# What Mutual Fund Advisers Can Learn From AXA Trial Win


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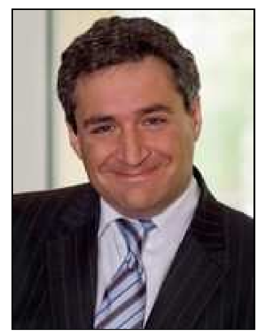
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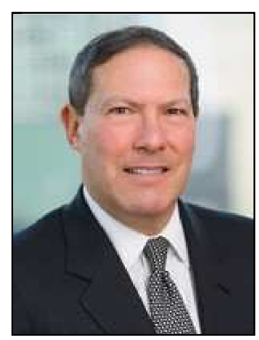
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Law360, New York (September 12, 2016, 11:35 AM ET) -- In the first trial of a recent wave of cases under Section 36(b) of the Investment Company Act, Judge Peter G. Sheridan of the U.S. District Court for the District of New Jersey ruled in favor of the defendant adviser, finding that the plaintiffs had failed to prove that the mutual fund advisory fees at issue were excessive. The decision entered in Sivolella v. AXA Equitable Life Insurance Co., No. 11-cv-4194 (D.N.J. Aug. 25, 2016) spans nearly 150 pages and follows a 25-day bench trial.

Section 36(b) imposes a fiduciary duty on mutual fund advisers with respect to their receipt of compensation for the services they render to the funds they manage. To win a Section 36(b) case, a plaintiff must prove that a mutual fund adviser's fee is "so disproportionally large that it bears no reasonable relationship to the services rendered and could not have been the product of arm's-length bargaining."

In analyzing this standard, courts consider all relevant factors, including: (1) the independence and conscientiousness of the fund's board of directors charged with approving the adviser's fee; (2) the nature and quality of the services provided by the adviser (which may include the fund's performance); (3) the adviser's profitability; (4) any "fallout" benefits received by the adviser; (5) whether economies of scale in operating the fund were shared with the fund's shareholders; and (6) comparative fee structures of other similar funds.[1]

In the recent trial, the plaintiffs — investors in 12 mutual funds managed by AXA Equitable Funds Management Group LLC — claimed that AXA's fees were excessive because it delegated virtually all management responsibilities to subadvisers but kept most of the fees. According to the plaintiffs, any additional fees paid to AXA beyond the amount of the subadvisers' fees were unjustified by the services AXA provided to the funds.

Considering the relevant factors with respect to AXA's fee, Judge Sheridan rejected the plaintiffs' excessive-fee theory.

Here are a few insights from that ruling:

(1) Mutual fund boards should continue to focus on both the independence and quality of

their annual advisory contract renewal process under Section 15(c) of the Investment Company Act, both of which we expect to continue to have an outsized influence on the outcome of future excessive-fee litigation;

(2) The court in AXA considered testimony and evidence beyond the advisory contract language to determine the services provided by the adviser to the mutual funds. Nevertheless, advisers should consider, in advance of litigation, whether the language of their advisory agreements and any subadvisory agreements accurately describes and fully reflects the nature and extent of the services they provide;

(3) The use of outside experts and advisers to provide guidance with respect to the adviser's fees or services (during the renewal process or otherwise) could be helpful in any subsequent litigation; and

(4) Boards and advisers should not hesitate to make continuous improvements to their annual advisory contract renewal process, even (and especially) after a Section 36(b) lawsuit is filed, because courts are unlikely to hold such improvements against them.

## 1. A Board Led by Independent Directors With Independent Advisers Remains Key to Defeating Section 36(b) Litigation

A thorough and consistent board process led by independent directors with independent advisers will likely be the key factor in defeating Section 36(b) litigation, and will influence the court's analysis of other relevant factors.

In AXA, the court determined that the board was "diverse and independent" and had "robustly reviewed" the adviser's compensation. A number of facts supported that finding:

- ***The board had appointed a lead independent director who conducted an "arm's-length" process separate from the adviser and the one director affiliated with the adviser.*** The court noted that the board consisted of a supermajority of independent directors and only one director affiliated with the adviser (the chairman of the board, who was also the president and CEO of the adviser). Although the plaintiffs criticized the chairman's affiliation with the adviser and the court expressed concern that the chairman "generally controll[ed] the information" in presentations to the board, that criticism was insufficient to overcome testimony and evidence reflecting a strong contract approval process led by the lead independent director, not the chairman.[2]

- ***The board had broad diversity of expertise on a variety of different subjects, even though it consisted "mainly of individuals with backgrounds in financial services."*** The court questioned whether the board had a "regulator type person" but acknowledged that the lead independent director had practiced in front of the U.S. Securities and Exchange Commission as a partner at a large law firm and that the board was assisted by independent counsel with regulatory experience. The court also questioned the "Wall Street leanings" of the board but found that it was offset by directors with backgrounds in consulting and public relations.

- ***New board members were identified by an executive search firm and benefited from a "comprehensive training regimen."*** The court credited testimony that the independent directors were assisted in selecting their replacements by a firm specializing in identifying independent directors. The court also noted that the board’s training program was comprehensive, and included presentations and materials from independent counsel in addition to materials provided by the adviser.

- ***The board sought and obtained information from multiple sources other than the adviser.*** The court rejected the plaintiffs’ argument that the board “placed too much faith” in materials provided by the adviser. Rather, the court noted that the board had received advice and information from multiple independent consultants and experts, including Lipper, Morningstar, Strategic Insights, Ernst & Young, the Investment Company Institute, the Independent Directors Council and independent legal counsel.

- ***The independent directors participated in preparing and requesting materials regarding the adviser’s fee.*** The court credited the board’s role in developing charts tracking the services provided and fees charged by the adviser as well as the subadvisers. The court also took note of a summary provided to the board regarding significant recent developments facing the funds or adviser. Although the court observed that some of these materials (such as the charts) were created only after the litigation, the court considered the use of the materials to be a positive factor, not evidence of a prior weakness in the board’s process.[3]

## 2. Advisers Should Consider Whether the Language of Their Advisory Agreements Accurately Describes and Fully Reflects the Services They Render

In litigation, advisers can benefit from clear sources of documentary evidence demonstrating the services provided to a fund in exchange for advisory fees. In AXA, the plaintiffs argued that AXA did not provide services to the funds that justified its fees because the subadvisory agreements included a similar list of services. Although the language of AXA’s advisory agreement did not fully describe or reflect AXA’s services to the funds, the court rejected the plaintiffs’ argument for multiple reasons:

- ***Although the plaintiffs were “essentially correct” that the services described in the advisory agreements were largely the same as those described in the subadvisory agreements, the court credited the adviser’s additional oversight responsibilities.*** The court found that the adviser’s responsibilities to oversee the subadvisers and other service providers were not apparent from the “generic and broad” language of the agreements. As one example, the court noted that although the subadvisers were assigned the task of carrying out a fund’s investment objectives, they were required to deliver performance data to the adviser for purposes of analysis and reporting. Likewise, although the contracts demonstrated that AXA delegated some administrative services to third-party vendors, it remained responsible for coordinating those service providers, as well as performing other tasks, such as valuation of complex securities, monitoring compliance with securities laws and regulations, and creating and organizing materials to be submitted to the funds’ board.

- ***Testimony and evidence demonstrated that the adviser provided services “beyond those expressly outlined in the agreements.”*** AXA retained responsibility for developing and implementing the investment strategies associated with each of the funds, conducting initial research in connection with hiring the subadvisers, providing risk management services, operating a shareholder call center, developing investment guidelines and benchmarks and continuously evaluating fund performance and potential restructuring or merger options. Regarding the latter task, the court noted that the adviser had restructured five of the funds at issue during the relevant time period.

- ***The court credited testimony and evidence presented by the adviser regarding the risks it assumed in operating the funds.*** The court found that the adviser's fee was justified, in part, by the "litigation and reputational risks" and "operational and business risks" associated with operating the funds. Although the funds had agreed to indemnify the adviser for some risks, the court credited testimony that "notwithstanding the contract language, which is standard in the industry, both the [b]oard and regulators would ultimately hold [the adviser] liable for any issues that impact the Funds or investors."

In sum, AXA could have benefited from language in the agreements that better reflected the nature and extent of the services it provided to the funds (separate and in addition to the services provided by the subadvisers). However, in the end, the court refused to elevate "form over substance" by limiting its analysis to the language of the contract and determined that AXA provided significant services beyond those expressly described in the contracts.

## 3. Outside Consultants Can Demonstrate Transparency and Credibility in Subsequent Fee Litigation

Throughout the decision, the court credited AXA's use of outside auditors, lawyers and consultants to review its processes and methodologies. For example, the court rejected the plaintiffs' contention that the adviser had improperly classified subadvisory fees as expenses to artificially deflate profitability, and noted that two independent accounting firms had reviewed the arrangement and found it to be within ordinary accounting principles. The court also rejected criticisms of the adviser's methodology for allocating expenses, noting that it also had been reviewed by two independent accounting firms. Similarly, the court rejected the plaintiffs' criticisms regarding the selection of peer groups in the adviser's comparative fee materials, noting testimony by the plaintiffs' expert that Lipper — the organization responsible for preparing the materials — is an "independent and authoritative source for data."

## 4. Improvements to the Board's Process After Commencement of Litigation Did Not Demonstrate Prior Deficiencies

Although the court found in favor of the defendants, it acknowledged that "the filing of the suit brought about positive changes to the Board's composition and process." For example, the court believed that the lawsuit had resulted "in a more scrupulous and rigorous examination of Board expenses" and the development of additional board materials analyzing AXA's fees. Moreover, the court observed that "the organization of the Board materials, specifically the binders, drastically improved in the years following the lawsuit." Notably, the court did not find that these improvements during the course of the litigation demonstrated deficiencies in the board's process in prior years. Instead, the court credited the board's efforts to improve its process and materials.

## Conclusion

While AXA was a decisive victory for the adviser, it serves as a reminder to boards and advisers alike of what really matters in excessive-fee litigation. In particular, diligent focus on board process and independence before litigation can be rewarded after a suit is filed. Boards and advisers should consider AXA's implications and whether the decision raises issues that should be reviewed by independent counsel with experience advising funds and advisers with respect to the Investment Company Act.

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[1] See Jones v. Harris Assocs. LP, 559 U.S. 335 (2010) (citing Gartenberg v. Merrill Lynch Asset Mgmt. Inc., 694 F.2d 923 (2d Cir. 1982)).

[2] Notably, the court found that the board's lead independent director provided "credible testimony regarding the Board's composition, training, and decision-making process in analyzing [AXA's] fees." In stark contrast, the court found all but one of the plaintiffs' witnesses to be less credible, which had a "significant impact on the outcome of the case." For example, the court gave the testimony of the plaintiffs' accounting expert "little weight" because his answers were "evasive" and "often inconsistent" with prior testimony. Likewise, the court discredited the testimony of the plaintiffs' mutual fund expert because of his "inconsistencies, oversimplification, and his sarcastic demeanor" and noted mathematical errors in his work product. The plaintiffs' corporate governance expert "also lacked credibility" because of his admittedly "cursory" review of the documents and unfamiliarity with open-end funds (the type of funds at issue).

[3] The court's finding with respect to the board's independence permeated the court's consideration of the other relevant factors. For example, regarding economies of scale, the court noted that the board had frequently discussed the topic, had received relevant information and presentations during its renewal meeting, and had successfully obtained additional management fee breakpoints from the adviser. The court also discounted evidence from the plaintiffs regarding potential fallout benefits received in connection with the fund (brokerage fees received by an entity affiliated with the adviser's parent) because the benefits had been disclosed to the board and properly considered at renewal meetings. Likewise, the court rejected the plaintiffs' criticisms of certain comparative fee materials because the board had considered the potential weaknesses in the data and requested additional information where appropriate.