Another Mutual Fund Adviser Prevails at Trial in Excessive Fee Case

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On July 31, 2019, Judge George H. Wu of the U.S. District Court for the Central District of California released tentative findings of fact and conclusions of law dismissing an excessive fee claim brought under Section 36(b) of the Investment Company Act. The decision follows a seven-day bench trial held in December 2018 during which 18 witnesses testified. *Thomas J. Kennis v. Metropolitan West Asset Management, LLC*, No. 15-08162 (C.D. Cal. 2019) (*MetWest*).

MetWest is the second trial[1] — following *In re BlackRock Mut. Funds Adv. Fees Litig.* (*BlackRock*) — rejecting the "subadvisory" or "reverse manager of managers" theory in excessive fee litigation. The court's decision reinforces several key lessons from the recent waves of Section 36(b) litigation and builds on that line of precedent.

First, while it reiterates the now-familiar tenet that the board should maintain a rigorous process involving ongoing and conscientious review of the *Gartenberg* factors, the *MetWest* court expressly held that a fund's board of trustees is not required to negotiate fee reductions to be entitled to substantial deference. Similarly, the *MetWest* court found that the board was not required to analyze metrics like cost and profitability data on a fund-by-fund basis, nor was it required to review the agreements for products managed under similar mandates as the funds at issue (here, subadvisory agreements). *MetWest* also further supports the principle set forth in prior Section 36(b) cases that trustees can and should refine their processes during litigation without facing any inference that the original process was deficient.

Second, *MetWest* is the latest installment in a string of cases rejecting the subadvisory theory of excessive fee litigation, finding that subadvisory and advisory services are not comparable and emphasizing the substantial differences in the scope and scale of the disparate services. In rejecting the subadvisory fee comparison, *MetWest* concludes not only that advisory and subadvisory services are different as a general matter, but that even similar services across product types — *e.g.*, portfolio management — can require differing amounts of adviser resources. Ultimately, *MetWest* rejects the comparison in favor of third-party comparisons to peer funds.

Third, on economies of scale, *MetWest* contrasts the resources required to manage small funds with the much more substantial resources required to manage large funds as assets under management (AUM) increase. *MetWest* also reinforces the principle that the proper analysis to demonstrate the existence of economies of scale requires more than simply a comparison of AUM, profitability and expenses over time. It requires controlling for extraneous variables that could contribute to decreasing expenses in order to demonstrate that a decline in expenses was due to economies of scale. *MetWest* also supports the principle that any retained economies of scale can be properly shared through nonpecuniary mechanisms like investments in personnel, technology and infrastructure. Although the at-issue fund in *MetWest* lacked fee breakpoints and was priced "at scale" when launched, the court held that breakpoints and fee reductions are not required to show that economies of scale were properly shared with funds.

[1] Prior to trial, the court granted partial summary judgment in favor of the defendants on two *Gartenberg* factors: (i) fall-out benefits and (ii) nature and quality of the services. Opinion at 2. The trial addressed all of the other *Gartenberg* factors.

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Background

The at-issue fund (the Fund) was launched in 1997 with an initial advisory fee of 55 basis points (bps). *See id.* at 3, 6. In 2000, after an increase of institutional investors in the Fund, MetWest lowered its advisory fee to 35 bps. *See id.* at 6. Throughout the litigation, the Fund did not have fee breakpoints. *See id.* at 13. During the period relevant to the plaintiffs' claims, the Fund had between $60 and $80 million in AUM, invested in a mix of "fixed-income securities of varying maturities issued by domestic and foreign corporations and governments." *Id*. at 4.

The Fund engages third-party service providers and compensates them directly (not included in the 35 bps advisory fee). *See id.* at 8. However, MetWest "is ultimately responsible for all services provided for the Fund whether the services are supplied by MetWest itself or by a third-party provider." *Id*. Under the investment management agreement (IMA), MetWest has the ultimate responsibility to "'act as the investment manager to the Fund,'" which includes negotiating the agreements with third-party service providers, overseeing those providers and ensuring that they "comply with regulatory requirements and with MetWest internal policies and procedures." *Id*. (citation omitted).

MetWest serves as a subadviser to third-party funds (the Subadvised Funds) using a similar mandate to the Fund. Each of the Subadvised Funds pays a subadvisory fee to MetWest and an advisory fee to an independent sponsor. The subadvisory fees ranged from 15 bps to 35 bps. *See id*. at 14-15.

The Fund's board reviewed (on an annual and ongoing basis) "various pertinent documents as to the Fund's performance, operations, finances, and services." *Id*. at 12. The materials reviewed by the board included (i) Broadridge data comparisons to peer funds, (ii) documentation of the Fund's performance, costs (including cost allocation) and profitability, (iii) subadvisory fee schedules and services, and (iv) comparisons between subadvisory and advisory services and risks. *See id*. at 12-13.

Key Takeaways

The Court Found That a Conscientious, Well-Informed Board Does Not Need To Negotiate Lower Fees To Be Entitled to Deference Under Jones

The plaintiffs argued that the board process was deficient and the board's decision to approve the fees at issue was not entitled to deference because the board: "(1) did not seek or discuss a reduction in fees; (2) failed to sufficiently analyze economies of scale, costs, and profits; (3) failed to consider services that MetWest performs for both the Fund and the Subadvised Funds; and (4) erroneously relied on captive fee comparisons." *Id*. at 34. The court rejected the plaintiffs' arguments and granted substantial deference to the board. *See id*. at 41.

In granting deference to the board, the court reached the notable conclusion that the board was *not* required to negotiate a fee reduction. In so holding, the court endorsed trustee testimony that "it wasn't the Board's responsibility to negotiate the amount of fees. [Instead, it] was the Board's responsibility to make sure that the fees were fair and reasonable." *Id*. at 40 (alteration in original) (citation omitted).

The court also emphasized several other factors in granting board deference, including:

- The board's Section 15(c) process was robust because: (i) throughout the year, the board requested, received and reviewed substantial "materials as to the Fund's performance, operations, finances, and services"; (ii) the board was advised by independent counsel; (iii) the board met "with Broadridge representatives to discuss the selection and methodology in regards to peer group comparison studies"; and (iv) in response to the board's Section 15(c) questionnaires, MetWest provided hundreds of pages of materials addressing the board's questions and follow-up questions. *Id*. at 34-35.
- MetWest provided the board with "sufficient information regarding the advisory fees that MetWest charged to the Fund and the services provided ... to the Subadvised Funds." *Id*. at 36. This information included fee schedules for the Subadvised Funds and a list of services not applicable to the Subadvised Funds. Beginning in 2016 — after the litigation began — MetWest also provided the board with documents that included a chart "detailing the significant differences in services provided and risks assumed by MetWest when functioning as an adviser and subadviser." *Id*. at 36-37.
- The board's "failure to receive and review the text of the subadvisory agreements themselves is insufficient evidence to deem the Board's process deficient in this regard." *Id*. at 37.
- MetWest provided the board with information on economies of scale, costs and profitability, and the board analyzed that information in detail. *See id*. at 38-39.

In light of these findings, the court granted "the rightful deference owed to the Board's decision." *Id*. at 41.

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The Court Acknowledged Not Only That Advisory and Subadvisory Services Are Different as a General Matter, but That Even Similar Services Across Product Types Can Require Differing Amounts of Adviser Resources

The plaintiffs asserted a standard reverse-manager-of-managers theory of excessive fee liability, arguing that "MetWest charges the Fund a higher advisory fee than the subadvisory fee it charges to the Subadvised Funds, despite providing substantially the same services to both." *Id*. The court resoundingly rejected this argument, holding that "the services MetWest provides to the Fund for the 35 bps fee differ significantly from the services it provides to the Subadvised Funds." *Id.*

In rejecting the subadvisory fee comparison, the court held that, despite some similarities, "the task of managing the Fund's portfolio is more difficult and involves exponentially more work than managing the portfolios of the Subadvised Funds." *Id*. at 43. Specifically, the court emphasized that the substantial difference in AUM between the Fund and Subadvised Funds meant that there were nearly 10 times as many unique securities in the Fund's portfolio than the Subadvised Funds' portfolios. *See id*. This difference — as well as the derivative investment strategies employed in connection with the Fund but not Subadvised Funds — demonstrated that "while the portfolio management services provided by MetWest to the Fund and to the Subadvised Funds are similar, they are very different in terms of the amount of work involved and often in terms of the type of efforts required." *Id*.

The court also considered several additional factors in rejecting the subadvisory fee comparison, including:

- MetWest is responsible for striking the net asset value for the Fund (but not the Subadvised Funds). *See id*. at 41-42.
- MetWest is responsible for maintaining sufficient liquidity in the Fund (but not the Subadvised Funds) to fulfill shareholders' requests for redemption. *See id*. at 42.
- MetWest is responsible for providing compliance services to the Fund (but not the Subadvised Funds). *See id.*
- MetWest must file disclosures with the Securities and Exchange Commission and certify that they are accurate and complete — subject to civil and criminal penalties — for the Fund (but not the Subadvised Funds). *See id*.
- MetWest "constantly provides information to and communicates with the Board" with respect to the Fund (but not the Subadvised Funds). *Id*. at 42-43.
- MetWest is responsible for overseeing and coordinating third-party service providers for the Fund (but not the Subadvised Funds). *See id*. at 43-44.
- MetWest incurs substantial reputational, financial, litigation, regulatory and business risks when serving as adviser to the Fund, but "the same is not true (or it is greatly reduced) when MetWest acts as a subadviser to the Subadvised Funds." *Id*. at 46.

In light of these findings, the court held that "[b]ased on substantial differences in the risk which MetWest incurs and the services it provides in relation to the Fund as compared to the Subadvised Funds, the Court concludes that the fees MetWest charges the Subadvised Funds are inapt for purposes of determining the propriety of the advisory fee it charges the Funds." *Id*. at 47. The court noted that several other courts had already reached this conclusion — including in *BlackRock*, *Goodman/JPM*, *AXA*, *Harbor Capital* and *UBS AG*.[2] *See id.* at 47-48. After determining that subadvisory fees provided inapt comparators, the court moved on to analyze the Broadridge data and found it reliable and compelling (although not dispositive). *See id*. at 50-52. In conclusion, the court weighed the comparative fees factor in favor of the defendants.

In Considering Economies of Scale, the Court Contrasted the Resources Required To Manage Small Funds With the Much More Substantial Resources Required To Manage Large Funds as AUM Increases

The plaintiffs argued that "(1) MetWest realized quantifiable economies of scale and captured for itself the benefits as increased profits, (2) MetWest has not reduced its advisory fee to share economies of scale with the Fund, and (3) MetWest does not otherwise share economies of scale with the Fund." *Id*. at 52. In support of their argument, the plaintiffs offered expert testimony and analyses, which were similar to those offered in *BlackRock*. *See id.* at 53-54. The court rejected the plaintiffs' arguments and held that they failed to prove the existence of economies of scale. *See id*. at 54.

[2] *In re BlackRock Mut. Funds Adv. Fees Litig.*, No. 14-1165 (FLW) (TJB), 2019 WL 1387450, *7 (D.N.J. Feb. 8, 2019); *Goodman v. J.P. Morgan Inv. Mgmt. Inc.*, 301 F. Supp. 3d 759, 769-74 (S.D. Ohio 2018); *Sivolella v. AXA Equitable Life Ins. Co.*, 742 F. App'x 604, 608 (3d Cir. 2018); *Zehrer v. Harbor Capital Advisors, Inc.*, No. 14-c-00789, 2018 WL 1293230 (N.D. Ill. Mar. 13, 2018); *Hoffman v. UBS AG*, 591 F. Supp. 2d 522 (S.D.N.Y. 2008).

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In rejecting the plaintiffs' economies of scale argument, the court reached the noteworthy conclusion that the plaintiffs failed to prove the existence of economies of scale because the adviser had to expend greater resources managing the Fund as its AUM increased over time. Specifically, the court held that "investing over $70 billion is far more difficult, and requires far more resources, personnel, technology, and infrastructure, than investing sums less than $10 billion (even if the strategy remains substantially the same)." *Id*. at 54. For example, it is more difficult for large funds than small funds to invest in certain bonds and, as funds grow, advisers "must search the relevant markets for securities that fit the investment strategy ... including turning to derivatives which are much more complicated and require more knowledgeable personnel and management attention." *Id.* Although the court cabined this reasoning within the context of economies of scale, the same reasoning applies to the inapt comparison of large retail funds to small subadvised funds.

Other factors that the court emphasized in rejecting the plaintiffs' economies of scale argument included:

- The plaintiffs' expert improperly "removed certain costs from some of his equations," including "compensation for certain of the Fund's portfolio managers as well as fees MetWest paid to intermediaries as related to distribution and shareholder services" and admitted that including those costs in his equations would actually show *dis*economies of scale. *Id*. at 54-55.
- The plaintiffs' expert's analysis failed to control for variables and demonstrate that any decline in expenses was "due to" economies of scale. *Id*. at 55.
- Even if the plaintiffs had demonstrated the existence of economies of scale, they provided insufficient evidence "to find that MetWest failed to share some of those economies of scale with the Fund/shareholders" through nonpecuniary mechanisms like investments in "employees, improving technology systems, and [retention]." *Id*. at 56.

In light of these findings, the court held that the plaintiffs failed to prove (i) the existence of economies of scale and (ii) that the defendants did not share economies of scale with the Fund. *See id.*

The Court Found That the Board Need Not Consider Profitability on a Fund-Specific Basis

The court summarily rejected the plaintiffs' argument that the Fund was impermissibly profitable. *See id.* at 57. The court noted that MetWest's profit margins (excluding distribution and recordkeeping fees) ranged from 28.8% to 31.6%, which were below the profit margins of peer funds and well below profit margins deemed reasonable by other courts, including in *Kasilag*, *Oppenheimer* and *T. Rowe Price*.[3] *See id.*

In reaching its conclusion, the court placed no weight on the fact that the board did not analyze fund-specific profitability or cost allocation information for any of the at-issue years except 2017. *See id*. at 23, 39. Specifically, the court noted that "while Plaintiff complains of a failure to allocate costs breakdowns and time spent by personnel on a fund specific basis, there is evidence that such breakdowns would be difficult to calculate with any precision because most of the MetWest Funds employees work for all of the managed funds collectively and not individually." *Id*. at 39.

Conclusion

After considering all of the relevant *Gartenberg* factors and the totality of the circumstances, the court held in favor of the defendants "in all material respects" and dismissed the plaintiffs' claims. *Id.* at 58-59. In reaching its holding, the court noted that "even if it had not found substantial deference owed to the Board's decision, it would still have found in Defendant's favor based on the totality of factors and evidence considered." *Id*. at 58, n.52.

In dismissing the plaintiffs' excessive fees claims, *MetWest* reinforces several principles enshrined in preexisting Section 36(b) case law and, based on the specific facts and circumstances of the case, builds on that precedent to the overall effect of further undermining theories central to the most recent waves of excessive fee litigation.

[3] *Kasilag v. Hartford Inv. Fin. Servs., LLC*, No. 11-1083 (RMB/KMW), 2017 WL 773880 (D. N.J. Feb. 28, 2017), *aff'd*, 745 F. App'x 452 (3d Cir. 2018); *Meyer v. Oppenheimer Mgmt. Corp.*, 707 F. Supp. 1394 (S.D.N.Y. 1988); *Schuyt v. Rowe Price Prime Reserve Fund, Inc.*, 663 F. Supp. 962 (S.D.N.Y. 1987), *aff'd*, 835 F.2d 45 (2d Cir. 1987).

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