# SEVENTH CIRCUIT ADOPTS NEW STANDARD FOR JUDICIAL REVIEW OF MUTUAL FUND ADVISORY FEES

In a recent opinion, the U.S. Court of Appeals for the Seventh Circuit adopted a new standard of judicial review for claims of breach of fiduciary duty by an investment adviser brought under Section 36(b) of the Investment Company Act of 1940, expressly disapproving of the widely applied standard for assessing advisers' liability for excessive fees established in Gartenberg v. Merrill Lynch Asset Management, Inc.[1] In its May 19, 2008 decision in Jones v. Harris Associates, L.P.,[2] the Seventh Circuit concluded that courts would not second-guess a fund board's approval of advisory fees where there has been candor in negotiation and fair dealing by a fund's investment adviser.

## Background

The Investment Company Act does not attempt to dictate what constitutes an appropriate investment advisory fee. In the Investment Company Amendments Act of 1970, however, Congress enacted Section 36(b) to impose a "fiduciary duty" upon an adviser with respect to its compensation and to authorize derivative actions by a fund's shareholders against an adviser for breach of this duty. Section 36(b) states:

> …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, or of payments of a material nature, paid by such registered investment company, or by the security holders thereof, to such investment adviser or any affiliated person of such investment adviser. An action may be brought under this subsection by the Commission, or by a security holder of such registered investment company on behalf of such company, against such investment adviser, or any affiliated person of such investment adviser, or any other person…who has a fiduciary duty concerning such compensation or payments, for breach of fiduciary duty….[3]

Neither Section 36(b) nor its legislative history describes the precise nature of this fiduciary duty or provides a particular framework for an analysis of a claimed violation.

To some extent, the federal courts have filled this void. In Gartenberg, the Second Circuit concluded that "to be guilty of a violation of § 36(b)…the [investment adviser] 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."[4]

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[1] 694 F.2d 923 (2d Cir. 1982), cert. denied, 461 U.S. 906 (1983) ("Gartenberg").

[2] No. 07-1624, 2008 U.S. App. LEXIS 10804 (7th Cir. May 19, 2008) ("Harris").

[3] 15 USC 80a-35.

[4] Gartenberg at 928.

The Gartenberg standard of review has become firmly established in the Second Circuit,[5] and has been applied by other circuits and district courts presented with cases under Section 36(b).[6]

Gartenberg and its progeny identified and discussed factors that courts believe should be considered by a fund's board of directors to withstand a claim that an investment adviser has breached its fiduciary duty under Section 36(b). In general, these factors include: (1) the nature and quality of the advisory services; (2) the profitability of a fund to the adviser; (3) the payments received by the adviser and its affiliates from all sources involving the fund, including any "fall-out" benefits received; (4) the sharing of economies of scale as the fund increases in size; and (5) the relationship that the amount of the advisory fee bears to the fees paid by other funds of similar size and objective.[7]

The Securities and Exchange Commission has also implicitly endorsed the Gartenberg approach. In June 2004, the SEC adopted rule and disclosure form amendments that require fund shareholder reports (and certain proxy statements) to discuss, in reasonable detail, the material factors and the conclusions with respect to the factors that formed the basis for the board of directors' approval of advisory contracts. In its release adopting these disclosure obligations, the SEC cited Gartenberg to note that courts have used "similar factors in determining whether investment advisers have met their fiduciary obligations under Section 36(b) of the Investment Company Act."[8]

On February 27, 2007, in Jones v. Harris Associates, L.P.,[9] a federal district court in the Northern District of Illinois granted a motion for summary judgment in favor of the defendant, an investment adviser, in its defense against a claim of excessive advisory fees under Section 36(b). As discussed below, the Seventh Circuit affirmed the district court's grant of summary judgment. The plaintiffs' primary theory of liability was that the investment adviser had achieved significant economies of scale as its funds grew in size, but had failed to pass those savings along to shareholders (through

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[5] *See, e.g.*, Olesh v. Dreyfus Corp., No. 94 CIV 1664, 1995 WL 500491 (E.D.N.Y. Aug. 8, 1995) (not reported in F. Supp.); Wexler v. Equitable Capital Management Corp., No. 93 CIV 3834, 1994 WL 48807 (S.D.N.Y. Feb. 17, 1994) (not reported in F. Supp.); In re TCW/DW North American Government Income Trust Securities Litigation, 941 F. Supp. 326 (S.D.N.Y. 1996); Strougo v. Scudder, Stevens & Clark, Inc., 964 F. Supp. 783 (S.D.N.Y. 1997); Strougo v. BEA Associates, 188 F. Supp. 2d 373 (S.D.N.Y. 2002); In re Eaton Vance Mutual Fund Fees Litigation, 380 F. Supp. 2d 222 (S.D.N.Y. 2005); In re Goldman Sachs Mutual Fund Fees Litigation, No. 04 CIV 2567, 2006 WL 126772 (S.D.N.Y. Jan. 17, 2006) (not reported in F. Supp.); In re Evergreen Mutual Fund Fees Litigation, 423 F. Supp. 2d 249 (S.D.N.Y. 2006) and In re Salomon Smith Barney Mutual Fund Fees Litigation, 528 F. Supp. 2d 332 (S.D.N.Y. 2007).

[6] *See, e.g.*, Migdal v. Rowe Price-Fleming Int'l, Inc., 248 F. 3d 321 (4th Cir. 2001); Krantz v. Fidelity Mgmt. & Research, Co., 98 F. Supp. 2d 150 (D. Mass. 2000) (Krantz was settled before it could be decided on the merits); Batra v. Investors Research Corp., *et al.*, 1991 U.S. Dist. LEXIS 14773 (W.D. Mo. Oct. 4, 1991) and Barrett v. Van Kampen Merritt Inc., *et al.*, 1993 U.S. Dist. LEXIS 3936 (N.D. Ill. Mar. 26, 1993).

[7] *See generally*, Gartenberg at 929-930.

[8] Disclosure Regarding Approval of Investment Advisory Contracts by Directors of Investment Companies, Investment Company Act Release No. 26486 (June 23, 2004), at n. 31.

[9] No. 04-C-8305, 2007 WL 627640 (N.D. Ill. Feb. 27, 2007).

breakpoints or other fee reductions), as it had to its institutional clients. The plaintiffs' claim rested upon the fact that the investment adviser, Harris Associates, L.P., charged different fees to its mutual funds than it did to certain institutional and sub-advisory clients for comparable services. The district court followed the Gartenberg standard and concluded that Harris Associates, L.P. must prevail because its fees were within the range of what would have been negotiated through an arm's-length transaction.

**The Seventh Circuit's Decision in Harris**

On May 19, 2008, the Seventh Circuit affirmed the district court's grant of summary judgment. In doing so, the court affirmatively disapproved of the approach taken in Gartenberg. In its opinion, the court noted that the fiduciary duty imposed by Section 36(b) does not imply judicial review for reasonableness or make the federal judiciary a "rate regulator." Rather, the court opined that the fiduciary standards of trust law apply and that the appropriate test is whether the adviser's client made a voluntary choice with the benefit of adequate information. The court stated that an investment adviser is held to an "obligation of candor in negotiation, and honesty in performance, but may negotiate in [its] own interest and accept what the…governance institution agrees to pay."[10] Notably, in analogizing to other exercises of fiduciary duty, the court said that when "the persons charged with the trust's administration make a decision [regarding compensation], it is conclusive."[11] Emphasizing its position that judges should not regulate advisory fees, the court concluded that so long as an investment adviser "make[s] full disclosure and play[s] no tricks,"[12] judges will not be in the business of "determin[ing] how much advisory services are worth."[13]

The Seventh Circuit also recognized the role of competition for fees in the market for mutual funds and expressed its skepticism of the Gartenberg court's distrust of the regulatory effect of market forces. The Harris court expressed its belief that the mutual fund industry is sufficiently competitive that, if an adviser's fee is excessive in relation to the results produced, the shareholders of the fund will move their money to alternative funds. Writing for the court, Chief Judge Frank H. Easterbrook theorized that the ability of a shareholder "cheaply and easily" to move his money to another fund acts as a natural check on the rate an investment adviser can set for services.

**Analysis of Harris and Its Practical Effect**

The Seventh Circuit's decision in Harris raises the bar in the Seventh Circuit for a successful suit against a fund's investment adviser for a breach of fiduciary duty in its receipt of compensation for advisory services under Section 36(b). In effect, the Harris court appears to require only that an investment adviser negotiate its fee in good faith and "play no tricks," making full disclosure of the information necessary for a fund board to make a voluntary choice to accept the fee based on

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10 Harris at *11.

11 *Id*.

12 *Id*. at *10-11.

13 *Id.* at *11.

adequate information. The Harris opinion suggests that absent compensation that is so unusual a court will infer that "deceit must have occurred," the compensation set by the parties will be respected.

The Seventh Circuit's discussion of the role of market forces in setting appropriate advisory fee rates adds to a plaintiff's burden to prove a violation of fiduciary duty by an investment adviser under Section 36(b). The court noted that when presumptively sophisticated investors, such as accredited investors, elect to pay more for advisory services in private funds than those charged by advisers to mutual funds, it is hard to conclude that the defendant's fee in Harris must be excessive. By contrast, the Second Circuit in Gartenberg rejected the premise that market forces play a significant role in mitigating the potential for inappropriate advisory fees. That court disagreed with the concept that the market price for advisory services serves as the principal factor when considering the fairness of an advisory fee. Rather, the court concluded that a shareholder's allocable portion of the advisory fee is "usually too small a factor to lead him to invest in one fund rather than in another or to monitor the [investment adviser's] fees."[14]

The Harris opinion also suggests that fund boards need not consider all of the factors promulgated by the Gartenberg court to fulfill their own fiduciary duties to their fund. The legal standard articulated in Harris provides directors with greater latitude to exercise their business judgment and evaluate a proposed advisory fee based upon issues and facts that the directors, rather than the courts, consider important. It is worth noting, however, that even though the Harris court does not require a review of the Gartenberg factors, a fund will still be required to disclose in its shareholder report next issued after an investment advisory contract is approved a discussion of whether or not the board considered factors similar to those of Gartenberg.

The different standards of review established by the Second and Seventh Circuit courts, along with the potential for the circuits that have not explicitly adopted either approach to apply still other standards in analyzing claims made under Section 36(b),[15] give rise to the possibility of a review of the issue by the United States Supreme Court. The Gartenberg and Harris opinions are not easily reconciled and appear to represent a split between the circuits. As discussed above, the Harris court expressly disapproved of the Second Circuit's factor-based analysis of the reasonableness of an advisory fee in favor of a standard based on a review of the investment adviser's candor in negotiation and fair dealing such that the approval of the advisory fee amounts to a voluntary choice made with the benefit of adequate information. Furthermore, the two circuits' interpretations of the basis for determining the reasonableness of fees are at odds. Where the Second Circuit rejected the notion that the market price for advisory services should be the principal factor for considering the fairness of an advisory fee, the Seventh Circuit criticized the Gartenberg court for relying too little on market forces. The potential for Supreme Court review, however, may be reduced by other

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[14] Gartenberg at 929.

[15] *See, e.g.*, Dumond v. Mass. Financial Services Co., 2006 U.S. Dist. LEXIS 1933 (D. Mass. Jan. 19, 2006) (noting that the First Circuit has not expressly adopted the Gartenberg analysis). *See also* Harris at *10 (noting that the Third Circuit has concluded that adherence to statutory procedures, rather than the level of price, is the correct way to understand the "fiduciary" obligation promulgated by Section 36(b)).

factors. Although the question of law under review by these courts is an issue of significant importance to the mutual fund industry, over 25 years have passed since the Second Circuit stated its standard of review in Gartenberg. In addition, because the district court in Harris dismissed the plaintiff's claim on summary judgment after conducting an analysis based on the Gartenberg standard, it appears likely that the defendants in Harris would prevail under either standard. As a result, the Supreme Court may wait to see how the various district courts apply the two standards, and whether cases are brought that may be decided differently based on the conflicting standards, before it would grant a petition for certiorari to settle the split currently existing between the circuits.

## Conclusion

The ultimate consequences of the Harris decision are difficult to predict. If the standard set in Harris gains acceptance among the circuit courts, fund boards may elect in the future to review advisory fees without specific consideration of the factors established in Gartenberg, bearing in mind current SEC disclosure obligations. However, until such time as the Supreme Court sets a standard of review for claims brought under Section 36(b), or the Harris decision becomes accepted as the primary standard, we believe it is advisable for fund boards to continue to consider advisory fees using the standard promulgated by Gartenberg.

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