Winston & Strawn profile recent excessive fees litigation

Thomas Weber, Kate Hundt and Joe Motto drill down on board takeaways from three recent excessive fees rulings
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Key Takeaways

- Decisions on the ***Kennis***, ***Davis*** and ***Calamos*** cases all came down over the last two quarters
- Judges supported what they deemed robust board review
- Quality of comparison fees one key area for boards

It was an eventful summer and fall for decisions regarding private right of actions under the Investment Company Act of 1940. Three notable decisions dismissed claims brought under Section 36(b), which expressly provides a private right of action for shareholders to bring claims against mutual fund advisers for breach of fiduciary duty for charging excessive fees.

Kennis v. Metropolitan West Asset Management, LLC, 2019 WL 4010747 (C.D.C.A. 2019), ***In re Davis New York Venture Fund Fee Litig.***, 2019 WL 2896415 (S.D.N.Y. 2019), and ***Chill v. Calamos Advisors LLC***, 2019 WL 5067746 (S.D.N.Y. 2019) add to the existing body of Section 36(b) law that provides funds, management companies, advisers, and boards with guidance on how to minimize future liability.

While the decisions in ***Kennis***, ***Davis***, and ***Calamos*** are insightful in many ways, this article focuses primarily on their analysis of the fund board's approval of fee arrangements and comparative fee structures.

These decisions provide considerable guidance to mutual fund complexes going forward, including important insight into a board's process for evaluating and approving the terms of the adviser's contract as well as the information supplied by the adviser.

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Board processes

In these cases, the courts considered the boards' independence and the steps the board took to ensure they were able to act as well-informed, independent checks on the adviser fees. This included:

The Independence of the board members. In ***Davis***, the court noted that this required the board members making the decision to have no affiliation with the advisers with whom they were negotiating.

Active involvement in the Section 15(c) process. In all three cases, the board members involved in the Section 15(c) process held multiple meetings, both with representatives from their advisers and on their own with independent counsel, to evaluate the information collected regarding the funds' performance, the advisers' fees and relevant comparator data.

In ***Kennis***, this included conference calls and in-person meetings with advisers to review and address various Section 15(c) materials, and opportunities to ask questions of the advisers or request additional information in advance of the board's Section 15(c) meeting. In

Davis, this involved questioning the adviser regarding fund performance, their funds' position in certain securities, fee levels of identified peer funds, adviser staff changes and shareholder education initiatives.

The ***Kennis*** court further noted that it was important for the board to keep abreast of compensation trends in the industry.

Reliance on independent counsel. In these cases, as expected, the courts noted that the boards were advised by independent counsel with whom they met separately from the adviser-affiliated board members.

Information requested by the board. As part of the Section 15(c) process, the boards issued questionnaires to their advisers to acquire additional information pertinent to the contract renewals. These questionnaires varied depending on advice received from the boards' independent counsel, relevant industry changes, or particular circumstances such as fund underperformance or efforts to improve performance. Additionally, the boards in these cases also asked their advisers for additional information, as needed.

Comparisons to "peer" funds. All of the boards relied on information from third-party analysts, such as Broadridge Solutions, Inc., to provide data and analyses comparing the performance, advisory fee rates, and expense ratios of their respective funds with other "peer" funds.

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In ***Davis***, these "peer" funds were selected based on a variety of criteria, including fund type, investment objectives, asset comparability, and expenses. In ***Kennis***, the board met with its third-party analysts to discuss the selection and methodology of the peer group for the comparison studies it relied on.

And in ***Calamos***, the court found it notable that the board retained a third-party data provider to accumulate fees received by twenty "custom-selected" funds determined to be most similar to the fund at issue, and the fund's management fee fell "within the range of its peers" each year.

Information provided by the advisers

In these cases, the courts also examined the types of information provided by the advisers to ensure the boards had sufficient information to render their decision.

Analyses of advisers' agreements and performance. In these cases the advisers prepared memoranda, or "Section 15(c) books."

Information regarding advisory fees and services provided to the adviser's subadvised funds. In these cases, the boards were also provided information regarding the fees charged to their advisers' subadvised funds and other private advisory clients, and information regarding the difference in services provided by and risks assumed by their advisers for their directly-advised funds versus subadvised funds.

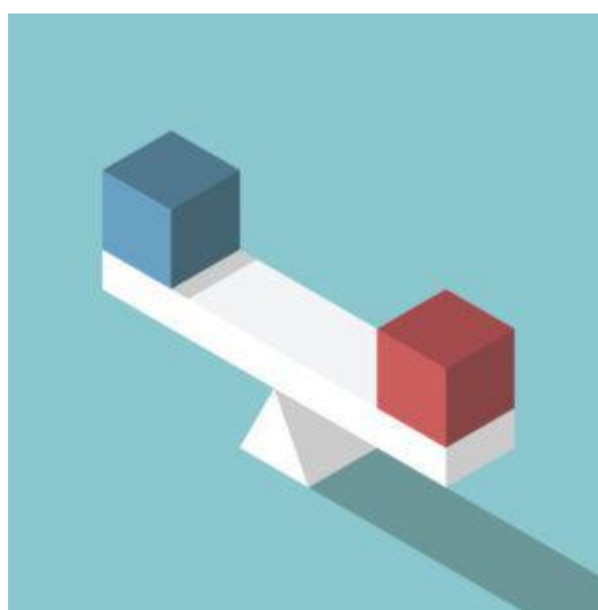
This information included the advisers' profit margins under the advisers' agreements with the funds and the rates paid by the subadvised funds.

In ***Kennis and Davis***, the courts concluded that the boards' review processes were sufficiently robust to warrant a "significant degree of deference." Additionally, both courts found that their respective advisers did not withhold important information from the boards.

Of particular note, finding that the boards' processes were sufficiently robust and that no pertinent information had been withheld by the advisers led the ***Kennis*** and ***Davis*** courts to conclude that deference was afforded to this process – a significant finding in favor of the mutual funds.

The conclusion reached in ***Calamos*** is especially enlightening on board process. There, the district court initially denied summary judgment on this issue because it found that the board's sole reliance on slides in a presentation listing Calamos' services provided to investment companies generally was insufficient; then, at trial, Calamos prevailed on this point by introducing specific evidence that the board carefully reviewed the ***differences*** in services that Calamos provided to the fund at issue and other sub-advised funds. That included identification of additional evidence that the board considered a bullet-point summary of the services and risks between advising mutual funds as compared to institutional or sub-advisory clients; frequent briefings received by the board regarding the services Calamos provided to the fund that are not provided to sub-advisory clients, such as IRS compliance and reviews of service provider relationships; and the vast experience of the board members in analyzing the advisory vs. subadvisory services and risks.

In ***Calamos***, consistent with prior precedent, it is important to understand that the board is not required to "provide a cost breakdown that quantifies in dollars and cents all of the different services and risks entailed in managing a mutual fund as compared to an institutional or sub-advisory account." All that is required is a factual showing that the board undertook a "robust review of the differences in services rendered" to the fund and non-fund clients.



Comparative fee structure

A plaintiff can offer other funds as "comparators" to the fund at issue to demonstrate the fees are excessive — typically unrelated funds managed by another investment advisory company for whom the defendant acted as a subadviser.

In this situation, plaintiffs try to establish an "apt comparison" between the services and responsibilities offered in the subadvisory capacity and advisory capacity, in which lower fees were received for subadvisory services. ***Kennis***, ***Davis***, and ***Calamos*** provide significant guidance into why, based on the facts of those cases, courts have rejected the comparison between advisory and subadvisory fees.

First, in ***Kennis***, the court held that it was "inapt" to compare the fees that the adviser charged the fund at issue to the fees charged to different funds where subadvisory services were provided. In reaching this decision, the court found that the **services and the risks were different** in providing advisory and subadvisory services.

With respect to portfolio management, the court in ***Kennis*** found that even though the portfolio management services were similar for the fund at issue and the alleged comparator subadvised funds, "the task of managing the Fund's portfolio is more difficult and involves exponentially more work than managing the portfolios of the Subadvised Funds." The court also noted that the AUM for the fund and the number of unique securities in the fund's portfolio far outnumbered both metrics in the subadvised funds.

The court in ***Kennis*** also introduced a relatively new concept in its analysis of the "comparative fee" factor: the ***differences in risk*** that an adviser and subadviser face, concluding that an adviser "takes on far more risk as adviser to the Fund than as a subadviser to the Subadvised Funds." For example, unlike a subadviser, an adviser faces direct "reputational, financial, litigation, regulatory, and

business risks when serving as the adviser to the Fund." The court also noted that the adviser assumes risks for the fund's regulatory and tax filings that could lead to criminal or civil penalties, as well as even risks relating to cybersecurity breaches.

In ***Davis***, the plaintiff also claimed that the fees the defendant charged to other, unrelated subadvisory funds were the product of arms-length negotiations and resulted in much lower fees for the same services than defendant was performing as an adviser.

The court acknowledged the parties' disputes over whether the defendant offered the same scope of services as an adviser to the fund at issue and as a subadviser to the unaffiliated fund, but concluded that even assuming this comparison is "apt," it remained undisputed that the adviser's fees were "within the range of fees" that the adviser received when it provided advisory services to other unaffiliated funds.

This "adviser-to-adviser" comparison led the court in ***Davis*** to find that the "comparative fee" factor weighed in favor of granting summary judgment, which the court ultimately did.

Thus, if a defendant can offer relevant examples of other, unaffiliated funds for which the adviser performed advisory services and received a similar fee, summary judgment may be proper on this factor if the plaintiff fails to offer any contrary evidence.

Finally, in ***Calamos***, the court found that, based upon the evidence at trial, Calamos' fees were "within the range of fees charged to the fund's peers." The court explained that while fees charged to peer mutual funds by other investment advisers is "not dispositive" because they "may not be the product of negotiations conducted at arm's length," they can still be an important consideration.

Joe Motto, Partner Winston & Strawn

As for comparisons between the fund at issue and instances where Calamos provides sub-advisory services, the court noted this was an "inapt" comparison because as the adviser Calamos assumed more risk and provided greater services relating to legal, regulatory, compliance, fund governance, oversight of third-party providers, portfolio management, and client/shareholder services.

Even though Calamos outsourced some of these services to third-parties, all of these third-party providers were "subject to Calamos' monitoring, supervision and oversight."

Conclusion

By following the recent guidance above, mutual funds can minimize their legal exposure by ensuring they have implemented and executed a robust board review process. As part of that analysis, it is also critical to fully evaluate fee "comparators" in a way that aligns with the legal principles above.

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