

SUPREME COURT TO CLARIFY INVESTMENT ADVISORS' DUTY TO MUTUAL FUNDS REGARDING MANAGEMENT FEES

During this term, the Supreme Court will decide a case of major significance to investors in mutual funds, the circumstances under which the fees paid to investment advisors for management of mutual funds may be challenged in court under the Investment Company Act of 1940 (ICA), 15 U.S.C. § 80a – 1 *et seq.* Specifically, in *Jones v. Harris Associates L.P.*, the court will address § 36(b) of the Act which imposes a fiduciary duty with respect to compensation for services and creates a right of action for breach of that duty.

Mutual funds provide an attractive investment option in that they allow a large group of individuals to obtain professional management of their investment funds through multiple types and classes of investments. However, because mutual funds are created by investment advisors who not only profit from managing the assets, but also often select affiliated persons to serve on the funds' boards, the relationship carries potential for conflicts of interest. Congress enacted the ICA to mitigate these conflicts.

In *Jones*, a group of investors who owned shares in several mutual funds filed suit against the investment advisors that manage these funds, alleging breach of the advisors' fiduciary duty concerning its compensation. The investors' primary complaint was that the advisors' fees for managing the fund were nearly twice what they charged independent, non-fund clients such as pension funds. The trial court granted summary judgment for the advisors and the United States Court of Appeals for the Seventh Circuit affirmed.

In dismissing the investors' claims, the lower courts created considerable uncertainty as to the standard aggrieved investors must meet in order to prevail on a claim that investment advisors have taken excessive fees in violation of their fiduciary duty under the ICA. Previously, in the leading case in this area, *Gartenberg v. Merrill Lynch Asset Management, Inc.*, 694 F.2d 923 (2nd Cir. 1982), the United States Court of Appeals for the Second Circuit held that the test is "essentially whether the fee schedule represents a charge within the range of what would have been negotiated at arm's-length in the light of all surrounding circumstances." 694 F.2d at 928. In *Jones*, the Seventh Circuit disapproved of the *Gartenberg* approach, instead finding that as long as the advisor has been candid to the fund's board, they cannot be held liable, and that the fees are not subject to any sort of reasonableness standard. 527 F.3d at 632. Under this standard, investors challenging advisors' fees as excessive would have to show that the advisors misled the directors of the fund at issue in order to prove a breach of fiduciary duty under the ICA.

Investors are rightly concerned that the investment advisors who manage mutual funds may be taking fees that are excessive and thus unfairly detrimental to their earnings. Likewise, investment advisors want to know what the courts consider as appropriate and reasonable fees so as to avoid litigation over the reasonableness of their fees. The Supreme Court has granted review and, it is hoped, will provide clear guidance on this issue. Of note, the Obama administration has filed an *amicus* brief in support of the investors, arguing that courts should consider all appropriate circumstances in determining the appropriateness of fees, and investors should not have to show that advisors misled the directors of a fund.

If you have any questions about appropriate and reasonable investment advisor fees, or the status of the Supreme Court case, please contact me at 1-(877) LAW-2555.

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