Opinion

How Boards Maintain Arm's Length Distance When Approving Fees

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Independent directors must be even more diligent about their oversight of mutual fund fee structures now as the Securities and Exchange Commission increases its scrutiny of advisory fees and distribution payments. The number of lawsuits concerning excessive mutual fund fees is growing, and the SEC has stepped up its evaluation of fund distribution payments, including board oversight of third-party fees and charges.

While fund directors lack the management oversight tools their counterparts on the boards of public companies possess, they are expected to represent shareholder interests and serve as "independent watchdogs" of the relationship between a fund and its adviser.

As directors are well aware, the benchmark for evaluating mutual fund fees is to ensure that a fee is not 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. However, this standard is hard to implement because of the captive nature of the relationship between a fund and its adviser. Ultimately, fee levels are not established through a competitive process.

To handle these various factors, directors should exercise their fiduciary duty by being cognizant of fees that are established through a true arm's length negotiating process and comparing them to what a mutual fund is being charged for similar services. Such fees can be found by looking at certain advisory and administrative arrangements that are determined through true competitive bidding.

Competitive Advisory Fee Comparisons

The plaintiff's bar is having some initial success with its argument that the advisory fees charged by mutual fund managers should be compared to what the same managers charge for subadvising a third-party fund.

For example, in past excessive fees cases, such as *Gallus v. Ameriprise Financial*, plaintiffs alleged that retail advisory fees were as much as 50% to 100% higher than fees established through true arm's length negotiations for investment services to institutional accounts or subadvised funds.

These are very large fee disparities when applied to individual funds with billions of dollars of assets under management. Assuming these disparities are accurate and the services almost identical, how can a fund board conclude that these fees are within the range of what would occur if there were true arm's length bargaining?

In negotiating the advisory fee contract, boards need to thoroughly evaluate the investment management fees their adviser is charging third parties in a competitive environment. For example:

- Boards need to compare fees the adviser charges for institutional account services with the fees it charges its retail fund clients.

- Boards should compare the adviser's fees for external subadvisory services with the fees it charges retail fund clients.

- Boards should evaluate fees the adviser charges to oversee subadvisers within their own fund complex in circumstances where investment management services have been delegated to a third party.

Arm's Length Fee Comparisons for Omnibus Accounts

A similar series of questions needs to be asked regarding payments made to third-party distribution platforms. Over the past decade, large broker-dealers and other intermediaries have demanded account maintenance, shareholder servicing and revenue sharing payments from funds and their advisers to finance a subaccounting structure. Millions of shareholder accounts have now been moved from the inexpensive National Securities Clearing Corporation Networking platform into omnibus accounts charging higher fees.

A mutual fund doing business with an omnibus account must pay a fee for each shareholder account that is about twice as expensive as what NSCC Networking charges. There, our research shows that accounts on the broker-dealer side are reconciled daily with the same positions on the mutual fund side. This NSCC service is automated and was created more than 25 years ago to permit intermediaries and funds to share shareholder-level information in a cost-efficient, transparent manner.

Funds are now paying more to finance distribution than before and are getting less back in value, as the opaque nature of omnibus accounts makes it more cumbersome and expensive for funds to enforce excessive trading rules, sales load breakpoints and myriad others outlined in fund prospectuses.

Fund directors need to increase their scrutiny of distribution and administrative fees, primarily by looking into the cost of procuring these same services in a competitive marketplace. Third-party transfer agency contracts for direct accounts are negotiated at arm's length, as one example, and the "at-cost" structure of the NSCC Networking service provides additional comparative data for fund boards.

The SEC, meanwhile, is looking into third-party distribution payments as a part of its examinations and inspections function. However, the commission does not regulate prices, so it is up to directors to decide where to draw the line on fees.

As a starting point, boards should ask for more data on the fees being charged for providing administrative services to direct and NSCC Networking accounts and compare these fees to what is being charged by broker-dealers and other intermediaries for similar services. Fund boards should also evaluate the services provided to funds by intermediaries and ensure that similar levels of value are provided as are already offered in more competitive arrangements for the same service.

Directors should request more information about these advisory fee and distribution arrangements. And they need to think about the importance of their role as “independent watchdogs” of shareholder interests. If directors do not assume this role, there is no one else in a position to do so.