LEGAL UPDATES

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Supreme Court Issues Decision in Mutual Fund Excessive Fees Case

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The U.S. Supreme Court recently affirmed the legal standard to be followed by federal courts in evaluating whether investment advisory fees charged to mutual funds are excessive. In *Jones v. Harris Associates, L.P.*, the Supreme Court confirmed the standard first outlined in 1982 by the Second Circuit in *Gartenberg v. Merrill Lynch Asset Management, Inc.*, 694 F.2d 923 (2nd Cir. 1982) and followed by most Circuits: an investment adviser does not face liability under Section 36(b) of the Investment Company Act of 1940 for breaching its fiduciary duties to the fund's shareholders unless the adviser charges "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." In reaching this conclusion, the Supreme Court in *Jones* rejected the Seventh Circuit's ruling that an adviser could not be liable for charging excessive fees unless there is fraud involved.

Although the Court's ruling does not support the adviser's position that its fees would not be excessive absent fraud, the Court's adoption of the *Gartenberg* standard still poses a high bar for plaintiffs. Plaintiffs face the burden of proving that the adviser breached its fiduciary duties and the Court made clear that Section 36(b) does not call for "judicial second guessing of informed board decisions" or "judicial price-setting." The Court will give "considerable weight" to a board's evaluation of the advisory fees so long as the "board's process for negotiating and reviewing investment-adviser compensation is robust." Nevertheless, the Court will "take a more rigorous" look at the compensation where the board's process was deficient or the investment adviser withheld pertinent information.

The Court upheld *Gartenberg's* standard that investment company board approval must take into consideration "all the circumstances," including factors outlined by the Securities and Exchange Commission in furtherance of

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Gartenberg (e.g., (1) the nature, extent and quality of the services to be provided by the investment adviser; (2) the investment performance of the fund and the investment adviser; (3) the costs of the services to be provided and profits to be realized by the investment adviser and its affiliates from the relationship with the fund; (4) the extent to which economies-of-scale would be realized as the fund grows; and (5) whether fee levels reflect these economies-of-scale for the benefit of fund investors).

The Court rejected the argument that a comparison between the fees charged by the investment adviser to its other clients and the fees charged to the mutual fund is the only appropriate way to determine whether the fund's fees are excessive since there may be significant differences between the services provided by the adviser to the independent clients and the fund. Likewise, the Supreme Court also rejected the argument that a comparison of a fund's fees to that of its peers is necessarily dispositive of the appropriateness of such fees because the fees charged to such peers may not have been the product of arm's length negotiation.

The decision could be viewed as a win by shareholder advocates as advisers cannot rely solely on market forces to shield advisers from excessive fee liability. However, given that the Supreme Court confirmed the *Gartenberg's* standard, which has been largely followed as the industry benchmark for over 25 years, it is unclear whether the decision will expose the industry to additional lawsuits.

Contact Info

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