The Investment Lawyer
Covering Legal and Regulatory Issues of Asset Management
VOL. 29, NO. 2 • FEBRUARY 2022

Navigating the Recent Wave of Section 36(b) Litigation: What Have We Learned?

By David Kotler, Catherine Wigglesworth, Megan Johnson, Corey Rose, and Devon Roberson

Mutual funds are one of the most popular types of investments in the United States. In 2020, approximately 46 percent of all US households, or an estimated 102.5 million people, owned mutual funds.[1] The Investment Company Act of 1940[2] regulates investment companies, including mutual funds. Section 36(b) of the Investment Company Act of 1940 imposes a fiduciary duty on an investment adviser to a mutual fund "with respect to the receipt of compensation" paid by the fund, and provides a private right of action to fund shareholders to enforce that duty.[3] In *Jones v. Harris Associates, Inc.*, the Supreme Court articulated the standard applicable to such claims: to prevail on a Section 36(b) claim, a shareholder must show that the adviser charged a fee that 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."[4] The Court further held that when reviewing such a claim, "[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] Moreover, although a court should take into account all relevant circumstances, "[i]t is also important to note that the standard for fiduciary breach under § 36(b) does not call for judicial second-guessing of informed board decisions."[6]

In assessing Section 36(b) claims, the Supreme Court endorsed consideration of a non-exclusive set of factors commonly called the *Gartenberg* factors, recognized in the Second Circuit's seminal ruling *Gartenberg v. Merrill Lynch Asset Management, Inc.*[7] These factors include: (1) the nature, extent, and quality of the services provided by the adviser to the mutual fund; (2) the profitability to the adviser of managing the fund; (3) "fall-out" benefits, or benefits that the adviser would not have realized but for its relationship with the fund; (4) the existence of any economies of scale achieved by the adviser as a result of growth in fund assets under management, and the extent to which such savings are shared with fund shareholders; (5) fee structures utilized by other similar accounts; and (6) the expertise of the fund's Independent Trustees,[8] whether the Independent Trustees are fully informed about all of the facts bearing on the adviser's service and fee, and the extent of care and conscientiousness with which the Independent Trustees perform their duties with respect to the adviser's fee.[9]

The last factor typically is recognized to be of special importance. In particular, Section 36 of the Investment Company Act states "[i]n any [Section 36(b)] action approval by the board of directors of [the fund] of such compensation or payments, . . . shall be given such consideration by the court as is deemed appropriate under all the circumstances."[10] To this end, in *Jones* the Court held that "[w]here a board's process for negotiating and reviewing investment-adviser compensation is robust, a reviewing

court should afford commensurate deference to the outcome of the bargaining process."[11] As a result, "if the disinterested directors considered the relevant factors, their decision to approve a particular fee agreement is entitled to considerable weight, even if a court might weigh the factors differently."[12] In contrast, "where the board's process was deficient or the adviser withheld important information, the court must take a more rigorous look at the outcome."[13]

After the issuance of the Supreme Court ruling in *Jones*, a wave of Section 36(b) litigation against the asset management industry ensued. Following the filing of the first post-*Jones* Section 36(b) case in 2011, advisers to 23 fund complexes were sued, with cases advancing a variety of novel (and not so novel) structural attacks. At its height, the total potential exposure for investment advisers exceeded $7 billion. While no plaintiff ever has prevailed on a Section 36(b) claim, analysis of the court decisions from this recent wave of litigation, which appears to have been concluded for the time being, reveals a variety of insights and best practices. This article highlights a few of these important developments.

Key Takeaways from the Post-*Jones* Section 36(b) Case Law

The Importance of Following (and Documenting) a Reasoned Fee Pricing Philosophy

The care and conscientiousness of a fund's Independent Trustees, as well as a robust and reasoned board process, long has been recognized as central to the successful defense of a Section 36(b) claim.[14] What has received less attention, however, is the importance of the adviser—in conjunction with the board—creating, following, and documenting a reasoned advisory fee pricing philosophy. Generally speaking, a successful business will have some justification in mind when setting prices, whether it relates to the scope or quality of services provided, competition in the marketplace, or some other metric. Recent cases have shown that courts will accord significant deference to Independent Trustees' business judgment where the rationale behind the advisory fee charged to the fund can be explained clearly by both the adviser and the Trustees.[15]

For example, the adviser's expertise in specialized asset classes or strategies, experience in investing in unique or novel strategies, pricing to scale, or the fund's competitive positioning in the market all can support a reasoned fee.[16] Evidence that the board engaged in discussion and analysis regarding the advisory fee is important to dispositive motions and even at trial. The rationale behind the fee charged can be just as informative as fee comparisons showing where the fund's fee ranks compared to peers. Materials (and witness testimony) explaining the rationale for why a fee is set at a specific level can be particularly persuasive and demonstrate the time and attention that was contributed to determining a fund's advisory fee. While earlier cases did not devote much attention to this topic, more recent cases have recognized not only the importance of a logical pricing philosophy but also the importance of contemporaneous board materials that explain and memorialize this pricing approach.[17]

Consideration of Benefits to Shareholders Other Than Fee Reductions

Recent cases also have recognized repeatedly that the Investment Company Act "does not impose a duty on the board of directors of a mutual fund to negotiate the lowest possible advisory fee as compensation for an investment adviser's services."[18] While a fund's Independent Trustees should follow a robust process and engage with the adviser on the fee that is charged, that does not equate with a duty to negotiate a basement-level fee. Indeed, in some instances a myopic focus on the lowest possible fee actually could harm the fund. For example, a fee could be so low that the adviser is unable to invest sufficient resources into managing the fund or afford to retain sufficiently skilled employees.[19]

In this regard, some courts recently have recognized that Independent Trustees can negotiate

benefits other than fee reductions that also inure to the benefit of fund shareholders. For example, the Trustees could require the adviser to make investments in its portfolio management team or other services it renders to the fund in seeking to improve those services.[20] The concept of negotiating for benefits other than a reduction in the fee is a relatively new frontier that traditionally has not been recognized by the courts.[21] Highlighting this perspective provides an opportunity to show potentially non-obvious benefits that the board can achieve for the fund(s) at issue. In short, a focus solely on fee reductions, to the exclusion of other benefits that can be enjoyed by funds and their shareholders, risks ignoring important work by the board and the adviser.

Aptness of Fee Comparisons

Fee comparisons have been a hot area of dispute in recent cases. In *Jones*, the Supreme Court cautioned that "courts may give such [fee] comparisons the weight that they merit in light of the similarities and differences between the services that the clients in question require, but courts must be wary of inapt comparisons."[22] The Supreme Court did not give any further specific guidance with regard to what should be considered apt or inapt, or what weight should be given to such a comparison. Accordingly, there has been substantial disagreement among plaintiffs, defendants, and the courts over what is an "apt" or "inapt" fee comparison. For example, at various points, fund management fees have been compared to fees paid by separate accounts (also known as separately managed accounts), which are portfolios managed by investment advisers and typically utilized by institutional investors or wealthy retail investors.[23] Advisory fees also have been compared to subadvisory fees, which are fees paid to a subadviser who handles a fund's investment portfolio but typically does not have the expansive duties and obligations of an investment adviser who manages and sponsors the fund.[24] There continues to be a lack of clear guidance in this area among the district courts, perhaps in part due to courts' lack of familiarity with the similarities and differences in managing different types of investment vehicles. But as a general matter in this recent wave of litigation, courts have found fee comparisons to be relevant but not dispositive.[25]

Courts remain reticent to dismiss arguments about fee comparisons prior to trial, often concluding that to do so would require a premature weighing of the evidence with regard to the services being provided to various different accounts or the amount of work those services entail.[26] But, as courts gain more familiarity with this area of litigation, they increasingly have recognized that the services provided by an adviser to a mutual fund are meaningfully different, and greater, than services provided to a separate account or as a subadviser to a fund.[27] Mutual funds operate in a highly-regulated space, and the adviser must take into account numerous laws and regulations.[28] Moreover, the adviser's interactions with and support provided to a fund's board as part of the yearly Section 15(c) process, including but not limited to amassing voluminous, detailed materials and providing a comprehensive presentation to the board, is far more extensive than any support provided to the board of a subadvised fund. Any similar obligation with respect to subadvised funds or separate accounts is far less work.[29] It remains to be seen whether courts will develop more comfort with drawing such distinctions at the motion to dismiss or summary judgment stages, as opposed to after a full presentation of evidence following a costly trial.

Relatedly, there is emerging recognition that the risks borne by the adviser for mutual funds are different from, and greater than for other types of accounts, including:

- More complex portfolio management due to daily purchase and redemption activity, regulatory requirements (for example, restrictions on certain security types), and tax considerations;[30]
- Operational risks, such as risk associated with calculating a fund's net asset value (NAV) and overseeing third party service providers;[31]

Copyright © 2022 by CCH Incorporated. All Rights Reserved.

- Entrepreneurial risk, such as risks associated with seeding and sponsoring a new fund;[32]
- Compliance risk, that is, risks assumed by the adviser in ensuring that the fund complies with applicable rules and regulations;[33]
- Risk to an adviser's reputation;[34] and
- Litigation and regulatory risk.[35]

Among other things, often the adviser is ultimately responsible for all of the advisory and administrative services provided to the fund, regardless of whether those services are provided directly by the adviser or by third parties. This responsibility does not exist to the same degree when an adviser subadvises a third-party fund or advises non-mutual fund accounts.

Furthermore, courts have rejected the contention that an adviser is required to quantify such risks to "justify" the fee charged to a mutual fund.[36] Rather, courts have recognized that it generally is not possible to quantify the cost or expense of such risks, nor is there any legal requirement to do so.[37]

The Existence of Separate Agreements

Courts also have dealt with cases where a fund may have separate agreements for different services that are provided by an adviser and separately by an affiliate of the adviser or a third party. For example, it is not uncommon for a fund to have an investment advisory agreement with its investment adviser, pursuant to which the fund pays an advisory fee, and an administrative agreement with the adviser or an affiliate of the adviser, pursuant to which it pays an administrative fee. In those circumstances, defendants have gotten into potentially avoidable squabbles over which services are covered by which agreement (and fee).

Plaintiffs in some recent cases have argued that various services were provided under the administrative agreement and therefore cannot "justify" the advisory fee. Plaintiffs then argue that the advisory fee is excessive because relatively few services are provided under the advisory agreement and therefore the services do not justify the fee. These arguments largely have made it past the motion to dismiss stage.[38] At trial, however, defendants generally have been successful in urging courts to consider the substantive evidence regarding the services provided, rather than restricting themselves to the plain terms of the agreements. The reality of what services are provided by whom ultimately matters more than the written terms of the agreements. Moreover, courts have found persuasive expansive language in the agreements that broadly describes what services are provided, rather than reading the agreements to delineate every single service provided.[39]

Competition in the Marketplace

Finally, there appears to be an emerging recognition that, despite the Supreme Court's historical concern about captive mutual funds,[40] the fact that individual investors can "vote with their feet" by redeeming their shares does play a role in a Section 36(b) analysis.[41] By the very nature of open-end mutual funds, shareholders are able to redeem their shares every day. At the end of 2020, there were 9,027 open-end mutual funds offered for sale in the United States by 804 fund sponsors.[42] Although an individual fund may not easily change its adviser, investors can easily move their investment to a different fund. As a result, there is significant competition for shareholder investments in the mutual fund industry.[43] Indeed, in at least some cases, survivorship statistics indicate that comparatively few mutual funds survive over time, perhaps as a result of this fact.[44]

Relatedly, courts have considered the economic reality that fund shareholders are, in practice, the parties that would be harmed by an excessive fee, because they are the ones who indirectly pay the fee, in the sense that fees paid by a fund reduce the fund's assets and consume money that otherwise could be invested on behalf of the fund.[45] Accordingly, there is growing understanding that, as a matter of economic common sense, the focus

of an excessive fee inquiry should be the shareholders rather than the relationship between the fund and its adviser.

Summary

With more than a dozen reported decisions covering many previously unsettled issues within the Section 36(b) jurisprudence, advisers, Trustees, and the asset management industry more broadly would be well served to consider the lessons that have come out of these decisions to further strengthen their structures and processes. Proactive consideration of such takeaways now may give guidance to potential Section 36(b) landmines to avoid in the future.

Mr. Kotler, **Ms. Johnson**, and **Mr. Rose** are partners; **Ms. Wigglesworth,** and **Mr. Roberson** are associates at Dechert LLP.

NOTES

1 "Characteristics of US Mutual Fund Owners," 2021 Investment Company Factbook, *https://www.icifactbook.org/21_fb_ch7.html* (2021).

2 15 U.S.C. § 80a-1, *et seq*.

3 15 U.S.C. § 80a-35(b).

4 Jones v. Harris Associates, Inc., 559 U.S. 335, 346 (2010).

5 *Id.* at 347 (quoting Pepper v. Litton, 308 U.S. 295, 306-07 (1939)).

6 *Id.* at 352.

7 Gartenberg v. Merrill Lynch Asset Management, Inc., 694 F.2d 923 (2d Cir. 1982).

8 As used herein, Independent Trustees also includes independent directors.

9 *See Gartenberg,* 694 F.2d. at 930-933. These factors are not elements of a Section 36(b) claim, but rather a series of topics that courts may consider when determining whether a fee is excessive.

10 15 U.S.C. § 80a-35(b)(2).

11 *Jones*, 559 U.S. at 351.

12 *Id.*

13 *Id.*

14 *E.g.*, *id.* at 351-352.

15 *E.g.*, Obeslo v. Great-W. Life & Annuity Ins. Co, 6 F.4th 1135, 1145, 1150 (10th Cir. 2021) (deferring to Independent Trustees where Trustees received fee proposal that was "'intended to position the Funds for future growth,'" and "'to be priced reasonably and competitively with peers'"); Chill v. Calamos Advisors LLC, 417 F. Supp. 3d 208, 258 (S.D.N.Y. 2019) (deferring to Independent Trustees' business judgment where Trustees received "sufficient information to evaluate the disparity in fees between the Fund and [adviser's] institutional and sub-advised clients . . . [as well as] detailed fee-comparison data from industry-recognized, third-party sources showing the Fund's fee placement relative to its peers"); In re BlackRock Mut. Funds Advisory Fee Litig., 327 F. Supp. 3d 690, 704 (D.N.J. 2018), *aff'd*, 816 F. App'x 637 (3d Cir. 2020) (deferring to Trustee business judgment where board requested and received "additional information regarding the fees that BlackRock receives for advisory services rendered to institutional investors, and requested that BlackRock perform a review of the advisory fee breakpoints contained in fee schedules across all funds under BlackRock's management").

16 *E.g.*, Kennis v. Metro. W. Asset Mgmt., LLC, 2019 WL 4010747, at *5 (C.D. Cal. July 9, 2019), *adopted*, 2019 WL 4010363 (C.D. Cal. Aug. 5, 2019), *aff'd*, 821 F. App'x 895 (9th Cir. 2020) (observing that the adviser "launched the Fund amid [a] competitive landscape" and "set that advisory fee . . . because that rate was at or below the median of the funds that MetWest expected to compete against, and the 55 bp fee would continue to constitute a below median fee if the Fund ultimately grew") (footnote omitted); *see also id.* at 33 (recognizing "evidence that MetWest 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"); *Chill*, 417 F. Supp. 3d at 220 ("Calamos prices the services it provides to the Fund by referring to the market rates that its competitor investment advisors charge to peer mutual funds.").

Copyright © 2022 by CCH Incorporated. All Rights Reserved.

[17] *Chill*, 417 F. Supp. 3d at 258; In re BlackRock Mut. Funds Advisory Fee Litig., 327 F. Supp. 3d at 704.

[18] *In re BlackRock Mut. Funds*, 327 F. Supp. 3d at 716; *Kennis*, 2019 WL 4010747, at *24 (crediting argument that "it was not the [b]oard's duty to negotiate the best deal possible, but instead to use its reasonable judgment in deciding whether to approve a fee once it had all relevant information."); *Cf. Chill*, 417 F. Supp. 3d at 261-62 ("Plaintiffs could not prevail by demonstrating *solely* that the fees are higher, even much higher, than those charged by third parties to peer funds. . . . Section 36(b) does not require that a fund experiencing below-median performance must charge a below-median fee").

[19] *Kennis*, 2019 WL 4010747, at *14 (finding that reinvestment "through adding new employees, improving technology systems, and . . . increasing compensation for retention purposes" was "necessary to keep talent from leaving due to competition"); *cf. id.* at *12 n.35 (recognizing "anecdotal testimony regarding the importance of key investment managers to mutual bond funds" and harm to funds if they depart).

[20] *Chill*, 417 F. Supp. 3d at 279 (finding that adviser made "numerous significant and costly changes to its investment team and investment process, which was not limited to additional personnel hired to service the Funds . . . And the Independent Trustees *did* conscientiously consider these significant and costly changes (along with several other factors) in determining whether to approve [the] advisory fee each year during the relevant period"); *see id.* at 231 (finding that the adviser "made several changes to its investment process and investment team to improve" including "transformation of its investment team from a 'vertical' structure with a 'one-team-one-process' approach to a 'horizontal' structure with a 'team-of-teams' approach"); *Kennis*, 2019 WL 4010747, at *24 (adviser engaged in "reinvestment in [its] infrastructure including the hiring of additional professionals and specialists").

[21] *Kennis*, 2019 WL 4010747, at *14; *Chill*, 417 F. Supp. 3d at 279.

[22] *Jones*, 559 U.S. at 349-50.

[23] *E.g.*, Kasilag v. Hartford Inv. Fin. Servs., LLC, 2012 WL 6568409, at *5 (D.N.J. Dec. 17, 2012) (considering comparison to fees charged to separate institutional accounts); *Chill v. Calamos Advisors LLC*, 175 F. Supp. 3d 126, 133 (S.D.N.Y. 2016) (considering comparison to fees charged by "third-party institutional clients").

[24] In re Davis New York Venture Fund Fee Litig., 2015 WL 7301077, at *2 (S.D.N.Y. Nov. 18, 2015) (considering comparison of advisory to subadvisory fees); In re Blackrock Mut. Funds Advisory Fee Litig., 2015 WL 1418848, at *6 (D.N.J. Mar. 27, 2015) (comparing advisory fees charged by adviser to subadvisory fees charged by adviser to other funds).

[25] *But see* Jones v. Harris Assocs. L.P., 611 F. App'x 359, 360–61 (7th Cir. 2015) (facts that "fees were in line with those charged by advisers for other comparable funds" and "the fees could not be called disproportionate in relation to the value of [the adviser's] work, as the funds' returns (net of fees) exceeded the norm for comparable investment vehicles. . . . jointly suffice under the Supreme Court's standard"); Pirundini v. J.P. Morgan Inv. Mgmt. Inc., 309 F. Supp. 3d 156, 165 (S.D.N.Y. 2018), *aff'd*, 765 F. App'x 538 n.10 (2d Cir. 2019) (granting motion to dismiss and observing that "Plaintiff's allegation that the fee rate JPMIM charges the Fund is above the average fee rate paid by the Bloomberg Funds misses the mark. It is well-settled that 'charging a fee that is above the industry average does not violate Section 36(b).'"); Paskowitz v. Prospect Cap. Mgmt. L.P., 232 F. Supp. 3d 498, 504–05 (S.D.N.Y. 2017) (granting motion to dismiss in part because adviser's "rate was above the average but less than the top rate paid. . . . The complaint shows that [the adviser's] stated and effective base and incentive fee rates are within the range of those paid by comparable funds.").

[26] *E.g.*, Chill v. Calamos Advisors LLC, 2018 WL 4778912, at *15 (S.D.N.Y. Oct. 3, 2018) (on motion for summary judgment, finding questions of fact regarding whether fund fees were comparable to non-fund fees); *In re BlackRock Mut. Funds Advisory Fee Litig.*, 327 F. Supp. 3d at 724 ("Based on the

record before me, I cannot find, on this Motion [for Summary Judgment], that Plaintiffs' comparison between the Advisory Fee and the Subadvisory Fee is inapt as a matter of law.").

[27] *Chill*, 417 F. Supp. 3d at 262 (following trial, finding that "fees charged to [separate accounts] are inapt comparators to the Fund's fees when considering whether the Fund's advisory fee is excessive"); *Kennis*, 2019 WL 4010747, at *11 ("Despite the fact MetWest provides portfolio management to the 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."); *In re BlackRock Mut. Funds Advisory Fee Litig.*, 2019 WL 1387450, at *27 (D.N.J. Feb. 8, 2019), *aff'd*, 816 F. App'x 637 (3d Cir. 2020) (finding that "the trial record elucidated substantial distinctions" between serving as an adviser and serving as a subadviser, including "in: (i) compliance; (ii) board administration; (iii) regulatory and financial reporting; (iv) determination and publication of daily NAV; and (v) managing service providers"); Goodman v. J.P. Morgan Inv. Mgmt., Inc., 301 F. Supp. 3d 759, 769-74 (S.D. Ohio 2018), *aff'd*, 954 F.3d 852 (6th Cir. 2020) (granting summary judgment and determining that a comparison of advisory fees and subadvisory fees was inappropriate due to: (1) the fact that the services were not substantially the same, and (2) based on different responsibilities, risks, and scope of services provided).

[28] *Chill*, 417 F. Supp. 3d at 262.

[29] *E.g.*, *Kennis*, 2019 WL 4010747, at *10 ("MetWest constantly provides information to and communicates with the [b]oard and various committees of the [b]oard with respect to the Fund. MetWest supports the [b]oard in fulfilling its duties, and it prepares the [b]oard for its meetings. On the other hand, MetWest communicates far less with the Subadvised Funds' boards and instead MetWest's main purpose in assisting with the 15(c) process is the completion of portions of the annual questionnaire for those funds.").

[30] *Kennis*, 2019 WL 4010747, at *10 (noting that the adviser must fulfill all requests for redemption and ensure compliance with SEC rules and regulations as well as other federal laws and regulations).

[31] *Chill*, 417 F. Supp. 3d at 267 (finding that "fund administration obligations (and risks) that Calamos undertook in advising the Fund greatly exceed the limited obligations (and risks) Calamos undertook in advising" other clients); *In re BlackRock Mut. Funds Advisory Fee Litig.*, 2019 WL 1387450, at *11 ("[The adviser] likewise bears financial risk and responsibility stemming from the operations of third-party service providers providing services to the Funds. . . . [The adviser] is ultimately responsible for 'making the funds whole' regardless of whether a service provider is at fault and agrees to contribute.") (citation omitted); *see id.* ("[A] single mistake in the Funds' NAV calculation 'could impact thousands of [the adviser's] clients, . . . [and] would have 'an incredible impact on [the adviser's] relationship with [its] clients. . . .") (citations omitted); *Goodman*, 301 F. Supp. 3d at 770-71 (risks borne by adviser to mutual fund include "operational risks," and the adviser "must set up and run the operational infrastructure required to manage these risks"); Sivolella v. AXA Equitable Life Ins. Co., 2016 WL 4487857, at *42 (D.N.J. Aug. 25, 2016), *aff'd*, 742 F. App'x 604 (3d Cir. 2018) (recognizing that "an error in the computation of the net asset value of a fund . . . can lead to . . . significant costs") (citation omitted).

[32] *Chill*, 417 F. Supp. 3d at 269-70 (finding that adviser took on greater "entrepreneurial risk in advising mutual funds as compared to non-mutual funds"); *In re BlackRock Mut. Funds Advisory Fee Litig.*, 2019 WL 1387450, at *11 (risks include "changes in the market or regulatory environment that may affect [the adviser's] return on investment"); *Goodman*, 301 F. Supp. 3d at 770 (risks borne by adviser to mutual fund include "pricing risks"); Kasilag v. Hartford Inv. Fin. Servs., LLC, 2017 WL 773880, at *7 (D.N.J. Feb. 28, 2017), *aff'd*, 745 F. App'x 452 (3d Cir. 2018) (entrepreneurial risk includes "the risk that one of the Funds might be offered but then the

Copyright © 2022 by CCH Incorporated. All Rights Reserved.

'market changes,' such that a feature of the fund that was deemed beneficial in the market no longer is considered to be a plus"); *Sivolella*, 2016 WL 4487857, at *42 ("[T]he risk that companies face in starting funds are the costs involved, the uncertainty of the successfulness of the fund, and the 'expense caps' that need to be put in place to make the fund 'viable at an early stage.'") (citation omitted).

[33] *In re BlackRock Mut. Funds Advisory Fee Litig.*, 2019 WL 1387450, at *11 ("[The adviser] bears risks for the Funds' compliance with laws and regulations, even within areas of operations assigned to third-party service providers."); *Goodman*, 301 F. Supp. 3d at 772 (the adviser "provided substantially more compliance services in both 'scale' and 'scope' to the Funds, as compared to the Subadvised Funds"); *Sivolella*, 2016 WL 4487857, at *42, *46 (risk arising out of compliance activities, as adviser's "compliance group facilitates and participates in examinations by the SEC and inquiries, external audits, and [] internal audits").

[34] *Kennis*, 2019 WL 4010747, at *12 ("[A]ny mistake related to the NAV or performance could harm MetWest's reputation and put all of the MetWest Funds in jeopardy as a result of a loss of confidence"); *Chill*, 417 F. Supp. 3d at 233 (noting that the "Independent Trustees were informed that the litigation risks associated with advising mutual funds clients are greater than the litigation risks associated with non-fund clients"); *In re BlackRock Mut. Funds Advisory Fee Litig.*, 2019 WL 1387450, at *11 ("[The adviser] assumes reputational risks even for the mistakes by the Funds' third-party service providers."); *Goodman*, 301 F. Supp. 3d at 770 (risks borne by adviser to mutual fund include "reputational risks"); *Kasilag*, 2017 WL 773880, at *7 ("[I]f the funds fail to deliver what the shareholders are expecting, [the adviser's] name is at risk because it is associated with the Funds."); *Sivolella*, 2016 WL 4487857, at *17, *42 ("[I]f there's a significant problem . . . reputationally [sic] it's going to be [the adviser's] name which is going to be everywhere") (citation omitted).

[35] *Chill*, 417 F. Supp. 3d at 262 ("[T]he credible evidence demonstrates that the higher fees charged to the Fund vis-à-vis [separate accounts] reflected the greater services and risks that [the adviser] experienced in managing the Fund when compared to its [separate accounts] — particularly in areas such as legal, regulatory, and compliance; fund governance; fund administration services; oversight of third-party service providers; portfolio management; and client/shareholder services"); *Kennis*, 2019 WL 4010747, at *12 ("MetWest also takes on risks with respect to the Fund's regulatory filings that could lead to criminal or civil penalties. . . . Based on the evidence presented at trial, there are a number of other risks (*i.e.,* cybersecurity, the risk of losing personnel essential to client relations, asset flight, among others) that the Court finds MetWest bears with respect to the Fund but not with the Subadvised Funds.") (footnotes omitted); *Goodman*, 301 F. Supp. 3d at 770 (risks borne by adviser to mutual fund include "litigation risks" and "regulatory risks"); *Kasilag*, 2017 WL 773880, at *7 ("[A]s regulations change, or interpretations of regulations change, there is a risk borne by Defendants that 'what we have built or the way we manage our fund is—in the future changes either with new regulation or with a different interpretation of the regulation.'") (citations omitted); *Sivolella*, 2016 WL 4487857, at *42 ("Litigation and regulatory risks 'essentially address the possibility of [the adviser] being sued or having regulatory issues.'") (citation omitted).

[36] *Chill*, 417 F. Supp. 3d at 257 ("[N]o court or regulator has ever held that an adviser must 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 subadvisory account."); *Sivolella*, 2016 WL 4487857, at *45 (holding that adviser "was not required to quantify the risk in order to justify a portion of its fee").

[37] *Chill*, 417 F. Supp. 3d at 257; *Sivolella*, 2016 WL 4487857, at *45.

[38] *E.g.*, *Chill*, 175 F. Supp. 3d at 141 (declining to dismiss allegation that management agreement was

limited in scope of services in light of existence of financial accounting services agreement).

39 *Chill*, 417 F. Supp. 3d at 267 (crediting trial witness testimony that the adviser "was required to provide all services necessary to advise the Fund under the [management agreement], regardless of whether the [accounting and administrative agreement] was in operation"); *Kennis*, 2019 WL 4010747, at *8 ("According to the testimony at trial, it was more important to the Independent Trustees to know what MetWest actually did for the Subadvised Funds and how much they were charged, rather than the intricacies of contractual language" between the advisory and subadvisory agreement); *see id.* at *6 ("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."); *Sivolella*, 2016 WL 4487857, at *47 (while "much of the contract language is generic and broad, and could easily be interpreted differently," it was "clear from the trial testimony that [the adviser] performed a host of duties that may not have been explicitly enumerated in the contracts").

40 *Jones*, 559 U.S. at 339 (observing that the relationship between a fund and its investment adviser was 'fraught with potential conflicts of interest'") (quoting *Daily Income Fund, Inc. v. Fox*, 464 U.S. 523, 536 (1984)) (internal citation omitted).

41 *Kennis*, 2019 WL 4010747, at *4 ("Each day, 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. The ordinarily low costs of switching between funds means that asset flight occurs frequently.") (citations omitted); *id.* at *35 n.53 ("The 'exponential' growth in the number of mutual funds, the size of their AUMs, and the number of investors in such funds since the passage of Section 36(b) should be considered. There definitely is competition among the funds for the investors' assets. Industry concentration is low, new entry is common, and barriers to entry are low.") (citations omitted).

42 2021 Investment Company Fact Book at 40 & 54, Investment Company Institute, *https://www.ici.org/system/files/2021-05/2021_factbook.pdf*.

43 *See Kennis*, 2019 WL 4010747, at *4.

44 *Chill*, 417 F. Supp. 3d at 279 (citing expert "analysis [that] shows that only nine of approximately sixty original peer mutual funds at the time of its inception have survived to the present date"); *Kennis*, 2019 WL 4010747, at *35 n.53 ("As to the top 10 bond funds in 2000, most were no longer on the list in 2015.") (citation omitted).

45 *See generally Chill*, 417 F. Supp. 3d 208.

Copyright © 2022 CCH Incorporated. All Rights Reserved.
Reprinted from *The Investment Lawyer*, February 2022, Volume 29, Number 2, pages 15–23, with permission from Wolters Kluwer, New York, NY, 1-800-638-8437, www.WoltersKluwerLR.com

Copyright © 2022 by CCH Incorporated. All Rights Reserved.