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CLIENT ALERT

Guidance for Mutual Funds from the Sixth Circuit's Recent Decision Addressing Claims of Excessive Advisory Fees

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The Sixth Circuit's March 30, 2020 decision in *Goodman v. J.P. Morgan Investment Management, Inc.* addresses shareholder claims against the mutual fund adviser, JPMIM, for breach of fiduciary duty under Section 36(b) of the Investment Company Act (ICA) for charging excessive advisory fees. In *Goodman*, the Sixth Circuit affirmed the district court's decision granting summary judgment in favor of JPMIM, finding as a matter of law that JPMIM's fees were not "excessive" under prevailing precedent. *Goodman* now further supplements the growing body of law rejecting plaintiffs' preferred method for attempting to establish excessive fee claims: the "subadvisory" theory, in which the fees received by the advisers from their proprietary funds are alleged to be "excessive" compared to the fees received for providing purportedly similar services as subadvisers to non-proprietary funds.

Overview of ICA Section 36(b) Legal Standard

The Supreme Court's decision in *Jones v. Harris Assocs. L.P.*, 559 U.S. 335 (2010), set the standard for asserting a Section 36(b) claim: an investment adviser could be liable for breach of fiduciary duty if the charged advisory fee is "so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been the product of arm's length bargaining." *Id.* at 346. To guide this analysis, the Supreme Court approved applying the six *Gartenberg* factors (named after the Second Circuit case adopting them):

1. the nature, extent, and quality of the services provided by the adviser to the shareholders; (2) the profitability of the mutual fund to the adviser; (3) 'fall-out' benefits, such as indirect profits to the adviser; (4) economies of scale achieved by the adviser as a result of growth in assets under the fund's management and whether savings generated from the economies of scale are shared with shareholders; (5) comparative fee structures used by other similar funds; (6) the level of expertise, conscientiousness, independence, and information with which the board acts.

Goodman, 2020 WL 1502451, at *2 (citing *Jones*, 599 U.S. at 344-45). In applying these factors, *Goodman* emphasized that "all relevant factors must be considered," and no factor is "dispositive standing alone." *Id.* at *4. The *Goodman* decision further noted that courts should avoid "taking on a rate-setting role" or trying to calculate with precision what fee rate is "representative of arms-length bargaining," but rather should simply address "whether the fees themselves were excessive." *Id.* at *2.

Sixth Circuit's *Gartenberg* Analysis

In analyzing together factors (1) and (5) regarding the nature and quality of services and comparative fee structures, *Goodman* made two key findings in favor of the investment adviser.

First, the Sixth Circuit rejected the shareholders' attempt to compare the fees JPMIM received for serving as an adviser for the funds at issue to other, non-proprietary funds for which JPMIM served as a subadviser. In particular, the Sixth Circuit found to be persuasive testimony from JPMIM's expert that the "liquidity risks, business risks, operational risks, pricing risks, litigation risks, regulatory risks, and reputational risks all differed between" JPMIM's proprietary funds and non-proprietary funds in which JPMIM functioned as a subadviser. This reasoning is consistent with a number of recent Section 36(b) decisions that also found in favor of investment advisers on the basis that higher fees for advisory services compared to subadvisory services are justified given the elevated risks and increased responsibility that the adviser assumes. *E.g.*, *Kennis v. Metropolitan West Asset Management, LLC*, 2019 WL 4010747 (C.D.C.A. 2019); *Chill v. Calamos Advisors LLC*, 2019 WL 5067746 (S.D.N.Y. 2019). While the shareholders in *Goodman* argued that it was a fact question whether the fee disparity between the proprietary funds and subadvised funds supported a claim of excessive fees, the Sixth Circuit emphasized that, if the record is clear that the advisory services at issue and other subadvisory services involve "different risks" and a "differential in the scale of services" associated with each, then summary judgment is proper.

Second, after finding the subadvisory comparison was "inapt," the Sixth Circuit, relying upon independent third-party data, agreed with the district court that the funds at issue "had good performance, with average advisory fees, as compared to similar funds," and on top of that, JPMIM "waived significant fees" based on economies of scale, as explained directly below. *Id.* at *7.

The *Goodman* court also focused fairly extensively on *Gartenberg* factor (4), namely whether JPMIM realized economies of scale and, if so, whether JPMIM shared those benefits with shareholders. The Sixth Circuit recognized that its role was not to determine "which of the methods for sharing economies of scale is the absolute best, but rather to determine if the fee charged is disproportionately large." *Id.* at *8. Because the undisputed evidence established that JPMIM shared the economies of scale it realized on its equity funds through fee waivers, and the shareholders failed to rebut that no economies of scale were realized on the bond funds, *Goodman* held that this factor "strongly" weighed against the shareholders. *Id.* at *9.

Finally, even though factor (6)—concerning the fund board's process for reviewing and approving adviser compensation (and the deference to fee decisions that result from that process)—is typically a primary consideration, it was only briefly addressed by the Sixth Circuit in *Goodman*. The Sixth Circuit acknowledged the board "was made up of experienced, independent trustees who met several times per year to review and request information from independent third parties, including the Board's independent counsel, the Funds' Senior Officer and Chief Compliance Officer, as well as two independent providers of mutual fund data (Lipper and Casey Quirk)." *Id.* at *10. As to the extent of information exchanged about JPMIM's performance and fees, the Sixth Circuit found that the board "engaged in a thoughtful review process that considered substantial information," and the shareholders' attempts to "nitpick" the board's process did "not create a triable issue of fact with regard to the Board's independent approval of the fees."

Because the *Gartenberg* factors favored the investment adviser, the Sixth Circuit affirmed the district court's decision to grant summary judgment and dismiss the case.

Takeaways

This most recent Section 36(b) decision provides mutual funds with considerable guidance:

- A rigorous board process for approving the advisory fees remains one of the most important steps boards can take to minimize Section 36(b) exposure. Particularly crucial are ensuring independence of the board, use of independent counsel, review of reliable third-party comparison data, and thorough information exchange about the adviser's performance and fees.

- This decision further strengthens the precedent rejecting plaintiffs' "subadvisory theory" given the different risks and responsibilities that accompany advisory versus subadvisory services.
- The *Goodman* court reiterated that Lipper data is "widely accepted" to "compare fees and performance in the mutual fund industry," so boards should continue to use reliable third-party data as part of evaluating the adviser's performance and fees in comparison to similar peer funds.
- Boards should continuously evaluate whether fee waivers (or other mechanisms) are appropriate to share economies of scale with shareholders. *Goodman* noted that using breakpoints is one potential way to ensure economies of scale are shared, but made clear "it is by no means the only way of doing so."

If you have additional questions or need further assistance, please reach out to Thomas G. Weber (tgweber@winston.com) or your Winston relationship attorney.

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