Harvard Law School Forum on
Corporate Governance and Financial Regulation
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Mutual Fund Excessive Fee Claims and Market Conditions

Posted by Robert Skinner, and Amy Roy, Ropes & Gray LLP, on Monday, August 26, 2019

Editor's note: Robert Skinner, and Amy Roy are partners at Ropes & Gray LLP. This post is based on their Ropes & Gray memorandum.

In a decisive August 5 ruling that could be the final nail in the coffin for plaintiffs' efforts to compare advisory and subadvisory fees, a federal court in the Central District of California rejected claims of excessive mutual fund fees asserted against Metropolitan West Asset Management, LLC ("MetWest") following a bench trial. Finding in MetWest's favor across the board, U.S. District Judge George Wu held that the plaintiff-shareholder had failed to prove that MetWest charged excessive advisory fees to its flagship fund, the MetWest Total Return Bond Fund, which grew to become the world's largest actively managed bond fund. The court ruled that the plaintiff's proposed comparison of the Fund's advisory fee to lower subadvisory fees MetWest charged to external funds was "inapt," because MetWest "provides substantially different services and takes on substantially different risks" as adviser and sponsor of a proprietary fund. The court looked instead to mutual fund peer group fees as a more apt comparator, while also giving deference to the fee approval of the Fund's independent trustees following a robust review process. Judge Wu further rejected the plaintiff's theory that MetWest failed to share economies of scale merely because it did not implement breakpoints as the Fund grew in size. Throughout the decision, the court recognized important market conditions of today's mutual fund industry, including the stiff competition among fund advisers to both attract investor assets and retain talented professionals. MetWest is represented in the case by a team of Ropes & Gray litigators.

Kennis v. Metropolitan West Asset Management, LLC was filed in October 2015, and was one in a series of cases asserted under Section 36(b) of the Investment Company Act of 1940 (the "ICA") in the wake of the Supreme Court's decision in *Jones v. Harris Associates L.P.* (2010), which established the "beyond arm's-length" standard for such claims. Many of these post-*Jones* cases sought to establish violations of Section 36(b) by comparing advisory and subadvisory fees. In *Kennis*, the plaintiff claimed that MetWest's advisory fee of 0.35% of assets under management (or 35 basis points), was "excessive"—and reflected unreasonable adviser profits—to the extent it was higher than the subadvisory fees MetWest charged to unaffiliated subadvised funds. The plaintiff also alleged that, as the Fund's assets grew over time, MetWest enjoyed large economies of scale that were not passed through to shareholders via breakpoints in the advisory fee schedule. According to the plaintiff, the board approval process for the advisory fee was flawed because, among other reasons, the independent trustees failed to negotiate lower fees or to obtain more detailed information regarding the subadvisory fees and economies of scale.

After reviewing extensive testimony and documentary evidence, the court rejected each of the plaintiff's theories. On the central issue of whether the subadvisory fee comparison carried any

weight, Judge Wu found that "it is clear . . . that the services MetWest provides to the Fund for the 35 bp fee differ significantly from the services it provides to the Subadvised Funds." The court recognized various differences in services related to daily pricing and striking the Fund's net asset value ("NAV"), shareholder redemption requests, compliance, public regulatory filings, supporting the board process, overseeing third-party service providers, and client servicing. Critically, the court recognized substantial differences in responsibilities with regard to striking the NAV daily and generating liquidity, two defining characteristics of mutual funds. The court found unpersuasive the plaintiff's arguments that the Fund's administrator, rather than MetWest, is ultimately responsible for striking the NAV. While the administrator carries out MetWest's instructions, MetWest bears the ultimate responsibility and liability for striking the correct NAV. Regarding liquidity, the court also recognized that MetWest was solely responsible to meet shareholder redemption requests from the Fund, but when acting as a subadviser, MetWest merely has to respond to inquiries from the sponsoring advisers.

In a departure from previous cases, MetWest successfully demonstrated that portfolio management services provided for the Fund were different both in nature and scope from those provided to the subadvised funds. In particular, Judge Wu found portfolio management services provided to the Fund to be "more difficult and involve[] exponentially more work than managing the portfolios of the Subadvised Funds."

In addition to recognizing substantial differences in services, the court also concluded that "MetWest takes on far more risk as adviser to the Fund than as subadviser to the Subadvised Funds." According to Judge Wu, these differences in reputational, financial, litigation, regulatory, and business risks can in part justify the difference between advisory and subadvisory fees.

As for comparative fees, the court found Broadridge data to be more persuasive than the plaintiff's proposed subadvisory fee comparison and a "useful tool for comparison." While noting that Broadridge comparative fee data was not dispositive, Judge Wu found such data persuasive. Specifically, the court found that when comparing the Fund to its Broadridge-selected peer groups from 2014 to 2017, the Fund's advisory fee consistently hovered below the median. This ranking was persuasive in part because the court found that the funds included in the comparator groups actively competed with the Fund.

Citing repeatedly to the testimony of the board's independent chair, Judge Wu found that the process by which the board annually approved the Fund's advisory fee was robust. Moreover, the court rejected the plaintiff's arguments that the board did not receive from MetWest sufficient information relating to services provided to the subadvised funds and economies of scale. Judge Wu declined to accept the plaintiff's contention that the fact that the board did not review the contracts with the subadvised funds constituted a deficiency, when the board did receive information on the actual services provided to the subadvised funds and the fees charged. The plaintiff failed to persuade the court that the lack of a quantitative economies of scale analysis was sufficient to negate deference, especially when the board frequently discussed breakpoints and considered that the Fund was already one of the lowest cost mutual fund providers in the United States.

Critically, the court rejected an argument often advanced by plaintiffs in Section 36(b) litigation, that the board's failure to negotiate a lower advisory fee negates any deference owed to the board. Consistent with well developed case law on this issue, Judge Wu found that it was not the

board's duty to "negotiate" fees, and that the board did fulfill its duty to ensure that the fees were "fair and reasonable."

Regarding economies of scale, the court found that the plaintiff failed to meet his two-pronged burden to show that economies of scale were both realized and not sufficiently shared with investors. Judge Wu did not credit an analysis conducted by the plaintiff's expert that purported to show economies of scale only after subtracting certain expenses (such as portfolio manager compensation) from total costs. The court recognized that the removal of these costs was done without any factual basis and that, when such costs were considered, the plaintiff's expert actually demonstrated diseconomies of scale. In contrast, Judge Wu found testimony from MetWest's Laird Landmann, a senior MetWest executive and a portfolio manager for the Fund, to be persuasive. Landmann detailed the manner in which increased scale can require increased marginal resources, particularly in the case of bond funds where advisers must employ creative means to achieve the desired exposure to certain securities. Further, the court found that plaintiff failed to show that any realized economies were not shared. The court pointed to evidence that, during periods of the Fund's asset growth, MetWest "reinvested through adding new employees, improving technology systems, and by increasing compensation for retention purposes." Additionally, Judge Wu cited "evidence that MetWest priced the Fund to scale at the outset, meaning that it priced the Fund below the level necessary to recoup costs in order to attract assets and investment."

In addition to rejecting across the board the theories advanced by the plaintiff's bar in recent years, the *Kennis* decision is notable for its express recognition of market realities facing mutual fund advisers, which provide important context for any consideration of fees. "Each day, investors can decide whether to redeem their shares of the Fund and move their monies elsewhere, resulting in a competitive business environment in which the managers and sponsors of mutual funds compete for investor assets." This finding runs counter to the common plaintiff theme that mutual funds are "captives" of their advisers, and thus can set advisory fees at will without fear of market repercussions. Although not adopting them for purposes of his ruling, Judge Wu pointed to the "persuasive" findings of MetWest's expert witness, economist John Coates, regarding competition in the mutual fund industry.