

No. 08-586

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In The  
**Supreme Court of the United States**

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JERRY N. JONES, MARY F. JONES,  
AND ARLINE WINERMAN,

*Petitioners,*

v.

HARRIS ASSOCIATES, L.P.,

*Respondent.*

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**On Writ Of Certiorari To The  
United States Court Of Appeals  
For The Seventh Circuit**

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**BRIEF OF *AMICUS CURIAE* NATIONAL  
ASSOCIATION OF SHAREHOLDER AND  
CONSUMER ATTORNEYS (NASCAT)  
IN SUPPORT OF PETITIONERS**

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**INTEREST OF *AMICUS CURIAE* NASCAT<sup>1</sup>**

The National Association of Shareholder and Consumer Attorneys (NASCAT) is a nonprofit membership organization. Founded in 1988, its members are law firms committed to the vigorous prosecution of corporate fraud. NASCAT is a trade organization and public policy voice for lawyers interested in a strong system of federal and state legal protections for investors and consumers. Acting through its Amicus Committee, NASCAT has filed more than two dozen *amicus curiae* briefs in the United States Supreme Court, federal circuit courts of appeal, and state supreme courts in cases involving federal and state securities, antitrust, civil racketeering, and consumer protection law.

In this instance, NASCAT represents the voice of the mutual fund shareholders in the face of a well-organized and powerful mutual fund lobby. It is these shareholders whose investments are at stake here. In 2008, an estimated 92 million individual investors representing 45 percent of all U.S. households owned mutual funds and held 82 percent of total mutual

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<sup>1</sup> No counsel for any party has authored this brief in whole or in part, and no person or entity other than *amicus curiae* had made a monetary contribution to the preparation or submission of this brief. *See* Sup. Ct. R. 37.6. Counsel for Petitioners filed a letter with the Clerk granting blanket consent to the filing of *amicus* briefs, and a letter reflecting the consent of Respondent to the filing of this brief has been filed with this brief. *See* Sup. Ct. R. 37.3.

fund assets by year-end. Inv. Co. Inst., 2009 Mutual Fund Fact Book, Section 6 (49th ed. 2009), *available at* [http://www.ici.org/pdf/2004\\_factbook.pdf](http://www.ici.org/pdf/2004_factbook.pdf). This case is of paramount importance to those investors evaluating mutual funds as it will represent the first decision by this Court regarding the standard for adviser compensation under Section 36(b) of the Investment Company Act (the “ICA”). As already recognized by this Court, Section 36(b) is a crucial component of Congress’s effort to protect mutual fund investors against abuse and overreaching by the advisers that hold their mutual funds captive.



### **SUMMARY OF ARGUMENT**

In 1940, Congress enacted the ICA (15 U.S.C. §80a-1 et seq.) due to “its concern with ‘the potential for abuse inherent in the structure of investment companies.’” *Daily Income Fund, Inc. v. Fox*, 464 U.S. 523, 536 (1984) (*citing Burks v. Lasker*, 441 U.S. 471, 480 (1979)). As applied by the courts, however, the version of Section 36 enacted at that time provided insufficient redress for mutual fund investors as it required them to demonstrate a “gross abuse of trust” on the adviser’s part to obtain relief under the statute. Realizing that existing standards did not adequately address that “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” (S. Rep. No. 91-184, at 5 (1969),

reprinted in 1970 U.S.C.C.A.N. 4897, 4901), Congress enacted Section 36(b) of the ICA in 1970.

Investors' ability to effectively prosecute claims under Section 36(b) is an essential component of any meaningful effort to police excessive advisory fees. As both Congress and this Court have recognized, Section 36(b) is necessary because the approval of fees by the funds' unaffiliated directors is not enough on its own to assure that the fees are the equivalent of those that would be charged if arm's-length bargaining had taken place. As discussed below, this unfortunate reality has repeatedly been demonstrated in litigation under Section 36(b) as well as in other cases in which the adequacy of the unaffiliated directors' representation of mutual fund interests was at issue. Among its benefits, Section 36(b) litigation can provide needed transparency with respect to the fee approval process of information which advisers normally hide from public view.

Despite all of the potential benefits of such litigation, mutual funds and their investors have been unable to get much relief from Section 36(b) actions as a result of decades of a misapplied standard under Section 36(b). Although *Gartenberg v. Merrill Lynch Asset Management*, 694 F.2d 923 (2d Cir. 1982) correctly included "arm's-length bargaining" as part of the standard governing Section 36(b), it also employed a standard requiring the compensation to be "disproportionately large" in relation to the value of the services which subsequent courts have effectively converted into a corporate

waste requirement. The Seventh Circuit below in *Jones v. Harris Associates, L.P.*, 527 F.3d 627 (7th Cir. 2008) further limited Section 36(b) by applying an extremely narrow interpretation of fiduciary duty tantamount to requiring that plaintiffs show fraudulent behavior on the adviser's part. Neither of these approaches fulfills Congress's goal of making Section 36(b) a vehicle through which funds and their investors can ensure that the fees charged will be consistent with what would have resulted from arm's-length bargaining. *Amicus* NASCAT submits that this Court should reject both these standards. The Eighth Circuit in *Gallus v. Ameriprise Finance, Inc.*, 561 F.3d 816 (8th Cir. 2009), has set forth an approach consistent with what Congress required by giving consideration to both the fairness of the fee charged and the adequacy of disclosure by the adviser to the unaffiliated directors. *Amicus* NASCAT respectfully submits that the *Gallus* standard be given consideration by this Court.

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## ARGUMENT

### **I. LITIGATION UNDER SECTION 36(b) IS A CRUCIAL MEANS OF PROTECTING MUTUAL FUNDS AGAINST THE LACK OF ARM'S-LENGTH BARGAINING AND CONFLICTS OF INTEREST THAT CHARACTERIZE THE MUTUAL FUND-ADVISER RELATIONSHIP**

Before Congress enacted Section 36(b) in 1970, existing legal remedies were insufficient to protect

mutual funds and their shareholders against the consequences of conflicts of interest between funds and their advisers, and a consequent lack of arm's-length bargaining. Courts subjected legal challenges to investment advisory fees to the nearly insurmountable "gross abuse of trust" and "corporate waste" standards, under which fees had to be "unconscionable." See *Fox*, 464 U.S. at 540 & n.12. Eventually, Congress took notice of the hurdles plaintiffs were facing and passed Section 36(b), which implemented the "fiduciary duty" standard that exists today.<sup>2</sup>

There are numerous reasons why shareholder litigation under Section 36(b) is vital to encourage the equivalence of arm's-length negotiation and to provide relief where such negotiation does not occur.<sup>3</sup> First, the unaffiliated directors' approval is often not enough to ensure that the fees charged to the funds will be consistent with what would have resulted from arm's-length bargaining. As this Court explained in *Fox*: "Congress decided not to rely solely on the fund's directors to assure reasonable adviser fees, notwithstanding the increased disinterestedness of

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<sup>2</sup> Section 36(b) imposes on investment advisers "a fiduciary duty with respect to the receipt of compensation for services." 15 U.S.C. §80a-35(b).

<sup>3</sup> This Court itself has commented on the importance of effective enforcement of investors' rights through private litigation. See *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 313 (2007).

the board.” *Fox*, 464 U.S. at 540. Instead, Congress mandated that director approval should be afforded only “such consideration by the court as is deemed appropriate under all the circumstances.” 15 U.S.C. §80a-35(b)(2). Thus, Congress provided a private right of action in Section 36(b) to complement director approval of advisory contracts.

Moreover, although the SEC has stated that “the best way to ensure [fair and reasonable fees] is a marketplace of vigorous, independent, and diligent mutual fund boards coupled with fully-informed investors,” (Statement of the Commission Regarding the Enforcement Action Against Alliance Capital Management, L.P., SEC Press Release 2003-176 (Dec. 18, 2003)), fund boards have failed to fulfill this role, primarily because the so-called “independent” directors, who are supposed to be the “watchdogs” of the funds, are often not truly independent of the adviser. *See Burks*, 441 U.S. at 485. This fact has been recognized, for example, in the following comment made by Warren Buffet (famous investor and chairman of Berkshire Hathaway) as quoted by a United States District Court:

I think independent directors have been anything but independent. The Investment Company Act, in 1940, made these provisions for independent directors on the theory that they would be the watchdogs for all these people pooling their money. The behavior of independent directors in aggregate since 1940 has been to rubber stamp every deal

that's come along from management – whether management was good, bad, or indifferent. Not negotiate for fee reductions and so on. A long time ago, an attorney said that in selecting directors, the management companies were looking for Cocker Spaniels and not Dobermans. I'd say they found a lot of Cocker Spaniels out there.

*Strougo v. BEA Assoc.*, 188 F. Supp. 2d 373, 383 (S.D.N.Y. 2002) (citation omitted).

The SEC has also recognized that “many boards continue to be dominated by their management companies.” Investment Company Governance, Investment Company Act Release No. 26,520, 69 Fed. Reg. 46,378, 46,381 (July 27, 2004). This is so because, as this Court has explained, “unlike most corporations, [a mutual fund] is typically created and managed by a pre-existing external organization known as an investment adviser . . . [that] often selects affiliated persons to serve on the [fund's] board of directors. . . .” See *Fox*, 464 U.S. at 536.

The frequent submission of purportedly “independent” fund directors to the will of the adviser is starkly demonstrated by the fact that “while independent fund directors have the right to demand advisory or distribution fee cuts or to fire the fund's adviser or underwriter, those rights are virtually never exercised.” John P. Freeman & Stewart L. Brown, *Mutual Fund Advisory Fees: The Cost of Conflicts of Interest*, 26 Iowa J. Corp. L. 609, 617 (2001). This domination can result in the directors

assuming a passive role in the fee approval process by not aggressively seeking full information from the adviser or conducting an otherwise serious and dispassionate review of the adviser's presentation to the directors. A sophisticated understanding of the fees the directors must approve requires a great deal of information that the unaffiliated directors will not have unless the adviser voluntarily provides it to them or they ask for it, which they often fail to do. This passivity thus limits the "independent" directors' ability to properly oversee the fees charged to the funds.

The need for continued vigilance with respect to advisers' abuse of their relationships with mutual funds has been amply demonstrated in litigation under Section 36(b) and other provisions of the ICA. For example, in *Galfand v. Chestnutt Corp.*, 545 F.2d 807, 812 (2d Cir. 1976), the Second Circuit held that the adviser had "ignored completely his duty to promote responsible directorial judgment by supplying information sufficient to enable the fund's [board of directors] to evaluate the new contract," resulting in "a patently one-sided revision of the advisory contract." *Id.* at 809. In *Moses v. Burgin*, 445 F.2d 369, 372 (1st Cir. 1971), a case under Section 36 of the 1940 ICA arising prior to Section 36(b)'s enactment, an adviser failed to disclose to the fund's directors that some of the brokerage commissions being paid by the funds might be able to be "recaptured" and credited against its advisory fees. Even under the "gross abuse of trust" standard

applied before the passage of Section 36(b), the First Circuit held that the adviser breached its fiduciary duty by failing to fully disclose to the directors the information available to it. *Id.* at 384; *see also Papilsky v. Berndt*, No. 71 Civ. 2534, 1976 U.S. Dist. LEXIS 14442, at \*43-44 (S.D.N.Y. June 24, 1976) (imposing liability on an adviser for breach of fiduciary duty under the ICA for failing in its duty of full disclosure with respect to recapturing brokerage commissions and stating, “[t]he effective performance of this crucial watchdog role depends on the flow of information to these [unaffiliated] directors from the affiliated directors.”).<sup>4</sup>

Indeed, the mutual fund industry has been pervasively characterized by shareholder abuses. In recent years, lawsuits instituted by private litigants, the SEC, and state regulators have uncovered swaths of industry-wide wrongdoing with respect to revenue sharing, directed brokerage, market timing and late trading that took place on the watch of the not-so-vigilant fund directors. *See, e.g., William A. Birdthistle, Compensating Power: An Analysis of Rents and Rewards in the Mutual Fund Industry*, 80 *Tul. L. Rev.* 1401, 1405-07 (2006). Such litigations have generated substantial benefits for mutual funds

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<sup>4</sup> The facts of the case at bar vividly illustrate this point as they strongly support a conclusion that the relationship between the adviser and the unaffiliated directors was not one in which the interests of the mutual funds were being adequately protected.

and their shareholders through agreements to reduce advisory fee schedules. For example, on December 18, 2003, in order to settle the market timing case brought by the New York State Office of the Attorney General (“NYAG”), adviser Alliance Capital Management agreed to an advisory fee reduction over five years of approximately \$350 million. *See Assurance of Discontinuance Pursuant to Executive Law §63(15), In re Alliance Capital Management, L.P.*, Att’y Gen. of N.Y. Bureau of Inv. Prot. at 23-24 (Aug. 19, 2004), *available at* [http://www.oag.state.ny.us/bureaus/investor\\_protection/investors/alliance\\_cap\\_mgmt\\_aod.pdf](http://www.oag.state.ny.us/bureaus/investor_protection/investors/alliance_cap_mgmt_aod.pdf). As another example, defendants in *In re Columbia Entities Litigation*, CV 04-11704 (D. Mass. Jan. 19, 2007), an action brought by private litigants under Section 36(b), acknowledged in their settlement agreement that the Section 36(b) litigation was a factor in their implementation of advisory fee breakpoints, as well as enhanced shareholder communications and reduced “soft dollar” spending. *See Stipulation and Settlement Agreement at 11, paragraphs 5.2(a)-(c).*

Finally, shareholder litigation under Section 36(b) is important because of the enforced transparency it can provide, as the inner workings of the mutual fund industry are shrouded in secrecy. Advisers and directors closely guard the details of fund board deliberations regarding fees and what information the fund boards request and receive. As a result, mutual fund shareholders receive little

information regarding the process of how and why the fees were approved.

Because the information underlying the fee approval processes is kept from the public, governmental bodies such as the SEC have acknowledged that even they have trouble acquiring the economic data from advisers relevant to evaluating the fairness of advisers' fees. See discussion at 14-15, *infra*. Section 36(b) litigation that makes it through to summary judgment stage or trial results in a court opinion from which the public with some meaningful information about the realities of what transpired during the fee approval process.<sup>5</sup>

## **II. COURTS HAVE ERRONEOUSLY EVISCERATED THE “ARM’S-LENGTH BARGAINING” STANDARD THAT GOVERNS ADVISER COMPENSATION UNDER SECTION 36(b)**

As discussed at length in Petitioner’s brief, in employing the phrase “fiduciary duty” in Section

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<sup>5</sup> The importance of an effective remedy under Section 36(b) became even greater as certain courts ruled that ICA Sections 15(a), 15(c) and 36(a) do not provide implied private rights of action for excessive fees. See *Tarlov v. Paine Weber Cashfund, Inc.*, 559 F. Supp. 429 (D. Conn. 1983) (no private right of action under Section 15(a)); *Halligan v. Standard & Poor’s/Intercapital, Inc.*, 434 F. Supp. 1082, 1084 (E.D.N.Y. 1977) (no private right of action under Section 15(c)). See Lyman Johnson, *A Fresh Look at Director “Independence”: Mutual Fund Fee Litigation and Gartenberg at Twenty-Five*, 61 Vand. L. Rev. 497, 510 (2008).

36(b), Congress incorporated the familiar common-law principles that phrase embodies. Brief for Petitioners dated June 10th, at 20-29. This Court has held that the fiduciary must act in “good faith,” and the transaction must be “fair[ ] from the viewpoint of the” beneficiary. *Pepper v. Litton*, 308 U.S. 295, 306-07 (1939). “The essence of the test is whether or not under all the circumstances the transaction carries the earmarks of an arm’s-length bargain.” *Id.*

The leading case interpreting Section 36(b) at this juncture is *Gartenberg*, 694 F.2d 923. *Gartenberg* embraced traditional fiduciary duty principles by correctly holding that advisers violate their fiduciary duty under Section 36(b) when they charge fees that exceed what they could have obtained in an actual arm’s-length transaction.<sup>6</sup> But *Gartenberg*, as interpreted and applied in subsequent decisions, is flawed. The first problem with the *Gartenberg* decision is that it also required that the fee must be “so disproportionately large that it bears no reasonable relationship to the services rendered” for an adviser to breach its fiduciary duty under Section 36(b). *See* 694 F.2d at 928. As interpreted and applied in

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<sup>6</sup> The district court in *Gartenberg* had relied upon *Galfand*, 545 F.2d 807, when determining the fiduciary standard upon which the adviser’s compensation would be weighed. *See Gartenberg v. Merrill Lynch Asset Management, Inc.*, 528 F. Supp. 1038, 1047 (S.D.N.Y. 1981) (quoting *Galfand*: “The conduct of the investment adviser must be governed by the ‘duty of uncompromising fidelity’ and ‘undivided loyalty’ to the Fund’s shareholders that is imposed by Section 36(b).”).

subsequent decisions by other courts, the “so disproportionately large” language places a higher burden on plaintiffs than that which exists under the law of fiduciaries<sup>7</sup>, and appears similar to the corporate waste approach Congress rejected in enacting Section 36(b). See 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, 129 (2008).

In part, this regression to the pre-enactment standard has been accomplished through various courts’ rigid application of the so-called “*Gartenberg* factors.” In *Gartenberg*, although the Second Circuit acknowledged that courts must consider “all of the surrounding circumstances” in determining whether the fee is comparable to an arm’s-length bargain, it then enumerated six factors that must be weighed to determine whether a fee violated Section 36(b). 694 F.2d at 928. Subsequent court decisions have erroneously interpreted the *Gartenberg* factors as a checklist of evidence that investors must satisfy in order to meet their Section 36(b) burden. See, e.g., *Krinsk v. Fund Asset Mgmt., Inc.*, 875 F.2d 404 (2d

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<sup>7</sup> See *Meinhard v. Salmon*, 164 N.E. 545, 546 (N.Y. 1928) (“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.”).

Cir. 1989). Some of these evidentiary requirements are extremely burdensome and difficult to prove.

For example, one of the *Gartenberg* factors is the fund's profitability to the adviser. To calculate profits, an investor must obtain data regarding the adviser's cost of providing services to the fund – data advisers fight to keep hidden from the public. As one commentator explained:

Indeed, some years ago, the SEC's Chief Economist was asked about seeking to collect industry-wide data on fund advisory firms' revenue, costs, and profitability. He responded: "As to your suggestion that the SEC's Chief Economist do a revenue/cost/profit study, I know I'd be interested, but I don't think the industry would oblige us." To even start a profitability analysis, a plaintiff must marshal evidence the SEC itself does not have and says it cannot obtain . . .

Next, even if the raw data is found, profitability calculations involve cost allocation issues that are subject to dispute, and there is no universally accepted methodology for making the analysis. This means that, in practice, profitability is bitterly contested. Recall that in *Gartenberg*, the experts' analysis of the advisers' profitability left the court in doubt whether the adviser had enjoyed a lush profit margin in 1980 of 38% or more or had suffered a loss . . . Given that profitability data is hidden, subject to fierce dispute once found, and next to impossible for courts to analyze, it is unclear what is

gained by making proof about the adviser's profitability a criterion for recovery in cases attacking advisory fees.

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, 131-32 (2008).

The difficulty in obtaining cost data also makes it difficult for investors to offer evidence regarding the *Gartenberg* factor of whether the adviser experienced economies of scale. By contrast, probative information regarding fees charged to institutional accounts is often a matter of public record and in any event is easy to obtain in discovery. Unlike issues concerning profitability or economies of scale, the fees actually charged to such institutions as compared with fees charged to retail investors is not subject to dispute.

Indeed, the "disproportionately large" standard coupled with a rigid application of the *Gartenberg* factors has made it nearly impossible for investors to recover excessive fees charged by investment advisers. Not a single investor has won at trial since courts started employing the *Gartenberg* standard. As one commentator noted:

Fund managers' unblemished, thirty-seven year record of success is all the more remarkable considering that a section 36(b) plaintiff need only prove the violation of a fiduciary duty, a presumably far less demanding hurdle than in many comparable types of claims.

Mercer E. Bullard, *Dura, Loss Causation, and Mutual Funds: A Requiem for Private Claims?*, 76 U. Cin. L. Rev. 559, 560 n.5 (2008) (citing *Acampora v. Birkland*, 220 F. Supp. 527, 549 (D. Colo. 1963) (requiring for state law excessive fees claim that plaintiffs show that fees were “unconscionable and shocking”)).

Although the application of *Gartenberg*’s “disproportionately large” standard and the “*Gartenberg* factors” have effectively neutered Section 36(b), *Gartenberg* nonetheless set forth the correct “arm’s-length bargaining” standard. In contrast, the Seventh Circuit in the instant case went too far in eschewing *Gartenberg* in its entirety in exchange for a standard that requires trickery on the part of the adviser and a truncated duty of disclosure. In so doing, the Seventh Circuit ignored the fiduciary requirement of “fairness” that exists independently of the adequacy of disclosure. Moreover, by reducing the standard under Section 36(b) to “an adviser must play no tricks,” the Seventh Circuit has essentially required that investors prove fraud to succeed on their Section 36(b) claim – something Congress undoubtedly did not contemplate when it replaced the “gross abuse of trust” standard with a standard based on common law fiduciary duties.

The Eighth Circuit’s recent decision in *Gallus*, 561 F.3d 816, represents the best approach to date – one that reconciles the *Gartenberg* standard with what is required under common law fiduciary duty standards. *Gallus* held that proving that the fee itself was so high it must be excessive is one way, but not

the only way, a plaintiff can prove a breach of fiduciary duty under Section 36(b). *Id.* at 823. The Eighth Circuit explained that another way for a plaintiff to show a breach of fiduciary duty under Section 36(b) would be to demonstrate that the adviser was not “honest and transparent throughout the negotiation process” and for the court to look to “both the adviser’s conduct during negotiation and the end result.” *Id.* *Gallus* is only the latest in a line of Section 36(b) cases which hold that advisers and their affiliates are governed by traditional fiduciary duty principles that are not limited to the factors specified in *Gartenberg*. See, e.g., *Galfand*, 545 F.2d at 809; *In re Mut. Funds Inv. Litig.*, 590 F. Supp. 2d 741 (D. Md. 2008). This approach is consistent with the statute’s express focus on fiduciary responsibilities and more meaningfully protects funds and their shareholders from the conflicts of interest inherent in the adviser’s relationship with the fund.



## CONCLUSION

Congress enacted Section 36(b) and its “breach of fiduciary duty” standard to afford greater rights to mutual funds and their investors. Since its enactment, however, courts, including the Seventh Circuit in this case, have applied Section 36(b) in a way that largely prevents redress under that statute. This Court should therefore reverse the Seventh Circuit below and require the courts to apply the fiduciary

duty standard of Section 36(b) that Congress intended.

Respectfully submitted,

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