MEMO# 24206

March 30, 2010

Supreme Court Issues Decision in Jones v. Harris Associates

[24206]

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TO: BOARD OF GOVERNORS No. 3-10
CLOSED-END INVESTMENT COMPANY MEMBERS No. 17-10
INVESTMENT COMPANY DIRECTORS No. 6-10
PUBLIC COMMUNICATIONS COMMITTEE No. 1-10
SEC RULES MEMBERS No. 27-10
SMALL FUNDS MEMBERS No. 21-10 RE: SUPREME COURT ISSUES DECISION IN JONES V. HARRIS ASSOCIATES

In a unanimous decision, the U.S. Supreme Court endorsed the well-tested legal framework—first articulated in the Second Circuit's 1982 decision in Gartenberg v. Merrill Lynch Asset Management—used by courts to assess claims of excessive fund advisory fees. [1] Specifically, the Court held that, in order to be found liable in a shareholder suit brought under Section 36(b) of the Investment Company Act of 1940, an investment adviser must charge 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." The background of this case and the Court's opinion are summarized below.

ICI and IDC will host a special one-day conference focused on the impact and implications of the Court's decision. The conference will take place on April 14, 2010 in Washington, DC. [2]

Background

Section 36(b) of the Investment Company Act of 1940 permits a mutual fund shareholder to file suit in federal court against the fund's adviser for an alleged breach of fiduciary duty with respect to the adviser's receipt of compensation from the fund. From 1982 until the Jones decision in the Seventh Circuit, federal district and appellate courts applied the "so disproportionately large" standard set forth by the Second Circuit in Gartenberg. Various factors relevant to this inquiry have been identified in Gartenberg and subsequent cases, and they have come to form the framework used by fund boards in assessing advisory fees as part of the annual advisory contract review process.

In Jones, a three-judge panel of the Seventh Circuit led by Judge Easterbrook disapproved the Gartenberg approach, stating that "we are skeptical about Gartenberg because it relies too little on markets." Instead, the decision by the Easterbrook panel stated that "a fiduciary must make full disclosure and play no tricks but is not subject to a cap on compensation. The trustees (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." Noting that the plaintiffs did not allege that the adviser "pulled the wool over the eyes of the disinterested trustees or otherwise hindered their ability to negotiate a favorable price for advisory services," the panel affirmed the district court's grant of summary judgment in favor of Harris Associates (which was based on a Gartenberg analysis).

Plaintiffs' request for a rehearing by the full circuit was denied on a 5-5 vote. In a strongly worded dissenting opinion, Judge Posner criticized the Easterbrook panel's reliance on market competition and its failure to consider, among other things, that the adviser charged its "captive" mutual funds more than twice what it charged to its unaffiliated institutional clients.

The Supreme Court granted plaintiffs' request for review, in order to resolve a split among the circuits over the proper legal standard under Section 36(b). ICI and IDC each filed an amicus curiae ("friend of the court") brief with the Court in support of respondent Harris Associates. ICI's brief defended the Gartenberg framework, arguing that it affords real and substantial protection to investors, provides fund boards and advisers with useful guidance, and serves judicial economy by not embroiling the courts in technical disputes over business judgment. IDC's brief highlighted the crucial role that independent directors play in evaluating and approving a fund's advisory fees and argued that courts should defer to independent directors' exercise of their business judgment in approving advisory fees. The Securities and Exchange Commission and the U.S. Solicitor General filed an amicus brief in support of the Jones plaintiffs that endorsed the Gartenberg standard. [3]

Supreme Court's Opinion

The opening pages of the opinion discuss the 1970 amendments to the Investment Company Act, which the Court described as having "bolstered shareholder protection in two primary ways"—first, by strengthening the independence of fund boards, referred to by the Court as "the 'cornerstone' of the Act's effort to check conflicts of interest," and second, by incorporating the fiduciary duty standard in Section 36(b). Later in the opinion, the Court recognized that "[fund] board scrutiny of adviser compensation and shareholder suits under [section] 36(b) are mutually reinforcing but independent mechanisms" for controlling adviser compensation.

Following a discussion of the Second Circuit's analysis in Gartenberg, the Court observed:

> The meaning of [section] 36(b)'s reference to "a fiduciary duty with respect to the receipt of compensation for services" is hardly pellucid, but based on the terms of that provision and the role that a shareholder action for breach of that duty plays in the overall structure of the Act, we conclude that Gartenberg was correct in its basic formulation of what [section] 36(b) requires: to face liability

> under [section] 36(b), an investment adviser must charge 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.

First, the Court reasoned that the Gartenberg standard "fully incorporates" the understanding of the term "fiduciary duty" as set forth in relevant Supreme Court precedent. Second, the Court looked to the language of Section 36(b)(2) [4] and concluded that two inferences may be drawn from the way it is written: (1) that a "measure of deference to a board's judgment may be appropriate in some instances;" and (2) that "the appropriate measure of deference varies depending on the circumstances." The Court concluded that "Gartenberg heeds these precepts" by recognizing that the expertise of a fund's independent directors, whether they are fully informed, and the care and conscientiousness with which they perform their duties are important factors to consider in evaluating whether there has been a breach of fiduciary duty under Section 36(b).

Board Approval of Adviser Compensation

Regarding deference to board approval, the Court stated:

> Where a board's process for negotiating and reviewing investment-adviser compensation is robust, a reviewing court should afford commensurate deference to the outcome of the bargaining process. Thus, if the disinterested directors considered the relevant factors, their decision to approve a particular fee agreement is entitled to considerable weight, even if a court might weigh the factors differently.

In contrast, where the board's process was "deficient," the court "must take a more rigorous look at the outcome."

The Court made clear that the standard for fiduciary breach under Section 36(b) "does not call for judicial second-guessing of informed board decisions" and that a court may not "supplant the judgment of disinterested directors apprised of all relevant information, without additional evidence that the fee exceeds the arm's length range." The Court found that Gartenberg's "so disproportionately large" standard reflects the Congressional choice to rely largely upon independent director "watchdogs" to protect shareholder interests.

Factors to be Considered

The Court noted that an analysis of adviser compensation requires consideration of "all relevant factors," and its opinion recited (but did not discuss) the factors outlined in the Second Circuit's 1982 opinion in Gartenberg.

On the issue of fee comparisons with institutional clients, the Court stated that there can be no "categorical rule" regarding such comparisons. Rather, courts may give such comparisons "the weight that they merit" given the similarities and differences in services between different clients, but courts "must be wary of inapt comparisons." The Court further instructed:

> If the services rendered are sufficiently different that a comparison is not probative, then courts must reject such a comparison. Even if the services provided and fees charged to an independent fund are relevant, courts should be

> mindful that the Act does not necessarily ensure fee parity between mutual funds and institutional clients contrary to [plaintiffs'] contentions.

Thus, according to the Court, "only where plaintiffs have shown a large disparity in fees that cannot be explained by the different services in addition to other evidence that the fee is outside the arm's-length range will trial be appropriate."

The Court also cautioned courts "not [to] rely too heavily on comparisons with fees charged to mutual funds by other advisers," calling such comparisons "problematic" because they "may not be the product of negotiations conducted at arm's length."

Disclosure as an Independent Basis for Liability under Section 36(b)

The Court's opinion is clear that a claim under Section 36(b) may not be based on an adviser's alleged failure to disclose information to the fund board. It noted that Section 36(b) claims are "sharply focused on the question of whether the fees themselves were excessive." Instead, any failure on the part of the adviser to disclose material information to the fund board would require a court to "take a more rigorous look at the outcome" of the board's approval of the fee. The Court explained that greater scrutiny in this instance would be justified because "the withheld information might have hampered the board's ability to function as an 'independent check'" upon the fund adviser. Instead, "an adviser's compliance or noncompliance with its disclosure obligations is a factor that must be considered in calibrating the degree of deference that is due a board's decision to approve an adviser's fees."

* * * *

The Court vacated the Seventh Circuit's judgment, which had disapproved Gartenberg, and remanded the case for further proceedings consistent with its opinion.

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endnotes

[1] Jones v. Harris Associates L.P., No. 08-586 (March 30, 2010), available on the Supreme Court's website at http://www.supremecourt.gov/opinions/09pdf/08-586.pdf. Justice Alito wrote for the Court; Justice Thomas wrote a separate concurring opinion.

[2] Information about the conference will be made available through a separate email communication.

[3] Information about the case, including copies of the lower court opinions and all briefs filed with the Court, are available through ICI's Jones v. Harris resource center (http://www.ici.org/jvh).

[4] Section 36(b)(2) provides, in relevant part, that the fund board's approval of the compensation paid to the adviser "shall be given such consideration by the court as is

deemed appropriate under all the circumstances."