Can the Market Be Relied on to Regulate Mutual Fund Fees?

CASE AT A GLANCE

Petitioners in this case, shareholders of Oakmark Mutual Funds, allege that the Fund's creator and adviser, Harris Associates, L.P., breached its fiduciary duty under the Investment Company Act of 1940 with respect to the fees charged to the fund's shareholders. Petitioners ask the Court to determine whether the fiduciary duties of an investment adviser can be breached when a disinterested board of trustees voted for the questionable fee structure.

Jones v. Harris Association
Docket No: 08-586

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From: The Seventh Circuit

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ISSUE

Should courts determine whether an investment adviser's compensation is so excessive as to breach fiduciary obligations under the Investment Company Act, without a showing that the Fund's trustees were misled in approving the compensation?

FACTS

Plaintiffs are shareholders of Oakmark Mutual Funds (Oakmark) who claim that Harris Associates, L.P. (Harris), the funds' sponsor, charged excessive fees in violation of the Investment Company Act.

Oakmark is a series of seven "captive" mutual funds established in 1991 by Harris Associates, L.P. A "captive" fund is a mutual fund whose shares are held entirely by the clients of the fund sponsor. As is typical in the industry, Harris Associates is both the fund sponsor and investment adviser for those funds. Each year, Harris Associates appoints Oakwood's board of trustees. In turn, the trustees appoint Harris Associates as the funds' investment adviser and a majority of Oakwood Fund's disinterested trustees approve Harris Associates' fees. As described in the Oakmark prospectus, "subject to the overall authority of the board of trustees Harris Associates furnishes continuous investment supervision and management to the funds and also furnishes office space, equipment, and management personnel." This relationship is typical within the mutual fund industry where such funds generally are managed by the investment advisers who create them.

The returns yielded by the Oakmark Funds to its shareholders have continuously exceeded market averages. As a result, the Oakmark Funds have increased in value and so has the compensation earned by Harris Associates.

The Oakmark board of trustees approved the fee schedule by a majority vote of disinterested trustees as mandated by relevant sections of the Investment Company Act of 1940 (ICA), despite the fact that the fees charged to Oakmark shareholders were twice as high as fees charged to other noncaptive investors such as institutional investors. Petitioners contend that the fees Harris charged on the Oakmark Funds are so excessive that they violate the ICA.

Oakmark shareholders sued Harris Associates in the District Court for the Northern District of Illinois. *Jones v. Harris Assocs. L.P.,* 2007 WL 627640 (N.D. Ill. Feb. 27, 2007). The district court granted summary judgment for Harris Associates, holding that the investment adviser had not violated the ICA. On appeal, the Seventh Circuit upheld the district court's decision. In an opinion authored by Judge Easterbrook, the court reasoned that because the disinterested Oakmark trustees had approved the compensation, the advisers were protected against an assertion of breach of fiduciary under the ICA.

CASE ANALYSIS

The shareholders' primary argument—that the fees charged by Harris are so high as to be a breach of fiduciary duty—stems from their interpretation of ICA § 36(b), which states that "the investment adviser of a registered investment company shall be deemed to have a fiduciary duty with respect to the receipt of compensation of services." It is this argument, on which both the district court and the Seventh Circuit ruled in favor of Harris that is now before the Supreme Court.

Shareholders' Arguments

Plaintiff-shareholders allege that Harris Associates violated ICA § 10(a), which requires at least 40 percent of a mutual fund's trustees to be disinterested. In addition, plaintiffs allege a violation of ICA § 15(c), which requires that the adviser's compensation must be voted on by a majority of disinterested trustees. The shareholders contend that Harris Associates violated these ICA sections by counting one of the Oakmark trustees, Victor Morgenstern, as a disinterested trustee. Morgenstern was a partner in Harris until 2000. Upon retirement, Harris Associates bought out Morgenstern's shares in the firm. Payment of Morgenstern's buyout was contingent on the performance of Harris. These payment terms, the shareholders assert, amount to profit-sharing securities and thus make Morgenstern a continued owner of Harris Associates and therefore an interested trustee. *Jones v. Harris Assocs. L.P.,* 2007 WL 627640, *2, aff'd, 527 F.3d 627, at 629 (7th Cir. 2008).

Shareholders also contend that Harris Associates violated ICA § 36(b), which imposes a fiduciary duty on investment advisers with respect to the advisers' compensation. The shareholders argued that the fees paid by Oakmark to Harris were excessive and established in the midst of an incestuous relationship and therefore, the receipt of those fees by Harris constituted a breach of its fiduciary duty. The district court ruled in favor of Harris and the shareholders appealed.

The Seventh Circuit's Opinion

As a threshold matter, the Seventh Circuit noted that ICA §§ 10(a) and 15(c) do not provide a private right of action, according to the Supreme Court's decision in *Alexander v. Sandoval*, 532 U.S. 275 (2001). Assuming *arguendo* that these sections did offer a private right of action, the court held that no violation had occurred because even if Morgenstern were deemed to be an interested trustee, the percentage of disinterested trustees required for voting on compensation still would not dip below the required 40 percent minimum under ICA § 10(a). The court also rejected the shareholders' contention that "Morgenstern possessed some Svengali-like sway over the other trustees, so that his presence in the room was enough to spoil their decisions." *Jones v. Harris Associates L.P.,* 527 F.3d 627, at 630 (7th Cir. 2008).

Unlike other sections of the ICA, § 36(b) does offer a right of private action, but the court affirmed the district court opinion holding that no fiduciary duty had been breached. The district court had relied on *Gartenberg v. Merrill Lynch Asset Management, Inc.,* 694 F.2d 923 (2d Cir. 1982) to reach this conclusion. In *Gartenberg,* the Second Circuit created a multifactor test to decide if compensation received by an investment adviser is disproportionately large and hence an indicator of breach of fiduciary. Under the test, the court considers all factors relevant to the establishment of the fee schedule including "the comparability of fees but also the cost to the adviser to provide services to the fund; the nature and quality of the services that are provided, including the fund's performance history; whether and to what extent the adviser realizes economies of scale as the fund's assets increase; the volume of orders from the fund's investors that need to be processed …; and the conduct of, expertise of, and level of information possessed by the trustees charged with approving the fee at the outset." *Id.* at 930. An investment adviser will breach its fiduciary duties only if the fee "is so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been the product of arm's-length bargaining." *Id.* at 928.

Although the Seventh Circuit affirmed the lower court's decision, it rejected the *Gartenberg* approach. Drawing on the law of trusts the court held that "a fiduciary duty differs from rate regulation. A fiduciary must make full disclosure and play no tricks but is not subject to a cap on compensation." *Jones v. Harris Assocs. L.P.,* 527 F.3d at 632. The Seventh Circuit concluded that, in the absence of deceit, market forces can be relied on to curb excessive fees. Investors "who vote with their feet and dollars … determine how much advisory services are worth." *Id.*

The Seventh Circuit admitted the possibility that compensation can be so abnormally large that a court could infer that deceit occurred, but it stated that "no court would inquire whether a salary normal among similar institutions is excessive." *Id.* The court concluded that the amount of fees cannot be dispositive of whether a fiduciary breach occurred under ICA § 36(b) unless the adviser somehow misled the trustees who voted for the compensation. The court noted that no evidence had been produced indicating that Oakmark trustees were misled in agreeing to the compensation and that the issue of Mr. Morgenstern's status as trustee was not dispositive.

The Seventh Circuit endorsed Harris Associates' argument that in order to determine the reasonableness of the fee structure, the court should compare captive funds to other captive funds, not to unaffiliated institutional funds that might have lower costs.

Rehearing: Battle of the Law and Economic Judges

The shareholders filed a petition for rehearing, which the Seventh Circuit denied per curiam. *Jones v. Harris, L.P.,* 537 F.3d 728 (7th Cir. 2008). Five judges dissented from the denial of rehearing. Judge Posner authored the dissent.

Judges Posner and Easterbrook have been leaders of the law and economics movement, which touts the efficiency of the capital market and its ability to accurately value stocks. Recently, however, Judge Posner has broken ranks with the law and economic crowd and has become a Keynesian. See "How I Became a Keynesian: Second Thoughts in the Middle of a Crisis," *The New Republic* (Sept. 23, 2009).

Judge Posner criticizes the Seventh Circuit panel's rejection of *Gartenberg* because "the panel bases its rejection of *Gartenberg* mainly on an economic analysis that is ripe for reexamination on the basis of growing indications that executive compensation in large publicly traded firms often is excessive because of the feeble incentives of boards of directors to police compensation." *Jones v. Harris, L.P.,* 537 F.3d at 730.

The Seventh Circuit had rejected *Gartenberg* "because it relies too little on markets" to curb excessive compensation. *Jones v. Harris Assocs. L.P.,* 527 F.3d at 632. The panel had held that compensation packages and fees "are constrained by competition in several markets—firms that pay too much to managers have trouble raising money. … Competitive processes are imperfect but remain superior to a 'just price' system administered by the judiciary." *Id.* at 633.

Judge Posner rejects the panel's over-reliance on the efficiency of the market, stating that "[c]ompetition in product and capital markets can't be counted on to solve the problem." *Jones v. Harris, L.P.,* 537 F.3d at 730. This is because "the governance structure that enables mutual fund advisers to charge exorbitant fees is industry-wide, so the panel's comparability approach would if widely followed allow those fees to become the industry's floor." *Id.* at 732. Judge Posner would have compared the fees Harris charged the Oakwood Funds (which it controls) to the fees that Harris charges independent funds.

In the Supreme Court

Oakwood shareholders petitioned the U.S. Supreme Court for certiorari on the following question: "Whether a shareholder's claim that the fund's investment adviser breached its fiduciary duty by charging an excessive fee—more than twice the fee it charged to funds with which it was not affiliated—is cognizable under § 36(b), even if the shareholder does not show that the adviser misled the fund's directors who approved the fee." Shareholders argued that the Seventh Circuit's application of *Gartenberg* was flawed because it compared Harris Associates' fees with the fees of similarly situated advisers to show that the fees charged to Oakmark shareholders are relatively comparable. Shareholders argued that because excessive fee structures between investment advisers and the funds they create is an industrywide phenomenon, the court should have compared compensation rates more narrowly. Instead, the court should have compared the rates that Harris charges Oakmark Funds to the fees it charges funds that it neither created nor controls. Shareholders argue that it is this comparison that shows the fees charged to Oakmark are excessive.

Shareholders also rely on studies by behavioral economists that show that mutual fund investors "do not rationally process fee information, so that the market does not punish high-priced funds in the way the Seventh Circuit speculated it should." *Id.* at *44.

Harris counters that the fees it charges institutional investors should be used for comparison only if the services provided are comparable. *Jones v. Harris Assocs. L.P.,* 2009 WL 2777652, at *39 (Aug. 27, 2009). They are not. Pension funds are long-term holders and have a lower turnover rate in contrast to mutual fund owners. In addition, Harris is required to provide additional services to Oakmark that institutional investors do not require, such as "administrative services; shareholder communications, including the preparation and distribution of prospectuses and periodic reports; oversight of third-party vendors, including the transfer agent, custodian, and intermediaries; trustee support, including preparation of materials for board meetings; tax administration; and compliance with a complex regulatory regime that is not required for institutional accounts." *Id.* at *40-41.

SIGNIFICANCE

This is a case of David versus Goliath where Goliath contends that it is the underdog because it cannot get as much compensation as the market will bear. This argument may fall on unsympathetic ears given the current state of the U.S. economy.

The case is likely to draw significant media attention, given that it hones in on some of the most pressing economic issues of the day: the reining in of excessive compensation; the tendency of boards to rubber-stamp executive decisions; the inability of consumers to understand complex fee structures hidden in lengthy prospectuses; and the retirement insecurity of most Americans who are dependent on employers for retirement income—employers who are cutting costs by replacing defined benefit plans with 401(k) plans that have dozens of mutual fund investment options.

In its amicus brief, the Cato Institute describes the case as "a case about who gets to decide the compensation levels for investment professionals: regulators and judges, who base their decisions on their own conceptions of fairness, or consumers, whose decisions result from open and free bargaining in the competitive financial services marketplace." It contends that "When an investment advisor, or any other person, agrees to perform a service for compensation, he has a right to that pay, no matter how large the amount may be, and regardless of whether others regard it as 'excessive.'" The Cato Institute argues against judicial interference in the regulation of mutual fund fees, stating that "[f]iduciaries have no obligation to work for below-market rates or to limit what they may charge for their services."

In recent years, the Securities and Exchange Commission has passed regulations designed to curb perceived mutual fund abuses such as market timing, late trading, revenue sharing, and fee disclosure. These abuses "took place on the watch of the not-so-vigilant fund directors," according to the Brief of Amicus Curiae National Association of Shareholder and Consumer Attorneys (NASCAT) in Support of Petitioners. In the words of Warren Buffet: "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." Brief of Amicus Curiae National Association of Shareholder and Consumer Attorneys (NASCAT) in Support of Petitioners, *Jones v. Harris Associates, L.P.,* 2009 WL 1759019, at *6-7 (June 17, 2009).

The amicus brief for the Independent Directors Council disagrees: "In petitioners' retelling, fund directors are mere puppets of the adviser who rubber-stamp the advisory fee and other aspects of the contractual relationship between the adviser and fund." But even the independent directors believe that investors should be the ultimate arbiter of compensation: "the selection of the adviser is best left to the individual investor and not the independent directors." This, says Law and Finance Amici Curiae in Support of Respondent, is because "whatever the fund's board's ability to 'fire' advisers, shareholders can and readily do 'fire' advisers by moving to another fund." For example, the Investment Company Institute (ICI) points out that there "is a clear Darwinian winnowing out of less competitive advisers from the fund marketplace." In 2008, "92 million individual investors in 52.5 million households owned mutual funds. These investors could choose from 8,022 funds offered by 717 advisory firms." ICI reports that "In 2008 alone, thirty-seven advisers left the market…. Almost 600 new funds were created in 2008 alone, and nearly 300 were liquidated." Investors who are dissatisfied with the fund's fee structure can simply "vote with their feet," and often do so.

John Bogle, the founder of the Vanguard Funds, writes in favor of the Oakmark shareholders. He confirms that shareholders are unlikely to replace mutual fund advisers. Bogle observes that only one fund board—Vanguard's—has ever attempted to oust its investment adviser. He notes that the "'insiders' who actually manage a fund are usually employees of the investment adviser, not the fund; insofar as stock options and similar arrangements help to align the insiders' interests with anyone, it is with the adviser, not the fund." Bogle continues: "In addition, because ownership of a fund's shares is ordinarily very widely dispersed and because there is no "market" for control of a fund's board, unseating directors is even harder than is the case with ordinary corporations. The threat that a director whom the adviser approves would be ousted is thus vanishingly small. Finally, it is relatively easy for advisers to seat directors who are not 'interested' within the meaning of the 1940 Act … but who nonetheless are sympathetic to the adviser." Thus Bogle, the founder of one of the largest mutual funds, argues that shareholders need the protection of the court to establish a standard of "reasonableness."

Moreover, as the amicus brief of Robert Litan, Joseph Mason, and Ian Ayres notes in support of petitioners, behavioral economists have concluded that "the vast majority of investors cannot accurately assess the quality of the mutual funds in which they invest—that is, they do not behave rationally as predicted by economic models." For example, the average person does not really understand the concept of probability. This is important because the returns generated by a fund are in part based on the skill of the investment managers and in part on the fluctuation of the market. As a result, "[i]nvestors face an incredibly difficult task in discerning whether their money is being managed well." In addition, mutual fund fees are complex, making it hard for the average investor to calculate the total fee.

In its amicus brief, AARP points out that if *Gartenberg* is reversed, millions of Americans who invest their retirement assets in mutual funds will be harmed. This problem is exacerbated by the trend toward the termination of defined benefits plans and the over-reliance of employers on defined contribution plans (which typically offer mutual funds as investment options). AARP argues that "Excessive fees can jeopardize retirement security even when financial market performance is satisfactory." It provides an example that illustrates that over time even a 0.5 percent increase in fees significantly reduces the amount available for retirement.

It remains to be seen whether the Supreme Court will use this case to take sides on the current rift in the Law and Economics debate. If so, the issue will be whether investors are adequately protected by the marketplace or whether the courts need to jump in and second-guess investment advisory fees under ICA § 36(b). Given the business judgment rule that governs fiduciary duties in a corporate setting, the Court may be reluctant to second-guess the fee structures absent fraud or deceit. The Court may, instead, apply fiduciary duties in the context of trust law and hold that trustees are "held to something stricter than the morals of the marketplace. Not honesty alone, but the punctilio of an honor the most sensitive, is the standard of behavior." *Meinhard v. Salmon,* 164 N.E. 545, at 546 (1928).

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PREVIEW of United States Supreme Court Cases, pages 87–90.

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