DechertOnPoint

May 2008 / Issue 11

A legal update from Dechert's Financial Services Group

Seventh Circuit Rejects *Gartenberg*'s Construction of Section 36(b) of the 1940 Act

Introduction

In a decision that is sure to impact fund fee litigation for the foreseeable future, the U.S. Court of Appeals for the Seventh Circuit dismissed an allegation of violation of Section 36(b) of the Investment Company Act of 1940, as amended, against Harris Associates, L.P., the investment adviser to the Oakmark funds.[1] In *Jones v. Harris Associates, L.P.*, the Seventh Circuit explicitly rejected the approach of *Gartenberg v. Merrill Lynch Asset Management*, the seminal opinion of the U.S. Court of Appeals for the Second Circuit, which held that an investment adviser's fiduciary duty under Section 36(b) broadly prohibits charging a fee "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."[2] Noting that "Section 36(b) does not say that fees must be 'reasonable' in relation to a judicially created standard," the Seventh Circuit in *Jones* held that "[j]udicial price-setting does not accompany fiduciary duties," and that "Section 36(b) does not call for a departure from this norm."[3]

Discussion

Section 36(b) provides in part that "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 securityholders thereof, to such investment adviser or any affiliated person of such investment adviser."[4] In *Gartenberg*, the Second Circuit interpreted an investment adviser's fiduciary duty under Section 36(b) principally by focusing on the amount of fee charged by the investment adviser, noting that "[t]he test is essentially whether the fee schedule represents a charge within the range of what would have been negotiated at arm's-length in light of all of the surrounding circumstances."[5]

The Seventh Circuit in *Jones* explicitly "disapprove[s] the *Gartenberg* approach," observing that "[a] fiduciary duty differs from rate regulation."[6] The court held that "[a] fiduciary must make full disclosure and play no tricks but is not subject to a cap on compensation. The trustees [of the fund] (and in the end investors, who vote with their feet and dollars), rather than a judge or jury, determine how much advisory services are worth."[7] Citing the law of trusts

1 *Jones v. Harris Associates L.P.*, No. 07-1624, 2008 WL 2080753 (7th Cir. 2008).

2 *Gartenberg v. Merrill Lynch Asset Management, Inc.*, 694 F.2d 923, 928 (2d Cir. 1982), *cert. denied sub nom. Andre v. Merrill Lynch Ready Assets Trust*, 461 U.S. 906 (1983).

3 *Jones*, 2008 WL 2080753, at *4 – *5.

4 15 U.S.C. § 80a-35(b) (emphasis added).

5 *Gartenberg*, 694 F.2d at 928.

6 *Jones*, 2008 WL 2080753, at *4.

7 *Id.*

Dechert LLP

in support of its view, the court stated that, like a trustee, a fiduciary "owes an obligation of candor in negotiation, and honesty in performance, but may negotiate in his own interest. . . ."[8] The Seventh Circuit's opinion in *Jones* does envisage the possibility of "compensation so unusual that a court will infer that deceit must have occurred, or that the persons responsible for decision have abdicated," but it implies that such instances would be rare.[9] The court observed, in this regard, that the process for fund board approval of investment advisory fees is similar to the process for determining how much public-company executives are compensated—where a committee of independent directors sets the top managers' compensation—and yet "[n]o court has held that this procedure implies judicial review for 'reasonableness' of the resulting salary, bonus, and stock options."[10]

In articulating this new standard for interpreting Section 36(b), the Seventh Circuit rejected the plaintiffs' contention that *Gartenberg* should be disregarded because it relies *too much on market prices* and there is a lack of actual fee competition in the mutual fund industry. In return, the court stated that "just as plaintiffs are skeptical of *Gartenberg* because it relies too heavily on markets, we are skeptical about *Gartenberg* because it relies *too little on markets*."[11] The court observed that thousands of mutual funds today compete for investor assets. Although mutual funds rarely "fire" their investment advisers, the court noted that investors themselves fire advisers "cheaply and easily by moving their money elsewhere."[12] Rejecting the notion that investors are too unsophisticated to pay attention to fund costs, the court noted that "the most substantial and sophisticated investors choose to pay substantially more for investment advice" through unregistered products (e.g., hedge funds) that oftentimes pay higher fees than registered funds.[13] The essence of the court's competition theory is that investors are willing to pay higher fees for superior net investment performance, and that competition in the fund industry is strong on relative basis—"what is 'excessive' depends on the results available from other investment vehicles, rather than any absolute level of compensation."[14]

The court also rejected the plaintiffs' argument that a mutual fund's fees are *per se* excessive if the investment adviser charges lower fees to "comparable" pension funds or other institutional products. Noting that "[d]ifferent clients call for different commitments of time," the court observed that mutual funds need to account for daily redemptions and have higher turnover than institutional products.[15] In essence, the court stated that an adviser is free to charge different amounts to clients for similar services based on what the market will bear, observing that advisers apportion their own internal costs for services to customers "according to their elasticity of demand, not according to any rule of equal treatment."[16]

Immediate Implications

The immediate impact of the *Jones* decision remains unclear. For now, the *Jones* court's construction of Section 36(b) controls in cases heard in the Seventh Circuit, which includes the states of Illinois, Indiana, and Wisconsin. The *Gartenberg* construction of Section 36(b) continues to control in cases heard in the Second Circuit—Connecticut, New York, and Vermont—as well as in other circuits that have adopted *Gartenberg*.[17] Due to the split among the circuit courts of appeal, it is more likely (but far from certain) that the Supreme Court would review *Jones* if petitioned to do so.

8 *Id.*

9 *Id.*

10 *Id.* Some may argue that this approach seems to place more emphasis on the fiduciary duty of fund directors than the fiduciary duty of the investment adviser specified in Section 36(b).

11 *Id.* (emphasis added).

12 *Id.*, at *5.

13 *Id.*, at *6.

14 *Id.*, at *5.

15 *Id.*, at *6.

16 *Id.*

17 *See, e.g.*, *Migdal v. Rowe Price-Fleming Intern., Inc.*, 248 F.3d 321 (4th Cir. 2001).

In our view, it is unlikely that Jones will have an immediate impact on how fund boards approach the annual investment advisory contract review process. The split in the circuits creates a degree of uncertainty about which interpretation of Section 36(b) would govern in a given case. Moreover, the *Gartenberg* standard has been enshrined by SEC rules requiring detailed disclosure of the factors considered, and conclusions reached, by fund boards in connection with the approval of investment advisory contracts.[18] The considerations that must be addressed in this disclosure are informed significantly by the standards set forth in *Gartenberg*. Accordingly, fund boards may feel compelled by these SEC disclosure requirements to continue to follow a *Gartenberg*-style contract-review process, notwithstanding the court's holding in *Jones*. The decision should prompt the SEC to rethink (and perhaps revise and simplify) its *Gartenberg*-based disclosure requirements in light of the Seventh Circuit's interpretation of Section 36(b). In the meantime, a robust consideration of all the *Gartenberg* factors remains the most prudent course to follow unless and until a uniform standard is adopted by the courts, and the SEC makes conforming changes to its contract review disclosure requirements.

[18] *See* Disclosure Regarding Approval of Investment Advisory Contracts by Directors of Investment Companies, SEC Release No. IC-26486 (June 23, 2004), at n. 31 (noting that the factors enumerated in the disclosure rule are similar to factors considered by courts, and citing *Gartenberg* in particular).

■ ■ ■

This update was authored by William K. Dodds (+1 212 698 3557; william.dodds@dechert.com), Robert A. Robertson (+1 949 442 6037; robert.robertson@dechert.com), Alan Rosenblat (+1 202 261 3332; alan.rosenblat@dechert.com), and Thomas C. Bogle (+1 202 261 3451; thomas.bogle@dechert.com).

Practice group contacts

For more information, please contact the authors, one of the attorneys listed, or any Dechert attorney with whom you regularly work. Visit us at www.dechert.com/financialservices.

Margaret A. Bancroft
New York
+1 212 698 3590
margaret.bancroft@dechert.com

Sander M. Bieber
Washington, D.C.
+1 202 261 3308
sander.bieber@dechert.com

Stephen H. Bier
New York
+1 212 698 3889
stephen.bier@dechert.com

Daphne T. Chisolm
Charlotte
+1 704 339 3153
daphne.chisolm@dechert.com

Christopher D. Christian
Boston
+1 617 728 7173
christopher.christian@dechert.com

Elliott R. Curzon
Washington, D.C.
+1 202 261 3341
elliott.curzon@dechert.com

Douglas P. Dick
Washington, D.C.
+1 202 261 3305
douglas.dick@dechert.com

William K. Dodds
New York
+1 212 698 3557
william.dodds@dechert.com

Ruth S. Epstein
Washington, D.C.
+1 202 261 3322
ruth.epstein@dechert.com

Susan C. Ervin
Washington, D.C.
+1 202 261 3325
susan.ervin@dechert.com

Joseph R. Fleming
Boston
+1 617 728 7161
joseph.fleming@dechert.com

Brendan C. Fox
Washington, D.C.
+1 202 261 3381
brendan.fox@dechert.com

Wendy Robbins Fox
Washington, D.C.
+1 202 261 3390
wendy.fox@dechert.com

David M. Geffen
Boston
+1 617 728 7112
david.geffen@dechert.com

David J. Harris
Washington, D.C.
+1 202 261 3385
david.harris@dechert.com

Robert W. Helm
Washington, D.C.
+1 202 261 3356
robert.helm@dechert.com

Jane A. Kanter
Washington, D.C.
+1 202 261 3302
jane.kanter@dechert.com

Geoffrey R.T. Kenyon
Boston
+1 617 728 7126
geoffrey.kenyon@dechert.com

George J. Mazin
New York
+1 212 698 3570
george.mazin@dechert.com

Jack W. Murphy
Washington, D.C.
+1 202 261 3303
jack.murphy@dechert.com

John V. O'Hanlon
Boston
+1 617 728 7111
john.ohanlon@dechert.com

Jeffrey S. Puretz
Washington, D.C.
+1 202 261 3358
jeffrey.puretz@dechert.com

Jon S. Rand
New York
+1 212 698 3634
jon.rand@dechert.com

Robert A. Robertson
Newport Beach
+1 949 442 6037
robert.robertson@dechert.com

Keith T. Robinson
Hong Kong
+1 852 3518 4705
keith.robinson@dechert.com

Alan Rosenblat
Washington, D.C.
+1 202 261 3332
alan.rosenblat@dechert.com

Kevin P. Scanlan
New York
+1 212 649 8716
kevin.scanlan@dechert.com

Frederick H. Sherley
Charlotte
+1 704 339 3100
frederick.sherley@dechert.com

Patrick W. D. Turley
Washington, D.C.
+1 202 261 3364
patrick.turley@dechert.com

Brian S. Vargo
Philadelphia
+1 215 994 2880
brian.vargo@dechert.com

David A. Vaughan
Washington, D.C.
+1 202 261 3355
david.vaughan@dechert.com

Anthony H. Zacharski
Hartford
+1 860 524 3937
anthony.zacharski@dechert.com

Dechert LLP

www.dechert.com

U.S. Austin • Boston • Charlotte • Hartford • Newport Beach • New York • Philadelphia Princeton • San Francisco • Silicon Valley • Washington, D.C. • **EUROPE** Brussels London • Luxembourg • Munich • Paris • **ASIA** Hong Kong