Securities Regulation Daily Wrap Up, INVESTMENT COMPANIES—6th Cir.: Lending agent's fees not excessive, (Sep. 30, 2014)

Click to open document in a browser

By Jay Fishman, J.D.

The Sixth Circuit Court of Appeals affirmed the Tennessee District Court's holding that certain fees charged shareholders by a lending agent were not excessive. The shareholders did not object to the general securities lending practice but complained that this lending agent's fees were excessive in violation of the Investment Company Act of 1940, Sections 36(a) and (b) (*Laborers' Local 265 Pension Fund v. iShares Trust*, September 30, 2014, Gilman, R.).

Case history. The shareholders were two pensions in exchange-traded funds issued by iShares, Inc. and iShares trust (iShares), whose substantial mutual fund revenue came from lending its securities holdings to various borrowers. The iShares affiliate and lending agent, BlackRock Institutional Trust Company, N.A. (BTC), was the middleman between iShares and the borrowers of iShares' securities holdings, and received a fee of 35 percent of all securities-lending net revenue. BTC's wholly owned subsidiary, BlackRock Fund Advisors (BFA), was iShares' investment adviser that managed the funds' portfolio under an advisory agreement for a fee separate and apart from BTC's 35 percent fee.

Party contentions. The shareholders' complaint against iShares, BFA and BTC, among individual directors, contended that BFA and BTC violated 1940 Act, Sections 36(a) and (b) by charging an excessive lending fee which bore no relationship to the actual services rendered and was about three times higher than what the industry typically charged. While the shareholders contended that BFA's advisory services bore no relationship to BTC's 35 percent lending fee, their complaint never protested BFA's separate advisory fee.

The district court granted iShares, BFA's and BTC's motion to dismiss on the shareholders' failure to state a claim. The defendants successfully argued that: (1) the Section 36(b) claim was barred by a 2002 SEC exemption order which permitted BTC's predecessor-in-interest to engage in securities lending activities for the 35 percent fee; and (2) the Section 36(a) claim did not provide an implied private right of action.

Section 36(b) claim denied. The shareholders argued on appeal that Section 36(b) permitted a lawsuit against BFA for excessive compensation even where, as here, the SEC previously blessed BTC's securities-lending operations. The shareholders, furthermore, contended that BTC's 35 percent fee should be aggregated with BFA's separate advisory fee to show the combined fees' excessiveness. But the appellate court declared that the shareholders forfeited their "aggregation argument" because the complaint never protested BFA's advisory fee. The court said, moreover, that the two fees were for entirely different services, namely advice on the one hand and sales and distribution on the other, and that if the fees for each service viewed separately were not excessive for the particular service rendered, then the two fees combined was also permissible.

Section 36(a) claim denied. The shareholders argued on appeal that the 1940 Act's text, structure and legislative history substantiated an implied right of action. The appellate court noted, however, that while other circuits were split on this issue, it was a matter of first impression in the Sixth Circuit. The court reviewed the U.S. Supreme Court's four factors for determining whether an implied private right of action exists in a statute. The court concluded that the statutory text must be phrased in terms of the "person benefited" rather than the "person regulated" to confer this right on a particular class of persons.

The court, in light of its conclusion from reviewing the Supreme Court factors, examined the text of Section 36(a), which declares that a "private right of action is the right of an individual to bring suit to remedy or prevent an injury from another person's actual or threatened violation of a legal requirement." The court determined that the text does not contain any "rights-creating language" and, instead, focuses on the "person(s) regulated rather than on the individuals protected." The court also found an express right of action in Section 36(b) which it said strong implies the absence of an implied right of action in Section 36(a).

The case is No. 13-6486.

Attorneys: James Gerard Stranch, IV (Branstetter Stranch & Jennings) for Laborers' Local 265 Pension Fund and Plumbers And Pipefitters Local No. 572 Pension Fund. Seth M. Schwartz (Skadden Arps Slate Meagher & Flom LLP) for iShares Trust, iShares, Inc., iShares Russell Midcap Index Fund, iShares MSCI EAFE Index Fund and iShares MSCI Emerging Markets Index Fund.

Companies: Laborers' Local 265 Pension Fund; Plumbers And Pipefitters Local No. 572 Pension Fund; iShares Trust; iShares, Inc.; iShares Russell Midcap Index Fund; iShares MSCI EAFE Index Fund; iShares MSCI Emerging Markets Index Fund

LitigationEnforcement: AlternativeInvestmentFunds InvestmentAdvisers InvestmentCompanies KentuckyNews MichiganNews OhioNews TennesseeNews