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## Board Oversight Duties of Performance of Alternative Funds

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The years since the crash of 2007-08 have seen a marked increase in the number and popularity of registered alternative funds – sometimes called liquid alternative funds or “liquid alts.” These funds have many different investment strategies, including long-short stock and bond funds, nontraditional bond funds, arbitrage funds, commodities funds, and fund-of-alts-funds to name just a few. Their strategies are often one of a kind and not designed to outperform standard market benchmarks as with traditional funds. Instead, they may be designed to achieve low volatility, consistent returns in bull and bear markets, reduced risk, or other parameters that distinguish them from traditional stock and bond funds. To complicate matters further, some liquid alt funds may have more than one investment objective or strategy, and one benchmark or peer group may not serve as a complete performance comparison.

Liquid alt fund boards and advisers, and even professional consultants that provide data to the fund industry, have struggled in many circumstances to find benchmarks and peer groups suitable for measuring the performance of these funds given their idiosyncratic nature.<sup>1</sup> A recent industry survey found that many liquid alt fund advisers and boards are using standard benchmarks like the S&P 500, which may not match the fund strategy and/or may provide misleading information about fund

performance.<sup>2</sup> And many of the consultants do not provide peer group data for strategies that are one of a kind. So, standard peer and benchmark comparisons may not always provide the right solution to evaluate a liquid alt fund’s performance.

Fund boards need to understand their responsibilities for monitoring liquid alt funds’ performance because performance oversight is one of the board’s most important responsibilities. This monitoring responsibility is part of a board’s general and continuing fiduciary duty to shareholders. Fund boards also must consider fund performance in connection with approval of a fund’s investment advisory agreement pursuant to Section 15(c) of the Investment Company Act of 1940 (the 1940 Act). This article explores the available legal guidance for boards in monitoring performance of liquid alt funds and concludes that a board may use non-standard performance measurement tools and data if it concludes in its business judgment that they are the best tools available to evaluate fund performance.

### 15(c) Performance Responsibilities of Directors: Case Law

*Gartenberg v. Merrill Lynch* was the first in a line of cases to discuss fund performance as a critical factor in evaluating the nature and quality of an investment adviser’s services for purposes of approval of the fund’s investment advisory contract under

Section 15(c) of the 1940 Act. In *Gartenberg*, investors in a money market fund sued the fund's adviser on an excessive fee claim under Section 36(b) of the 1940 Act.<sup>3</sup> The Second Circuit Court of Appeals held that for there to be a violation of Section 36(b), the adviser's fee must be "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."<sup>4</sup>

In evaluating whether the fees charged were excessive, the Second Circuit considered six non-exclusive factors, one of which was the nature and quality of the services provided by the adviser. The court found that the fund at issue in that case had performed reasonably well; its average percentage yields over a three-year span were "slightly above average for all similar funds," and in 1980 it ranked 37th out of 76 money funds in terms of yield.<sup>5</sup> In concluding that the fees were not excessive, the court explained that while the fund had not realized the "highest possible yield," its investors had enjoyed an above-average return. "There is no evidence," wrote the court, that the "services rendered... have not been of the highest quality."<sup>6</sup>

Plaintiffs have filed numerous Section 36(b) claims since *Gartenberg*, and in assessing the nature and quality of services provided, the courts have relied heavily on measures of the fund's performance.<sup>7</sup> The court in *Kalish v. Franklin Advisers* wrote that "the most significant indication of the quality of an investment adviser's services is the fund's performance relative to other funds of the same kind."<sup>8</sup> In *Kalish*, investors sued an adviser to a fixed income fund and its affiliates that invested primarily in obligations of the Government National Mortgage Association (GNMA) for excessive fees under Section 36(b). To assess performance, the court relied on Lipper rankings of fixed income funds with assets in excess of \$5 billion (all of which were government securities funds) and fixed income funds with assets in excess of \$2 billion (most of which were government securities funds). In those rankings, the fund ranked first and fourth, respectively, in the years considered by the court.<sup>9</sup>

To support their claims, the plaintiffs in *Kalish* pointed to a Vanguard fund that invested primarily in GNMA obligations and had allegedly outperformed the fund at issue. The court noted the difficulties in comparing the performance of the two funds because they had different fiscal years. And even though the funds invested primarily in the same limited subset of obligations, the court observed that "significant differences in structure, peculiar to the Vanguard family of funds... lessen the value of the [performance] comparison."<sup>10</sup>

In *Meyer v. Oppenheimer Management*, a federal district court looked to "money market funds with comparable objectives" to evaluate performance. In dismissing the Section 36(b) claim, the court stated that the fund's performance was in the top third of that group.<sup>11</sup>

The federal district court in *Shuyt v. Rowe Price Prime Reserve Fund* relied on Lipper and Donoghue rankings in dismissing the investor's claims.<sup>12</sup> It cited the fund's annual, three-year trailing, and five-year trailing Lipper rankings for each of the past three relevant time periods and the fund's Donoghue ranking for the previous three years. The court noted that the fund had not performed outside the top 20 percent in any ranking during the time relevant to the litigation. "These statistics," wrote the court, "clearly speak for themselves with respect to the quality of the service provided by the Adviser."<sup>13</sup>

In *Krinsk v. Fund Asset Mgmt.*, the plaintiff conceded that the services provided were of the highest quality, and the court noted that over a three-year period the fund had the third best performance of 56 prime money funds. It ranked second in a list of money market funds associated with central asset accounts.

The *Gartenberg* line of cases offers little guidance to fund boards on how they should evaluate performance for liquid alt funds with complex, unconstrained strategies. The cases all involved money market or other standard fixed income funds with readily ascertainable and relevant comparative peer groups and/or benchmarks, and were decided more

than 25 years ago, well before the advent of liquid alt strategies. The cases do stand for the proposition, however, that a board should evaluate fund performance using some objective criteria that is relevant to the fund's strategy.

## SEC Requirements for Performance Disclosure

In 2004, the SEC issued rules requiring funds to discuss the investment advisory contract approval process in greater detail in shareholder reports and proxy statements. Drawing largely from the factors outlined in *Gartenberg*, the then new rules required disclosure including, but not limited to, the investment performance of the fund and the investment adviser.<sup>14</sup> Notably, the SEC included investment performance as a separate criterion from the quality of the services provided, perhaps emphasizing the importance of this factor in the approval process.

SEC enforcement actions provide little guidance as to how to evaluate an adviser's performance, but the most recent enforcement action related to advisory contract approval, announced on June 17, 2015, serves as a reminder that the SEC is looking closely at this area.<sup>15</sup> In that case, the SEC charged an advisory firm with providing incomplete or inaccurate information to two mutual fund boards in connection with the advisory contract approval process, and it charged the boards' directors for failing to follow up and request the missing information. Notably, the SEC faulted the adviser for comparing an actively managed fund's fees to those of funds that were not sufficiently similar, including an exchange-traded fund, an unmanaged index fund, and funds with different fee structures. Beyond this case, the SEC has brought only a "handful" of enforcement actions related to investment advisory contract approval,<sup>16</sup> and those actions generally related to advisers' failures to disclose relevant information to directors.<sup>17</sup>

In the advertising context, the SEC has stated that use by an adviser of comparisons of fund or account performance to inappropriate indexes or

comparisons unaccompanied by sufficient disclosures of the material differences between the fund or account and the index could violate Section 206(4) of the Investment Advisers Act of 1940 (the Advisers Act).<sup>18</sup>

## Industry Guidance and Practices

Industry groups such as the Independent Directors Council (IDC) and Mutual Fund Directors Forum (MFDF) have provided directors with guidance related to investment adviser performance reviews. Consistent with existing case law and regulatory guidance, these groups advise boards to consider a fund's performance relative to its benchmark and other funds in its peer group.<sup>19</sup>

With respect to benchmarks, every fund must provide in its prospectus a comparison to a third-party selected, broad-based market index.<sup>20</sup> Industry guidance has suggested that fund directors also may want to consider examining "more narrowly based indices that reflect the market sectors in which the fund invests" and internally created custom benchmarks.<sup>21</sup> The IDC has noted that "alternative funds, with long-term return and shorter-term volatility objectives... might use one benchmark for measuring and evaluating the relative long-term returns and another for measuring and evaluating how the fund is accomplishing the shorter-term objective of limiting volatility."<sup>22</sup>

For peer-group comparisons, boards typically turn to reports created by third-party vendors such as Lipper or Morningstar. The IDC has observed that for "evolving categories of alternative funds... there may not be a sufficient number of peers for the vendor to establish a peer group for that investment objective."<sup>23</sup> In those instances, the board may consider a custom peer group for comparison purposes, according to the guidance. But for both custom peer groups and custom benchmarks, the IDC has recommended that the adviser provide an explanation as to why the custom comparison is more appropriate than the third-party comparison.<sup>24</sup>

In addition to benchmark and peer group comparisons, industry groups have noted that directors

may consider performance attribution, risk-adjusted returns, and other standard risk metrics,<sup>25</sup> and some consultants also are offering to create custom peer groups. Some fund boards are also using other kinds of performance analytics, including sharpe ratios, sector analyses, contribution analyses by asset class, country, or other measure, value at risk analyses and similar metrics, either along or in combination with other metrics, benchmarks or peer groups. Yet, these same boards are questioning whether reliance on non-standard benchmarks and peer groups or other methods for evaluating liquid alt fund performance will be respected by courts and regulators.

### Board Evaluation of Liquid Alt Performance

If challenged, courts and securities regulators should respect board decisions regarding performance measurement tools for liquid alt funds provided the board has diligently investigated and evaluated these tools. As the Court in *Jones* noted, “where a board’s process . . . is robust, a reviewing court should afford commensurate deference to the outcome of the . . . process.”<sup>26</sup> According to the Supreme Court in the *Jones* case, the independent trustees must be fully informed about all facts bearing on the investment adviser’s service to the fund – with performance being a key factor.<sup>27</sup>

State law generally permits directors to rely on reports provided by outside experts. But the directors’ reliance on these reports must be reasonable in light of the qualifications, reliability, and interests of the expert, and any red flags that might exist. In order to rely on the report, it “must be pertinent to the subject matter upon which the board is called to act, and otherwise be entitled to good faith, not blind reliance.”<sup>28</sup> Further, a director may rely on reports provided by management “so long as the director reasonably believes that the reports are reliable and competent with respect to relevant matters.”<sup>29</sup>

A board of a liquid alt fund may consider the following factors, among others, in developing its processes and establishing its diligence in

determining the appropriate criteria for evaluating the performance of a liquid alt fund:

- As a starting point, directors of a liquid alt strategy fund should have a clear understanding of the fund’s investment objective and strategies and what the fund is designed to achieve, which is the baseline for determining the appropriate performance comparison tools. Directors of a liquid alt fund should then use this information to evaluate the advantages and disadvantages of various performance measurement tools.
- Fund directors may need to investigate whether third-party data consultants can provide custom and/or blended benchmarks and/or peer groups to assist in evaluating performance. Consultants like Morningstar and Lipper create peer groups for more traditional funds relatively easily, but do not create peer groups for every fund offered, especially niche liquid alt funds. Nevertheless, they may be able to create useful custom benchmarks or peer groups for a board’s use. It is important though that the board be aware of any limitations on reliance on the custom benchmark or peer group in terms of differences with the fund’s strategy.
- A board may consider whether its analysis of a liquid alt fund’s performance may benefit from using multiple benchmarks and/or peer groups, assuming multiple comparison points are helpful in understanding performance and do not introduce confusion into the board’s analysis. Multiple criteria may be appropriate where a liquid alt fund has more than one investment objective or in cases where the comparison points may have inherent limitations on reliability.
- Boards should vet with management and qualified third-party data providers other non-standing non-benchmark/peer group risk metrics that may be applicable to a particular fund for measuring performance either alone or in combination with custom and/or traditional benchmarks. Non-standard metrics sometimes

discussed in connection with liquid alt fund performance include, for example, R squared, standard deviation, downside deviation, and maximum drawdown to name a few.<sup>30</sup>

- A board also may use custom peer groups or benchmarks provided by management, although a board may consider whether such data should be vetted by a qualified third party for reasonableness given that management has a conflict of interest in the outcome of the process. If custom peer groups or benchmarks are provided by management, the board should request that management provide it with a complete analysis of the material differences and similarities between the liquid alt fund and the custom comparison and any limitations on the comparison. An adviser is required under Section 206(4) of the Advisers Act and Section 15(c) of the 1940 Act to provide this information to the board.
- Boards should periodically request information on backtesting of benchmarks and peer groups used for liquid alt funds to determine how they react in different market cycles and economic periods. This information can help a board evaluate whether the benchmarks and/or peer groups chosen serve as relevant comparison points for the fund.
- Regardless of the source of data, liquid alt fund boards should ask a lot of questions about (i) the appropriateness of, and rationale for, the performance tools provided; (ii) the methodology used to construct peer groups and benchmarks; and (iii) the similarities and differences in the fund and the benchmarks or peer components. As noted above, fund directors have a responsibility to understand the performance reports and data provided to them by consultants and management and cannot merely rely on those reports and data without attempting to establish their reliability. Liquid alt fund boards may find it helpful to engage counsel and/or third-party consultants to assist them in understanding the data and its relevance.

- Fund boards also should consider their disclosure responsibilities with respect to the criteria used to evaluate fund performance. These disclosure responsibilities arise in the context of the Form N-1A requirements to describe the factors considered by the board in approving an investment advisory agreement. In this context, it would be appropriate to describe the criteria used and, if it is customized data provided by either a third party or management, the reasons why the board believes the performance tool is appropriate and relevant and any limitations on its usefulness.
- Fund boards should ensure that their process for determining the appropriate performance tools to evaluate fund performance is thoroughly documented. This step is particularly important in order to establish the board's diligence in the event of an SEC inquiry or later litigation.

## Conclusion

Evaluating and measuring the performance of liquid alt funds, particularly funds with unconstrained objectives and strategies, has proved to be a vexing problem for many fund boards. There is limited case law and regulatory guidance available to fund boards with respect to the choice of performance tools. Therefore, directors should use their business judgment to determine the most relevant evaluative criteria, consistent with the investment objectives and strategies of the fund.

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## NOTES

- <sup>1</sup> See Trevor Hunnicut, "Some advisers using ill-suited benchmarks to measure alts performance," *Investmentnews.com* (July 7, 2014) <http://www.investmentnews.com/article/20140707/FREE/140709954/some-advisers-using-ill-suited-benchmarks-to-measure-alts-performance>.

- <sup>2</sup> See Josh Charlson, “3 Surprising Findings From Morningstar’s Alternative Survey” (July 15, 2014) <http://news.morningstar.com/articlenet/HtmlTemplate/PrintArticle.htm?time=115130243>.
- <sup>3</sup> Gartenberg v. Merrill Lynch Asset Mgmt., 694 F.2d 923, 925 (2d Cir. 1982). Section 36(b) provides that an adviser has a fiduciary duty to a fund with respect to its advisory fee. 15 U.S.C. § 80a-36(b).
- <sup>4</sup> Gartenberg, 694 F.2d at 928.
- <sup>5</sup> *Id.* at 926.
- <sup>6</sup> *Id.* at 930.
- <sup>7</sup> See, e.g., Kalish v. Franklin Advisers, Inc., 742 F. Supp. 1222 (S.D.N.Y. 1990); Meyer v. Oppenheimer Mgmt. Corp., 707 F. Supp. 1384 (S.D.N.Y. 1988), *aff’d*, 895 F.2d 861 (2d Cir. 1990); Shuyt v. Rowe Price Prime Reserve Fund, 663 F. Supp. 962 (S.D.N.Y. 1987); Krinsk v. Fund Asset Mgmt., 875 F.2d 404 (2d Cir. 1989).
- <sup>8</sup> Kalish, 742 F. Supp. at 1229.
- <sup>9</sup> *Id.* at 1229-30.
- <sup>10</sup> *Id.* at 1231.
- <sup>11</sup> Meyer, 707 F. Supp. at 1409. The Second Circuit affirmed the dismissal on appeal. 895 F.2d 861 (2d Cir. 1990).
- <sup>12</sup> Shuyt, 663 F. Supp. at 976-77.
- <sup>13</sup> *Id.*
- <sup>14</sup> Final Rule – *Disclosure Regarding Approval of Investment Advisory Contracts by Directors of Investment Companies*, Securities Act Rel. No. 8433 (June 29, 2004).
- <sup>15</sup> *In the Matter of Commonwealth Capital Mgmt. et. al.*, Investment Company Act Rel. No. 31678 (June 17, 2015).
- <sup>16</sup> H. Norman Knickle, “The Mutual Fund’s Section 15(c) Process: Jones v. Harris, the SEC and Fiduciary Duties of Directors,” 31 *Rev. Banking & Fin. L.* 265, 285 (2011); William F. Sullivan, Domenick Pugliese and John Durrant, “Fund Boards in the Cross Hairs – Increased Litigation and Enforcement Activity Relating to Advisory Fees,” *Securities Regulation and Law Report*, 46 *SRLR* 550 (March 24, 2014).
- <sup>17</sup> See, e.g., *In the Matter of Northern Lights Compliance Servs. et. al.*, Investment Company Act Rel. No. 30502 (May 2, 2013); *In the Matter of Morgan Stanley Inv. Mgmt., Inc.*, Investment Advisers Act Rel. No. 3315 (Nov. 16, 2011); *In the Matter of Oppenheimer Funds, Inc.*, Exchange Act Rel. No. 52420 (Sept. 14, 2005).
- <sup>18</sup> See, e.g., Cavato/Lipitz, Inc., SEC Staff No-Action Letter (Oct. 23, 1981); Clover Capital Mgmt., SEC Staff No-Action Letter (Oct. 28, 1986); Letter from the SEC Office of Compliance Inspections and Examinations: To Registered Investment Advisers, on Areas Reviewed and Violations Found During Inspections, May 1, 2000, available at [https://www.sec.gov/divisions/ocie/adultr.htm#FOOTNOTE\\_21](https://www.sec.gov/divisions/ocie/adultr.htm#FOOTNOTE_21).
- <sup>19</sup> See, e.g., Mutual Fund Directors Forum, “Practical Guidance for Mutual Fund Directors: Board Governance and Review of Investment Advisory Agreements” (October 2013) [hereinafter *MFDF Practical Guidance*]; Independent Directors Council, “Fundamentals for Newer Directors” (February 2014); Independent Directors Council, “Investment Performance Oversight by Fund Boards” (October 2013) [hereinafter *IDC Performance Oversight*]; Mutual Fund Directors Forum, “Chapter Two: A Practical Guide to the ‘15(C) Process’” (September 2010).
- <sup>20</sup> Item 4(b)(2)(ii) of Form N-1A requires funds to show past returns in a table, subject to various criteria. Per Item 4(b)(2)(iii), that table must also “show the returns of an appropriate broad-based securities market index,” which Instruction 5 to Item 27(b)(7) defines as “one that is administered by an organization that is not an affiliated person of the Fund, its investment adviser, or principal underwriter, unless the index is widely recognized and used.”
- <sup>21</sup> *IDC Performance Oversight* at 4.
- <sup>22</sup> *Id.*
- <sup>23</sup> *Id.* at 5.
- <sup>24</sup> *Id.*
- <sup>25</sup> *MFDF Practical Guidance* at 18; *IDC Performance Oversight* at 5-6.
- <sup>26</sup> Jones v. Harris Assocs. L.P., 559 U.S. 335, 348 (2010) (“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’”) (quoting *Burks v. Lasker*, 441 U.S. 471, 482 (1979)).

- <sup>27</sup> *Jones*, 559 U.S. at 351.
- <sup>28</sup> *Smith v. Van Gorkom*, 488 A.2d 858, 875 (Del. 1985).
- <sup>29</sup> *Commission Guidance Regarding the Duties and Responsibilities of Investment Company Boards of Directors with Respect to Investment Advisor Portfolio Trading Practices*, Exchange Act Rel. No. 58264 (July 30, 2008).
- <sup>30</sup> R squared is a measure that indicates the extent that fluctuations in portfolio returns correlate with those of a benchmark. “3 Yardsticks for Measuring Fund Performance,” *ThinkAdvisor* (June 7, 2013) <http://www.thinkadvisor.com/2013/06/07/3-yardsticks-for-measuring-fund-performance>. Standard deviation measures the variability of actual returns from their expected average values and the dispersion

of the variations. “Standard Deviation,” *Morningstar Investing Glossary*, [http://www.morningstar.com/InvGlossary/standard\\_deviation.aspx](http://www.morningstar.com/InvGlossary/standard_deviation.aspx). A higher value indicates a wider dispersion of the variations from their mean (average) and would be associated with a higher degree of risk. Downside deviation is the measure of downside risk in fund performance against minimum acceptable return by isolating the negative portion of volatility. “Downside Deviation,” *Morningstar Investing Glossary*, [http://www.morningstar.com/InvGlossary/downside-deviation-definition-what\\_is.aspx](http://www.morningstar.com/InvGlossary/downside-deviation-definition-what_is.aspx). Maximum draw is a calculation that reflects the most negative cumulative return over a given time period. “Max Drawdown,” *YCharts*, [http://ycharts.com/glossary/terms/max\\_drawdown](http://ycharts.com/glossary/terms/max_drawdown).

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