



# FEDERAL COURT PROPERLY REJECTS JUDICIAL MANAGEMENT OF INVESTMENT ADVISOR PAY

by

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The mutual fund industry occupies a central role in the American economy. Individual investors, 401(k) plans, retirement accounts, pension funds and others have invested over \$13 trillion in U.S. mutual funds, which as a result are critical participants in the domestic capital formation process and important contributors to overall market liquidity.<sup>1</sup> The industry is both complex and highly regulated. Mutual funds must be governed by independent boards; transactions between funds and management are prohibited; and the Securities and Exchange Commission (SEC) is a zealous regulator of all aspects of the business, from sales practices to fund operations, including investment decision making and securities trading. Because the operations and management of mutual funds are typically externalized, and delegated to investment managers and their affiliates by contracts, the regulatory regime protects investors by focusing upon fund independence and minimizing conflicts between funds and their outside managers.

One ingredient in that system centers upon the compensation that funds pay to their investment advisers and managers. To minimize the risk of conflicts, investment advisory contracts must be terminable upon 60 days notice. Advisory agreements must be approved annually by a fund's independent trustees or directors. The negotiation of fees is not fully at arm's length, but is tilted toward fund boards. Advisory firms are statutorily obliged to furnish complete information for evaluating contractual terms to funds' independent directors. And the Investment Company Act explicitly makes investment advisers "fiduciaries" with respect to their "receipt of compensation." As "fiduciaries" to the funds that they manage, investment advisers owe obligations of "utmost candor, rectitude, care, loyalty and good faith" when setting and negotiating their own compensation.

But that statutory "fiduciary" obligation was never understood as a cap on compensation or as a brake on the market forces that influence advisers in setting advisory contract rates and boards in approving them. Indeed, in the nearly four decades since that "fiduciary" standard was imposed, the SEC has never once challenged the magnitude of fees an investment adviser has charged a mutual fund. The few private lawsuits brought to challenge adviser compensation have mostly failed. Invoking a standard first articulated some twenty-five years ago by the U.S. Court of Appeals for the Second Circuit in a seminal case known as *Gartenberg v. Merrill Lynch*, courts typically have declined to impose liability on managers for ostensibly "excessive" compensation unless

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<sup>1</sup>Investment Company Institute, Trends in Mutual Fund Investing (Apr. 2008), available at [http://www.ici.org/stats/mf/trends\\_04\\_08.html#TopOfPage](http://www.ici.org/stats/mf/trends_04_08.html#TopOfPage) (last visited 6/19/08).

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their fees were “so disproportionately large” compared to the value of services rendered that the contract “could not have been the product result of arms’ length bargaining.” *Gartenberg v. Merrill Lynch Asset Mgmt., Inc.*, 694 F.2d 923, 928 (2d Cir. 1982).

In 2003, the private plaintiffs’ bar undertook to reverse the “hands-off” attitude about mutual fund advisory fees displayed by the SEC and courts by initiating lawsuits against a dozen mutual fund complex advisers, accusing them of charging “excessive” fees in violation of the “fiduciary” duty the statute imposed. The plaintiffs’ two theories were simple. They contended, first, that since mutual fund assets had dramatically multiplied from fund sales and portfolio appreciation, but fees as a percent of assets remained constant, simple arithmetic established that advisers earned “too much,” and had not shared economies of scale with funds they managed. The plaintiffs argued, second, that the asset-based rates advisers charged other investment advisory clients, like pension funds, were a fraction of mutual fund rates, “proving” mutual fund fees to be “excessive.” In each of these dozen suits, the plaintiffs sought a judge’s determination of whether the fees were “reasonable” and the return to the fund of any “excess” amount (less, of course, lawyers’ fees for effecting the transaction).

In a decision issued on May 19, 2008, the Seventh Circuit rejected both of the plaintiffs’ theories of “excessiveness” and more closely tied the standard to the statute than had *Gartenberg* by holding that it is inappropriate to examine the excessiveness of fees prior to the showing of a process-based reason that justifies such examination. In *Jones v. Harris Associates, L.P.*, 527 F.3d 627 (7th Cir. 2008), the court deferred to the “market” to set and validate adviser compensation, effectively declaring that judges – and plaintiffs’ lawyers – have no business interfering in rate setting.

The Seventh Circuit’s opinion serves as a refreshing reminder that judicial intervention in market mechanics can do more harm than good. A judicial search for a “just price,” *see id.* at 633, at which to compensate investment advisers inescapably interferes with the deployment of capital, and the attraction and retention of managerial talent, with no countervailing benefit to investors. In view of the importance of the mutual fund industry to the breadth and depth of capital markets, reliance on the “invisible hand” is decidedly preferable to having a judge’s finger on the scale.

**Brief Synopsis of Opinion.** The plaintiffs attacked Harris Associates’ compensation on both procedural and substantive grounds. They claimed, first, that one ostensibly independent trustee actually was interested; therefore, Harris Associates “receiv[ed] a fee that was not approved consistently with the ICA’s requirements of directorial independence and disclosure.” Brief and Required Short Appendix of Plaintiffs-Appellants at 20, *Jones v. Harris Assoc.*, 527 F.3d 627 (7th Cir. 2008) (No. 07-1624). The Seventh Circuit made “short work” of this argument. *Harris Assoc.*, 527 F.3d at 629. Since the Board was “comfortably over the statutory requirement that 40% of trustees be disinterested, . . . it makes no difference how [the challenged trustee] is classified.”<sup>2</sup> The court also quickly dispatched the plaintiffs’ argument that the challenged trustee “possessed some Svengali-like sway over the other trustees, so that his presence in the room was enough to spoil their decisions.” *Harris Assoc.*, 527 F.3d at 630.

The court then addressed the plaintiffs’ twin substantive contentions about fees: that the asset-based formula had not changed over time as fund assets increased, and that Harris Associates charged lower fees to its institutional clients. The court noted that Harris Associates had instituted “breakpoints” pursuant to which the fee percentage it charged decreased on assets above certain thresholds. *Id.* at 631. Additionally, Harris Associates’ fees were roughly the same as those charged by similar funds, and Harris Associates’ funds had grown more than competing mutual funds. *Id.* Indeed, the District Court had found the fees to be “ordinary.” *Id.*

The court agreed with the plaintiffs that it should not adopt *Gartenberg*, but its rationale was different: “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.” *Id.* at 632. The court explained that there is a powerful

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<sup>2</sup>*Id.* at 630. During the relevant time period, the ICA required 40% of trustees to be independent, *see* 15 U.S.C. § 80a-10(a), and SEC regulations required that 50% of trustees be independent in order to take advantage of certain exemptive rules promulgated under the ICA, *see* 17 C.F.R. § 270.0-1(a)(7) (2001) (amended 2004). SEC regulations now require that 75% of trustees be independent in order to take advantage of the exemptive rules. *See* 17 C.F.R. § 270.0-1(a)(7) (2004).

incentive for advisers and funds to hold down their costs, for “[a]n advisor can’t make money from its captive fund if high fees drive investors away.” *Id.*

The court went on to analyze the common law meaning of “fiduciary duty.” As illustrated by the law of trusts, the law of business corporations, and the law of client-lawyer relationships (a list that “could be extended”), “[j]udicial price-setting does not accompany fiduciary duties.” *Id.* at 633. Therefore, Section 36(b)’s fiduciary duty language does not call for courts to review fees for “reasonableness.” *Id.* at 632. Section 36(b)’s contradictory legislative history, some of which mentions a reasonableness standard, is unhelpful in understanding the meaning of “fiduciary duty with respect to fees,” since other portions reject a reasonableness standard. *Id.* at 633.

The court also held that comparisons with institutional accounts are not instructive; not only do such accounts have different requirements than mutual funds, but also, to the extent that costs may be shared between mutual funds and institutional accounts, “[i]n competition those joint costs are apportioned among paying customers according to their elasticity of demand, not according to any rule of equal treatment.” *Id.* at 633-35. Since “[p]laintiffs [did] not contend that Harris Associates pulled the wool over the eyes of the disinterested trustees or otherwise hindered their ability to negotiate a favorable price for advisory services,” the court affirmed the judgment of the district court. *Id.* at 635.

***Competition and the Law of Adviser Compensation.*** The plaintiffs’ position, and to a certain extent *Gartenberg*’s own reasoning, assumed that there is insufficient competition in the mutual fund industry because funds are captives of their advisers and the adviser’s “brand.” See *Gartenberg*, 694 F.2d at 929. Boards of funds in a “family” of funds do not put advisory contracts out to bid; they negotiate exclusively with one adviser.

What this analysis misses, as Chief Judge Easterbrook explained, is that investors’ capital is mobile, *Harris Assoc.*, 527 F.3d at 632-34; thus rational advisers cannot charge more than will retain investors. Shareholders dissatisfied with the fees an adviser charges – or with investment returns net of fees – can simply transfer their investments to another fund with lower fees or superior returns.<sup>3</sup> Indeed, empirical academic research cited by Chief Judge Easterbrook has concluded that shareholders do consider fees in making their investments (and increasingly choose low-fee funds), resulting in fee-based competition among funds with different advisers.<sup>4</sup> Alternatively, wealthy investors may (and often do) invest in hedge funds, which customarily charge fees substantially higher than mutual funds’ fees. *Harris Assoc.*, 527 F.3d at 634.

Likewise, an additional market force faced by advisers – competition to recruit and retain investment management talent – disposes of the plaintiffs’ argument that mutual fund advisory fees are just “too high.” “Talent flight” from mutual fund companies to hedge funds is a “brain-drain” that exposes mutual fund performance to deterioration. Since 2000, the number of hedge funds – broadly defined as private investment pools not subject to acute SEC regulation oversight – and the size of hedge fund assets have grown exponentially. According to reliable estimates, unregulated hedge funds now manage some \$1.9 trillion,<sup>5</sup> having grown to more than 20% of the mutual fund industry’s size.<sup>6</sup> Hedge funds are estimated to control half of the volume on the New York and London Stock Exchanges.<sup>7</sup> But arguably more important than their growth and increasing position

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<sup>3</sup>*Id.*; see also Mem. from Paul F. Roye, Division of Investment Mgt. of the SEC to Chairman William H. Donaldson, June 11, 2003, at 67 (“Funds compete for shareholders on many bases, including, among others, price, performance, investment objective, and shareholder services.”).

<sup>4</sup>*Harris Assoc.*, 527 F.3d at 634 (citing John C. Coates & R. Glenn Hubbard, *Competition in the Mutual Fund Industry: Evidence and Implications for Policy*, 33 IOWA J. CORP. L. 151 (2007)); see also Coates & Hubbard at 15, 27; Mem. from Paul F. Roye at 3 (also stating that “there is a basis for arguing that significant competition based on costs exists in the mutual fund industry”).

<sup>5</sup>Gregory Zuckerman, *Hedge Funds Are Caught in a Tight Spot*, Wall St. J., Sept. 2, 2008, at C1, available at [http://online.wsj.com/article/SB122031122769488671.html?mod=googlenews\\_wsj](http://online.wsj.com/article/SB122031122769488671.html?mod=googlenews_wsj).

<sup>6</sup>See Paul Kedrosky, *Hedge Fund Assets vs. Mutual Funds Assets* (Dec. 1, 2006), available at [http://paul.kedrosky.com/archives/2006/12/01/hedge\\_fund\\_asse.html](http://paul.kedrosky.com/archives/2006/12/01/hedge_fund_asse.html) (accessed Sept. 9, 2008); Registration Under the Advisers Act of Certain Hedge Fund Advisers, Release No. IA-2333 [File No. S7-30-04] (Dec. 7, 2004), available at [http://www.sec.gov/rules/final/ia-2333.htm#P80\\_18049](http://www.sec.gov/rules/final/ia-2333.htm#P80_18049) (accessed Sept. 9, 2008).

<sup>7</sup>See Jenny Anderson, *Banks’ Leases to Hedge Funds Are Questioned*, N.Y. Times, Jan. 2, 2007, available at [http://www.nytimes.com/2007/01/02/business/02hedge.html?\\_r=1&oref=login](http://www.nytimes.com/2007/01/02/business/02hedge.html?_r=1&oref=login) (accessed Sept. 9, 2008).

in the capital markets is the compensation that hedge funds offer based upon the fees they charge investors. Hedge funds typically charge a management fee of 2% of net asset value – or more than twice what mutual funds pay on average<sup>8</sup> – plus hedge funds charge performance fees typically equal to 20% of fund profits. In short, hedge funds and hedge fund assets have grown exponentially in part because they offer investment management talent compensation that can be exponentially higher than elsewhere – including at mutual fund management companies.<sup>9</sup> It follows that the “market” for talented investment managers is robust. Investment advisers deploy the fees they charge mutual funds to compete against alternative asset class managers to retain investment professionals.

These competitive factors are decidedly within the competence of management – investment advisers and fund boards – to consider when negotiating fees. While any system that has the potential for conflict is susceptible to criticism,<sup>10</sup> boards are better situated than courts or plaintiffs’ attorneys to determine how the market for adviser talent responds to the compensation competition.

The Seventh Circuit appears to have understood this. Chief Judge Easterbrook recognized that judicial second-guessing is inappropriate without an adequate trigger that review is required. As Chief Judge Easterbrook recounted, in other areas of fiduciary duty law in which there already is a disinterested entity, such as a board, protecting beneficiary interests, a challenger must first show a substantial, process-based reason to doubt that disinterested entity’s judgment – for example, that a mutual fund adviser “pulled the wool over the eyes of the disinterested trustees or otherwise hindered their ability to negotiate a favorable price for advisory services”, *Harris Assoc.*, 527 F.3d at 635 – before a court may review the fairness of the transaction. Leaping to the “fairness” prong of the standard fiduciary duty test (having reversed it, as is required by the statute<sup>11</sup>) without first requiring challengers to show a reason to justify judicial examination of fees jumps the market gun.

Invoking “reasonableness” or other “proportionality” standards upon the basis of “factors” that the *Gartenberg* court proposed as a rubric for examination has a practical effect on the role of the boards. While Section 15(c) requires boards to obtain certain information from advisers in their fee deliberations, *see* 15 U.S.C. § 80a-15(c), the *Gartenberg* factors as developed<sup>12</sup> suggested restrictions on permissible uses of such information and limitations on boards’ freedom to look to other information that they may consider relevant.<sup>13</sup>

**Conclusion.** The familiar principles of fiduciary duty and deference to markets that are the talismans adopted in *Harris Associates* provide a logical way to ensure that boards fulfill their function to protect shareholder interests. Deference to funds’ boards is consistent with the structure of the Investment Company Act, which makes trustees the shareholders’ watchdogs, and reflects an appropriate reliance on markets for validation. The Seventh Circuit’s approach should serve as a guide for courts dealing with these same issues around the country.

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<sup>8</sup>The asset-weighted average of annual expense ratios and annualized loads for individual securities funds was 1.02% in 2007. *See* 2008 Investment Company Fact Book, available at [http://www.icifactbook.org/fb\\_sec5.html#5.1](http://www.icifactbook.org/fb_sec5.html#5.1) (accessed Sept. 9, 2008).

<sup>9</sup>U.S. General Accounting Office, *Mutual Fund Fees: Additional Disclosure Could Encourage Price Competition*, GAO/GGD-00-126 (Washington, D.C.: June 7, 2000) at 39-40.

<sup>10</sup>Peter Wallison and Robert Litan have attacked the board structure under section 36(b) as damaging to competition. *See* Peter J. Wallison & Robert E. Litan, *Competitive Equity: A Better Way to Organize Mutual Funds* (AEI Press 2007).

<sup>11</sup>15 U.S.C. § 80a-35(b)(1) (“[T]he plaintiff shall have the burden of proving a breach of fiduciary duty . . .”).

<sup>12</sup>*See Amron v. Morgan Stanley Invest. Advisors Inc.*, 464 F.3d 338, 340 (2d Cir. 2006) (listing six “*Gartenberg* factors”).

<sup>13</sup>Wallison and Litan explain their view of the damaging effects of this approach. *See, e.g.*, Wallison and Litan at 78-81.