FUND DIRECTIONS

Board oversight of 'soft assets' are an opportunity for increasing returns

C. Meyrick Payne of Management Practice Inc. and Peter Saparoff of Mintz Levin et al write a time/cost benefit analysis and most often third-party specialist work are required

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Key Takeaways

- Class action suits and foreign tax among key areas
- Boards as always have to avoid micromanagement
- Aggregating positions across entire fund can be complex

In the highly competitive current mutual fund environment, even small increases in shareholder returns and resulting comparative rankings are crucial to customer retention and platform accessibility.

Mutual fund managers need to capture every ounce of returns; not only from portfolio construction, rigorous research, effective trading, competitive fees and cost-effective processing, but also from other inconspicuous revenue possibilities.

These include securities lending, proprietary research, IPO rights, proxies, warrants, rebates of foreign taxes withheld, and securities class action recoveries, sometimes referred to as "soft assets". Without guidance, these are not conspicuous to the average fund director.

Under the Gartenberg doctrine fund directors have a responsibility to oversee all the assets of the mutual funds they govern, particularly at the time of contract renewal. Ensuring additional returns to which a fund shareholder is entitled is a key component of the "nature and quality of services". The rights to a securities class action and foreign tax recovery is associated with fund assets and a fund director has an obligation to ensure that fund shareholders receive the benefit.

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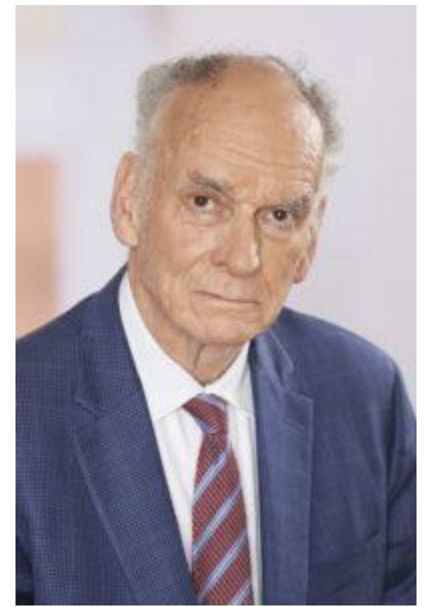
Like every aspect of fund governance, the director has oversight responsibility, not operational authority. And it is important the fund directors do not become so immersed in class action recovery or excess foreign tax withheld that they drift into micro-management, which will frustrate management and become disruptive to the effective operation of the funds.

But fear of micro-managing does not exempt directors from the responsibility to oversee the reasonable pursuit of all sources of possible return.

Securites fraud claims

When securities fraud causes a demonstrable loss in a fund's portfolio, the resulting class action potentially represents an important source of supplemental return. Although the overwhelming majority of class action cases are US domestic, some large cases often have a significant component of global activity, such as the LIBOR and FX cases.

The dollar value of class action lawsuits has been steadily rising over the past years reaching $403bn in 2018, according to an independent study by Cornerstone Research. Mintz Levin points out that the percent of allowable loss recovery by mutual funds can reach hundreds of millions of dollars in the aggregate over the course of a year for large- and medium-sized fund complexes. Funds can recover as much as 100% of allowed losses in some cases, and recoveries are frequently over 30%.


Peter Saparoff of Mintz Levin

Fund management may decide to remain or "opt in" as a participant in the class or may decide to "opt out" and proceed with its own case outside the class. Either way, the actual process of recovering a fund's share of the award is a time-consuming task, requiring specialized expertise sometimes in global securities regulation and legal procedures.

Frequently fund complexes chose to outsource this labor-intensive undertaking, to a specialist law firm with global expertise or an international shareholder services company.

Participating in a securities class action suit in the US is relatively straightforward. If the fund purchased shares during the class period, then membership of the class is virtually automatic. The plaintiff law firm will make the task as simple as possible because it is anxious to have institutional investors join to earn designation as "lead counsel".

Many fund managers are not excited to have plaintiffs law firms rattling around their back offices and, therefore, retain an independent specialist firm to evaluate recovery opportunities at the beginning stages, particularly for non-US cases where the legal landscape may be murky.

In addition to understanding different legal regimes around the world, perhaps the greatest workload in the evaluation process of either "soft asset" is aggregating the offended positions across all the funds in the complex. Similarly, the task of dividing up any recoveries across all the offended funds in the complex is a tedious process.

The real work for the management company comes after the case is settled; when the claim must be documented and recovered from the settlement pool or foreign jurisdiction. This process involves extensive research, particularly about timing of the qualifying trades. Once again, this task is often done by a third-party recovery specialist, working closely with an internal team.

Foreign tax left on the table

The second "soft asset" is excess foreign tax withheld by overseas authorities. This occurs because those jurisdictions withhold based on a formula and do not apply the specific circumstances of a fund or management company. In many cases refunds can be claimed, but not without considerable effort.

Since several years may have elapsed since the case or tax was first recorded, historical records of trades may be required. While this is troublesome, it is not justification to abandon the recovery effort.

The statutory tax withholding for many countries is often in the range of 35% and the statute of limitations is generally about three years. As a result, prompt action is required. Since considerable time may have elapsed since the case or tax was first recorded, historical records of trades are generally required.

Literature in this field indicates that as much as 50% of valid claims are left unrecovered because of the perceived distraction from day to day fund operations and an equal percent of overpaid foreign taxes never recaptured. In fact, most of the "trade blotters" retain investment activity either to satisfy an SEC enquiry, to evaluate code of ethics compliance, for internal or external audit purposes, or to measure "best execution".

Fund management's decision about how much effort to expend on a class action or tax recovery will depend upon a disciplined cost-benefit analysis which may consist of four steps.

1. Developing an estimate of the recovery by analyzing the size of the holding, estimating the extent of losses, and paying close attention to the statute of limitations.
2. Estimating the recoverable damages or taxes after taking the recovery agent's split into account. The fees could be an annual retainer, flat monthly fee or a percentage of the recovery.
3. Conducting a critical assessment of the merits of the claim, particularly the validity, provability, timing and documentation of the claim.
4. Estimating the net benefit after the cost of the recovery effort.

Conducting these four steps is sometimes delegated to a third party due to the extensive knowledge and independent judgement required. The workload will most often fall on the general counsel and compliance departments.

Recovering potential damages in securities litigation or excess foreign tax is a complex legal and business decision in which the fund directors have an interest because these damages represent an asset of the funds.

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