Bloomberg Law Reports® Securities Law

Vol. 2, No. 40 October 6, 2008

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# Featured Article

## Another Critique of Mutual Fund Fees: Coals to Newcastle?

*Contributed by:*
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*Introduction*

The authors of an article recently published in the *Oklahoma Law Review* (OLR Article) should be pleased with the publicity generated by the two Seventh Circuit appellate decisions in *Jones v. Harris Associates L.P.* (*Jones I* and *Jones II*).[1] The OLR Article, titled *Mutual Fund Advisory Fees: New Evidence and a Fiduciary Duty Test*,[2] claims that evidence demonstrates that "price gouging over portfolio management fees is a way of life in the fund industry," and comes against the backdrop of a very public dispute between Judges Easterbrook and Posner in *Jones I* and *Jones II* concerning these fees. Indeed, largely due to the prominence of the participants, *The New York Times* ran an article about the jurists and their dispute over how mutual fund fees are determined.[3]

Much ink already has been spilled concerning *Jones I* and *Jones II* and their implications for the mutual fund industry (including the fact that the plaintiffs' attorneys stated that they will petition the United States Supreme Court to review the case). This article does not revisit the decisions, except to note that both decisions cite academic studies. In particular, Judge Posner, in his dissent in *Jones II*, cites a 2001 study by two of the OLR Article's authors (2001 Study). The OLR Article reports that it builds upon the 2001 Study.[4] Therefore, this article instead examines the OLR Article's methodology to reveal what appears to be a serious omission.

*Comparable or Different?*

*Early Lessons*

One of my first assignments after law school was to a team representing a defendant coal company located in the southwestern United States. The plaintiff, an electric utility, alleged that the coal company had attempted to monopolize the market for "steam coal" used to produce electricity. The utility and the coal company were parties to a long-term contract for the sale of coal by the coal company to the utility, but the utility no longer needed the coal. I believed that the utility brought the lawsuit in order to litigate its way out of a losing long-term contract.

The utility produced its expert with his list of comparable transactions. The transactions, all of which occurred roughly contemporaneously with the execution date of the disputed long-term contract, along with the expert's testimony, were the utility's evidence that the price specified in the long-term contract was not the result of competitive bargaining. Specifically, the expert claimed, because the price specified in the long-term contract was greater than the prices in his list of comparable transactions or "comparables," the long-term contract's price demonstrated the coal company's monopoly power.

However, upon closer examination, many of the utility's comparables were anything but comparable to the coal described in the long-term contract. The utility's comparables included coal mined east of the Mississippi River (a different geographic market), metallurgical grade coal, unmined coal in uneconomic deposits and, in general, coal sold in transactions that were distinguishable from the coal covered by the disputed long-term contract.

The lesson I learned from that lawsuit is that it is difficult to make inferences about the competitiveness of one market, even for a commodity such as coal, based upon price data from another market.

*OLR Article's Comparables*

To prove its central thesis—that mutual fund advisory fees are excessive—the OLR Article compares fees paid by mutual funds to fees paid by other types of institutional investors. The fees paid by these other types of institutional investors are the OLR Article's comparables. Because the fees paid by mutual funds are significantly greater than the comparables, the OLR Article concludes that competitive pricing does not exist in the market for mutual fund advisory services.

The first comparable provided by the OLR Article is the average fee paid by the subset of actively managed Vanguard mutual funds that employ subadvisers that are *unaffiliated* with the Vanguard group. We are told that these subadvisers are "hired in the free market by the funds' boards." The OLR Article reports that the average total expense ratio for the Vanguard funds with an unaffiliated subadviser is 40 basis points (bps) or 0.40 percent, while the mutual fund industry average total expense ratio is 91 bps.

The second comparable provided also relies on data from the Vanguard fund group. The OLR Article reports that a majority of the unaffiliated subadvisers hired by the Vanguard funds' boards also manage their own "captive" mutual funds. When the subadvisers provide identical advisory services to their own captive mutual funds, the captive funds' boards of directors approve fees that are significantly more than the fees paid by the Vanguard funds. The OLR Article estimates that the subadvisers charge their (non-Vanguard) captive mutual funds between 41 bps and 49 bps more than the competitive price charged for identical services to the Vanguard funds.

The third comparable provided by the OLR Article is taken from the 2001 Study. The 2001 Study reported that equity pension fund portfolios paid an asset-weighted average advisory fee of 28 bps, while the average equity mutual fund, with an average asset size three times that of the average pension fund portfolio, paid an asset-weighted average advisory fee of 56 bps. Thus, the 2001 Study concluded, mutual fund advisers were paid twice as much (56 bps versus 28 bps) to manage mutual funds that, on average, were nearly three times bigger than pension funds.

*OLR Article's Conclusions*

Referring to its comparables, the OLR Article concludes that "the evidence demonstrat[es] that price gouging over portfolio management fees is a way of life in the fund industry." The OLR Article also reports that, building upon prior studies, mutual fund advisory fees are "wildly out of line" with the fees received for similar investment advisory services in the free market. According to the OLR Article, these excessive fees are caused by the lack of competition in providing advisory services to mutual funds. Underlying the lack of competition is the conflicted relationship between the mutual fund's adviser and the fund's board of directors, where the directors "are under compulsion to buy services from or through their controlling [adviser] sponsor."

In its conclusion, the OLR Article makes this *cri du coeur*:

> [M]utual fund fees negotiated between captive funds and their adviser, whether considered individually or collectively [*e.g.*, Lipper data on similar funds], cannot reflect fair market value and should not be used to judge whether a particular fee is fair.
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> Other available comparators are superior. After all, mutual funds are not the only institutional investors holding portfolios of securities needing professional management; almost all institutional investors have that need. Pension funds, endowment funds, trusts, separate accounts, and even mutual funds that hire sub-advisers, are all able to purchase investment advisory services in arm's-length transactions in the free market. Those separate institutional contracts are findable and easy to evaluate. They present an array of comparables eligible for use in evaluating pricing in the fund market when conflicted advisers deal with their captive funds. These actual arm's-length transactions [according to the OLR Article] can and should be used as reliable benchmarks when judging the unfairness of prices set by a fund adviser for portfolio management services rendered to a captive fund.

*Comments*

Certainly, mutual funds are not "the only institutional investors holding portfolios of securities needing professional management". Given this truism, it is notable that the OLR Article omits any mention of the advisory fees paid by institutional investors as investors in hedge funds. U.S. hedge funds have approximately $2 trillion in assets under management while U.S. mutual funds have approximately $11 trillion in assets.

In *Jones I*, Judge Easterbrook noted that "the most substantial and sophisticated investors choose to pay substantially more for investment advice than [mutual fund] advisers receive." Hedge funds "regularly pay their advisers more than [100 bps] of the pool's asset value, plus a substantial portion of any gains from successful strategies." Similarly, a recent article in *The Wall Street Journal* noted that, while a handful of hedge funds were reducing their management fees due to recent underperformance, the traditional hedge fund management fee is 200 bps, plus 20 percent of the fund's gains.[5]

The money invested in hedge funds belongs to pension funds, trusts, separate accounts, insurance companies, endowments and funds-of-funds. Indeed, these institutional investors are the same investors indicated in the OLR Article who, in a competitive market, negotiate lower fees when they are clients of an adviser that also manages captive mutual funds.

The fees paid by institutional investors when they invest in hedge funds are purchased in arm's-length transactions in the free market. However, the hedge fund management fees *alone* significantly exceed the 91 bps mutual fund industry average *total expense ratio* to which the OLR Article directs us in its examination of its comparables. This seems to undercut the OLR Article's thesis that mutual fund advisory fees are excessive. The OLR Article does not report why it omitted fees paid by hedge funds.

Perhaps the OLR Article's authors could provide a defensible rationale for excluding hedge fund fees from their comparables. However, without that explanation, the OLR Article's purported comparables seem either incomplete or less than comparable after all.

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[1] *Jones v. Harris Associates L.P.*, 527 F.3d 627 (7th Cir. 2008) (*Jones I*), *reh'g en banc denied* No. 07-CV-1624, 2008 BL 165962 (7th Cir. Aug. 8, 2008) (*Jones II*).

[2] J. Freeman, S. Brown & S. Pomerantz, *Mutual Fund Advisory Fees: New Evidence and a Fiduciary Duty Test*, Okla. L. Rev. 83 (2008).

[3] F. Norris, *Judges in Dispute Over Mutual Funds*, THE N.Y. TIMES, Aug. 16, 2008, at C3.

[4] J. Freeman & S. Brown, *Mutual Fund Advisory Fees: The Cost of Conflicts of Interest*, 26 J. CORP. L. 609 (2001).

[5] J. Strasburg & C. Karmin, *Hedge Funds' Capital Idea: Fee Cuts*, THE WALL ST. J., Sept. 9, 2008, at C1.