



The Garten

ON MAY 19, 2008, the United States Court of Appeals for the Seventh Circuit issued an opinion (*Jones v. Harris Associates*) that purports to “disapprove” the standards — widely recognized as the *Gartenberg* Standards — under which most federal courts have considered whether the advisory fees paid by mutual funds violate Section 36(b) of the Investment Company Act of 1940. For an expert view of this opinion — and its possible impact on the investment management industry — *Investment Management Review* spoke with Scot E. Draeger, a Shareholder of Bernstein Shur’s Business Law Practice Group and the Practice Leader for its Securities and Financial Services Industry Group.

Gartenberg Standards:

AN EXPERT'S POINT OF VIEW



By Scot E. Draeger

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What is the significance of the recent opinion?

Although the Seventh Circuit's unanimous rejection of the *Gartenberg* Standards is not binding on other circuits, we believe the recent decision may present investment managers with potential market opportunities and a platform for re-opening a dialogue with regulators regarding additional flexibility in the negotiation of advisory fees.

As background, 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. Because Section 36(b) obligations relate specifically to the compensation received by the fiduciary, rather than the performance of the fiduciary functions, it is a unique duty under the law. The Section was put in place in 1970 after Congress determined, among other things, that investors lacked sufficient bargaining power to keep mutual fund fees reasonable.

Since then, there has been a significant amount of case law examining the relationship between fiduciary duty and compensation. The most important case was decided in 1982 (*Gartenberg v. Merrill Lynch Asset Management*), in which the Second Circuit Court of Appeals essentially set a "reasonableness" or "fairness" test to determine whether advisory fees "...represent a charge within the range of what would have been negotiated at arm's length in light of all the surrounding circumstances." In other words, to be guilty of a violation of Section 36(b), the adviser must charge a fee that is so disproportionately large that it bears no reasonable relationship to the services rendered. As a general proposition, directors of mutual funds have interpreted that to mean there must be a finding that the fees are "fair" and "reasonable" and not misaligned with other fees charged in the industry. Many in the industry and the securities bar, including myself, believe that the most important focus for the courts in Section 36(b) cases is on the integrity of the decision-making process, particularly as it relates to the independent directors, rather than the specific size of the management fee or the profitability of the adviser.

For more than two decades, the factors set forth in *Gartenberg* have shaped the process followed by independent mutual fund directors and have become the standard benchmarks in their annual review of advisory fee contracts. The so-called *Gartenberg* Standards include:

- the nature and quality of services provided to fund shareholders by the adviser;
- the profitability of the adviser under the relationship;
- any indirect costs or benefits (“fall-out” benefits) enjoyed by the adviser;
- the existence of economies of scale realized by advisers and the extent those economies of scale are shared with fund shareholders;
- a comparison of fees and expense ratios with those of similar investment companies; and
- the independence and conscientiousness of the trustees.

Until the *Harris* opinion, courts generally had been unwilling to find a breach of fiduciary duty, provided that a review of these factors indicated that an adviser’s fee was within the range of what could be negotiated at arm’s length.

Complicating matters in the *Harris* decision is the fact that, for good or bad, the SEC has incorporated the *Gartenberg* Standards into its regulations. In 2004, the Commission adopted rules that require fund-to-shareholder reports to contain a discussion of the material considerations the fund board takes into account when evaluating and approving advisory contracts. When the SEC selected what those considerations must be, it relied heavily on the standards from the *Gartenberg* decision, which are reflected in the rule. This is an important piece of traction the industry has to consider, notwithstanding any judicial decisions because the decisions do not supersede relevant SEC rules.

The *Harris* opinion placed heavy emphasis on the role of market forces in controlling mutual fund advisory fees. The Seventh Circuit reasoned that while Section 36(b) creates a fiduciary duty, it does not require that advisory fees be “reasonable” in relation to any judicially stated standards. Instead, the court held that because the existence

of a fiduciary duty does not imply judicial review for reasonableness, the standard for contesting fees is whether a shareholder made a voluntary choice with the benefit of adequate information.

Although mutual funds rarely fire their investment advisers, the court noted that investors follow the “Wall Street Rule” by firing advisers cheaply and easily by moving their money elsewhere. The court rejected the notion that investors are too unsophisticated to pay attention to fund costs, noting that the most substantial and sophisticated investors sometimes choose to pay considerably more for investment advice for products like hedge funds, where the returns are perceived to be higher. These are significant departures from the way *Gartenberg* viewed these considerations and from the way the SEC has encouraged mutual fund boards to consider them.

The Seventh Court also took the position that, like a trustee, a fiduciary owes an obligation of candor in negotiation and honesty in performance, but the adviser may negotiate in his own interest. *Harris* noted that others with fiduciary responsibilities, such as lawyers, may set their own fees, which clients are free to accept or reject. Under the Court’s reasoning, advisers should have the same ability, since investors also have other options. While an adviser must make full disclosure of the fees he or she charges, the court ruled that he or she is not subject to a cap on compensation. This line of reasoning, if adopted by other Courts, may impact fund fee litigation in the foreseeable future.

Finally, the Court observed that the process for fund board approval of advisory fees is very similar to the process for determining compensation for public company executives. Essentially, a committee of directors of a public company sets top executives’ compensation, yet no court has held that that procedure implies judicial review of the reasonableness of the executives’ salary, bonuses or other compensation. The *Harris* decision is advocating the position that advisers’ compensation should be viewed in the same way that public company executives’ compensation is considered. Understandably, this will not be popular with the investor advocacy groups and institutional investor forums.

How might this recent opinion affect the investment management marketplace?

For now, the *Harris* decision controls cases in the Seventh Circuit, which covers Indiana, Illinois, and Wisconsin. The larger impact remains unclear. The *Gartenberg* construction of Section 36(b) will continue to control all other jurisdictions, and certainly will control in cases heard in the influential Second Circuit (New York, Connecticut and Vermont) as well as other circuits that have adopted the *Gartenberg* Standards.

In our view, the investment management industry may benefit from reopening the dialogue with the SEC regarding future guidance and rulemaking relative to how mutual fund boards evaluate and approve investment advisory contracts. The *Harris* decision provides a platform for discussion about whether the SEC should rethink its *Gartenberg*-based approach in light of the Seventh Circuit interpretation of 36(b). With the *Harris* decision, the court appears to be trending toward a more flexible approach, similar to traditional consideration of executive compensation issues.

Interestingly, the *Harris* court took on a specific issue that significantly affects investment advisers that manage mutual funds side-by-side with pension funds and other institutional products. The court rejected the plaintiff's argument that a mutual fund's fees are *per se* excessive if an investment adviser charges fees lower than a "comparable" pension fund or institutional product. This decision may lend support for the negotiating posture of investment advisers, who often take the position that the needs of mutual funds are meaningfully distinct from the needs of pension funds and other institutional products.

The court supported that proposition by noting that different clients call for different commitments of time and resources. For instance, mutual funds need to account for daily redemptions and have higher turnovers than institutional products. Under the *Harris* position, if more broadly adopted, advisers may have more freedom to apply varying fee structures to different clients for similar services based on what the market will bear. To the extent

that investment managers have felt bound to have equal fee structures among mutual funds, pension plans and institutional products, investment managers may find the *Harris* decision as an opening for discussion with mutual fund boards and regulators now that the judicial trend may be going in a direction to allow different fees to be charged for similar services.

What should investment managers do?

Our view is that right now *Harris* will not likely have an impact on how fund boards approach the annual investment advisory contract review process. While the split in the Circuit Courts creates a degree of uncertainty about the interpretation of Section 36(b), because the *Gartenberg* Standards have been encoded into the SEC rules requiring the detailed disclosure of the factors considered and the decisions reached by fund boards, we believe that a prudent course of action for fund boards is to continue to follow the *Gartenberg* factors unless and until there's a uniform standard adopted by the courts, or the SEC engages in further guidance.

Will the US Supreme Court decide to review this opinion in its next session? If so, what will be the outcome?

The split among the Circuit Courts of Appeals makes it more likely – but not certain – that the Supreme Court would review the *Harris* case on petition to do so. But no one has insight yet whether such petition will be granted. Historically, the courts have shown significant deference to the opinions of the SEC. In a case like this, it may very well be that the Commission will weigh in with an *amicus curae* brief to the Supreme Court with its views, and we would expect those views would be given deference. We believe the Commission is unlikely to depart from the standards that were encoded into the 2004 rules, especially given the current regulatory environment and the remaining criticism of investor advocate groups that mutual fund fees are too high.