EXECUTIVE RISKS PRACTICE

Willis

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# MUTUAL FUNDS FEES: HOW MUCH IS TOO MUCH

## ISSUE

The U.S. Supreme Court recently handed down its much anticipated ruling in *Jones vs. Harris,* the landmark excessive mutual fund fee case. While the mutual fund industry initially issued a collective sigh of relief, the decision is not as decisive as many fund managers had hoped for and may very well have opened the door for additional litigation contesting the fees asset managers charge mutual funds.

Alarms were raised in the industry in 2008 when the Seventh Circuit U.S. Appeals Court[1] rejected the long held standard set forth in the *Gartenberg* case that, to be deemed unreasonable, the fees charged a mutual fund by a manager must be "so disproportionately large that they could not have been the result of arm's length bargaining."[2] The Seventh Circuit placed a greater emphasis on market forces in dictating what constitutes reasonable fees and downplayed the role and discretion of independent fund directors in the process. Concern in the industry was that such a standard, if affirmed, would open the floodgates for fee-based litigation

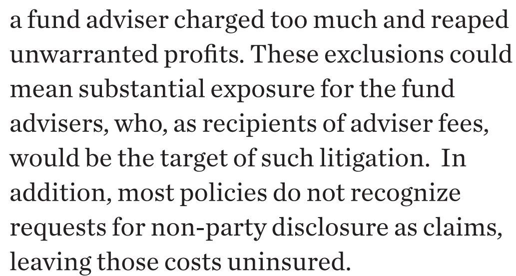
The Supreme Court held *Gartenberg* did apply the correct standard and vacated the Seventh Circuit decision in *Jones vs. Harris,* remanding the matter to the lower court.

## IMPACT

In upholding the *Gartenberg* standard, the Supreme Court stressed that the Investment Company Act of 1940 "requires consideration of all relevant factors" and that the "courts should not rely too heavily upon comparisons with fees charged to mutual funds by other advisors."[3] While some commentators hail the decision as an affirmation of the status quo, there is also the viewpoint that the Court's lessening of the emphasis on peer comparisons of fees paid by other funds is a shareholder victory and that the broader consideration will make it easier for shareholders to prevail on excessive fee cases.

While only time will tell as to the ultimate impact of this decision, one can rest assured that there will be further litigation testing to what extent the decision impacts what is considered a reasonable fee. Such litigation will lead to additional costs associated with defending these actions. In addition, parties who are not sued, such as funds themselves and the independent directors, likely will find themselves the subject of extensive non-party disclosure requests seeking the production of documents and testimony regarding the fees charged. Compliance with these requests requires involvement of counsel and oftentimes the courts if the requests are overreaching or unduly burdensome. These costs are typically borne by the fund or, in fewer instances, the directors themselves.

Most relevant Executive Risks policies carry fee exclusions, meaning that claims related to adviser fees are not covered. Many also include unwarranted profit exclusions, which could come into play if plaintiffs contend that



a fund adviser charged too much and reaped unwarranted profits. These exclusions could mean substantial exposure for the fund advisers, who, as recipients of adviser fees, would be the target of such litigation. In addition, most policies do not recognize requests for non-party disclosure as claims, leaving those costs uninsured.

# ACTION

Insured funds and advisers can expect greater scrutiny from underwriters of the fees charged and how they are calculated. While '40 Act registered advisers and funds generally have received better treatment from underwriters over the past few years than their other financial services brethren, an increase in mutual fund fee litigation could impact the underwriting landscape for them.

In addition, funds and advisers should examine closely their policies to see if there are any fee exclusions and seek their removal or modification to include a carve-back for defense costs related to fee-based litigation. The same is recommended for unwarranted profit exclusions. Fund trustees and executive officers can pursue adding coverage for non-party disclosure costs as well.

# CONTACT

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*The observations, comments and suggestions we have made in this report are advisory and are not intended nor should they be taken as legal or financial advice. Please contact your own legal or financial adviser for an analysis of your specific facts and circumstances.*

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[1] The Seventh Circuit is comprised of federal courts in Illinois, Indiana and Wisconsin.
[2] *Gartenberg v. Merrill Lynch Asset Management, Inc.*, 694 F. 2d 923 (CA2 1982).
[3] *Jones vs. Harris Associates, L.P.*, Case No. 08-586 (3/30/2010)