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Mutual Fund Advisory Fees

Seventh Circuit Finds That Courts Should Not Review the Reasonableness of Fees Paid to Investment Advisers So Long as the Fund's Directors Have Full Disclosure and the Ability to Negotiate

SUMMARY

The United States Court of Appeals for the Seventh Circuit has ruled that as long as a mutual fund investment adviser does not breach the fiduciary duty owed to shareholders by failing to disclose all of the pertinent facts or otherwise hindering the fund's directors from negotiating a favorable price, no judicial review of the reasonableness of the adviser's fee is required to dismiss a claim under Section 36(b) of the Investment Company Act of 1940. *Harris Assocs.* v. *Jones*, No. 07-1624 (7th Cir. May 19, 2008). This decision rejects the long-followed Second Circuit decision in *Gartenberg* v. *Merrill Lynch Asset Management, Inc.,* 694 F.2d 923 (2d Cir. 1982), which, while respecting the deliberations of independent directors, required courts to consider those deliberations in light of multiple factors in determining whether investment adviser fees were excessive. The Seventh Circuit examined the definition of fiduciary duty, rather than the amount of the fee itself, to evaluate whether the adviser complied with the duty created under Section 36(b), and held that a court should not substitute its judgment of what is "reasonable" for a fee determined by marketplace competition, absent lack of disclosure, deceit or some other breach of a fiduciary duty.

EVALUATING WHEN FEES VIOLATE THE INVESTMENT COMPANY ACT

Section 36(b) of The Investment Company Act

Section 36(b) of the Investment Company Act governs the compensation or payments made to investment advisers of registered investment companies and imposes a fiduciary duty on those advisers in connection with their receipt of fees from the funds they manage. 15 U.S.C. § 80a-35(b). Specifically, Section 36(b) provides that "the investment adviser of a registered investment company shall be deemed to have a fiduciary duty with respect to the receipt of compensation for services" and provides for claims of excessive fees to be brought by the SEC and by shareholders.

The *Gartenberg* Decision

In 1982, the Second Circuit considered whether fees paid to a money market fund manager were "so disproportionately large as to constitute a breach of fiduciary duty in violation of § 36(b)." *Gartenberg*, 694 F.2d at 925. After analyzing the legislative history, *Gartenberg* concluded that a court should scrutinize the fee itself using a variety of factors. As articulated in *Gartenberg,* the test is "whether the fee schedule represents a charge within the range of what would have been negotiated at arm's-length in the light of all of the surrounding circumstances." *Id.* at 928. Put another way, "[t]o be guilty of a violation of § 36(b) . . . the adviser-manager must charge a fee that 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." *Id*. In evaluating the reasonableness of adviser fees, *Gartenberg* found that the fees paid to other fund advisers were not dispositive because there was insufficient competition in the adviser marketplace. *Id*. at 929.

Gartenberg identified a number of factors that courts should consider in evaluating "whether a fee is so excessive as to constitute a 'breach of fiduciary duty'" under Section 36(b), including, among others: (i) the cost to the adviser-manager of providing the service, (ii) the nature and quality of the service, (iii) "the extent to which the adviser-manager realizes economies of scale as the fund grows larger" and (iv) the volume of orders being processed by the manager. *Id.* at 930. In other words, in assessing the adviser's fee, a court should rely on its own business judgment to determine whether the fee is reasonable rather than recognizing that the inherent competition of the marketplace sets an appropriate fee.

Harris Rejects *Gartenberg*

In *Harris* v. *Jones*, shareholders of various Oakmark funds ("Funds") advised by Harris Associates L.P. ("Harris") alleged that the fees paid to Harris were excessive and therefore in violation of Section 36(b). While the Court affirmed the ruling below, which followed *Gartenberg* and held that Harris had not violated the Act because its fees were ordinary, the Seventh Circuit explicitly rejected the approach used in *Gartenberg* "because it relies too little on markets." *Harris*, No. 07-1624, slip op. at 7.

The Seventh Circuit held that the analysis does not turn on whether the fees paid are "reasonable" based on the considerations enumerated above. Rather, the court held that a "fiduciary must make full disclosure and play no tricks but is not subject to a cap on compensation. The 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." *Id*. at 8. Drawing from the law of trusts, the Court continued: "A trustee 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." *Id.* (citing *Restatement (Second) of Trusts* § 242 & comment f).

The Seventh Circuit held that if an unaffiliated board of directors sets the fee for an investment adviser after candid negotiations, this fee is not subject to "judicial review for 'reasonableness.'" *Harris*, No. 07-1624, slip op. at 9. The hallmark of *Harris'* analysis is that market competition, rather than "a 'just price' system administered by the judiciary", is both appropriate and just. *Id*. The court concluded with a discussion of how the fee-setting market will regulate itself—if a fee is "excessive" investors will respond by moving their money elsewhere. *Id.* at 11. In sum, the Investment Company Act works "by requiring disclosure and then allowing price to be set by competition in which investors make their own choices." *Id.* at 13.

Implications

The Seventh Circuit's decision means that, in cases brought in the Seventh Circuit, courts will not evaluate the reasonableness of an adviser's fees in Section 36(b) cases. Rather, so long as a fund's board is comprised of a majority of disinterested directors that has access to adequate information about the adviser and the adviser has not deceived the board or "pulled the wool over the eyes of the disinterested trustees," a court should not engage in second guessing the board's fee decision and such claims will be dismissed.

While *Harris* provides more leeway for funds to set and advisers to negotiate fees without considering the *Gartenberg* factors, *Gartenberg* remains the law in the Second Circuit (which includes New York, Connecticut and Vermont). Therefore, clients who are sued in the Second Circuit likely will still be subject to the "reasonableness" assessment used in *Gartenberg*. It should also be noted that the Third Circuit (which covers New Jersey, Pennsylvania and Delaware) has disagreed with *Gartenberg* and is closer to *Harris* in the requirements imposed on advisers, *Green* v. *Fund Asset Management, L.P.,* and another case, *Gallus* v. *Ameriprise Financial, Inc*., is pending in the Eighth Circuit on the same issue.

The SEC rules currently require disclosure of the directors' consideration of the adviser's fees, generally tracking the *Gartenberg* considerations. The *Harris* decision does not impact these disclosure requirements.

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