Westlaw Journal Formerly *Andrews Litigation Reporter*

SECURITIES LITIGATION & REGULATION

Litigation News and Analysis • Legislation • Regulation • Expert Commentary

VOLUME 16, ISSUE 14 / NOVEMBER 16, 2010

Expert Analysis

The SEC's Mutual Fund Fee Initiative: What to Expect

By James G. Cavoli, Esq., James N. Benedict, Esq., Sean M. Murphy, Esq., and Mia C. Korot, Esq.
Milbank, Tweed, Hadley & McCloy

In testimony before the Senate Judiciary Committee Sept. 22, the director of the Securities and Exchange Commission's Enforcement Division, Robert Khuzami, announced several new initiatives that the division will focus on over the coming months and years. Among these will be a "mutual fund fee initiative," established by the SEC's newly formed Asset Management Unit,[1] to "develop analytics … for inquiries into the extent to which mutual fund advisers charge retail investors excessive fees."[2]

While Khuzami provided no details as to the nature of the "analytics," he said they are "expected to result in examinations and investigations of investment advisers and their boards of directors concerning duties under the Investment Company Act."[3] The SEC has disclosed precious little additional information since Khuzami's remarks.

The announced initiative is a departure from the SEC's historical, relatively hands-off approach to mutual fund fees. It raises myriad questions as to what the future holds for mutual funds, their directors and fund advisory companies in terms of investigations and/or enforcement efforts by the SEC.

While it is impossible to predict with certainty, this commentary outlines some of the analytics the SEC may use in determining whether to launch an "excessive fee" investigation and the applicable liability standard that would apply in any follow-on civil enforcement action under Section 36(b) of the Investment Company Act of 1940.[4] The SEC may invoke other statutory provisions in the context of such investigations and/or actions, and various issues may arise in terms of the agency's fact-gathering.

THE SEC'S HISTORICAL APPROACH

The agency's motivation for launching the fee initiative is unknown, as Khuzami did not elaborate. It is clear, however, that the SEC's stated intent to initiate inquiries regarding mutual fund fees represents a stark departure from its past inactivity in this area.

THOMSON REUTERS™ Westlaw.

In 1970 the Investment Company Act was amended to include Section 36(b), among other provisions. "Congress added 36(b) … because it concluded that [fund] shareholders should not have to rely solely on the fund's directors to assure reasonable advisory fees, notwithstanding the increased disinterestedness of the board."[5] Thus, Section 36(b) imposes a "fiduciary duty" on mutual fund advisers "with respect to the receipt of compensation … paid by" a mutual fund for services rendered by the adviser and provides for a private cause of action by a fund shareholder for the alleged breach of such duty.[6] The statute also expressly vests the SEC with authority to bring an action for such a breach.[7]

Since enactment, the duty imposed by Section 36(b) was almost uniformly construed to focus on fee levels and to prohibit investment advisers from charging "excessive" fees. The Supreme Court recently confirmed this meaning in *Jones v. Harris Associates L.P.*, 130 S. Ct. 1418 (2010).

While the SEC has had authority to pursue actions under Section 36(b) for the past 40 years, it has been largely inactive in this space, leaving issues surrounding fee levels to market forces, mutual fund boards and private shareholders. Indeed, the agency has pursued only two cases under Section 36(b) since 1970, and both were 30 years ago.[9]

This SEC's past inactivity with respect to mutual fund fees is consistent with its expressed policy view that it should take a limited role in this arena. In a 2000 report on mutual fund fees, the SEC noted that:

> [T]he Investment Company Act of 1940 … does not give the commission the direct role of arbiter in determining the appropriate level of fees to be paid by a mutual fund. Rather, the regulatory framework generally allows the level of fund fees to be determined by marketplace competition and entrusts fund independent directors with the responsibility to approve and monitor the arrangements under which funds pay for investment advice or the distribution of their shares.[10]

The SEC expressed a similar sentiment in the context of the various "market timing" cases that were initiated in 2003 and 2004. Although the New York attorney general sought to weigh in on the collateral issue of fee levels, the SEC refrained. "We see no legitimate basis for the commission to act as a 'rate-setter' and determine how much mutual fund customers should pay for the services they receive in the future. … This decision is better left to informed consumers, independent and vigorous mutual fund boards, and the free market."[11]

More recently, in 2009, the SEC, as *amicus curiae* in *Jones v. Harris Associates*, observed that Congress did not intend for the agency to engage in rate regulation or for the courts to engage in judicial price-setting with respect to mutual funds.[12]

The SEC's past stance finds support in Section 36(b)'s legislative history, which provides that the statute does not impose a "'cost-plus'" basis as the standard or "introduce general concepts of rate regulation as applied to public utilities."[13] It is also consistent with the notion that Section 36(b) does not "authorize [courts] to substitute [their] business judgment for that of the mutual fund's board of directors in the area of management fees."[14]

"Under the [Investment Company] Act, scrutiny of investment adviser compensation by a fully informed mutual fund board is the cornerstone of the …. effort to control

 ©2010 Thomson Reuters

conflicts of interest within mutual funds."[15] Still, board scrutiny of fees and lawsuits by either shareholders or the SEC "are mutually reinforcing but independent mechanisms for controlling conflicts."[16]

The agency's newly announced intent to pursue excessive-fee investigations is at odds with its prior reliance on full disclosure of fees, board oversight and market forces to set fee levels. There is also a possible tension between the announced initiative and Congress' view, as stated in 1970, that Section 36(b) is not to be treated as a rate-setting mechanism and that fees approved by a fund's independent directors are to be accorded significant deference. Regardless, the SEC has articulated a new approach and focus, and this development should be taken seriously.

The SEC's stated intent to initiate inquiries regarding mutual fund fees represents a stark departure from its past inactivity in this area.

THE APPLICABLE LIABILITY STANDARD AND RELEVANT FACTORS

Given the terms of Section 36(b), which apply equally to "civil actions by the commission *or* security holder," any civil enforcement action pursued by the SEC will be governed by the same core liability standard that applies to private litigants.

In *Jones* the Supreme Court held that "to face liability under Section 36(b), an investment 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."[17]

The 2nd U.S. Circuit Court of Appeals first established this "so disproportionately large" standard nearly 30 years ago in *Gartenberg v. Merrill Lynch Asset Management*, 694 F.2d 923, 928 (2d Cir. 1982), *aff'g* 528 F. Supp. 1038 (S.D.N.Y. 1981), and, in adopting that standard, *Jones* recognized that "something of a consensus had developed" around *Gartenberg*.[18]

Under this standard, a claimant must show that the fee in question falls outside the range of that which could have been negotiated at arm's length; "it is not enough [to demonstrate] that a better bargain was possible."[19]

By statute, the SEC, just like private litigants, "shall have the burden of proving a breach of fiduciary duty."[20] This burden is "heavy"[21] and erects a "very high hurdle"[22] for the SEC. In the seven Section 36(b) cases that have been tried to final judgment, no plaintiff has succeeded in proving that the challenged fee was excessive.[23]

All pertinent facts and circumstances are to be considered in assessing a Section 36(b) claim under the "so disproportionately large" standard. These include the factors first identified in *Gartenberg*:

- The nature and quality of services provided to fund shareholders, including a fund's performance.
- Comparative fee structures.
- The profitability of the fund to the adviser-manager.
- So-called "fallout benefits" (collateral benefits that accrue to the adviser and would not exist "but for" its relationship with the mutual fund).
- Any economies of scale that may exist and the extent to which such economies have been passed along to fund shareholders.
- The independence and conscientiousness of the independent trustees who serve on the fund's board.[24]

In *Jones* the Supreme Court cited these factors and clarified certain aspects of two: the comparative-fee factor and the "care and conscientiousness" factor.[25] Like the *Gartenberg* court had in 1982, the high court cautioned against putting too much reliance on fee comparisons among retail mutual funds.[26] The court held, however, that comparisons between retail mutual fund fees and fees charged by the same adviser to institutional customers may be appropriate in certain instances — an issue that had been somewhat unsettled under previous case law.

But the court cautioned against "inapt" comparisons and held that, even where such a comparison is appropriate, the Investment Company Act "does not necessarily ensure fee parity between mutual funds and institutional clients."[27]

The SEC may have access to various profitability information, particularly when a fund adviser is publicly traded.

With respect to the director approval process, the Supreme Court confirmed that, absent any material deficiency in that process, courts should defer to the directors' judgment. Where the directors' process in approving adviser compensation "is robust" and they consider "the relevant factors, their decision to approve a particular fee agreement is entitled to considerable weight, even if a court might weigh the factors differently."[28]

The high court also made clear, however, that an adviser's alleged lack of disclosure to a fund board engaged in a fee review process, or a claimed flaw in such process, cannot amount to liability under Section 36(b).[29] The court emphasized that Section 36(b) "is sharply focused on the question of whether the fees themselves were excessive,"[30] and it reasoned that an adviser's disclosure or nondisclosure is relevant only as "a factor that must be considered in calibrating the degree of deference that is due a board's decision to approve an adviser's fees."[31]

Where that "process [is] deficient or the adviser withheld important information, the court must take a more rigorous look."[32] At all times, however, the ultimate focus remains on whether the fees were "so disproportionately large" in comparison with the services rendered.[33]

THE SEC'S 'ANALYTICS'

Khuzami's remarks to Congress in September suggested that the SEC's "analytics" will be used as a precursor to any investigation; they will be used to assess whether a particular fund's fees warrant further, more formal investigative efforts. Since then, Bruce Karpati and Robert Kaplan, co-chiefs of the agency's Asset Management Unit, confirmed that the analytics will be used "to determine appropriate candidates for further review."[34]

They also indicated that the analytics are *already* in use by the SEC, were developed collaboratively by several different arms of the agency, are being "continually refined" and vary depending on the type of mutual fund at issue.[35] Other than to say that they will not use a "single fee threshold" or "ceiling," however, the co-chiefs, like Khuzami, offered no detail as to the scope and type of analytics being employed.[36]

Still, given the existing body of case law and the legislative history of Section 36(b), it is likely that the SEC's analytics involve statistical or other analyses of one or more aspects of at least some of the *Gartenberg* factors. Some possible metrics include the following:

Performance

Perhaps the most obvious analytic is fund performance. Indeed, "[o]ne of the most important measures of the nature and quality of services provided to mutual fund

©2010 Thomson Reuters

shareholders is 'the fund's performance relative to other funds of the same kind.'"[37] Thus, the SEC may gather publicly available information with respect to annualized returns,[38] analyzing it over various historical time periods and/or as compared with other funds with the same or similar investment objectives and/or various benchmarks, such as the S&P 500.

The SEC may focus on "outliers" in terms of underperformance but presumably would evaluate various time periods, with particular focus on the longer term, and would take into account the nature and quality of any other services provided by the adviser to the fund and its shareholders.[39]

Fees

A similar approach may be taken with respect to fee levels. Unlike performance data, however, useful fee comparisons among retail mutual fund fees may be more difficult to come by, particularly if the SEC focuses on a particular fee component (such as administrative service fees or advisory fees) as opposed to overall expense ratio.[40] This difficulty arises because, depending on the fund complex, different services are provided in exchange for different fees with differing labels, making apples-to-apples comparisons very difficult in many instances.[41]

Given *Jones*, the SEC may also compare fee levels for an adviser's retail funds with fee levels for the same adviser's institutional clients. Again, however, this may be difficult as a preliminary analytic since any meaningful comparison requires that any and all differences in services be taken into consideration, as well as any differences in the markets in which the separate products are offered.[42] As a practical matter, such differences may be difficult to identify, quantify and/or evaluate, particularly in the early phases of an inquiry.[43]

It is also possible that the SEC will attempt to identify mutual funds with sub-advisory arrangements. Where a fund's adviser delegates investment management responsibilities to a sub-adviser but receives a portion of the management fee, the SEC may naturally be interested in gathering information about the nature and extent of the services provided by the adviser in exchange for the portion it retains.

Economies of scale

Economies of scale are difficult to assess at any stage of an investigation and would be particularly troublesome as a preliminary analytic.[44] Still, the SEC could develop a rudimentary evaluative tool bearing on scale economies. It may evaluate, for example, whether a given fund's assets have grown over time (and, if so, by how much) and whether any fee breakpoints and/or fee waivers (or caps) are triggered as a result of that growth.

Such information may be available in standard disclosure documents such as annual and semiannual shareholder reports and/or registration statements, on websites of mutual fund complexes, or through industry information sources such as Morningstar or Lipper. While the combination of increased assets and lack of fee reductions is in no way conclusive (or perhaps even probative), the SEC may view it as meaningful in some way.[45]

Profits

The SEC may also have access to various profitability information, particularly when a fund adviser is publicly traded. Using such data, the agency can identify reported

profit levels, at least on a complex-wide basis, and compare such levels with those of other public advisers.[46]

The SEC should be particularly cautious, however, in attempting to evaluate individual fund profitability, since such an analysis invariably involves cost allocations, which courts have recognized can produce wide variations in results and are not particularly reliable.[47]

Board process

Finally, the SEC may seek to evaluate the process the board followed in approving fees and/or agreements. For example, the agency may study fund proxy statements and shareholder reports, which, pursuant to SEC rules, must contain a discussion of the factors considered by a fund's board in approving an investment advisory contract, including a discussion of the *Gartenberg* factors.[48]

The SEC may also assess the information requested and obtained by a fund board during the approval process through its routine books-and-records inspections pursuant to Section 31(b) of the Investment Company Act.[49] Such steps, however, are more labor-intensive and more qualitative than quantitative; as such, they may not fit well within the preliminary "analytics" used by the SEC.

It must be noted that all these potential analytics suffer from significant short-comings; indeed, some have been held insufficient to survive a motion to dismiss in the private civil context.[50] At best, the SEC may use one or more of these evaluative tools to determine, preliminarily, whether a more thorough investigation is warranted.

Given that not one of the above-mentioned factors is dispositive under Section 36(b)[51] and that certain factors may lend themselves more readily to preliminary analysis, it is difficult to assess how they will be weighted by the SEC and what the "line" will be between those cases that result in further investigation and those that do not.

Moreover, even if a preliminary decision is made to pursue an investigation, any later decision to charge a violation of Section 36(b) will almost certainly turn on the perceived strength of the SEC's case and its likelihood to prevail at trial. Given *Jones*' confirmation that an informed board's decision to approve a fee should be given considerable weight and not be second-guessed by a court, a key area of investigation by the SEC will likely be the nature and quality of the process used by a fund's board to evaluate and approve the fee in question. Thus, those who find themselves being pursued by the SEC can probably expect an investigation that focuses on the annual contract renewal process, often called the Section 15(c) process,[52] and related matters such as director independence.

In the end, given Section 36(b)'s very high liability hurdles and the SEC's limited resources, it is possible that the decision to charge will be reserved for the most egregious cases that involve not only high fees and low performance, but also serious process deficiencies, such as where an adviser makes affirmative material misrepresentations to a fund board.

VENTURING BEYOND SECTION 36(B)

Section 36(b) is the only provision in the Investment Company Act that imposes a fiduciary duty with respect to fund fee levels, and it is the sole provision of the law that contains an express private right of action.[53]

©2010 Thomson Reuters

In addition, Section 36(b)'s fiduciary duty applies only with respect to the "receipt of compensation" paid by the fund, and subsection (b)(3) provides that "[n]o … action shall be brought or maintained against any person other than the recipient of such compensation or payments."[54] Thus, individual mutual fund directors, or other individuals and entities that do not receive any of the fees paid by a mutual fund to the investment manager, have traditionally been considered to be beyond the purview of Section 36(b).[55]

While the same limitations that apply to private litigants under Section 36(b) also generally apply to the SEC, passage of the Dodd-Frank financial reform law in July gave rise to one notable exception: the agency's ability to pursue aider and abettor liability under the Investment Company Act.

Dodd-Frank amends Section 48 of the ICA to provide that "[f]or purposes of any action brought by the commission under subsection (d) or (e) of Section 42" (the general enforcement provisions of the ICA), "any person that knowingly or recklessly provides substantial assistance to another person in violation of a provision of this act ….shall be deemed to be in violation of such provision to the same extent as the person to whom such assistance is provided."[56]

With this amendment, the SEC, but not private litigants, can likely pursue claims against an individual who did not receive compensation from a mutual fund, such as a fund director or other third party, if he substantially assisted the adviser in obtaining "excessive" compensation in violation of Section 36(b). Unlike primary violators, however, the SEC would be required to establish that the alleged aider and abettor acted with a culpable state of mind (either knowingly or recklessly).

A key area of investigation by the SEC will likely be the nature and quality of the process used by a fund's board to evaluate and approve the fee in question.

The SEC also has a statutory arsenal beyond Section 36(b) that it may bring to bear in the context of fee-related investigations. Indeed, Khuzami remarked that the agency expects to use its "analytics" to spur investigations of advisers and fund boards concerning duties not only under Section 36(b), but under the Investment Company Act in general.[57] Thus, while the stated initiative centers on "excessive" fees, it may result in investigations and enforcement actions that do not involve Section 36(b) at all or involve the provision together with some other provision of the ICA or other relevant statute.

Section 36(a)

One of the obvious statutory provisions the SEC can invoke, but private plaintiffs cannot, is Section 36(a) of the Investment Company Act. This provision authorizes the SEC to bring an action against an officer, director, member of an advisory board, investment adviser, depositor or principal underwriter for "any act or practice constituting a breach of fiduciary duty involving personal misconduct in respect of any registered investment company" with which they are affiliated.[58]

While judicial opinions vary, many courts interpreting Section 36(a)'s "personal misconduct" standard have found a violation only in cases involving some type of self-interested behavior by a defendant.[59] Courts have rejected the view that Section 36(a) provides a cause of action and/or remedy for all types of fiduciary breaches. "After all, the statutory reference to 'a breach of fiduciary duty involving personal misconduct' would be patently redundant if 'personal misconduct' were read to encompass any general breach of fiduciary duty."[60]

Section 42 and other ICA provisions

More generally, Section 42 of the Investment Company Act vests the SEC with the power to bring an action for injunctive relief and/or monetary penalties "whenever it

©2010 Thomson Reuters

shall appear to the commission that any person has engaged or is about to engage in any act or practice constituting a violation of any provision of this subchapter, or of any rule, regulation or order hereunder."[61] The plenary power afforded by Section 42 is quite broad, providing for enforcement actions for the violation of any of the ICA's substantive provisions, which run the gamut.

One substantive provision that may be invoked in the context of the SEC's mutual fund fee initiative is Section 15 of the ICA. This statute requires that there be a written contract between a fund and its investment adviser, approved annually by the fund's board, and, among other things, imposes a duty on fund directors "to request and evaluate" and on the investment adviser "to furnish" "such information as may reasonably be necessary to evaluate the terms of any contract whereby a person undertakes regularly to serve or act as investment adviser of" the fund.[62]

Via Section 42(a), the SEC may bring actions against an adviser and/or individual board members if it finds the communication and disclosure process between the adviser and the board to be inadequate in some material respect. Such inadequacies could range from the relatively benign (a lack of thoroughness on the part of fund directors) to the more pernicious (intentional and material omissions or misrepresentations by a fund adviser).

Another provision is Rule 12b-1, which governs situations where a mutual fund pays for the distribution of its own shares.[63] Among other things, Rule 12b-1 provides that:

- Any payments by a fund for distribution must be pursuant to a written plan approved each year by a fund's board.[64]
- In approving such a plan, the fund's directors "shall have a duty to request and evaluate, and an[] [adviser or related entity] … shall have a duty to furnish, such information as may reasonably be necessary to an informed determination of whether such plan should be implemented or continued" and must make and preserve minutes "describing the factors considered and the basis for the decision to use company assets for distribution."[65]
- A fund may implement or continue a 12b-1 plan only if the directors conclude "that there is a reasonable likelihood that the plan will benefit the company and its shareholders."[66]

While private plaintiffs have challenged Rule 12b-1 fees as excessive under Section 36(b), they lack standing to pursue direct claims alleging violations of the rule itself.[67] The SEC, however, has standing to pursue such claims pursuant to Section 42, and its fee "initiative" may result in allegations that an adviser (or related distribution entity) or fund directors violated Rule 12b-1 by, for example, failing to request or provide certain material information, or that directors wrongly concluded that the 12b-1 plan in question was likely to benefit the fund and its shareholders.

Another possibility is Section 34(b) of the ICA, which makes it unlawful for any person "to make any untrue statement of a material fact in any registration statement, application report, account, record or other document filed" with the SEC.[68] Here, the agency may uncover, in the context of an "excessive" fee investigation, that a fund adviser may have made untrue or misleading statements related to, for example, portfolio managers' education or experience levels, or the past performance of a given fund.[69]

 ©2010 Thomson Reuters

In addition to different statutory provisions being invoked, the SEC's fee initiative may reach industry players that traditionally have not been the focus of the private plaintiffs bar pursuing excessive-fee actions under Section 36(b). Like in other areas of private securities litigation, Section 36(b) cases are driven largely by plaintiff-oriented law firms that are motivated to pursue claims by the prospect of large monetary recoveries. As a result, Section 36(b) lawsuits have typically targeted large, well-known and profitable mutual fund complexes.

The SEC, which is driven by different incentives and often pursues injunctive relief as a primary remedy, is likely to cast a larger net. Thus, smaller mutual fund complexes with shallower "pockets," which have largely flown below the radar of plaintiffs' counsel, may find themselves embroiled in the SEC's fee initiative.

INVESTIGATIVE CONSIDERATIONS

Should the SEC decide, based on preliminary "analytics," to launch a formal investigation, fund advisers and boards should be prepared for a fact-gathering process that differs from private civil actions in notable respects. Section 42 of the Investment Company Act vests the SEC with broad investigatory powers, providing, in pertinent part:

> The commission may make such investigations as it deems necessary to determine whether any person has violated or is about to violate any provision of this subchapter or of any rule, regulation, or order hereunder, or to determine whether any action in any court or any proceeding before the commission shall be instituted under this subchapter against a particular person or persons, or with respect to a particular transaction or transactions.[70]

In aid of this authority, the SEC has the power to "administer oaths and affirmations, subpoena witnesses, compel their attendance, take evidence, and require the production of any books, papers, correspondence, memoranda, contracts, agreements, or other records which are relevant or material to the inquiry."[71]

Unlike discovery in private civil actions pending in U.S. district courts, the investigative stage of an SEC enforcement inquiry will not be governed by the Federal Rules of Civil Procedure and will commence before any complaint is filed. The SEC's primary investigative tool is the administrative subpoena.[72] The scope of the agency's power to compel the production of documents pursuant to such subpoenas is arguably greater than that afforded a civil litigant.[73]

The SEC can demand the production of electronically stored information that may otherwise be protected from disclosure under federal court rules.

Further, the SEC can demand the production of electronically stored information that may otherwise be protected from disclosure under the federal rules.[74] It may also seek monetary penalties, in the same or related proceedings, where a regulated entity fails to produce requested documents.[75]

The SEC's powers with respect to the taking of testimony are also quite different from civil depositions under the Federal Rules of Civil Procedure. The agency is not limited in the number of witness it can examine under oath, for example.[76] Also, the rights typically afforded each party to a civil action to attend all depositions — and object or pose questions, as the case may be[77] — do not exist in an SEC investigation.

While each witness is entitled to representation by counsel during testimony,[78] the SEC typically excludes attorneys for any other individual or entity connected with the investigation.[79] Thus, for example, counsel for an adviser would almost certainly be precluded from attending testimony by a fund director. Moreover, counsel's con-

duct during an SEC examination is governed by regulatory limitations that do not otherwise exist under the federal rules.[80]

Finally, investigations by the SEC's Enforcement Division may give rise to unique privilege issues. Traditionally, the agency considers several factors in determining whether, and to what extent, to bring an action or to seek penalties against an individual or entity, including that individual's or entity's cooperation with the staff's investigation in the form of full and timely disclosure of relevant facts and information.[81]

This dynamic may incentivize a fund adviser, for example, to provide full and prompt disclosure of information and documents related to the investigation, and that incentive may, at times, include the disclosure of materials that are otherwise protected by the attorney-client privilege. This could include draft 15(c) materials, which are not infrequently crafted and/or commented upon by counsel for the adviser, and recommendations by counsel as to the nature and content of materials to be provided to fund boards. Similar communications may also exist between a fund board and the board's independent counsel.

Careful consideration must be given when weighing the incremental benefits that flow from the disclosure of privileged information, if any, against any increased risk. The primary risk stems from the pendency, or likely pendency, of follow-on, related private civil actions because the production of otherwise privileged documents to the SEC may constitute a waiver of the privilege, meaning that a civil litigant could gain access to those documents through standard discovery requests.[82]

CONCLUSION

While the SEC's stated intent to identify and investigate possibly "excessive" mutual fund fees is a stark departure from its past inactivity in this area, it is too early to tell how the fee initiative will be executed and what it will mean for the mutual fund industry.

Fund advisers and boards should continue to take the annual 15(c) process very seriously and do everything reasonably possible to ensure that it can stand up to scrutiny, by both the SEC and private litigants. Pursuing that course will serve the interests of not only fund shareholders, but also fund advisers and boards by making investigations and lawsuits less likely.

NOTES

1. Earlier this year, the SEC established five units "dedicated to particular highly specialized and complex area of securities law." Among them is the Asset Management Unit, headed by Bruce Karpati and Robert B. Kaplan, which focuses on investment advisers, investment companies (such as mutual funds), hedge funds and private equity firms. Press Release, SEC, SEC Names New Specialized Unit Chiefs and Head of New York Office of Market Intelligence (Jan. 13, 2010), *available at* http://www.sec.gov/news/press/2010/2010-5.htm.
2. *Investigating and Prosecuting Fraud after the Fraud Enforcement and Recovery Act: Hearing Before the S. Comm. on the Judiciary, 111th Cong.* (Sept. 22. 2010) (statement of Robert Khuzami, Director, Division of Enforcement, SEC), *available at* http://www.sec.gov/news/testimony/2010/ts092210rk.htm.
3. *Id.*
4. *See* 15 U.S.C. § 80a-1 *et seq.*
5. *Kamen v. Kemper Fin. Servs.,* 500 U.S. 90, 108 (1991) (citations and quotations omitted).
6. 15 U.S.C. § 80a-35(b).
7. *See id.* ("An action may be brought under this subsection by the commission or by the security holders thereof.").

©2010 Thomson Reuters

[8] In *SEC v. Fundpack Inc.,* Civil Action No. 79-0859 (D.D.C. 1979), the agency alleged that various defendants violated the anti-fraud, proxy, reporting, registration and other provisions of the federal securities laws, including 36(b), for promoting switching among mutual funds to generate transaction fees and excessive securities transactions for the benefit of the adviser and brokerage subsidiaries. *See* SEC Litigation Release No. 8698 (Mar. 22, 1979). The defendants were found liable and the funds at issue were required to elect four new directors and appoint special counsel to assist in fulfilling their duties, among other remedies. *Id.;* SEC Litigation Release No. 8838 (Aug. 13, 1979); SEC Litigation Release No. 8880 (Oct. 1, 1979).

[9] In *SEC v. American Birthright Trust Management Co.,* Civil Action No. 80-3306 (D.D.C. 1980), the agency alleged that the compensation paid to the management company by certain funds was excessive because, in part, most of the services were provided by a sub-adviser. The defendants settled the case, agreeing to pay back $465,000 to the funds. SEC Litigation Release No. 9266 (Dec. 30, 1980).

[10] SEC Division of Inv. Mgmt., Report on Mutual Fund Fees and Expenses (December 2000), *available at* http://www.sec.gov/news/studies/feestudy.htm.

[11] Press Release, SEC, Alliance Capital Management Will Pay Record $250 Million and Make Significant Governance and Compliance Reforms to Settle SEC Charges (Dec. 18, 2003), *available at* http://www.sec.gov/news/press/2003-176.htm.

[12] *See* Brief for the United States as Amicus Curiae Supporting Petitioners at 23 n.6, *Jones v. Harris,* No. 08-586 (U.S.).

[13] S. Rep. No. 184, 91st Cong., 1st Sess., reprinted in 1970 U.S.C.C.A.N. 4897, 4902.

[14] *Id.*

[15] *Jones,* 130 S. Ct. at 1427 (citations and quotations omitted).

[16] *Id.* at 1428.

[17] *Id.* at 1426 (emphasis added).

[18] *Id.*. at 1425.

[19] *Gartenberg v. Merrill Lynch Mgmt.,* 528 F. Supp. 1038, 1047 (S.D.N.Y. 1981); *see also Jones,* 130 S. Ct. at 1426.

[20] 15 U.S.C. § 80a-35(b)(1).

[21] *Jones,* 130 S. Ct. at 1431.

[22] *In re Am. Mut. Funds Fee Litig.,* No. 04-CV-5593, 2009 WL 5215755, at *2 (C.D. Cal. Dec. 28, 2009).

[23] *Id.*; *Kalish v. Franklin Advisers Inc.,* 742 F. Supp. 1222 (S.D.N.Y. 1990), *aff'd*, 928 F.2d 590 (2d Cir. 1991); *Meyer v. Oppenheimer Mgmt. Corp.,* 715 F. Supp. 574 (S.D.N.Y. 1989), *aff'd*, 895 F.2d 861 (2d Cir. 1990); *Krinsk v. Fund Asset Mgmt.,* 715 F. Supp. 472 (S.D.N.Y. 1988), *aff'd,* 875 F.2d 404 at 409 (2d Cir. 1989); *Schuyt v. Rowe Price Prime Reserve Fund,* 663 F. Supp. 962 (S.D.N.Y.), *aff'd,* 835 F.2d 45 (2d Cir. 1987); *Gartenberg v. Merrill Lynch Asset Mgmt.,* 694 F.2d 923, 928-29; *Gartenberg v. Merrill Lynch Asset Mgmt.,* 573 F. Supp. 1293 (S.D.N.Y. 1983), *aff'd,* 740 F.2d 190 (2d Cir. 1984).

[24] *Krinsk*, 875 F.2d at 409 (citing *Gartenberg,* 694 F.2d at 929-30); *In re Am. Mut. Funds Fee Litig.,* 2009 WL 5215755, at *44, ¶21. The SEC has endorsed the *Gartenberg* factors in its rules and regulations. *See* Amicus Curiae Brief, *supra* note 12, at 23, 25.

[25] *Jones*, 130 S. Ct. at 1426 & n.5.

[26] *Id.* at 1429 ("[C]ourts should not rely too heavily on comparisons with fees charged to mutual funds by other advisers. These comparisons are problematic because these fees, like those challenged, may not be the product of negotiations conducted at arm's length.").

[27] *Id.* The court indicated that there should be no categorical rule against comparisons between institutional account fees and retail fund fees. *Id.* at 1428. At the same time, it held that "[i]f the services rendered are sufficiently different that a comparison is not probative, then courts must reject such a comparison." *Id.* at 1429.

[28] *Id.* at 1429.

[29] *Id.* at 1430 ("panel erred" by "focusing almost entirely on the element of disclosure" as a basis for liability).

[30] *Id.* (internal quotation omitted).

[31] *Id.*

[32] *Id.*

[33] *Id.* at 1429.

©2010 Thomson Reuters

[34] Beagan Wilcox, *SEC Sheds New Light on Fund Fee Initiative,* Ignites 2 (Oct. 21, 2010).

[35] *Id.* at 1-2. Specifically, the analytics were developed by the SEC's Asset Management Unit, the Division of Investment Management, the exam staff, and the Division of Risk, Strategy and Financial Innovation. *Id.* at 2.

[36] *Id.* at 1.

[37] *In re Am. Mut. Funds Fee Litig.,* 2009 WL 5215755 at *48, ¶ 46 (quoting *Kalish*, 742 F. Supp. at 1229); *see also Krinsk,* 715 F. Supp. at 488.

[38] All mutual funds are required to report annualized returns net of fees. *See* 17 C.F.R. § 239.15A; SEC Form N-1A at Item 4(b)(2), Item 13 & Instructions to Item 13(a). As such, comparable data is publicly available.

[39] *See In re Am. Mut. Funds Fee Litig.,* 2009 WL 5215755 at *48, ¶ 47 ("[T]he short-term performance of a mutual fund generally is not a good indicator of a fund's overall performance."). Underperformance alone is insufficient to prove that an advisory fee is excessive. *See, e.g., Migdal v. Rowe Price-Flemming Int'l,* 248 F.3d 321, 327 (4th Cir. 2001).

[40] The co-chiefs specifically identified transfer agent and custodian fees, in addition to advisory fees, as areas that the SEC will look into; all fees are likely in play, however. *See* Wilcox, *supra* note 34, at 2.

[41] The SEC has recognized the difficulty in comparing mutual fund fees. *See* SEC Fee Report, *supra* note 10, at 15.

[42] *See* note 27 *supra; Jones,* 130 S. Ct. at 1428-29 & n. 8 (identifying items that may make services sufficiently different so as to render comparisons inapt). In its *amicus* brief in *Jones*, the SEC said "the fees an investment adviser charges unaffiliated clients will be relevant to the Section 36(b) analysis *only to the extent* that the adviser performs sufficiently comparable services in the two contexts." *See* Amicus Curiae Brief, *supra* note 12, at 30 (emphasis added).

[43] The co-chiefs stated that they "are aware of the admonition [in *Jones*] of not engaging in inapt comparisons … and we [will] look[] at the total facts and circumstances of the board's approval of fees." *See* Wilcox, *supra* note 34, at 1.

[44] Economies of scale occur when the "long-run average total cost falls as the quantity of output increases." N. Gregory Mankiw, Principles of Microeconomics 283 (3d ed. 2003); *see Kalish,* 742 F. Supp. at 1237. To establish the existence of scale economies, the SEC must prove "that the per-unit cost of performing fund transactions decreased as the number of transactions increased." *Krinsk*, 875 F.2d at 411. It is insufficient to simply show "that since a fund increased dramatically in size, economies of scale must have been realized." *Kalish*, 742 F. Supp. at 1238. Nor is it enough to demonstrate changes in a defendant's revenue and/or expenses from managing the fund. *Krinsk*, 875 F.2d at 411.

[45] The ultimate question with respect to economies of scale is whether the investment adviser has appropriately shared the benefits of any scale economies that may exist with fund shareholders. *See Kalish,* 742 F. Supp. at 1228. Scale economies can be shared in at least four different ways: pricing to scale (pricing a mutual fund from inception as if it were already at scale), fee reductions and waivers, breakpoints, and reinvestment in services. *See In re Am. Mut. Funds Fee Litig.,* 2009 WL 5215755, at *52, ¶ 70; *accord* SEC Fee Report, *supra* note 10, at § IV.B.1. Given the various ways to share, looking at breakpoints or fee waivers alone may reveal very little.

[46] *See In re Am. Mut. Funds Fee Litig.,* 2009 WL 5215755 at *50, ¶ 58. A wide range of profits are acceptable. *See id.* (pre-tax profit margins ranging from 30 percent to 35 percent acceptable); *Krinsk*, 715 F. Supp. at 494 (pre-tax margins up to 33 percent reasonable); *Schuyt*, 663 F. Supp. at 979 (pre-tax margins up to 77.3 percent); *Meyer v. Oppenheimer Mgmt. Corp.,* 707 F. Supp. 1394, 1401 (S.D.N.Y. 1988) (pre-tax margins up to 89 percent).

[47] *See Krinsk,* 715 F. Supp. at 489; *Schuyt*, 663 F. Supp. at 978 n.48.

[48] *In re Disclosure Regarding Approval of Inv. Advisory Contracts,* SEC Release No. 33-8433; 83 SEC Docket 261 at 4 (June 23, 2004), 2004 WL 1575780.

[49] *See* 15 U.S.C § 80a-30(b).

[50] *See, e.g., Amron v. Morgan Stanley Inv. Advisors,* 464 F.3d 338 (2d Cir. 2006); *In re Salomon Smith Barney Mut. Fund Fees Litig.,* No. 04 Civ. 4055 (PAC), 2007 WL 4326514, at *3 (S.D.N.Y. Dec. 3, 2007) (same).

[51] *See, e.g., Benak v. Alliance Capital Mgmt.,* No. 01-cv-5734, 2004 WL 1459249, at *9 (D.N.J. Feb. 9, 2004).

[52] *See infra* and note 61 (briefly discussing the annual contract renewal process and certain requirements imposed by Section 15 of the ICA in connection with that process).

[53] Fund shareholders have attempted to pursue private claims under other provisions of the ICA on the theory that they create an implied private right of action, but such efforts have been consistently rejected since the 2nd Circuit's seminal decision in *Olmsted v. Pruco Life Insurance Co.,* 283 F.3d 429

©2010 Thomson Reuters

(2d Cir. 2002) (rejecting prior cases finding implied private rights of action as part of an "ancient regime"). *See, e.g., Northstar Fin. Advisors v. Schwab Invs.,* 615 F.3d 1106, 1122 (9th Cir. 2010) (reversing federal court's holding that Section 13(a) of the ICA provides a private right of action); *Bellikoff v. Eaton Vance Corp.,* 481 F.3d 110, 116 (2d Cir. 2007) (same as to Sections 34(b), 36(a) and 48(a)); *DH2 Inc. v. Athanassiades,* 359 F. Supp. 2d 708, 714-15 (N.D. Ill. 2005) (same as to Section 17(j)); *see also* James G. Cavoli & Sean M. Murphy, *Court Finds Implied Private Right of Action Under the Investment Company Act,* 15 Sec. Litig. & Regulation Reporter 1 (May 19, 2009) (discussing notion of implied rights of action under the ICA and criticizing the District Court's decision in *Northstar,* 615 F.3d 1106).

[54] 15 U.S.C. § 80a-35(b)(3).

[55] *See, e.g., Bellikoff,* 481 F.3d 110.

[56] Dodd-Frank Wall Street Reform and Consumer Protection Act, 55. Pub. L. No. 111-203, § 929M (2010).

[57] *See* Khuzami statement, *supra* note 2.

[58] 15 U.S.C. § 80a-35(a).

[59] *E.g., SEC v. Vintage Group,* Civil Action No. 94-0772 (N.D. Cal. Nov. 2, 1994), SEC Litigation Release No. 14319; *SEC v. Strategic Mgmt.* No. 91-02489 (N.D. Tex. July 9, 1993), *aff'd,* No. 93-1707, slip. op. (5th Cir. Jan. 11, 1994), SEC Litigation Release No. 13701.

[60] *Jacobs v. Bremner,* 378 F. Supp. 2d 861, 867 (N.D. Ill. 2005) ("Courts have typically read Section 36(a) claims to require some sort of element of self-dealing.").

[61] 15 U.S.C. §§ 80a-41(d) ("Action for injunction") and (e) ("Money penalties in civil actions").

[62] 15 U.S.C. § 80a-15(c).

[63] *See* 17 C.F.R. § 270.12b-1 *et seq.*

[64] *See* 17 C.F.R. § 270.12b-1(b)(1)-(3).

[65] 17 C.F.R. § 270.12b-1(d).

[66] 17 C.F.R. § 270.12b-1(e).

[67] *See Strigliabotti v. Franklin Res.,* 2005 WL 645529 (N.D. Cal. Mar. 7, 2005); *Krinsk*, 404 F.2d at 406.

[68] 15 U.S.C. § 80a-33(b).

[69] There are numerous other provisions of the ICA that could come into play in the context of an SEC investigation, including Section 12(d)(1) ("limitations on acquisition by investment companies of securities of other specific businesses"), Section 17(j) ("rules and regulations prohibiting fraudulent, deceptive or manipulative courses of conduct"), and Section 22 (requirements relating to the "distribution, redemption, and repurchase of securities; regulations by securities associations").

[70] 15 U.S.C. § 80a-41(a).

[71] 15 U.S.C. § 80a-41(b).

[72] *See* 15 U.S.C. § 78u(b).

[73] The scope of the SEC's subpoena power is coextensive with its investigative authority. *See SEC v. Arthur Young & Co.,* 584 F.2d 1018, 1024-25 (D.C. Cir. 1978). The "test is relevance to the specific purpose, and the purpose is determined by the investigators." *Id.* at 1031. Given the SEC's broad investigatory authority under the ICA, it is often difficult to challenge the scope of an SEC subpoena. *See, e.g., Rosiere v. SEC,* No. 09-cv-01975, 2010 WL 489526 (D. Nev. Feb. 5, 2010).

[74] Under Federal Rule of Civil Procedure 26(b)(2)(B), "[a] party need not provide discovery of electronically stored information from sources that the party identifies as not reasonably accessible because of undue burden or cost."

[75] *See, e.g., SEC v. Morgan Stanley & Co.,* Civil Action No. 06-882 (D.D.C. 2006), SEC Litigation Release No. 19693 (May 10, 2006) (Morgan Stanley pays $15 million to settle claim that it failed to timely produce documents during SEC investigation).

[76] *See* Fed. R. Civ. P. 30(b)(a)(2)(a)(i).

[77] *See* Fed. R. Civ. P. 30(b) and (c); *but see id.* 26(c)(1)(E) (if "good cause" shown, protective order may issue that limits attendees at deposition).

[78] 17 C.F.R. § 203.7(b) (2010); *see also SEC v. Whitman,* 613 F. Supp. 48, 49-50 (D.D.C. 1985) (right to counsel is absolute).

[79] 17 C.F.R. § 203.7(b) (2010).

[80] *See* 17 C.F.R. § 203.7(c) (2010). Counsel is permitted to advise a witness before, during and after the examination, to briefly question the witness at the conclusion of the exam to clarify answers, and to take summary notes solely for the use of the witness. Counsel may not object to questions posed by SEC staff. Also, staff may report "dilatory, obstructionist and contumacious" conduct by counsel to the agency. *Id.*

©2010 Thomson Reuters

[81] *See* SEC Enforcement Manual, § 6.1.2 (Jan. 13, 2010), *available at* http://www.sec.gov/divisions/enforce/enforcementmanual.pdf.

[82] Many courts have rejected the "selective waiver" doctrine, which would allow a party to waive the attorney-client privilege for the limited purpose of producing materials to the government without the waiver extending to third parties. The one notable exception is the 8th Circuit. *Compare, e.g., In re Qwest Commc'ns Int'l,* 450 F.3d 1179 (10th Cir. 2006) (finding waiver); *In re Steinhardt Partners,* 9 F.3d 230, 235 (2d Cir. 1993) (same), *with Diversified Indus. v. Meredith,* 572 F.2d 596 (8th Cir. 1978) (*en banc*) (corporation's voluntary disclosure of documents relating to internal investigation to SEC waived privilege only with respect to SEC and not with respect to third parties).

James G. Cavoli (left) is a partner in the litigation department of **Milbank, Tweed, Hadley & McCloy** in New York. His practice focuses on a full range of complex commercial litigation, including private civil litigation and arbitration, with a concentration in defending mutual fund advisers against claims of excessive fees, as well as representations in connection with government regulators' civil and criminal enforcement of the securities and antitrust laws. He may be contacted at (212) 530-5172 or jcavoli@milbank.com. **James N. Benedict** (second from left) is the chairman of the firm's litigation department and head of its securities litigation practice group. He has handled more than 150 major class and shareholder derivative actions alleging violations of state and federal antitrust and securities law, and he has more than 30 years of experience representing mutual fund investment advisers and their affiliates in litigation under the federal securities laws. He may be contacted at (212) 530-5696 or jbenedict@milbank.com. **Sean M. Murphy** (second from right) is a partner in the litigation department whose practice focuses on complex securities matters, defending companies in class action and derivative cases, including numerous representations of mutual fund investment advisers, that often involve regulatory investigations by federal or state agencies. He may be contacted at (212) 530-5688 or smurphy@milbank.com. **Mia C. Korot** (right) is an associate in the litigation group. Her practice primarily focuses on securities litigation, with a concentration in litigation arising under the Investment Company Act of 1940. She may be contacted at (212) 530-5132 or mkorot@milbank.com.

Milbank, Tweed, Hadley & McCloy LLP is a leading international law firm which has been providing innovative legal solutions to clients throughout the world for more than 140 years. Headquartered in New York, we have lawyers operating out of 11 offices in the US, Europe, Asia and South America. Milbank provides a full and integrated range of legal services to the world's leading commercial, financial and industrial enterprises, as well as to institutions, individuals and governments.

Milbank

©2010 Thomson Reuters. This publication was created to provide you with accurate and authoritative information concerning the subject matter covered, however it may not necessarily have been prepared by persons licensed to practice law in a particular jurisdiction. The publisher is not engaged in rendering legal or other professional advice, and this publication is not a substitute for the advice of an attorney. If you require legal or other expert advice, you should seek the services of a competent attorney or other professional. For subscription information, please visit www.West.Thomson.com.