Supreme Court Addresses Standard for Challenges to Investment Adviser Fees Under the Investment Company Act

By Scott Schreiber and John Freedman

On November 2, 2009, the United States Supreme Court heard oral argument in *Jones v. Harris Associates L.P.,* No. 08-586, a matter concerning claims under Section 36(b) of the Investment Company Act of 1940 against a mutual fund investment adviser alleging that the adviser breached its fiduciary duties because fees charged were "disproportionate" to the services rendered and "not within the range of what would have been negotiated at arm's length."

Following the standard set forth in the seminal Second Circuit case, *Gartenberg v. Merrill Lynch Asset Mgmt.,* Inc., 694 F.2d 923 (2d Cir. 1982), the United States District Court for the Northern District of Illinois granted summary judgment for defendants. The Court concluded that, because the fees were negotiated between the adviser and the mutual funds trustees, they were not "disproportionately large," and were "comparable to those charged by other similar funds." Also, there was no genuine dispute that the fees fell within the "range of acceptable results." *Jones v. Harris Associates L.P.,* No. 04-C-8305, 2007 WL 627640, *7-8 (N.D. Ill. Feb. 27, 2007).

The Seventh Circuit affirmed, but expressly disavowed the *Gartenberg* standard, holding instead that although the adviser's fiduciary duty encompasses an "obligation of candor in negotiation and honesty in performance," it does not require a determination that fees bear a "reasonable relationship to the services rendered" or that the fees must fall "within the range of what would have been negotiated at arm's length." *Jones v. Harris Associates L.P.,* 527 F.3d 627, 632, 631 (7th Cir. 2008).

Although the Supreme Court's review of the Seventh Circuit's decision presents an opportunity to provide clarity and uniformity in the standard courts are to apply in assessing challenges to advisory fees, individual Justices expressed both support for the Seventh Circuit's view that courts are not well suited to second-guess advisory fees, as well as skepticism that Seventh Circuit's approach would make such determinations unreviewable.

The Gartenberg Test For Assessing Advisory Fees

Section 36(b) of the Investment Company Act provides that investment advisers "shall be deemed to have a fiduciary duty with respect to the receipt of compensation for services." 15 U.S.C. § 80a-35(b). For over 25 years, causes of action against mutual fund advisers for fiduciary breaches in relation to their advisory fees have been determined according to the standard set forth in the Second Circuit case.

In *Gartenberg*, shareholders of a money market fund brought suit alleging that the fees paid by the fund to the manager were so disproportionately large as to constitute a breach of fiduciary duty under section 36(b). The Second Circuit, after reviewing the legislative history of section 36(b), concluded that the purpose of the provision is to mitigate the bargaining disparity between a fund and its adviser. According to the Second Circuit, the "usual arm's length bargaining between strangers does not occur between an adviser and a fund." 694 F.2d at 928. A mutual fund cannot practically sever its relationship with its adviser because typically a "fund is organized by its investment adviser which provides it with almost all management services and because its shares are bought by investors who rely on that service."

Consequently, the Second Circuit adopted a test to determine whether an advisory fee constitutes a breach of fiduciary duty. The test is whether, taking into account "all facts and circumstances," the fee "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." The *Gartenberg* court expressly noted that circumstances to be taken into account include the fees charged by other advisers to similar funds, the nature and quality of the services provided by the adviser, the profitability of the mutual fund, the extent to which "fall-out" benefits inure to the adviser, the economies of scale realized by the adviser, and the independence and conscientiousness of the fund trustees. The Second Circuit, however, rejected the lower court's suggestion that the principal factor to be considered is the price charged by other advisers to similar funds managed by them. The court explained:

the existence in most cases of an unseverable relationship between the adviser-manager and the fund it services tends to weaken the weight to be given to rates charged by advisers of other similar funds. . . . A fund cannot move easily from one adviser-manager to another. Therefore investment advisers seldom, if ever, compete with each other for advisory contracts with mutual funds.

Moreover, the Second Circuit rejected the argument that the lower fees charged by investment advisers to institutional clients, such as large pension funds, should be used as a criterion for determining reasonable advisory fees for money market funds, reasoning that "the nature and extent of the services" required by institutional clients are typically significantly less than a mutual fund because a "pension fund does not face the myriad of daily purchases and redemptions throughout the nation which must be handled by [a money market fund], in which a purchaser may invest for only a few days."

Following *Gartenberg*, the Third and Fourth Circuits adopted the *Gartenberg* test, as have district courts in the First, Fifth, Ninth, and Tenth Circuits. *See, e.g., Migdal v. Rowe Price-Fleming Int'l*, 248 F.3d 321 (4th Cir. 2001); *Krantz v. Prudential Investments Fund Management LLC*, 305 F.3d 140 (3d Cir. 2002). Both parties to the *Harris Associates* case (as well as the United States Government) argued before the Supreme Court that *Gartenberg* set the appropriate test, although the parties diverged over how *Gartenberg* applies to the facts of the *Harris Associates* case.

The Claims Against Harris Associates

Harris served as an investment adviser to three mutual funds (the Funds), as well as institutional clients, and for its services, Harris received a fee that was calculated according to a contractual schedule. Plaintiffs brought suit alleging, among other things, that the advisory fees paid to Harris were so disproportionate to the value of its services that it breached its fiduciary duty under section 36(b) by receiving them. *Jones*, 2007 WL 627640. Harris moved for summary judgment arguing that the fees were within an acceptable range because, among other reasons, the fees were in line with those charged by other similar funds managed by other companies. plaintiffs asserted that the court should compare Harris's fees not to those charged to similar funds run by other managers but to those charged to institutional clients. plaintiffs argued that comparison was the more meaningful because institutional clients received the same services that the Funds did.

The District Court's Decision

Following the test articulated in *Gartenberg*, the district court granted summary judgment for Harris. While the court would not disregard the comparison to fees paid by Harris's institutional clients, the court emphasized that:

at least nine other mutual funds investors were paying fees at the same level that the Funds were. Even assuming for the mere sake of comparison that the services Harris's institutional clients received were indistinguishable from those the Funds received, the amounts paid by different parties establish a range of prices that investors were willing to pay. The range extended from a low-end figure below what the institutional clients were paying and a high-end figure beyond the fees that other mutual fund clients paid.

Jones, 2007 WL 627640. Harris's fees fell within the range, "thus preventing a conclusion that the amount of fees indicates that self-dealing was afoot." According to the court, section 36(b) does not create a duty that advisers receive the lowest possible fee. Thus, whether the Funds could have gotten more for their money from Harris was irrelevant.

The Seventh Circuit Decision

The Seventh Circuit's approach stands in sharp contrast to the test set forth in *Gartenberg*. The Seventh Circuit, on appeal, rejected the proposition that courts should evaluate the reasonableness of an adviser's fee. Instead, the Seventh Circuit held that "[a] fiduciary must make full disclosure and play no tricks but is not subject to a cap on compensation." 527 F.3d at 632. Specifically, the *Harris Associates* court explained:

The [fund] trustees (and in the end investors, who vote with their feet and dollars), rather than a judge or jury, determine how much advisory services are worth. Section 36(b) does not say that fees must be "reasonable" in relation to a judicially created standard. It says instead that the adviser has a fiduciary duty. . . . A [fiduciary] owes an obligation of candor in negotiation, and honesty in performance, but may negotiate in his own interest and accept what the settlor or governance institution agrees to pay.

During the Supreme Court argument, both Chief Justice Roberts and Justice Scalia expressed sympathy for this view, commenting that investors can easily withdraw their money if they believe fees are too high. Justices Roberts and Scalia also questioned whether it was appropriate for courts to make these determinations, with Chief Justice Roberts at one point suggesting that the U.S. Securities and Exchange Commission was better suited to "regulate rates."

The Seventh Circuit, in direct response to the Second Circuit's skepticism of the market's ability to constrain adviser fees, rejected the economic assumptions underlying the Second Circuit's decision in *Gartenberg*:

[h]olding costs down is vital in competition, when investors are seeking maximum return net of expenses-and as management fees are a substantial component of administrative costs, mutual funds have a powerful reason to keep them low unless higher fees are associated with higher return on investment.... That mutual funds are 'captives' of investment advisers does not curtail [ ] competition. An adviser can't make money from its captive fund if high fees drive investors away.

However, the Seventh Circuit, in agreement with the *Gartenberg*, found that the appellees charging a lower percentage of assets to other clients, such as pension funds, did not suggest that they were charging the appellants too much. Reiterating the sentiment in *Gartenberg*, the court noted that different clients require different time commitments: "[p]ension funds have low (and predictable) turnover of assets. Mutual funds may grow or shrink quickly and must hold some assets in high-liquidity instruments to facilitate redemptions." Thus, the Seventh Circuit declined comparison to the fees charged to such clients as pension funds. Plaintiffs' Petition for Rehearing and Rehearing En Banc was denied. Judge Posner dissented, emphasizing that *Jones* is the only appellate decision disagreeing with *Gartenberg* and arguing that "competition in product and capital markets can't be counted on to solve the problem because the same structure of incentives operates on all large corporations and similar entities, including mutual funds. Mutual funds are a component of the financial services industry, where abuses have been rampant." *Jones v. Harris Associates L.P.,* 537 F.3d 728, 730 (7th Cir. 2008) (J. Posner dissenting). Of particular concern is an adviser charging its "captive" funds more than twice what it charges independent funds.

A Different Approach: The Eighth Circuit Decision in *Gallus v. Ameriprise Fin. Inc.*

On the heels of the Supreme Court granting *certiorari* in *Harris Associates*, the Eighth Circuit, in *Gallus v. Ameriprise Financial Inc.,* 562 F.3d 816 (8th Cir. 2009), took a third approach to the standard for assessing whether fees complied with fiduciary duties. Plaintiffs, shareholders of 11 mutual funds, brought a breach of fiduciary duty suit against Ameriprise, the funds' adviser, arguing that the fees negotiation was inherently flawed because it was not based on the adviser's costs and profits but on fee agreements of similar funds; that Ameriprise charged lower fees to its institutional, non-fiduciary clients; and that Ameriprise misled the Board about its arrangement with non-fiduciary clients.

Although in certain ways, the Eighth Circuit approach contemplates a middle ground between the Second and Seventh Circuit approaches, in important respects it suggests an expansion of the *Gartenberg* factors that could be adopted by the Supreme Court. Based upon its review of the cases, legislative history, and scholarship regarding section 36(b), the Eighth Circuit found that the factors articulated in *Gartenberg* provide a "useful framework." Yet, the *Gallus* court found that the Seventh Circuit "highlight[ed] a flaw in the way many courts have applied *Gartenberg*," as *Gartenberg* offers only one way a fund adviser can breach its fiduciary duty. *Gallus*, 561 F.3d at 823. In agreement with the Seventh Circuit, the court concluded that "the plain language of § 36(b) [also imposes] on advisers a duty to be honest and transparent throughout the negotiation process[,]" which, in the court's view, is not inconsistent with *Gartenberg. Id.* Thus, the Eighth Circuit, in *Ameriprise*, found that "the proper approach to § 36(b) is one that looks to both the adviser's conduct during negotiation and the end result."

Surprisingly, however, the Eighth Circuit, in contrast to the courts in *Gartenberg* and *Harris Associates*, determined that a comparison between the fees charged to Ameriprise's institutional clients and its mutual fund clients was relevant. The court found that the court's refusal in *Gartenberg* to compare the adviser's fees for money market mutual funds and equity pension funds was merely dicta. The court concluded that the comparison is particularly relevant when there is greater similarity between the accounts and when the investment advice received by a mutual fund account and an institutional account is essentially the same. Specifically, the court rejected the contention that the fee disparity simply reflects what different investors are willing to pay, commenting that "the purpose of an inquiry into the fees paid by institutional, non-fiduciary clients is to determine what the investment advice is worth."

Although *Ameriprise* was not explicitly discussed during the Supreme Court oral argument, several Justices seemed sympathetic to an analysis requiring courts to compare mutual fund fees with fees charged to institutional investors, such as pension funds. For example, Justice Breyer indicated that the fees charged to institutional investors would be a "normal question to ask" of a mutual fund adviser.

The Supreme Court Argument and Implications

Although both parties in the *Harris Associates* case argued that the Supreme Court should adopt the *Gartenberg* standard, the comments from several Justices during oral argument suggest that they were sympathetic to the Seventh Circuit's views. Both Chief Justice Roberts and Justice Scalia noted the ease with which investors could move their money, and questioned whether courts should be involved in the review of fees. Justices Scalia and Kennedy also noted that the Section 36(b) language was vague - with Scalia referring to the standard for court review to be "utterly meaningless" and Kennedy calling the use of the term fiduciary "odd." Several other Justices questioned whether the free market could effectively regulate fees, with Justice Breyer noting that many fund trustees have close relationships with investment advisers. Justices Breyer, Ginsberg, and

Sotomayor also seemed sympathetic to the notion that fund trustees should compare the fees charged to institutional investors.

At bottom, the Supreme Court's forthcoming decision in *Harris Associates* should resolve the debate among the courts, and the Court's determination potentially will have profound consequences. For instance, if the Court adopts something close to the Seventh Circuit's approach, the market will dictate fees that advisers can charge. There will be little, if any, judicial review of the actual fees, and the courts will only scrutinize the truthfulness and completeness of an adviser's disclosures during the negotiation process. On the other hand, if the Court adopts the test articulated in *Gartenberg*, the focus of the court will be on the "totality of the circumstances," including comparisons of fees paid to advisers of similar funds, but not those charged to institutional clients. And, if the Court adopts the standard set forth by the Eighth Circuit and allows the comparison of fees charged to institutional clients, advisers likely will be forced to charge mutual funds fees comparable to those paid by non-fiduciary, institutional clients (such as pension funds), which will result in the loss of substantial fees to advisers.

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