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Investors Continue To Deserve More From Boards and Courts On Mutual Fund Fees

Posted by Aaron T. Morris, Barr Law Group, on Saturday, May 30, 2020

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American investors pay $100 billion *every year* in mutual fund fees. These fees are deducted from their savings and reduce future investment returns. Over 20 years, the compounded drag on investment returns is well into the trillions, which begs the question: Is even one dollar of these fees "excessive" under the fiduciary standards of the Investment Company Act? [1]

The answer from mutual fund boards and federal district courts has been a resounding "no." Each of the billions of dollars in annual fees was approved by independent boards of directors, and each instance in which investors have challenged a fee has been rejected by a federal judge.

But, as discussed herein, there appears to be good reason to question whether mutual fund fees are, in fact, universally fair. If price constraints on fees make up a "three-legged stool"—a term coined by academics in reference to (i) competitive pressures; (ii) board oversight; and (iii) excessive fee lawsuits—then the more than $20 trillion in assets supported by this "stool" are in a precarious position. Two of the legs—boards and federal courts—have demonstrated little appetite for disrupting the fees charged by advisors, and recent court decisions have begun to further deteriorate the effectiveness of board oversight. The remaining leg, the competitive market, has been left to function largely on its own (a state of affairs that Congress expressly sought to avoid). And while it's certainly true that some investors have caught on to high fees in recent years and have moved to lower cost options, competition has yet to eradicate significant pricing anomalies in the marketplace.

This post suggests a critical reexamination of the path onto which fund boards and federal district courts have drifted in recent years, and ends with a call to amplify the power of the market for the benefit of fund investors.

[1] As background, Section 36(b) of the Investment Company Act imposes a fiduciary duty on investment advisors with respect to fees charged to mutual funds, and creates a private right of action for investors to enforce this duty. The abbreviated story behind Section 36(b) goes like this: In the 1950s and 1960s, in light of industry growth and certain abuses of investors, the SEC commissioned the Wharton School of Finance to conduct a comprehensive study of the mutual fund industry, including the level of advisory fees. That study concluded that competitive forces do not constrain mutual fund fees in the same way that they constrain prices in other markets. The SEC subsequently conducted its own study finding largely the same thing, and Congress, in 1970, passed Section 36(b) based on its own findings along the same lines. Since then, fee litigation has generally involved investors asserting claims under Section 36(b) against mutual fund advisors for deriving excessive compensation from the funds at issue.

1. Docile Fund Boards

Independent fund directors are the cornerstone of the Investment Company Act's efforts to constrain mutual fund prices. In the Supreme Court's words, directors are intended to be the "watchdogs" who "negotiate and scrutinize adviser compensation." *Jones v. Harris Associates L.P.*, 559 U.S. 335, 339 (2010). But "negotiate and scrutinize" is not common parlance in the world of mutual fund governance. Indeed, if you are a fund director, try searching your counsel's most recent memorandum on director duties for the phrase "negotiate and scrutinize." Rather, it appears that many boards have skewed heavily toward process (supplemented by mountains of paper and expensive consultants) and away from the actual substance of their role: obtaining a good deal for shareholders.

This version of board governance may appear antithetical at first, but it would be hard to blame directors (especially those with no prior experience) who conclude that the term "watchdog" means something a little more domesticated. Recent federal district court decisions have all but relieved fund boards of the burden to genuinely engage with advisors on fees (at least in federal court under federal law).

For example, in the most recent trial on excessive fee claims, the board chair (an independent director) went as far as to testify that "it wasn't the Board's responsibility to negotiate the amount of fees"; rather, all the board had to do was make sure "the fees were fair and reasonable." *Kennis v. Metro. West Asset Mgmt.*, LLC, No. CV 15-8162, 2019 WL 4010747, at *25 (C.D. Cal. July 9, 2019) (hereinafter "*MetWest*"). One might question whether this style of "negotiation" has been adopted in any other business context. Remarkably, however, the court agreed on that point, finding it to be "consistent with applicable law." Yet, in support of this holding, the court cited only one case, which held only that a board need not obtain the "best deal possible"—hardly a revocation of the board's duty to negotiate *at all*—and, in any event, preceded the Supreme Court's seminal decision in *Jones* by twenty years. [2]

A year earlier, a judge in the S.D.N.Y. went even further, on equally tenuous grounds, holding that "[i]t is well settled that [the Investment Company Act] does not require negotiation between a board of trustees and fund investment adviser." *Chill v. Calamos Advisors LLC*, No. 15 CIV 1014, 2018 WL 4778912, at *14 (S.D.N.Y. Oct. 3, 2018). As above, the court relied on a narrow line of cases stating that a board does not have a duty to obtain the lowest price possible (again, an entirely distinct concept).

If these recent trial court rulings are indicative of the direction of the law under the Investment Company Act, then investors should be worried. Imagine hiring an agent to purchase a vehicle who employs a similarly lackadaisical approach. Say the agent gathers all of the records associated with the car, hires a consultant to provide data on comparable sales over the past year, meets with the car dealer multiple times, and then accepts the dealer's first offer at sticker price. What's worse, imagine that the price is not only above the median of the comps, but exponentially higher than the lowest price in the data set. No reasonable person would be satisfied with that agent's efforts (especially not at the rate that fund directors are paid for their services).

[2] The case cited by the court was *Krinsk v. Fund Asset Mgmt., Inc.*, 875 F.2d 404, 409 (2d Cir. 1989).

Yet, this scenario is uncomfortably similar to some of the board processes revealed by recent excessive fee litigation. While it isn't the case for every fund complex, the process employed by some boards, even at large complexes, has drawn into doubt the capacity of board oversight to constrain prices.

2. Hesitant Federal Courts

If the acuity of board oversight is questionable, federal district courts have not picked up any slack. (Note that federal courts have exclusive jurisdiction under the Investment Company Act and, for reasons beyond this post, Section 36(b) claims have not been afforded a jury right). As the defense bar is fond of recounting, in forty years of litigation under the Investment Company Act, no judge has ever held, at the merits stage, that a fee is "excessive." But this fact alone should strike an observer as curious. This is the same industry that has accepted responsibility for, to name a few things, late trading, market timing, soft dollar abuses, and fund value overstatements, and even with those scandals in the rearview, in 2019, still paid to the SEC the second-highest amount in fines ever (over $4 billion) for new misconduct in recent years. Despite this, and the fact that virtually no other industry pays higher executive compensation or key person salaries (indeed, even non-executive employees, namely portfolio managers, may earn compensation on par with public-company CEOs), it has maintained higher profit margins than nearly all other industries with few exceptions. It seems implausible that after forty years, trillions in management fees deducted from investor returns, thousands of SEC investigations, hundreds of billions paid in fines, and dozens of public scandals, every management fee ever examined on the merits by the federal judiciary has comported with fiduciary standards.

That said, this post does not suggest a conspiracy of district court judges across the country in support of the fund industry. Rather, perhaps the unusually one-sided outcome of fee litigation suggests that judges—faced with complicated facts, a difficult standard to apply, and the potential for an eye-popping judgment—just haven't been able to get comfortable enough with the fee mechanisms at issue to challenge the industry, despite compelling arguments to the contrary. The most recent excessive fee case to reach trial provides support for this theory.

In the *MetWest* case, plaintiffs relied on fee comparisons between one of MetWest's large retail mutual funds and certain of its institutional accounts, which were priced significantly cheaper. The court rejected this comparison, in part, because it credited testimony that "the services that MetWest provides to the [retail] Fund . . . are significantly different than the services it provides [to institutional accounts]." 2019 WL 4010747 at *25. But the court left open the obvious question: *how* different were the services? Different enough to justify an additional $1 million in fees? $10 million? $50 million? The spread at issue in the case was allegedly between $60 million and $117 million annually depending on the comparator, but the court didn't consider whether the value of the additional services (largely administrative, shareholder, and legal/compliance services) actually justified the differences in fees. The court similarly credited testimony that MetWest "takes on far more risk as advisor to the [retail] fund" than for the institutional accounts, but again didn't consider whether those risks might actually justify the differences in fees. *Id.* at *28. Certainly, under *Jones*, differences in services or risks might justify different fees, but without some effort to quantify the differences, how could a court (or a board for that matter) make the determination?

The court's analysis of other relevant factors also yielded to common, but questionable, industry arguments. For example, although the MetWest fund had grown from roughly $5 billion under management to *$78 billion in only ten years*—all the while charging the same flat management fee with no breakpoints—the court found no evidence that "economies of scale even existed," much less that savings were insufficiently shared with shareholders. *Id.* at *32. This should raise an eyebrow for anyone even modestly acquainted with the concept of asset-based pricing. (As far as I know, fee litigation is the only context in which fund advisors disclaim the existence of economies of scale in pooled investment products.) The court also credited testimony 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," but again the court did not consider (nor did the board) the *extent* to which portfolio management had become more difficult or expensive as assets increased. *Id.* It's certainly plausible that the advisor's additional fee revenue—which spiked from roughly $20 million to over $250 million during the ten-year period—covered (with some left over) any corresponding increases in the difficulty or expense of managing the portfolio. Indeed, trial court briefing suggested that the advisor's relative costs had decreased, and profitability had increased, as the fund grew in size, although the details were redacted in public versions of the filings (excessive redaction is a problem in and of itself in excessive fee litigation). Nonetheless, the court didn't consider this point one way or the other.

In the same vein, the court justified the absence of breakpoints in the fund's fee schedule by crediting certain unquantified "reinvestment" by MetWest in its business (a common litigation-driven argument by advisors in cases involving flat fees). [3] *Id.* at *33. But the court did not consider whether such investments were material to the fund at issue or how they related in size to the savings realized by the advisor through scale. Perhaps worst of all, the court also credited the advisor's contention (conjured for the first time in litigation) that it had "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." *Id.* But what does that really mean? Virtually every fund is unprofitable at inception. The record suggested that the fund had not been priced since 2000, at which point it had only $250 million under management (i.e. it had less total assets when priced than MetWest derived in fee revenue *every year* by the time of litigation). What particular "scale" had the fund been "priced" to? $5 billion? $25 billion? $50 billion? In order to credit this contention in favor of the advisor, the court would have had to conclude that the fund had been priced 19 years in advance to an expected scale in excess of $70 billion (its asset level during the period at issue). This is an extraordinary finding to make implicitly, especially in the absence of contemporaneous evidence (indeed, the record suggested that the fund's board had never considered the concept of "pricing to scale").

[3] The industry argument goes as follows: Advisors need not always share savings from economies of scale with investors in the form of fee reductions (e.g. through breakpoints). Advisors may, instead, take a portion of their savings (i.e. their additional revenue) and reinvest it in fund infrastructure, personnel or technology, which equally benefits investors. One might question how a board is to determine which reinvestments constitute "sharing scale" and which are simply the advisor's necessary costs of doing business (in litigation, the distinction has thus far been irrelevant, as advisors have commonly taken credit for every type of reinvestment, including SEC-mandated improvements like compliance with the new liquidity rules). But, in any event, as exemplified in the *MetWest* case above, even assuming that the reinvestments at issue were above and beyond the advisor's usual costs of doing business, and they accrued to the benefit of investors, courts have not critically examined the actual value to investors in comparison to the savings that could have been obtained through reasonable breakpoints. For example, many reinvestments touted by advisors in recent litigation applied to all funds in the complex and involved tiny expense outlays relative to assets under management. To the extent that fund boards have tolerated an absence of advisory fee breakpoints in light of immaterial reinvestments in the fund complex, they have cost investors millions (more likely, billions) of dollars over the long run.

In sum, the point, at the risk of belaboring it, is not that the fees challenged by investors over the years were, in fact, excessive. Perhaps many were not. But the fact that not a single federal judge has ever held an investment advisor to account on fees, coupled with the superficiality of many of the findings in fee cases, draws into doubt the capacity of the federal judiciary to constrain prices.

3. A Functioning But Imperfect Market

In comparison to boards and courts, which have largely conceded to the status quo, the market in recent years has done the better job of keeping fees in check. The passive-investing revolution has fueled enormous flows away from expensive, actively managed funds and into low-cost index funds. Prices have fallen for both active and passive funds (albeit more so for the latter), and research shows that lower-fee funds are, on average, gathering assets faster than more expensive competitors. Yet, competition left on its own (a state of affairs that Congress sought to avoid by passing the Investment Company Act) has not been able to expose and remediate every pricing anomaly.

For example, while the *asset-weighted* average management fee for S&P 500 index funds is 0.03% (according to Morningstar data), the average management fee is nearly nine times higher at 0.26%. The significant difference between these averages suggests that many investors are successfully identifying lower-cost options, but high-cost options somehow remain viable in the market. It also suggests that investors are doing a better job than boards at figuring out what's a high fee and what's a low fee for identical index products. But while investors have the power to vote with their feet on prices (and many have apparently done so), boards actually have the power (dare I say, the duty) to push fees on higher-cost funds toward lower-cost funds. Yet, boards appear to be moving slower in this regard than investors.

Examining the actual range of management fees charged to identical S&P 500 funds is also insightful. While some advisors are offering zero-cost products or fees in the single-digit basis points, high-cost options remain surprisingly viable, even at fees exceeding 0.15%, 0.20% and even 0.50%. One might expect that a competitive market would push fees to an equilibrium, especially in the case of indistinguishable products, but it hasn't happened yet in the market for identical index funds. [4] While real-world markets may not deliver entirely uniform pricing, even for indistinguishable products, few other markets appear to have this much variation. For example, imagine a supermarket stand of identical oranges from four different growers, but priced at $1, $15, $20 and $50 per pound. [5] [6]

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[4] Other commentators also have recognized this pricing phenomenon among identical mutual funds. *See, e.g.,* Jill E. Fisch, *Why Do Retail Investors Make Costly Mistakes? An Experiment on Mutual Fund Choice* (2014) ("[M]any commentators are puzzled by the large number of fund choices and by the persistence of high fee funds that underperform the market").

[5] One might argue that for an average (i.e. small) investor, pricing differences are not as stark as the example above. For example, an investor with $10,000 invested in a fund might have a choice between fees of $5 per year for a low-cost fund and $50 per year for a high-cost fund. This is a 10x difference, but relative to the amount invested, is probably immaterial to an average investor. Even compounded and combined with overpayments in subsequent years, it takes a while for the number to reach what investors might consider important. But what does this point prove other than one of the flaws of price competition in the fund industry? Across a fund at scale, say $1 billion under management, the annual fee difference would be in the range of $4.5 million, which compounded and combined with fees in subsequent years quickly becomes a number that would shock even the largest institutional investors.

[6] This example also addresses arguments attributing fee differences solely to differences in scale (i.e. that high-priced index funds lack the scale to compete on price with larger and cheaper competitors). Setting aside that it is fundamental in the fund industry to price products below cost at the outset until they reach scale (as discussed in part 2 above), and that many high-cost advisors have complex-wide scale on par with low-cost providers, what other competitive

How are high-cost index products remaining viable? Perhaps, in part, it's the result of the very market characteristics that led Congress to pass the Investment Company Act in 1940 and Section 36(b) in 1970: some assets are sticky or price insensitive for various reasons, and thus haven't moved as the market has brought fees down around them; some distribution channels, like small retirement plans, have little or no choice with respect to the particular funds within a fund class; and some investors may still lack an understanding of the impact of high fees on their investments, especially those subject to sales efforts of brokers, financial advisors and flashy advertisements. [7] Yet, these shortcomings in the market can be mitigated by boards and courts if they faithfully perform their respective roles.

4. A Solution

Boards need not become tyrants, nor courts become price regulators, in order to improve the current state of affairs for fund investors. The market has already set into motion a concurrence of factors that appear to be leading toward, on average, lower fees and better investment products for investors. By the same token, however, boards and courts need not abdicate their roles assigned by Congress and the Investment Company Act, as current trends suggest that they are considering. [8] Rather, both boards and courts have a golden opportunity in the current environment to supplement the power of the market in areas where pricing pressures are not felt as strongly.

Boards may begin this process, of course, in their annual fee renewal meetings. Rather than framing the analysis around whether the advisor's current fees can be justified by marketplace data, consider a shareholder-focused approach: Does the advisor have room to move? While data can almost always be collected and arranged in an effort to satisfy the former approach (albeit some efforts are more compelling than others), the latter approach gets to the heart of the matter. Are there a significant number of competitors charging lower fees? Did the advisor realize savings during the year that did not accrue to investors? Has the advisor's profit margin increased materially over recent years? Has the advisor's dollar profit reached a point that merits attention? A board may consider any of the innumerable factors that may apply, but ultimately a conscientious board must make reasonable efforts to determine whether it is able to obtain improvements in the advisor's fees (and, as a result, improvements in investors' returns) for the coming year. This process, if conducted diligently, will piggyback on pre-existing market

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market permits producers to offer products at enormous mark-ups until they sell enough to lower prices? Orange growers and virtually any other manufacturer in the country could testify that this is not how a competitive market works, and the producer of the $50 oranges above will soon be looking for a new line of work. Pricing in the fund industry, however, is not so limited by competitive forces.

[7] Research continues to suggest that typical investors do not sufficiently understand the relationship between fees and investment performance. For example, in a 2014 study, a menu of investment options provided to participants included "two index funds that were described as identical except for fees—they tracked the same index, contained the same holdings, and reported the same past performance." *See* Fisch, *supra* note 4, at 22. Inexplicably, 65% of one study group and nearly 75% of another "invested in the low-fee index fund [and] the high-fee index fund" at the same time. *Id.*

[8] Industry proponents have long suggested that the federal judiciary, at least, ought to step back from its role of enforcing Section 36(b) in favor of a "trust the market" approach. Recently, such commentary has been revived by a short paragraph in the *MetWest* decision acknowledging that "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." (For example, see the last paragraph of this post on the Forum in 2019 penned by the venerable Rob Skinner and Amy Roy.) Setting aside the merits of such an approach, the opportunity to pursue it has simply passed. Congress rejected a purely market-based approach in 1970 when it passed Section 36(b), and the Supreme Court rejected such an approach in 2010 when it reversed a lower court decision that attempted to refashion the Section 36(b) standard to rely more prominently on competition. *See Harris Associates L.P.*, 559 U.S. at 353 ("The debate . . . regarding today's mutual fund market is a matter for Congress, not the courts."). A more constructive discussion might focus on how boards and courts can amplify competitive pressures rather than hide behind them.

pressures (e.g. decreasing fees, movement away from unitary fees, etc.), which boards can leverage to obtain improvements for shareholders.

Federal courts, for their part, may also begin to amplify the effects of competition between advisors. For example, investors who remain in high-cost outlier funds should consider vindicating their rights by bringing Section 36(b) claims. Courts should not grant deference to boards who failed to make genuine efforts, using competitive data, to drive fees down (just as we would not credit the efforts of an agent who does nothing but accept the dealer's sticker price on a car). Courts also should be willing to look below the surface of common industry arguments that have thus far prevailed in excessive fee litigation. For example, if a fund's fee falls below the median of their "peer group," courts should carefully consider whether the funds in the peer group are actually competitors (or whether they were selected for other reasons). If a fund was supposedly "priced to scale," courts should ask "what scale?" If an advisor claims to require a particular profit margin to remain viable, courts should consider whether that claim holds true for other investment products. If an advisor denies economies of scale concurrent with asset growth, courts should closely examine where the extra revenue went (indeed, in the SEC's view, advisors that do not realize economies of scale are doing something wrong). Innumerable additional factors may be relevant for a given fund, but consistent with the Supreme Court's mandate, district courts should critically consider those factors under this framework: Is this *really* a price that an arm's-length *negotiation* in the market would have produced? *See Harris Associates L.P.*, 559 U.S. at 347 ("[T]he essence of the test is whether or not under all the circumstances the transaction carries the earmarks of an arm's length bargain.").

5. Conclusion

While investors have benefitted from fee pressures in the marketplace in recent years, now is not the time for boards or courts to relinquish their important (and statutory) roles in constraining fund prices. Directors should use these market pressures in the boardroom to reasonably push advisors on fees, especially as to those that depart significantly from competitors or result in significant increases in revenue without proportionate benefits to shareholders. Courts should more critically examine fees subject to litigation, especially where the fund's board made no genuine efforts to obtain lower fees, the advisor may be evading competitive pressures, or significant increases in revenues or cost savings were not shared with investors. With trillions in fees at stake, even small adjustments can provide enormous benefits to shareholders over the long term.