Investment Management Industry News Summary - November 2005

NOVEMBER 30, 2005

This Summary, which draws from a wide range of sources, endeavors to condense important investment management regulatory news of the preceding week into one, easily digestible source. This Summary is not intended as legal advice. Readers should not act upon information contained in this Summary without professional legal counsel. This Summary may be considered advertising under the rules of the Supreme Judicial Court of Massachusetts.

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Massachusetts federal district court dismisses suit concerning payment of Rule 12b-1 fees by "closed" fund

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Following recent precedent, the U.S. District Court for the District of Massachusetts dismissed a shareholder derivative action contending that a mutual fund distributor (the "Distributor") and its affiliates breached their fiduciary obligations under Section 36(b) of the Investment Company Act of 1940 by continuing to receive Rule 12b-1 distribution and service fees after the fund had closed to new investors.

The fund in question offered several classes of shares with traditional varying sales loads and Rule 12b-1 fees. Class A shareholders paid a front-end sales charge at the time of purchase. For Class B and Class C shareholders, the Distributor paid the sales commissions and other initial sales-related expenses. In turn the fund reimbursed the Distributor a commission, plus interest on outstanding amounts through monthly Rule 12b-1 "distribution fee" payments to the Distributor equal to 0.75% per year on Class B and C shares until the distribution expenses were fully paid. After that point, the fund would no longer collect the 0.75% distribution fee. In addition, the fund imposed an annual 0.25% "service fee" on all three share classes to cover expenses for ongoing personal services, such as assisting shareholders and maintaining shareholder accounts.

The fund "closed" (i.e., stopped selling shares) to new shareholders but continued selling shares to existing shareholders. After closing to new investors, the fund continued to charge the 0.75% distribution fee and the 0.25% service fee. The fund had paid a approximately $155 million in distribution and service fees since it closed to new investors.

In the complaint, the plaintiff contended that once the fund closed to new investors, the distribution and service fees charged greatly exceeded the minimal distribution costs then actually being incurred. She alleged that the Distributor breached its fiduciary duties under Section 36(b) of the 1940 Act by receiving such fees after the fund had closed to new investors.

In dismissing the action, however, the court stated that the plaintiff set forth no factual support for her contentions. Rather, she relied upon the categorical contention that the challenged fees are per se disproportionately large and therefore unreasonable when paid out while the fund is closed. The court explained that in cases alleging that a mutual fund charged excessive fees, in order to survive a dismissal motion a complaint must set forth more than just a legal conclusion that a fee is excessive.

Although the parties did not dispute that the fund's distribution and service fees were within the limits set by NASD regulations, the court noted that this fact does not necessarily mean that the fees are per se reasonable. Rather, the test for breach of fiduciary duty under Section 36(b) is whether the 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. The plaintiff claimed the closure of the fund to new investors was highly relevant to the decision to continue the fees because sales-related expenses were minimal thereafter. The court noted, however, that the plaintiff failed to demonstrate any substantive connection between the trustees' fiduciary duties and the allegedly excessive fees.

The court noted that because the plaintiff did not complain that the fees were excessive when the fund was open, the complaint relied upon the argument that fees must be per se excessive because they exceed the de minimis ongoing sales expenses of a closed fund. However, the court noted that it rejected such a claim earlier this year based on nearly identical facts (ING Principal Protection Funds Derivative Litigation, 369 F. Supp. 2d (D. Mass, 2005)). In that case, the court observed that Rule 12b-1 has been authoritatively interpreted by SEC officials to allow mutual funds to compensate companies for past distribution services.

Accordingly, the court concluded that the plaintiff (1) failed to allege that Rule 12b-1 distribution and service fees are disproportionate and unrelated to the sales-related services actually provided when shares of the funds were marketed and sold to the general public, and (2) provided no factual assertions that would support such an allegation, with respect to either the

0.75% distribution fee or the 0.25% service fee.

BNA Securities Regulation & Law Reporter Volume 37 Number 43 (October 31, 2005); Yameen v. Eaton Vance Distributors Inc., D. Mass., Civil Action No. 03-12437-DPW, October 24, 2005

Discussion of SEC "soft dollar" proposal attached

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Attached is a discussion of the SEC's proposed interpretive guidance on money managers' use of client commissions to pay for brokerage and research services while falling within the safe-harbor under Section 28(e) of the Securities Exchange Act of 1934.

Significant Litigation:

- ***New York appellate court finds officers of investment adviser may be personally liable for client losses***

A New York appellate court recently found that individual officers of an investment advisory firm may be personally liable for the losses of a client based on a breach of their fiduciary duties arising out of their course of dealing with their client.

The firm entered into an agreement with the client (a trust that managed municipal annuity payments) for investment consultancy services and supervision of third-party investment managers. The firm's duties under the agreement were largely limited to providing reports used to evaluate the return and asset allocation of the portfolio managers. One of the third-party investment managers deviated from the asset allocation model by holding over 80 percent of the client's portfolio in equities instead of the 60 percent equity benchmark set forth in the model. The client alleged that when the stock market declined, the trust's value declined substantially as a result of this allocation. The suit also named the adviser's president and vice president (the "officers") as defendants.

The advisory firm and the officers argued that they were not obligated to provide rebalancing services under the agreement with the client, which required only that they provide performance reports. The client argued, however, that:

- a fiduciary duty had arisen because the officers held themselves out as experienced investment consultants, and provided investment advice upon which the client's trustees relied; and
- the fiduciary duty obligated the adviser to rebalance the portfolio to comply with the asset allocation benchmark and to terminate the third-party investment manager.

The trial court allowed claims against the adviser to go forward but dismissed all counts against the individual officers, because it found no indication of a fiduciary relationship between the client and the officers either in the agreement itself or resulting from the individual officers' conduct outside the scope of the agreement. The client appealed the dismissal of the case against the individual officers. The New York appellate court, however, voted 3-1 to overturn the decision of the trial court, noting that ongoing conduct may give rise to a fiduciary relationship even if not explicitly imposed by the advisory agreement. According to the majority of the court, this conduct involves one party placing confidence in the other and reasonably relying on the other's superior expertise or knowledge. The court noted that the breach of fiduciary duty claim was not a contract claim relating to a breach of the agreement with the client, but rather a tort claim based on the theory that company officers can be held personally liable for tortious conduct. The single dissenting justice concurred with the trial court in concluding that there was no evidence that the officers acted in a fiduciary capacity with respect to the client.

Investment Company Institute Memorandum No. 19279 (October 26, 2005); 2005 NY Slip op. 04460 (NY App. Div. June 2, 2005)