STRADLEY RONON

Fund Alert

A Publication of the Stradley Ronon
Investment Management Group

WWW.STRADLEY.COM

MARCH 2018

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Two More 36(b) Wins for Advisers

In two separate rulings over the past week, federal district courts have granted summary judgment motions filed by investment advisers sued for excessive fees under Section 36(b) of the Investment Company Act of 1940. Both courts issued substantive opinions, and both carefully followed the principles established by the Supreme Court's landmark *Jones v. Harris Associates* decision in 2010. The two theories relied on most heavily by plaintiffs in the most recent wave of 36(b) cases – the sub-advised funds comparison and the manager-of-managers theory – were each carefully evaluated and squarely rejected by the courts.

On March 9, the U.S. District Court for the Southern District of Ohio issued its 39-page opinion in *Goodman v. J.P. Morgan Investment Management, Inc.* (https://www.stradley.com/~/media/Files/Publications/2018/03/JP_Morgan_court_version.pdf). The plaintiff shareholders in *J.P. Morgan* focused primarily on a comparison of the fees charged by the adviser to its own funds versus the fees charged by the adviser to funds it sub-advises. The plaintiffs argued that the "arm's-length bargaining range" described in *Jones v. Harris* was "unequivocally established" by the fees that the adviser charged sub-advised funds and that no further analysis was necessary. After a comprehensive review of the law established in *Jones v. Harris*, the court in *J.P. Morgan* rejected this comparison, finding that the comparators were "not materially similar."

In rejecting the sub-advised funds comparison, the court in *J.P. Morgan* relied on the Supreme Court's instruction that "if the services rendered are sufficiently different that a comparison is not probative, then courts must reject such a comparison." In the most thorough treatment to date of the sub-advised funds comparison, the court focused on not only the differential in scale of services but also the different risks associated with the roles of adviser and sub-adviser. Citing at length from a report of J.P. Morgan's expert, the court described the liquidity risks, business risks, operational risks, pricing risks, litigation risks, regulatory risks and reputational risks that advisers confront, which are vastly different in both type and magnitude from the risks faced by sub-advisers. The court's detailed analysis of this foundational issue should provide a useful road map in the remaining cases where plaintiffs advance this same theory.

Just four days later, the U.S. District Court for the Northern District of Illinois granted summary judgment to Harbor Capital in a 36(b) case rejecting the second, equally prominent comparison relied on by recent 36(b) plaintiffs. In *Zehrer v. Harbor Capital Advisers, Inc.* (https://www.stradley.com/~/media/Files/Publications/2018/03/Harbor_Capital%20_court_version.pdf), the court considered the plaintiff's theory that the adviser's fees were excessive in view of its delegation of responsibilities to a sub-adviser. Like the *J.P. Morgan* court, the court in *Harbor Capital* began with a review of the standard established in *Jones v. Harris*, summarized by the Seventh Circuit on remand: "The Supreme Court's approach does not allow a Court to assess the fairness or reasonableness of adviser's fees; the goal is to identify the outer bounds of arm's-length bargaining and not engage in rate regulation." The court then carefully reviewed the facts regarding the 15(c) process of the board, finding that the plaintiff's challenges to the board's process constituted "armchair quarterbacking and captious nit-picking."

The *Harbor Capital* court then addressed the manager-of-managers theory at the heart of the plaintiff's case. The plaintiff's principal contention was that only those advisory services directly performed by Harbor Capital should be considered in determining whether its fees were excessive, and those provided by the sub-advisers retained by Harbor Capital should be excluded. Here the court readily agreed with the judgment of the court in *Hartford* that "the combined services should be considered against the entire advisory fee." Citing *Hartford*, the court held that disregarding the services rendered by the sub-adviser "solely because [the adviser] made the permissible business decision that they were better or more efficiently (or even more inexpensively) performed by [sub-advisers] is nonsensical."

J.P. Morgan and *Harbor Capital* carefully evaluate and soundly reject the two theories of liability relied on most heavily by plaintiffs since *Jones v. Harris*, continuing a string of recent successes by defendants in Section 36(b) cases. In the nearly 50 years since Section 36(b) was added to the Investment Company Act, plaintiffs suing for allegedly excessive fees have yet to win a judgment.

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