Mutual Fund Advisory Fees

The U.S. Supreme Court Endorses Gartenberg Standard for Assessing the Reasonableness of Fees Paid to Investment Advisers

SUMMARY

In a long-awaited decision for mutual fund shareholders, directors, and investment advisers, the Supreme Court of the United States held that, in judicial review of the reasonableness of fees paid by mutual funds to investment advisers for the purpose of determining whether there has been a breach of fiduciary duty by investment advisers with respect to the receipt of compensation for services in violation of Section 36(b) of the Investment Company Act of 1940, the approach established nearly thirty years ago by the United States Court of Appeals for the Second Circuit in Gartenberg v. Merrill Lynch Asset Management, Inc., 694 F.2d 923 (2d Cir. 1982), is “correct in its basic formulation”. Jones v. Harris Associates L.P., No. 08-586 (March 30, 2010).

Gartenberg held that a fee violates Section 36(b) only when it 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.” 694 F.2d at 928. Since Gartenberg was decided, federal courts and the Securities and Exchange Commission (“SEC”) have looked to that decision for guidance in interpreting the contours of the fiduciary duty that Section 36(b) imposes. Jones v. Harris came before the Supreme Court largely because the Seventh Circuit’s decision in the case below rejected the basic Gartenberg approach followed by essentially all others considering the Section 36(b) question.

In Jones, shareholders of various mutual funds advised by Harris Associates filed suit against the investment adviser, alleging a violation of Section 36(b) of the Investment Company Act. The District Court held that the shareholders had failed to raise a triable issue of fact under Gartenberg and granted summary judgment for the investment adviser. On appeal, in a decision that caused considerable uncertainty for the mutual fund industry, a panel of the Seventh Circuit affirmed the decision to grant summary judgment but rejected the lower court’s application of Gartenberg. Noting that the Gartenberg
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standard “relies too little on markets,” the Seventh Circuit instead applied a test that would have courts review whether full disclosure of fee-related matters was made, as opposed to judicial review of the “reasonableness” of the advisory fee. Jones v. Harris Assocs., 527 F.3d 627, 632 (7th Cir. 2008) (“a fiduciary must make full disclosure and play no tricks but is not subject to a cap on compensation”).

### ASSESSING REASONABLENESS OF INVESTMENT ADVISER FEES UNDER SECTION 36(b) OF THE INVESTMENT COMPANY ACT OF 1940

**Section 36(b) of the Investment Company Act of 1940**

Section 36(b) of the Investment Company Act imposes a “fiduciary duty [on investment advisers] with respect to the receipt of compensation for services.” The Investment Company Act grants investors a private right of action to enforce this obligation by seeking judicial review of fees charged by investment advisers under a breach of fiduciary duty standard. Id. In recognition of the role of disinterested directors in setting adviser compensation, the Investment Company Act instructs courts reviewing for breach of fiduciary duty to give board approval of investment adviser compensation “such consideration . . . as is deemed appropriate under all the circumstances.” 15 U.S.C. § 80a-35(b)(1).

**Gartenberg Standard for Determining the Reasonableness of Fees Charged by Investment Advisers**

In determining whether an advisory fee violates Section 36(b), Gartenberg held that a court should review “whether the fee schedule represents a charge within the range of what would have been negotiated at arm’s-length in light of all the surrounding circumstances.” 694 F.2d at 928. These circumstances may include (i) the cost 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 adviser-manager. Id. at 930. Gartenberg found comparisons of fees paid to other fund advisers were not dispositive, due to insufficient competition in the adviser marketplace. Id. at 929. The Gartenberg court also rejected the utility of a comparison between advisory fees for money market mutual funds and fees for equity pension funds. Id. at 930 n.3. The court reasoned that these funds are fundamentally different investment vehicles and the nature and extent of the services required by each vary drastically. Id. Ultimately, the Gartenberg court held that to be in violation of Section 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. at 928.

**The Seventh Circuit’s Decision in Jones**

The Seventh Circuit rejected the Gartenberg approach. The court instead concluded that Section 36(b) required a fiduciary to “make full disclosure and play no tricks”, but that fiduciary was “not subject to a cap on compensation;” thus, a judicial determination of whether fees are “reasonable” based on the Gartenberg considerations was not appropriate. 527 F.3d at 632. The court concluded that Gartenberg relied too little on markets, noting that directors who review compensation and, ultimately, investors (who
“vote with their feet and dollars”), rather than a judge or jury, determine the value of advisory services and, implicitly, whether the fees charged for those services are “reasonable.” Id. The Seventh Circuit concluded that the critical test was whether the unaffiliated board of directors charged with approving a fee for an investment adviser had appropriate information so that it could be said that the board’s decision was based on full information after candid negotiations. Thus, courts presented with Section 36(b) claims should review the process by which a fee was approved, but an approved fee should not be subject to an independent judicial review for reasonableness, which could amount to a “‘just price system’ administered by the judiciary.” Id. at 632-33.

The Seventh Circuit denied a rehearing en banc, over a dissent by Judge Posner that derided the court’s creation of a circuit split in spite of the importance of the issue to the mutual fund industry and long-standing support for Gartenberg in the federal courts. Jones v. Harris Assocs., 537 F.3d 728, 732-33 (7th Cir. 2008) (Posner, J.). Judge Posner’s dissent criticized the court’s approach, arguing that it failed to appreciate inherent conflicts of interest in the mutual fund industry and possible favoritism among fund directors and advisory firms which, he wrote, undermine true arm’s-length negotiations and make it difficult for investors to “vote with their feet.” He further noted that the advisers in Jones charged “captive funds” more than twice the fee for “independent funds,” Id. at 731, and added that the Gartenberg standard has not been unduly harsh for investment advisers, as the overwhelming majority of post-Gartenberg cases have ended in judgments favoring fund manager defendants. Id. at 730.

**Eighth Circuit Decision in Gallus Deepens Circuit Split**

On April 8, 2009, the Eighth Circuit decided Gallus v. Ameriprise Financial, Inc., 561 F.3d 816 (8th Cir. 2009), in which the court noted the circuit split but purported to reject the Jones approach and uphold Gartenberg. Nevertheless, the Eighth Circuit decision, noting that Gartenberg demonstrated “one way in which a fund adviser can breach its fiduciary duty, but it is not the only way,” appeared to modify Gartenberg by combining Gartenberg’s focus on the end result, or fee itself, with the Seventh Circuit’s focus in Jones on the means to the end, with the Gallus court placing greater emphasis on the negotiation process and disclosure of all facts to a fund’s disinterested directors. Id. at 823.

In Gallus, the shareholders of a number of mutual funds advised by Ameriprise brought suit under Section 36(b), presenting evidence purporting to indicate that the fees charged by Ameriprise to mutual funds were nearly double those it charged to institutional investors. The shareholders also alleged that Ameriprise had misled the funds’ board in the fee-setting process. The Eighth Circuit reversed the District Court’s holding that Section 36(b) was satisfied simply because the fees in question passed muster under the Gartenberg standard, and further noted that the District Court had also erred in declining to consider a comparison between the fees charged to Ameriprise’s institutional clients and its mutual fund clients and in failing to determine whether Ameriprise had misled the board about the fee discrepancy between different types of clients. The Eighth Circuit remanded for consideration of a number of factors, including
disputed issues of fact concerning similarities and differences between mutual funds and institutional accounts.

The Supreme Court’s Decision
The Supreme Court reaffirmed the Gartenberg standard enunciated in 1982 as consistent with Congressional balancing of interests under the statutory scheme. Jones, No. 08-586, slip op. at 8.

The Court noted the general workability of the Gartenberg standard, its consistency with the standards of fiduciary duties set forth in other substantive areas of the law, and the fact that “something of a consensus” had developed around it, including its adoption by many lower federal courts and the SEC. Id. at 6. The Court also noted the standard’s consistency with the statutory scheme adopted by Congress in the Investment Company Act, which combines shareholder suits with other “mutually reinforcing but independent mechanisms for controlling conflicts of interest,” including scrutiny of adviser compensation by an informed and disinterested board of directors. Id. at 8 (citing Daily Income Fund Inc. v. Fox, 464 U.S. 523, 541 (1984)).

The Court also clarified that, although the Seventh Circuit’s exclusive focus on disclosure was improper, Gartenberg itself recognized that whether disinterested directors are fully informed about all facts bearing on the adviser’s services and fees is an important factor to be considered in evaluating fiduciary duty claims under Section 36(b). However, the Court also noted that the Investment Company Act already balances the interest of investment advisers by shifting the burden that the law generally places on a fiduciary to the shareholders who claim a breach of fiduciary duty. They must show that a breach in fact occurred. Id. at 8. To do so in Section 36(b) cases, shareholders must show that the fee is outside the range that arm’s-length bargaining would produce. Noting a provision in the Investment Company Act instructing courts to give deference to board approval of fee arrangements “as is deemed appropriate under all the circumstances,” the Court explained that the appropriate level of deference to board approval is related to both procedure and substance. Where disinterested directors consider all relevant factors, their decision to approve a fee agreement is entitled to considerable weight, even if a court would have weighed those factors differently. Where, however, the process was deficient or the adviser withheld important information from the board of directors, the court should be much more rigorous in evaluating the reasonableness of the fee. Id. The Court observed that Gartenberg’s “so disproportionately large” standard reflects the Congressional choice to rely largely on disinterested directors to protect shareholder interests. Id.

A basic allegation of the shareholders in both Jones and Gallus was that the fees charged by the adviser to mutual fund clients and institutional clients were so disparate as to prove a breach of fiduciary duty with respect to the fees charged to mutual fund clients. The Court discussed how to evaluate such claims within the Gartenberg standard. With respect to the comparison of fees charged to different types of clients (e.g., a comparison between the fees charged to a mutual fund and the fees charged to an
in institutional client such as a pension fund), the Court rejected a categorical rule, but expressed skepticism, urging courts to shy away from “inapt comparisons.” Id. at 9. The Court noted that the fees an investment adviser charges a “captive” mutual fund and its independent clients must be viewed in light of the circumstances, including similarities and differences among the services provided. Where the services provided are “sufficiently different that a comparison is not probative,” then courts must reject such comparisons. Id. The Court went on to caution that even where the services provided and fees charged to institutional clients are relevant, the Investment Company Act does not necessarily ensure fee parity. Id. The Court also cautioned that courts “should not rely too heavily on comparisons with fees charged by other advisers,” which may themselves not have resulted from arm’s-length negotiations. Id. at 9.

Justice Thomas issued a brief concurring opinion, the principal purpose of which appears to be to caution that, although the Court’s opinion could be said to affirm the Gartenberg standard, he did not interpret the Court’s opinion to “countenance the free-ranging judicial ‘fairness’ review of fees that Gartenberg could be read to authorize.” Id. at 12. Instead, in his view, the Court’s opinion ratified the way Gartenberg had been applied in practice by the lower federal courts – giving deference to the informed conclusions of disinterested boards and requiring shareholders to sustain the burden of proof in challenging investment adviser fees for reasonableness by showing that the fee in question was outside the range that arm’s-length bargaining would produce. Id.

Following its decision in Jones, the Supreme Court granted certiorari in Gallus, vacated the Eighth Circuit’s decision, and remanded the case to the Eighth Circuit for further consideration in light of Jones. Ameriprise Financial, Inc. v. Gallus, No. 09-163 (April 5, 2010). Jones also was remanded to the Seventh Circuit for application of the Gartenberg test as defined by and in accordance with the Court’s opinion.

IMPLICATIONS

The Supreme Court’s insistence on examining both substance and procedure (that is, both the amount of the fee and the fee-setting process) appears to uphold Gartenberg, while taking into account the Seventh and Eighth Circuit commentaries that market dynamics are at play and that courts are not in a better position than a fully informed board of directors to evaluate the appropriateness of mutual fund fee arrangements reached with the investment advisers of those mutual funds. As such, shareholder suits under Section 36(b) will only be successful where fees are “so disproportionately large” that they bear “no reasonable relationship to the services rendered,” a standard that the Court noted lacks “analytical clarity” but is clearly influenced by the attention to process noted by the Court. This underscores the importance of a robust board process for reviewing adviser compensation, as well as full disclosure to the board by the adviser, to ensure the most deferential approach to the business judgment of the directors.

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