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No. 08-586

In The

Supreme Court of the United States

JERRY N. JONES, *ET AL.*,

Petitioners,

v.

HARRIS ASSOCIATES, L.P.,

Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Seventh Circuit

BRIEF OF THE NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION, INC., AS *AMICUS CURIAE* IN SUPPORT OF PETITIONERS

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TABLE OF CONTENTS

TABLE OF AUTHORITIES iii

INTEREST OF THE *AMICUS CURIAE* 1

SUMMARY OF THE ARGUMENT 4

ARGUMENT 6

I. THE FIDUCIARY DUTY IN SECTION 36(B) PROHIBITS MORE THAN DECEIT IN FEE NEGOTIATIONS; IT ALSO REQUIRES COURTS TO ENSURE THAT FEES ARE FAIR AND REASONABLE . . . 6

A. The Plain Language Of Section 36(b) Shows That Congress Intended To Proscribe More Than Deceit 7

B. The Fiduciary Duty Not Only Permits, But Affirmatively Requires, Courts To Scrutinize Fee Arrangements For Fundamental Fairness In Addition To Honesty In Negotiations 8

II. UNDER SECTION 36(B), COURTS CAN AND SHOULD EXAMINE ALL FACTS BEARING ON THE FAIRNESS OF AN ADVISER'S COMPENSATION, INCLUDING FEES THAT THE ADVISER CHARGES TO NON-CAPTIVE CLIENTS . 15

A. Congress Intended Courts To Entertain All Relevant Factors When Applying Section 36(b) 15

B. Recent Case Law Appropriately Acknowledges That The Fees Advisers Charge To Non-Captive Clients Are Relevant Under Section 36(b) And May Create Genuine Issues Of Material Fact . 17

III. THE LOWER COURT'S INTERPRETATION OF SECTION 36(B) EVISCERATES CONGRESS'S CAREFULLY CHOSEN REMEDY AND THWARTS ATTAINMENT OF A VITALLY IMPORTANT CONGRESSIONAL OBJECTIVE 20

CONCLUSION 22

TABLE OF AUTHORITIES

CASES

Basic Inc. v. Levinson,
485 U.S. 224 (1988) 2

Burks v. Lasker,
441 U.S. 471 (1979) 20

Capital Research & Mgmt. Co. v. Brown,
147 Cal. App. 4th 58 (Cal. Ct. App. 2007) 1

Daily Income Fund, Inc. v. Fox,
464 U.S. 523 (1984) 11, 13, 17, 20, 21

Galfand v. Chestnutt Corp.,
545 F.2d 807 (2d Cir. 1976) 11, 12

Gallus v. Ameriprise Fin., Inc.,
561 F.3d 816 (8th Cir. 2009) 13, 18, 19

Gartenberg v. Merrill Lynch Asset Mgmt., Inc.,
694 F.2d 923 (2d Cir. 1982) 12, 13, 14, 18

Green v. Fund Asset Mgmt.,
286 F.3d 682 (3d Cir. 2002) 10

Jones v. Harris Assocs.,
527 F.3d 627 (7th Cir. 2008) 4, 5, 6, 14, 15

Jones v. Harris Assocs.,
537 F.3d 728 (7th Cir. 2008) 4, 19

Krantz v. Prudential Invs. Funds Mgmt.,
305 F.3d 140 (3d Cir. 2002) 16

Meinhard v. Salmon,
249 N.Y. 458 (N.Y. 1928) 9

Migdal v. Rowe Price-Fleming Int'l, Inc.,
248 F.3d 321 (4th Cir. 2001) 16

Pepper v. Litton,
308 U.S. 295 (1939) 9, 12

SEC v. Capital Gains Research Bureau, Inc.,
375 U.S. 180 (1963) 9, 10

Stoneridge Inv. Partners v. Scientific-Atlanta, Inc.,
522 U.S. 148 (2008) 2

Weinberger v. UOP, Inc.,
457 A.2d 701 (Del. 1983) 14

STATUTES

15 U.S.C. § 80a-35(b) 2, 3, 4

15 U.S.C. § 80a-35(b)(1) 7, 16

15 U.S.C. § 80a-35(b)(2) 8, 16

OTHER AUTHORITIES

17 C.F.R. § 240.14a-101(c)(11)(i). 19

Brief of N. Am. Sec. Admins. Assoc., Inc. as Amicus Curiae in Support of Petitioner, *Stoneridge Inv. Partners v. Scientific-Atlanta, Inc.*, 522 U.S. 148 (2008) (No. 06-43), *available at* http://www.nasaa.org/content/Files/Amicus_Stoneridge.pdf 2

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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 (2008) 3, 19, 21

NASAA Enforcement Statistics, http://www.nasaa.org/issues___answers/enforcement___legal_activity/1002.cfm 1

Press Release, Office of N.Y. State Att'y Gen., State Investigation Reveals Mutual Fund Fraud (Sept. 3, 2003), *available at* http://www.oag.state.ny.us/media_center/2003/sep/sep03a_03.html 1

Restatement (Third) of Trusts § 38 cmt. e (2001) . . . 14

S. REP. NO. 91-184 (1969), *reprinted in* 1970 U.S.C.C.A.N. 4897, 1969 WL 4981 . 7, 10, 16, 17, 21

INTEREST OF THE *AMICUS CURIAE*[1]

The North American Securities Administrators Association, Inc. ("NASAA"), is the nonprofit association of state, provincial, and territorial securities regulators in the United States, Canada, and Mexico. It has 67 members, including the securities regulators in all 50 states, the District of Columbia, Puerto Rico, and the U.S. Virgin Islands. Formed in 1919, it is the oldest international organization devoted to protecting investors from fraud and abuse in the offer and sale of securities and investment advice.

State securities regulators collectively initiate thousands of enforcement actions each year against broker-dealers and investment advisers who violate the securities laws. *See* NASAA Enforcement Statistics, http://www.nasaa.org/issues___answers/enforcement___legal_activity/1002.cfm. Some of the states' most significant cases have been aimed at curbing systemic abuses in the mutual fund industry, including late trading, market timing, and undisclosed shelf-space agreements. *See, e.g.,* Press Release, Office of N.Y. State Att'y Gen., State Investigation Reveals Mutual Fund Fraud (Sept. 3, 2003), *available at* http://www.oag.state.ny.us/media_center/2003/sep/sep03a_03.html; *Capital Research & Mgmt. Co. v.*

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[1] A letter from counsel for Petitioners granting blanket consent to the filing of *amici curiae* briefs was docketed on May 22, 2009, and written consent from counsel for Respondent has been filed with this brief. No counsel for a party authored this brief in whole or in part, nor did any person or entity, other than the *amicus curiae*, its members, or its counsel, make a monetary contribution intended to fund the preparation or submission of this brief.

Brown, 147 Cal. App. 4th 58 (Cal. Ct. App. 2007) (holding that federal law did not preempt California's enforcement action for failure of investment adviser and broker-dealer to disclose shelf-space agreements).

Recognizing that private actions are an essential complement to governmental enforcement of the securities laws, NASAA and its members also support the rights of investors to seek redress in court for investment-related fraud and abuse. *See, e.g.,* Brief of N. Am. Sec. Admins. Assoc., Inc. as Amicus Curiae in Support of Petitioner, *Stoneridge Inv. Partners v. Scientific-Atlanta, Inc.*, 522 U.S. 148 (2008) (No. 06-43), *available at* http://www.nasaa.org/content/Files/Amicus_Stoneridge.pdf (citing *Basic Inc. v. Levinson*, 485 U.S. 224, 230-31 (1988) (the private cause of action constitutes "an essential tool for enforcement of the 1934 Act's requirements")).

NASAA and its members have an interest in this appeal because the Court's decision will profoundly affect the ability of millions of mutual fund investors to protect themselves from investment advisers who extract exorbitant fees from the captive funds they manage. The Petitioners allege that the Respondent is violating its fiduciary duty under Section 36(b) of the Investment Company Act of 1940 ("ICA"), as amended, by charging inflated advisory fees. 15 U.S.C. § 80a-35(b) (2006). This form of abuse has been widespread in the mutual fund industry for decades. It harms millions of Americans, the majority of whom are Main Street investors. In 2008, approximately 92 million individuals, representing 52.5 million households, held over $10 trillion in mutual funds. Inv. Co. Inst., 2009 Inv. Co. Fact Book 11, 76 (49th ed.

2009), *available at* http://www.ici.org/pdf/2009_fact book.pdf.

In 1970, Congress attempted to address the problem of excessive fees by fortifying the provisions of the ICA. It imposed a fiduciary duty on mutual fund investment advisers with respect to their compensation. 15 U.S.C. § 80a-35(b). It also created a private right of action so that investors could enforce that duty in federal court. *Id.* Unfortunately, this ostensibly powerful remedy has been ineffective because the federal courts have consistently failed to interpret and apply the fiduciary standard in Section 36(b) with the breadth and rigor that it deserves. In fact, in the years since the adoption of Section 36(b), "no plaintiff has ever won a fee case brought under" its provisions. 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).

The court below has compounded the problem by essentially writing Section 36(b) out of the ICA. The court held 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). All of these holdings conflict with the plain language of the ICA, the weight of authority interpreting Section 36(b), and Congress's obvious desire to deter abusive fee arrangements.

This Court should reverse the decision below and afford the Petitioners the opportunity to prove their claims at a trial on the merits. Further, the Court

should enunciate a strong and clear interpretation of Section 36(b), under which fee arrangements must be (1) untainted by deception in the negotiation 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. Absent such a decision by this Court, millions of everyday investors across the country will continue to see their savings and retirement funds siphoned away as unjust enrichment for mutual fund advisers.

SUMMARY OF THE ARGUMENT

Section 36(b) of the ICA declares that investment advisers "shall be deemed to have a fiduciary duty with respect to the receipt of compensation for services . . . ." 15 U.S.C. § 80a-35(b). The Petitioners allege that the Respondent has violated its fiduciary duty under Section 36(b) by exacting excessive fees from its captive mutual funds. The record before the court below included uncontroverted evidence that the Respondent charges its mutual funds more than twice what it charges the clients that it does not control. *Jones v. Harris Assocs.*, 537 F.3d 728, 731 (7th Cir. 2008) (Posner, J., dissenting from denial of petition for rehearing en banc). Nevertheless, the lower court affirmed the trial court's grant of summary judgment in the Respondent's favor. *Jones v. Harris Assocs.*, 527 F.3d 627, 635 (7th Cir. 2008).

The decision of the lower court was erroneous on three grounds. First, the court held that the fiduciary duty set forth in Section 36(b) only requires disclosure by the investment adviser during fee negotiations and imposes no substantive limitations on the magnitude

of the fees that the adviser may charge its mutual funds. *Id.* at 632. This is a profound departure from the proper legal standard that defines the fiduciary duty. The language of Section 36(b) and the cases applying the fiduciary duty make clear that Section 36(b) imposes two distinct requirements on investment advisers: not only must they be scrupulously honest in their dealings with respect to compensation, but the amount of their compensation must be fair and reasonable in light of all the facts and circumstances.

Second, the lower court held that some of the most compelling evidence of an excessive fee arrangement was irrelevant to the application of Section 36(b) and was therefore insufficient to raise a genuine issue of material fact warranting trial. *Id.* at 634-35. The court brushed aside the fact that the Respondent charges significantly lower fees to its independent institutional clients. Without citing any legal, economic, or empirical support, the court asserted that free market forces would inhibit any abuses that these price differentials might reflect. *Id.* The court furthermore speculated, again without support, that such fee disparities might be justified by differences in the amount of work an investment adviser performs for different clients. *Id.* at 634. Because these are precisely the genuine issues of material fact that require resolution at trial, the court erred by affirming dismissal based on the Respondent's motion for summary judgment.

Finally, the lower court's decision conflicts with the Congressional objectives underlying Section 36(b). The decisions of this Court, the legislative history of Section 36(b), and expert commentators all make abundantly clear that investment advisers have been

exploiting their captive mutual funds for decades. Intent on solving this problem, Congress adopted a series of increasingly powerful legislative remedies, culminating in Section 36(b) and the imposition of a fiduciary duty upon investment advisers with respect to their compensation. So far, however, the interpretation and application of Section 36(b) in the courts has been weak, affording little or no relief to aggrieved mutual fund shareholders. The lower court's ruling virtually guarantees that this trend will continue by eliminating any realistic prospect for success by investors with claims under Section 36(b). It therefore frustrates rather than advances Congress's goals, to the detriment of millions of investors, and it should be reversed.

ARGUMENT

I. THE FIDUCIARY DUTY IN SECTION 36(B) PROHIBITS MORE THAN DECEIT IN FEE NEGOTIATIONS; IT ALSO REQUIRES COURTS TO ENSURE THAT FEES ARE FAIR AND REASONABLE.

In defining the scope of the fiduciary duty under Section 36(b), the lower court focused exclusively on whether the adviser had made "full disclosure," played "tricks," or "pulled the wool over the eyes of the disinterested trustees . . . ." *Jones*, 527 F.3d at 632, 635. This exceedingly narrow interpretation of the fiduciary duty conflicts with the express wording of Section 36(b), innumerable cases defining the fiduciary duty, and the Congressional purposes set forth in the legislative history. Those authorities show that Congress intended courts to examine fee arrangements not only for fraud, but for substantive fairness as well.

A. The Plain Language Of Section 36(b) Shows That Congress Intended To Proscribe More Than Deceit.

The short answer to the lower court's attempt to equate breach of fiduciary duty with deceit lies in Section 36(b)(1) of the ICA. 15 U.S.C. § 80a-35(b)(1). It states that, in actions to enforce the fiduciary duty, "[i]t shall *not* be necessary to allege or prove that any defendant engaged in personal misconduct . . . ." *Id.* at § 80a-35(b)(1) (emphasis added). Thus, in Section 36(b), Congress plainly intended to address more than misconduct. It imposed the fiduciary duty not only to police fraud, but also to ensure that courts could engage in a meaningful review of the fairness of an adviser's fees.

The legislative history supports this reading of Section 36(b). The Senate Report frames the purpose of the bill not in terms of eradicating fraud, but rather in terms of addressing the conflicts of interest arising from an adviser's de facto control over the mutual funds that pay its fees. The Report explains that a mutual fund is typically organized and managed by its investment adviser, and therefore cannot, "as a practical matter[,] sever its relationship with the adviser." S. REP. NO. 91-184 (1969), *reprinted in* 1970 U.S.C.C.A.N. 4897, 4901, 1969 WL 4981. As a result, "the forces of arm's-length bargaining do not work in the mutual fund industry in the same manner as they do in other sectors of the American economy." *Id.* The Report goes on to observe that the safeguards contained in the 1940 Act were inadequate because they "did not provide any mechanism by which the *fairness* of management contracts could be tested in court." *Id.* (emphasis added). Conspicuously absent

from the Report is any reference to Congressional concerns over advisers defrauding or similarly abusing their mutual funds. The Report thus refutes the lower court's notion that deceit defines the scope of the fiduciary duty in Section 36(b).[2]

B. The Fiduciary Duty Not Only Permits, But Affirmatively Requires, Courts To Scrutinize Fee Arrangements For Fundamental Fairness In Addition To Honesty In Negotiations.

In addition to ignoring the impact of Section 36(b)(1), the lower court failed to recognize the broad scope of the fiduciary duty. When Congress decided to adopt a fiduciary standard in Section 36(b), the concept had a well-established meaning, developed over decades under state and federal law in areas ranging from trusts and corporations to securities. The standard had evolved well beyond mere candor in negotiations, encompassing a duty of extreme care, loyalty, and fair dealing. As Chief Judge Cardozo explained in describing the fiduciary duty:

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[2] Section 36(b)(2), read in conjunction with Section 36(b)(1), further supports the inference that Congress intended courts to examine fees for fairness, not just corruption. Section 36(b)(2) provides that "approval by the board of directors of such investment company of such compensation . . . shall be given such consideration by the court as is deemed appropriate under all the circumstances." 15 U.S.C. § 80a-35(b)(2). If neither adviser misconduct nor mutual fund approval are dispositive in a case brought under Section 36(b), then the only conceivable purpose of the action must be an assessment of the fee itself—whether it is fair and reasonable.

> Many forms of conduct permissible in a workaday world for those acting at arm's length, are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior. As to this there has developed a tradition that is unbending and inveterate.

Meinhard v. Salmon, 249 N.Y. 458, 464 (N.Y. 1928).

This Court's own pronouncements on the fiduciary duty have been similarly expansive. For example, in *Pepper v. Litton*, 308 U.S. 295 (1939), the Court set aside an attempt by a controlling shareholder to gain advantage over creditors in a bankruptcy proceeding. The Court observed that the dealings of fiduciaries must be subjected to "rigorous scrutiny" to ensure their "*inherent fairness* from the viewpoint of the corporation and those interested therein." *Id.* at 306 (emphasis added). The Court further admonished that a fiduciary "cannot use his power for his personal advantage and to the detriment of the stockholders and creditors no matter how absolute in terms that power may be and no matter how meticulous he is to satisfy technical requirements." *Id.* at 311. In *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180 (1963), the Court removed any doubt that investment advisers in general are fiduciaries, obligated not only to disclose all possible conflicts of interest to their advisory clients, but also to observe the "affirmative

duty of utmost good faith." *Id.* at 194 (footnote omitted).[3]

Against this backdrop, Congress's decision to incorporate a fiduciary duty into Section 36(b) speaks volumes. It reflects a resolve to hold investment advisers to the highest possible standard with respect to their compensation arrangements with the mutual funds they advise and manage. This is something vastly more substantive than a mere prohibition on dishonest bargaining tactics.[4]

Decisions following the enactment of Section 36(b) in 1970 reinforce this view. This Court, for example, recognized that Congress's primary goal in Section 36(b) was to ensure that mutual fund adviser fees were actually "reasonable" in amount, not simply to eradicate fraud or deception by investment advisers.

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[3] The legislative history indicates that Congress regarded the fiduciary duty in Section 36(b) as no less extensive than the fiduciary duty generally applicable to investment advisers: "Your committee believes that the investment adviser should be a fiduciary of the fund in such matters as the handling of the fund's assets and investments. Therefore, we have added a new section 36(b) to the investment company act to specify that the adviser has a fiduciary duty with respect to compensation for services or other payments paid by the fund or its shareholders to the adviser or to affiliated persons of the adviser." S. REP. NO. 91-184 at 4902.

[4] Congress imposed procedural limitations on actions to enforce the fiduciary duty under Section 36(b), but it did not weaken the duty itself. *But see Green v. Fund Asset Mgmt.*, 286 F.3d 682, 685 (3d Cir. 2002) (section 36(b) fiduciary duty is "more circumscribed than common law fiduciary duty . . ."). Presumably opponents of the fiduciary duty standard recognized the power and scope of the obligation it would impose and sought to limit its effect through the attendant procedural constraints.

Daily Income Fund, Inc. v. Fox, 464 U.S. 523 (1984). In *Daily Income Fund*, the Court exhaustively reviewed the history and rationale of Section 36(b), ultimately holding that Congress intended shareholders and the SEC—rather than mutual funds themselves—to enforce the fiduciary duty. *Id.* at 540-41. The opinion is replete with statements to the effect that the goal of the provision was to ensure "reasonable" adviser fees. *See, e.g., id.* at 534 n.10 (Congress believed "corporate waste actions were inadequate to ensure reasonable adviser fees"); *id.* at 537 (the SEC felt that percentage based compensation "could produce unreasonable fees in light of economies of scale"); *id.* at 540 (the SEC proposed the amendment due to concerns that structural governance requirements "would not alone ensure reasonable adviser fees"); *id.* at 540 ("Congress decided not to rely solely on the fund's directors to assure reasonable adviser fees . . . ."); *id.* at 541 ("Congress intended [court actions], on the one hand, and directorial approval of adviser contracts, on the other, to act as independent checks on excessive fees.").

An early decision from the Second Circuit offers an especially clear statement of the distinction under Section 36(b) between disclosure and fairness. In *Galfand v. Chestnutt Corp.*, 545 F.2d 807 (2d Cir. 1976), the court held that an adviser had breached his fiduciary duty under Section 36(b) by misleading the mutual fund's board in order to obtain "a patently one-sided revision of the advisory contract." *Id.* at 809. Although the decision focused on deceit as the basis for a Section 36(b) claim, the court nevertheless offered a comprehensive description of the dual obligations that all fiduciaries owe and that courts must enforce:

> Congress, in imposing a fiduciary obligation on investment advisers, plainly intended that their conduct be governed by the traditional rule of undivided loyalty implicit in the fiduciary bond. It is axiomatic, therefore, that a self-dealing fiduciary owes a duty of full disclosure to the beneficiary of his trust. . . . *Moreover, even where a fiduciary has made full disclosure, it is the duty of a federal court to subject the transaction to rigorous scrutiny for fairness.*

Id. at 811-12 (citing *Pepper*, 308 U.S. at 306-07) (emphasis added) (footnote omitted).

Cases decided since *Galfand* adhere to the view that Section 36(b) requires courts to scrutinize the amount that advisers charge their funds. Although many of those decisions are disappointing in the benchmark they set for what is "reasonable" or in the specific factors they consider, none of them has adopted the extraordinary hands-off approach that the lower court adopted in this case.

For example, in the leading decision applying Section 36(b), *Gartenberg v. Merrill Lynch Asset Mgmt., Inc.*, 694 F.2d 923 (2d Cir. 1982), the Second Circuit held that courts must indeed assess the magnitude of an adviser's fee and weigh a host of factors to determine whether the fee is so large that it violates Section 36(b). *Id.* at 928-29. Among those factors were the adviser's costs, the quality of the services rendered, any economies of scale that the adviser enjoys, the volume of orders the adviser must process, and the expertise and care of the mutual fund board. *Id.* at 930. The court in *Gartenberg* left much to be desired in its formulation of what constitutes an

intolerably large fee, essentially acquiescing in any fee except one deemed "so disproportionately large that it bears no reasonable relationship to the services rendered . . . ." *Id.* at 928. In addition, as discussed below in Part II.B., the court took a narrow view of the evidence that courts should weigh in identifying unfair advisory fees. *Id.* at 930 n.3. Nevertheless, the *Gartenberg* decision at least pointed other courts in the right direction with respect to the nature of the inquiry they must undertake: a substantive evaluation of the fees in question, under all (or at least many) of the facts and circumstances.[5]

A recent decision from the Eighth Circuit offers a modern day articulation of the scope of the fiduciary duty under Section 36(b). In *Gallus v. Ameriprise Fin., Inc.*, 561 F.3d 816 (8th Cir. 2009), the court explicitly identified the two components of the adviser's duty: "[w]e believe that the proper approach to § 36(b) is one that looks to both the adviser's conduct during negotiation and the end result. . . . Unscrupulous behavior with respect to either can constitute a breach of the fiduciary duty." *Id.* at 823. The court held that the trial court should have more fully explored both aspects of the adviser's fee—whether the adviser secured it through deliberate omissions or obfuscations, *and* whether it was high in light of the fees charged to other institutional accounts. *Id.* at

[5] The court in *Gartenberg* also explained that substitution of the term "fiduciary duty" for "reasonable" in the legislative process was "a semantical [rather] than substantive compromise." 694 F.2d at 928. And as noted above, in *Daily Income Fund*, this Court repeatedly described the 1970 amendment essentially as an attempt to ensure that mutual fund advisory fees were "reasonable." 464 U.S. at 534-41.

824. It reversed the trial court's grant of summary judgment and remanded for further proceedings.

The court below committed error by rejecting this line of decisions. It expressly disapproved the *Gartenberg* approach, offering instead its simplistic view that under Section 36(b), courts should content themselves with looking for trickery, not fair and reasonable fees. "[W]e now disapprove the *Gartenberg* approach. . . . A fiduciary must make full disclosure and play no tricks but is not subject to a cap on compensation." *Jones*, 527 F.3d at 632. The Seventh Circuit stands alone in suggesting that the fiduciary duty under Section 36(b) proscribes only concealment and that courts should refrain from determining whether fees are substantively fair or reasonable. Its holding nullifies the ability of mutual fund shareholders to challenge excessive investment adviser fees in court, in direct conflict with the provisions of Section 36(b) and Congress's intent. For this reason, it should be reversed.[6]

[6] The lower court mischaracterized the scope of the fiduciary duty under state law as well. Trustee fees are in fact subject to judicial scrutiny for reasonableness. *See Restatement (Third) of Trusts* § 38 cmt. e (2001). In addition, cases under state law reflect a rigorous application of the fiduciary duty, specifically where corporate officers face unavoidable conflicts of interest. *See Weinberger v. UOP, Inc.*, 457 A.2d 701, 710 (Del. 1983) (holding that merger was tainted due to lack of candor by directors serving parent and subsidiary and due to unfair share pricing; "[t]he requirement of fairness is unflinching in its demand that where one stands on both sides of a transaction, he has the burden of establishing its entire fairness, sufficient to pass the test of careful scrutiny by the courts.").

II. UNDER SECTION 36(B), COURTS CAN AND SHOULD EXAMINE ALL THE FACTS BEARING ON THE FAIRNESS OF AN ADVISER'S COMPENSATION, INCLUDING FEES THAT THE ADVISER CHARGES TO NON-CAPTIVE CLIENTS.

The lower court erred by entirely discounting evidence in the record showing that the Respondent charges a significantly lower percentage of assets to the institutional clients that it does not manage or control. *Jones,* 527 F.3d at 634-35. This restrictive and counter-intuitive approach conflicts with the language and history of Section 36(b), the better reasoned case law, and scholarly opinion. At a minimum, such evidence creates genuine issues of material fact for trial. Unless courts are permitted to entertain the much lower fees that advisers charge their non-captive clients, plaintiffs will find it exceedingly difficult to advance to the trial stage, even with legitimate claims under Section 36(b). Unless this Court establishes the relevance of such evidence, Section 36(b) will never achieve its underlying purpose.

A. Congress Intended Courts To Entertain All Relevant Factors When Applying Section 36(b).

The structure of Section 36(b) and its legislative history show that Congress intended courts to consider a broad range of factors in cases challenging the reasonableness of an investment adviser's fee. As discussed in Part I.B. above, the fiduciary duty is an exacting standard of behavior, one that requires courts to examine all facets of a transaction to ensure

fairness. An adviser's practice of charging its captive mutual funds much higher fees than it charges its non-captive clients, without a factual justification, epitomizes the self-serving behavior that Congress intended to eliminate. Comparing those fee structures is obviously relevant as a court determines whether a breach of fiduciary has occurred.

The text of Section 36(b) certainly does not limit the type of evidence that a court may consider when evaluating a claimed breach of fiduciary duty. On the contrary, the language of Section 36(b) is fundamentally open-ended. It makes explicitly clear that misconduct by an adviser on the one hand, and board approval of fees by a mutual fund on the other, are factors that courts may consider, but they do not set the boundaries for a court's factual inquiry. *See* 15 U.S.C. § 80a-35(b)(1), (2).

The legislative history confirms that courts are expected to engage in a comprehensive factual inquiry under Section 36(b). The Senate Report states that "[i]n the event that court action is brought to enforce this fiduciary duty of an investment adviser as to compensation or payments received by him, it is intended that the court look at *all the facts* in connection with the determination and receipt of such compensation . . . ." S. REP. NO. 91-184 at 4910 (emphasis added). The report indicates that a principal focus should be on services rendered to the fund and compensation paid for those services. *Id.* Many courts have emphasized those considerations. *See Krantz v. Prudential Invs. Funds Mgmt.*, 305 F.3d 140, 143 (3d Cir. 2002) (court must examine the relationship between the fees charged and the services rendered); *Migdal v. Rowe Price-Fleming Int'l, Inc.*,

248 F.3d 321, 327 (4th Cir. 2001) (same). However, the Senate Report also states that under certain circumstances, a wider, comparative analysis may be appropriate, one that looks beyond the relationship between the adviser and the mutual fund immediately at issue. S. REP. NO. 91-184 at 4910. The specific examples cited in the report concern the fees that an adviser charges to other funds in a mutual fund complex, but the report does not suggest that those examples should be considered exhaustive.

Nor would it make any sense from the standpoint of legislative history and statutory construction to read such an evidentiary limitation into Section 36(b). The most harmful and persistent trend that gave rise to Section 36(b) was that "investment advisers often charged mutual funds higher fees than those charged the adviser's *other* clients." *See Daily Income Fund*, 464 U.S. at 537 (citing the Wharton School Study of Mutual Funds that prompted the SEC to propose the 1970 amendments) (emphasis added). It is untenable to suggest that when applying Section 36(b), courts must ignore the very type of evidence that helped inspire the legislation in the first place. Yet such evidence is precisely what the lower court refused to consider in this case.

B. Recent Case Law Appropriately Acknowledges That The Fees Advisers Charge To Non-Captive Clients Are Relevant Under Section 36(b) And May Create Genuine Issues Of Material Fact.

Early case law construing Section 36(b) summarily discounted evidence reflecting the markedly lower prices that advisers have historically charged to

unaffiliated clients. In *Gartenberg,* for example, the Second Circuit simply asserted that such evidence must be rejected because "the nature and extent of the services required by each fund differ sharply." 694 F.2d at 930 n.3. The court offered no support for this contention, legal or factual.

Fortunately, not all courts have adhered to this view. In *Gallus*, the Eighth Circuit expressly rejected this aspect of the holding in *Gartenberg*. It ruled that the trial court had "erred in rejecting a comparison between the fees charged to Ameriprise's institutional clients and its mutual fund clients." 561 F.3d at 823. It explained that the fee comparison was especially *appropriate* because, under the facts of the case, "the investment advice may have been the same for both accounts," making different fee structures all the more suspect. *Id.* at 824.

The court in *Gallus* also correctly rejected the "free market" rationale for excluding evidence of an adviser's differential pricing for its clients. The court was "unpersuaded" that such fee disparities must be accepted simply as a reflection of what the market will bear. *Id.* The court explained that "[t]he purpose of an inquiry into the fees paid by institutional, non-fiduciary clients is to determine what the investment advice is worth." *Id.* That valuation is directly relevant to a claim under Section 36(b), because if an investment adviser charges more than what its services are worth, it is abusing its relationship and breaching its fiduciary duty. Commentators agree: "the *Gartenberg* court's greatest failing was its refusal to accept that the pricing of investment advisory services offered in the free market provides a legitimate and helpful guidepost for evaluating such

services in the fund market." Freeman, 61 OKLA. L. REV. at 86; *see also Jones*, 537 F.3d at 732 (Posner, J., dissenting) (lamenting that the panel's approach will allow "exorbitant fees" to become the "industry's floor").[7]

In *Gallus*, the court acknowledged that advisers will challenge such evidence on grounds that "the comparison with institutional clients is inapt or that the discrepancy is substantively justified." 561 F.3d at 824. But as the court noted, such contentions simply create "disputed issues of material fact." *Id.* at 824. This highlights the procedural infirmity in the lower court's ruling. The point here is not that fee disparities are conclusive proof of a breach of fiduciary duty, only that they might be. Their significance depends on all the facts and circumstances, including any explanations that an adviser might offer. Such factual determinations are appropriate for resolution at trial, not on motions to dismiss or for summary judgment. Those fee disparities should not be excluded from consideration as a matter of law, and the lower court erred in so holding.

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[7] The SEC's regulations confirm the relevance of the fees that advisers charge their non-mutual fund clients. In 2004, the SEC adopted regulations requiring mutual funds to disclose the factors they considered when they selected an adviser and approved its fees. Those factors include whether the board compared the approved contract with other contracts, such as contracts between the investment adviser and "other types of clients (e.g. pension funds and other institutional investors)." 17 C.F.R. § 240.14a-101(c)(11)(i).

III. THE LOWER COURT'S INTERPRETATION OF SECTION 36(B) EVISCERATES CONGRESS'S CAREFULLY CHOSEN REMEDY AND THWARTS ATTAINMENT OF A VITALLY IMPORTANT CONGRESSIONAL OBJECTIVE.

The lower court's interpretation of Section 36(b) eliminates any hope that this legislative remedy will achieve Congress's goal of eradicating excessive investment adviser fees in the mutual fund industry. This is especially discouraging not only because those fees harm so many millions of investors, but because the problem has persisted for so long. Reversal is important in this case to revitalize Section 36(b) as means of protecting investors from abuse and to restore confidence in the integrity of the mutual fund market.

The conflicts of interest that gave rise to predatory fee arrangements have been recognized since the 1930s, and they helped inspire passage of the ICA in 1940. *Daily Income Fund*, 464 U.S. at 536. Congress's initial remedy was to impose corporate governance controls, including independent director requirements. *Burks v. Lasker*, 441 U.S. 471, 482 (1979). Studies thereafter indicated, however, that investment advisers continued to charge mutual funds high fees relative to other clients, and that the "structure of the industry, even as regulated by the Act, had proven to be resistant to efforts to moderate adviser compensation." *Daily Income Fund*, 464 U.S. at 537 (citing Wharton School Study of Mutual Funds and SEC studies). Part of the problem was that investors had no meaningful judicial recourse because the applicable corporate waste standards applicable under

state law were insuperably high. S. REP. NO. 91-184 at 4901; *Daily Income Fund,* 464 U.S. at 541 n.12. Section 36(b), with its fiduciary duty enforceable in federal court, was thus born from an unusually long and frustrating effort to rectify a systemic problem in the mutual fund industry.

The abuses have largely persisted notwithstanding enactment of Section 36(b). "Fee gouging remains pervasive within the fund industry." Freeman, 61 OKLA. L. REV. at 149. The promise of Section 36(b) may yet be fulfilled if it is forcefully interpreted and applied by the courts. The lower court's ruling, however, removes any chance that Section 36(b) can achieve Congress's objectives. By equating fiduciary duty with garden variety fraud, the lower court has nullified the powerful standard that Congress intended to deploy and has stripped Section 36(b) of any real force or effect. And by disallowing evidence of prices charged to non-captive clients, the lower court has robbed plaintiffs of the most meaningful benchmark for determining whether fees are reasonable. "Relegating plaintiff shareholders to comparing a given fund's no-bid pricing schedules to other similar funds' no-bid pricing schedules will never yield any fee relief for shareholders . . . ." Freeman, 61 OKLA. L. REV. at 142. In effect, the lower court's decision repeals Section 36(b) and should be reversed.

CONCLUSION

For the reasons set forth above, the decision of the United States Court of Appeals for the Seventh Circuit should be reversed.

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