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Mutual Fund Ruling May Make Fee Challenges More Difficult

By **Keith Dutill and Joseph Kelleher** (September 30, 2019, 4:30 PM EDT)

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Since 1970, when Congress amended the Investment Company Act of 1940 to add Section 36(b) and provide fund shareholders with a private right of action against fund advisers for charging excessive fees, more than 100 such suits have been filed.

While the specific theories of liability have varied over the years, all rely to one degree or another on a common theme: Advisers dominate the funds they advise and set their fees largely unchecked by independent directors or any other force. Despite the pervasiveness of this theme in 36(b) cases, plaintiffs have consistently failed to muster evidence to support the notion that advisers have unbridled control in setting the fees charged to their affiliated mutual funds.

And, to the contrary, in several notable recent decisions, courts have focused, quite properly, on the role of independent directors in the fee approval process, dissecting the so-called 15(c) process, and explicitly finding that the director review process was robust and entitled to significant deference.[1]

The realities of the marketplace in which funds operate and the role of market forces in both shaping the risk advisers face, and constraining the fees they charge has received less attention. A recent decision out of the U.S. District Court for the Central District of California changes that, and the potential impact on future 36(b) claims is significant.

In Kennis v. Metropolitan West Asset Management LLC,[2] a shareholder in the MetWest Total Return Bond Fund alleged that Metropolitan West Asset Management breached its fiduciary duty to the fund by charging an excessive advisory fee. Echoing a claim advanced by multiple other plaintiffs since the U.S. Supreme Court’s decision in Jones v. Harris Associates LP,[3] the shareholder argued that MetWest charged the fund a substantially higher advisory fee than it charges to other, unaffiliated funds it subadvises, despite providing substantially the same services.

Following a bench trial, the court issued a lengthy set of findings that carefully examined the facts in light of the clear standard set in Jones, with particular focus on the Gartenberg factors first established by the U.S. Court of Appeals for the Second Circuit,[4] and subsequently endorsed by the Supreme Court.

The court found **in favor** of MetWest in all material respects, concluding that the plaintiff had failed to meet its burden with respect to any of the Gartenberg factors.[5]

That outcome, of course, is not unique. In the nearly 50 years since 36(b) was adopted, plaintiffs have yet to notch a win. The court's recognition of the market realities confronted by fund advisers is unique, however, and goes to the heart of most claims brought under 36(b).

First, in evaluating the plaintiff's argument that the fees MetWest charged to the fund should be comparable to the fees it charges unaffiliated, subadvised funds because the services are substantially the same, the court took a detailed look at the services actually rendered by MetWest in both circumstances.

It then cataloged a variety of substantial services MetWest provided to the fund that it does not provide to its subadvised funds, including daily pricing and striking of net asset value, maintaining liquidity to manage shareholder redemption requests, ensuring ongoing compliance, making all public filings, and assisting the board in executing its duties.

The court then examined the portfolio management services, and based on the evidence at trial found "the task of managing the Fund's portfolio is more difficult and involves exponentially more work than managing the portfolios of the Subadvised Funds."[6] To reach that conclusion, the court considered the relative holdings of the portfolios, noting that the fund held over 1,900 unique securities, as compared with 200-300 in the subadvised fund.

It also credited testimony respecting the nature of bond investing, and the challenge of locating bonds that meet specified criteria. These real-world issues, confronted by advisers and portfolio managers daily, have received less attention than they merit in prior 36(b) cases. The MetWest decision may change that.

Second, and perhaps even more significant, the court acknowledged the competitive marketplace in which mutual funds and their advisers operate, and the impact of that marketplace on advisory fees. At the outset, in describing the fund, the court noted that, "[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."[7]

It traced the history of the fund's advisory fee, observing that it started at a rate at or below the median for comparable funds, and later reduced its fee due to competitive forces. The court found expert testimony regarding competition in the mutual fund industry "persuasive," including that "the most salient characteristic of a mutual fund [is] redeemable shares. … [Fund] investors may 'fire' advisers at any time by redeeming shares and switching into other investments."[8]

It also acknowledged empirical studies showing that increasing advisory fees results in a corresponding reduction in the level of assets in the fund. In so doing, the court addressed the reality that fund advisers face constantly, but 36(b) plaintiffs ignore consistently when they frame their claims with allegations of funds held hostage to advisers capable of setting fees without constraint: Competition operates as a major check on advisory fees, and that check is a centrally relevant part of the context in evaluating 36(b) claims.

Repeated losses by plaintiffs in 36(b) cases have caused new case filings to dwindle, and the last few cases in the most recent wave of 36(b) lawsuits are winding their way to conclusion.

While the recent MetWest decision could be viewed as just one more victory in a long series of defense wins in the post-Jones era, the decision is notable because, more so than in prior decisions, the court recognized the wide range of work required of modern portfolio managers and acknowledged the competitive landscape in which mutual fund advisory fees are determined.

The underlying narrative driving 36(b) litigation — that mutual fund advisers can charge what they please — cannot be reconciled with the current realities of the mutual fund industry. The court in MetWest recognized this, and if other courts do the same, the already difficult environment for 36(b) plaintiffs may get even tougher.

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[1] See, e.g., Kasilag v. Hartford Inv. Fin. Servs., LLC, Nos. 11-cv-1083, 14-cv-1611, 15-cv-1876, 2017 WL 773880 (D.N.J. Feb. 28, 2017), aff'd, 745 F. App'x 452 (3d Cir. 2018); Sivolella v. AXA Equitable Life Ins. Co., No. 11-cv-4194, 2016 WL 4487857 (D.N.J. Aug. 25, 2016), aff'd, 742 F. App'x 604 (3d Cir. 2018).

[2] Kennis v. Metro. W. Asset Mgmt., LLC, No. 15-cv-8162, 2019 WL 4010747 (C.D. Cal. July 9, 2019), adopted, No. 15-cv-8162 2019 WL 4010363 (C.D. Cal. Aug. 5, 2019).

[3] Jones v. Harris Assocs., L.P., 559 U.S. 335 (2010).

[4] Gartenberg v. Merrill Lynch Asset Mgmt., Inc., 694 F.2d 923 (2d Cir. 1982).

[5] Kennis, 2019 WL 4010747, at *35.

[6] Id. at *26.

[7] Id. at *4.

[8] Id. at *35, n.53.
