
Original Article

Negotiating mutual fund advisers' fees: The Supreme Court has spoken

Received (in revised form): 30th April 2010

Tamar Frankel

is Professor of Law, Michaels Faculty Scholar, at Boston University School of Law and has written and taught in the areas of mutual funds, securitization, financial system regulation, fiduciary law and corporate governance. She is the author of *Trust and Honesty, America's Business Culture at a Crossroad* (2006), *The Regulation of Money Managers* (2nd edn. with Ann Taylor Schwing) (2nd edn. 2001), *Securitization* (2nd edn. 2006) and *Investment Management Regulation* (2nd edn. 2003 with Clifford E. Kirsch). She has published more than 60 articles and book chapters, and for more than 10 years has co-chaired the ALI-ABA Investment Management Advanced Course with Clifford E. Kirsch. In 1998, Professor Frankel was instrumental in the establishment and corporate structuring of the Internet Corporation for Assigned Names and Numbers (ICANN). A long-time member of the Boston University School of Law faculty, Professor Frankel was a visiting scholar at the Securities and Exchange Commission (1995–1997) and at the Brookings Institution (1987). She has taught and lectured at Oxford University, Tokyo University, Harvard Law School and Harvard Business School, and has consulted with the People's Bank of China. A native of Israel, Professor Frankel served as an attorney in the legal department of the Israeli Air Force, an assistant attorney general for Israel's Ministry of Justice and the legal adviser of the State of Israel Bonds Organization in Europe. She has also been in private practice in Israel, Boston and Washington DC, and is a member of the Massachusetts Bar, the American Law Institute and the American Bar Foundation.

This article offers an update to Professor Frankel's previous paper, 'Mutual fund advisers' fees and executive compensation', published in the *International Journal of Disclosure and Governance* 7(1): 7–19. DOI:10.1057/jdg.2009.26. The online version of the article can be accessed here: <http://www.palgrave-journals.com/jdg/journal/v7/n1/full/jdg200926a.html>.

ABSTRACT On 30 March 2010 the Supreme Court decided *Jones v. Harris Associates L.P.* It has unanimously remanded the case to the lower court with directions concerning mutual fund advisers' fees. The Court rejected the lower court's holding that shareholders should do their due diligence. It held that the funds' boards of directors should negotiate the advisory fees, pursuant to Section 36(b) of the Investment Company Act, and should collect the information necessary to do so, following a 30-year precedent of the Gartenberg case. The Supreme Court suggested a somewhat broader inquiry by the board of directors. The fees must be the result of negotiation between the board and adviser.

International Journal of Disclosure and Governance (2010) 7, 213–215. doi:10.1057/jdg.2010.8; published online 1 July 2010

Keywords: mutual fund; adviser; fees; fiduciary; director

THE SUPREME COURT HAS SPOKEN

On 30 March 2010, the United States Supreme Court entered a unanimous decision in the case

of *Jones v. Harris Associates L.P.* (2010), discussed in my article *Mutual Fund Advisers' Fees and Executive Compensation* (Frankel, 2010). As mentioned in my previous article (Frankel, 2010), the majority opinion of the Seventh Circuit interpreted fiduciary relationships between the mutual funds (and indirectly their shareholders), on the one hand, and the advisers that manage the funds, on the other, as contract relationships, subject to the investment managers' duty to

Correspondence: Tamar Frankel
Boston University School of Law,
765 Commonwealth Avenue, Room 1144,
Boston MA 02215, USA
E-mail: Tfrankel@bu.edu

disclose certain facts to their shareholders. The Seventh Circuit Court held that in light of the thousands of funds and the competition among them, the advisers' fees should be determined by the *investors and the markets*. This process is different from the process envisioned in the Investment Company Act of 1940 under which the advisers have a fiduciary duty to avoid excessive fees.

THE SUPREME COURT DISAGREES WITH THE MAJORITY DECISION OF THE SEVENTH CIRCUIT

In contrast to the Seventh Circuit characterization of fiduciary relationships as agreements with the investors, subject to disclosure, the Supreme Court viewed fiduciary duties as imposed on the advisers towards the funds and their investors. 'Under the [Investment Company] Act, scrutiny of investment adviser compensation by a fully informed mutual fund board is the "cornerstone of the ... effort to control conflicts of interest within mutual funds"'. The Court noted that three decades of interpretation of Section 36(b) of the Investment Company Act (15 U.S.C. §80a-35, 2006) require the funds' directors to evaluate relevant information and determine what advisory fees and expenses are not excessive (Jones, 2010, pp. 22–23).¹

THE SUPREME COURT APPROVED THE GUIDELINES FOR THE DIRECTORS THAT THE SECOND CIRCUIT HAS ESTABLISHED AND THAT OTHER COURTS HAVE FOLLOWED FOR DECADES

(Jones, 2010, pp. 15–17). The Supreme Court held that even though '[t]he meaning of §36(b)'s reference to "a fiduciary duty with respect to the receipt of compensation for services is hardly pellucid" [the Court] conclude[d] that the [Second Circuit's decision] was correct in its basic formulation of what §36(b) requires: to face liability under

§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' (Jones, 2010).²

THE SUPREME COURT ENUNCIATES SOME SUBTLE CHANGES IN GUIDING THE DIRECTORS

Rather than rigidly or almost automatically following comparisons with the fees and expenses charged by advisers to similar funds, the Supreme Court emphasized a more flexible process. A mutual fund board may, and indeed perhaps should, compare the fees charged to pension funds and large institutions for the same services to those charged to the aggregate of small investors represented by the boards. Similarly, following the fees charged to similar funds may not be satisfactory if the followed funds, though similar, have other dissimilar features (Jones, 2010, pp. 25–26).³ Therefore, although the courts are unlikely to overrule the amount of fees and expenses that the boards would agree on, the courts should guide the boards in their considerations and processes following the Supreme Court's suggestion.

THE SUPREME COURT REITERATES THE LEVEL OF JUDICIAL INTERFERENCE ON THE ISSUE

This level is low and its guide is fairly specific. Courts should interfere in the decisions of the directors only when the amounts upon which the boards agreed could not have reasonably been reached through arm's length bargaining. (Jones, 2010, pp. 18–19). The term 'bargaining' used by the Supreme Court sets forth both the process in which fund directors engage with the advisers and the point at which courts should interfere in the outcome of the directors' decision. Judicial interference in the directors' *process* can be expansive. Interference in the *amounts of fees and expenses* to which the directors agreed is fairly restricted.



HOW WOULD THE SUPREME COURT'S DECISION AFFECT OTHER POSSIBLE DISAGREEMENTS CONCERNING MANAGEMENT COMPENSATION?

First, it seems that the Court would strictly follow any statutory provisions that deal with such fees. For example, corporations that received support from the government during the recent financial crisis might be subject to the courts' close following of, and attention to, the statutory provisions that deal with the fees. Second, when the fees of fiduciaries are involved, and when the fiduciaries have a significant influence on the investors' representatives, it is highly unlikely that the Court will shift the duty of negotiating with management to the shareholders and send them to the market. It is more likely that the Court would continue to focus on the process by which the corporate directors represent the shareholders' interests in approving the managements' compensation. After all, the current process in business corporations is not fundamentally different from that of the process relating to advisory fees. However, the Court's emphasis might change the boards' process and the kind and source of the information they gather to achieve and demonstrate an arm's length negotiation.

NOTES

- 1 The opinion quotes *Burks* (1979).
- 2 The opinion quotes 15 U.S.C. §80a-35(b).
- 3 The unanimous Court wrote that '[W]e do not think that there can be any categorical rule regarding the comparisons of the fees charged different types of clients. Instead, courts may give such comparisons the weight that they merit in light of the similarities and differences between the services that the clients in question require, but courts must be wary of inapt comparisons. As the panel below noted, there may be significant differences between the services provided by an investment adviser to a mutual fund and those it provides to a pension fund which are attributable to the greater frequency of shareholder redemptions in a mutual fund, the higher turnover of mutual fund assets, the more burdensome regulatory and legal obligations, and higher marketing costs' (citations omitted).

REFERENCES

- 15 U.S.C. (2006).
Burks v. Lasker, 441 U.S. 471, 482 (1979).
Frankel, T. (2010) Mutual fund advisers fees and executive compensation. *International Journal of Disclosure and Governance* 7(1): 7–19.
Jones v. Harris Assocs. L.P., No. 08-586, 2010 U.S. LEXIS 2926 (U.S. Mar. 30, 2010).