SEC Backs *Gartenberg* Standard in Supreme Court Case

BY PATRICK LAVELLE

For over two decades the Second Circuit's *Gartenberg* decision has set forth guiding principles for reviewing lawsuits brought under Section 36(b) of the Investment Company Act. Now, with oral arguments before the Supreme Court in *Jones v. Harris Associates* set to begin November 2, 2009, the SEC and Department of Justice have filed jointly an amicus brief, on behalf of the United States, disagreeing with the Seventh Circuit's rejection of the Gartenberg standard.

The SEC finds two fundamental flaws in the Seventh Circuit's decision. First, the SEC disagrees that the adviser's fiduciary duty under Section 36(b) is limited to complete and accurate disclosure of information related to the advisory contract. Second, the SEC disagrees that "the only suitable benchmark" for evaluating the reasonableness of the adviser's fees are the fees paid by comparable investment companies.

In its brief, the SEC counters that a fully informed board's approval of compensation is not conclusive and does not guarantee against a fiduciary breach under Section 36(b). Rather, there must be an analysis of all relevant circumstances, as indicated in *Gartenberg*, to determine whether compensation received by the adviser is within a range of fees that arm's-length bargaining might have produced. In conducting that inquiry, the SEC contends that there should be a review of not only the fees paid by other investment companies, but also the fees the adviser charges unaffiliated clients for comparable services, if applicable.

In sum, the SEC advocates the view that while a board's approval is not determinative, its receipt of necessary information and its careful consideration of the *Gartenberg* factors when approving advisory compensation is "strong probative evidence that the adviser has complied with its fiduciary obligation."

Court Follows *Gartenberg* in Post-*Harris Associates* Decision

BY STEPHANIE FICHERA

In *In re American Funds Fee Litigation*, a recent decision by the U.S. District Court for the Central District of California, investors in several American Funds mutual funds brought a derivative action against a registered investment adviser and its subsidiary, a registered broker-dealer and American Funds' distributor and underwriter, alleging that they breached their fiduciary duties to investors under Section 36(b) of the Investment Company Act of 1940 in connection with various fees charged to the funds.

The court elected to apply the standard for a Section 36(b) case set forth by the Second Circuit in *Gartenberg v. Merrill Lynch Asset Management, Inc.*, notwithstanding contrary law in the Seventh and Eighth Circuits and the court's recognition that *Gartenberg* "establishes a barrier so high that the Court [could find] no instance where an investor/plaintiff successfully met that burden." The court rejected the Seventh Circuit's *Jones v. Harris Associates* L.P., which is presently under review by the U.S. Supreme Court, on the ground that its standard created an even higher burden for investors. The court likewise rejected the Eighth Circuit's *Gallus v. Ameriprise Financial, Inc.*, arguing that it created a cause of action broader than what is contemplated by Section 36(b).

Gartenberg standard overshadows Seventh Circuit decision

Applying the several factors outlined in *Gartenberg* for deciding Section 36(b) cases, the court held that plaintiffs failed to meet their burden of proving that defendants had breached their fiduciary duties to investors. The court supported its decision with the following findings: plaintiffs failed to present sufficient evidence to prove that the nature and quality of defendants' services were lacking or disproportionate to the fees charged; the funds' profitability to the investment adviser was within the range deemed acceptable under Section 36(b); plaintiffs failed to show that economies of scale existed and were not adequately shared with investors; and defendants showed that their unaffiliated directors were sufficiently independent and conscientious to satisfy *Gartenberg*.