ROPES & GRAY

ALERT

Asset Management

March 7, 2017

Another Court Rejects Excessive Fee Claims Following Trial on Mutual Fund "Manager of Managers" Theory

Attorneys
John D. Donovan
Robert A. Skinner
Amy D. Roy

On February 28, 2017, Judge Renée Bumb of the New Jersey federal district court entered judgment in favor of Hartford Funds Management Group, Inc. ("Hartford") following last November's four-day bench trial relating to plaintiffs' allegations of excessive fees under Section 36(b) of the Investment Company Act of 1940. The *Hartford* case is the second to proceed to trial after the Supreme Court's 2010 decision in *Jones v. Harris Associates L.P.*, which established the standard by which courts assess allegations that investment advisers charge mutual fund investors excessive fees.[1] Although the court had declined to grant summary judgment in Hartford's favor, Judge Bumb's trial decision embraces several helpful principles – including its recognition of the adviser's right to earn a reasonable profit, the various risks borne by sponsoring investment advisers, and the legitimacy of Lipper comparisons.

The complaint in *Hartford* was filed in 2011 among a wave of more than two dozen post-*Jones* Section 36(b) cases. Six of Hartford's mutual funds were at issue in the case, each of which is subadvised by Wellington Management entities. The plaintiffs' case largely hinged on allegations that Wellington and other third-party service providers perform substantially all of the advisory services rendered to the funds, yet Hartford retains a significant portion of the advisory fee for providing minimal work. According to the plaintiffs, Hartford's services are primarily supervisory in nature and limited in scope, requiring minimal personnel and expenditure of resources. The plaintiffs sought to establish that Hartford retained excessive fees for its supposedly limited services, building their case largely on the notion that, as a matter of accounting principles, fees paid to Wellington should be disregarded (rather than treated as an expense of Hartford) in calculating Hartford's profitability.

In late 2012, the court denied Hartford's motion to dismiss, finding that the plaintiffs had stated a claim for a violation of Section 36(b). Following two years of discovery, the parties filed cross-motions for summary judgment. In an opinion issued in April 2016, the court determined that the approval of the funds' fees by the funds' independent directors would be given deference because the board was independent and informed. However, the court ruled that a trial was necessary because factual disputes remained regarding the so-called *Gartenberg* factors beyond the board's independence and conscientiousness, including the nature and quality of the services provided, the funds' profitability, fall-out benefits, and economies of scale.

At trial, Hartford's defense focused on three key points. First, Hartford asserted that the funds' fees and performance are entirely in line with peer funds, demonstrating that the fees charged cannot be excessive as a matter of law. Second, Hartford argued that the plaintiffs' argument that the fees paid to Wellington should be completely disregarded in analyzing Hartford's profitability lacked foundation in accepted accounting principles. Finally, to the extent that the plaintiffs' claim was based on the notion that Hartford's profits are just too high, Hartford emphasized the principle that Section 36(b) does not assign courts with the task of regulating an investment adviser's fees or profits – a principle expressly recognized in *Jones* and other cases.

[1] The Supreme Court asserted that to face liability under Section 36(b), "an investment adviser must charge 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." *Jones v. Harris Assoc. L.P.*, 559 U.S. 335, 346 (2010).

ATTORNEY ADVERTISING

Throughout the 70-page opinion, Judge Bumb rejected outright nearly all of the plaintiffs' arguments, deeming the evidence offered as insufficient to show that Hartford's fees were excessive. Significantly, the court deemed unpersuasive the plaintiffs' attempts to draw distinctions between the services rendered to the funds by Hartford as adviser and Wellington as subadviser, which Judge Bumb called the "crux of Plaintiffs' case." She reasoned that Section 36(b) and *Jones* require courts to look at the totality of services rendered by the adviser, including subadvisory services performed under the adviser's supervision, in assessing whether the fees paid to the adviser are within the arm's-length bargaining range. As part of this reasoning, Judge Bumb rejected the plaintiffs' accounting theory, finding it inconsistent with nearly all relevant authority, including GAAP. In another portion of the opinion, the court rejected the plaintiffs' argument that she should disregard Lipper performance data and focus solely on less favorable comparisons to the funds' benchmarks. In doing so, the court recognized the broad acceptance of Lipper as an objective data source in the investment management industry and ultimately relied on the Lipper data in finding that Hartford prevailed despite sometimes average or, in the case of one fund, well below average performance.

The *Hartford* opinion is encouraging because it reflects a more nuanced understanding of the complexities of the investment management industry than some earlier decisions, including the significant oversight responsibilities retained – and various risks borne – by investment advisers. Although the opinion still relies heavily on the framework of the *Gartenberg* factors, it includes significant favorable language emphasizing that the overarching test remains the stringent *Jones* arm's-length standard and how Section 36(b) does not authorize courts to engage in rate review or set a reasonable "cost-plus" rate of profit. At the same time, it is unfortunate that the court was unpersuaded to find in Hartford's favor at summary judgment, given the very strict "beyond arm's length" standard set by the *Jones* court, her finding of a rigorous board process, and the obvious weaknesses in the plaintiffs' case.

Ropes & Gray's litigators are actively involved in defending advisers in Section 36(b) litigation, and are closely monitoring developments in the case law. For further information, please contact John Donovan, Robert Skinner, or Amy Roy.

This alert should not be construed as legal advice or a legal opinion on any specific facts or circumstances. This alert is not intended to create, and receipt of it does not constitute, a lawyer-client relationship. The contents are intended for general informational purposes only, and you are urged to consult your attorney concerning any particular situation and any specific legal question you may have. © 2017 Ropes & Gray LLP

ATTORNEY ADVERTISING