ETF boards need to apply Gartenberg differently

Advisory fee deliberations should consider external distribution, unitary fees and operational differences from mutual funds

By Amy Doberman, partner, WilmerHale

The differences between the respective cost structures of exchange-traded funds and mutual funds and the nature of advisory services provided for each product may require boards to think about the Gartenberg factors differently when considering approval of an ETF advisory contract.

A fund's advisory contract must be approved both at the outset and each year after a two-year initial term. According to the well-known Gartenberg factors, confirmed by the U.S. Supreme Court in *Jones v. Harris Assocs.*, the board must consider whether the advisory fee is fair and reasonable, based on certain delineated factors that are principally focused on the nature and quality of the services provided and the financial stability and profitability of the adviser. As part of the contract approval and renewal process, boards typically request, and advisers provide, information pertaining to the services rendered by the adviser, the adviser's profitability and information about competitor funds, including their performance, advisory fees and total expenses.

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The competitive landscape for ETFs has evolved differently from that of mutual funds, and their respective cost structures reflect this. The costs associated with operating ETFs are different from those of operating mutual funds. ETFs do not charge 12b-1 fees (because distribution is externalized), and other operating expenses are lower for ETFs because individual shareholder accounts and associated services are provided outside the fund structure by intermediaries holding the accounts of shareholders purchasing on the secondary market. Moreover, unlike mutual funds, many ETFs utilize a unitary fee structure, where a single fee is charged and collected by the adviser and all expenses, including fees charged by third-party service providers, are paid from that unitary fee.

The ETF unitary fee may cover a more comprehensive set of services than a mutual fund advisory or management fee making it difficult to draw any apples-to-apples comparisons with competitor mutual funds (i.e., those that offer similar investment objectives or strategies but are organized as mutual funds rather than ETFs). Therefore, in assessing whether a fee is fair and reasonable, boards need to carefully consider which services are covered by the

fees charged within the fund, and the competitor information provided must be evaluated accordingly.

In evaluating the nature and the quality of services provided by an investment adviser to a fund, boards also must be cognizant of the operational differences between mutual funds and ETFs. ETF shares are issued and redeemed by the fund at net asset value in large creation unit blocks (for example, 50,000 shares), exclusively by large institutions known as authorized participants. Other shareholders purchase and sell shares on the secondary market at prices that correlate strongly with, but may deviate from, the net asset value per share. ETF creation units are often purchased and redeemed from the issuer in kind instead of in cash, meaning that a creation unit of ETF shares is exchanged for a basket of portfolio securities often representing a pro rata share of the ETF's portfolio. ETFs buy and sell portfolio securities in large baskets tied to creation unit activity, often based on the composition of a benchmark index. Mutual funds, in contrast, buy and sell securities individually and offer daily redemptions to shareholders, requiring management of daily cash flows that can be somewhat unpredictable.

ETF portfolio managers must understand the impact of their trading on capital markets activity as well. The efficiency of the market-making and arbitrage activity for an ETF depends somewhat on the portfolio manager's ability to minimize transaction costs (and deviation from the benchmark for index funds, discussed below) in the basket process. This has a tangible impact on the experience of the secondary market shareholders who expect to buy and sell shares at prices close to the net asset value of the fund. Therefore, the day-to-day functions are different for ETF portfolio managers and mutual fund portfolio managers, and the board needs to be able to evaluate the quality of their services accordingly.

Furthermore, because most ETFs are passively managed and seek to track an index, investment performance also has to be evaluated differently from that of a mutual fund. The value provided by an adviser to a mutual fund can be measured in terms of absolute and competitive performance metrics, that is, how the fund's performance compares to that of its peers and a broad-based index, and depends on the skill of the adviser in selecting individual securities. ETF performance, in contrast, is measured by tracking error, or how much the ETF's performance deviates from the performance of its underlying benchmark index, which depends largely on the basket composition process and the adviser's ability to manage transaction costs. Because the ETF is designed to track an index (for which a separate license fee is paid), an ETF's market performance is more a function of how well the index is constructed.

Although the adviser plays a role in selecting and perhaps has some input into the design of the index, the index construction process is often undertaken by a third party, and in any case is separate from the advisory services rendered by the adviser, and requires the ETF or the adviser to pay a separate licensing fee. Because the design and relative success of the index are not within the scope of advisory services, they should not be considered by the board in evaluating the quality of the services provided by the adviser in determining whether the advisory fee is fair and reasonable.

To further complicate matters for the board, although the evaluation of the adviser's services is different at most ETFs and mutual funds, the success of an ETF may very well depend on its actual performance as compared to actively managed mutual funds. This, once again, depends on the index design, not on the adviser's ability to select securities.

The first-generation ETFs were distinguishable from actively managed mutual funds as low cost alternatives pegged to broad-based indices such as the S&P 500, filling a different investment niche. Now, as the sophistication of the so-called smart-beta indices has evolved to incorporate many of the same factors employed by active managers, the line between ETFs and actively managed mutual funds has blurred from an investor's or intermediary's perspective. Thus, an investor or intermediary is likely to look to actively managed mutual funds with similar strategies for comparisons when evaluating whether to purchase an ETF.

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Boards need to apply the Gartenberg factors through a different lens when evaluating ETF advisory contracts, and should be careful to take into account only those services provided by the adviser (as distinct from the index provider). The way the market has evolved, as well as the differences in cost structure, create challenges when comparing and contrasting the fees and expenses of ETFs to those of mutual funds. There are substantive differences in the adviser's activities in managing the two structures since mutual funds have to accommodate daily cash flows while ETF advisers must manage basket composition and index replication. Finally, as ETF indexes become more sophisticated, these products will be competing to a certain extent with actively managed funds from the perspective of the investor. Nevertheless, in evaluating advisory contracts, boards need to be cognizant of the actual differences in the role of the adviser in managing these products.