Guidance Update is available at: https://www.sec.gov/investment/im-guidance-2016-06.pdf, and the CG Letter is available at: https://www.sec.gov/divisions/investment/noaction/2017/capital-group-011117-22d.htm.

SEC Staff Issues Interpretive Letter Permitting Open-End Funds to Acquire Shares of Affiliated Closed-End Funds

On January 25, 2017, the staff of the SEC's Division of Investment Management issued an interpretive letter (the Letter) agreeing with a law firm's position that registered open-end funds (and unit investment trusts) may invest in closed-end funds in reliance on Rule 12d1-2 under the 1940 Act, regardless whether the investing and underlying funds are in "the same group of investment companies."

Section 12(d) of the 1940 Act generally makes it unlawful for a registered investment company to purchase or other otherwise acquire any security issued by another registered investment company except in accordance with the limits

set forth in that Section. Section 12(d)(1)(G) permits open-end funds to invest in other open-end funds that are part of the same group of investment companies, together with government securities and short-term paper, provided that certain other conditions are met. Rule 12d1-2, adopted by the SEC in 2006, allows open-end funds relying on Section 12(d)(1)(G) also to invest in a broad range of other investments, including securities of non-investment company issuers, certain money market funds and securities issued by an investment company "other than securities issued by another registered investment company that is in the same group of investment companies."

Section 12(d)(1)(G) defines "same group of investment companies" as "any 2 or more registered investment companies that hold themselves out to investors as related companies for purposes of investment and investor services." As the incoming letter to the SEC staff explains, it is possible that, under an interpretation of Rule 12d1-2, closed-end funds could also be deemed to be part of the investing open-end fund's "group of investment companies" and thus be excluded from the investments permitted to be made by such open-end funds under the Rule.

The Letter resolved this uncertainly by stating that, for purposes of Rule 12d1-2, the term "group of investment companies" does not include closed-end investment companies. Accordingly, the Letter stated that "a registered open-end investment company or a registered unit investment trust may rely on [Rule 12d1-2] to invest in a closed-end investment company regardless of whether the two companies hold themselves out to investors as related companies for purposes of investment and investor services."

The Letter is available at: https://www.sec.gov/divisions/investment/noaction/2017/dechert-012517-12d1.htm.

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