

THE SUPREME COURT’S REVIEW OF *JONES V. HARRIS ASSOCIATES* AND § 36(b) CLAIMS UNDER THE INVESTMENT COMPANY ACT OF 1940—A PROSPECTIVE AND ANALYTICAL VIEW

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INTRODUCTION

Since its enactment, no plaintiff has ever prevailed in a court case challenging the size of an advisory fee charged by a mutual fund adviser under § 36(b) of the Investment Company Act of 1940 (the “ICA”).¹ That is unlikely to change if the United States Supreme Court adopts the standard for advisory fee cases under § 36(b) set forth in the Seventh Circuit Court of Appeals decision in *Jones v. Harris Associates L.P.*² On March 9, 2009, the United States Supreme

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1. John P. Freeman, Stewart L. Brown & Steve Pomerantz, *Mutual Fund Advisory Fees: New Evidence and a Fair Fiduciary Duty Test*, 61 OKLA. L. REV. 83, 86 (2008).

2. *Jones v. Harris Assoc. L.P.*, 527 F.3d 627 (7th Cir. 2008).

Court granted a Writ of Certiorari³ to hear an appeal of the Seventh District Court of Appeals' decision in *Jones*, and is expected to establish the liability standard for plaintiffs asserting claims alleging that a mutual fund adviser has run afoul of its "fiduciary duty" under § 36(b). The Court's decision in *Jones* is expected to have great ramifications for the mutual fund industry, as it construes the "fiduciary duty" standard set forth in § 36(b) of the ICA.⁴ It is the opinion of these authors that, depending upon the Supreme Court's holding in *Jones*, the decision could have wide-reaching effects not only for mutual fund advisers and investors, but for all registered investment advisers.

This article addresses the Seventh Circuit's decision in *Jones*, its deviation from a well-entrenched § 36(b) standard established by the Second Circuit Court of Appeals in *Gartenberg v. Merrill Lynch Asset Mgmt., Inc.*,⁵ and the manner in which the Supreme Court is expected to analyze the *Jones* decision and § 36(b) in general. Part one will provide a discussion of investment companies regulated by the ICA, certain ICA provisions relevant to this discussion, and a review of § 36(b) in particular. Part two will provide a perspective on the *Jones* case from a non-legal standpoint, as well as discussion of the procedural history and lower court rulings. Part three will focus on a § 36(b) case decided subsequent to *Jones*, and how the standard set forth in that decision may impact the Supreme Court's review in *Jones*. Part four will discuss the various amicus briefs submitted in the Supreme Court case, discussing how the opinions contained therein may impact the Supreme Court's decision. Part five discusses these authors' view on how the Supreme Court could be expected to rule on the *Jones* case, and the reasons therefore. Finally, part six discusses the practical implications which could emanate from the *Jones* decision, and contains a commentary on § 36(b)'s purpose and effectiveness from the authors' perspective. One thing is for certain—everyone can agree with the *Jones* petitioners' assertion in their Writ of Certiorari brief that "proper interpretation of § 36(b) presents a question of surpassing importance to the 44 percent of American

3. Petition for Writ of Certiorari, *Jones*, 129 S. Ct. 1579 (2009).

4. 15 U.S.C. § 80a-35(b) (2006).

5. *Gartenberg v. Merrill Lynch Asset Mgmt., Inc.*, 694 F.2d 923 (2d Cir. 1982).

families with \$11.5 trillion in retirement and personal savings invested in mutual funds.”⁶

1. *Discussion of Investment Companies, The ICA, and § 36(b)*

While mutual funds are theoretically owned by shareholders who purchase shares of the fund through various outlets, in practice, mutual funds are created and managed by investment advisers who, virtually without exception, are then retained by the fund they have created to manage the fund’s securities portfolio.⁷ The advisers are then compensated for services provided to the mutual fund by virtue of agreements between the fund and the adviser. “In the nascent stages of a fund’s development, the adviser often has the ability to influence who will sit on the fund’s board of directors, though this power is limited by federal securities regulations on director independence.”⁸

The ICA was enacted with a view towards regulating certain perceived “inherent abuses” which could arise from advisers entering into advisory fee contracts with the funds they have created, and the fund boards they have designated. The ICA’s purpose and main statutory thrust were succinctly summarized by the United States Supreme Court in *Daily Income Fund, Inc. v. Fox* as follows:

Congress adopted the Investment Company Act of 1940 because of its concern with “the potential for abuse inherent in the structure of investment companies.” *Burks v. Lasker*, 441 U.S. 471, 480, 99 S.Ct. 1831, 1838, 60 L.Ed.2d 404 (1979). Unlike most corporations, an investment company is typically created and managed by a pre-existing external organization known as an investment adviser. *Id.*, at 481, 99 S.Ct., at 1838. Because the adviser generally supervises the daily operation of the fund and often selects affiliated persons to

6. Petition for a Writ of Certiorari at *3, *Jones*, No. 08-586, 2008 WL 4792489 (Nov. 3, 2008) (citing INVESTMENT COMPANY INSTITUTE, *Trends in Ownership of Mutual Funds in the United States, 2007*, 1 (Nov. 2007) available at <http://www.ici.org/pdf/fm-v16n5.pdf>; INVESTMENT COMPANY INSTITUTE, *Trends in Mutual Fund Investing, August 2008* (Sept. 29, 2008), available at http://www.ici.org/stats/latest/trends_08_08.html#TopOfPage).

7. *Gallus v. Ameriprise Fin., Inc.*, 561 F.3d 816, 820 (8th Cir. 2009) (citing *Burks v. Lasker*, 441 U.S. 471, 480-81 (1979)).

8. *Gallus*, 561 F.3d at 820 (citing William A. Birdthistle, *Compensating Power: An Analysis of Rents and Rewards in the Mutual Fund Industry*, 80 TUL. L. REV. 1401, 1422 (2006); *Burks*, 441 U.S. at 482-83).

serve on the company's board of directors, the "relationship between investment advisers and mutual funds is fraught with potential conflicts of interest." *Ibid.*, quoting *Galfand v. Chestnutt Corp.*, 545 F.2d 807, 808 (2d Cir. 1976). In order to minimize such conflicts of interests, Congress established a scheme that regulates most transactions between investment companies and their advisers, 15 U.S.C. § 80a-17; limits the number of persons affiliated with the adviser who may serve on the fund's board of directors, § 80a-10; and requires that fees for investment advice and other services be governed by a written contract approved both by the directors and the shareholders of the fund, § 80a-15.⁹

The ICA requires that no more than forty percent of the mutual fund's board of directors may be "interested persons" of the adviser.¹⁰ When considering the advisory contract presented by the fund's investment adviser, the contract may only be approved if adopted by a majority vote of the "disinterested" directors.¹¹

Reacting to perceptions in the investment community that investment advisers continued to unduly profit from their relationship with mutual funds at consumers' expense, Congress revisited its prior regulation of investment companies via the ICA. After years of litigation over whether investors had a private right of action for violations of the ICA, and if so, what standard applied to such cases, § 36 expressly created a private right of action for the receipt of unlawful advisory fees by investment advisers. In original versions of §36(b) debated in Congress, the SEC suggested a "reasonableness" standard governing advisers' receipt of fees.¹² The reasonableness standard was heavily opposed by industry professionals. Eventually, the industry accepted a "fiduciary duty" standard in § 36(b), with a brief damages period limited to one year prior to institution of the lawsuit.¹³

Pursuant to §36(b), investment advisers have a fiduciary duty with respect to receipt of fees:

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9. *Daily Income Fund, Inc. v. Fox*, 464 U.S. 523, 536 (1984).
 10. Investment Company Act of 1940 § 10(a), 15 U.S.C. § 80a-10(a)(2006).
 11. Investment Company Act of 1940 § 15(c), 15 U.S.C. § 80a-15(c)(2006).
 12. See *Gartenberg*, 694 F.2d at 928 (citing Investment Company Amendments Act of 1970, S. Rep. No. 91-184, (1970); Investment Company Amendments Act of 1970, H.R. Rep. No. 91-1382, (1970)).
 13. Investment Company Act of 1940 § 36(b)(3), 15 U.S.C. § 80a-35(b)(3).

For the purposes of this subsection, the investment adviser of a registered investment company shall be deemed to have a fiduciary duty with respect to the receipt of compensation for services, or of payments of a material nature, paid by such registered investment company or by the security holders thereof, to such investment adviser or any affiliated person of such investment adviser. An action may be brought under this subsection by the Commission, or by a security holder of such registered investment company on behalf of such company, against such investment adviser, or any affiliated person of such investment adviser, or any other person enumerated in subsection (a) of this section who has a fiduciary duty concerning such compensation or payments, for breach of fiduciary duty in respect of such compensation or payments paid by such registered investment company or by the security holders thereof to such investment adviser or person.¹⁴

Section 36(b) expressly relieves shareholders of the obligation to prove misconduct by the adviser.¹⁵ Furthermore, approval of the adviser's compensation by the fund's directors does not relieve the adviser of all liability, as such approval is merely to be "given such consideration by the court as is deemed appropriate under all the circumstances."¹⁶ Recovery for violations of § 36(b) is limited to actual damages for a period of one year prior to suit.¹⁷ Pursuant to § 1(b), the statute is to be interpreted in the "best interest of investors."

Since 1982, courts and litigants have analyzed § 36(b) claims under the standard established by *Gartenberg v. Merrill Lynch Asset Mgmt., Inc.*¹⁸ The *Gartenberg* court articulated two inquiries in evaluating fee cases asserted under § 36(b): (1) "Whether the fee schedule represents a charge within the range of what would have been negotiated at arm's-length in light of all the surrounding circumstances"; and (2) Whether the adviser is charging "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."¹⁹

14. 15 U.S.C. § 80a-35(b).

15. § 80a-35(b)(1).

16. § 80a-35(b)(2).

17. § 80a-35(b)(3).

18. *Gartenberg*, 694 F.2d at 923.

19. *Id.* at 928.

2. Background History of the *Jones v. Harris Associates* Case

The *Jones* complaint was one of a series of complaints filed by, among others, a group of lawyers who had broken away from the Charleston, South Carolina firm of Ness, Motley, Loadholdt, Richardson & Poule, a firm noted for asbestos litigation and having secured the \$246 billion tobacco settlement for the state. The economic stakes in the *Jones* litigation are enormous as well. A move of only fifty basis points in the fee charged a \$12 billion fund complex would save the shareholders \$60 million annually. Across the mutual fund industry as a whole, judicial regulation of investment advisory fees carries immense stakes for investment advisers, mutual fund shareholders, and plaintiff's attorneys alike.

The original complaint filed in the U.S. District Court for the Western District of Missouri²⁰ named three individual plaintiffs and one defendant,²¹ Harris Associates L.P. Harris was the investment adviser for the Oakmark Funds, six open-end mutual funds based in Chicago, Illinois.²² Each of the Oakmark Funds is organized as a Massachusetts business trust and is overseen by the board of trustees of Harris Associates Investment Trust.²³ The plaintiffs were owners of shares of several of the Oakmark Funds.²⁴ The complaint alleged that Harris charged the funds advisory fees that far exceeded the fees charged other clients for identical services.²⁵ The complaint alleged that the standard applicable to the § 36(b) claim was that adopted by the Second Circuit in *Gartenberg*.²⁶ The defendants successfully moved pursuant to 28 U.S.C. § 1404(a) to transfer venue to the Northern District of Illinois.²⁷ There, an amended complaint was filed.²⁸

20. Case No. 04-4184-CV-C-NKL.

21. *Jones v. Harris Assoc. L.P.*, No. 04 C 8305, 2007 WL 627640, at *2 n.3 (N.D. Ill. Feb. 27, 2007).

22. *Jones*, 2007 WL 627640, at *1.

23. See *id.* at *2.

24. *Id.* at *1.

25. *Id.* at *3.

26. See *id.* at *6-7.

27. Court Order, *Jones et al. v. Harris Assoc. L.P.*, 1:04cv08305, (N.D. Ill., Dec. 28, 2004) (“[T]he Court finds that allowing the action to proceed in the Western District of Missouri would significantly inconvenience the parties and witnesses, and would not promote the interests of justice.”).

28. *Jones*, 2007 WL 627640, at *2 n.3.

The amended complaint also expressly invoked the *Gartenberg* standard as controlling.

Harris Associates was responsible for founding and establishing the Oakmark funds. Each year, the Oakmark Board reselects Harris Associates as the fund adviser. Harris Associates then manages the entire Oakmark portfolio.²⁹ As alleged by the plaintiffs, Harris Associates charges the mutual fund shareholders twice the management fees that it charges its institutional clients. Fees for the Oakmark fund were 1% of first \$2 billion in assets, with certain “breakpoints” established thereafter.³⁰ By contrast, fees for independent clients were roughly 0.5% of first \$500 million.³¹

Although the plaintiffs’ complaints were based upon the *Gartenberg* standard, after conducting discovery, plaintiffs abandoned *Gartenberg*, apparently concluding that they could not satisfy that standard. Plaintiffs argued against summary judgment based upon *Gartenberg*, but noted at p. 6, fn. 4 of their Opposition Brief:

Though the facts of this case clearly surpass what is required by the *Gartenberg* standard, Plaintiffs do not agree that *Gartenberg* sets forth the appropriate test for determining whether a violation of § 36(b) has occurred. While Plaintiffs acknowledge that the Second and Fourth Circuits have applied this standard when analyzing excessive fee claims under § 36(b), this Circuit, like the Third Circuit, views § 36(b) more broadly. *Green v. Nuveen Advisory Corp.*, 295 F.3d 738, 743 n. 8 (7th Cir. 2002). In light of the Seventh Circuit’s broader view of the scope of § 36(b), Plaintiffs question whether this Circuit would adopt the *Gartenberg* standard, which departs so dramatically from the notion of what constitutes a breach of fiduciary duty. Nevertheless, Plain-

29. *Jones*, 527 F.3d at 631.

30. *Id.* “Oakmark Fund paid Harris Associates 1% (per year) of the first \$2 billion of the fund’s assets, 0.9% of the next \$1 billion, 0.8% of the next \$2 billion, and 0.75% of anything over \$5 billion”. *Id.*

31. *Id.* “Harris Associates, like many other investment advisers, has institutional clients (such as pension funds) that pay less. For a client with investment goals similar to Oakmark Fund, Harris Associates charges 0.75% of the first \$15 million under management and 0.35% of the amount over \$500 million. . . .” *Id.*

tiffs respond to Harris' motion based on the *Gartenberg* test.³²

Disagreeing with the plaintiffs, the District Court followed *Gartenberg*, holding that to sustain a § 36(b) claim, the plaintiff must show that the fees were unreasonable, or that they "were so disproportionately large that they could not have been the result of arm's-length bargaining."³³ Because the Harris fees were "ordinary" and similar to those of other funds, the District Court held that Harris' fees did not violate § 36(b).³⁴

On appeal to the Seventh Circuit Court of Appeals, the plaintiffs again disclaimed the *Gartenberg* standard.³⁵ The plaintiffs advanced two primary arguments as to why *Gartenberg* should not be followed.³⁶ First, plaintiffs asserted that *Gartenberg* relies too heavily on market prices in the mutual fund industry as the benchmark of reasonable fees.³⁷ Plaintiffs asserted that using the fees charged by other mutual funds "is inappropriate because fees are set incestuously rather than by competition."³⁸ Second, plaintiffs asserted "that if any market should be used as the benchmark, it is the market for advisory services to unaffiliated institutional clients."³⁹

As summarized in the Seventh Circuit's opinion:

The first argument stems from the fact that investment advisers create mutual funds, which they dominate notwithstanding the statutory requirement that 40% of trustees be disinterested. Few mutual funds ever change advisers, and plaintiffs conclude from this that the market for advisers is not competitive. The second argument rests on the fact that Harris Associates, like many other investment advisers, has institutional clients (such as pension funds) that pay less. For a client with investment goals similar to Oakmark Fund, Harris Associates charges 0.75% of the first \$15 million under management and 0.35% of the amount over \$500 million, with

32. Memorandum of Law in Support of Plaintiffs' Opposition to Defendant Harris Associates, L.P.'s Motion for Summary Judgment at 6 n.4, *Jones*, 2006 WL 3673446 (N.D. Ill., Oct. 10, 2006).

33. *Jones*, 2007 WL 627640, at *7.

34. *Id.* at *8.

35. *Jones*, 527 F.3d at 631.

36. *Id.*

37. *Id.*

38. *Id.*

39. *Id.*

intermediate breakpoints. Plaintiffs maintain that a fiduciary may charge its controlled clients no more than its independent clients.⁴⁰

The Seventh Circuit agreed to abandon *Gartenberg*, but did not adopt the plaintiffs' suggested standard.⁴¹ Rather, the Seventh Circuit found that the law only requires advisers to be transparent.⁴² The Court set a "play no tricks" standard, stating that advisers are not subject to a cap on compensation:

A fiduciary differs from rate regulation. A fiduciary must make full disclosure and play no tricks but is not subject to a cap on compensation. The trustees (and in the end, investors who vote with their feet and dollars), rather than a judge or jury, determine how much advisory services are worth.⁴³

The Seventh Circuit abandoned any notion that mutual fund advisory fees must be "reasonable," a standard urged without success by the plaintiffs: "Section 36(b) does not say that fees must be 'reasonable' in relation to a judicially created standard. It says instead that the adviser has a fiduciary duty. That is a familiar word; to use it is to summon up the law of trusts."⁴⁴ Applying its interpretation of trust law, the court stated that a trustee "owes an obligation of candor in negotiation, and honesty in performance, but may negotiate in his own interest and accept what the settlor or governance institution agrees to pay."⁴⁵

The court did not completely foreclose the possibility that a plaintiff could prevail based solely upon an irrationally high fee. However, the court's standard would require proof of "compensation so unusual that a court will infer that deceit must have occurred, or that the persons responsible for decision have abdicated"⁴⁶ Absent such unusual circumstances, it is apparent that, after the Seventh Circuit's decision in *Jones*, plaintiffs in that Circuit would in most instances be required to demonstrate conduct by the adviser tantamount to fraud upon the mutual fund board in order to prevail on a § 36(b) case.

40. *Jones*, 527 F.3d at 631.

41. *Id.* at 632.

42. *Id.*

43. *Id.*

44. *Id.* (citing *Firestone Tire & Rubber Co. v. Bruch*, 489 U.S. 101 (1989)).

45. *Jones*, 527 F.3d at 632 (citing RESTATEMENT (SECOND) OF TRUSTS § 242 & cmt. f).

46. *Id.*

Chief Judge Frank H. Easterbrook opined that *Gartenberg*'s "reasonableness" standard requires judicial rate regulation that is not mandated by the statute and is ineffective for protecting investors.⁴⁷ Judge Easterbrook stated that § 36(b) does not require that an adviser's fees be reasonable.⁴⁸ The Seventh Circuit's opinion in *Jones* found that many sophisticated investors in hedge funds pay disproportionately high fees, and therefore, high fees alone are insufficient to support a fiduciary duty claim under the statute.⁴⁹

The Seventh Circuit's decision is highly dependant upon the notion that market forces will constrain advisory fees.⁵⁰ Writing for the majority, Judge Easterbrook acknowledged that mutual funds rarely fire their advisers, but that "investors can and do 'fire' advisers cheaply and easily by moving their money elsewhere."⁵¹ The court relied upon a study conducted by Professors John C. Coats and R. Glenn Hubbard, which stated that mutual fund fees are kept in check by the threat of investors moving money elsewhere.⁵² The Seventh Circuit decision relied heavily upon its perception of the operation of competitive markets in the mutual fund industry. The court stated that while competitive markets may be an imperfect mechanism for eliminating outlying fees, "the judicial process is worse."⁵³ "[R]egulating advisory fees through litigation is unlikely to do more good than harm."⁵⁴

On August 8, 2008, nearly 3 months after Judge Easterbrook's opinion in *Jones*, Judge Richard A. Posner filed a dissent to the Se-

47. *Id.* at 633.

48. *Id.* "The existence of the fiduciary duty does not imply judicial review for reasonableness; the question a court will ask, if the fee is contested, is whether the client made a voluntary choice *ex ante* with the benefit of adequate information." *Id.*

49. *Id.* at 634 (citing René M. Stulz, *Hedge Funds: Past, Present, and Future*, 21 J. ECON. PERSP. 175 (2007); Joseph Golec & Laura Starks, *Performance Fee Contract Change and Mutual Fund Risk*, 73 J. FIN. ECON. 93 (2004)).

50. *Jones*, 527 F.3d at 632 ("So just as plaintiffs are skeptical of *Gartenberg* because it relies too heavily on markets, we are skeptical about *Gartenberg* because it relies too little on markets.").

51. *Id.* at 634.

52. *Id.* (citing John C. Coates & R. Glenn Hubbard, *Competition in the Mutual Fund Industry: Evidence and Implications for Policy*, 33 IOWA J. CORP. L. 151 (2007)).

53. *Id.* at 633.

54. *Id.* at 634 (citing John C. Coates & R. Glenn Hubbard, *Competition in the Mutual Fund Industry: Evidence and Implications for Policy*, 33 IOWA J. CORP. L. 151 (2007)).

venth Circuit's decision to deny a rehearing of the case *en banc*.⁵⁵ Judge Posner's dissent was joined by Circuit Judges Ilana Diamond Rovner, Diane P. Wood, Ann Claire Williams, and John D. Tinder.⁵⁶ None of these judges served on the original *Jones* panel.⁵⁷

The Posner dissent disagreed with the Seventh Circuit's willingness to overturn years of federal court precedent relying upon the *Gartenberg* standard, finding that *Jones* was the only case that had expressed disapproval with the Second Circuit opinion.⁵⁸ The Posner dissent further opined that the market forces approach employed in the panel's decision was inappropriate to establish a standard for evaluating § 36(b) cases, finding that it was based upon "an economic analysis that is ripe for reexamination on the basis of growing indications that executive compensation in large publicly traded firms often is excessive because of the feeble incentives of boards of directors to police compensation."⁵⁹ Judge Posner noted that the Harris-Oakmont situation is a prime example of the type of incestuous relationship

55. *Jones v. Harris Assoc. L.P.*, 537 F.3d 728 (7th Cir. 2008).

56. *Jones*, 537 F.3d at 729.

57. *Jones*, 527 F.3d at 629. This proceeding was before Chief Judge Easterbrook, and Circuit Judges Michael S. Kanne and Terence T. Evans. *Id.*

58. *Jones*, 537 F.3d at 729 ("*Jones* is the only appellate opinion noted in Westlaw as disagreeing with *Gartenberg*; there are a slew of positive citations." (citing *Migdal v. Rowe Price-Fleming Int'l, Inc.*, 248 F.3d 321, 326-27 (4th Cir. 2001); *In re Salomon Smith Barney Mutual Fund Fees Litigation*, 528 F. Supp. 2d 332, 336-37 (S.D.N.Y. 2007); *Gallus v. Ameriprise Financial, Inc.*, 497 F. Supp. 2d 974, 979 (D. Minn.2007); *Sins v. Janus Capital Management, LLC*, 2006 WL 3746130, at *2 (D. Colo. 2006); *Siemers v. Wells Fargo & Co.*, 2006 WL 2355411, at *15-16 (N.D. Cal. 2006); *Hunt v. Invesco Funds Group, Inc.*, 2006 WL 1581846, at *2 (S.D. Tex. 2006); *Stegall v. Ladner* 394 F. Supp. 2d 358, 373-74 (D. Mass. 2005); *Becherer v. Burt*, 2003 WL 24260305, at *2 (S.D.Ill. 2003); *Millenco L.P. v. MEVC Advisors, Inc.*, 2002 WL 31051604, at *3 (D. Del. 2002))).

59. *Jones*, 537 F.3d at 730 (citing Lucian Bebchuk & Jesse Fried, *PAY WITHOUT PERFORMANCE: THE UNFILFILLED PROMISE OF EXECUTIVE COMPENSATION* 23-44 (2004); Charles A. O'Reilly III & Brian G.M. Main, *It's More Than Simple Economics*, 36 *ORG. DYNAMICS* 1 (2007); Ivan E. Brick, Oded Palmon & John K. Wald, *CEO Compensation, Director Compensation, and Firm Performance: Evidence of Cronyism?*, 12 *J. CORP. FIN.* 403 (2006); Arthur Levitt, Jr., *Corporate Culture and the Problem of Executive Compensation*, 30 *J. CORP. LAW* 749, 750 (2005); Gary Wilson, *How to Rein in the Imperial CEO*, *WALL ST. J.*, July 9, 2008, at A15; Joann S. Lublin, *Boards Flex Their Pay Muscles: Directors Are Increasingly Exercising More Clout in Setting CEO Compensation; and in Some Cases, the Boss Is Actually Feeling a Little Pain*, *WALL ST. J.*, Apr. 14, 2008, at R1; Ben Stein, *In the Boardroom, Every Back Gets Scratched*, *N.Y. TIMES*, Apr. 6, 2008, at B9).

§ 36(b) was enacted to address: “The Oakmark-Harris relationship matches the arrangement described in the Senate Report accompanying § 36(b): a fund ‘organized by its investment adviser which provides it with almost all management services.’”⁶⁰ Thus, Judge Posner, in his dissent seemed to agree with the plaintiffs, arguing that a meaningful benchmark could not be established merely by comparing fees across the mutual fund industry:

The governance structure that enables mutual fund advisers to charge exorbitant fees is industry-wide, so the panel's comparability approach would if widely followed allow those fees to become the industry's floor. And in this case there was an alternative comparison, rejected by the panel on the basis of airy speculation-comparison of the fees that Harris charges independent funds with the much higher fees that it charges the funds it controls.⁶¹

While the Posner dissent conceded that the “*outcome* of this case may be correct,”⁶² it nonetheless disagreed with the panel's unwillingness to rehear the case: “[T]he creation of a circuit split, the importance of the issue to the mutual fund industry, and the one-sided character of the panel's analysis warrant our hearing the case en banc.”⁶³ However, until the Supreme Court issues a ruling to the contrary, the panel opinion in *Jones* establishes the standard for § 36(b) claims in the Seventh Circuit, and is subject to being adopted by other federal courts addressing claims under § 36(b).

3. *The Eighth Circuit Court of Appeals Decision in Gallus v. Ameriprise Financial, Inc.*

The Eighth Circuit Court of Appeals' decision in *Gallus v. Ameriprise Financial, Inc.*⁶⁴ poses an interesting alternative to the battle of theories proposed by the *Gartenberg* and *Jones* decisions. In *Gallus*, the plaintiffs sued their mutual fund advisers over allegedly high fees, arguing that Ameriprise provided lower fees to its institutional clients

60. *Jones*, 537 F.3d at 731 (citing S. REP. No. 91-184, (1969)).

61. *Id.* at 732.

62. *Id.*

63. *Id.* at 732-33.

64. *Gallus v. Ameriprise Fin., Inc.*, 561 F.3d 816, 820 (8th Cir. 2009).

and that Ameriprise mislead the fund board during fee negotiations regarding fees charged to its institutional clients.⁶⁵

The district court granted summary judgment for the defendants based upon the *Gartenberg* standard. The district court found that the defendants satisfied *Gartenberg* because the fees were in line with industry norms.⁶⁶ However, the Eighth Circuit held that the district court “construed too narrowly the extent of the defendants’ duty under § 36(b)”⁶⁷ “The *Gartenberg* case demonstrates one way in which a fund adviser can breach its fiduciary duty, but it is not the only way.”⁶⁸ The Eighth Circuit ultimately adopted a test which is essentially an amalgam of the *Gartenberg* and *Jones* tests, while also adopting the *Jones* plaintiffs’ argument that a court should consider the fees charged by an adviser to its unrelated, institutional clients. The Eighth Circuit read into § 36(b) an obligation by fund advisers to be “honest and transparent” in the negotiation process.⁶⁹ The court also took issue with the manner in which *Gartenberg* had been applied.

[T]he standard that the Second Circuit enunciated should not be construed to create a safe harbor of exorbitance, for under such a view an adviser's fiduciary duty would be diluted to a simple and easily satisfiable requirement not to charge a fee that is egregiously out of line with industry norms. To apply *Gartenberg* in this fashion across the entire mutual fund market would be to eviscerate § 36(b).⁷⁰

Thus, according to the Eighth Circuit, “the proper approach to § 36(b) is one that looks to both the adviser’s conduct during negotiation and the end result,”⁷¹ and found that the district court erred in granting summary judgment merely because the defendants passed the *Gartenberg* test. The court found that a proper evaluation of § 36(b) should include a comparison between fees charged to institutional clients and mutual fund clients.⁷² Even though *Gartenberg* did not undertake such a comparison, “[i]t does not follow, however, that a comparison will be irrelevant when there is greater similarity between

65. *Gallus*, 561 F.3d at 818.

66. *Id.*

67. *Id.*

68. *Id.* at 823.

69. *Id.*

70. *Gallus*, 561 F.3d at 823.

71. *Id.*

72. *Id.* at 823-24.

the funds being compared.”⁷³ The court found that a § 36(b) defendant’s conduct should be evaluated independent from the result of the negotiation.⁷⁴ Based upon its interpretation of the § 36(b) fiduciary duty standard, the Eighth Circuit reversed the district court’s grant of summary judgment to the defendants, and remanded the case for further proceedings.⁷⁵

4. *Certiorari to U.S. Supreme Court, Parties’ Briefs, and Amicus Briefs*

On March 9, 2009, the United States Supreme Court granted the petitioners’ Writ of Certiorari to review the Seventh Circuit’s decision in *Jones*.⁷⁶ The Statement of Question presented, as framed by the petitioners, is as follows:

Whether the court below erroneously held, in conflict with the decisions of three other circuits, that a shareholder’s claim that the fund’s investment adviser charged an excessive fee – more than twice the fee it charged to funds with which it was not affiliated – is not cognizable under § 36(b), unless the shareholder can show that the adviser misled the fund’s directors who approved the fee.⁷⁷

Because the merit briefs submitted by the parties essentially reiterate their arguments at the appellate level, this article will focus on interesting aspects of certain amicus briefs submitted by interested regulators and industry groups. As expected, amicus briefs were submitted by a wide-ranging contingency of interested groups, including the Securities and Exchange Commission (the “SEC brief”),⁷⁸ the North American Securities Administrators Association, Inc. (the “NASAA brief”),⁷⁹ and a consortium of professors from law schools.⁸⁰

73. *Id.* at 824.

74. *Id.*

75. *Gallus*, 561 F.3d at 825.

76. Petition for Writ of Certiorari, *Jones*, 129 S. Ct. 1579 (2009).

77. Petition for a Writ of Certiorari at *i, *Jones*, 2008 WL 4792489.

78. Brief for the United States as Amicus Curiae Supporting Petitioners, *Jones v. Harris Assoc. L.P.*, No. 08-586, 2009 WL 2564712 (U.S. June 15, 2009), available at http://www.abanet.org/publiced/preview/briefs/pdfs/07-08/08-586_PetitionerAmCuUSA.pdf.

79. Brief for the North American Securities Administrator’s Association, Inc., as Amicus Curiae Supporting Petitioners, *Jones v. Harris Assoc. L.P.*, No. 08-586, 2009 WL 1759018 (U.S. June 17, 2009), available at

The SEC brief is certain to receive close attention from the Court in analyzing the *Jones* case. In its amicus brief, the SEC argued for reversal of the Seventh Circuit's *Jones* decision.⁸¹ According to the SEC, § 36(b) requires more than full disclosure. Thus, the SEC urges the Court to look to trust law interpretation of the "fiduciary duty" standard when applying § 36(b).⁸² Quoting the First and Second Restatement of Trusts, the SEC believes that the Seventh Circuit incorrectly interprets trust law on fiduciary duty.⁸³ The SEC referenced its own study conducted prior to enactment of § 36(b) concluding that "board and shareholder approval could not protect shareholder interests with respect to advisory compensation because mutual funds could not, as a practical matter, terminate their relationship with advisers."⁸⁴ The SEC argues that § 36(b) was enacted to give investors an "independent check" on excessive fees, citing to *Daily Income Fund*.⁸⁵ Thus, the fiduciary duty standard in § 36(b) was enacted from concern that the non-arm's-length relationship between investment advisers and investment companies could cause mutual funds to agree to excessive compensation.

The SEC argues that in § 36(b) cases, courts should not set the fees themselves, as rate-setters, but should determine whether the fee is within a range that could have resulted from arm's-length bargaining.⁸⁶ Thus, courts should examine fees charged by advisers to their unaffiliated clients, who are truly bargaining at arm's length.

An evaluation under § 36(b) of "all the circumstances" should include consideration of any fees the adviser receives for providing comparable services to unaffiliated clients, such as pension funds and other institutional investors. Boards are encouraged to consider such information by in-

http://www.abanet.org/publiced/preview/briefs/pdfs/07-08/08-586_PetitionerAmCuNASAA.pdf.

80. Brief of Amici Curiae Law Professors in Support of Petitioners, *Jones v. Harris Assoc. L.P.*, No. 08-586, 2009 WL 1681458 (U.S. June 15, 2009), available at http://www.abanet.org/publiced/preview/briefs/pdfs/07-08/08-586_PetitionerAmCuLawProfessors.pdf.

81. Brief for United States, *supra* note 78.

82. *Id.* at *15-16.

83. *Id.*

84. *Id.* at *3-4 (citing H.R. REP. 89-2337, at 148 (1966)).

85. *Id.* at *10 (citing *Daily Income Fund v. Fox*, 464 U.S. 523, 534 n.10 (1984)).

86. Brief for United States, *supra* note 78, at *11.

dustry best practices and SEC regulations, and courts appropriately may consider the same information.⁸⁷

The SEC asserts that its Regulations require discussion of comparison of services and amounts to be paid with other investment advisory contracts “such as contracts of the same and other investment advisers with other registered investment companies or other types of clients (e.g., pension funds and other institutional investors).”⁸⁸ Thus, according to the SEC, the Court should not be concerned with *only* whether all pertinent information was provided to the board. “[A]n investment adviser’s fiduciary duty under § 36(b) extends beyond the obligation to disclose all relevant facts to the board, and includes the duty to refrain from charging an excessive fee.”⁸⁹

The NASAA brief further argues for reversal of the *Jones* decision.⁹⁰ The NASAA believes that the Seventh Circuit has essentially written § 36(b) out of the ICA by holding that “the fiduciary duty is nothing more than a disclosure obligation, that courts should refrain from passing judgment on mutual fund advisory fees, and that the more modest fees that advisers charge other clients are irrelevant to the application of Section 36(b).”⁹¹ The NASAA argues that the Court “should enunciate a strong and clear interpretation of § 36(b), under which fee arrangements must be (1) untainted by deception in the ne-

87. *Id.* at *12.

88. *Id.* at *24 (citing 17 C.F.R. § 240.14a-101 (2009)). In actuality, the SEC regulations do not *require* fund boards to discuss the disparity in fees charged to non-affiliated clients, and do not *require* fund boards to actually take this information into account. Rather, such a discussion is only required *if* the fund board took fees charged to “other types of clients” into account, and is not required where such fees were not actually considered by the fund board. The text of the SEC regulation reads:

Also, indicate in the discussion *whether the board relied upon comparisons* of the services to be rendered and the amounts to be paid under the contract with those under other investment advisory contracts, such as contracts of the same and other investment advisers with other registered investment companies or other types of clients (e.g., pension funds and other institutional investors). *If the board relied upon such comparisons*, describe the comparisons that were relied on and how they assisted the board in determining to recommend that the shareholders approve the advisory contract . . .

17 C.F.R. § 240.14a-101 (2009) (emphasis added).

89. Brief for United States, *supra* note 78, at *20.

90. NASAA is a “nonprofit association of state, provincial, and territorial securities regulators in the United States, Canada, and Mexico.” NASAA brief, *supra* note 79, at *1.

91. NASAA brief, *supra* note 79, at *3.

gotiation process and (2) demonstrably fair and reasonable in light of all the facts and circumstances, including the more favorable fee structures that non-captive institutional clients are able to negotiate.”⁹²

An amicus brief on behalf of the Respondents Harris Associates was submitted by the Securities Industry and Financial Markets Association (“SIFMA”).⁹³ SIFMA argues for affirmance of the Seventh Circuit’s opinion, and asserts that the plaintiffs should not be permitted to recover since they “purchased their shares in arm’s-length transactions after the fee rates—which were ordinary for the industry—were fully disclosed to them.”⁹⁴ According to SIFMA, because the fees were disclosed at the outset, were ordinary in the market, and were never increased, the plaintiffs “never had to pay a single penny more than what they agreed to pay at the outset” and thus there could be no argument that they were “treated unfairly, let alone unlawfully.”⁹⁵ SIFMA opines that the plaintiffs should not be permitted to “buy into a lawsuit by purchasing shares in a fund, and then, after the fact, be heard to complain that the pre-existing, disclosed fees are too high compared to what other customers are paying.”⁹⁶

5. *How the United States Supreme Court Will Likely Decide the Jones Review*

The Supreme Court has several options available to it. It can: (1) reaffirm the Second Circuit’s *Gartenberg* standard; (2) adopt Judge Easterbrook’s approach from the *Jones* decision; (3) adopt the *Gallus* and Judge Posner dissent standard in *Jones*; or (4) create its own standard. It is entirely possible that the Supreme Court could adopt its own standard which incorporates some, or all, of the *Jones* plaintiffs’ arguments that additional evidence of irregularities in the negotiation process is relevant to the inquiry. For instance, the Seventh Circuit dismissed evidence that a potentially interested director (Morgens-

92. *Id.* at *3-4.

93. Brief for the Securities Industry and Financial Markets Association as Amicus Curiae in Support of Respondents, *Jones v. Harris Assoc. L.P.*, No. 08-586, 2009 WL 2722569 (U.S. Aug. 27, 2009), available at http://www.abanet.org/publiced/preview/briefs/pdfs/07-08/08-586_RespondentAmCuSIFMA.pdf. SIFMA is a consortium of “more than 600 securities firms, banks, and asset managers.” SIFMA brief, *supra* note 93, at *1.

94. *Id.* at *2.

95. *Id.*

96. *Id.* at *21.

tern), who was a former partner of Harris Associates and received severance benefits from Harris, was chairman of the “disinterested” directors and participated in the decision to approve Harris Associates’ advisory fees.⁹⁷ The compensation received by Morgenstern was not disclosed to the fund investors.⁹⁸ Other allegedly “disinterested” directors were claimed to have invested in hedge funds which had ties to Harris Associates.⁹⁹ With facts such as these, the Supreme Court could rationally rule that these facts, if true, bear on the “fiduciary duty” inquiry and should have been considered by the district court in ruling upon the summary judgment motions.

The Supreme Court’s decision in *Jones* turns on whether the Court believes that courts should be determining the reasonableness of investment adviser fees. The case has spawned a variety of debates about the basis for its ultimate outcome, including a fascinating debate on economical behavioral analysis based upon a battle of the experts in the Easterbrook and Posner opinions.¹⁰⁰ The behavioral economics debate centers on whether investors’ free-market decisions require “paternal” oversight by courts.¹⁰¹

Questions and comments posed by the Supreme Court Justices in response to the parties’ positions stated at oral argument held on November 2, 2009, provide little insight into the direction in which the Court will head.¹⁰² At oral argument, while counsel for the Petitioners and the SEC attacked the Seventh Circuit’s decision, counsel for the Respondents likewise failed to attempt to defend the Seventh Circuit standard adopted by Judge Easterbrook. Instead, the parties, and the

97. *Jones*, 527 F.3d at 629-30.

98. *Id.*

99. *Id.*

100. See JOSH WRIGHT, *JONES V HARRIS AND SOME RAMBLINGS OF BURDENS OF PROOF, EMPIRICAL EVIDENCE, AND BEHAVIORAL LAW AND ECONOMICS*, Aug. 21, 2009, <http://www.truthonthemarket.com/2009/08/21/jones-v-harris-and-some-ramblings-on-burdens-of-proof-empirical-evidence-and-behavioral-law-and-economics/>; see also William Birdthistle, *Deep Economic Theory in Jones v. Harris*, *THE CONGLOMERATE*, Aug. 21, 2009, <http://www.theconglomerate.org/2009/08/deep-economic-theory-in-jones-v-harris.html>.

101. See Posting of Larry E. Ribstein, *Mutual Funds and the New Paternalism*, to Ideoblog, <http://busmovie.typepad.com/ideoblog/2009/08/mutual-funds-and-the-new-paternalism.html> (Aug. 18, 2009, 09:15:00 EDT).

102. Transcript of Oral Argument, *Jones*, No. 08-586 (S. Ct. argued Nov. 2, 2009), http://www.supremecourtus.gov/oral_arguments/argument_transcripts/08-586.pdf.

Court, seemed to center the inquiry on disputes over the nuances in applying the *Gartenberg* test—namely, whether courts should be required to consider fees charged to non-institutional clients as urged by the Petitioners.

The Court's inquiry at times appeared sympathetic to the Petitioners' argument, and at one point Justice Antonin Scalia requested from Respondent's counsel a citation to the lower court record "which would render it unnecessary for us to remand for the lower court to consider a comparison . . . with institutional charges?"¹⁰³ However, earlier questioning from Chief Justice John G. Roberts Jr. indicated a distaste for courts, rather than the SEC itself, to regulate mutual fund fees. Chief Justice Roberts opined:

Counsel, if we are going to have regulation of what fees can be charged, you cite in your brief the various regulations the SEC has issued. It makes a lot more sense to have the SEC regulate rates than to have courts do it, doesn't it?¹⁰⁴

Chief Justice Roberts and Justice Ruth Bader Ginsburg also elicited an admission from counsel for the SEC that, while the SEC has authority under § 36 to file suits to enforce § 36(b), it has not filed any such suits since 1980. Justice Scalia then drew the conclusion that the SEC's deferment "suggests . . . that the SEC may think that this is indeed a self-contained industry and that the comparison with investment advice given to other entities . . . is not a fair one."¹⁰⁵

Throughout oral argument, the Justices' questioning shed little light on the ultimate outcome. At one end of the spectrum, such as with Justice Scalia's and Chief Justice Roberts' questioning directly above, certain Justices appeared receptive to the Seventh Circuit's reasoning that courts should decline to enter the fray in setting mutual fund advisory fees. At the other end of the spectrum, as quoted above, the Justices seemed equally inclined to remand the entire dispute for application of the *Gartenberg* standard, with the added requirement that charges applicable to non-affiliated clients should be considered.

We believe the Court will likely create a "*Gartenberg*-plus" approach, taking into account both the adviser's conduct toward negotiating an advisory fee with the board, and the amount of the actual fee received by the adviser set against certain benchmarks—likely to in-

103. Transcript of Oral Argument at 43, lines 4-8.

104. Transcript of Oral Argument at 20, lines 10-14.

105. Transcript of Oral Argument at 21, lines 19-23.

clude other mutual funds *and* unaffiliated institutional clients. This approach is urged by the SEC and the *Gallus* Court. *Gartenberg* is unlikely to be adopted unmodified by the Court, as it was decided 30 years ago under different economic circumstances. The Seventh Circuit decision in *Jones* is unlikely to be adopted, as it is clearly contrary to the statute's express language and intent. Indeed, the Supreme Court has already expressed on at least one previous occasion a belief, albeit in dicta, that § 36(b) requires "reasonableness" in fees charged by advisers to mutual funds:

The new right created by § 36(b) is not only formally distinct from that asserted in a state claim of corporate waste; it is substantively different as well. *Indeed, an important reason for the enactment of § 36(b) was Congress's belief that the standards applied in corporate waste actions were inadequate to ensure reasonable adviser fees.*¹⁰⁶

The Court will likely rely heavily upon the position urged by the SEC, based upon certain SEC Regulations for what it deems to be deciding factors in the fee analysis. The SEC urges a focus on adviser's fees charged to unaffiliated clients for similar services.¹⁰⁷ This inquiry is not necessarily contained in the *Gartenberg* test, which focuses more on the fees charged to other mutual funds.

The *Jones* standard is likely to be summarily rejected by the Supreme Court. Section 36 is not a disclosure statute, it is a regulatory statute. The Seventh Circuit's "play no tricks" standard is tantamount to fraud, which is covered by other sections of the Act. If Congress had merely intended to regulate fraud, there was no need for a separate § 36(b), as fraud is already actionable in other sections of the ICA. Thus, the fiduciary duty standard must necessarily be aimed at conduct falling short of fraud.

Additionally, the *Jones* decision is contrary to the statute's express wording. Section 36(b) expressly states that approval of fees by the fund's board is not conclusive, but is only a factor in determining whether the fiduciary duty has been breached. Section 36(b) also expressly states that "it shall not be necessary to allege or prove that any defendant engaged in personal misconduct"¹⁰⁸ Contrary to the

106. *Daily Income Fund v. Fox*, 464 U.S. 523, 534 n.10 (1984) (emphasis added).

107. *See supra* note 87 and accompanying text.

108. ICA § 36(b)(1), 15 U.S.C. § 80a-35(b)(1). Section 36(b)(1) expressly believes the plaintiffs of the necessity of alleging or proving that any defendant en-

statute's express language, the "play no tricks" standard requires proof of personal misconduct. Finally, the obligation to fully and fairly deal with the board in negotiations by providing necessary and accurate information to the board is already regulated by other sections of the ICA, such as § 15(c).¹⁰⁹

Further, the "play no tricks" standard is virtually inapplicable to many investment adviser-fund board relationships. The inherent conflicts of interest present in such relationships—indeed, the very purpose behind many ICA provisions—means that tricks will rarely, if ever, be played. One commentator has stated:

[T]he board suffers from fundamental structural flaws. Independent directors are neither independent of the management firm nor truly capable of being directors. They are selected by the management firm, rely on it for information and direction, and are paid (sometimes handsomely) not according to the results of the fund investors, but based on currying favor with the firm they are supposed to supervise.¹¹⁰

While many would argue this overstates the incestuous relationship between the advisers and the board, a "play no tricks" standard would immunize what could be considered the more troubling fund-adviser relationships from judicial scrutiny because the closer the directors and advisers are related, the less "tricks" will be played. The fact that no "tricks" have been played will rarely, if ever, have any bearing upon whether the fees are grossly excessive.

The interplay between fund boards and fund advisers has been recognized in the investment community for years. In a letter to Berkshire Hathaway shareholders written in February 2004, Warren Buffet noted: "Year after year, at literally thousands of funds, directors had routinely rehired the incumbent management company, however pathetic its performance had been. Just as routinely, the directors had mindlessly approved fees that in many cases far exceeded those that

gaged in personal misconduct. *Id.*; see also *Gartenberg*, 694 F.2d at 930 ("Moreover, an intent to defraud need not be proved to establish a violation.").

109. ICA § 15(c), 15 U.S.C. § 80a-15(c). Section 15(c) requires advisers to provide full disclosure to directors of information necessary to evaluate the adviser's contract. *Id.*

110. John A. Haslem, *Why Have Mutual Fund Independent Directors Failed as 'Shareholder Watchdogs'?* (U. Md. Robert H. Smith Sch. Bus. Working Paper 1140320), available at <http://ssrn.com/abstract=1140320> (last revised Sept. 7, 2009).

could have been negotiated.”¹¹¹ Buffet noted the “lapdog” behavior of independent fund directors: “[B]oardroom atmosphere’ almost always sedates their fiduciary genes.”¹¹² Buffet also sagely noted that, just because a director may qualify as “independent” under the ICA, does not mean that the director is independent as a practical matter. Some “independent” directors receive up to 100% of their income in director fees.¹¹³ In Buffet’s opinion, mutual fund directors should certify on each annual report for a year in which an adviser’s contract is renewed that: (1) they have looked at other management companies and believe the one they have retained is among the best options; and (2) the directors have negotiated a fee comparable to what other clients with equivalent funds would negotiate.¹¹⁴

Compare this with *Jones*. The lack of independence of the “independent” directors in *Jones* was a particular problem in that case. For example, one of the “disinterested” directors was a former partner of the adviser who had his buyout compensation tied, in some respects, to the adviser’s performance.

Another issue with the Easterbrook standard is that it fails to discuss the segregation of sophisticated from unsophisticated investors in the marketplace. As Professor Birdthistle noted, segregation keeps sophisticated investors’ willingness and ability to shop for prices from acting as a safeguard for unsophisticated investors, who are buying a different product.¹¹⁵

Additionally, it is virtually impossible for the typical investor to determine what fees being charged by the fund are attributable to management fees. It would require an extremely sophisticated investor to: (1) determine the management fees for its own funds; and (2) compare those fees to comparable mutual funds, whose management fees are likely equally difficult to decipher. As noted in Harris Associates’ own Motion for Summary Judgment filed with the District Court, the fund trustees had to commission a third-party consultant to provide comparisons of the Oakmark fund’s performance and fees to

111. Letter from Warren Buffet, Chairman of the Board, Berkshire Hathaway, 8 (Feb. 27, 2004) available at <http://www.berkshirehathaway.com/letters/2003ltr.pdf>.

112. Buffet, *supra* note 111, at 8.

113. *Id.* at 8-9.

114. *Id.* at 9.

115. Birdthistle, *supra* note 100.

those of a peer group of competitors.¹¹⁶ Since few, if any, investors will be capable of performing or affording these studies, it is unreasonable to assume that investor shopping will adequately police mutual fund fees.

To predict the outcome, one must ask why the Supreme Court agreed to hear the case in the first place. No one has prevailed on a § 36(b) claim under the *Gartenberg* standard. The Seventh Circuit opinion lays down an even more arduous standard, but as a practical matter would not lead to a different result in the legal arena since plaintiffs were not winning these cases anyway. Perhaps the Supreme Court, as a sign of the times, feels compelled to set a standard plaintiffs can meet. If so, the Supreme Court will adopt the standard substantially similar to that urged by the *Jones* plaintiffs, the SEC, and several interested industry groups urging reversal of the *Jones* decision.

6. *Practical Implications of Supreme Court's Decision*

While the Supreme Court may very well confine its opinion to the interpretation of § 36(b) cases, and could even further limit its opinion to the specific facts presented by the *Jones* case, the opinion will assuredly contain statements or express policy concerns that could be applied in other contexts. For example, if the Supreme Court were to hold that mutual fund advisers' contracts with the fund must be "fair," "reasonable," or something approximating that standard, such an opinion may contain dicta which permits litigants to urge courts to extend the holding to ordinary investment adviser contracts outside the ICA.

In addressing the petitioners' argument that mutual fund advisers' fees must be compared to fees charged to non-affiliated clients, there is a risk that the opinion may also be framed in such a manner that advisers will simply charge everyone the same fee in order to avoid being sued. Such an opinion calls into play whether courts should be reviewing and evaluating contracts, such as advisory contracts, between sophisticated parties. It calls into play whether courts should be evaluating the disparate services provided by investment advisers to investment companies and other clients. Mutual fund boards frequently consist of seasoned businessmen, attorneys, CPAs, and other

116. Memorandum of Law in Support of Defendant Harris Associates, L.P.'s Motion for Summary Judgment, No. 1:04-cv-08305 CPK, 2006 WL 3054110, at *11 (N.D. Ill. Sept. 12, 2006).

professionals. If sophisticated professionals such as these cannot negotiate and write their own contracts, then who can?

An additional argument for the incongruity between mutual fund advisory fees and non-affiliated client fees is that, for non-affiliated clients, the adviser does not assume a “fiduciary duty” to the client regarding the receipt of compensation for their services. The Supreme Court should consider whether a registered investment adviser should be permitted to charge higher fees *because of* the fiduciary duty imposed upon it by § 36(b) to mutual funds. The higher liability risk inherent in managing funds under such a standard may justify higher fees charged to those clients compared to other clients.¹¹⁷ Thus, advisers subject to a higher risk exposure should be permitted to charge a higher fee to account for the increased assumption of risk.

In analyzing the parties’ arguments, and the conundrum faced by the Supreme Court in deciding this case, it becomes apparent that the ultimate problem is that § 36(b) is such an irregular statute. In the context of free markets, it is a foreign concept to a seller and purchaser that the provider of a service that no one is compelled to buy, and certainly is not compelled to retain, has a “fiduciary duty” regarding the amount of fee they can charge for such a service.

While the mutual fund industry is unique and arguably incestuous, such an arrangement is part and parcel of the product which the consumer is buying, and which the consumer has knowledge of prior to its purchase of the product. The fact that the consumer proceeded with the purchase is, in many instances, an informed and conscious decision that the consumer is willing to accept the realities present in that marketplace. While, as discussed above, the “arm’s-length transaction” between advisers and fund boards is arguably non-existent, the real arm’s-length transaction is between the adviser/fund on one side, and the investor on the other in deciding whether to purchase fund shares in the first instance.

In this regard, the Seventh Circuit in *Jones* focused on the wrong point in the transaction flow to decide the case. Judge Easterbrook focused on the investor-fund transaction after the point of initial purchase, when the investor has an option to “vote with its feet” if it feels that the fees for a particular fund are too high. However, as stated above, few mutual fund investors have the ability, much less the fore-

117. See, e.g., SIFMA brief, *supra* note 93, at *21 (“Mutual funds must bear the costs and burdens of federal and state laws that do not apply to institutional funds.”).

thought, to conduct this analysis. The analysis most investors *can* and *do* undertake is deciding whether to purchase mutual fund shares at all, and which fund to purchase—the initial point in the transaction. As stated in the SIFMA brief discussed above, “a recent survey commissioned by ICI reveals that consumers are more likely to review fees and expenses than any other type of information *before* purchasing shares in a mutual fund, and most investors continue to monitor fees and expenses after making their purchase.”¹¹⁸

The Senate Report stating that a mutual fund is typically organized and managed by the investment adviser, and therefore cannot, “as a practical matter sever its relationship with the adviser”¹¹⁹ is now 40 years old. The disparity in mutual fund advisory fees as opposed to other investment fee structures is now a part of the marketplace. Many investors know what they are buying from the outset. And many investors are themselves advised by brokers or investment advisers in the selection of mutual funds. The fact that consumers are aware of the disparate fee structure between advisers of mutual funds and advisers of unaffiliated funds, and decided to proceed with the purchase anyway, should inform the Court’s analysis in addressing the scope of § 36(b)’s fiduciary duty protection.¹²⁰

If Congress truly intended to regulate fees in its purest sense—with judicial oversight as to their reasonableness, it could have stood by its original draft which required fees to be reasonable. Congress could have required fees to be non-excessive, subject to similar language. However, mutual fund advisers solely have a fiduciary duty regarding their “receipt of compensation.” Does that necessarily imply a fiduciary duty with regard to the amount of compensation received? Or could it solely pertain to the manner in which the compensation is obtained—not only in the negotiations with the fund, but in the performance of the advisers’ duties to the fund. Should the Court

118. SIFMA brief, *supra* note 93, at *6 (citing Investment Company Institute, *Understanding Investor Preferences for Mutual Fund Information*, 3 fig.1 (1996) available at http://www.ici.org/pdf/rpt_06_inv_prefs_full.pdf).

119. S. REP. NO. 91-184 (1969), as reprinted in 1970 U.S.C.C.A.N. 4897, 4901.

120. See Troy A. Paredes, SEC Commissioner, Remarks Before the Investment Company Institute’s Annual Capital Markets Conference 5 (Sept. 24, 2009) transcript available at <http://www.sec.gov/news/speech/2009/spch092409tap-ici.htm> (“[A]dequate market discipline can obviate the need for more exacting and burdensome regulation, including demanding judicial scrutiny of advisory fees. . . . Put differently, the legal accountability of section 36(b) can be thought of as substituting for a lack of market-based accountability.”).

be solely concerned with the mutual fund advisers' handling of so-called "soft dollars" and evaluate whether the adviser has actually provided the services to the fund as promised?

The market forces approach adopted in the Seventh Circuit is illogical. The fact that no one has ever prevailed on a § 36(b) claim suggests that most funds which have been sued maintain fees roughly proportionate to their competition—after all, that is the comparison benchmark established in *Gartenberg*. If all comparable mutual fund fees are generally in the same range, consumers are unlikely to "vote with their feet" based upon fees. Because the amount of fees an individual is responsible for is *de minimus*, the incentive to switch, based upon fees alone, is non-existent. A rational investor would never leave the Oakmark fund earning a 22% return and paying a 1% fee for another fund earning a 2% return but charging a 0.5% fee. An individual's out-of-pocket share of an advisory fee is too small to justify its inclusion as a material factor in the investor's decision to remain with a particular fund.¹²¹ Thus, the deciding factor must be performance, not fees—that is, how the market operates. With price being equal, the better product wins.

The inclusion of § 36(b) in the ICA, in retrospect, could be viewed as an overreaction to other market abuses occurring at the time, where Congress noted a problem in an industry and overlegislated with regard to that industry. It may have been sufficient to merely require transparency, openness, and honesty by funds and advisers in the charging of fees, so that investors can make an honest and informed decision on whether the returns they earn justify the fees they pay. There is no reason that capitalistic organizations cannot create a product and charge whatever they want for it, as long as those charges are fully and honestly disclosed. Perhaps "fiduciary duty" was created only to promote open and honest disclosure, and faithful performance of the advisory services. This is the standard that should be adopted by the Supreme Court in passing upon the *Jones* decision.

121. As the *Gartenberg* court noted: "The fund customer's shares of the advisory fee is usually too small a factor to lead him to invest in one fund rather than in another or to monitor adviser-manager fees. 'Cost reductions in the form of lower advisory fees do not figure significantly in the battle for investor favor.'" *Gartenberg*, 694 F.2d at 929 (citing H.R. REP. NO. 89-2337, (1966)) (For example, in *Gartenberg*, the fees plaintiffs' alleged to violate § 36(b) amounted to a mere \$2.88 per year for each \$1,000 invested.).

The industry and consumers both need and would benefit from a clear enunciation of the fiduciary duties owed by brokers¹²² and investment advisers to their clients. The proliferation of financial products and compensation models has resulted in a muddled field where it is often difficult to determine when fiduciary duties commence, when they cease, and how they should be applied. Even distinguishing between investment advisers and brokers has become difficult.¹²³ In framing its decision, the Supreme Court needs be mindful of administration proposals to eliminate the distinction between brokers and investment advisers with respect to their fiduciary duties. The Supreme Court should also refrain from using the unique fiduciary duty created by § 36 of the ICA to fashion a broad judicially created fiduciary duty applicable to all. Perhaps this is best addressed by Congress.

122. *See, e.g., DeKwiatkowski v. Bear Stearns & Co., Inc.*, 306 F.3d 1293 (2d Cir. 2002) (Traditionally, brokers have been viewed as having a duty to faithfully execute trades, but absent special circumstances, no duty to continuously monitor the customer's account.).

123. Mary Shapiro, SEC Chairman, Testimony Before the House Financial Services Committee (July 14, 2009) (“Many investors do not recognize the differences in standards of conduct or the regulatory protections applicable to broker-dealers and investment advisers”).

