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Opinion

Gallus Fee Decision Is No Panacea for Fund Boards

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Last week's decision by a panel of Eighth Circuit Court of Appeals judges in the Gallus advisory fee case was a relief for many in the mutual fund industry. The court ruled in favor of **Ameriprise Financial**, and this case is now essentially over. However, the Securities and Exchange Commission may pick up where the plaintiffs bar is leaving off, making it necessary for fund boards to remain vigilant on excessive-fee issues.

In its Gallus ruling, the Court of Appeals determined that the advisory fee review process used by the Ameriprise fund board was "robust." It also concluded that the lower court's review of the disputed fees was a "rigorous look at the outcome." A robust board process and a rigorous court review were two of the standards recently articulated by the U.S. Supreme Court in its Jones v. **Harris Associates** opinion.

But the Gallus decision was actually a surprising outcome, given the plaintiffs' allegations that Ameriprise Financial charged its mutual fund clients more than twice as much for advisory services than it charged its institutional clients. Since fees for institutional accounts are established through a more competitive process than fees for retail funds, the plaintiffs in the Gallus case argued that the large disparity demonstrated that the fund fees were costlier than what would have been charged had they resulted from an arm's length negotiation.

Outside of the mutual fund industry, it is hard to defend a 2:1 pricing disparity for similar services when a truly competitive process is used for price discovery.

At issue now is whether advisory services to institutional accounts are significantly different from advisory services to retail funds. It is unfortunate that the plaintiffs in Gallus were not able to have the benefit of a trial to test the premise that there are substantial similarities in the delivery of advisory services to different types of clients. During oral arguments, plaintiffs' counsel stressed that purchases and sales of equities by the investment adviser were often handled in the exact same manner across all institutional accounts and retail funds, in order to ensure that the adviser complied with the fiduciary duties owed to all its clients.

Previous court decisions have discussed the difficulties of comparing institutional and retail advisory fees. The conclusions by these courts focused on the additional services that a mutual fund must provide to its retail shareholders and the importance of making fee comparisons on an "apples to apples" basis. This is a fair point. For example, investment advisers to institutional accounts do not have to contend with the additional regulatory obligations placed on mutual funds and the higher costs of marketing and distributing funds to retail shareholders.

However, these court opinions gloss over the fact that mutual funds and their advisers utilize a financing structure outside of the advisory fees they charge – a structure that relies on 12b-1 fees, account maintenance charges, and revenue sharing payments – to compensate themselves and various intermediaries for the unique

services that retail investors require. In fact, for many advisers, the actual investment services being provided through the advisory fee to institutional and retail investors are not as disparate as the industry has argued in excessive-fee cases like Gallus.

Once a similarity in advisory services is established, it is hard to argue that retail investors should be paying more than twice what institutional investors are paying, especially when the latter are subject to a more competitive negotiating process.

Despite the Gallus ruling, the issue of excessive fees is not going away. Independent directors should be mindful of the fact that the SEC has separate authority to bring excessive-fee cases under section 36(b) of the Investment Company Act. As has been well publicized, the SEC has created the Asset Management Unit that is looking hard at excessive fees of all kinds under the agency's Mutual Fund Fee Initiative. Private litigation may be replaced by increased SEC enforcement proceedings.

Fund boards should develop a fee review framework that compares services rendered by an adviser to different groups of investors, keeping in mind what those services would cost in a competitive process for price discovery. Only through the implementation of a truly robust fee review process can independent directors satisfy themselves that they are serving as "watchdogs" to protect the interests of fund shareholders.

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