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

BRIEF OF AARP AND CONSUMER FEDERATION OF AMERICA AS *AMICI CURIAE* IN SUPPORT OF PETITIONERS

JAY E. SUSHELSKY*
AARP FOUNDATION LITIGATION

MICHAEL SCHUSTER
AARP

601 E Street, NW
Washington, DC 20049
Telephone: (202) 434-2060

Counsel for *Amici Curiae*
*Counsel of Record

TABLE OF CONTENTS

TABLE OF AUTHORITIES

FEDERAL CASES

FEDERAL STATUTES AND LEGISLATIVE HISTORY

OTHER AUTHORITIES

STATEMENT OF INTEREST[1]

AARP is a nonpartisan, nonprofit membership organization of nearly 40 million persons age 50 and older. Its mission is to help people 50+ achieve independence, choice and control in ways that are beneficial and affordable to them and society. Through education, advocacy, and service, and by promoting independence, dignity, and purpose, AARP seeks to enhance the quality of life for all. In its efforts to foster the economic security of individuals as they age, AARP seeks to increase the availability, security, equity, and adequacy of public and private pension programs and the protections available to investors who accumulate savings outside of formal retirement plans.

Consumer Federation of America (CFA) is a non-profit association of 300 consumer groups, which in turn represent more than 50 million individuals. CFA advances the consumer interest through research, education, and advocacy. As increasing numbers of people have come to rely on the nation's financial markets to fund their retirement and invest their savings, CFA has made enhancing investor protection a top legislative and regulatory priority. CFA's policies in this area are based on a fundamental belief that investors are entitled to a

---

[1] The parties have consented to the filing of this brief. *Amici curiae* state that no counsel for a party authored this brief in whole or in part, and no counsel or party made a monetary contribution intended to fund the preparation or submission of this brief. No person other than *amici*, its members, or its counsel made a monetary contribution to the preparation or submission of this brief.

marketplace that provides them with a choice of appropriate investments and service providers, the information necessary to make informed choices, protection against fraud and abuse, and effective remedies when they are defrauded.

As part of their advocacy efforts to protect investors and preserve the legal means for redress when they are harmed in the marketplace, AARP and CFA have participated as *amici curiae* in numerous cases involving investor protections, including the scope of a fiduciary's duties as well as legislative and regulatory protections against fraudulent and deceptive conduct. AARP and CFA have filed *amicus curiae* briefs in cases involving the construction and application of federal securities laws. *See, e.g.*, *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta*, 128 S. Ct. 761 (2008) (AARP & CFA); *Merrill Lynch, Pierce, Fenner & Smith v. Dabit*, 547 U.S. 71 (2006) (AARP); *Dura Pharms., Inc. v. Broudo*, 544 U.S. 336 (2005) (AARP & CFA); *SEC v. Edwards*, 540 U.S. 389 (2004) (AARP); *SEC v. Zandford*, 535 U.S. 813 (2002) (AARP & CFA). AARP also has filed briefs in numerous cases involving the duties of various fiduciaries involved in pensions and other retirement plans. *See*, *e.g.*, *LaRue v. DeWolff, Boberg & Assocs.*, 552 U.S. __, 128 S.Ct. 1020 (2008); *Varity Corp. v. Howe*, 516 U.S. 489 (1996).

Due to the vulnerability of retired persons and the critical role that mutual funds play in helping guarantee financial security in retirement, a top priority of AARP and CFA is to ensure that mutual fund investors receive the full return on their investments to which they are entitled. The issues in this case directly bear on the fiduciary duty of mutual fund investment advisors and whether that duty includes an obligation not to charge excessive fees against the retirement accounts and other savings vehicles of millions of individuals. Mutual fund investors face significant risks if the Seventh Circuit's statement of the fiduciary duty prevails because it fails to recognize how the relationship between mutual funds and their investment advisers overrides traditional market forces that otherwise might ensure that advisers' compensation is consistent with their fiduciary duty. Because investment adviser compensation is deducted from mutual fund assets, resolution of the issues in this case will have a significant impact on the ability of current and future retirees to realize financial security in retirement. AARP and CFA, therefore, respectfully submit this brief *amici curiae* to facilitate the Court's decision in this case.

SUMMARY OF ARGUMENT

The Seventh Circuit's narrow interpretation of the fiduciary duty that a mutual fund investment adviser owes to the fund's investors under § 36(b) of the Investment Company Amendments Act of 1970, 15 U.S.C. § 80a-35(b), circumvents the intent of Congress in enacting § 36(b) and jeopardizes the ability of all American families to save sufficiently for retirement and for their children's future educational needs. Based on flawed assumptions about the competitive nature of the mutual fund industry and a flawed reading of the common law of trusts, the Seventh Circuit disapproved of the reasonableness approach established in *Gartenberg v. Merrill Lynch Asset Mgmt., Inc.*, 694 F.2d 923, 928 (2d Cir. 1982), which had been followed by courts for almost thirty years. Instead the court held that the fiduciary duty created by § 36(b) means no more than a duty to refrain from "pull[ing] the wool over the eyes" of the fund's board. *Jones v. Harris Assocs. L.P.*, 527 F.3d 627, 632 (7th Cir. 2008). In so holding, the Seventh Circuit significantly eroded the legal protections Congress created under the Investment Company Act and its subsequent amendments. The Seventh Circuit's holding that the investment advisor's § 36(b) fiduciary duty is breached by a failure to make full disclosure or by engaging in dishonest behavior ("play[ing] … tricks," *id.*) is a correct statement of law insofar as it asserts a sufficient condition for a § 36(b) violation. But rather than limiting the investment advisor's duty as the court did in *Jones*, this Court should adopt an approach similar to that used by the Eighth Circuit's in *Gallus v. Ameriprise Fin. Inc.*, 561 F.3d 816 (8th Cir. 2009). *Gallus* applied traditional principles of fiduciary duty in requiring advisers both to make full disclosure and deal fairly with the funds they advise. *See id.* at 823. Under a interpretation of the statute, an adviser must both act properly in the negotiation process and ensure that a fair outcome results. Applying that rule, which is faithful to the common-law principles that § 36(b) incorporates, achieves the full measure of protection Congress intended under § 36(b).

ARGUMENT

I. MUTUAL FUND INVESTMENT FEES SIGNIFICANTLY REDUCE LONG-TERM SAVINGS FOR RETIREMENT AND FUTURE EDUCATION EXPENSES FOR VIRTUALLY ALL SAVERS IN THE NATION.

Ninety-one million individuals representing nearly half of all U.S. households (fifty-three million) and almost one-fifth of all household assets are invested in mutual funds. William A. Birdthistle, *Compensating Power: An Analysis of Rents and Rewards in the Mutual Fund Industry*, 80 TUL. L. REV. 1401, 1414 (2006) (citations omitted). This considerable percentage of individual wealth in the United States is invested in multi-purpose mutual fund investment vehicles. Mutual funds thus play a central role in savings for retirement and college education. Because a comparatively small current reduction in principal significantly reduces long-term returns on investment, the policies of the mutual fund industry, including those related to investment fees,[2] will seriously impact the future

---

[2] *See* U.S. GOV'T ACCOUNTABILITY OFFICE, GAO/GGD-00-126, MUTUAL FUND FEES: ADDITIONAL DISCLOSURE COULD ENCOURAGE PRICE COMPETITION 5 (June 2000) [hereinafter GAO, MUTUAL FUND FEES] ("Mutual fund fees that investors pay include operating expenses, which cover the day-to-day costs of running a fund. . . . Generally shown as a percentage of the fund's average net assets, the annual total operating fee amount is referred to as the fund's operating expense ratio. The largest portion of a fund's expense ratio is generally the

wellbeing for the vast majority of American families.

A. Mutual Funds Are The Dominant Investment Vehicles For Retirement Savings.

Even with the attention being paid to the long-term health of the Social Security system, the widespread shift in employer-sponsored retirement plans from defined benefit plans ("DB plans") to defined contribution plans ("DC plans") has resulted in the retirement savings of tens of millions of Americans being invested in mutual funds. *See* Alan R. Palmiter & Ahmed E. Taha, *Mutual Fund Investors: Divergent Profiles*, 2008 COLUM. BUS. L. REV. 934, 1018 (2008). DC plans have so eclipsed DB plans that by 2005, approximately 55 million participants were covered by DC plans, while only 21 million were covered by DB plans. U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-07-530T, PRIVATE PENSIONS: INCREASED RELIANCE ON 401(K) PLANS CALLS FOR BETTER INFORMATION ON FEES 5 (March 2007) [hereinafter GAO REPORT: PRIVATE PENSIONS: INCREASED RELIANCE ON 401(K) PLANS]. Seventy-eight percent of mutual fund owners held DC accounts. INVESTMENT CO. INST., 2009 INVESTMENT COMPANY FACT BOOK: A REVIEW OF TRENDS AND ACTIVITY IN THE INVESTMENT COMPANY INDUSTRY 73 (49th ed. 2009), *available at* http://www.icifactbook.org/pdf/2009_factbook.pdf [hereinafter ICI FACT BOOK]. By the end of 2008, 95 percent of mutual fund investors claimed their

---

fund adviser's compensation, which is used to cover its operating costs and earn profits for its owners.").

reason for investing in mutual funds was to save for retirement, and 69 percent of individuals invested in mutual funds held over half of their financial assets in mutual funds. *Id.* at 73. Moreover, IRAs and employer-sponsored DC plans accounted for approximately one-third ($3.1 trillion) of the $9.6 trillion in assets held by the United States mutual fund industry and 47 percent of all long-term mutual fund assets. *Id.* at 101.

A fundamental risk reallocation has occurred in the world of retirement planning. The shift to DC plans has eliminated the financial security previously provided by DB plans and it has consequently caused the retirement security for tens of millions of Americans to become dependent on a mutual fund's investment returns. Unlike the workings of a DB plan, which is generally funded solely by the employer and is required to provide a life-time annuity as a distribution option, there is no guaranteed benefit under a DC plan because the amount received is dependent upon the amount of employee and employer contributions and whether those investments experience growth or suffer losses during the life of the account. U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-08-8, PRIVATE PENSIONS: LOW DEFINED CONTRIBUTION PLAN SAVINGS MAY POSE CHALLENGES TO RETIREMENT SECURITY, ESPECIALLY FOR MANY LOW-INCOME WORKERS 4 (2007); U.S. DEP'T OF LABOR, PENSION & WELFARE BENEFITS ADMIN., STUDY OF 401(K) PLAN FEES AND EXPENSES §1.1 (1998), *available at* http://www.dol.gov/ebsa/pdf/401krept.pdf. *See also Strengthening Worker Retirement Security: Before* *the H. Comm. On Education and Labor*, 111th Cong. 5 (2009) (statement of John C. Bogle, Founder and former Chief Executive of the Vanguard Group), *available at* http://edlabor.house.gov/ documents/111/ pdf/testimony/20090224JohnBogleTestimony.pdf [hereinafter *Strengthening Worker Retirement Security*]. (describing this transition to DC plans as "a massive transfer from business enterprises to their employees of both investment risk (and return) and the longevity risk of retirement funding").

B. With The Advent Of 529 Savings Plans, Mutual Funds Are Central In Family Saving For Their Children's Educational Expenses.

Another important financial goal for individuals who invest in mutual funds is to plan and save for future educational expenses. ICI FACT BOOK, *supra*, at 104 ("[A]bout 12 percent of all U.S. households considered future education expenses their most important motivation for saving . . . [and] 25 percent of households that owned mutual funds in 2008 cited education as a financial goal for their fund investments").[3] Given the evolving labor market in the United States, education is increasingly seen as a central contributing factor "to individual success and to the nation's productivity and competitiveness." INVESTMENT CO. INST., A

[3] *See also* Investment Co. Inst., *A Guide to Understanding 529 Plans*, (2007), *available at* http://www.ici.org/pdf/bro_529_plans.pdf ("While most parents today expect their children to receive a postsecondary education, research shows that only one-third say they expect to be prepared to pay for their child's education.").

GUIDE TO UNDERSTANDING 529 PLANS, (2007), *available at* http://www.ici.org/pdf/bro_529_plans.pdf; *see also Grutter v. Bollinger*, 539 U.S. 306, 331 (2003) ("We have repeatedly acknowledged the overriding importance of preparing students for work and citizenship, describing education as pivotal to 'sustaining our political and cultural heritage' with a fundamental role in maintaining the fabric of society.") (quoting *Plyler v. Doe*, 457 U.S. 202, 221 (1982)). With proof that education levels contribute to disparities in earning potential, the ability to afford postsecondary education has become a concern for our nation. *See* INVESTMENT CO. INST., A GUIDE TO UNDERSTANDING 529 PLANS, 2 (2007), *available at* http://www.ici.org/pdf/bro_529_plans.pdf ("According to the Business-Higher Education Forum, the average difference in lifetime earning potential between someone who spends two years in college and a high-school graduate is $500,000. The typical bachelor's degree recipient can expect to earn about 67 percent—or about $1.5 million—more over a working life than a typical high school graduate.").

With the addition of section 529 to the Internal Revenue Code in 1999, 26 U.S.C. § 529, they have become one of the "fastest growing investment products in America." Mercer E. Bullard, *The Visible Hand In Government-Sponsored Financial Services: Why States Should Not Be Allowed to Offer 529 Plans*, 74 U. CIN. L. REV. 1265, 1265 (2006) [hereinafter Bullard, *Visible Hand*]. 529 plans provide a "tax-advantaged way for parents to invest for their children's college education." *Id.*

These plans are "state-sponsored, tax-deferred investment vehicles where the account value fluctuates based on the performance of the underlying investment," because "mutual funds are the predominant investment vehicles for 529 plans." *Id.* at 1267-68. At the end of 2008, 529 savings plans contained $89.4 billion, comprised of approximately 8.9 million accounts, with an average of approximately $10,000 per account. ICI FACT BOOK, *supra*, at 104.

C. Because Investment Fees Are Deducted From Retirement Plan Assets, Even A Seemingly Small Annual Percentage Fee Significantly Reduces The Ultimate Return On Mutual Fund Investments.

Investment fees associated with retirement and education savings have a significant impact on a plan participant's return on investment. Investment-adviser fees, which are the most costly fees associated with 401(k) plans and mutual funds, are usually paid by participants out of plan assets. U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-07-21, PRIVATE PENSIONS: CHANGES NEEDED TO PROVIDE 401(K) PLAN PARTICIPANTS AND THE DEPARTMENT OF LABOR BETTER INFORMATION ON FEES 10 (2006). Such payments ultimately decrease the return on investment because the fees "are paid with funds that could otherwise be earning and compounding on a tax-deferred basis." *Are Hidden 401(k) Fees Undermining Retirement Security?: Hearing Before the H. Comm. On Education & Labor*, 110th Cong.

(2007) (testimony of Stephen J. Butler, President of Pension Dynamics Corporation, Author and Weekly Financial Columnist on "Undermining Worker's Retirement Security") *available at* http://edlabor.house.gov/testimony/030607StephenButlertestimony.pdf. This reduction in principal [or returns] can be critical, especially considering the low account balances of many 401(k) plans and 529 accounts,[4] and "can significantly decrease retirement [and education] savings over the course of a career." GAO REPORT: PRIVATE PENSIONS: INCREASED RELIANCE ON 401(K) PLANS*, supra*, at 10. This impact is demonstrated in a report by the Employee Benefits Security Administration:

> Assume that you are an employee with 35 years until retirement and a current 401(k) account balance of $25,000. If returns on investments in your account over the next 35 years average 7 percent and fees and expenses reduce your average returns by 0.5 percent, your account balance will grow to $227,000 at retirement, even if there are no further contributions to your account. If fees and expenses are 1.5 percent,

---

[4] Most 401(k) account balances are not high to begin with: "[w]hile some participants have account balances of greater than $100,000, most have smaller balances. Based on industry estimates for 2005, 37 percent of participants had balances of less than $10,000, while 16 percent had balances greater than $100,000." GAO REPORT: PRIVATE PENSIONS: INCREASED RELIANCE ON 401(K) PLANS, *supra*, at 9-10].

> however, your account balance will grow to only $163,000. The 1 percent difference in fees and expenses would reduce your account balance at retirement by 28 percent.

U.S. DEP'T OF LABOR, EMPLOYEE BENEFITS SECURITY ADMINISTRATION, A LOOK AT 401(K) PLAN FEES 2, *available at* http://www.dol.gov/ebsa/pdf/401kFeesEmployee.pdf. A small difference in fee rates, therefore, substantially alters the amount of benefits a participant will have accumulated upon retirement.

This reduction in the ultimate retirement benefit caused by the imposition of excessive mutual fund investment fees jeopardizes the ability of countless current workers to become financially self-sufficient in retirement. *See Strengthening Worker Retirement Security*, *supra*, at 5. In describing the dangers of high costs, Mr. Bogle quoted an article that he wrote in the *Journal of Portfolio Management*: "These enormous costs seriously undermine the odds in favor of success for citizens who are accumulating savings for retirement. Alas, *the investor feeds at the bottom of the costly food chain of investing,* paid only *after* all the agency costs of investing are deducted from the markets' returns." *Id.* at 3. It is difficult to square this state of affairs with the fiduciary that Section 36(b) imposes on investment advisers.

II. THE SEVENTH CIRCUIT'S RATIONALE FOR A NARROW 36(b) FIDUCIARY DUTY FAILS TO CONSIDER MARKET FAILURES IN THE MUTUAL FUND INDUSTRY THAT PROMOTE RESTRICTIONS ON THE ABILITY OF INVESTORS TO NEGOTIATE AT ARM'S LENGTH WITH MUTUAL FUND ADVISORS.

The Seventh Circuit's decision to narrow the § 36(b) fiduciary duty rests on a specious perception that the market for investment fees in the mutual fund industry is perfectly competitive, and therefore additional controls are not necessary to keep such fees fair.[5] Contrary to the court's assertion that "[m]utual funds come much closer to the model of atomistic competition than do most other markets," *Jones*, 527 F.3d at 634, a report by the United States Government Accountability Office found that "[t]he structure and nature of competition in the mutual fund industry appear to resemble the type of market referred to by economists as 'monopolistic competition.'" U.S. GOV'T ACCOUNTABILITY OFFICE, GAO/GGD-00-126, MUTUAL FUND FEES: ADDITIONAL DISCLOSURE COULD ENCOURAGE PRICE COMPETITION 56 (June 2000) [hereinafter GAO, MUTUAL FUND FEES]. The monopolistic nature of competition in the mutual fund industry that focuses attention on brand and reputation allows investment advisors to deflect attention from the fact that, although returns

---

[5] The Seventh Circuit states: "[a]n adviser can't make money from its captive fund if high fees drive investors away." *Jones*, 527 F.3d at 632.

are competitive within the industry, they would be substantially higher if investment advisors were forced to compete on the basis of price.

A. Contrary To The Assertion Of The Seventh Circuit, Investment Advisors In The Mutual Fund Industry Do Not Compete On The Basis Of Price.

The court argues that price competition protects investors by reducing costs. However, evidence suggests that mutual fund "managers do not compete on costs." John C. Bogle, Lecture, *A New Order of Things: Bringing Mutuality to the "Mutual" Fund*, 43 WAKE FOREST L. REV. 1089, 1113-14 (2008). The General Counsel to the SEC has noted that the mutual fund industry defies the "law of one price,"[6] concluding that if "we're not seeing the price convergence one would expect," then the industry "may be depriving American investors of the long-term returns they deserve." Brian G. Cartwright, Gen. Counsel, SEC, Remarks before the 2006 Securities Development Conference (Dec. 4, 2006), *available at* http://www.sec.gov/news/speech /2006/spch120406bgc.htm. "Under the normal rules of capitalism, any industry that can produce double-digit annual growth should soon be swamped by eager competitors until returns are driven down. But . . . that does not seem to be happening . . .

[6] The "law of one price" is a principle that "in an efficient, competitive market, nearly identical goods will sell at nearly identical prices . . . because with full information . . . no rational buyer would pay more." Cartwright, *supra*.

because most fund managers do not compete on price." *Money for Old Hope*, THE ECONOMIST, 3 (Mar. 1, 2008); *see also GAO*, MUTUAL FUND FEES, *supra*, at 7 ("[C]ompetition in the mutual fund industry may not be strongly influencing fee levels because fund advisers generally compete on the basis of performance (measured by returns net of fees) or services provided rather than on the basis of the fees they charge."). SEC Chairman Christopher Cox has remarked that "because of a regulatory cumbersomeness that *obscures the real numbers*, our financial services industries are able to *skim off* much more of the assets they handle than would be the case in a well-functioning market." Christopher Cox, Chairman, SEC, Address to Mutual Fund Directors Forum Seventh Annual Policy Conference (Apr. 13, 2007) (emphasis added), *available at* http:www.sec.gov/news/speech/2007/spch041207cc.htm. Therefore fees are higher than they would be if investment advisers were forced to compete on the basis of price.

B. Mutual Fund Directors Do Not Bargain At Arm's Length On Behalf Of Fund Investors.

Unlike beneficiaries of pension funds, who benefit from having plan managers negotiate with investment advisors to reduce investment fees, individual investors in mutual funds lack collective bargaining power to lower investment fees because mutual fund directors are captives of their investment advisors. "Compensation for [advisory] services is determined under an advisory contract, the terms of which are all too often dictated to unwary or negligent fund directors and fund shareholders by the investment adviser" *Galfand v. Chestnutt Corp.*, 545 F.2d 807, 808 (2d Cir. 1976). Unlike a normal business where the "firm's management is free to hire and fire outside service providers, [the mutual fund industry's] outside managers actually have *de facto* control of the fund and its board." John P. Freeman et al., *Mutual Fund Advisory Fees: New Evidence and a Fair Fiduciary Duty Test*, 61 OKLA. L. REV. 83, 87 (2008) [hereinafter Freeman et al., *Advisory Fees: New Evidence*]. A mutual fund adviser "often has the ability [at the initial stages of establishing the fund] to influence who will sit on the fund's board of directors," *Gallus,* 561 F.3d at 820, consequently increasing the likelihood that boards will behave favorably to the investment advisors.

> Since a typical fund is organized by its investment adviser which provides it with almost all management services . . . , a mutual fund cannot, as a practical matter sever its relationship with the adviser. Therefore, 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.

Burks v. Lasker, 441 U.S. 471, 480 (1979) (citing S. Rep. No. 91-184, 91st Cong., 2d Sess. (1969), *as reprinted in* 1970 U.S.C.C.A.N. 4897, 4901). Because mutual funds "cannot move easily from one adviser-manager to another," *Gartenberg,* 694 F.2d at 929, "'investment advisors seldom, if ever, compete with each other for advisory contracts with mutual funds.'" *Id.* (quoting Report of the Securities and Exchange Commission on the Public Policy Implications of Investment Company Growth, H.R.Rep. No. 2337, 89^{th} Cong., 2d Sess. 126, 131, 148 (1966)). Moreover, Judge Posner has noted that connections between the mutual fund industry agents "'foster favoritism, to the detriment of investors. Fund directors and advisory firms that manage funds hire each other preferentially based on past interactions. When directors and the management are more connected, advisors capture more rents and are monitored by the board less intensely.'" *Jones*, 537 F.3d at 730-31 (Posner, J., dissenting from denial of rehearing en banc) (quoting Camelia M. Kuhnen, *Social Networks, Corporate Governance and Contracting in the Mutual Fund Industry*, (Mar. 1, 2007), *available at* http://ssrn.com/abstract=849705).

The significance of the captive nature of these funds cannot be understated. A comparison to Vanguard mutual funds, which are not captive because of the use of outside "sub-advisers," demonstrates that the average advisory fee rate charged by the industry's 500 largest equity funds is nearly five times higher than that charged by Vanguard. *See* Freeman et al., *Advisory Fees: New Evidence*, *supra*, at 101. *See also Jones*, 537 F.3d at 731-32 (Posner, J., dissenting from denial of rehearing en banc) ("'[T]he chief reason for substantial advisory fee level differences between equity pension fund portfolio managers and equity mutual fund portfolio managers is that advisory fees in the pension field are subject to a marketplace where arm's-length bargaining occurs. As a rule, [mutual] fund shareholders neither benefit from arm's-length bargaining nor from prices that approximate those that arm's-length bargaining would yield were it the norm.'" (quoting John P. Freeman & Stewart L. Brown, *Mutual Fund Advisory Fees: The Cost of Conflicts of Interest*, 26 J. CORP. L. 609, 634 (2001))).

Moreover, mutual fund directors do not feel compelled to negotiate lower investment fees because they believe in the theory of "consumer acceptance in the absence of deceit." Donald C. Langevoort, *Private Litigation to Enforce Fiduciary Duties in Mutual Funds: Derivative Suits, Disinterested Directors and the Ideology of Investor Sovereignty*, 83 WASH. U. L.Q. 1017, 1037 (2005). Proponents of the laissez faire theory of market governance argue that because investors can easily exit a mutual fund, their continued investment is ample evidence that investors do not see investment fees as too high. Many "independent directors of mutual funds . . . share this normative vision based on consumer sovereignty . . . and [are] chosen *because* they do." *Id.* at 1038 (emphasis added). Because they view shareholders as being "responsible for their own choices, directors are less likely to feel obliged to act aggressively on their behalf." *Id.*; *see*, *e.g.*, Mercer E. Bullard, *The Mutual Fund Summit: Context and Commentary*, 73 MISS. L.J. 1129, 1142-43 (2004) (remarking on discussion between SEC Commissioner Harvey Goldschmid who believes that "independent directors . . . have to be far more effective and active than they've been in the past" and an industry insider who argues that the board of a mutual fund should not engage in "a negotiation process; [rather] its' [sic] an oversight process . . . (T)he independent directors are asked to look over the process . . . (and) make sure that the fee arrangement is within a band of reasonableness").

However, this theoretical justification for a limited role of the directors and the difference in investment fees is undermined because high prices are pervasive throughout the industry. *See*, *e.g.* Freeman et al., *Advisory Fees: New Evidence*, *supra*, at 93; Freeman & Brown, *supra*, at 640 (finding the problem of excessive fees exists both in actively and passively managed mutual funds. Investment fees for mutual index funds are more than ten times higher than comparable pension index funds). The pervasiveness of high fees deprives investors of the choice to "vote with their feet" based on their dissatisfaction with the rate of investment fees. Leaving one high-priced mutual fund merely provides the investor with the ability to invest in a competing high priced mutual fund. The result is a circular process in which investors tolerate higher fees because they lack realistic alternatives while directors tolerate higher fees because they misinterpret continued investment as consent to higher fees. Therefore, the laissez faire theory of market regulation permits mutual funds to compete solely on the basis of investment return while ignoring the congressional interest in moderating investment fees. So long as investment fees are not so high that they reduce the competitiveness of the fund's return on investment, absent meaningful enforcement of the fiduciary duty, there is no mechanism to ensure that investment advisors are not reaping huge rewards at the expense of the retirement funds of tens of millions of Americans.

C. Investors In Mutual Funds Are "Captive Investors" Not Freely Able To Reinvest In Competing Mutual Funds.

Another reason investment advisors are able to avoid price competition is that, contrary to the Seventh Circuit's assumption that investors are able to protect themselves by simply "firing" advisers and "moving their money elsewhere," *Jones*, 527 F.3d at 634, many investors in mutual funds are "captive investors" in that they cannot freely exit and move their money to an alternative fund.[7] Before switching out of a fund, an investor must weigh many factors to determine whether it would be cost effective. *See* Caroline J. Dillon, *Do You Get What You Pay For? A Look at the High Fees and Low*

---

7 The accuracy of the Seventh Circuit's contention that "investors can and do protect their interests by shopping" has further been called into question because the "careful study" cited by the court to support this proposition was funded in large part (over $100,000) by the Investment Company Institute, a national association of investment companies. Asher Hawkins, *Well-Funded Opinion*, Forbes Magazine (May 8, 2009), *available at* http://www.forbes.com/2009/05/07/mutual-funds-fidelity-columbia-business-school-personal-finance-hubbard.html.

Protections of Mutual Funds, 2006 COLUM. BUS. L. REV. 281, 303 (2006) (noting that there may be hidden costs such as "capital gains taxes and payments of a sales load on a new fund" which "overshadow any benefits that a shareholder may receive when moving to a fund with lower fees") (citations omitted). For example, in the context of 529 plans, the ability of investors merely to switch out of a fund anytime they find fees to be exorbitant is limited by the enabling statutory scheme. A 529 plan must meet several requirements in order for an investor to benefit from the federal and state tax advantages of the 529 statutory scheme:

> Participants may not direct the investment of their contributions or earnings in the plan except in selecting from among different broad-based investment strategies designed exclusively for the 529 plan. Once the initial selection is made at the time of a contribution, transfers to other options may occur only once per calendar year or when the beneficiary is changed.

Bullard, *Visible Hand*, *supra*, at 1269 (citations omitted). Additionally, in the context of retirement plans, participants in 401(k) plans who are mutual fund investors may fairly be characterized as "captive investors," because they may only select funds from a limited menu of options provided to them by their plan administrators.

D. The Magnitude Of The Impact That Fees Have On Mutual Fund Investments Is Less Than Transparent To Investors.

The disclosures to employees and retirees fail to provide a "simple way for participants to compare fees among investment options." GAO REPORT: PRIVATE PENSIONS: INCREASED RELIANCE ON 401(K) PLANS*, supra*, at 15. "Information on fees is disclosed to participants in a piecemeal way. In order to get a more complete picture of fees, participants must collect various documents over time." U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-07-21, PRIVATE PENSIONS: CHANGES NEEDED TO PROVIDE 401(K) PLAN PARTICIPANTS AND THE DEPARTMENT OF LABOR BETTER INFORMATION ON FEES, 17-18 (Nov. 2006) ("[T]o piece together certain fees associated with a plan's investment options, a participant often must collect multiple prospectuses or fund profiles. Furthermore, because ERISA does not require that these documents be provided automatically to all participants, some participants may need to request them but may not know to do so"); *see also* Jon Forman, *Taking on 401 (k) Plan Fees that Take Away From You*, THE JOURNAL RECORD, Jan. 8, 2007, at 6A, *available at* http://jay.law.ou.edu/faculty/jforman/Opeds/2007-1(401kFees).htm ("Fees, especially investment fees, are Wall Street's dirty little secret. It is extremely difficult for investors to get a complete picture of the fees that fund managers skim off the top. Fund managers rarely advertise how much they make on your money.").

The problems surrounding the lack of disclosure regarding fees charged to participants has recently been recognized by the SEC. *See* Dillon, *supra*, at 302 (citing SEC, DIV. INV. MGMT.: REPORT ON MUTUAL FUND FEES AND EXPENSES (2000), *available at* http://www.sec.gov/news/studies/feestudy.htm#item13. Owing to questionable disclosure practices, participants often are unaware fees are even being charged to their plans. According to a recent AARP survey, "more than eight in ten (83%) participants acknowledged that they actually do not know how much they pay in fees and expenses associated with their own plan." AARP, COMPARISON OF 401(K) PARTICIPANTS' UNDERSTANDING OF MODEL FEE DISCLOSURE FORMS DEVELOPED BY THE DEPARTMENT OF LABOR AND AARP, 1 (2008).

This lack of knowledge may be due in part to the fact that participants are led to believe that there are no fees being charged, when that is simply not the case:

> [F]ees collected by bundled providers are generally always charged against participants' accounts. Because the plan sponsor is not paying a fee for services directly to the service provider, bundled providers will present the plan to the plan sponsor

> as having 'free' recordkeeping and administration. There is currently little to no disclosure of this to either plan sponsors or plan participants. There are literally tens of thousands of 401(k) plans that report zero costs for recordkeeping and administration on their annual report [ ] filed with the Department of Labor. In actuality, participant accounts are being charged for these 'free' plan services in the form of investment fees assessed against their accounts.

Hidden 401(K) Fees: How Disclosure Can Increase Retirement Security: Hearing before the Special Committee on Aging, 3, 110th Cong. (2007), (statement of Michael Kiley, President/CEO of Plan Administrators, Inc. on behalf of ASPPA and CIKR) *available at* http://aging.senate.gov/events/hr182mk.pdf.

Moreover, the current market structure tolerates a symbiotic relationship between sophisticated financial advisers and naïve investors. *Strengthening Worker Retirement Security*, *supra*, at 14 (quoting Davis F. Swensen, Chief Investment Officer at Yale University, who stated that "'[t]he drive for profits by Wall Street and the mutual fund industry overwhelms the concept of fiduciary responsibility, leading to an all too predictable outcome: . . . the powerful financial services industry exploits vulnerable individual investors . . . ."). Because investors lack the knowledge to interpret investment options, even if information is provided, they are reliant upon investment advisors to get adequate returns on their investments. It is because of this special relationship and the market failures associated with the investment fee negotiations that investment advisors owe a fiduciary duty to their investors.

E. Pervasive Conflicts Of Interest Within The Mutual Fund Industry Cause Investment Advisors To Exploit The Lack Of Price Competition To The Detriment Of Investors.

The Seventh Circuit's limited analysis also overlooks the potential for conflicts of interest, which are inherent in the external management arrangement of mutual funds, to cause investment advisors to take advantage of the lack of price competition for their own gains. "[M]anagement companies [ ] seek to earn high returns for fund investors, to be sure, but seek at the same time to earn the highest possible returns for themselves." Freeman et al., *Advisory Fees: New Evidence*, *supra*, at 88 (quoting John C. Bogle, Honing the Competitive Edge in Mutual Funds, Remarks Before the Smithsonian Forum 5 (Mar. 23, 1999) (transcript on file with the authors)); *see also* Langevoort, *supra*, at 1019 ("The typical mutual fund is organized by a sponsor who expects to profit by providing advisory and other services to the fund, with returns growing as the fund grows in size.") (citation omitted). "Mutual funds are unique . . . in that they are 'organized and operated by people whose primary loyalty and pecuniary interest lie outside the enterprise.'" *Role of Indep. Dirs. of Inv. Cos.*, Securities Act Release No. 33-7754 [1999-2000 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 86,212, at 82,451 (Oct. 14, 1999).

The financial incentive coupled with the opportunity created by the captive nature of the mutual fund drives investment advisers to "increase assets at shareholder expense even though increasing the size of the fund does not increase (and can sometimes decrease) returns to its investors." Langevoort, *supra*, at 1020 (citations omitted). "If the industry remains dominated by conflicts of interest, then excessive fees will be the norm, and the norm should not be made the benchmark for propriety." *Id.* at 1023-24 (citations omitted). Despite these conflicts of interest, there is little incentive for directors of mutual funds to monitor the activities of their investment advisors. *See Jones*, 537 F.3d at 730 (Posner, J., dissenting from denial of rehearing en banc) ("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").

III. THE SEVENTH CIRCUIT'S INTERPRETATION OF THE SCOPE OF THE SECTION 36(b) FIDUCIARY DUTY IS INCONSISTENT WITH THE STATUTORY TEXT, THE COMMON LAW OF TRUSTS, AND THE CONGRESSIONAL INTENT TO PROTECT MUTUAL FUND INVESTORS FROM EXCESSIVE INVESTMENT FEES.

With more Americans entrusting their retirement and education savings to mutual funds, Congress' goal of protecting investors from the significant impact of excessive investment fees is more important than ever. The Investment Company Act of 1940 ("ICA"), 15 U.S.C. § 80a-1 *et seq*., provides legal protection to individuals invested in mutual funds. Section 36(b) specifies that "the investment adviser of a registered investment company shall be deemed to have a *fiduciary duty* with respect to the receipt of compensation for services." 15 U.S.C. § 80a-35(b) (emphasis added).

A. The Seventh Circuit's Interpretation Of The 36(b) Fiduciary Duty Is Inconsistent With The Statutory Text.

The Second Circuit in *Gartenberg* created the standard that courts have turned to for the past three decades to define an investment adviser's "fiduciary duty" under section 36(b).[8] *See Gallus*,

---

[8] *See Gallus*, 561 F.3d at 821 ("A number of courts have indicated approval of the *Gartenberg* framework in cases

561 F.3d at 821 (referring to *Gartenberg* as the "starting point for interpreting a fund adviser's fiduciary duty"). The Second Circuit found that "the test is essentially 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 surrounding circumstances." *Gartenberg*, 694 F.2d at 928.

Unlike the Seventh Circuit's blanket statement that a fiduciary "is not subject to a cap on compensation," the *Gartenberg* standard gives meaning to all sections of the 36(b), particularly the provision of subparagraph (1) that "it shall not be necessary to allege or prove that any defendant engaged in personal misconduct." 15 U.S.C. § 80a-35(b)(1). The Seventh Circuit's narrow interpretation of the fiduciary duty to entail a duty merely to "make full disclosure and play no tricks," squarely conflicts with subparagraph (1) because these bad acts necessarily would require allegations and proof of personal misconduct. Instead, a focus on the reasonableness and fairness of the transaction, as suggested by the broader reading of the fiduciary duty under the common law, adequately gives

---

challenging adviser's fees under § 36(b).") (citing *Krantz v. Prudential Invs. Fund Mgmt. L.L.C.*, 305 F.3d 140 (3d Cir. 2002) (following a Fourth Circuit analysis that was based on *Gartenberg*); *Migdal v. Rowe Price-Fleming Int'l*, 248 F.3d 321 (4th Cir. 2001); *Forsythe v. Sun Life Fin., Inc.*, 417 F.Supp.2d 100 (D. Mass. 2006); *Sins v. Janus Capital Mgmt., L.L.C.*, 2006 WL 3746130 (D. Colo. 2006); *In re Dreyfus Mut. Funds Fee Litig.*, 428 F. Supp. 2d 342 (D. Pa. 2005); *Zucker v. Aim Advisors, Inc.* 371 F. Supp. 2d 845 (S.D. Tex. 2005); *Strigliabotti v. Franklin Res., Inc.*, 2005 WL 645529 (N.D. Cal. 2005)).

meaning to all provisions of the ICA text.

B. The Seventh Circuit Applies An Incomplete Interpretation Of The Common Law Of Trusts.

Because Congress did not define "fiduciary duty" as used in the context of the ICA, *see Gartenberg*, 694 F.2d at 928, one must look to the "accumulated settled meaning" of the term under common law." *NLRB v. Amax Coal Co.*, 453 U.S. 322, 329-30 (1980). The Seventh Circuit correctly observed that the term "fiduciary duty" has been given substantial meaning by the common law of trusts. *Jones*, 527 F.3d at 632 (citing *Firestone Tire & Rubber Co. v. Bruch*, 489 U.S. 101 (1989)). In contrast, the Seventh Circuit's misreading of the common law led it to conclude that the fiduciary duty is "straightforward" and only entails "an obligation of candor in negotiation, and honesty in performance" - an obligation the court watered down considerably by holding that the adviser is not liable unless it "pulls the wool over the eyes" of the fund's board. *Jones*, 527 F.3d at 635. A more faithful review of pertinent common law reveals that "a person in a fiduciary relationship to another is under a duty to act for the benefit of the other," *Restatement (Third) of Trusts* § 2 cmt. b (2003), and when negotiating its compensation with the one to whom it owes a duty, must both provide full disclosure of all material facts and ensure that the compensation is fair. *See*, *e.g.*, *Restatement (Second) of Trusts* §§ 2 cmt. b, 170(2), 242 cmt. i (1959).

Moreover, the fiduciary duty under the common law of trusts also entails "a duty not to profit at the expense of the other . . . without the latter's consent." *Restatement (Third) of Trusts* § 2 cmt. b (2003). Although advisers arguably receive formal consent through approval of their compensation contracts by the fund's board, even where there is consent, "if the fiduciary enters into a transaction with the other and . . . the transaction is unfair to the other, the transaction can be set aside by the other." *Id.*; *see also Restatement (Second) of Trusts* § 216(2)(b), (3). Because of economies of scale and the market failures that are pervasive in the mutual fund industry, *see infra*, excessive investment fees are not the result of a fair, arm's length negotiation. Thus, the Seventh Circuit's narrow interpretation of the fiduciary duty derives scant support from common law.

C. The Eighth Circuit's Test Is Consistent With The Congressional Intent Behind The ICA.

The Seventh Circuit's decision seems to be premised upon a theory of *laissez faire* market control that justifies the outcome of a transaction on "consumer acceptance in the absence of deceit." Langevoort, *supra*, at 1037. According to the theory, because mutual fund investors can "vote with their feet," the fact that investors remained invested in mutual funds indicates consumer consent to pay investment fees. *Id.* at 1038. This strain of academic finance dogma finds no support in the history and purpose of Section 36(b). Congress was unwilling to allow investment fees to be determined solely on the basis of market forces. Instead of relying on existing statutory and common law consumer protections against false advertising and fraud, Congress enacted a fiduciary duty specifically related to the compensation of investment advisors.

The Court has previously acknowledged that the congressional purpose of the ICA was more than merely an interest in transparency and honesty in negotiations, noting a report commissioned by the SEC which found that "the structure of the [mutual fund] industry, even as regulated by the Act, had proven resistant to efforts to moderate adviser compensation." *Daily Income Fund, Inc. v. Fox*, 464 U.S. 523, 537 (1984) (citation omitted). In fact, § 36(b) was added to the statute based in part on the SEC's "concern that the structural requirements for investment companies imposed by the Act [including the Act's provisions for independent directors and approval of advisor contracts] would not alone ensure reasonable adviser fees." *Id.* at 539-40. Consequently, the Senate Report proposing the final version of § 36(b) noted that shareholder and director approval of advisor contracts "would not be controlling in determining whether or not the fee encompassed a breach of fiduciary duty." *Id.* at 540 (citing S. Rep. No. 91-184, 1970 U.S.C.C.A.N., *supra*, at 4910). Therefore, the common law's fairness requirement and the standard articulated in *Gallus* and *Gartenberg* more faithfully serve the congressional interests both in ensuring that investors benefit from savings caused by economies of scale and in restoring investors to the bargaining positions they would have occupied but for market failures within the mutual fund industry.

1. The Protection Of A Fairness Standard Is Necessary Because The Unprecedented Size Of Most Mutual Funds Has Created An Environment In Which Investment Fees Become Unfair To Investors Due To Economies Of Scale.

The Court has recognized that because investment advisor compensation is typically based on a set percentage of the fund's assets rather than on services performed, "as a fund's assets grew, this form of payment could produce unreasonable fees in light of the economies of scale realized in managing a larger portfolio." *Daily Income Fund, Inc.*, 464 U.S. at 537 (citation omitted); *accord.*, *Migdal v. Rowe Price-Fleming Int'l, Inc.*, 248 F.3d 321 (4th Cir. 2001); *Kalish v. Franklin Advisers, Inc.*, 742 F. Supp. 1222, 1237 (S.D.N.Y. 1990) ("The concept of 'economies of scale' assumes that as a mutual fund increases in size, its operational costs decrease proportionally"). The Fourth Circuit recognized that § 36(b) was enacted "to ensure that investment advisers passed on to fund investors the savings that they realized from these economies of scale." *Migdal*, 248 F.3d at 321; *see also Kalish*, 742 F. Supp. at 1237 ("If a fund realizes economies of scale, its willingness to let the shareholders participate in the resulting benefits becomes a factor in evaluating the reasonableness of the adviser-manager's fees"). *See also* S. Rep. No. 91-184, 1970 U.S.C.C.A.N., *supra*, at 4902 ("[P]roblems arise due to the economies of scale attributable to the dramatic growth of the mutual fund industry. In some instances these economies of scale have not been shared with investors").

While fee breakpoints have been established by many funds to help compensate for economies of scale, "the fee breakpoints may fail to consider further economies of scale, as most fee schedules max out at some high asset value." Dillon, *supra*, at 298. A SEC study of the 100 largest mutual funds found that "most of the funds in the sample with management fee breakpoints had assets above the last breakpoint." Paul Roye, The Investment Management Institute, Keynote Address, *Mutual Funds and Investment Management* (2001), in 1250 PLI/Corp 11, 17 (2001). Thirty-four out of the forty-seven funds in the study that used breakpoints (72 percent) had assets that exceeded their highest breakpoint. Moreover, the combined assets in excess of these highest breakpoints totaled $318 billion, representing 37 percent of the total assets invested in those funds. SEC, DIV. INV. MGMT.: REPORT ON MUTUAL FUND FEES AND EXPENSES (2000), *available at* http://www.sec.gov/news/studies/feestudy.htm#item13.

The failure to adequately pass on to the investor the gains realized from economies of scale is further demonstrated by assessing the fees charged by investment advisors used by Vanguard. Contrary to the mutual fund industry practice, where investment firms sponsor mutual funds that are largely controlled and operated by investment advisers, Vanguard stands alone in the industry by hiring outside advisers, called "sub-advisers," to manage its professionally-advised mutual funds. *See* Freeman et al., *Advisory Fees: New Evidence*, *supra,* at 95. As the size of Vanguard funds increased from just $10 million to more than $25 billion, the fee charged Vanguard shareholders decreased by more than 50 percent, allowing "Vanguard's boards to capture those cost savings and pass that saving on to Vanguard's shareholders." *Id.* at 100. Conversely, when managing their own captive funds, the same sub-advisors contracted by Vanguard reduced their fees by only 10 percent over the same range in fund size. *Id*.

2. A Fairness Standard Is Needed To Compensate For The Market Failures That Are Inherent In The Mutual Fund Industry.

The Seventh Circuit's standard is also inconsistent with the congressional intent to "mitigate the competitive deficiencies of the mutual fund industry." *Gallus*, 561 F.3d at 821 (citing *Gartenberg,* 694 F.2d at 928-29). As the mutual fund industry flourished, Congress recognized the need to further protect investors from the monopolistically competitive nature of the mutual fund industry as well as the inherent conflicts of interest pervasive throughout the industry. *See Daily Income Fund, Inc.*, 464 U.S. at 536 (noting that Congress had acted based on "its concern with 'the potential for abuse inherent in the structure of investment companies'") (quoting *Burks*, 441 U.S. at 480)). *See generally Gallus*, 561 F.3d at 821 ("Several unique features of the mutual fund industry have made it the focus of congressional regulation") (citing *Burks*, 441 U.S. at 480-81).

The *Gartenberg* court recognized that § 36(b)'s legislative history does not permit the court "to substitute its business judgment for that of a mutual fund's board of directors." 694 F.2d at 928 (quoting S. Rep. No. 91-184, 91st Cong., 2d Sess. (1969), *as reprinted in* 1970 U.S.C.C.A.N. 4897, 4902). Thus the Seventh Circuit is correct to the extent that "Section 36(b) does not say that fees must be "reasonable" in relation to a judicially created standard." *Jones*, 527 F.3d at 632. However, the court in *Gartenberg* also noted that the Senate Report states that "a 'corporate waste' standard would be 'unduly restrictive.'" 694 F.2d at 928. *See also Daily Income Fund, Inc.,* 464 U.S. at 540 ("Congress decided not to rely solely on the fund's directors to assure *reasonable* adviser fees, notwithstanding the increased disinterestedness of the board") (emphasis added). But the Seventh Circuit's test implicitly rejects the *Gartenberg* analysis on this point, as it essentially reflects such an "unduly restrictive" waste standard and thus is inconsistent with congressional intent behind the ICA.[9] Conversely, the Eighth Circuit's standard

[9] The Seventh Circuit assessed the amount of compensation only in the context of asking whether "compensation [may be] so unusual that a court will infer that deceit must have occurred, or that the persons responsible for decision have abdicated." *Jones,* 527 F.3d at 632.

reflects the balance between these two extreme interpretations of the breadth of the ICA's fiduciary duty. It is less restrictive than a waste standard but is also not a simple reasonableness test permitting courts to exercise their own business judgment. Instead, it is anchored in familiar common-law principles of fiduciary duty, which Congress incorporated in § 36(b). The test compares the fees paid by the fund to fees resulting from arm's length negotiations – negotiations that do not occur between fund and their advisers because of the recognized market failures that are persistent in the mutual fund industry.

IV. IN LIGHT OF MUTUAL FUND MARKET DEFICIENCIES, THE COURT SHOULD ADOPT AN INTERPRETATION OF "FIDUCIARY DUTY" THAT RECOGNIZES THE SEVENTH CIRCUIT'S CONCERN WITH DISCLOSURE OF INFORMATION WHILE CONTINUING TO PROTECT INVESTORS' INTERESTS IN INVESTMENT FEES NEGOTIATED AT ARM'S LENGTH.

The Eighth Circuit recently decided that although the *Jones* test was a sufficient condition for establishing a breach of the duty, demonstrating that an investment advisor played "tricks" or failed to make full disclosure is not a necessary condition for establishing a breach of fiduciary duty. *Gallus,* 561 F.3d 816. The court favored an approach which uses the tests of *Gartenberg* and *Jones* each as means of establishing a breach, stating that "the proper approach is one that looks to the adviser's conduct during negotiation *and the end result*." *Id.* at 823 (emphasis added) ("The *Gartenberg* case demonstrates one way in which a fund adviser can breach its fiduciary duty; but it is not the only way").[10]

Additionally, when assessing the fairness of the fees charged by investment advisors, the court should not limit itself to "comparing the adviser's fee with the fees charged by other mutual fund advisers" as was suggested by the Seventh Circuit in *Jones*. 537 F.3d at 732 (Posner, J., dissenting from denial of rehearing en banc). The Eighth Circuit held in *Gallus* that the district court "erred in rejecting a comparison between the fees charged to Ameriprise's institutional clients and its mutual fund clients." *Gallus,* 561 F.3d at 823. In *Gallus* the court found that a "reliance on other fees throughout the industry will not satisfy § 36(b) because of the competitive defects of the mutual fund market." *Id.* at 821 (citing *Gartenberg,* 694 F.2d at 930). Limiting such a standard could potentially allow a fiduciary to evade liability by comparing a fund charging excessive fees to other funds charging excessive fees. *See Jones*, 537 F.3d at 732 (Posner, J., dissenting from denial of rehearing en banc) ("The governance structure that enables mutual fund advisers to charge exorbitant fees is industry-wide, so the

---

[10] As the *Gallus* court points out, the *Gartenberg* approach alone has not been able to protect investors concerning the advisor's fee, but is one factor to consider in determining whether a fiduciary breach occurred under § 36(b). *Gallus*, 561 F.3d at 823 n.4 ("This may explain why no plaintiff has ever obtained a judgment in an action brought under that provision.").

panel's comparability approach would if widely followed allow those fees to become the industry's floor."). The comparison is particularly compelling in the case of indexed funds, because "[i]ndexing is a mechanical process that is essentially identical for pension funds and mutual funds." Freeman & Brown, *supra*, at 640 ("It is difficult to see how mutual fund investment advisors can justify advisory fees [for index funds] that are more than ten times greater than those charge for pension funds").

The *Gallus* court explained that "the argument for comparing mutual fund advisory fees with the fees charged to institutional accounts is particularly strong in this case because the investment advice may be essentially the same for both accounts." *Gallus,* 561 F.3d at 824; *see* Freeman et al., *Advisory Fees: New Evidence*, *supra*, at 150 ("Courts need to understand that in advisory fee cases, where the absence of arm's-length bargaining is the central issue, the focus belongs on free market comparators where arm's-length bargaining actually occurs and fair market values are honestly established."). In *Jones*, such a comparison also may have been warranted, especially since "[a] particular concern in this case is the adviser's charging its captive funds more than twice what it charges independent funds." 537 F.3d at 731 (Posner, J., dissenting from denial of rehearing en banc).

CONCLUSION

Because investments in mutual funds are critical to the retirement security and future educational opportunities of millions of Americans and because market failures effectively deprive investors of meaningful bargaining power to negotiate lower investment fees, the Court should overrule the decision of the Seventh Circuit. Absent the application under § 36(b) of a standard reflecting traditional common-law requirements, the laissez faire theory of regulation promoted by the Seventh Circuit allows mutual funds to avoid price competition while tens of millions of Americans fail to receive the full return on their investments. The Court should adopt a balanced test like that used by the Eighth Circuit in *Gallus*, which incorporates a fiduciary test that mimics the result of what would be achieved through arm's length negotiations.

For the foregoing reasons, the judgment of the Seventh Circuit Court of Appeals should be reversed.

Respectfully submitted,

JAY E. SUSHELSKY*
AARP Foundation Litigation

MICHAEL SCHUSTER
AARP

601 E Street, NW
Washington, DC 20049
Telephone (202) 434-2060

Counsel for *Amici Curiae*
*Counsel of Record