August 04, 2021 **ARTICLES**

Two (Thousand) and Twenty: Developments in Asset Management Litigation

As managers have scrambled to protect their revenue streams in recent years, they've found solace from courts, legislatures, and even independent fund directors.

By Aaron Morris

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Concerning trends for asset managers continued apace in 2020, as did efforts in courtrooms, legislatures, and boardrooms to protect the industry's underbelly. Last year, we saw continued evidence of the failure of active management, including confirmation that "owning active for the downturn" is still bad advice. A study entitled *Mutual Fund Performance and Flows During the COVID-19 Crisis* by Lubos Pastor and Blair Vorsatz of the University of Chicago found that three-quarters of active funds underperformed their passive benchmarks during the COVID turmoil in the spring of 2020, with "particularly strong" underperformance relative to the S&P 500. SPIVA reports that, across all fund categories, 64 percent of funds underperformed their respective S&P indices over the past year. The 5-year number is nearly 80 percent; the 15-year number is worse. Of course, academics have argued for decades that there is essentially no predictable way to outperform the market save by luck. Nonetheless, according to the Investment Company Institute's *Investment Company Factbook* (2020), 61 percent of U.S. assets remain in active funds (roughly $14 trillion), and Americans collectively pay a management "tax" to the tune of $90 billion annually. What's more, the Investment Company Institute also reports that the median financial assets of households investing in mutual funds are only $250,000, with well over half of those assets invested in mutual funds. Also according to the Investment Company Institute, nearly all of these households (about 92 percent) report that their investments are earmarked for retirement, among other

compelling purposes like emergencies and education. These investors aren't family offices. We're talking about billions of dollars extracted every month from the pockets of regular American savers—all in the face of an estimated $4 trillion shortfall in U.S. retirement savings.

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Nonetheless, as managers have scrambled to protect their revenue streams in recent years, they've found solace from courts, legislatures, and even independent fund directors.

In the courtroom, asset managers continued their streak of victories in excessive fee cases brought pursuant to section 36(b) of the Investment Company Act of 1940, which imposes a fiduciary duty on investment advisors with respect to their fees and creates a private right of action for investors to enforce the duty. In 2020, courts of appeals in the Second, Third, Sixth, and Ninth Circuits affirmed trial wins in favor of Davis Advisers, BlackRock, J.P. Morgan, and MetWest, respectively. Despite apparent analytical deficiencies in recent section 36(b) decisions (as addressed by commentators, including me in a recent article), a contingent of geographically and philosophically diverse courts have aligned unanimously in favor of asset managers.

The most recent trial of an excessive fee case resulted in a win for Great-West, despite seemingly significant irregularities in the fees at issue. Some of the funds at issue were "clones" of popular products managed by name-brand advisors like Putnam and Goldman Sachs, except that Great-West's versions were significantly more expensive. Great-West suggested at trial that it earned its additional fees by making sure that the folks at, say, Goldman Sachs, were doing a good job. Not surprisingly, little evidence suggested that Great-West's periodic oversight improved a fund's performance, much less to the extent necessary to justify its additional fees. Another fund at issue—an index fund with an expense ratio exceeding 0.50 percent—had been previously crowned the "worst mutual fund in the world." Internal documents showed that Great-West knew these products couldn't actually compete against other mutual funds, nor did it even try. The vast majority of assets had been gathered

through retirement accounts in which participants had limited or no other options (administered by Empower, Great-West's parent), as well as through Great-West's target date funds, which invest exclusively in other Great-West mutual funds rather than cheaper and better competitors.

After an 11-day trial, thousands of pages of exhibits, and hundreds of pages of briefing, the trial court found in Great-West's favor in an opinion (subscription required) that largely avoided grappling with the problematic facts above. Perhaps the most interesting portion of the decision might be the citation to one plaintiff's testimony—a retired Great-West employee—that "her retirement account . . . was making money every time . . . which is what I wanted." As the late Johnnie Cochran might have said, "if it grows in time, fees are fine." Catchy as it may be, asset growth is not a recognized defense to an excessive fee claim for an obvious reason: Whatever a fund's performance history, it would have performed better if its fees weren't excessive. To add insult to injury, after informing the parties at trial that "all have done a fabulous job" and the case had been "very well tried by both sides," the judge awarded sanctions (subscription required) against the plaintiffs' lawyers for "recklessly proceed[ing] to trial" (the order is now on appeal).

With that backdrop, we move to the legislators, one of whom announced a bill in 2020 to "support Americans' mutual fund investments" by, of all things, making it even harder for investors to show that fees are excessive under section 36(b). The bill would require investors to plead "with particularity all facts establishing a breach of fiduciary duty" and would likewise heighten the evidentiary burden by requiring "clear and convincing evidence" to prove a claim. The bill's sponsor, Republican Congressman Tom Emmer, doesn't appear to have a particular interest in investment companies other than the receipt of campaign donations from multiple asset managers, but an interview suggests that he did recently reread *The Road to Serfdom* by Friedrich Hayek. Perhaps he missed Hayek's declaration that "the last resort of a competitive economy is the bailiff." The bill's efforts to displace the "bailiff" over mutual fund fees is misplaced. Requiring "clear and convincing" evidence to prove an excessive fee claim is unlikely to change the outcome of litigation; courts appear to be applying an impossible standard anyway (under the so-called *Gartenberg* factors). Meanwhile, if the bill achieves its goal of "discourag[ing] plaintiffs' attorneys," we can be certain that whatever fee-constraining effect litigation risk currently has, meager as it may be, will be lost. For example, while the most recent wave of excessive fee cases did not produce trial wins, multiple funds at issue reduced fees during litigation, and industry-wide awareness of the wave of cases resulted in significant enhancements to board processes, including closer examination of the particular services provided to retail funds relative to institutional accounts. For this, we must thank the essentially pro bono

efforts of the plaintiffs' bar.

Finally, this brings us to the role of independent directors in recent developments. With increasing challenges facing active managers, including fee pressures, the long-anticipated flight to consolidation appears to be taking off. One or two advisor mergers per year gave way to three major deals in 2020 with a handful of smaller deals and more in the works. Here too, the industry has been the recipient of gratuitous aid and comfort, this time from independent directors, who have rubber-stamped these combinations without considering whether fund shareholders might actually get something out of them. To be precise, when an advisor enters into a merger transaction with another advisor, it triggers a change-of-control provision in the advisory agreements between the target and the funds it manages (this is a 1940 Act requirement). To complete the transaction, a fund's board of trustees must approve new advisory agreements with the acquiror, and therein lies the fund board's leverage. One might imagine that before approving the new agreements, a diligent board would seek some form of a "get" for shareholders, given that it is shareholders' assets being sold at a profit to the parties involved—i.e., the target advisor and its shareholders are getting cash and the acquiring advisor and its shareholders are getting a revenue stream that they value more than the cash. But such is not the case. Too many fund board processes proceed as follows:

1. The fund board learns of the deal after it is signed (as late as the day of the announcement) and has no opportunity to choose its new transaction partner.
2. The fund board has some form of an initial meeting with the acquiring advisor, who talks up the potential deal from the viewpoint of the advisors and their shareholders, not necessarily the funds and their shareholders.
3. The board's counsel requests routine documents and information from the acquiring advisor, similar to the type provided to the board before its annual contract renewal meeting.
4. The board makes essentially the same findings it makes annually as part of its renewal process but substitutes the name of the new advisor for the old one and approves the new agreements.

Fees aren't reduced. New investments in personnel and infrastructure aren't guaranteed. Performance metrics aren't discussed. And the deal price isn't shared with fund shareholders, despite the fact that the value of the advisor being sold—largely the assets held by the funds it manages—

was built at the expense of investors through decades of management and distribution fees.

Where does all of this leave investors? Well, the good news continues to be that the market is pushing fees down as investors gravitate toward passive strategies. The bad news is that the other potential constraints on fees—courts, legislatures, and independent directors—aren't contributing much. And this is concerning, given that the mutual fund market is only partially competitive (as recognized by Congress in 1940 and 1970 and by the Supreme Court as recently as 2010). Outlier funds with abnormally high fees continue to persist, as noted by a recent study finding significant "fee dispersion" among similar funds, including identical S&P 500 index funds. To police these outliers, fund directors must be willing to take bold action during annual fee meetings as fees decline around them. If fund directors aren't willing, legislatures must ensure that shareholders have real causes of action to assert, and courts must give the claims fair and critical examination. Prior waves of fee litigation have demonstrated that even unsuccessful cases can bring about some level of industry-wide change; a successful case (or two) may bring truly meaningful improvements for American savers.

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