

Advisory Contract Approval

Session 2 of
Core Responsibilities of Fund Directors
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Panel

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Agenda – Advisory Contract Approval

- Overview of Relevant Statutes and Case Law
- Board Structure and Processes
- Review of *Gartenberg* and Disclosure Factors
- Nature, Extent and Quality of Services
- Investment Performance
- Profitability Analysis
- Economies of Scale
- Ancillary or “Fall-out” Benefits
- Comparative Fees and Services
- Concluding Thoughts on this Key Board Responsibility

Overview of Relevant Statutes and Case Law

- All advisory contracts must be approved by board and majority of independent directors (Section 15 of the 1940 Act)
 - » In-person meeting required
 - » Subadvisory contracts included
 - » Initial term: up to two years
 - » After initial term: annually
- Section 15 provides:
 - » It is the **duty** of the directors of a registered investment company to **request and evaluate** and the duty of an investment adviser to furnish **such information as may reasonably be necessary to evaluate** the terms of any advisory contract.

Overview of Relevant Statutes and Case Law

- Section 36(b): **Adviser** has fiduciary duty with respect to receipt of compensation; shareholders have right of action to recover excessive fees from adviser.
- Second Circuit's *Gartenberg* standard (1981) approved by Supreme Court in *Jones v. Harris* (2010):
 - » “[T]o face liability under § 36(b), an investment adviser 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.**”

Overview of Relevant Statutes and Case Law

- *Jones v. Harris*: Supreme Court emphasized the importance of fund independent directors (not just court review under § 36(b)):
 - “Under the Act, scrutiny of investment adviser compensation by a fully informed mutual fund board is the cornerstone of the . . . effort to control conflicts of interest within mutual funds.”
 - “Board scrutiny of adviser compensation and shareholder suits under § 36(b) are mutually reinforcing but independent mechanisms for controlling conflicts.”

Overview of Relevant Statutes and Case Law

- Court deference to board decisions if the process is robust:
 - » “Where a board’s process for negotiating and reviewing investment-adviser compensation is **robust**, a reviewing court should afford **commensurate deference** to the outcome of the bargaining process. Thus, if the disinterested directors considered 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.”
- Court review is more rigorous if the process is deficient:
 - » “[W]here the board’s process was **deficient or the adviser withheld important information**, the **court must take a more rigorous look** at the outcome.”
- “[T]he standard for fiduciary breach under § 36(b) does not call for judicial second guessing of informed board decisions.”

Overview of Relevant Statutes and Case Law

- Recent 36(b) Litigation
 - » Manager – subadviser funds
 - Allegation: management fee excessive; subadviser performs “virtually all” services, yet manager retains significant portion of fee
 - Focus on manager services, including subadviser selection and oversight, administration and compliance, and manager assumption of risks, including entrepreneurial risk
 - Comparisons to other fees, including fees charged by subadviser to other funds
 - » Single adviser funds
 - Allegation: management fee is excessive; same adviser charges less to subadvise other funds
 - Focus on additional services and risks

Board Structure and Processes

- Many boards handle entire process at the board level
 - » Some use contracts review committee (which may be all independent directors or a subset)
- Some boards have a multi-meeting process
 - » First meeting to receive response; second for final consideration and vote
 - » Some boards receive response and take vote at a single meeting
- Information requests and management presentations
 - » Some use formal request letter from counsel; some have presentation by management based on informal discussions/requests
 - » Some use consultants to assist in request and evaluation
 - » Performance data often from independent third party
- 15(c) is a year-round process

Board Structure and Processes

Disclosure

- Shareholder reports must “discuss in reasonable detail the material factors and the conclusions with respect thereto that formed the basis for the board’s approval.”
 - » “Conclusory statements or a list of factors will not be considered sufficient disclosure.”
- Consider process for drafting and reviewing disclosure
- Northern Lights Board enforcement action (2013)
 - » Process for drafting minutes and disclosure resulted in boilerplate statements including material misstatements and omissions
 - » Other deficiencies: missing disclosure (10 approvals); recordkeeping omissions (Section 15(c) materials); compliance program approvals (certifications only)
 - » Directors cited for violations of Section 34(b) (untrue statements in reports) and Rule 38a-1 (failure to follow policy on compliance program approvals)

Review of *Gartenberg* and Disclosure Factors

- Section 15 sets forth no specific factors
 - » Consider factors and information “reasonably necessary”
- Advisory contract review also subject to overall fiduciary duty
- Two sources of factors commonly used by directors
 - » Gartenberg case (2d Cir. 1981)
 - » Shareholder report disclosure requirements based on *Gartenberg*

Review of *Gartenberg* and Disclosure Factors

1. Nature, extent and quality of services
2. Investment performance of the fund and the adviser
3. Costs of services and profitability of adviser and its affiliates
4. Extent to which economies of scale would be realized as the fund grows, and whether fee levels reflect these economies of scale for the benefit of shareholders
5. Fall-out benefits – benefits derived by adviser from the relationship with the fund, such as soft dollar arrangements
6. Comparisons of services and fees with those under other advisory contracts

Nature, Extent and Quality of Services

- Investment services
 - » Performance is part of review, but not the only factor
 - » Process
 - » People
- Administrative services
- Compliance services
- Risk oversight services
- Securities lending services
- Oversight and reporting services with respect to service providers, including any sub-advisers

Nature, Extent and Quality of Services

Investment Performance

- Annual 15(c) process builds on quarterly reviews
 - » Performance charts showing total returns:
 - Quarter, 1-year, 3-year, 5-year, 10-year, since inception
 - » Comparisons to benchmark index (or indices):
 - Prospectus benchmark, which must be “broad-based”
 - Sometimes secondary benchmark, more closely aligned with investment strategy
 - Sometimes to comparable mutual funds
 - » Portfolio manager presentations
- Watch lists are often used
 - » Criteria varies widely and lists should be used as tool, not a conclusion

Nature, Extent and Quality of Services

Investment Performance

- Adviser should explain the factors that account for any under-performance of a fund relative to comparable funds or industry benchmarks
- Directors should be aware of relevant performance metrics for various types of funds, for example:
 - » Market capitalization funds
 - » Money market funds
 - » Funds of funds
 - » Alternative strategy funds

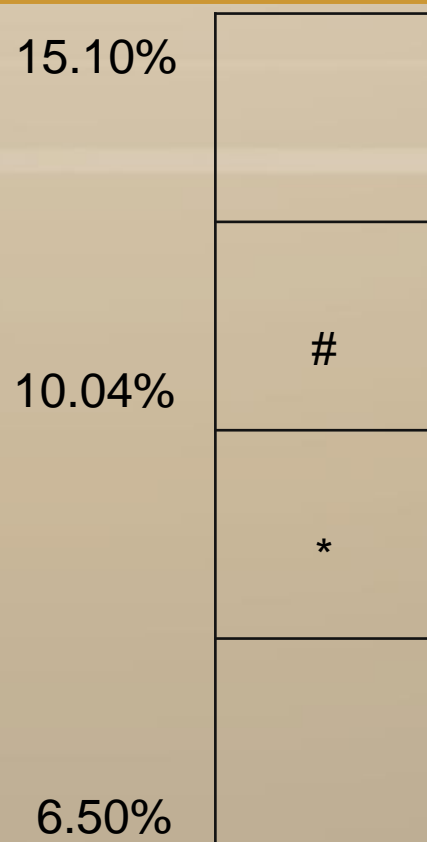
Nature, Extent and Quality of Services

Investment Performance – Peer Groups

- Peer group comparisons are common
- Who selects the peer groups?
 - » Management?
 - » Independent third party? Who engages the third party?
 - » Directors should receive information regarding the selection of peer groups
- How are peer groups selected?
 - » Retail, institutional, variable insurance product funds
 - » Narrow vs. broad
 - » All similar investment strategies vs. competitors in marketplace

Nature, Extent and Quality of Services

Investment Performance – Peer Groups



= Fund

* = Benchmark Index

Quartile charts showing peer and benchmark relative performance over various periods:

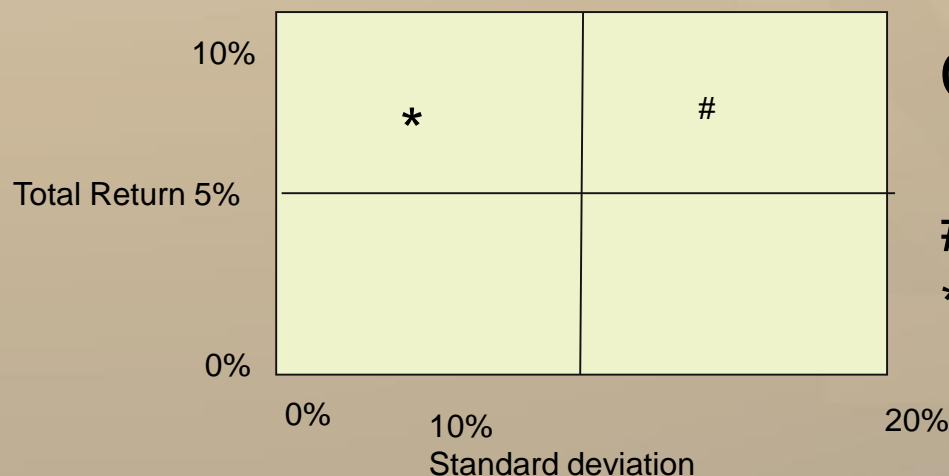
- Quarter
- Year-to-date
- One year
- Three years
- Five years
- Ten years (or since inception)

Calendar year results provide another way of reviewing performance

Nature, Extent and Quality of Services

Investment Performance – Volatility

- Performance comparisons may look to volatility of returns
- Standard deviation is a common measure



Center = median
manager

= Fund

* = Benchmark Index

Profitability Analysis

- No standard approach used by courts or industry
 - » Firms do not generally calculate profitability by fund for business purposes
 - » Allocations are key part of process
- No court has held any particular level of profitability to be excessive
 - » *Schuyt* (S.D.N.Y. 1987): pre-tax profitability up to 77.3%
 - » Court cautioned that it was not holding that 77.3% can never be excessive
- Profitability may be of limited relevance with unaffiliated subadviser
- Directors may consider requesting, among other information, recent financial statements of the adviser and revenue and costs on a fund by fund basis, if available, as well as compensation practices

Economies of Scale

- Challenge in determining economies of scale
 - » Advisers do not run business on fund-by-fund basis
- Challenge in determining how economies are shared
 - » Breakpoints
 - » Initial fee rates
 - » Fee waivers
- Courts have rejected claims that economies of scale should be assumed as assets grow

Ancillary or “Fall-out” Benefits

- Adviser or affiliates may receive benefits other than the advisory fee
- Directors should consider information related to the nature and amount of any ancillary benefits attributable to management of the fund
- *Gartenberg* (sweep money market): float on checks of redeeming shareholders; free credit balances in brokerage accounts from redemptions
- Soft dollars
- Other benefits may arise from affiliate arrangements with fund, including reputational benefits

Comparative Fees and Services

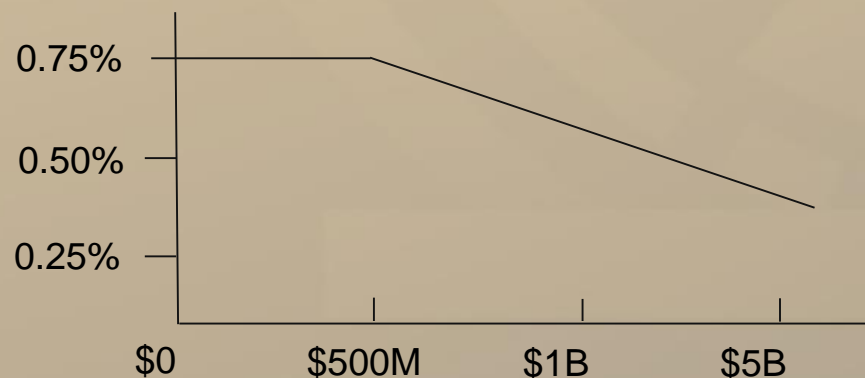
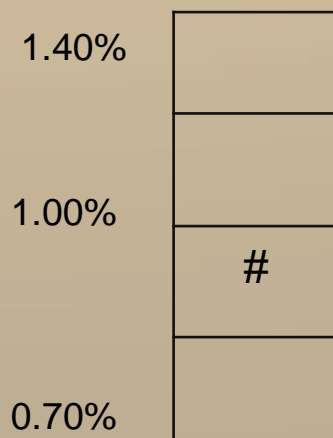
Other Mutual Funds

- Other registered funds advised by same adviser
 - » Fees usually vary depending on whether serving as overall adviser or only as subadviser; historical differences among funds
- Comparisons with peers is common
- Determination of peers is important
 - » May be different than performance peers
 - » Asset size generally considered relevant
- *Jones v. Harris*:
 - » “[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 . . . may not be the product of negotiations conducted at arm’s length.”

Comparative Fees and Services

Other Mutual Funds

- Sample peer comparisons
 - » Actual total expenses vs. larger universe
 - » Actual total expenses vs. smaller peer group based on asset size
 - » Contractual management fees at common asset level
 - » Contractual management fee at variety of asset levels (showing impact of break points)



= Fund

Comparative Fees and Services

Institutional Accounts

- *Jones v. Harris*: There are no categorical rules
 - » “[C]ourts may give such comparisons the weight that they merit in light of the similarities and differences between the services that the clients in question require, but courts must be wary of inapt comparisons.”
 - » “Act does not necessarily ensure fee parity between mutual funds and institutional clients.”

Comparative Fees and Services

Institutional Accounts

- *Jones v. Harris*: There may be important differences between funds and institutional accounts
 - » “As the panel below noted, there **may be significant differences** between the services provided by an investment adviser to a mutual fund and those it provides to a pension fund which are attributable to:
 - the greater frequency of shareholder redemptions in a mutual fund,
 - the higher turnover of mutual fund assets,
 - the more burdensome regulatory and legal obligations, and
 - higher marketing costs.”
 - » “If the services rendered are **sufficiently different that a comparison is not probative**, then **courts must reject** such a comparison.”

Conclusion

- Advisory contract approval process is at the center of a Board's responsibilities and role
- There is no one right approach
- Oversight of fund operations and performance is part of a year-round 15(c) process
- Adjust requests and process as appropriate as funds and industry experience changes
- Understand disclosure and process
- Ask questions and seek guidance from counsel and experienced directors

Resources

- IDC website
 - » www.idc.org
 - » Fundamentals for Newer Directors, <http://fundamentals.idc.org>
- IDC papers
 - » Considerations for Board Composition: From Recruitment Through Retirement
 - » Investment Performance Oversight by Fund Boards
 - » Overview of Fund Governance Practices, 1994-2012
 - » Board Oversight of Exchange-Traded Funds
 - » Board Oversight of Target Retirement Date Funds
 - » Fund Board Oversight of Risk Management

Resources

- IDC papers cont'd.
 - › Board Oversight of Subadvisers
 - › Board Oversight of Fund Compliance
 - › Board Oversight of Derivatives
 - › Board Oversight of Certain Service Providers
 - › Board Consideration of Fund Mergers
 - › Director Oversight of Multiple Funds
 - › Board Self-Assessments: Seeking to Improve Mutual Fund Board Effectiveness
 - › Implementing the Independent Chairperson Requirement

Resources

- SEC website
 - › www.sec.gov
- ABA Fund Directors' Guidebook
 - › www.abanet.org
- ICI Investment Company Fact Book
 - › www.icifactbook.org
- Matt Fink, “The Rise of Mutual Funds” (Oxford Press, 2008)
- Robert Pozen & Theresa Hamacher, “The Fund Industry: How Your Money is Managed” (Wiley Finance, 2011)

Future Webinars

- Investment Performance Oversight – June 2014
- Oversight of the Fund's Service Providers – September 2014
- Specific Regulatory Responsibilities – December 2014

Panelist Biographies

- **Stephanie Grauerholz-Lofton** is Vice President, Secretary and Chief Legal Counsel of Janus Investment Fund and Janus Aspen Series. Stephanie also serves as Vice President and Assistant General Counsel of Janus Capital Management LLC, Vice President and Assistant Secretary to Janus Distributors LLC, and Director of Janus Diversified Alternatives Subsidiary, Ltd. Her primary areas of responsibility are overseeing the preparation of board materials, legal and compliance issues related to board matters, fund corporate governance, registration and disclosure for the Janus funds, including fund mergers and proxies, and supporting global product development. Prior to joining Janus in 2003, Stephanie was an associate with the law firm of Vedder, Price, Kaufman & Kammholz in Chicago. She received her undergraduate degree from Pacific Lutheran University in 1992 and her JD, *cum laude*, from DePaul University College of Law in 1995.
- **Cynthia Hostetler** is an independent director and trustee of the Aberdeen Mutual Funds. She currently serves full time as an independent board member on several public and private corporate boards. Ms. Hostetler previously served as Head of Private Equity at the Overseas Private Investment Corporation, overseeing a multi billion dollar international private equity fund. Prior to OPIC, she was President of First Manhattan Bancorporation. Ms. Hostetler received her BA, magna cum laude and as a Dedman Scholar, from Southern Methodist University and her JD from University of Virginia School of Law. She lives with her husband in Georgetown, Washington, DC, and in an old mill in Oxfordshire England.

Panelist Biographies

- **Christopher E. Palmer** is a partner and leader of the business law department in Goodwin Procter's Washington, D.C. office, and is a member of the financial services group. He represents mutual funds, investment advisers, insurance companies and broker-dealers on the development, regulatory approval, sale and administration of a variety of investment products, including mutual funds and variable and fixed life insurance and annuity contracts. He also represents mutual fund independent directors. Mr. Palmer advises companies on securities law matters, including reporting and corporate governance matters. He also represents companies in financial services litigation, SEC inspections and enforcement actions, and before state insurance departments. Mr. Palmer earned his BA, *egregia cum laude*, from St. John's University in Minnesota and JD, *magna cum laude*, from the Georgetown University Law Center.
- **Jon Zeschin** is a partner and chief executive officer of Essential Investment Partners, LLC, an independent investment counsel and wealth management firm serving individuals, family entities and institutions. Prior to founding Essential, he held senior executive positions with Founders Asset Management, INVESCO and Stein Roe & Farnham. Mr. Zeschin serves as an independent trustee and chair of the audit committee for Matthews Asia Funds, a \$20 billion mutual fund family dedicated to Asia investing. He is also an audit committee financial expert. Mr. Zeschin currently serves on the Governing Council and Policy Steering Committee of the Independent Directors Council. Mr. Zeschin holds a Masters of Management degree from the Kellogg School of Management at Northwestern University. He also holds a BBA in Accounting with Distinction from the Ross School of Business at the University of Michigan and is a CPA.