IDC Independent Directors Council
Promoting Excellence in Fund Governance

MEMORANDUM

September 4, 2009

TO: INVESTMENT COMPANY DIRECTORS No. 21-09

RE: IDC FILES BRIEF IN SUPREME COURT CASE; SUMMARY OF ADDITIONAL BRIEFS

The Independent Directors Council has filed an *amicus curiae* ("friend of the court") brief in the *Jones v. Harris Associates* Supreme Court case. As previously reported, the case is on appeal from a decision by the Seventh Circuit Court of Appeals, which affirmed a district court decision granting summary judgment in favor of a fund adviser in an excessive fee lawsuit brought under Section 36(b) of the Investment Company Act of 1940. The Supreme Court will hear oral arguments in the case on November 2 and will issue its opinion before the term ends in June 2010.

In *Jones*, the Court will determine the appropriate standard for a court's review of an excessive fee claim against a fund's adviser under Section 36(b) of the Investment Company Act, which provides a private right of action against mutual fund advisers who breach their fiduciary duty with respect to the receipt of compensation. Prior to this case, most courts reviewed such claims under the *Gartenberg* standard, articulated by the Second Circuit Court of Appeals nearly thirty years ago. This standard has helped shape the advisory contract review process followed by boards and advisers.

IDC's amicus brief and the briefs filed by the respondent (fund adviser) and other amici in support of the respondent (including the Investment Company Institute) are summarized below.

Independent Directors Council

Role of Independent Directors and the Advisory Contract Approval Process

The first part of IDC's brief discusses the important role and responsibilities of independent directors and the rigorous process they follow in evaluating and approving fund advisory contracts. IDC explains that mutual funds are subject to a comprehensive and reticulated set of federal and state requirements; fund directors bear primary responsibility for protecting shareholders; fund boards are robustly independent; and the effectiveness of fund directors is a product not only of their independence from the adviser, but also of the in-depth knowledge they develop through their sustained and ongoing oversight of numerous aspects of fund operation and management.

The brief states that one of the independent directors' most important responsibilities is to annually evaluate and approve the advisory contract, including the amount of compensation paid to the adviser. IDC describes a process that involves a substantial time commitment, and careful consideration of significant amounts of information. The brief explains that while the statute requires one annual in-person meeting of the independent directors for the purpose of evaluating and approving the advisory contract, the process of preparing for that meeting takes several months, and often the entire year. The brief discusses the process and states that boards apply the Gartenberg factors in its consideration.

Standard for Court Review of Section 36(b) Claims

Against the backdrop of the discussion regarding a board's robust independence and the rigor it applies to the contract approval process, the brief then discusses the standard for court review of a claim under Section 36(b) of the Investment Company Act. IDC asserts that, to give effect to the statutory directive of Section 36(b)(2), which provides that approval of adviser compensation by a fund's board of directors "shall be given such consideration by the court as is deemed appropriate under all the circumstances," a court must:

> defer to the independent directors' exercise of their business judgment in approving the advisory fees. In contrast, little or no deference may be due when the directors' approval was a mere formality, or when there were other deficiencies in the approval process so fundamental that they precluded the board from making a business judgment. If (but only if) such fundamental deficiencies are proved, courts may review advisory fees de novo, utilizing factors such as those articulated in *Gartenberg*.

IDC states that petitioners would have courts review fees in the first instance, essentially relegating the independent directors to

advisory status at best and to irrelevance at worst. IDC asserts that this is not the scheme that Congress intended when, in 1970, it enacted Section 36(b), strengthened the provisions for director independence and enhanced Section 15(c). IDC cites the legislative history of the 1970 amendments that states that Congress did not intend for courts to "substitute [their] business judgment for that of the mutual fund's board of directors in the area of management fees." IDC asserts that courts should not be permitted to weigh (or reweigh) the *Gartenberg* factors anew absent proof of a fundamental deficiency in the approval process, noting that there is simply no way to reconcile such *de novo* review with the type of review envisioned by Congress.

IDC asserts that departure from the congressionally mandated deference owed to board decisions absent a fundamental deficiency in the fee approval process would not be in the best interests of investors. Without such deference, plaintiffs' lawyers could find a basis to litigate the fees paid by virtually any mutual fund. And the costs would ultimately be borne by the very investors on whose behalf the litigation is ostensibly brought. As a result, even if directors are not defendants but mere witnesses in Section 36(b) lawsuits, rules that encourage such litigation would "deter" board service by the "qualified individuals" needed to perform the board's independent watchdog function, which would ultimately be detrimental to investors.

Investment Company Institute

Adherence to the Gartenberg Standard

ICI's brief argues that the standard set forth in Gartenberg, especially as implemented in subsequent cases, represents the appropriate approach to judicial review of adviser compensation. ICI argues that the standard—whether a fee received by a mutual fund adviser 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—and the framework that has been developed around it have provided fund boards and advisers with useful guidance, ensured investor protection, and served judicial economy by not embroiling the courts in technical disputes over business judgment.

In ICI's view, the *Gartenberg* decision set forth a flexible analytical framework that allows a court hearing a Section 36(b) claim to decide which factors are most relevant to the case before it. ICI asserts that the factors courts have found to be most relevant are: the nature and quality of services provided to investors; the price of comparable services paid by similar funds; and the expertise, care, and conscientiousness of the fund's independent directors who evaluated and approved the advisory fees. ICI highlights this last factor, arguing that a court deciding a Section 36(b) claim normally should give considerable weight to the fee-approval decision of the fund's independent directors. ICI notes that courts have found other *Gartenberg* factors, including profitability, less useful.

ICI takes issue with petitioners contention that a disparity between the fees an adviser receives from a mutual fund and those it receives from its non-mutual fund institutional clients should be dispositive or "highly probative" in most cases. ICI argues that comparisons between fees paid by mutual funds and by institutional clients can be highly misleading as the services, business risks, portfolio management, and legal and compliance requirements are not comparable.

Competitive Mutual Fund Industry

The second part of ICI's brief demonstrates that the mutual fund industry is a dynamic, competitive industry that provides substantial benefits to investors. ICI explains the fundamental economic relationship between a fund and its adviser, noting that a mutual fund operates as a vehicle through which an adviser can offer diversification and professional management services, and that investors usually choose a mutual fund precisely for the benefit of the adviser's services.

ICI's brief also shows that the market in which fund advisers compete to manage investors' dollars is highly competitive, with large numbers of investors, funds, and advisory firms sponsoring funds and low barriers to entry and exit. ICI explains that investors have ready access to a wealth of information about every mutual fund, including its fee, and have demonstrated a high degree of sensitivity to the level of fund fees. ICI asserts that the competitive mutual fund marketplace benefits investors by giving them a wide choice of funds at low cost, and demonstrates a decades-long decline in the total cost of fund investing.

Respondent Harris Associates. Respondent's brief also defends the Gartenberg standard, arguing that it is faithful to the text, structure, and history of the Investment Company Act and should be adopted by the Court. By contrast, petitioners' proposed standard—requiring "reasonableness" of fees—improperly imports trust law principles that Congress explicitly rejected in the 1970 Amendments to the Investment Company Act. Petitioners also err, in respondent's view, in asserting that Section 36(b) covers non-compliance with the requirements of Section 15(c) and its accompanying regulations. Rather, Section 36(b) only authorizes a remedy for excessive fees. Therefore, an imperfect fee-setting process that does not result in the receipt of disproportionate fees is not a predicate for a Section 36(b) claim. Respondent also explains that a comparison of the fees an adviser charges to mutual funds and those it charges to its institutional clients is probative only if the services provided and risks incurred are comparable, a prerequisite that petitioners have failed to show. Finally, respondent argues that petitioners' proposed standard would impose extraordinary burdens on funds and advisors without commensurate benefits to investors.

Set forth below are summaries (in alphabetical order) of the other briefs filed in support of the respondent. Of particular note are the briefs filed by Fidelity and the Mutual Fund Directors Forum, which discuss the role of fund directors.

Cato Institute. The Cato Institute argues that the Investment Company Act imposes no limit on the amount of compensation an investment adviser may receive, so long as the compensation agreement is freely and honestly adopted by both sides. According to the Cato Institute, because the plain text of Section 36(b) imposes no "reasonableness limitation" on fees, the *Gartenberg* approach should be rejected.

Chamber of Commerce. The Chamber's brief argues that the sole purpose of Section 36(b) is to enable mutual fund investors to recover payments of excessive management fees, not to police the process by which investment advisory fees are set or to challenge a fund's disclosures regarding those fees. Rather, the power to enforce compliance with such procedural safeguards rests solely with the SEC. The Chamber also argues that because neither Section 15(c) nor Section 206 of the Investment Advisers Act of 1940 confers a private right of action, allowing claims under Section 36(b) for conduct governed by those two sections would be an impermissible end-run around their limits. According to the Chamber, permitting holders of mutual fund shares to sue for misleading disclosures under Section 36(b) would also allow plaintiffs to evade the rule (imposed by other federal securities laws) that only purchasers and sellers are entitled to bring disclosure claims. Petitioners' position would also lead precisely to the harms Congress intentionally sought to avoid, such as excessive difficulty in dismissing unmeritorious suits at the pre-trial stage, coercive pressure to settle unmeritorious suits, and detrimental ripple effects in the system, including decreased competition and diminished mutual fund options—all of which ultimately burden investors with the costs of litigation.

Fidelity Management & Research Co. Fidelity's brief argues that the language, structure, and judicial history of Section 36(b), as well as SEC pronouncements, show that Congress created a private cause of action only for fees so unusual or so disproportionate that they could not have resulted from arm's-length bargaining. Fidelity further argues that Congress intended courts to give significant deference to the judgment of independent directors in evaluating and approving the fees. According to Fidelity, this deference is due even if an adviser's fees to institutional clients may be lower than those it charges to mutual funds, because fees to institutional clients do not provide an appropriate comparison, and because isolating portfolio management fees as petitioners propose is rarely possible. In Fidelity's view, to accept petitioners' contrary position—that a court may decide the economic worth of advisory fees—would mire courts in intractable disputes, based on loose economic comparisons and speculation, for which the courts are institutionally unsuited, and would invite suits against every fund.

Law and Finance Professors. Twenty-five professors from well-respected law and business schools argue that the mutual fund industry is robustly competitive and competition constrains advisory fees. According to the professors, the relevant competition is for the investment dollars of individual investors, not for the fund's advisory contract. Accordingly, the professors urge that courts should consider first the fees charged by advisers of similar funds as more probative of arm's-length bargaining than any other measure. The professors also argue that courts should consider evidence of the extent to which competition constrains the fees charged by advisers and whether such competition is likely to be similar to arm's-length bargaining.

Mutual Fund Directors Forum. According to MFDF, the Investment Company Act (and its implementing regulations) specifically assigns responsibility to the board for evaluating and approving advisory contracts, relies on the board to fulfill those functions, and limits judicial intervention for "truly unusual circumstances." Thus, absent unusual circumstances, the directors' decision to approve a particular contract is entitled to deference and should be conclusive. MFDF cites the *Gartenberg* standard with approval, particularly *Gartenberg*'s recognition that the expertise of the independent directors and the extent of care and conscientiousness with which they perform their duties are important factors in assessing a Section 36(b) claim. By contrast, MFDF criticizes the type of mechanical reliance on benchmark comparisons of fees advanced by petitioners as misplaced and inconsistent with Congressional intent.

Securities Industry and Financial Markets Association. SIFMA's brief argues that, contrary to petitioners' suggestion, Congress did not incorporate the common law of trusts into Section 36(b). Moreover, SIFMA argues that even if Section 36(b) did incorporate the law of trusts, trust law only requires (as petitioners recognize) "fairness," and there can be no unfairness here given that petitioners purchased shares in a mutual fund in an arm's-length transaction after fee rates were fully disclosed. According to SIFMA, petitioners and their amici fail to cite a single common law trust case finding a fee unlawful under similar circumstances. SIFMA further argues that directors, not courts, have the "primary" role in determining advisers' compensation. Congress did not intend for courts to substitute their business judgment for that of directors in setting fees. Finally, SIMFA argues that if the marketplace is competitive, courts should apply a presumption that a fiduciary did not breach its duties by charging an excessive fee. But even if the marketplace is not competitive, courts should not second-guess advisers' fees, but should give full consideration to the directors' independence, conscientiousness, and compliance with statutory procedures.

IDC's website will be updated to include a resource page listing all of the relevant materials associated with the Jones v. Harris case. In the meantime, click here for access to the briefs filed in the case.

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