Supreme Court Hears Argument on *Jones v. Harris*

2009-11-05

On November 2, the Supreme Court heard arguments in *Jones v. Harris*, a case in which plaintiff contends that an investment adviser violates Section 36(b) of the Investment Company Act when its fees for managing a registered investment company exceed those which it charges for institutional separate accounts. The case is on review from a decision by the United States Court of Appeals for the Seventh Circuit, holding that an adviser which makes "full disclosure and play[s] no tricks" on the independent trustees has not violated Section 36(b). This alert discusses the parties' competing views about the fiduciary duty that advisers owe to mutual fund investors, and the relevance of institutional separate account advisory fees to that assessment.

I. Fiduciary Duty with Respect to the Receipt of Compensation

Section 36(b) creates a private right of action for breach of "fiduciary duty with respect to the receipt of compensation for services" paid by the investment company to the adviser or its affiliates. The Investment Company Act, however, does not expressly define fiduciary duty and the lower courts, for more than twenty years, have followed the Second Circuit's formulation of fiduciary duty in *Gartenberg v. Merrill Lynch Asset Management, Inc.*, 694 F.2d 923 (2d Cir. 1982); that a breach of fiduciary duty occurs when a fee is "so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been the product of arms-length bargaining." The Seventh Circuit's decision in *Jones v. Harris* departed from the *Gartenberg* standard, in favor of a "play no tricks" interpretation of fiduciary duty. Remarkably, no party to the litigation made any serious effort to defend the Seventh Circuit's formulation. Although the defense and the Solicitor General's Office argued on behalf of *Gartenberg*, there was very little exploration of *Gartenberg* by the Court, and no obvious groundswell of opinion that *Gartenberg* has been the prevailing standard for so long that the Court should do nothing to modify that standard.

Plaintiff, instead, advanced a fiduciary standard that would require three considerations: fairness of the advisory fee, full disclosure by the adviser to the independent trustees, and a good-faith negotiation between the adviser and the independent trustees. Harris, by contrast, argued on behalf of a *Gartenberg* framework, with the caveat that a violation of the fiduciary duty proscribed by Section 36(b) should be limited to fees that are "far outside of the bounds of what could have been bargained." See Transcript of oral argument, available here ("Tr.") at 30. The Solicitor General was in accord with Harris: any breach of full disclosure, the Office argued, would not be actionable unless there were "actual damages flowing from the lack of disclosure." (Tr. at 25.)

Members of the Court understandably expressed frustration that the Investment Company Act does not provide greater guidance on the nature of the fiduciary duty that an adviser has with respect to compensation. Justice Sotomayor, for example, noted that the statute does not mandate reasonable advisory fees. Rather, she noted, the statute makes a "subtle but very important difference between . . . a reasonable fee and a fiduciary duty with respect to fees." (Tr. at 16.) Justice Kennedy, who repeatedly pressed the litigants to define the obligation owed by a fiduciary in the context of setting advisory fees, stated: "I will just tell you the problem I'm having with the case. If I look at a standard that the fees must be reasonable and I compare that with what a fiduciary would do, I thought a fiduciary has the highest possible duty. But apparently the submission is the fiduciary has a lower duty, a lesser duty than to charge a reasonable fee. I just find that quite a puzzling use of the word 'fiduciary'. . . I don't know why Congress didn't use some other word." (Tr. at 18-19.)

Justice Scalia also expressed some skepticism about the deference courts should pay to the independent trustees who negotiated the challenged fee. After asking defense counsel to read the statutory language regarding deference – that the judgment of the independent directors "shall be given such consideration by the court as is deemed appropriate under all the circumstances"– Justice Scalia commented, "[I]t's meaningless. It tells the court to make its own judgment. Such consideration as the court deems due." (Tr. at 31.)

II. Relevance of the Comparison of Fees Charged to Institutional Investors

Much of the argument was directed to how courts should determine that a fee is fair. Is fairness measured objectively, or is it a relative assessment? The Justices' questions appeared to be premised on the view that fairness is relative. Justice Sotomayor, for example, described a "fair fee" as "meaningless, because it has to be fair in relationship to something." (Tr. at 14.) But what is the baseline for consideration?

Plaintiff consistently has maintained that the baseline for a fairness assessment is the management fee that an investment adviser charges for institutional separate accounts. (Tr. at 16.) The central tenet of this argument is that fairness is what is charged in an arm's-length negotiation, and the best example of an arm's-length negotiation is that which is achieved in negotiations between entities that have no historical relationship with each other. Defense counsel argued that the relevant baseline is "other funds of a similar stripe" (Tr. at 32), though counsel conceded that separate account fees could be relevant in some cases. (Tr. at 39.) In its support of *Gartenberg*, the defense argued that fairness is "a result that could have been fairly bargained at arm's length." (Tr. at 36.) The baseline for comparison need not be, however, "other kinds of fees" (Tr. at 36) but, instead mutual funds with the same investment objective and style. (Tr. at 32.)

III. Misperceptions about the Investment Company Act

The argument featured several observations about the regulatory framework for investment companies that came as a surprise to 1940 Act lawyers, mostly because they were not correct. Three statements stand out.

First, plaintiff stated that the board cannot fire the investment adviser. (Tr. at 7.) As a premise of a question, Justice Scalia appeared to accept that accuracy of the statement. (Tr. at 17.) Boards, however, retain authority to replace an adviser with an alternative (see §15) and there are examples of boards that have lost confidence in the adviser for the funds for which they provide oversight. The most famous example involved the Yacktman Fund, in which the president of the adviser became embroiled in litigation with the independent directors who sought to remove him as president of the fund. See David Sturms, "Enhancing the Effectiveness of Independent Directors: Is the System Broken, Creaking or Working?" Villanova Journal of Law and Investment Management (1999).

Second, plaintiff represented that the adviser selects the members of the board. (Tr. at 6, 17.) Yet again, the observation reflected a misperception about the statute or, more precisely, its enabling rules. Although the Investment Company Act permits the adviser to select the initial slate of directors for a new fund, the Investment Company Act rules require, as a condition to reliance on certain exemptions, that investment company boards be comprised of 40% independent directors, and that new independent directors be selected by the other independent directors. "Role of Independent Directors of Investment Companies," 1940 Act Release No. 24816 (January 2, 2001). Moreover, there is a state law overlay to board elections insofar as state law requires that shareholders elect directors.

Third, Chief Justice Roberts asked whether the SEC had authority to regulate mutual fund advisory fees. (Tr. at 20.) In fact, the Investment Company Act does not give the SEC authority to set advisory fees. The SEC's tools are more limited. They include disclosure obligations, requiring that independent directors articulate the reasons that they approved a particular fee. Disclosure Regarding Approval of Investment Advisory Contracts by Directors of Investment Companies, 69 Fed. Reg. 29,798 (June 30, 2004). The SEC also has statutory authority to litigate excessive fees under either Section 36(a) or 36(b). Like private litigation under Section 36(b), the trier of fact in an action brought by the SEC is a court, which undermines the assumption that the SEC, rather than the courts, has authority to regulate rates. (See Tr. at 20.)

IV. Court Observations that Got it Just Right

Though not specialists, many of the Justices' observations about the investment company industry reflected nuance and sophistication. Three of those observations are notable.

First, Chief Justice Roberts aptly observed that technological advancements have resulted in the provision of significant information about mutual fund fees and performance to fund shareholders. He noted: "These days all you have to do is push a button and you find out exactly what the management fees are. I mean, you just look it up in Morningstar and it's right there and you can make – as an investor you can make whatever determination you'd like, including to take your money out." (Tr. at 12.)

Second, Chief Justice Roberts and Justice Scalia separately remarked that investors are not locked into high cost mutual funds. (Tr. at 13-14.) They seemed to dismiss plaintiff's assertion that investors lack investment choice in 401(k) plans, or that tax consequences may preclude investors from changing funds. Chief Justice Roberts probed that assertion, noting: "Companies . . . change who they invest with under 401(k)'s all the time. The employees are not happy with the return they are getting because the company has limited their choices, they change. It happens all the time." (Tr. at 14.)

Last, Justice Kennedy appreciated that a reasonable fee is not a specific number, but rather a "range." (Tr. at 27.) The Second Circuit, of course, premised its original decision in *Gartenberg* on the proposition that fees may be "*within the range* of what would have been negotiated at arm's-length in the light of all of the surrounding circumstances." Any decision that embraces the concept of a range of reasonable fees appropriately acknowledges that well-informed boards, acting in good faith, may reach a number of outcomes, and that the lowest possible number is not required by the imposition of a fiduciary duty with respect to compensation.

V. Conclusion

Until such time as the Supreme Court renders a decision announcing its interpretation of an investment adviser's fiduciary duty under Section 36(b), we continue to recommend that mutual fund advisers and boards of directors review the *Gartenberg* factors when considering investment company advisory agreement renewals.

Ms. Martin is a partner in the Securities and Litigation/Controversy Departments, and a member of the Investment Management and Securities Litigation and Enforcement Practice Groups, and the Business Trial Group. She, along with Seth Waxman and Paul Wolfson, represented the Investment Company Institute in its Supreme Court amicus brief.

For more information on this or other investment management matters, contact James E. Anderson, Robert G. Bagnall, Jeannette K. Boot, Matthew A. Chambers, Stuart E. Fross, Richard F. Jackson, Martin E. Lybecker, Lori A. Martin, Leonard A. Pierce, Carol Robinson Schepp, Timothy F. Silva and Dino Wu.

Authors

Lori A. Martin

PARTNER

lori.martin@wilmerhale.com

+1 212 295 6412