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## REGULATORY MONITOR

### SEC Update

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#### Fund of Funds Shareholders Cannot Sue on Advisory Fees of Underlying Funds

Until recently, no appellate court had addressed whether shareholders of fund of funds mutual funds may pursue claims under Section 36(b) of the Investment Company Act of 1940 (ICA) concerning the fees charged by underlying funds in which the fund of funds invests. The Eighth Circuit's recent opinion in *American Chemicals & Equipment 401(k) Retirement Plan v. Principal Management Corporation*<sup>1</sup> addressed that issue squarely, holding that fund of funds shareholders lack standing to pursue claims for excessive fees charged by the underlying funds.

On June 24, 2017, Principal Management Corporation (PMC) prevailed in a derivative lawsuit alleging that several of its target-date mutual funds charge excessive fees to shareholders. The Eighth Circuit held that the plaintiff lacked standing to pursue its claims under the ICA because it was not a security holder of the at-issue funds. The decision establishes significant limitations on a plaintiff's ability to bring claims against investment advisers under the ICA.

The plaintiff, American Chemicals & Equipment, Inc. (ACE), is an Alabama 401(k) retirement plan that held shares in six target-date mutual funds offered by Principal Funds, Inc. (the LifeTime

Funds). The LifeTime Funds are funds of funds, meaning that each LifeTime Fund invests entirely in other mutual funds (the Underlying Funds). PMC served as advisor to the LifeTime Funds and also served as advisor to the Underlying Funds. The shares of the Underlying Funds are owned by the LifeTime Funds themselves, not by the shareholders of the LifeTime Funds.

In this action, ACE purported to challenge the management fees that PMC charged the Underlying Funds by focusing on what is known as the Acquired Fund Fees and Expenses, or AFFE. The AFFE is a figure that the Securities and Exchange Commission (SEC) requires be disclosed in the prospectus of all funds of funds such as the LifeTime Funds. It is intended to provide investors with a better understanding of the costs of investing in a fund of funds and represents the weighted average expense ratio of each underlying fund. SEC regulations contain the specific formula by which the AFFE must be computed, and there was no dispute in the litigation that PMC calculated the AFFE for the LifeTime Funds in accordance with the SEC's formula.

In its motion for summary judgment, PMC argued that ACE lacked standing to challenge the fees of the Underlying Funds because it was not a security holder in those funds and, moreover, the AFFE was not a fee that could be challenged under the ICA. PMC also argued that even if the court

determined ACE had standing to challenge the AFFE, PMC was nonetheless entitled to summary judgment on the merits because ACE could not establish a violation of Section 36(b).

On February 3, 2016, the district court granted summary judgment in favor of PMC. *American Chemicals & Equipment 401(k) Retirement Plan v. Principal Management Corp.*<sup>2</sup> The district court rejected ACE's claim that it had standing to challenge the AFFE, finding that the AFFE is not a fee that the LifeTime Fund shareholders paid and is, instead, a disclosure item that reflects the expenses paid by the Underlying Funds, including the management fee PMC received for its services to the Underlying Funds. The court found that, by purporting to challenge the AFFE, ACE was, in actuality, challenging the fees of the Underlying Funds. And, because ACE was not a security holder of the Underlying Funds, it did not have standing under the ICA to assert claims respecting the fees of those funds. The district court did not reach the merits of ACE's claim regarding PMC's fees.

At the time of the district court's ruling, there were many other similar lawsuits pending against mutual fund advisers around the country. The district court's decision marked the first of the cases to proceed to verdict, and the first victory for the mutual fund adviser.

ACE appealed the district court's ruling to the Eighth Circuit. On appeal, ACE renewed its argument that it had standing to challenge the AFFE because it was a shareholder in the LifeTime Funds. It also asserted a new, alternative argument: that it was, in fact, a security holder of the Underlying Funds (and therefore had standing to challenge the fees of the Underlying Funds) because the LifeTime Funds and the Underlying Funds are part of a single "registered investment company" for purposes of the ICA. In particular, ACE focused on the portion of Section 36(b) that states: **"An action may be brought under this subsection by the Commission, or by a security holder of such registered investment**

**company** on behalf of such company, against such investment adviser...."<sup>3</sup>

On July 24, 2017, the Eighth Circuit affirmed summary judgment in favor of PMC. *American Chemicals & Equipment 401(k) Retirement Plan v. Principal Management Corp.*<sup>4</sup> Like the district court, the appellate court held that plaintiffs such as ACE that hold shares in a fund of funds do not have standing to challenge the fees of the underlying funds in which the fund of funds invests. The Eighth Circuit also rejected ACE's argument that it had standing because the Underlying Funds and the LifeTime Funds are a single registered investment company under the ICA; the court reasoned that where a corporation is arranged as a "series company" (that is, a single company that offers multiple investment options, each of which is called a "series"), each fund must be treated as its own registered investment company for purposes of the ICA.

Thus, the Eighth Circuit's ruling is significant because it is the first appellate court to address these issues and it creates meaningful limitations on the standing of mutual fund shareholders to sue investment advisers under the ICA.

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## NOTES

<sup>1</sup> 864 F.3d 859 (8th Cir. 2017).

<sup>2</sup> No. 4:14-cv-00044-JAJ, 2016 WL 7155791 (S.D. Iowa Feb. 3, 2016).

<sup>3</sup> 15 U.S.C. § 80a-35 (emphasis added).

<sup>4</sup> 864 F.3d 859 (8th Cir. 2017).

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