Judicial Review of Mutual Fund Advisory Fees: Reliance on Markets or Statutory Language?

*By Joanne T. Medero**

Do you own mutual fund shares either directly or through your 401(k) plan? If so, you should be interested in the outcome of the case *Jones v Harris Associates* to be heard early in the 2009-2010 Supreme Court Term. [1] The case involves allegations of "excessive fees" paid to a mutual fund's investment adviser and is notable because the Court rarely takes cases arising under the Investment Company Act ("ICA").[2] The Court was likely motivated to grant review by the differing views of Seventh Circuit Chief Judges Frank Easterbrook and Richard Posner.

I. Case History and Background

The plaintiffs were investors in certain mutual funds advised by Harris Associates, L.P. They alleged that the adviser's compensation was excessive and that, as a result, the adviser had violated ICA Section 36(b).[3] On a motion for summary judgment, the district court dismissed the case, relying on the standard established in a 1982 Second Circuit decision in *Gartenberg v. Merrill Lynch Asset Management*, where the court of appeals found that in order for an adviser to violate Section 36(b), the fee must be so disproportionately large so as to bear no reasonable relationship to the services provided and could not have been the product of arm's length bargaining between the adviser and the mutual fund. The *Gartenberg* court had given considerable weight to whether a fund's board carefully considered the fee and had applied various factors in determining whether a fee is disproportionately large.[4]

On appeal, the Seventh Circuit, in an opinion authored by Chief Judge Easterbrook, affirmed the order of summary judgment but "disapproved" the *Gartenberg* standard, holding that under Section 36(b) a court need only determine whether the fee was negotiated by the investment adviser in a manner consistent with its fiduciary duty to the fund. Stating that it was "skeptical about *Gartenberg* because it relies too little on markets," the opinion went on to say that a "[f]iduciary must make full disclosure and play no tricks but is not subject to a cap on compensation." [5] The panel reasoned that fees are subject to competitive pressure because investors can easily exit a fund when costs are too high relative to return, and what is "excessive" depends on the results available from other investment vehicles, rather than any absolute level of compensation.

Plaintiffs sought rehearing en banc, which was denied as the Seventh Circuit's active judges split five-to-five, with one judge not participating. Joined by four other judges, Judge Posner authored a dissent, arguing that due to the nature of the "captive" relationship of a fund and its directors to an adviser, a court is required in a Section 36(b) case to do more than determine whether the fee negotiations had been open and honest. The dissent criticized the panel for its conclusion that a breach of fiduciary duty could only be inferred from a fee that was "unusual," which the panel would have "applied solely by comparing the adviser's fee with the fees charged by other mutual fund advisers," stating that the comparability approach would allow fees that have resulted from less than arm's length bargaining "to become the industry's floor."[6]

II. ICA Section 36(b)

At its core, the ICA is a regime designed to protect investors in two ways: by providing disclosures about the investment, including historical performance and fees, and by putting in place structural safeguards against the actual and potential conflicts of interest inherent in the structure of mutual funds. Although mutual funds are technically owned by the shareholders who invest in the funds, most mutual funds are created, organized, and managed by external investment advisers. Advisers are compensated for their administrative services and investment management through agreements that must be approved annually by the board of directors of the fund company. Advisory fees are usually calculated as a percentage of the funds' net assets and fluctuate with the value of the funds' portfolio. The ICA provides that a majority of directors must be independent of the adviser and its affiliates, and that advisory contracts must be approved by a majority of these disinterested directors.

It is rare that fund companies fire their advisers. This is not only because of the intertwining of management and services to the fund, but also because a primary reason to invest in a fund is the performance history and reputation of the adviser. To replace the advisory firm with another is tantamount to changing one of the principal factors considered by the fund's shareholders in deciding whether to invest, something directors would naturally be reluctant to do absent extraordinary circumstances.

Congress added Section 36(b) to the ICA in 1970 to impose on advisers a "fiduciary duty with respect to the receipt of compensation for services" and to create a right of action for breach of that fiduciary duty to be exercised by either the SEC or by fund shareholders. In an action under Section 36(b), the approval by the directors of compensation paid to the adviser "shall be given such consideration by the court as is deemed appropriate under all the circumstances." The burden of proof is on the plaintiff to show that there has been a violation of this provision of the ICA. Damages are limited to "actual damages resulting from the breach of fiduciary duty" and cannot exceed the amount of compensation received by the adviser.

While it may seem convoluted that it is the *receipt* of compensation by the adviser that creates the fiduciary duty, rather than the approval of the advisory contract by the directors, this is in fact logical, given the unique structure of mutual funds and the relationship of the adviser to the fund company. At the time of the enactment of Section 36(b), Congress also enacted ICA Section 36(a), which authorizes the SEC—but not by its terms shareholders—to bring actions for

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breach of fiduciary duty involving personal misconduct against the officers or directors of the fund company or the investment advisory firm.

The legislative history of Section 36(b) shows that Congress was concerned that although as originally enacted the ICA provided a comprehensive construct for the elimination and mitigation of conflicts, it did not provide an effective mechanism by which the fairness of investment advisory contracts could be tested in court. Earlier versions of the legislation that ultimately became Section 36(b) contained language that advisory fees should be "reasonable," but the version enacted eliminated this concept, substituting breach of fiduciary duty as the test instead. It is apparent from a review of this history that the mutual fund industry was concerned that the SEC or the courts would engage in rate-setting, and that the industry clearly preferred the language of Section 36(b) as enacted.[7]

III. Economic Analysis

To date, much of the commentary on the *Harris Associates* case has focused on the differing economic analysis approach in the panel's decision as compared to that in the rehearing dissent, thus setting up Judge Easterbrook against Judge Posner.[8] The panel decision is based on a classical economic analysis that there are thousands of mutual funds available and investors will vote with their feet if the costs relative to performance are too high, so advisers are strongly incented to keep costs low to attract investors. In the dissent, the focus is much more on behavioral economic studies that show that mutual fund investors do not make decisions based on costs. Further, the dissenters also believe the governance structure of the industry is such that directors have "feeble incentives" to police an adviser's compensation. Judge Posner compares the setting of fund advisory fees to excessive executive compensation in publicly traded firms and notes further that mutual funds are a component of the financial services industry, where "abuses have been rampant." In sum, the panel decision concludes that market forces—the competition for more assets—functions well, while the dissent focuses on the distortions created by the mutual fund governance structure, and concludes that there is a market failure that may warrant intervention.

Both the panel decision and the dissent look to "comparability" as a source of information on whether the advisory fees are potentially in violation of Section 36(b). They differ, however, as to what the appropriate comparison should be. The panel would look to mutual funds of similar size with similar investment strategies, while the dissenters' view is that the courts should look to the potential disparity of fees charged by an advisor to its affiliated mutual fund as compared to its unaffiliated institutional clients.[9] This latter approach has been adopted by the Eighth Circuit in a case decided after *Harris Associates* that may further influence the decision of the Court.[10]

IV. Statutory Construction

Actions brought under ICA Section 36(b) are generally referred to as "excessive fee" cases (in an implicit reference to *Gartenberg*), but nowhere in the language of the Section is there any reference to the relative level of fees. Rather, the statute simply states that the investment adviser to a mutual fund shall be deemed to have a fiduciary duty in the receipt of compensation paid by the fund.

Under established principles of statutory construction, the term "fiduciary duty" is to be construed by its plain meaning. But there is no per se law of fiduciary obligations because the nature of fiduciary duty depends on the circumstances and the relationship of the parties involved. As a result, the obligations of a fiduciary may be different depending on whether the relationship is formed under the common law of agency, corporations, wills, or trusts. Regardless of the law under which the relationship formed, a fiduciary is not precluded from earning a fee or other compensation (although it is common to prohibit or limit the ability of a fiduciary to purchase assets from, or sell assets to, the person or entity for which it acts as a fiduciary). In construing the term "fiduciary duty," the panel decision in *Harris Associates* considers the term in relation to the law of trusts, and concludes based on its reading of the *Restatement (Second) of Trusts* that provided that the trustee has fulfilled his obligation of candor in negotiation and honesty in performance, a trustee may negotiate his fee in his own interest and accept what the settlor agrees to pay. The decision does allow, however, that fiduciary compensation could be "so unusual" that a court will infer that deceit must have occurred or the decision-makers have abdicated their responsibilities.[11]

While not addressed in the decision, another provision of the ICA enacted contemporaneously with Section 36(b) supports the panel's analysis of the scope of the adviser's fiduciary obligation. The 1970 amendments added Section 15(c), which requires the approval of the investment advisory contract by a majority the disinterested directors, and stipulates that it shall be "the duty of the directors… to request and evaluate, and the duty of the investment adviser… to furnish, such information as may reasonably be necessary to evaluate the terms of any contract." Reading Section 36(b) together with Section 15(c), it is reasonable to conclude that the fiduciary duty of the adviser is to make all relevant disclosures both proactively and in response to particular queries from the directors. The ICA has thus adopted a common approach to a potential "self-dealing" conflict: disclosure to a competent and disinterested decision-maker.

At the same time, the approval of the compensation by the directors is, in the language of Section 36(b), to be given "such consideration by the court as is deemed appropriate under all the circumstances." This preserves for plaintiffs the ability to show that the directors, in the words of the panel decision, "abdicated" their role.

This analysis needs to be reconciled with Section 36(a)—also added in the 1970 amendments—which addresses breaches of fiduciary duty involving personal misconduct, and Section 36(b), which specifically states that the plaintiff need not prove personal misconduct. The text here provides an explanation: Section 36(a) establishes a cause of action against persons acting in certain listed capacities, such as an officer or director of the fund or an adviser. Section 36(b) is directed to the adviser and affiliated persons of the adviser, which, given the structure of the mutual fund industry, are not individuals but rather corporate

and other legal entities. Section 36(b) does not seek recompense from individuals for receipt of compensation for a fiduciary breach but rather seeks it from the entity which directly received the compensation. It seems logical not to require that the plaintiff prove "personal misconduct" when the action lies against an entity rather than its officers and directors.[12]

V. Conclusion

Decisions under Section 36(b) have illustrated the reluctance of judges to substitute their judgment for that of mutual fund directors and a strong desire to avoid substantive rate setting. The *Gartenberg* decision does so by establishing the factors to be considered by the directors in approving the contract, and *Harris Associates* by its reliance on the market and its reading of fiduciary obligations established by trust law. While it can be argued that *Gartenberg* goes beyond the statutory language of Section 36(b), it can also be said that the panel in *Harris Associates* failed to give the ICA its full effect.

A solution that gives more weight to the statutory language can reconcile one apparent split between the Second and Seventh Circuit. *Gartenberg*, with its emphasis on factors, can be said to set out the type of information that a fiduciary should present as part of full disclosure of its fee arrangements, and what most directors would consider to be important in their evaluation of an advisory contract. Congress did not specify the elements of information that would discharge the fiduciary duty of the adviser, so it would not be appropriate for the Court to establish a mandatory list itself. But it could acknowledge that these factors are relevant to the analysis of the fair disclosure obligation found in *Harris Associates*.

The Court must resolve whether *Gartenberg* is correct that a "disproportionately large" fee violates Section 36(b) or whether the Seventh Circuit is correct in rejecting what it calls a "reasonableness" test. Here, Chief Judge Easterbrook is more true to the statute: Congress imposed a fiduciary duty on an adviser, not a cap on its compensation. Neither the absolute level of the compensation nor the comparative level, whether relative to other mutual fund advisory fees or to fees charged other clients of the adviser, is an appropriate inquiry under Section 36(b), except in the narrow circumstances where the "unusual" fee signals a potential fiduciary breach. In such circumstances, if the plaintiff is unable to show that the disclosures made by the adviser are materially inadequate, the action under Section 36(b) must fail.

Endnotes

1 Jones. v. Harris Associates, L.P., No. 08-586. Oral argument has been set for November 2, 2009.

2 (15 U.S.C. § 80a-1 *et seq.*).

3 527 F. 3d 627 (7th Cir. 2008).

4 694 F.2d 923 (2d Cir. 1982), cert. denied, 461 U.S.906 (1983). These non-exclusive factors include fees charged by other advisers to similar funds, the adviser's costs in providing the services, the nature and quality of the services, the economies of scale in providing services as the fund grows larger to the extent realized by the adviser, and the volume of orders or transactions the adviser must process. These factors have been incorporated into SEC regulations. *See* Disclosure Regarding Approval of Investment Advisory Contracts by Directors of Investment Companies, 69 F.R. 39798 (June 30, 2004).

5 *Harris Associates* at 632.

6 Jones v. Harris Associates, L.P., 537 F.3d 728, 732 (7th Cir. 2008).

7 *See* Investment Company Amendments Act of 1970, S. Rep. No. 91-1382, 91st Cong., 2d Sess (1970).

8 *See, e.g.,* Floyd Norris, "The Supremes Will Decide Which Economics Makes Legal Sense," *New York Times* (March 9, 2009). Of course, there has also been considerable commentary on whether the case means the end of *Gartenberg*, especially since mutual fund advisers rarely have been found to have violated Section 36(b) by courts applying this analysis.

9 *Compare* Harris Associates, 527 F. 3d at 634, *with* Harris Associates, 537 F.3d at 731-732 (Posner, J., dissenting). While both opinions proffer explanations as to why differing advisory fees may be warranted as between a mutual fund and an institutional client—largely based on services and the differing nature of the investor (such as a pension fund), neither opinion focuses on what may also be an important distinction: pension funds generally invest through separately managed accounts or bank maintained collective trust funds. Exempted from regulation under the ICA, separate accounts and collective trust funds avoid the legal, accounting, and other expenses of investment company registration and regulation. Thus, advisers using these accounts and funds can offer lower fees. Any comparability analysis needs to take into account not only the type of investor but also the structure of the investment.

10 Gallus v. Ameriprise Financial, Inc., 615 F.3d 816 (8th Cir. 2009).

11 *Harris Associates*, 537 F.3d at 632.

12 Further support that Section 36(a) is focused on individual conduct is that it does not authorize a private right of action and makes no mention of recoupment of the "actual amount of damages" caused by the fiduciary breach Rather, it provides the SEC the authority to seek an injunction and any other relief as may be appropriate under the circumstances.