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In the Supreme Court of the United States

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

v.

HARRIS ASSOCIATES, L.P.

*ON PETITION FOR A WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE SEVENTH CIRCUIT*

**BRIEF FOR JOHN C. BOGLE AS AMICUS CURIAE
IN SUPPORT OF PETITIONERS**

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QUESTION PRESENTED

Whether a shareholder's claim that a mutual fund's investment adviser charged an excessive fee to the mutual fund—more than twice the fee it charged to funds with which it was not affiliated—is not cognizable under Section 36(b) of the Investment Company Act of 1940, 15 U.S.C. 80a-35(b), unless the shareholder can show that the adviser misled the fund's directors who approved the fee.

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INTEREST OF AMICUS CURIAE

Amicus John C. Bogle is a pioneer in the mutual fund industry.[1] As a recent industry reference noted, he "has led a life-long crusade as an advocate for the investor by fighting against excessive cost in asset management that erodes investors' returns." Lee Gremillion, *Mutual Fund Industry Handbook* 26 (2005).

Mr. Bogle began in 1951 with the Wellington Management Company. In 1974, he founded what is now The Vanguard Group, Inc., one of the largest mutual fund organizations in the world presently managing assets in excess of $1 trillion. He served as Chief Executive Officer of Vanguard until 1996 and is now President of Vanguard's Bogle Financial Markets Research Center. He has been recognized as one of the investment industry's four "Giants of the 20th Century" (Fortune, 1999), one of the "Financial Leaders of the 20th Century" (Macmillan Press Ltd., 1997), and as one of "The Time 100—the world's 100 most powerful and influential people" (Time 2004). He served as a Member (1969-1974) and Chairman (1969-1970) of the Board of Governors of the Investment Company Institute—the mutual fund industry trade association—at the time Section 36(b) of the Investment Company Act was under consideration by Congress. A list of Mr. Bogle's institutional affiliations and professional memberships, honorary degrees,

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

awards, and publications is included in Appendix A to this brief.

As a close observer and participant in the mutual fund industry, Mr. Bogle has pioneered investment vehicles—such as index funds—that have made available sound, low-cost investment options to the general public. He has also consistently spoken out on the legal and ethical duties owed by investment industry professionals to those whose money is entrusted to their care. In his speeches and writings, he has often drawn attention to the potential and actual conflicts between the business interests of those who manage mutual funds and the fiduciary duty they owe to fund shareholders. The court of appeals in this case found reasons to disregard those conflicts and instead dilute the fiduciary duties imposed by Section 36(b). Mr. Bogle submits this brief in the hopes that his experience and perspectives will assist the Court in understanding the problems that Congress intended to solve in Section 36(b) and the even-greater need for robust enforcement of Section 36(b) in today's mutual-fund marketplace.

SUMMARY OF ARGUMENT

Section 36(b) imposes a "fiduciary duty with respect to the receipt of compensation" on investment advisers to mutual funds. 18 U.S.C. 80a-35(b). At its core, a fiduciary duty requires that the fiduciary act not in its own interests, but in the interests of those to whom the duty is owed. This case presents the question whether, notwithstanding that duty, an investment adviser to captive mutual funds may simply take as much compensation as it can get, with no regard for the interests of the fund shareholders to whom the adviser's fiduciary

duty is owed. The court of appeals held that an investment adviser could do so. Its decision should be reversed.

I. Mutual funds differ dramatically from most business organizations. Most funds are "externally managed," *i.e.*, they have little or no personnel or facilities, and substantially all of their activities are carried on by their investment adviser. That creates an inherent conflict of interest, since the adviser is responsible to its own board and shareholders—not to the board and shareholders of the fund. The conflict is particularly grave when it comes to the adviser's compensation, since the adviser's interest is naturally in maximizing its compensation, while the fund's shareholders benefit from minimizing it. In negotiations over compensation, the fund's board (if it were inclined to try to strike a hard bargain) does not have available the key option that is ordinarily available to a firm that wants to contract for goods or services: finding another contracting partner if the price asked is too high. And in any event, the dominance of a captive fund by its adviser gives the fund board little incentive to attempt to negotiate a hard bargain on behalf of fund shareholders. The result is excessive fees paid to advisers for selecting the fund's securities. The structure of the relationship fails to protect the interests of fund shareholders.

It became increasingly clear as assets of mutual funds and the amount of their advisers' fees burgeoned in the 1950s and 1960s that the problem of adviser compensation was worsening. Studies of the industry by the Wharton School and the SEC found that advisers often charged their captive funds excessive fees, far higher than the same advisers charged independent clients for similar services. Based on those studies and its own

examination, Congress was profoundly skeptical that "bargaining" between an adviser and its captive fund would produce fair fees.

II. Congress imposed a "fiduciary duty" on advisers in Section 36(b). The court of appeals disregarded the fact that a fiduciary dealing with those to whom it owes its duty—as is the adviser in negotiating a fee with a captive fund—has always been understood to have obligations of both disclosure and fairness. Accordingly, the "fiduciary duty" of Section 36(b) requires advisers themselves not merely to make full disclosure, but also to ensure that their fees are substantively fair.

The history of Section 36(b) dramatically confirms that conclusion. Section 36(b) was drafted, at Congress's request, by the SEC and the Investment Company Institute. Both the SEC and the industry agreed in substance that the new duty is breached in the event of "an unreasonable or excessive charge" (SEC) or where the adviser has "overreach[ed] in the amount of his fee" (the Institute). That understanding was correct then, it was accepted by Congress, and there is no basis to alter it now. Moreover, the court of appeals' conclusion that an adviser can take as large a fee as it can get is inconsistent with the purposes of Section 36(b).

III. An adviser's fees satisfy its fiduciary obligation to ensure fairness if they are comparable to fees that would have been negotiated in an arm's-length transaction. The most direct way to establish that fact is to examine fees for similar services that *have* been negotiated at arm's length between independent companies. In this case, evidence bearing on that inquiry is particularly strong, since, based on the summary judgment record, respondent charged its captive funds advisory

fees that were more than twice as high in percentage terms (and in at least one case *more than 42 times as high in dollar terms*) as it charged for similar services to independent clients. But even when such clear evidence is not available, evidence of other arm's-length transactions for investment advisory services will often be the most probative.

In concluding that Section 36(b) imposes no restriction on the amount of fees that an adviser can charge, the court of appeals relied on its view that competition among funds for customers will hold the fee rates that an adviser charges its captive funds in check. Even if the court's one-sided view of that highly disputed factual issue were correct, it would not justify the court's conclusion. The duties imposed by Section 36(b) were established by Congress in 1970, and the court of appeals had no authority to vary them in accordance with its (disputed) views on the need for such duties in the current mutual fund marketplace.

In any event, the court's view is mistaken. The explosive growth in mutual fund assets has only exacerbated the problems about which Congress was most concerned—conflicting loyalties of investment advisers, the failure of advisers who are paid on a percentage of assets to share the enormous economies of scale that exist in fund management with fund shareholders, and advisers that charge captive mutual funds much higher fees for the same services than are charged to independent clients.

ARGUMENT

I. SECTION 36(b) IS BASED ON THE PREMISE THAT THERE ARE INHERENT STRUCTURAL CONFLICTS THAT JUSTIFY SKEPTICISM ABOUT WHETHER INVESTMENT ADVISERS' FEES ARE FAIR TO FUNDS AND SHAREHOLDERS

A. The Structure Of Externally Managed Mutual Funds Creates Inherent Conflicts Of Interest

1. "A mutual fund is a pool of assets, consisting primarily of portfolio securities, and belonging to the individual investors holding shares in the fund." *Burks v. Lasker*, 441 U.S. 471, 480 (1979). Mutual funds are "open-ended," *i.e.*, they "sell new shares to investors wanting to invest money, or redeem shares from investors wanting their money back, at a price dependent on the net asset value . . . of the fund." Lee Gremillion, *Mutual Fund Industry Handbook* 5 (2005).

2. Though mutual funds are organized as corporations or similar entities, with shareholders and boards of directors, the management of mutual funds differs dramatically from that of most business corporations. Other business corporations manage themselves internally; they maintain their own personnel, physical facilities, and logistical support as necessary to carry on their functions. While they may hire other firms to provide goods or perform services, they do so in arm's-length transactions, hoping to obtain the most favorable combination of price and quality that will maximize their shareholders' profits.

"Unlike most corporations, an investment company is typically created and managed by a pre-existing external organization known as an investment adviser." *Daily Income Fund, Inc. v. Fox*, 464 U.S. 523, 536 (1984); see S. Rep. No. 91-184 (1969) (*Senate Report*). "The advisers select the funds' investments and operate their businesses." *Burks*, 441 U.S. at 481 (quoting *Senate Report* 5). Most mutual funds "have shareholders, directors, assets (cash and securities) and contracts, and not much else." *Mutual Fund Industry Handbook* 9. They have essentially no internal ability to manage their own operations.[2]

3. The adviser's dominant role has a major effect on its captive mutual funds. "Because of the unique structure [of mutual funds] the relationship between mutual funds and their investment adviser is not the same as that usually existing between buyers and sellers or in conventional corporate relationships." *Senate Report* 5. The most important difference is that, although a mutual fund's board does in principle have the option of hiring its own staff and negotiating contracts at arm's-length

[2] See Robert Pozen, *The Mutual Fund Business* 22 (2008). Commentators routinely note the unique qualities of—and potential for conflicts inherent in—the organization of mutual funds. See, *e.g.*, Donald 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, 1020, 1031-1032 (2005); Lyman Johnson, *A Fresh Look at Director "Independence": Mutual Fund Fee Litigation and* Gartenberg *at Twenty-Five*, 61 Vand. L. Rev. 497, 502-505 (2008). Mr. Bogle himself has written extensively on the subject. See, *e.g.*, John C. Bogle, *A New Order of Things: Bringing Mutuality to the "Mutual" Fund*, 43 Wake Forest L. Rev. 1089 (2008); John C. Bogle, *Re-Mutualizing the Mutual Fund Industry—the Alpha and the Omega*, 45 B.C. L. Rev. 391, 391-392, 398-400 (2004).

for investment advice and other services from independent entities, in practice that option is nonexistent. With one exception—the Vanguard family of funds, founded under Mr. Bogle's leadership[3]—fund boards have virtually never attempted to replace their investment adviser with another firm. Even if the boards of captive mutual funds were inclined to negotiate hard with their investment advisers on the terms of the investment advisory contract, the ultimate threat of withdrawing the fund's business and bringing it to a competitor is thus simply not present. See, *e.g.*, *Senate Report* 5 (contrasting "the mutual fund industry, where . . . marketplace forces are not likely to operate effectively," with ordinary contexts in which "the protections of arm's-length bargaining are present").

4. In addition to the general dominance of fund boards by investment advisers and the inability of boards

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[3] The Vanguard funds became independent, with arm's-length relationships with their suppliers of services and advisers, in a series of steps, beginning in the mid-1970s. See Bogle, 45 B.C. L. Rev. at 398-407. In approving the final step in the series, the SEC concluded that the Vanguard arrangement "furthers the Act's objectives" by ensuring that the fund directors "are better able to evaluate the quality of" the services provided to the funds and by "enhanc[ing] the Funds' independence, permitting them to change investment advisers more readily as conditions may dictate." *The Vanguard Group, Inc.*, 22 S.E.C. Docket 238, 1981 WL 36522, at *14 (1981); see *id*. at *5 ("Increased independence from its adviser gives each fund much greater flexibility in negotiating advisory fees.") The Vanguard funds have continued to operate in this way, with internal management. Its individual mutual funds are co-owners of the Vanguard Group, the central entity that provides the individual funds with administrative, distribution, and, in some cases, portfolio management services. Despite the enormous growth of Vanguard, no other of the thousands of mutual funds now in existence has followed its lead. See *Mutual Fund Industry Handbook* 10.

(if they were so inclined) to employ the ultimate bargaining threat of finding another adviser, there are other factors in the structure of externally managed funds that limit the normal incentives that tend to keep a corporation aligned with the interests of its shareholders. 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. As for the adviser itself, its compensation is ordinarily determined as a percentage of assets under management, which it therefore wants to see grow; the growth of assets may or may not benefit shareholders, depending on the extent to which it comes from new investments or from better performance. Mutual fund directors are ordinarily paid in cash, not shares in the mutual fund that would align their interests with shareholders. See, *e.g.*,Langevoort, 83 Wash. U. L. Q. at 1031-1032.

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, see 15 U.S.C. 80a-2(a)(19), but who nonetheless are sympathetic to the adviser. See Johnson, 61 Vand. L. Rev. at 513-514; *id.* at 521-527. Congress's skepticism of the ability of fund boards to control advisers' compensation was well-founded.

B. Section 36(b) Grew Out Of The Wharton And SEC Studies, Which Brought The Problem Of High Advisory Fees, Caused By The Absence Of Arm's-Length Bargaining, To The Attention Of Congress

1. Congress originally provided for special regulation of investment companies in 1940 because of the "potential for abuse inherent in the structure of investment companies." *Burks*, 441 U.S. at 480. See Investment Company Act of 1940, 15 U.S.C. 80a-1(b).[4] The remedies Congress adopted in the 1940 Act were primarily structural ones, such as limiting the number of fund directors who could be affiliated with the adviser, 15 U.S.C. 80a-10, and requiring that fees for advice be governed by written contracts, which had to be approved initially by the shareholders and then annually by the shareholders or the board of the mutual fund, 15 U.S.C. 80a-15(a).

2. In the succeeding years, "investment companies enjoyed enormous growth, prompting a number of studies" commissioned by or undertaken by the SEC "of the effectiveness of the Act in protecting investors." *Daily Income Fund*, 464 U.S. at 537. Among those studies was a 1962 empirical study based on data from 156 funds; the study was commissioned by the SEC from the Wharton School and transmitted to Congress. *A Study of Mutual Funds*, H.R. Rep. No. 87-2274 (1962) (*Wharton Study*). The SEC then undertook its own study of mutual fund growth "to test the conclusions of the Wharton . . . Report[] by an intensive firsthand examination of a cross

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[4] Although the dominant form of investment company was originally the closed-end fund, mutual funds had more assets than closed-end funds by 1943, and their dominance has increased ever since. See *Mutual Fund Industry Handbook* 16, 21.

section of the investment company industry." *Public Policy Implications of Investment Company Growth*, H.R. Rep. No. 89-2337 (1966) (*SEC Study*). As relevant here, the two studies focused on the weakness of the position of externally managed mutual fund boards in controlling fees charged by investment advisers, which, "as a fund's assets grew, . . . could produce unreasonable fees in light of the economies of scale realized in managing a larger portfolio." *Daily Income Fund*, 464 U.S. at 537.

Both studies agreed on the basic nature of the problem. As the SEC concluded:

> The ability of unaffiliated directors to bargain at arm's length is seriously hampered because they are seldom free as a practical matter to terminate a long established management relationship solely because of differences over fee rates. Under these circumstances, the essential element of arm's length bargaining—the freedom to terminate negotiations and to bargain with other parties—is lacking.

SEC Study 12; see *id.* at 45-49, 74-75; *Wharton Study* xiii. Indeed, "even a requirement that all of the directors of an externally managed investment company be persons unaffiliated with the company's adviser-underwriter would not be an effective check on advisory fees and other forms of management compensation." *SEC Study* 148; see *Daily Income Fund*, 464 U.S. at 540-541.

The studies also noted that the problem had been exacerbated by the substantial growth of mutual funds and the failure meaningfully to share the resulting economies of scale with investors. The SEC explained that "increases in an investment company's assets do not lead to commensurate increases in the cost of furnishing it

with investment advice." *SEC Study* 10; see *id*. at 94-96. Yet, "[b]ecause of the absence of competition, the limitations of disclosure, the ineffectiveness of shareholder voting rights and the difficulty of effective action by unaffiliated directors, *advisory fee rates did not decline as the funds grew*." *Id*. at 12 (emphasis added); see *id*. at 125-132, 149; *Wharton Study* xii, 490.[5]

Finally, the studies concluded that "externally managed mutual funds pay substantially higher advisory fee rates than . . . companies which are operated exclusively as equity investment vehicles for banks and other institutions"; such advisory fees "also are substantially higher for comparable asset levels than the rates that private individuals pay for investment advice"; and "the higher management expenses of the externally managed funds cannot be attributed solely to cost factors." *SEC Study* 11; see *id*. at 102-114, 114-121, 121-125; see also *Wharton Study* xii-xiii, 34, 492-495.

3. As a result of those studies and the recommendations of the SEC, Congress amended the Act in 1970. One change was to provide in Section 15(c) that fund directors had a "duty . . . to request and evaluate," and

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[5] It is important to distinguish between the already-high *rates* (as a percentage of assets) that advisers charge and the even more excessive dollar *amounts* that are produced by those fee rates. It was the huge increase in mutual fund assets and, therefore, the amount of mutual fund fees, that concerned the SEC in 1966, since the cost of providing advisory services (essentially, managing an investment portfolio) rises far more slowly than the fees generated by taking a percentage of the increase in assets. Yet courts have generally acceded to the advisers' desire to frame any debate about fees in percentage—not dollar—terms, thereby giving advisers a license to charge fees that are unjustifiable under any standard. See John C. Bogle, *The Battle for the Soul of Capitalism* 155-157, 198 (2005).

investment advisers had a "duty . . . to furnish, such information as may reasonably be necessary to evaluate the terms of any contract whereby a person undertakes regularly to serve or act as investment adviser" to a fund. 15 U.S.C. 80a-15(c). That duty ensured that, insofar as fund board members were inclined and able to police excessive fees, they would have the necessary information to do so. Another change required annual approval of contracts with investment advisers by fund directors who were not "interested persons," *i.e.*, affiliated with the investment adviser, in addition to the annual approval by the board as a whole or the shareholders. 15 U.S.C. 80a-15(c).

"In contrast to its approach in other aspects of the 1970 amendments," however, Congress chose in Section 36(b) "not to rely solely on the fund's directors to assure reasonable adviser fees." *Daily Income Fund*, 464 U.S. at 540; see *Kamen v. Kemper Fin. Servs., Inc.*, 500 U.S. 90, 108 (1991). Accordingly, Section 36(b) provides 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" paid by an investment company. 18 U.S.C. 80a-35(b). It further provides for an express private right of action by a security holder of an investment company against the adviser "for breach of fiduciary duty in respect of such compensation." *Ibid.* Congress considered the industry's desires as well: It provided that the plaintiff has the burden of proving breach of fiduciary duty, 15 U.S.C. 80a-35(b)(1), and that the plaintiff may recover damages limited to the amount of compensation or payments received only for a "look back" period beginning one year before the action was instituted, 15 U.S.C. 80a-35(b)(3). See also 15 U.S.C. 80a-35(b)(6) (finding of breach of fiduciary duty may not

be basis for a finding of a violation of certain other provisions or for an injunction prohibiting a person from serving as an investment adviser or officer of a fund).

Before Section 36(b), there had been suits by investors challenging excessive fees. Because the fund board had approved the compensation, the plaintiffs' claims had been analyzed "according to common law standards of corporate waste, under which an unreasonable or unfair fee might be approved unless the court deemed it 'unconscionable' or 'shocking'," or the plaintiffs could prove "gross abuse of trust." *Daily Income Fund*, 464 U.S. at 540 n.12. Congress cut loose the new cause of action in Section 36(b) from a "waste" standard by providing that "approval by the board of directions of [the] investment company of [the advisers'] 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).

II. SECTION 36(b) REQUIRES THE ADVISER TO ENSURE FULL DISCLOSURE *AND* SUBSTANTIVE FAIRNESS

A. The Text Of Section 36(b) Requires Full Disclosure And Substantive Fairness

This Court has explained that "[t]he fiduciary duty imposed on advisers by § 36(b) is owed to the company itself *as well as its shareholders*." *Daily Income Fund*, 464 U.S. at 535 n.11 (emphasis added); see *id.* at 541 n.12. Under the 1940 Act, an adviser *must* obtain annual approval of its compensation from the fund board or its shareholders—*i.e.*, those to whom it owes its duty of loyalty. 15 U.S.C. 80a-15(a) and (c). Thus, an investment

adviser when dealing with the issue of compensation is annually in the position of a fiduciary dealing with those to whom the fiduciary owes its duty—*i.e.*, the "beneficiaries."

A fiduciary, "[w]hether acting in a fiduciary or personal capacity, . . . has a duty in dealing with a beneficiary *to deal fairly* and to communicate to the beneficiary all material facts the trustee knows or should know in connection with the matter." Restatement (Third) of Trusts § 78(3) (2001) (emphasis added); see also *id.* cmt. g (trustee "must be able to show that the dealings were fair"). Fair dealing, in addition to full disclosure, are required. See Bogert & Bogert, *The Law of Trusts and Trustees* § 976 (rev. 2d ed. 1993) ("If the beneficiaries are of full age and sound mind, they may enter into a valid agreement with the trustee as to the trustee's compensation, provided the trustee displayed the utmost good faith and fairness in the transaction.") (footnotes omitted). That duty of fair dealing applies specifically to a fiduciary's dealings regarding compensation. See Restatement, *supra*, § 38 cmt. f; see also *id.* § 78(2) cmt. c(4).

The court of appeals' conclusion that an investment adviser may take as much compensation as it can get was based on the view that "when the settlor or persons charged with [a] trust's administration make a decision [on compensation], it is conclusive." Pet. App. 9a. That principle, however, has no application here, where the fiduciary is not dealing with anyone in the role of a *settlor*, who after all owns a trust's assets before the trust is created, but rather with those in the role of *beneficiaries* whom the fiduciary is supposed to be pro-

tecting.[6] The court entirely disregarded that fundamental point.

B. The SEC And The Industry, Which Jointly Drafted Section 36(b), Told Congress That It Required Compensation To Be Substantively Fair

The 1966 SEC report recommended that Congress require that fees charged by investment advisers be "reasonable." *SEC Study* 143-149. That standard, however, was not ultimately employed in Section 36(b). Instead, the terms of Section 36(b) were drafted jointly by the SEC and the Investment Company Institute (of which Mr. Bogle was at the time the Chairman). When the SEC and the Institute were asked what the "fiduciary duty" standard in Section 36(b) meant, they *agreed, in formal memoranda submitted to Congress, that it imposed a substantive limit on fees*.[7]

1. The Senate initially passed the bill including Section 36(b)'s new "fiduciary duty" language. See 115 Cong. Rec. 13,700 (1969). Then, at a hearing of the House subcommittee considering the bill, the SEC representative was asked about the differences between the

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[6] Even when a settlor of a trust sets the compensation for a fiduciary, it is not "conclusive." "If the amount of compensation provided by the terms of the trust is or becomes unreasonably high or unreasonably low, the court may allow a smaller or larger compensation." Restatement, *supra*, § 38 cmt. e. And the adviser's dominant role and influence over a captive fund would also require the adviser to demonstrate the utmost fairness when negotiating compensation with the fund.

[7] It is not surprising that the SEC agreed with the fiduciary duty standard, since it had originally proposed the "reasonableness" standard on the ground that it captured what a fiduciary's obligations are in these circumstances. See, *e.g.*, *SEC Study* 143-144.

earlier "reasonableness" standard and the new "fiduciary duty" standard. The SEC submitted its views on the new bill in a formal memorandum, which is reprinted as Appendix B to this brief.

The memorandum stated that "[t]he short answer to the question . . . is that there is little substantive difference between the standard of reasonableness and the standard of breach of fiduciary duty." *Mutual Fund Amendments (Part I): Hearings Before the Subcomm. on Commerce & Finance of the H. Comm. on Interstate & Foreign Commerce*, 91st Cong. 189 (1969) (*House Hearings*). The Commission explained that "[u]nder the new language, a breach of fiduciary duty occurs when a fiduciary permits an unreasonable or excessive charge to be levied on the fund." *Ibid*. Because the "shift in language from 'reasonableness' to 'fiduciary duty'" had primarily the effect of "shift[ing] the focus of any litigation . . . from the directors of the fund to the investment adviser," it was "primarily procedural not substantive." *Id*. at 190. "It was designed to assure reasonable fees just as the original language . . . was meant to do." *Ibid*.; see also *ibid*. ("[A] breach of fiduciary duty . . . would occur when compensation to the adviser for his services is excessive in view of the services rendered—where the fund pays what is an unfair fee under the circumstances.").

2. The Investment Company Institute confirmed that understanding. It, too, sent the committee a letter, reprinted as Appendix C, *infra*. While the Institute was understandably more laconic when discussing the substance of the standard, the Institute was quite clear that the "fiduciary duty" standard precludes an unreasonable fee:

> Many words have been used in attempting to describe how far a fiduciary may go in negotiating his fee without violating his fiduciary relationship. *A good way to put it is that he 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.*

House Hearings 441 (emphasis added).

3. Finally, this understanding of the "fiduciary duty" principle is further confirmed by a statement that Congs. Dingell, Adams, and Eckhardt added to the report of the House committee. They objected to the committee's addition to Section 36(b) of a provision (later dropped from the final bill) requiring plaintiffs to prove a breach of fiduciary duty by "clear and convincing" evidence. See H.R. Rep. No. 91-1382 168. They made plain that they understood the "fiduciary duty" standard of Section 36(b) exactly as had the SEC and the industry. See, *e.g.*, *id.* at 201 ("In testing whether or not a fiduciary duty has been breached *by virtue of an inordinately high level of compensation* for services of an investment adviser . . . , it is necessary under the terms of the bill as reported for the stockholder complaining *of the high level of compensation* to prove 'a breach of fiduciary duty *by clear and convincing evidence*.'") (first two emphases added).

C. Permitting The Adviser To Take As Much As It Can Get Is Inconsistent With The Purposes Of Section 36(b)

1. The court of appeals' holding that the adviser can take as much compensation as it can get gives the industry that which it was unable to obtain when the bill was being considered, and deprives the investing public of precisely the protection that *everyone involved* believed

the bill would provide. It would also render Section 36(b)'s imposition of a fiduciary duty standard on advisers essentially superfluous. In 1970, Congress amended Section 15(c) to provide that fund directors had a duty to request, and investment advisers had a "duty . . . to furnish, such information as may reasonably be necessary to evaluate the terms of any contract" for the adviser. 15 U.S.C. 80a-15(c). Insofar as the "fiduciary duty" standard of Section 36(b) merely imposed a duty to "make full disclosure and play no tricks" on investment advisers, as the court of appeals held, Pet. App. 8a, it would thus be redundant of the obligation Congress added to Section 15(c). The "fiduciary duty" standard of Section 36(b) avoids redundancy, and justifies the very substantial attention Congress paid to it, only because it imposes an added, substantive duty on the adviser to ensure not only that facts relating to its fees are fully disclosed (as required in any event by Section 15(c)), but also that the fees are fair. See, e.g., *Duncan v. Walker*, 533 U.S. 167, 174 (2001) ("It is a cardinal principle of statutory construction that a statute ought, upon the whole, to be so construed that, if it can be prevented, no clause, sentence, or word shall be superfluous, void, or insignificant.") (internal quotation marks omitted).

2. The court of appeals fundamentally departed from Congress's purposes in enacting Section 36(b) when it held that the adviser/fiduciary can take as much compensation as it can get, with no concern for the interests of the fund and its shareholders. As this Court has explained, Congress was concerned in 1970 that the state-law standard of "corporate waste" that had previously governed shareholder suits charging excessive fees was "inadequate to ensure reasonable adviser fees." *Daily Income Fund*, 464 U.S. at 534 n.10. The court of appeals'

elimination of *all* substantive review under Section 36(b) would obviously be even more inadequate, since it would completely eliminate the obligation to ensure reasonable fees—even in cases in which corporate waste could be proven. See *id.* at 540 (noting that Congress in 1970 "decided not to rely solely on the fund's directors to assure reasonable adviser fees, notwithstanding the increased disinterestedness of the board").

3. More fundamentally, the court of appeals' holding would essentially convert Section 36(b) into an anti-fraud statute, requiring only that investment advisers make full disclosure and avoid dishonesty. Congress, however, chose to impose on investment advisers a fiduciary duty—a far more stringent duty than was imposed by already existing antifraud prohibitions elsewhere in the securities laws. See, *e.g.*, 15 U.S.C. 80b-6; 15 U.S.C. 77q; 15 U.S.C. § 78j(b); 17 C.F.R. § 240.10b-5. Under then-Judge Cardozo's classic statement of fiduciary duty,

> [a] trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior. . . . Only thus has the level of conduct for fiduciaries been kept at a level higher than that trodden by the crowd.

Meinhard v. Salmon, 164 N.E. 545, 546 (1928). The court of appeals' reduction of that most stringent obligation to the commonplace duty to avoid dishonesty is profoundly at odds with the language, history, and purposes of Section 36(b).

III. THE COURT OF APPEALS' VIEW THAT COMPETITION AMONG FUNDS KEEPS ADVISORY FEES IN CHECK, EVEN IF CORRECT, COULD NOT ALTER THE FIDUCIARY OBLIGATIONS OF INVESTMENT ADVISERS UNDER SECTION 36(b)

A. Section 36(b) Requires An Inquiry Into Whether Advisory Fees Are Comparable To What Would Have Been Negotiated In An Arm's-Length Transaction

1. The court of appeals in this case rejected the Second Circuit's holding in *Gartenberg v. Merrill Lynch Asset Mgmt., Inc.*, 694 F.2d 923, 928 (2d Cir. 1982), that "the test [under Section 36(b)] 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 of the surrounding circumstances." That arm's-length standard is consistent with Section 36(b), which at bottom is based on profound skepticism that transactions between investment advisers and captive funds are arm's-length, and therefore substantively fair, transactions.[8]

[8] *Gartenberg* also, without explanation, used the distinct formulation that the adviser violates Section 36(b) if it "charge[s] a fee that 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." 694 F.2d at 928. The duties that a fiduciary owes, however, are more rigorous. Insofar as this alternative formulation suggests that an investment adviser/fiduciary may take advantage of its position at the expense of those to whom it owes its obligation, so long as the adviser does not go too far in doing so, it is incompatible with any accepted account of fiduciary duty. The relative inability of Section 36(b) to control excessive fees to date is due in part to courts

The arm's-length standard also follows from the fiduciary principles discussed above. The core duty of a fiduciary is "to act for the benefit of the other as to matters within the scope of the relationship." Restatement, *supra*, § 2 cmt. b. The fund and its shareholders receive all the benefit they reasonably could expect if they obtain the fiduciary's services at a price comparable to the price that would have been charged in an arm's-length, marketplace transaction. The fiduciary, too, who is permitted "reasonable" compensation, see Restatement *supra*, § 78(2) cmt. c(4), has received all that it is entitled to expect.

2. *Gartenberg* discussed some ways of proving whether an adviser's compensation is consistent with Section 36(b). See 694 F.2d at 930. *Gartenberg* correctly questioned the probative value of a comparison of an adviser's fee to fees that other advisers of externally managed funds charged their own captive mutual fund. *Id.* at 929. As Judge Posner explained, "[t]he governance structure that enables mutual fund advisers to charge exorbitant fees is industry-wide," such that the comparison "would . . . allow those fees to become the industry's floor." Pet. App. 41a; accord *Gallus v. Ameriprise Financial, Inc.*, 561 F.3d 816, 823 (8th Cir. 2009) ("[T]he standard that the Second Circuit enunciated should not be construed to create a safe harbor of exorbitance, for under such a view an adviser's fiduciary duty would be diluted to a simple and easily satisfiable requirement not to charge a fee that is egregiously out of line with industry norms."). The premise of Section 36(b) is skepticism that compensation deals between advisers and their

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using this incorrect formulation instead of the "arm-s-length transaction" standard that captures far better the duty that a fiduciary owes.

captive funds are arm's-length transactions. Such transactions cannot provide a benchmark for what Section 36(b) requires of a fiduciary.

Gartenberg discussed factors that could be useful in proving excessive fees, such as the adviser's "cost in providing the service, the nature and quality of the service, the extent to which the adviser-manager realizes economies of scale as the fund grows larger, and the volume of orders which must be processed by the manager." 694 F.2d at 930. Most of those factors are ultimately designed to compare the adviser's costs with the fees it obtains from the fund. Such a cost-based test, though no doubt useful in some cases, relies on a series of highly contestable facts that are in general under the adviser's unique control and unavailable to shareholders. Cf. *Senate Report* 6 ("Nothing in the bill is intended . . . to suggest that a 'cost-plus' type of contract would be required."). It also relies on rather subjective qualitative judgments ("the nature and quality of the service") that are extraordinarily difficult to evaluate. See John P. Freeman, Stewart L. Brown, & Steve Pomerantz, *Mutual Fund Advisory Fees: New Evidence and a Fair Fiduciary Duty Test*, 61 Okla. L. Rev. 83, 130-139 (2008) (*Freeman/Brown/Pomerantz*).

4. There are better approaches. The most direct and probative evidence of whether the adviser is violating its fiduciary duty by charging an excessive fee (in percentages or, even better, in dollars) is likely to be based not on the adviser's costs, but on an examination of arm's-length transactions involving the sale of essentially identical advisory services in the marketplace, where arm's-length bargaining over investment advisory services regularly occurs. From the beginning, the concerns that triggered Section 36(b) have centered on investment

advisers that charged high fee rates (and even higher fee *amounts*) to their captive mutual funds and much lower fee rates (and amounts) to pension plans and others who were in a position to bargain for the best quality investment advice at the best price. See *Daily Income Fund*, 464 U.S. at 537. As the Eighth Circuit recently held in *Gallus*, when the services rendered by the adviser to a captive fund and to an independent pension fund or other institutional investor are genuinely comparable (even if not exactly the same), that kind of comparison is probative on the question whether the adviser has satisfied its Section 36(b) fiduciary duty. 561 F.3d at 824.[9]

Indeed, it is difficult to imagine a clearer violation of an adviser's fiduciary duty than when the adviser charges its captive fund more than others for similar (or lesser) services. In such cases the difference in fee is likely to reflect either an improperly excessive fee charged to the fund or the forbidden appropriation by the adviser/fiduciary of value from the fund and use of that value to enrich itself in its dealings with third parties. Either would be a violation of the adviser's fiduciary duty under Section 36(b).

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[9] In *Gartenberg*, the court held that the "arm's-length transaction" inquiry is not advanced by comparing the defendant's fees for providing investment advice to a money market fund to "fees charged by investment advisers to large pension funds." 694 F.2d at 930 n.3. The court relied on the fact that the "nature and extent of services required" by the money market fund, which had to deal with a "myriad of daily purchases and redemptions," "differ[ed] sharply" from the services required by a large pension fund that did not provide those services. *Ibid*. *Gartenberg* did not reject the general proposition that apples-to-apples comparisons between a defendant's fees and those actually charged in comparable arm's-length transactions can be highly probative under Section 36(b).

Comparisons with other arm's-length transactions can also be highly probative, especially in cases in which the investment adviser (unlike respondent) does not have comparable independent clients to which it supplies advice. It would thus be probative to compare the fee charged by a given investment adviser/defendant to its captive fund with fees charged by *other* investment advisers to their independent clients, so long as the advisory services provided in the two cases are comparable. Similarly, the internally managed funds (today, primarily Vanguard funds, see note 3, *supra*) that retain outside investment advisers do so in arm's-length transactions, since an internally managed fund faces no conflict in negotiating the most favorable terms it can get from the investment adviser. The prices paid by such funds accordingly provide another probative benchmark of arm's-length transactions.

In short, the most probative evidence of what would have been negotiated in an arm's-length transaction will often be the evidence of actual similar arm's-length transactions. This is not primarily a litigation issue. Fund boards should ask for such information under Section 15(c) when considering adviser compensation, and advisers should in any event furnish it under both Section 15(c) and Section 36(b). But the issue will arise in litigation as well, and, when it does, data concerning fees paid in comparable arm's-length transactions is likely the most probative.

B. The Court Of Appeals' Reliance On Its Disputed View Of The Present Effect Of Competition In The Industry Was Legally Faulty And Factually Incorrect

1. In reaching its conclusion that an investment adviser/fiduciary under Section 36(b) need only "make full disclosure and play no tricks," Pet. App. 8a, the court of appeals relied in substantial part on its view that competition among mutual funds for customers operates to keep advisory fees at a fair level. See Pet. App. 11a-13a. As a matter of law, the court's reliance on that disputed factual premise was mistaken. Because Congress in 1970 imposed a duty on investment advisers not merely to make full disclosure, but also to deal fairly with the funds and shareholders to whom they owe their obligation, that obligation remains today. Current market conditions cannot justify eliminating the fair dealing obligation.

2. The court of appeals relied on one source in concluding that investment advisory fees generally are held to competitive levels—even though, as the court of appeals conceded, "investment advisers create mutual funds, which they dominate" and "mutual funds are 'captives' of investment advisers." Pet. App. 6a, 7a; see Pet. App. 12a (citing John C. Coates & R. Glenn Hubbard, *Competition in the Mutual Fund Industry: Evidence and Implications for Policy*, 33 J. Corp. L. 151 (2007) (*Coates/Hubbard*)). Other sources, discussed below, come to the opposite conclusion: that the problems of excessive fees and inadequate controls on compensation in the mutual fund industry have, if anything, become worse since the Wharton and SEC studies of the 1960s, as the assets under management at mutual funds (and the amount of the fees paid) have skyrocketed.

This Court need not resolve this essentially factual dispute. Coates and Hubbard claim that because of competition among funds for investors, market incentives require mutual funds generally to keep their fees to a competitive level. If that is correct, then advisory fees paid by funds will be justifiable under Section 36(b). But if Coates and Hubbard are wrong, then the court of appeals' rule would remove the only constraint that keeps advisory fees from going even higher than their already excessive levels, to the substantial detriment of this nation's investors. Either way, there would be no basis to relax the Section 36(b) "fiduciary duty" standard.

3. In any event, the court of appeals' view is mistaken; the conditions outlined in the Wharton and SEC studies that provided the impetus for Section 36(b) have become even more troubling today. Fund costs (including advisory fees), while sometimes measured in fractions of a percent, have an enormous effect on the ability of investors over long periods of time to keep pace with the market and achieve their investment objectives. See, *e.g.*, *The Battle for the Soul of Capitalism* 159-168 (illustrating the huge impact of fund costs generally on investment returns). It is exceptionally important that this Court retain the protection for investors that Congress built into Section 36(b).

4. a. A study published in 2001 specifically compared the investment advisory fees paid by mutual funds, on the one hand, and those paid by pension funds and by an internally managed fund family (Vanguard), on the other. See John P. Freeman & Stewart L. Brown, *Mutual Fund Advisory Fees: The Cost of Conflicts of Interest*, 26 J. Corp. L. 609, 627-640 (2001) (*Freeman/Brown*). The study compared actively managed mutual funds with pension funds, *id.* at 627-637, and actively managed

mutual funds with Vanguard funds that get investment advice from outside firms, *id.* at 637-639. It also compared S&P 500 index mutual funds with pension funds that follow the same index strategy and with the costs that Vanguard's similar fund incurs for investment advice from the Vanguard Group, which provides the advice at cost. *Id.* at 639-640. In each case, externally managed mutual funds were paying substantially more for investment advice than were the pension funds and the Vanguard funds.[10]

Moreover, an adviser's captive mutual funds not only are frequently charged larger percentage fees, but also, because they frequently have larger assets, are charged even more in dollar terms. For example, on the summary judgment record in this case, respondent charged

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[10] For example, on average actively managed large-cap equity mutual funds paid 52 basis points for investment advice, while large-cap pension funds paid 21 basis points. *Freeman/Brown*, 635. The difference in dollars is even greater, because the mutual funds on average had much larger assets ($2,068 million) than the pension fund clients ($555 million). *Ibid.* In addition, six firms that provided advice to both captive mutual funds and pension funds charged their captive funds an average of 54 basis points, while they charged pension fund clients 23 basis points. *Id.* at 636. One adviser charged its captive mutual funds 4.5 times more in basis points (84 basis points versus 18 basis points) than it charged its pension customers. *Ibid.* The difference was *more than 14 times as great* in dollar terms—$20.644 million for the captive funds (84 basis points times $24,577 million in assets) versus $1.4 million (18 basis points times $7,817 million in assets) for the pension funds. *Ibid.* Indeed, perhaps the most striking results were provided by the S&P 500 index funds, which in fact require very little investment advice. While mutual funds examined in this category paid either 16 or 20 basis points for investment advice (depending on the universe examined), pension funds paid 1.4 basis point, and Vanguard's fund paid .01 (not a misprint) basis point to the parent Vanguard Group. *Id.* at 640.

one of its captive mutual funds (Equity & Income) an effective rate of 73 basis points for investment advice, while it charged an independent client 31 basis points for the same thing. J.A. 448. The percentage rate it thus charged its captive fund was more than twice what it charged the independent client. But in dollar terms, the difference was vastly larger, because the captive fund had much larger assets than the independent client ($7.7 billion versus $429 million). *Ibid.* In dollar terms, that means that the captive fund paid an advisory fee of $56.21 million (.73% times $7.7 billion), while the independent client paid only $1.33 million (.31% times $429 million) for essentially the same services. Thus, in dollar terms, respondent charged its captive fund 42 times what it charged an independent client. And these are advisory fees only; they do not include the additional fees that respondent charges its captive funds for administrative and other services.[11]

That evidence alone suggests that the concerns that led Congress to enact Section 36(b) are still present today. Certainly, the structural problems in the industry have remained: mutual fund boards remain completely dependent on their investment advisers, as the court of appeals itself conceded, and even greater fees have been reaped by advisers as mutual fund assets have ballooned

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[11] See *The Battle for the Soul of Capitalism* 199-200 (discussing three mutual fund advisers that charge three of their captive funds an average of seven times the *rate* that the same advisers charge a large pension fund with similar investment advisory needs (61 basis points versus 8 basis points), while the three advisers charge their captive funds in aggregate nearly 100 times the *dollars* charged to the pension fund ($56 million versus $600,000)).

to levels not dreamed of in 1970.[12] As in 1970, funds do not generally compete on the basis of costs, and investors accordingly are generally unaware of how much they are paying in costs or the enormous effects that such costs can have on performance over long periods of time. See, *e.g.*, GAO, *Mutual Fund Fees: Additional Disclosure Could Encourage Price Competition* 7 (2000) (http://www.gao.gov/archive/2000/gg00126.pdf); Alan Palmiter and Ahmet Tata, *Mutual Fund Investors: Divergent Profiles*, 2008 Colum. Bus. L. Rev. 934, 980-990, 1003-1008 (2008).

b. Coates and Hubbard did not directly study the level of fund fees, but instead studied the mutual fund market, and reasoned that lower fees give a competitive advantage to a fund in acquiring new assets. See *Coates/Hubbard* 174-184. Even if taken at face value, however, that proposition means only that there is a segment of the market in which customers seek low fund costs; the relative success of Vanguard demonstrates that fact. But the fact that *some* investors are sensitive to low costs, and that competition among funds for new investment money may place *some* limit on fund costs, does not mean that investment advisory fees overall are held to the competitive level that would be expected to result from in arm's-length transactions. The evidence adduced by Freeman and Brown and others is strongly to the contrary.[13]

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[12] At the time Congress was considering Section 36(b), total mutual fund assets were around $50 billion. 115 Cong. Rec. 13692 (1969) (Sen. Bennett). At the end of 2008, they were $9.6 trillion. 2009 *Investment Company Factbook* 9 (http://www.ici.org/pdf/2009_factbook.pdf).

[13] For example, although a recent study published by the American Enterprise Institute proposes as a remedy that Congress provide for a new industry structure, the study agrees with Freeman and Brown

Moreover, Coates and Hubbard are unable adequately to explain the observed facts—which they do not contest—that pension plans, other institutional investors, and Vanguard funds generally pay far less when they hire investment advisers than do captive mutual funds. Coates and Hubbard assert that comparisons of advisory fees paid by captive mutual funds with advisory fees paid by pension and other funds are not probative, because "[a] number of cost-related factors differ between public pension funds and retail customers, including liquidity requirements, number and size of accounts, and services provided to retail but not public pension plans." *Coates/Hubbard* 183-187. As Judge Posner said of the court of appeals' similar statements, Coates and Hubbard offer that explanation "purely as speculation, rather than anything having an empirical basis." Pet. App. 39a.

Indeed, no credible study has ever been able to isolate the assertedly large extra costs, somehow routinely hidden in fund advisory fees and disclosure prospectuses, that are said to make managing dollars in mutual fund portfolios so much more expensive than managing dollars in other institutional (*e.g.*, pension, college endowment, etc.) portfolios. And mutual funds, of course, typically pay separate and additional fees to the adviser for shareholder services, which are disclosed in prospectuses and other documents. In any event, the extremely low overall costs of many index funds offered by Vanguard and other firms, which essentially provide

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that the current industry structure produces advisory fees in excess of those that would prevail in a competitive market, despite competition among mutual funds for customers. See Peter J. Wallison & Robert E. Litan, *Competitive Equity: A Better Way to Organize Mutual Funds* 8-13, 61-69 (2007).

all mutual fund services to their shareholders *except* investment advice, establishes that the extra costs of serving retail customers could not possibly account for the much larger fees those customers pay. See generally *Freeman/Brown/Pomerantz, supra*, at 95-103, 113-117.[14]

5. Whether Coates and Hubbard, Freeman and Brown, or any other students of the industry are correct is ultimately, however, beside the point. Congress imposed a fiduciary duty on fund advisers, who violate that duty if they fail to make full disclosure *or* if they charge a fee that is higher than what would have been negotiated in a comparable arm's-length transaction. Nothing in the disputed empirical evidence about today's mutual fund marketplace could justify excusing advisers from satisfying the fiduciary duty imposed by Congress in Section 36(b).

[14] The claim of Coates and Hubbard that prior studies, including the Wharton and SEC studies, did not adequately isolate advisory fees of mutual funds from their other management fees is mistaken. Petitioners in this case have in fact isolated advisory fees. See J.A. 352-353. More generally, there are a number of techniques—used by Freeman and Brown and others—to determine such fees. See *Freeman/Brown/Pomerantz*, 109-113, 117–121.

CONCLUSION

The judgement of the court of appeals should be reversed.

Respectfully submitted.

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APPENDIX A

John Clifton Bogle

Employment Positions:

2000-present	Founder, Vanguard Group, and President of the Bogle Financial Markets Research Center
1996-2000	Senior Chairman, Vanguard
1974-1996	Chairman and Chief Executive Officer, Vanguard
Sept. 1974	Created The Vanguard Group
1970-1996	Chairman, Wellington Fund and associated funds
1967-Jan. 1974	President, Wellington Management Company
1965-1967	Executive Vice President, Wellington
1962-1965	Administrative Vice President, Wellington
1955-1962	Assistant to the President, Wellington
June 1951	Hired by Walter L. Morgan, Founder and Chairman, Wellington Management Co.

Directorships and Trusteeships:

1999-present	National Constitution Center, Chairman of the Board of Trustees, Chairman Emeritus
2000-2005	Instinet Corporation, Director
1996-2002	American Indian College Fund, Trustee
1996-2000	Chris-Craft Industries, Director
1989-1993	Princeton University Investment Company, Director
1981-1987	The American College, Trustee
1978-1999	Mead Corporation, Director & Chairman of Finance Committee

1975-2000	The General Accident Group of Insurance Companies, (later Connecticut Union), Director
1971-present	Blair Academy, Trustee, Chairman, 1986-2001
1971-1991	Meritor Financial Group, Director
1971-1991	Bryn Mawr Hospital, Director and Chairman, Finance Committee

Memberships and Committees:

2009	Financial Crisis Advisory Group
2007-present	Adirondack Roundtable Chairman
2006-present	Dow Jones Wilshire Advisory Board
2004-present	American Philosophical Society
2004-present	American Academy of Arts and Sciences
2003-present	*Journal of Investment Management*, Advisory Board
2003-present	Financial Analysts Journal, Advisory Council
2002-2003	Conference Board Commission on Public Trust and Private Enterprise
2002-2007	Phi Beta Kappa Society, Investment Committee
1997-2000	U.S. Independence Standards Board
1972-1976	National Assoc. of Securities Dealers, Chairman, Investment Companies Committee
1972 - 1978	Princeton University, Economics Dept. Advisory Council (Chairman 1978)
1969-1974	Investment Company Institute, Board of Governors (Chairman 1969-70)

Honorary Degrees:

May 18, 2007	Georgetown University, Doctor of Humane Letters
May 31, 2005	Princeton University, Doctor of Laws
May 15, 2005	Immaculata University, Doctor of Laws
May 15, 2004	Pennsylvania State University, Doctor of Humane Letters
June 14, 2003	Drexel University, Doctor of Business Administration
May 23, 2001	New School University, Doctor of Laws
May 13, 2001	Susquehanna University, Doctor of Laws
Dec. 15, 2000	Eastern University, Doctor of Humane Letters
June 11, 2000	University of Rochester, Doctor of Laws
Oct. 22, 1999	University of Delaware, Doctor of Laws
Oct. 15, 1999	Albright College, Doctor of Humanities
May 17, 1997	Widener University, Doctor of Humane Letters

Publications: Books

2008 *Enough. True Measures of Money, Business & Life* (Wiley, November 2008)

2007 *The Little Book of Common Sense Investing* (Wiley, March 2007)

2005 *The Battle for the Soul of Capitalism* (Yale University Press)

2002 *Character Counts: The Creation and Building of The Vanguard Group* (McGraw-Hill)

2000 *John Bogle on Investing: The First 50 Years* (McGraw-Hill)

1999 *Common Sense on Mutual Funds: New Imperatives for the Intelligent Investor* (Wiley)

1993 *Bogle on Mutual Funds: New Perspectives for the Intelligent Investor* (Irwin)

1996 *John Bogle and the Vanguard Experiment: One Man's Quest to Transform the Mutual Fund Industry* (Written by Robert Slater, Irwin)

Publications: Articles

2008 *A New Order of Things: Bringing Mutuality to the "Mutual'"Fund*, 43 Wake Forest L. Rev. 1089

2008 *Black Monday and Black Swans*, Financial Analysts Journal

2008 *A Question So Important That It Should Be Hard To Think About Anything Else*, The Journal of Portfolio Management

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2004 *Re-Mutualizing the Mutual Fund Industry*The Alpha and the Omega*, 45 B.C.L. Rev. 391

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2003 *Whether Markets are More Efficient or Less Efficient, Costs Matter*, CFA Magazine,

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1998 *The Implications of Style Analysis for Mutual Fund Performance Evaluation*, The Journal of Portfolio Management,

1995 *The 1990s at the Halfway Mark*, The Journal of Portfolio Management,

1992 *Selecting Equity Mutual Funds*, The Journal of Portfolio Management

1991 *Investing in the 1990s: Remembrance of Things Past, and Things Yet to Come*, The Journal of Portfolio Management,

1997-present *The Wall Street Journal*, numerous op-eds

1999-2003 *The New York Times*, numerous op-eds

Awards:

2009 Outstanding Article Award for *A Question So Important That It Should Be Hard To Think About Anything Else*

2009 Graham & Dodd Perspective Article Award for "Back Monday & Black Swans"

2008 The Bonnell Award, Community College of Philadelphia

2007 Heritage Award, The Historical Society of Pennsylvania

2007 Union League Business Leadership Award

2006 Center for Corporate Excellence Exemplary Leader Award

2006 Chester County Economic Development Council Hall of Fame

2005 Friend of the Delaware Investor Award, Delaware Dept.of Justice

2004 Committee of Seventy, Philadelphia Good Citizenship Award

2004 Marketing Expo, Lifetime Achievement Award

2004 *Institutional Investor* Magazine Lifetime Achievement Award

2003 Cardiovascular Institute Leadership Award

2003	National Foundation for Teaching Entrepreneurship, Entrepreneur of the Year
2003	Yale School of Management, Legends of Leadership
2003	Better Business Bureau, Certificate of Commendation
2002	Union League of Philadelphia, Founders Award for Business Leadership
2002	Franklin Celebration in Philadelphia, Benjamin Franklin Founders Award
2000	Pennsylvania Chamber of Commerce, Pennsylvania's Business Leader of the Year
1999	Princeton University, Woodrow Wilson Award for "Distinguished Achievement in the Nation's Service"
1999	Fixed Income Analysts Society, Inc., Hall of Fame
1999	Partnership for Economic Education, Adam Smith Distinguished Leadership Award
1999	National Association of Personal Financial Advisers, Special Achievement Award
1999	National Investment Company Service Association, Robert L. Gould Award
1998	Assoc. for Investment Management and Research, Award for Professional Excellence
1997	Temple University, Musser Excellence in Leadership Award
1997	*Leadership in Financial Services* (Macmillan Press Ltd), one of the "Financial Leaders of the 20th Century"
1995	Advancement for Delaware Valley Independent Schools, Award for Philanthropy to Independent Education

1993	Financial Analysts of Philadelphia, Lifetime Award of Distinction
1992	Newcomen Society, Honor for innovation

Public Recognition:

2005	FINANCIAL PLANNING Magazine, Hall of Fame
2005	TIME magazine, "Ten Questions for John Bogle"
2004	TIME magazine, "The *Time* 100—the world's 100 most powerful and influential people"
2002-2004	Weekly program with Tyler Mathisen on CNBC
2001	Louis Rukeyser's Wall Street Week, Hall of Fame
1999	FORTUNE magazine, one of the investment industry's four "Giants of the 20th Century."
1999	*Barron's*, "Investment Hall of Fame"
1996	*Fund Action* Magazine, "Fund Leader of the Year"
Ongoing	Numerous appearances on: CNBC,C NN, Bloomberg, Fox Business, NPR

Other Achievements:

1999-2000	Henry Kaufmann Visiting Professor of Business, New York University
1999	Leadership Speakers Series, Fox School of Business Management, Temple University

Distinguished Lectures:

2009 Columbia Business School Stanley R. Klion Forum
2008 George Washington University, Manuel Cohen Lecture
2007 Princeton University, The Maclean House 2007 Lecture Series
2005 Vanderbilt University, Distinguished Speaker Series
2005 Duke University's Fuqua School of Business, Distinguished Speakers Series
2004 Washington State University, The Gary M.Brinson Distinguished Lecture
2003 Vanderbilt University, The Owen School of Management – Distinguished Speaker Series
2003 Wake Forest University, Joseph A. Jones Lecture
2003 Bryn Mawr Presbyterian Church, Community Forum Distinguished Speaker Series
2002 Cornell University, Park Distinguished Lecture Series
2002 Princeton University, Center for Economic Policy Studies
2002 Texas Christian University, M. J. Neeley School of Business, Executive Speaker Series
2002 Blair Academy, Hollerith Lecture Series
2000 New York University, Executive Lecture Series
2000 New York University, Seymour Jones Distinguished Lecture
1998 Massachusetts Institute of Technology (Lincoln Laboratories), Distinguished Lecture Series
1998 Houston Club, Distinguished Speaker Series

APPENDIX B

MEMORANDUM OF THE SECURITIES AND EXCHANGE COMMISSION IN RESPONSE TO QUERY BY CHAIRMAN MOSS REGARDING THE DIFFERENCES BETWEEN THE REASONABLENESS IN S. 34 AND THE "BREACH OF FIDUCIARY DUTY" STANDARD OF S. 2224 AND H.R. 11995 WITH RESPECT TO MANAGEMENT FEES

This memorandum is submitted in response to Chairman Moss' request on November 12, 1969, that we discuss the differences, if any, between the standard of "reasonableness" in respect of management fees in S. 34 and the "breach of fiduciary duty" standard of S. 2224 and H.R. 11995.

I.

The history of this change in language was related by Chairman Budge before this Committee on November 12, 1969:

"With respect to management fees, the Commission had recommended that the Investment Company Act should be changed to specify that management fees should be reasonable and to provide for court enforcement of this standard. S. 3724, passed by the Senate in July 1968, substantially adopted that recommendation with certain additional changes designed to meet some of the objections of the industry. S. 34, precursor to the present bill, contained the same provisions. However, the industry continued to oppose the form of the management fee amendments, although no one objected to the basic proposition that management fees should be reasonable and that the bill should change the present

standard of gross abuse of trust in Section 36 to some more realistic and stricter standard. Following the April 1969 Senate hearings, the commission and industry representatives resumed their discussions of this matter and in May 1969 agreed on and jointly submitted to the Senate Banking Committee, a provision in substitution of the reasonableness standard which would specify that the investment adviser has a fiduciary duty with respect to management fee compensation. This was in accord with the Commission's basic recommendation that the present effective standard 'waste' under state law, and gross abuse of trust under Section 36 of the Act as applied to management fees, be replaced with a more meaningful standard."

* * * * * * *

"Thus, H.R. 11995 and S. 2224 add a new Section 36(b) to the Investment Company Act to specify that the adviser has a fiduciary duty with respect to compensation for services or other payments paid by the fund or its shareholders to the adviser or to affiliated persons of the adviser. Other persons enumerated in Section 36(a) who may have a similar fiduciary duty with respect to compensation or payments received by them from the fund or its shareholders may also be sued for a breach of such duty in addition to liability imposed by Section 36(a). Subsection (b) also provides that payments by the fund to affiliated persons of the adviser are subject to challenge under this section. Approval of the management fee by the directors, and shareholder ratification is to be given such consideration as the court deems appropriate in the circumstances of a particular case.

The adoption of this standard precludes the assertion of a claim of ratification, although a vote of share-

holders or directors approving a management contract may be considered by the court in determining the fairness of the contract. The difficult waste test previously prevailing under state law in cases of ratification, and gross abuse of trust under present Section 36 of the Act, have thus been replaced by the more realistic standard, breach of fiduciary duty. The Commission views this as a significant and meaningful improvement over the existing law and at least as helpful as the reasonableness standard of S. 34, particularly in view of the restrictions on the enforcement of that standard which were contained in S. 34 but are not found in S. 2224 and H.R. 11995.

As the Senate Committee report pointed out, it is contemplated that the court would look at all the facts in connection with the determination and receipt of compensation by fund managers, including all services rendered to the fund or its shareholders and all compensation and payments received, in order to reach a decision as to whether the adviser has properly acted as a fiduciary in relation to such compensation."

As we have indicated, we cannot now state specifically at what levels a breach of fiduciary duty occurs in respect of management fee compensation since the circumstances will differ from fund to fund. In S. 34, the following factors were listed in Section 8 as among those to be considered in reaching a determination that a fee was unreasonable: The nature, quality and extent of the service to be rendered, the extent to which economies of scale and common management were shared with the fund, comparable charges made by the adviser to others and in the industry generally and the value of all other benefits received. S. 34 contemplated that in

the course of negotiating the management contract, fund directors would evaluate these and other relevant factors in order to determine whether the contract was fair to the fund. Although a specific list of factors as set out in Section 8(d)(2) of S. 34 is no longer included in the bill, it nevertheless seems clear that these and other similar factors would in any event be relevant to a determination of whether a fee is fair or constitutes a breach of fiduciary duty.

The change in language from unreasonableness to breach of fiduciary duty with respect to management fee compensation was made at the request of the industry, particularly the ICI after extensive negotiations between the ICI and the Commission. The reasonableness standard was not agreeable to the ICI, although they did not object to the proposition that management fees should be reasonable, because the ICI argued that the earlier standard would focus any court action which might arise on the conduct of the fund directors. The ICI wanted to shift the focus of any litigation in the fee area to the investment adviser. To accomplish this the reasonableness standard was replaced by the standard in H.R. 11995 which specifies that the investment adviser has a fiduciary duty with respect to management fee compensation. Because the Commission was satisfied that his change would not be detrimental to fund shareholders and that it would be possible with the change to still achieve the goal of fair and proper management fees, the Commission agreed to the change. It was felt that the substitution met the Commission's desire for a more meaningful and effective standard than the existing Section 36 language and the waste standard under state law. Under the new language, a breach of fiduciary duty occurs when a fiduciary per-

mits an unreasonable or excessive charge to be levied on the fund. The new language would not relieve the directors of a fund from their general fiduciary duty or insulate them from suit under Section 36(b), but it would achieve the ICI's purpose in focusing any fee litigation under that provision primarily on the adviser's role as a fiduciary and on the amount of the fee received rather than on the role of the fund's directors.

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. That this result was intended is made clear by Senator Bennett's statement on this issue on the floor of the Senate:

> Last year's bill would have required that the fees should be reasonable, and no one disagreed. Under that bill, the question of whether a fee was or was not reasonable would have been determined by the Securities and Exchange Commission and the Federal courts. While the goal of reasonableness was accepted by all, the method of reaching that goal was offensive to many.
>
> We have now deleted the entire management section from last year's bill and in its place added a subsection specifying that the investment adviser himself has a fiduciary duty with respect to the compensation he receives for services provided to the fund. As a fiduciary, the adviser and others who may receive compensation from the adviser's fee, are subject to lawsuits which may be instigated by shareholders or the Securities and Exchange Commission in the event that the fee received is claimed to be so excessive as to constitute a breach of fiduciary duty. Directors of the fund will, of course, continue to have a fiduciary responsibility with

respect to their own compensation and for the overall operation of the fund.

In determining whether the adviser has met his responsibility to the fund shareholders, the court must give appropriate weight to shareholder ratification of the management fee or its approval by directors.

This provision, instead of being an intrusion by the Federal Government, is in accordance with the traditional function of the courts to enforce fiduciary duties.

It is well established that both under the Investment Company Act and under general concepts of fiduciary law, the investment adviser is a fiduciary of the fund he advises. The industry has never seriously disputed this proposition. The court of appeals in *Securities and Exchange Commission* v. *Insurance Securities, Inc.*, 254 F. 2d 642, 650 (C.A. 9, 1958), *certiorari denied*, 358 U.S. 823, recognized that such a fiduciary relationship exists under the 1940 Act. Section 1(b)(2) states that one of the objectives of the Act was to eliminate situations in which "investment companies are organized, operated, managed or their portfolio securities are selected in the interest of directors, officers, *investment advisers* . . . or other affiliated persons thereof. . . ." (Emphasis added). The present Section 36 specifically imposes a duty on investment advisers not to engage in activities which would constitute gross abuse of trust in respect of the fund they manage. Sections 10 and 15, which permit affiliated persons of the investment adviser to serve on the boards of the funds they advise, also make clear that these affiliated directors are fiduciaries of the fund even though they may also be officers of directors of the investment adviser.

See *Brown* v. *Bullock*, 194 F. Supp. 207, 238-240 (S.D.N.Y., 1961), *affirmed*, 294 F. 2d 415 (C.A. 2, 1961).

Investment advisers like other corporate fiduciaries, such as banks, are entitled to make a profit, but they are not entitled to charge excessive or unreasonable fees. The law is especially alert to unfairness where affiliated persons of the fiduciary (the adviser) also serve on the board of the corporation (the fund). As the Supreme Court stated in its landmark opinion in *Geddes* v. *Anaconda Copper Mining Co.*, 254 U.S. 590 at 599 (1921):

The relation of directors to corporations is of such a fiduciary nature that transactions between boards having common members are regarded as jealously by the law as are personal dealings between a director and his corporation, and where the *fairness* of such transactions is challenged the burden is upon those who maintain them to show their *entire fairness* and where a sale is involved the full adequacy of the consideration. Especially is this true where a common director is dominating in influence or in character. (Emphasis added).[1]

The courts have long held that directors and other fiduciaries have a duty to deal with their corporations fairly and that a failure to accord such treatment to those they serve is a breach of fiduciary duty.[2] As the Supreme Court stated in *Pepper* v. *Litton*, 308 U.S. 295, 311 (1939):

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[1] See also: *Globe Woolen Co.* v. *Utica Gas & Elec. Co.*, 212 NE 378 (N.Y. 1918) (Cardozo, J.).

[2] *Geddes* v. *Anaconda Copper Mining Co.*, 254 U.S. 590 (1921); *Meinhard* v. *Salmon*, 249 NY 458, 164 NE 545 (1928); *Pepper* v. *Litton*, 308 U.S. 295, 311 (1939); *Shlensky* v. *South Parkway Building Corp.*, 90 Ill. 2d 268, 166 NE 2d 793 (1960).

"He who is in such a fiduciary position cannot serve himself first and his *cestuis* second. . . . He cannot use his power for his personal advantage and to the detriment of the stockholders and creditors no matter how meticulous he is to satisfy technical requirements. For that power is at all times subject to the equitable limitation that it may not be exercised for the aggrandizement, preference, or advantage of the fiduciary to the exclusion or detriment of the *cestuis*. Where there is a violation of those principals, equity will undo the wrong or intervene to prevent its consummation."[3]

Thus under the standard contained in the present bill, a breach of fiduciary duty involving management fees would occur when compensation to the adviser for his services is excessive in view of the services rendered—where the fund pays what is an unfair fee under the circumstances.[4]

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[3] That this statement is applicable in the 1940 Act context in cases involving violations of Sec. 36 was made clear in *Aldred Inv. Trust* v. *S.E.C.*, 151 F. 2d 254, 260 (CA 1, 1945), cert. denied, 326 US 795 (1946), one of the first cases decided under the Act.

[4] On the issue of the definition of fairness, the Supreme Court of Illinois in a case involving self-dealing directors stated:

While the concept of "fairness" is incapable of precise definition courts have stressed such factors as whether the corporation received in the transaction full value in all the commodities purchased; the corporation's need for the property; its ability to finance the purchase; whether the transaction was at the market price, or below, or constituted a better bargain than the corporation could have otherwise obtained in dealings with others; whether there was a detriment to the corporation as a result of the transaction; whether there was a possibility of corporate gain siphoned off by the directors directly or through corporations they controlled; and whether there was full disclosure --- *although neither disclosure nor shareholder assent can convert a dishonest transaction into a fair one. Shlensky* v. *South Parkway*

In summary, the failure of fiduciaries to deal fairly or reasonably with those to whom they are so obligated is a breach of fiduciary duty. It is also a breach of fiduciary duty to charge excessive or unreasonable fees. This was made explicit in the Commission's original explanation of S. 1659[5] and H.R. 9510.[6]

We would conclude on the basis of the foregoing that the effect of the shift in language from "reasonableness" to "breach of fiduciary duty" is primarily procedural and not substantive. It was designed to assure reasonable fees just as the original language of S. 34 was meant to do. The change would shift the focus of any litigation based on that Section from the directors of the fund to the investment adviser.

Bldg. Corp., 166 N.E. 2d 793, 801-02 (Illinois, 1960) (Emphasis added).

[5] Senate Hearings Committee on Banking and Currency, 90th Cong., 1st Sess., Pt. I, 139-141 (1967).

[6] House Hearings, Subcommittee on Commerce and Finance of the Committee on Interstate and Foreign Commerce, 90th Cong., 1st Sess., Pt. I, 105-107 (1967).

APPENDIX C

Investment Company Institute
New York, N.Y., December 17, 1969

Hon. John E. Moss

Chairman, Subcommittee on Commerce and Finance, Committee on Interstate and Foreign Commerce, Rayburn House Office Building, Washington, D.C.

Dear Congressman Moss: In the course of my testimony on H.R. 11995, delivered on November 13, 1969 you requested the Institute's views on the legal meaning of the terms "reasonableness" and "fiduciary duty." This letter is in compliance with that request.

We have previously testified both before this Subcommittee and the Senate Committee on Banking and Currency as to why we were opposed to the provisions in S. 34 (91st Congress, First Session) introduced on January 15, 1969, making it a statutory requisite that advisory fees and other compensation be "reasonable" and authorizing litigation under this standard. In our view this might be interpreted to obligate a court to determine *de novo* on a case-by-case basis whether such compensation was in any particular case, in fact, "reasonable." We refer to our testimony at pages 241-243 of the printed House hearings on H.R. 9510 and H.R. 9511, 90th Congress, First Session, Serial No. 90-21 and at pages 298-299 of the printed Senate hearings on S. 1659, Part 1, 90th Congress, First Session and at page 100 of the printed hearings on S. 34, 91st Congress, First Session and ask that such testimony be considered as part of this response. Our basic concern was that in applying the "reasonable" standard the courts might

feel called upon to substitute their business judgment for that of the directors of the fund.

Section 20 of H.R. 11995 provides that the adviser has a fiduciary duty with respect to the receipt of his compensation paid by a registered investment company to the adviser. This provision differs from the "reasonableness" approach first in a procedural way. That is under the present provision a suit may be brought by the Commission or a security holder of the investment company only against the adviser or other person who received the compensation. The "reasonable" approach provided that recovery was limited to the recipients but did not eliminate non-recipients as parties to litigation.

As to the nature of the standard itself it is first of all clear that it is not intended to imply that the investment adviser is not entitled to make a profit or to suggest that any type of "cost plus" contract would be required. Thus, it should be recognized that the investment adviser is running a business which is a commercial enterprise, albeit subject to high standards of conduct.

We believe the court will look to the general law of fiduciary relationships which involve the negotiating of fees by a fiduciary with the other party to the particular transaction. In such situations it would appear that there is no question that a fiduciary can negotiate for his fee.

Many words have been used in attempting to describe how far a fiduciary may go in negotiating his fee without violating his fiduciary relationship. A good way to put it is that he 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. The court would undoubtedly consider whether the investment adviser has acted fairly and diligently in supplying information to the Board of Directors of the investment company so that they can function properly in establishing the terms of the advisory contract and in supervising the continuance of the arrangements with the adviser and its affiliated persons. 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.

Sincerely yours,

Robert L. Augenblick

President and General Counsel