No. 08-586

IN THE

Supreme Court of the United States

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

HARRIS ASSOCIATES L.P.,
Respondent.

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

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The Seventh Circuit devised a novel standard for assessing § 36(b) claims, which half that court rejected and neither Harris nor its industry *amici* defend in this Court.[1] Harris now advocates an approach it ascribes to *Gartenberg v. Merrill Lynch Asset Management, Inc.*, 694 F.2d 923 (2d Cir. 1982), a case the Seventh Circuit "disapprove[d]." Pet. App. 8a. Because all parties agree the court below applied the wrong standard, at a minimum this Court must remand for further proceedings under the correct standard.

Under the proper test, an adviser violates § 36(b) when it fails to provide full and accurate disclosure of all material facts relating to its compensation or charges fees that are not fair to the fund. That standard flows directly from the well-settled meaning of "fiduciary duty," § 36(b)'s history, and this Court's cases, including *Pepper v. Litton*, 308 U.S. 295 (1939), and *Daily Income Fund, Inc. v. Fox*, 464 U.S. 523 (1984). Pet. Br. 20-29; U.S. Br. 16-17.

Harris, by contrast, offers no discernible standard. It urges near-absolute deference to the "business judgment" of fund directors and relies on selected language from *Gartenberg* to argue that an adviser does not violate § 36(b) unless it charges a fee "so disproportionate[]" to the fees levied by advisers to similar mutual funds that it "could not have been" agreed to by parties bargaining at arm's length. Resp. Br. 28 (internal quotations omitted). That approach is unfaithful to the statutory text, § 36(b)'s history, and Congress's aims in restraining excesses among mutual fund investment advisers.

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[1] *Cf.* Br. in Opp. 30 ("[T]he Seventh Circuit's approach is clearly correct.").

Harris's reliance on policy arguments cannot obscure these critical facts:

- This case concerns the fees Harris charged the funds for *advisory services*, which are essentially the same in nature and cost as the services Harris provided to its independent clients. Pet. Br. 48-49 & n.47. The funds paid separate fees under separate agreements for *non*-advisory services. *Id.* at 49-50 & n.49.
- In percentage terms, Harris charged the funds, to which it owes a fiduciary duty, approximately twice as much for *advisory services* as it charged its independent clients, to which it owes no duty, for *advisory services*. *Id.* at 9-10.
- In dollar terms, Harris charged one of the funds *76 times* what it charged an independent client in an arm's-length transaction ($55 million compared to $720,000 for the independent client with a comparable investment objective). *Id.* at 10.[2]
- Harris's profit margins on advisory services were estimated to exceed 90% (excluding profit-sharing payments from costs). *Id.* at 11.
- The supposedly disinterested chair of the funds' board was a former Harris partner who received hundreds of thousands of dollars in deferred compensation from Harris annually. That deferred compensation was contingent on Harris's continued receipt of sufficient revenues, derived in large part from fees the board chair "negotiated" on the funds' behalf. *Id.* at 12, 39 n.29; JA74.

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[2] The disparity was 42 times between another fund and a comparable independent client. *See* Bogle Br. 29.

- Harris's partners received compensation of more than *six times* the industry average. JA413.

By any reasonable measure, those facts raise material issues regarding Harris's compliance with its fiduciary duty under § 36(b). Harris stands out in the industry for its rapacious appetite for income at its investor-beneficiaries' expense.

ARGUMENT

I. SECTION 36(b) REQUIRES FULL DISCLOSURE AND FAIR FEES

A. Section 36(b) Incorporates The Common-Law Fiduciary Duty Of Fairness And Full Disclosure

When Congress uses a term with a well-settled common-law meaning, it is presumed to incorporate that meaning into the statute. Pet. Br. 20. Although Harris concedes (at 27) that basic interpretive canon, it refuses to acknowledge that § 36(b)'s "fiduciary duty" incorporates the common-law principles that term embodies. Harris incorrectly asserts (at 27-36) that petitioners' test derives from special rules of trust law that Congress did not intend to incorporate in enacting § 36(b).

It has long been settled, however, that *all* fiduciaries, not just trustees, must provide full and accurate disclosure of all material facts and ensure that the transaction is fair to the one to whom the fiduciary duty is owed. *See*, *e.g.*, *Restatement (Second) of Trusts* § 2 cmt. b (1959) ("If the *fiduciary* enters into a transaction with the other and fails to make a full disclosure of all circumstances known to him affecting the transaction or if the transaction is unfair to the other, the transaction can be set aside

by the other.") (emphasis added). This Court has consistently applied those foundational principles of fiduciary-duty law outside the specific context of trusts. *See*, *e.g.*, *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 194 (1963) (investment management); *Geddes v. Anaconda Copper Mining Co.*, 254 U.S. 590, 599 (1921) (corporations).[3]

Pepper v. Litton confirms the universal applicability of the standard Congress adopted. As Harris admits (at 28), *Pepper* articulates the "essence of the test" as "whether or not under all the circumstances the transaction carries the earmarks of an arm's length bargain." 308 U.S. at 306-07. But Harris ignores the immediately preceding sentence, in which this Court identified the "earmarks of an arm's length bargain." There, the Court explained that a fiduciary's dealings "are subjected to rigorous scrutiny" to determine (1) whether the fiduciary acted in "good faith," and (2) whether the transaction was "fair[] from the viewpoint of the" beneficiary. *Id.*

Moreover, *Pepper* – a corporate law case – drew for its two-part test for breach of fiduciary duty from the common law of trusts. *See id.* at 306 ("[Fiduciaries'] powers are powers in trust.") (citing *Jackson v. Ludeling*, 88 U.S. (21 Wall.) 616, 624 (1874)). As *Jackson* explained, "in a very legitimate sense," the officers of a company "h[o]ld" its property "as trustees." 88 U.S. (21 Wall.) at 624; *see also Varity Corp. v. Howe*, 516 U.S. 489, 502 (1996) (looking to "ordinary trust law understanding" because statute refer-

[3] In *Manufacturers Trust Co. v. Becker*, 338 U.S. 304 (1949), which Harris cites (at 33), this Court abided by its "repeated[] insiste[nce] on good faith and fair dealing on the part of corporate fiduciaries." 338 U.S. at 310 (citing *Pepper*, 308 U.S. at 308-09).

enced "fiduciary"). Thus, *Pepper* and the authority on which it relied recognize that trust law is an especially influential source of fiduciary law, not a special body of law inapplicable in other contexts.

To be sure, Congress did not incorporate the common law wholesale in § 36(b). It placed the burden of proof on the plaintiff, for example, rather than on the fiduciary. *See* 15 U.S.C. § 80a-35(b)(1); Pet. Br. 24 n.17. But, contrary to Harris's assertion (at 28), Congress's adoption of a different approach to the burden of proof does not support the inference that it intended to alter the substance of what must be proved. Rather, Congress's action reflects an understanding of how the common law ordinarily operated and a choice to alter the burden of proof while leaving the substantive standard for a breach of fiduciary duty unchanged. *See* U.S. Br. 18.

B. Harris Concedes The Relevance Of Fees Charged To Independent Clients For Comparable Services

Harris's embrace of *Pepper* is important for an additional reason: it concedes the relevance of fees the adviser charges to independent clients for comparable services. According to Harris, the "fundamental consideration" and the "'essence of the test'" under § 36(b) is whether "'the transaction carries the earmarks of an arm's length bargain.'" Resp. Br. 28 (quoting *Pepper*, 308 U.S. at 306-07). The best way to make those determinations is to compare the transaction at issue to bargains produced by arm's-length negotiations. If an investment adviser's fees exceed materially those obtained in normal market transactions, then those fees do not "carr[y] the ear-

marks of an arm's-length bargain," and a violation of § 36(b) has occurred.[4]

Harris and its *amici* do not dispute that arm's-length transactions occur routinely in the marketplace for investment advisory services, particularly to independent institutional clients such as pension funds. If plaintiffs show that an adviser's fees compare poorly to the fees paid in such arm's-length transactions and that the services being provided by the adviser in the arm's-length transactions are comparable (even if not identical), then a court determines whether § 36(b) was violated by examining the aptness of the comparison and the materiality of any differences in services provided.

Harris's disagreement (at 40-43) that the services it provides to the funds and its independent clients are comparable is both incorrect (*see supra* p. 2; *infra* pp. 25-26; Pet. Br. 48-50) and a factual point to be evaluated on remand under the correct legal standard. The district court below rejected the independent-client comparison as a matter of law, *see* Pet. App. 30a, and the court of appeals dismissed it without citing record evidence, *see id.* at 39a, 41a (Posner, J.). Thus, neither court below evaluated the comparability of the services here under the correct legal test.

C. Harris's Version Of *Gartenberg* Finds No Support In § 36(b)'s Text

Harris offers no textual or historical support for its assertion that § 36(b) imposes liability only for fees that are "so disproportionately large" that they "'could not have been the product of arm's-length

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[4] *Cf. Basic Inc. v. Levinson*, 485 U.S. 224, 231-32 (1988) (defining "materiality" in the securities context).

bargaining.'" Resp. Br. 28 (quoting *Gartenberg*, 694 F.2d at 928). It repeatedly invokes *Gartenberg*, but that case offered inconsistent standards: the "so disproportionate[]" formulation (without any authority), and another one that more accurately captures the common-law fiduciary duty § 36(b) embodies – "whether the fee schedule represents a charge within the range of what would have been negotiated at arm's-length in the light of all the surrounding circumstances," 694 F.2d at 928. This Court's task, of course, is not to parse *Gartenberg*'s unexplained deviation from common-law principles when it used the "so disproportionate[]" language, but to construe § 36(b) as Congress wrote it. There is no basis elsewhere in the law to excuse a fiduciary's breach merely because it represents a somewhat less than "so disproportionate[]" departure from the fiduciary's legal obligations. The law of fiduciary duty rejects Harris's proffered approach. *See*, *e.g.*, *Meinhard v. Salmon*, 164 N.E. 545 (N.Y. 1928); Pet. Br. 21-24.

Further, nothing in § 36(b)'s text or history suggests that Congress intended that an investor must meet the extraordinary burden of proving a negative – that the fees *could not have been* the product of an arm's-length bargain. By reversing the burden of proof from common-law breach-of-fiduciary actions, Congress evinced no intent to change the underlying substantive standard, which requires the shareholder to prove that the compensation is not comparable to what would have been agreed to in an arm's-length transaction (not that no arm's-length negotiation could have produced the fees). Evidence that the adviser charges much lower fees to other, independent clients with whom it bargains at arm's length is highly probative on that question.

In addition, Harris's repeated assertion that enforcing § 36(b) will lead inexorably to "judicial rate regulation" (at 38) does not withstand scrutiny. Under a traditional scheme of rate regulation, the regulated entity is limited to recovering its costs and obtaining a "fair return" on invested capital – nothing more – and a regulatory agency polices the entity's rates to ensure compliance. *See generally Verizon Communications Inc. v. FCC*, 535 U.S. 467, 481-86 (2002).

Courts adjudicating claims of breach of fiduciary duty engage in a fundamentally different analysis. They evaluate "all the circumstances"[5] to determine whether "the transaction carries the earmarks of an arm's length bargain." *Pepper*, 308 U.S. at 306-07. Performing that traditional inquiry does not involve courts in the type of cost-based judicial ratemaking that Congress sought to avoid in imposing a fiduciary duty on investment advisers. Put differently, a court need not set a fee; it need only determine that the fee charged violates the adviser's fiduciary duty. Certainly, Harris's practice of charging captive funds twice in percentage terms what it charges independent clients – which supports a 90% profit margin and partner compensation at six times the industry average (*supra* p. 2) – should flunk any reasonable assessment of fiduciary duty without entangling federal judges in fee setting. Indeed, when evidence of what the adviser charges in arm's-length transactions for comparable services is available, courts can compare those market prices to the prices the adviser charges its captive funds without undertaking any

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[5] *Pepper*, 308 U.S. at 306; Resp. Br. 28; *accord* S. Rep. No. 91-184, at 15 (1969) ("all the facts"); *Gartenberg*, 694 F.2d at 928 ("all of the surrounding circumstances").

analysis of the adviser's costs or appropriate rate of return.

D. The History Of § 36(b) Confirms The Statute's Plain Meaning

The origin of § 36(b)'s fiduciary duty is undisputed. *See*, *e.g.*, Pet. Br. 44-48; U.S. Br. 19-20; Bogle Br. 16-18. After an initial version of the 1970 Amendments imposing a "reasonableness" standard on investment advisers failed to pass the House, the SEC and the Investment Company Institute ("ICI"), the entity representing investment companies and advisers, separately submitted to the House explanations of the proposed "fiduciary duty" standard ultimately enacted in § 36(b). *See* 1969 Hearings[6] 187 (SEC Memorandum), 441 (ICI Letter); *see also* Bogle Br. Apps. B-C. The SEC and ICI agreed that (1) the "fiduciary duty" standard derived from the common law and required full disclosure and substantive fairness, Pet. Br. 47 & nn.44-45; (2) the "fiduciary duty" standard differed from the "reasonableness" standard procedurally, *id.* at 45-47; and (3) the switch to "fiduciary duty" eliminated concerns that the "reasonableness" standard could subject fund *directors* to suit and could be misconstrued as authorizing cost-based rate regulation, *id.* at 46 & nn.41-42. There is no evidence that Congress intended to relieve *investment advisers* of the requirements of fairness and disclosure inherent in their fiduciary duty to investors.

Harris emphasizes (at 36-37) that Congress changed the amendment's wording from "reason-

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[6] *Mutual Fund Amendments (Part 1): Hearings Before the Subcomm. on Commerce and Finance of the H. Comm. on Interstate and Foreign Commerce*, 91st Cong. (1969) ("1969 Hearings").

ableness" to "fiduciary duty," but Harris provides no response to the reasons why Congress did so. That legislative history undermines Harris's claim that Congress intended a much more limited standard in revising the proposed language. *See* 1969 Hearings 189 (SEC Memorandum) ("The short answer to the question posed by Chairman Moss then is that there is little substantive difference between the standard of reasonableness and the standard of breach of fiduciary duty."), 441 (ICI Letter) (adviser "may not overreach in the amount of his fee even though the other party to the transaction, in full possession of all the facts, does not believe the fee is excessive").[7] *Gartenberg* recognized as much, concluding that "the substitution of the term 'fiduciary duty' for 'reasonable'" was "a more semantical than substantive compromise." 694 F.2d at 928; *see also Daily Income Fund*, 464 U.S. at 534 n.10 (Congress enacted § 36(b) because it believed existing law inadequate "to ensure reasonable adviser fees"). Thus, § 36(b)'s history lends no support to Harris's cramped construction of that provision.

E. The ICA's Structure Confirms Congress Intended § 36(b) To Be An Independent Check On Excessive Fees And Unscrupulous Negotiations

1. Harris contends (at 34) that the normal principle of incorporating meaning to Congress's use of a

[7] Harris incorrectly implies (at 36) that this Court in *Burks v. Lasker*, 441 U.S. 471, 483 (1979), identified "reasonableness review" as one of the "more drastic remedies" Congress rejected in the 1970 Amendments. In fact, the *Burks* Court listed remedies "such as complete disaffiliation of the companies from their advisors or compulsory internalization of the management function," *id.* – not so-called "reasonableness review."

common-law term like "fiduciary duty" should be ignored because, "[i]f Congress had intended to incorporate a specific trust-law standard, it could have required investment adviser compensation to be 'fair' or 'reasonable,'" as it did in "*other* provisions of the ICA." That argument proves too much. Any time Congress relies on a common-law term, it could have used more specific language to convey its intent. Congress employs common-law terms to invoke a body of law associated with them, rather than an unfamiliar phrase that could be misconstrued if interpreted outside the context Congress intends. *See*, *e.g.*, *Nationwide Mut. Ins. Co. v. Darden*, 503 U.S. 318, 323 (1992) (inferring intent to incorporate common-law meaning of "employee" in the Employee Retirement Income Security Act of 1974).

More fundamentally, language requiring "fair and reasonable" adviser fees would not have achieved all Congress intended. While it would have established a standard for evaluating the size of adviser fees, it would not have required full and accurate disclosure of all material facts relating to fees. Congress instead imposed on advisers a fiduciary duty, which incorporates both the obligation of full disclosure and the requirement of substantive fairness.

Harris's effort (at 34-35) to find support for its interpretation through citation to other provisions using reasonableness language ignores the different contexts in which those provisions operate. For example, ICA § 17(b)(1), which requires transactions between an affiliate of an investment company and the company to be "reasonable and fair," 15 U.S.C. § 80a-17(b)(1), is administered by the *SEC* in the first instance, not courts, *see id.* § 80a-17(b). Congress wanted the SEC, "an agency with great experi-

ence in the industry," to apply the criteria of fairness and reasonableness "to particular business situations in a manner consistent with the legislative intent." *E.I. du Pont de Nemours & Co. v. Collins*, 432 U.S. 46, 54 (1977). In contrast, when Congress sought to subject investment advisers to judicial (as opposed to regulatory) oversight, Congress used a familiar term – "fiduciary duty" – that courts historically have applied.

2. Harris and its *amici* misunderstand the role of fund boards of directors in Congress's design for § 36(b) actions. They assert that a "so disproportionate[]" standard properly "captures the deference that federal courts owe to the business judgment of the board." Resp. Br. 29-30, 35-36. Harris's proposal for unconstrained deference to fund boards, whose members are hand-picked by advisers, *see*, *e.g.*, JA122-23, finds no support in § 36(b)'s text or history or this Court's cases. Rather, Harris's deference claim, which would allow advisers to take as much as they can get so long as they obtain board approval, runs directly counter to Congress's purpose in enacting § 36(b) and would reintroduce the "waste" standard that Congress rejected.

When Congress amended the ICA in 1970, it "decided not to rely solely on the fund's directors to assure reasonable adviser fees, notwithstanding the increased disinterestedness of the board." *Daily Income Fund*, 464 U.S. at 540; *accord Kamen v. Kemper Fin. Servs., Inc.*, 500 U.S. 90, 108 (1991). Instead, Congress intended fund directors and § 36(b) suits to function as "*independent* checks on excessive fees." *Daily Income Fund*, 464 U.S. at 541 (emphasis added). As the Solicitor General and the SEC have explained, § 36(b) "reflects a congressional determi-

nation that, due to conflicts of interest in assessing the fairness of compensation paid to a company's investment adviser, courts cannot defer to the business decisions of investment company directors." SEC Br. at 9, *Daily Income Fund*, *supra* (No. 82-1200). Thus, the role of fund boards in policing adviser compensation (albeit important to the statutory scheme) provides no basis for weakening § 36(b)'s independent right of action for injured shareholders.

Harris claims (at 30) that fund boards "negotiate from a position that is *better* than arm's-length" through receipt of ICA-required disclosures from investment advisers. That argument strains credulity on this record. Harris provided the funds' board with inaccurate and misleading information regarding (among other things) the comparability of services provided to its independent clients, Pet. Br. 11-12, 52, in "negotiating" a fee 76 times more in dollar terms than the fee it negotiated in an actual arm's-length transaction with an independent client (*see supra* p. 2). Harris and its *amici*'s assumption that advisers always provide complete and accurate information regarding their compensation is false and cannot support the standard they propose.

More fundamentally, § 36(b) is based on skepticism that even a properly informed fund board can engage in true arm's-length bargaining with the adviser. The board lacks the critical tool of an arm's-length negotiator – the ability to walk away from the negotiations and deal with someone else instead. *See Burks*, 441 U.S. at 481 ("'[A] mutual fund cannot, as a practical matter[,] sever its relationship with the

adviser.'") (quoting S. Rep. 91-184, at 5).[8] That structural defect in the typical mutual fund-adviser relationship necessitates § 36(b) as an independent check on adviser compensation.

Harris pins much of its deference claim on § 36(b)(2). But Harris's argument contradicts the statutory language, which does not use the word "deference" and instead provides that board approval of adviser 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). That language *frees* courts from being bound by what fund boards have approved; it does not command judicial *deference* to that approval. As this Court has recognized, Congress intended § 36(b)(2) to reverse the former "waste" standard, which was highly deferential to fund boards, and to establish § 36(b) as an "independent check[] on excessive fees." *Daily Income Fund*, 464 U.S. at 534 n.10, 540 n.12, 541. Thus, the point of Congress instructing courts to give board approval only such consideration "as is deemed appropriate under all the circumstances," 15 U.S.C. § 80a-35(b)(2), was to *reject* deference in favor of a standard making board review one circumstance among many to be considered. Harris offers no support for the incongruous notion that Congress created an independent check on fund directors' decisions to approve adviser compensation but commanded courts to abdi-

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[8] *See also Public Policy Implications of Investment Company Growth*, H.R. Rep. No. 89-2337, at 12 (1966) (with the typical captive mutual fund, "the essential element of arm's length bargaining – the freedom to terminate negotiations and to bargain with other parties – is lacking").

cate their normal function by giving "deference" to those decisions.[9]

F. The ICA Requires "Fair Process" As Part Of The Adviser's Fiduciary Duty

In the starkest example of its abandonment of the decision below and the position advanced in its brief in opposition, Harris now claims (at 44) that § 36(b)'s fiduciary duty "does not extend to the process of disclosure and negotiation by which fees are approved."[10] Harris bases its excessive-fees-only rule on § 36(b)'s language providing that the adviser's fiduciary duty applies "with respect to the receipt of compensation." 15 U.S.C. § 80a-35(b). But Harris fails to explain why an adviser's provision of information about and negotiations regarding its *compensation* lie beyond the scope of that fiduciary duty. Nor could it. As this Court has concluded, the phrase "with respect to" quite broadly encompasses the subjects in issue. *See Riegel v. Medtronic, Inc.*, 128 S. Ct. 999, 1010 (2008)

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[9] Harris's *amici* argue that review of a fund board's approval of adviser compensation should be "highly deferential." Ind. Dir. Br. 24; *see also* Fidelity Br. 8. But, to give § 36(b) some function, they must concede that "little or no deference may be due when the directors' approval was a mere formality." Ind. Dir. Br. 3. That concession is decisive. Even judicial review for the "mere formality" of a board's action must extend beyond ascertaining whether the board received the requisite information and then voted favorably on the contract. A price charged to the fund that is materially greater than the fee charged in comparable arm's-length transactions for investment advisory services gives great reason to doubt that board approval was more than a "mere formality." (At a minimum, a court would have to find that the board received complete and accurate information and suffered from no conflicts of interest before it could give the board's approval significant consideration.)

[10] *Cf.* Br. in Opp. 30 ("An adviser can breach its fiduciary duty, for example, through lack of candor in negotiation.").

(rejecting argument that a statute preempting requirements "with respect to a device" was inapplicable unless the requirement in question applied "*only* to the relevant device, or only to medical devices and not to all products and all actions in general").

Indeed, Harris's newfound argument cannot be squared with the ICI's contemporaneous explanation to Congress in 1969 of its understanding of § 36(b)'s fiduciary duty. The ICI then stated that the "receipt of compensation" language was included to make clear that "the adviser or other person who received the compensation" – and not fund board members or other "non-recipients" – may be sued under § 36(b). 1969 Hearings 440-41; *accord id.* at 189 (SEC Memorandum). Thus, the "receipt of compensation" language was intended to identify the correct *defendant*, not to limit the fiduciary duty. Nothing suggests that Congress employed the "receipt of compensation" language in § 36(b) to depart from the common-law meaning of "fiduciary duty."

Nor can Harris find support in Congress's decision to limit recovery under § 36(b) to "actual damages." 15 U.S.C. § 80a-35(b)(3). That restriction on the *remedies* available for a violation of § 36(b)'s fiduciary duty does not create a limitation on the duty itself. A plaintiff need not have suffered "actual damages" to have a valid cause of action under § 36(b). Indeed, § 36(b)(3) expressly contemplates that plaintiffs will seek "other relief," such as an injunction or rescission of the adviser's contract. *Id.* § 80a-35(b)(3); *see id.* § 80a-46(b) (rescission). The district court in this case recognized as much in rejecting Harris's argument that petitioners' request for rescission should be stricken, explaining that § 36(b)(3)'s reference to "damages or other relief," *id.* § 80a-35(b)(3), "refutes

Harris's contention that the only remedy to be had is monetary." JA27; *see* Pet. Br. 8-9.

In addition, Harris argues (at 45) that the existence of ICA § 15(c) shows that the disclosure-and-negotiation process must be beyond the scope of § 36(b). Section 15(c) requires that a majority of disinterested fund directors approve the adviser's contract with the fund and obligates advisers to furnish information necessary to facilitate the fund board's review of that contract. *See* 15 U.S.C. § 80a-15(c). Even assuming that the fair-process prong of the § 36(b) fiduciary duty requires no more than what § 15(c) requires,[11] § 36(b)'s process-oriented obligations are not superfluous. Section 36(b) provides "new enforcement mechanisms" (U.S. Br. 14-15), including a damages remedy for shareholders injured by an adviser's failure to provide full disclosure or to negotiate fairly. Although Congress might have achieved a similar result by providing an explicit right of action for violations of § 15(c), that alone would not have

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[11] That assumption is dubious, because § 36(b)'s fiduciary duty requires more than just the provision of information; it also imposes an affirmative obligation to negotiate in good faith. *See*, *e.g.*, *Capital Gains Research Bureau*, 375 U.S. at 194 (a fiduciary has "an affirmative obligation to employ reasonable care to avoid misleading his clients") (internal quotations and footnote omitted); 1969 Hearings 441 (ICI Letter) ("In addition to considering the adviser's conduct the court would focus on the substance and quality of the negotiations which led to the contract in determining whether the adviser had breached his fiduciary obligations."); IIA Austin W. Scott & William F. Fratcher, *The Law of Trusts* § 170.25, at 436 (4th ed. 1987) (a trustee may "take[] no advantage of his position" in negotiating with a beneficiary); George G. Bogert & George T. Bogert, *The Law of Trusts and Trustees* § 544, at 493 (rev. 2d ed. 1993) (fiduciary owes a duty of "fair play in the direct dealing with his principal").

fulfilled Congress's full purpose. Section 36(b) requires both fair process and fair result, and the statute provides a cause of action for violating either requirement. Creating an express right of action for violation of § 15(c) would not have accomplished Congress's goal of empowering investors to redress excessive adviser fees.

Finally, Harris argues (at 46) that "adviser misconduct unrelated to a fee" can be addressed by the SEC under ICA § 36(a), 15 U.S.C. § 80a-35(a). That assertion is off point because the § 36(b) fair-process prong does not apply to matters "unrelated to a fee." Instead, it requires full disclosure of material facts *relating to the adviser's fees* and fair negotiation *regarding those fees*. In any event, § 36(a) and § 36(b) fulfill complementary, not duplicative, functions. The fiduciary duty of § 36(a) is enforceable only by the SEC, is not limited to the receipt of compensation, and is imposed on officers, directors, and advisers alike; further, a breach requires "personal misconduct." *Id.* In contrast, § 36(b) is privately enforceable, is limited to the receipt of compensation, and is imposed only on the recipient of compensation, *id.* § 80a-35(b); further, a breach does not require proof "that any defendant engaged in personal misconduct," *id.* § 80a-35(b)(1).[12]

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[12] Harris claims (at 48) that no case before *Gallus v. Ameriprise Financial, Inc.*, 561 F.3d 816 (8th Cir. 2009), had recognized the adviser's duty to provide full disclosure and negotiate in good faith, but it ignores *Galfand v. Chestnutt Corp.*, 545 F.2d 807 (2d Cir. 1976), on which the Eighth Circuit relied, *see Gallus*, 561 F.3d at 823 n.3; Pet. Br. 24-25.

II. HARRIS'S POLICY ARGUMENTS LACK MERIT

A. Post-Enactment Developments Support The Need For Sound Enforcement Of § 36(b)

1. In an effort to convince this Court that the protections of § 36(b) are no longer necessary, Harris and its *amici* assert that "average expenses for stock funds declined from 2.32% of assets in 1980 to 0.99% in 2008." Resp. Br. 7; *see* ICI Br. 30-31; SIFMA Br. 5; Chamber of Commerce Br. 21; Fidelity Br. 22. That argument cannot affect this Court's interpretation of Congress's intent in enacting § 36(b), which by its terms provides a check on each adviser's compensation, regardless of whether total expenses industry-wide are increasing or decreasing. *See* Pet. Br. 42; U.S. Br. 29.

In any event, the actual industry-wide trend has been toward ever-increasing costs, both in percentage terms and in dollar amount. Based on Harris's own statistics (at 7), total industry costs in 1980 were approximately *$16.6 million* (*i.e.*, total assets of $715 million times costs of 2.32%), while total industry costs in 2008 had risen to *$95 billion* (*i.e.*, $9.6 trillion times 0.99%). Yet Congress enacted § 36(b) to address the failure of funds to account for the huge fees that resulted from applying a constant (or relatively constant) percentage fee to an ever-increasing asset base. *See Daily Income Fund*, 464 U.S. at 537; S. Rep. 91-184, at 4, 6. No one believes that managing a $5 billion portfolio of stocks costs 10 times as much as managing a $500 million portfolio with the same investment objectives.

Even taking Harris's assertion at face value – that percentages, not dollars, are what matter – the

industry's self-serving calculations are misleading. A large proportion of the supposed decline in total costs under the industry's figures stems from the massive growth since 1980 in index funds.[13] Index funds require little investment advice and operate at low cost. By including them in the overall statistics, Harris and its *amici* cloak that *actively managed* equity funds of the sort at issue here have been charging steadily higher fees to their clients. Properly calculated, total costs of equity funds as a percent of assets have increased, not decreased, over the last 30 years.[14]

Further, Harris's statistics are suspect because they represent *total* fund costs. This case involves only investment *advisory* fees, not any other components of total-investment expenses, such as sales loads or administrative expenses. Thus, for example, the figures cited by Harris and its *amici* include sales loads, which have declined significantly over the years but have nothing to do with the trend in investment advisory fees.[15]

2. Harris erroneously claims (at 38) that the "mutual fund market" has become "extraordinarily competitive." But, in making that assertion, Harris focuses on the wrong market. Neither Harris nor its

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[13] *See*, *e.g.*, *Mutual Fund Industry Practices and Their Effect on Individual Investors: Hearing Before the Subcomm. on Capital Markets, Insurance, and Government Sponsored Enterprises of the H. Comm. on Financial Services*, 108th Cong. 81, 118-19 (2003) (testimony of John Bogle).

[14] *See*, *e.g.*, *id.* at 79 (expense ratio of average equity fund increased from 0.98% in 1978 to 1.61% in 2002).

[15] *See*, *e.g.*, *id.* at 81, 118-19. A sales load is a one-time charge of a certain percentage of assets usually assessed when the investor purchases a mutual fund.

amici dispute that, for the typical captive mutual fund, there is no "market" for investment advice; the captive fund will always be run by the adviser that created it, and neither investors nor the board have any practical ability to change that adviser.

Harris instead claims that competition among funds for investors constrains adviser fees. Substantial economic evidence rebuts that contention, however. *See*, *e.g.*, Pet. App. 37a-38a (Posner, J.) (Harris's "economic analysis" is "ripe for reexamination"); *Gallus*, 561 F.3d at 820 (citing six studies concluding that "inherent conflicts of interest and a lack of meaningful competition between mutual funds have led to systematic overpricing of investment advice"); Litan Br. 7-15 (arguing that market forces cannot constrain mutual fund fees to competitive levels). Moreover, Harris offers no response to petitioners' explanation of the practical constraints on investors' ability to avoid high-priced funds and the contemporary insights from behavioral economics regarding investors' decision-making. Pet. Br. 42-43. Finally, Harris does not dispute the impact that investors' brokers – who have been known to receive from advisers referral fees paid out of fund assets unbeknownst to fund shareholders (or even fund boards) – have on investors' fund choices. *Id.* at 44; *see, e.g.*, *In re Franklin Advisers, Inc. and Franklin/ Templeton Distributors, Inc.*, Investment Advisers Act Rel. No. 2337 (Dec. 13, 2004).[16]

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[16] The industry claims that the lack of competition among advisers for fund business does not matter because fund complexes compete for shareholders' business. That argument, however, undermines its separate assertion that courts should defer to fund directors' business judgment. If the only alleged competitive constraint comes from investors, then there is no

B. Harris Exaggerates The Litigation Effects Of Implementing Congress's Intent

To distract the Court from its unsound interpretation of § 36(b), Harris complains (at 49-52) – without empirical support – that interpreting § 36(b) as Congress intended would impose an undue burden on investment advisers without benefiting investors. But Harris's complaints about the expense and burdens of litigation should be addressed to Congress, which made the policy decision to subject investment advisers to shareholder suits under § 36(b).

In fact, Congress addressed the types of fears raised by Harris in enacting § 36(b). It armed investment advisers with a number of litigation weapons to thwart frivolous suits under § 36(b), such as shifting the burden of proof to the plaintiff, *see* 15 U.S.C. § 80a-35(b)(1); limiting the damages period and the amount of damages recoverable, *see id.* § 80a-35(b)(3); and requiring suits to be brought in federal court, *see id.* § 80a-35(b)(5).

Harris contends that those protections are inadequate and asserts (at 49-50) that a common-law fiduciary-duty standard will require a trial in every case. But courts applying the common law regularly dismiss breach-of-fiduciary-duty claims on the pleadings.[17] Further, Harris offers the unfounded worry

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reason to believe that fund boards serve the bargaining function that Harris and its *amici* attribute to those boards. Instead, the adviser will take as much as it can get from the fund, constrained only by the supposed concern that high fees – which often are difficult for even knowledgeable investors to ferret out – will drive away investors.

[17] *E.g.*, *Covinsky v. Hannah Marine Corp.*, 903 N.E.2d 422, 432 (Ill. App. Ct. 2009); *Desimone v. Barrows*, 924 A.2d 908, 948-50 (Del. Ch. 2007); *Robinson v. Midlane Club, Inc.*, No. 94-C-1459, 1995 WL 453057, at *3-*6 (N.D. Ill. July 28, 1995).

that a plaintiff or expert "could quibble" with the adviser's fees or "nitpick about how the information was used" (*id.*) and thereby force a trial. Quibbling and nitpicking do not entitle a plaintiff to a trial under the common law or otherwise. Instead, a plaintiff must produce evidence creating *genuine* issues of material fact. *See* Fed. R. Civ. P. 56(c)(2); *Celotex Corp. v. Catrett*, 477 U.S. 317, 322-27 (1986). Federal courts have ample tools to weed out meritless claims under § 36(b).

Equally unpersuasive is Harris's complaint (at 51) that "no individual shareholder could justify the cost of litigating fee and process 'fairness' for the tiny, speculative personal benefit that might result," and that lawyers are the true beneficiaries of § 36(b). To the contrary, fund shareholders are the beneficiaries of § 36(b); § 36(b) suits are brought derivatively "on behalf of" a mutual fund, and all shareholders benefit from any damages (or other relief) obtained in the action. 15 U.S.C. § 80a-35(b). For example, a prospective reduction in the adviser's fee schedule can amount to tens of millions of dollars in annual fee savings for the funds, Pet. Br. 10, and can make a substantial difference in returns for individual investors.[18] Thus, what Harris dismissively characterizes (at 49) as "grains off a penny" amount to a real stake for the funds and its shareholders – not to mention millions of dollars of its beneficiaries' money in profits to Harris.

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[18] *See*, *e.g.*, Pet. Br. 43 n.32; U.S. Dep't of Labor, Employee Benefits Security Administration, *A Look at 401(k) Plan Fees* 2 ("[A] 1 percent difference in fees and expenses would reduce your account balance [after 35 years] by 28 percent."), http://www.dol.gov/ebsa/pdf/401kFeesEmployee.pdf.

III. PETITIONERS' EVIDENCE WARRANTS A TRIAL ON THE MERITS

Because Harris does not defend the Seventh Circuit's reasoning, this case at a minimum should be remanded for further proceedings under the correct standard. Harris seeks (at 52-55) to avoid that result, relying on the district court's supposed application of *Gartenberg*. That argument is unavailing because, like the court of appeals, the district court applied an incorrect legal standard.

A. The District Court Made No "Findings"

Harris repeatedly claims that the district court "found" from an "undisputed" record that Harris's services to its independent clients were "'more limited'" than services provided to the funds. *E.g.*, Resp. Br. 52 (quoting Pet. App. 16a). But the court's "more limited" reference was in the background section of its opinion, *see* Pet. App. 16a, and was not a "finding" comparing services.[19] In fact, the district court dismissed the independent-client comparison as a matter of law. It held that the "range" of permissible fees "extended from a low-end figure below what the institutional clients were paying and a high-end figure beyond the fees that other mutual fund clients paid." *Id.* at 30a. The test, however, is not whether fees fall within the range of all fees charged to all

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[19] To the extent the district court intended its brief background statement to constitute a "finding" that differences in services explain the fee disparity, the court's action impermissibly resolved a genuine evidentiary dispute on summary judgment. *See Anderson v. Liberty Lobby, Inc.*, 477 U.S. 242, 249 (1986) ("[A]t the summary judgment stage the judge's function is not himself to weigh the evidence and determine the truth of the matter but to determine whether there is a genuine issue for trial.").

other customers. Indeed, every fee but the highest will fall within that range, rendering the test self-fulfilling. *See Gallus*, 561 F.3d at 823; *Gartenberg*, 694 F.2d at 929. Where, as here, the evidence shows that independent clients who bargain at arm's length with Harris receive comparable services at materially lower fees, at a minimum there is a genuine issue of material fact regarding the fees' fairness.

Harris lists various services purportedly offered to the funds but not independent clients.[20] But Harris fails to acknowledge that the funds pay separate fees for those additional services under agreements that are separate from the funds' "investment advisory" agreements with Harris, which provide only for actual investment advisory services. JA352 (¶ 19), 529-31. For instance, a separate "administration agreement," JA558, covers, among other things, preparation of financial information for the funds' management, board, and shareholders; portfolio compliance monitoring; and preparation of tax forms.[21] The funds also have a separate "transfer agency and service agreement" that covers shareholder services, including shareholder communications, among a host of other services. JA542, 551-55. For the other categories that Harris mentions (at 40-41) – "oversight of third-party vendors" and regulatory compliance – Harris makes no effort to explain these services or to quantify or justify its costs in light of the huge

[20] *See* Resp. Br. 40 (listing, *e.g.*, "administrative services," "shareholder communications, including the preparation and distribution of prospectuses and periodic reports," "trustee support, including preparation of materials for board meetings," and "tax administration").

[21] *See* Administration Agreement, App. B (Exh. C-38 to Plaintiffs' Statement of Additional Facts (Oct. 10, 2006)).

disparity in fees charged. Indeed, petitioners' experts demonstrated that the cost of any supposed additional services provided by Harris is negligible compared to the difference in fees, JA354-55 (¶ 22), 432-33, and that it actually costs Harris *more* to serve its institutional clients than its funds, JA354-55 (¶ 22), 431-34, 493-96.

B. Supposed Performance Does Not Justify Harris's Fees

Harris unpersuasively attempts (at 53) to justify its compensation through performance. First, fund performance casts little light on whether an adviser is fulfilling its fiduciary obligation where, as here, the advisory fee is not explicitly tied to investment results and the same fee applies no matter how the fund performs. Second, virtually all of Harris's evidence predates the relevant damages period in this case, which began on August 17, 2003. *See* Pet. App. 17a n.2; JA335. Since then, the funds' performance has declined. Pet. Br. 51. And, even at its best performance, Harris cannot justify charging the captive funds *76 times* in dollar terms what Harris charged independent clients.[22]

C. Fee "Negotiations" Were Not "Robust"

Harris also rests (at 53) on the "fee negotiation process." But Harris notably does not dispute that the funds' board chair – and a designated disinterested trustee – Victor Morgenstern was a former

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[22] The claim by Harris's *amici* that Harris did not "increase the advisory fee rates for any of these funds" (SIFMA Br. 7) is a semantic deflection. Fund assets grew so substantially over time that, even by keeping rates the same, Harris reaped dramatic increases in fees – an increase of more than $45 million in one year alone. *See* Pet. Br. 11; *see also Daily Income Fund*, 464 U.S. at 537.

Harris partner who remained *interested in Harris* within the meaning of the ICA. Pet. Br. 39 & n.29. The lower courts dismissed that fact as irrelevant, noting that Harris's compensation was approved by a majority of disinterested trustees even if Morgenstern's vote were excluded. *See* Pet. App. 3a, 25a. But the lower courts refused to examine Morgenstern's influence over the negotiation process. *See id.* at 4a. His status and role belie Harris's claim (at 53) that the process was "robust," particularly when combined with petitioners' other evidence of conflicts among Harris and the board and Harris's failure to disclose those conflicts (not to mention Harris's failure to provide the board with complete and accurate information). *See* Pet. Br. 11-13, 52; JA83, 364-68; *see also* Pet. App. 40a (Posner, J.) (the more connected the directors and management, the higher the fees that go to management).[23]

D. Harris Abandons The Seventh Circuit

Neither Harris nor its industry *amici* attempt to defend the Seventh Circuit's analysis. Instead, Harris asserts (at 54) that the Seventh Circuit did not disturb the "factual analysis" of the district court. But the district court did not make (and could not have made) findings on summary judgment that the court of appeals could leave undisturbed. And, as

[23] The district court made no finding that the process *in fact* functioned properly; instead, it said only that it had "*no reason to discount **the notion*** that the shareholders' interests were represented at the negotiating table by a group of people who were *capable* of giving those interests primacy." Pet. App. 31a (emphases added). Indeed, Harris identifies nothing in the record (*e.g.*, minutes of a board meeting) suggesting that the funds' board actually discussed and approved paying Harris 76 times what an independent client paid for comparable services.

Judge Posner recognized, the Seventh Circuit's discussion of factual issues in this case amounted to nothing more than "suggestions" and "airy speculation" with no "evidentiary or empirical basis." Pet. App. 39a, 41a (Posner, J.).[24]

CONCLUSION

The judgment of the court of appeals should be reversed and the case remanded.

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[24] This Court's practice of accepting "factual determinations" of lower courts does not apply to review of summary judgment; it only applies when the trial court has made – and the appellate court has reviewed – findings of fact. *See Branti v. Finkel*, 445 U.S. 507, 508-09 (1980) (indicating that the district court "hear[d] evidence for eight days" and "entered detailed findings of fact" before entering a permanent injunction); *Exxon Co., U.S.A. v. Sofec, Inc.*, 517 U.S. 830, 835, 841 (1996) (indicating that the issue on which there were "concurrent findings of fact" that this Court declined to review resulted from a "3-week bench trial in admiralty") (internal quotations omitted).

Respectfully submitted,

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