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

BRIEF OF *AMICI CURIAE* LAW PROFESSORS IN SUPPORT OF PETITIONERS

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INTEREST OF *AMICI CURIAE*[1]

Amici are scholars[2] at American law schools whose research and teaching interests focus on federal securities regulation, business organizations, and the law of investment funds. *Amici* have no financial stake in the outcome of this case but are interested in ensuring a uniform and coherent interpretation of the Investment Company Act of 1940. We file this brief to urge this Court to clarify the proper scope of the fiduciary duty that investment advisors owe to fund shareholders with respect to the compensation that advisors receive. We are prompted to submit this brief because the decision in this case will have wide-ranging consequences for millions of American investors and the trillions of dollars they entrust to these fiduciaries.

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

[2] A full list of *amici*, who join this brief as individuals and not as representatives of any institutions with which they are affiliated, is set forth in the Appendix to this brief.

SUMMARY OF ARGUMENT

Even in a time of historic financial disruption and ferment, this case presents a remarkably opportune question regarding the extent to which federal courts "may, or indeed must, defer to market forces."[3]

In enacting the Investment Company Act of 1940 (the "Company Act"), Congress constructed a *sui generis* regulatory regime to govern a system of saving, which has grown to ninety-three million U.S. shareholders of mutual funds and ten trillion dollars of assets, and to protect investors and investments from the fees that advisors charge, which now surpass one hundred billion dollars each year.[4] Concluding that mutual funds are riven with structural conflicts of interest and uncommonly impoverished in protective market forces, Congress in 1970 armored investors with the additional aegis of judicial review by statutorily imposing "a fiduciary duty upon advisors with respect to the receipt of compensation for services." 15 U.S.C. § 80a-35(b). To determine whether the fees an advisor charges violate this Section 36(b) duty, this Court should apply a fiduciary standard with modest scope but forceful effect to counterbalance the structural and behavioral vulnerabilities preventing market forces alone from imposing competitive discipline upon advisory fees.

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[3] William A. Birdthistle, *Investment Indiscipline: A Behavioral Approach to Mutual Fund Jurisprudence*, 2010 U. Ill. L. Rev. (forthcoming), *online at* http://ssrn.com/abstract=1412878.

[4] *See* Investment Company Institute, *2009 Fact Book* 7 (49th ed. 2009), *online at* http://www.icifactbook.org; John C. Bogle, *Enough: True Measures of Money, Business, and Life* 44 (2008) ("In 2007, the direct costs of the mutual fund system (largely management fees and operating and marketing expenses) totaled more than $100 billion.").

The ruling below profoundly errs by embracing an approach that reduces the Section 36(b) fiduciary duty to a practical nullity while endorsing the validity of fees generated in a mutual fund market distinctly bereft of competitive market forces. *Jones v. Harris Assocs. L.P.*, 527 F.3d 627 (7th Cir. 2008). With its imaginative economic reinterpretation of Section 36(b), the Seventh Circuit elided a critical provision of the statute; ignored the purposes of the legislation so clearly enunciated by Congress in Section 1(b) of the Company Act, which commands that the act's language be interpreted to favor "the interests of investors" over industry; and retreated from the notably uniform and consistent legislative history elucidating this fiduciary duty.

The court below initiated its argument first by unmooring itself from the appellate precedent governing this field for the past quarter-century, *Gartenberg v. Merrill Lynch Asset Management, Inc.*, 694 F.2d 923 (2d Cir. 1982). In *Gartenberg*, the Second Circuit defined Congress's "fiduciary duty" language through an overlapping troika of standards – one substantive, one procedural, and one multivariate – which have been misread and distorted by subsequent rulings to demand an exaggerated showing of outlandish compensation to trigger a violation. The *Gartenberg* court may have gone too far in requiring not just largeness or unreasonableness in a fee but what Professor Lyman Johnson characterizes as even greater "extremeness"[5]: the advisor "must charge a fee that is *so disproportionately large* that it *bears no reasonable relationship* to the services rendered *and*

[5] Lyman Johnson, *A Fresh Look at Director "Independence": Mutual Fund Fee Litigation and Gartenberg at Twenty-Five*, 61 Vand. L. Rev. 497, 516 (2008).

could not have been the product of arm's-length bargaining." *Gartenberg*, 694 F.2d at 930 (emphases added). Nevertheless, the *Gartenberg* court did enumerate a menu of factors that could, if applied faithfully, demonstrate the excessiveness or unreasonableness of a fee. *See id.* at 929-930. Inasmuch as no plaintiff has ever prevailed under any litigation purporting to interpret these standards in more than a quarter-century,[6] however, either no advisor has breached its fiduciary duty during that time or, as Johnson concludes instead, "something is amiss under Section 36(b)."[7]

Last year in the case below, the Seventh Circuit contracted the Section 36(b) fiduciary standard even further. Expressly disavowing the doctrinally convoluted and substantively weak duty that has evolved in Section 36(b) litigation over the past twenty-five years, the court in *Jones* concocted a doctrinally simple but substantively impotent variation. Rather than seeking guidance from enlightening mutual fund or corporate precedent, the court relied instead on a meager reading of the law of trusts to reach the conclusion that the Section 36(b) duty requires only that a "fiduciary must make full disclosure and play no tricks but is not subject to a cap on compensation." *Jones*, 527 F.3d at 632. Thus, the Seventh Circuit's new standard reduces Section 36(b) to merely a generic anti-fraud entreaty, providing no substantive limit on fees and duplicating the pre-existing regulatory regime that already required advisors to behave themselves.

[6] *See* James D. Cox et al., *Securities Regulation: Cases and Materials* 1211 (3d ed. 2001).

[7] Johnson, *supra* note 5, at 519.

In the ruling below, the court of appeals undervalued the need for a meaningful fiduciary duty because – notwithstanding congressional conclusions to the contrary – it overvalued the efficacy of market forces in disciplining mutual fund advisory fees. But as Judge Richard Posner noted when dissenting from the Seventh Circuit's denial of rehearing en banc in *Jones*, the economic analysis propping up such jurisprudence is lamentably "one-sided" and "ripe for reexamination." *Jones v. Harris Assocs. L.P.*, 537 F.3d 728, 733, 730 (7th Cir. 2008) (Posner, J., dissenting from denial of rehearing en banc). With the dramatic failure of large and sophisticated sectors of the U.S. and global economies, neither mutual fund trustees nor federal courts can reasonably continue to indulge such a credulous vision of romanticized market forces while ignoring the congressionally enacted fiduciary duty designed expressly to safeguard shareholders who "stand in special need of legal protection" from the demonstrated vulnerability of such forces. S. Rep. No. 91-184, at 3 (1969), *reprinted in* 1970 U.S.C.C.A.N. 4897, 4899.

The structure of mutual funds is notoriously "incestuous," with "each fund a captive"[8] to the investment advisor who forms, incubates, and rules it.[9] Upon creating a fund, an advisor then sustains its new client on "life support" by externally providing the fund's entire management.[10] An important step in this dependent relationship is the advisor's appointment of all the fund's trustees, whose earliest

[8] *Gartenberg*, 694 F.2d at 927, 929.

[9] *See* Paul G. Mahoney, *Manager-Investor Conflicts in Mutual Funds*, 18 J. Econ. Persp. 161, 163-164 (2004).

[10] William A. Birdthistle, *Compensating Power: An Analysis of Rents and Rewards in the Mutual Fund Industry*, 80 Tul. L. Rev. 1401, 1423-1424 (2006).

duties include blessing the size of the advisor's compensation.[11] Indeed, when enacting Section 36(b), Congress noted that "the forces of arm's-length bargaining do not work in the mutual fund industry in the same manner as they do in other sectors of the American economy." *Id.* at 5, *reprinted in* 1970 U.S.C.C.A.N. 4901. Moreover, when considering the Company Act previously, this Court has twice examined the legislative history to descry Congress's "concern with the potential for abuse inherent in the structure of investment companies." *Daily Income Fund, Inc. v. Fox*, 464 U.S. 523, 536 (1984) (quoting *Burks v. Lasker*, 441 U.S. 471, 480 (1979)) (internal quotation marks omitted).

In typical corporations, whose governance is policed by a wide array of market mechanisms absent from mutual funds,[12] the decisions of boards of directors on issues such as managerial compensation are often afforded judicial deference through the business judgment rule.[13] *See, e.g.*, *Kamen v. Kemper Fin. Servs., Inc.*, 500 U.S. 90, 101 (1991) (citing *Zapata Corp. v. Maldonado*, 430 A.2d 779, 784 & n.10 (Del. 1981)). That rule, however, has no application and courts do not abstain when conflicts of interest exist.[14] Taking particular note of the "unique struc-

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[11] *See generally* 2 Tamar Frankel & Ann Taylor Schwing, *The Regulation of Money Managers* § 12 (2d ed. 2001).

[12] *See* 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, 1032-1036 (2005).

[13] For a vigorous critique of compensation in corporations, see Lucian Bebchuk & Jesse Fried, *Pay Without Performance: The Unfulfilled Promise of Executive Compensation* (2004).

[14] *See*, *e.g.*, Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 Nw. U. L. Rev.

ture of mutual funds" – and, more importantly, "the potential conflicts of interest" inherent in their structure – Congress refused to adopt a similar rule of judicial abstention in the context of mutual funds. S. Rep. No. 91-184, at 2, *reprinted in* 1970 U.S.C.C.A.N. 4898. On the contrary, the imposition of the Section 36(b) fiduciary duty was a deliberate attempt to devise "an effective means for the *courts* to act where mutual fund shareholders or the SEC believe there has been a breach of fiduciary duty." *Id.* (emphasis added). Although the numbers of funds, advisors, and investments in this industry have changed since the enactment of Section 36(b), the structure of the mutual fund industry – which is what troubled Congress – remains unchanged to this day.

As the Eighth Circuit has very recently held, in the nation's first ruling in favor of a mutual fund shareholder in over thirty years of Section 36(b) litigation, the impact of these economic infirmities can readily be observed when a court considers the actual operations of funds. *See Gallus v. Ameriprise Fin., Inc.*, 561 F.3d 816, 819 (8th Cir. 2009). In *Gallus*, the court emphasized the troubling disparity between the high fees the advisor charged its retail shareholders and the low fees it charged "institutional, non-fiduciary clients" for "essentially the same" services and concluded that an inquiry into that discrepancy was critical "to determine what the investment advice is worth." *Id.* at 824. Most importantly, the court in *Gallus* demonstrated that, when reasonably expanded and applied, the *Gartenberg* standards are sufficiently broad to compass additional

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547, 603 (2003) ("The business judgment rule . . . has no application where the board of directors is disabled by conflicted interests.").

ways "in which a fund adviser can breach its fiduciary duty." *Id.* at 823.

The fiduciary test in *Jones* effectively invalidates the duty that Congress enacted in Section 36(b) by placing faith in an unsupported and anachronistic economic interpretation of mutual funds. Specifically, the decision below undermines an act of Congress by ruling that investors must seek their protection from governance and competition, not from a fiduciary duty. But the overwhelming preponderance of academic studies continues to find economic and behavioral constraints inherent in the structure of mutual funds and to validate Congress's refusal to abandon shareholders to the vicissitudes of a flawed market. This Court should develop a more effective fiduciary duty – one that actually implements the statutory language promulgated in Section 36(b) – by endorsing the more sophisticated and robust economic analysis undergirding the opinions of Judge Posner and the Eighth Circuit.

ARGUMENT

I. THE SECTION 36(b) FIDUCIARY DUTY POSSESSES MEANINGFUL INDEPENDENT FORCE

In *Jones*, the court of appeals failed to acknowledge that the Section 36(b) fiduciary duty possesses any meaningful force. Shareholders have never prevailed in practice under cases misapplying *Gartenberg*; they cannot prevail even in theory under *Jones* without either proving the violation of some other, preexisting prohibition against fraud or demonstrating impossibly gross distortions in the advisor's compensation. In the absence of fraud, the court below found it "possible to imagine compensation so unusual that a court will infer that deceit must have occurred" only in circumstances equivalent to an advisor charging the cartoonish fee of more than fifty percent – or five thousand basis points – of assets under management. *Jones*, 527 F.3d at 632.[15]

In essence, these rulings perpetuate the status quo ante legislation and thus judicially void Section 36(b)'s purpose and puissance. By imparting content to the statutory standard, this Court will give meaning to Congress's clear command that an advisor's compensation is guided by a fiduciary duty. For guidance as to that content, this Court should consider Section 36(b)'s text and structure, the legislative reports that accompanied the statute's enactment, and the corresponding duties elaborated in the analogous doctrinal field of corporate law.

A. The Structure and Content of the Company Act Substantiate the Fiduciary Duty's Independent Force

By declining to define "fiduciary duty" in Section 36(b), Section 2, or elsewhere in the Company Act, Congress ceded to the federal courts the duty of imbuing this concept with operational meaning. When adding this new provision in 1970, Congress did not, however, fail to provide useful guidance as to the broader fiduciary standard imposed by Section 36(b). Indeed, Congress furnished a text of full legal force together with a template for its explication.

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[15] The Seventh Circuit's example involved a university paying its president "$50 million a year" when such an amount constitutes a twenty-five fold increase over the next-highest salary. *Gartenberg*, 527 F.3d at 632. Given that several advisors currently charge fees greater than two percent of assets, an equivalent "violation" in the mutual fund setting would require a fee greater than fifty percent, which is so fantastic as to be impossible.

First and foremost, the very language of Section 36(b) includes a critical clause that distinguishes this fiduciary duty from any preexisting or generic legal obligation. This duty applies specifically to "the receipt of compensation for services." 15 U.S.C. § 80a-35(b). The use of this language clearly modifies the Section 36(b) duty to require an advisor to vouchsafe good faith, fair dealing, and other trappings of a fiduciary expressly in conjunction with the fees it charges. The court below *completely elides this critical provision of the statute*, effectively reading pivotal language out of its analysis. To conclude that this provision means only that a "fiduciary must make full disclosure and play no tricks," as the Seventh Circuit did, renders the fiduciary duty impotent and otiose in a regulatory regime already bristling with antifraud provisions. Indeed, this Court has previously concluded that surplusage cannot be the fate of this duty, noting instead that "Section 36(b) creates an entirely new right." *Daily Income Fund*, 464 U.S. at 541.

At the time of Section 36(b)'s enactment, investment advisors were specifically obliged to make full disclosure and to play no tricks by Section 34(b) of the Company Act, 15 U.S.C. § 80a-33(b) (making unlawful any untrue statements of material fact in a registration statement or other documents); Section 206 of the Investment Advisers Act of 1940, 15 U.S.C. § 80b-6 (making unlawful any fraud upon clients or prospective clients); Sections 11, 12, and 17 of the Securities Act of 1933, 15 U.S.C. §§ 77k, 77*l*, 77q (imposing civil liability for false registration statements and for noncompliant prospectuses, and making unlawful any fraudulent interstate transactions); and Section 10(b) of the Securities Exchange

Act of 1934, 15 U.S.C. § 78j(b), and Exchange Act Rule 10b-5, 17 C.F.R. § 240.10b-5 (making unlawful the use of any manipulative or deceptive devices). The obvious implication and effect of adding the Section 36(b) duty to this regime was to create a distinct and new legislative duty specifically promulgated to obligate advisors to behave as fiduciaries in connection with the compensation that they can charge and receive.

Second, Section 1 of the Company Act clearly declares the policy animating this legislation and unequivocally asserts the manner in which the law should be interpreted. 15 U.S.C. § 80a-1. Under the heading of policy, the act enumerates occasions on which the "national public interest" is "adversely affected," including "when investment companies are organized, operated, [or] managed . . . in the interest of directors, officers, [or] investment advisers . . . rather than in the interest of all classes of such companies' security holders." *Id.* § 80a-1(b). To remedy this situation, the statute provides the following statement of purpose and guidebook to explication:

> It is hereby declared that the policy and purposes of this title, in accordance with which the provisions of this title shall be interpreted, are to mitigate and, so far as is feasible, to eliminate the conditions enumerated in this section which adversely affect the national public interest and the *interest of investors*.

Id. (emphasis added). In setting forth this controlling interpretive rubric, Congress clearly expressed its solicitude for investors over industry in competing claims of welfare, such as in the debate concerning excessive compensation. Surprisingly, Section 1 of the Company Act is not even mentioned in *Jones*.

Notwithstanding the clear text and this interpretive guidance, the ruling below gives no weight to Congress's decision to move advisors beyond their minimal requirements of providing disclosure and avoiding trickery.

B. The Legislative History Provides Consistent and Cumulative Support for a Robust Fiduciary Duty That Is Judicially Enforceable

Contrary to the assertions of the courts in *Gartenberg* and *Jones*, the legislative history accompanying the enactment of Section 36(b) is not "tortuous," *Gartenberg*, 694 F.2d at 928, nor does it "contain[] expressions that seem to support every possible position," *Jones*, 527 F.3d at 633. This Court has twice delved deeply and comfortably into this legislative history without expressing frustration at indeterminacy. *See Daily Income Fund*, 464 U.S. at 535-541 ("In evaluating such a claim, our focus must be on the intent of Congress when it enacted the statute in question."); *Burks*, 441 U.S. at 480-481. In this case, the supporting legislative record is remarkably uniform in its repeated critique of the structure of the mutual fund industry and emphatic in its repeated demand for a meaningful standard that the judiciary can enforce. *See generally* S. Rep. No. 91-184, *reprinted in* 1970 U.S.C.C.A.N. 4897.

Only in one brief passage does the Senate Report discuss the fact that a provision in an earlier version of the bill stating that "management fees should be 'reasonable'" was ultimately replaced with the creation of a "fiduciary duty." *Id.* at 5-6, *reprinted in* 1970 U.S.C.C.A.N. 4902. But nothing suggests that a fiduciary standard permits any lesser conduct by advisors. In the Report's own words, the fiduciary duty is simply "a different method of testing management compensation," though notably one accompanied by "the traditional function of the courts to enforce such fiduciary duties in similar type relationships." *Id.*

More importantly, the Report is unambiguous in rejecting an extreme standard that would require a "showing of 'corporate waste'" or a fee that "[s]hock[s] the conscience of the court." *Id.* at 5, *reprinted in* 1970 U.S.C.C.A.N. 4901. While "[s]uch a rule may not be an improper one when the protections of arm's-length bargaining are present," it is "unduly restrictive" in "the mutual fund industry where[] these marketplace forces are not likely to operate as effectively." *Id.* Yet the standard set forth in *Jones* is equivalent to corporate waste and conscience-shocking tests, inasmuch as no plaintiff has ever prevailed under Section 36(b) and apparently cannot do so without identifying fees so grotesque as to shock the laws of economics.

Although the determination of compensation in the standard business organization is often insulated from judicial review by the business judgment rule, *see*, *e.g.*, *Kamen*, 500 U.S. at 101, Congress chose a different approach for mutual funds. Judicial abstention is not appropriate – even under the business judgment rule[16] – when conflicts exist. Based on its conclusion that conflicts are an indelible and inherent feature of the architecture of mutual funds, Congress therefore decreed that judicial abstention is never warranted here. *See* S. Rep. No. 91-184, at 2, *reprinted in* 1970 U.S.C.C.A.N. 4898. Repeatedly and without contradiction, the Report forcefully calls

[16] *See*, *e.g.*, Bainbridge, *supra* note 14, at 603.

upon the federal courts to establish and then to police the contours of this fiduciary duty.

The Senate Report consistently demonstrates Congress's preference for courts to supplement market forces, adopting "the basic principle that, in view of the potential conflicts of interest involved in the setting of these fees, there should be effective means for the courts to act where mutual fund shareholders or the SEC believe there has been a breach of fiduciary duty." *Id.* Furthermore, "[t]his bill . . . provides an effective method whereby the courts can determine whether there has been a breach of this duty by the adviser or by certain other persons with respect to their compensation from the fund." *Id.* In addition, "the Congress recognized that investment companies and those who entrust their savings to such companies stand in special need of legal protection." *Id.* at 3, *reprinted in* 1970 U.S.C.C.A.N. 4899. Finally, Section 36(b) "authorize[s] the court to determine whether the investment adviser has committed a breach of fiduciary duty in determining or receiving the fee." *Id.* at 6, *reprinted in* 1970 U.S.C.C.A.N. 4902. This cumulative and uncontroverted legislative history is inimical to the standard established in *Jones*, which explicitly rejects any participation of courts in standing sentinel at the perimeter of the Section 36(b) fiduciary duty.

C. Although Mutual Funds and Corporations Differ *Economically*, the *Law* of Corporations Is Analogous and Persuasive

Perhaps the central error of the Seventh Circuit's ruling in *Jones* is that it compares mutual funds overenthusiastically to corporations in its *economic* analysis but apathetically in its *legal* analysis. That is, the court insisted that mutual funds and corporations are alike in competitive market dynamics when, in fact, they are not, *see infra* Part II.B; yet the court then applied to mutual funds a crabbed legal interpretation of corporate fiduciary principles. Inasmuch as Congress has imbued mutual funds with considerable statutory protections of their own, this Court should raise shareholders' fiduciary protections *at least* to the level actually enjoyed by corporate shareholders.

Rejecting guidance from legislation, legislative history, and the *Gartenberg* precedent regarding the meaning and content of the Section 36(b) fiduciary duty, the court below cast about for another source of illumination. *See Jones*, 527 F.3d at 632. The Seventh Circuit derived its conception of fiduciary duty from an impoverished reading of the law of trusts and corporations. *Id.* Repeatedly in *Jones*, the court invoked parallels from corporations in its musings upon the competitiveness of market forces affecting mutual funds. *See*, *e.g.*, *id.* ("Things work the same for business corporations"); *id.* at 632-633 ("Publicly traded corporations use the same basic procedures as mutual funds"); *id.* at 634 (comparing shares in mutual funds to automobiles). With respect to competitive market dynamics, such comparisons are inapposite and misleading because they fail to acknowledge the critical structural and operational differences between the two different species of business entity.[17] With respect to judicial doctrine, however, a fair comparison would be highly appropriate given the analogous legal features and agency incentives governing participants in both systems.

[17] *See* Langevoort, *supra* note 12, at 1031-1032.

The doctrine of fiduciary duties in corporations, read properly, is particularly robust when addressing instances of self-dealing similar to the conflicted compensation system of mutual funds. Indeed, the typically impenetrable business judgment rule that shields compensation and other managerial decisions must yield when conflicts exist. Inasmuch as conflicted self-dealing is built into the very structure and operation of mutual funds, the application of corporate – to say nothing of mutual fund – fiduciary principles would provide far greater protection in these circumstances than the Seventh Circuit offered. *See*, *e.g.*, *Telxon Corp. v. Meyerson*, 802 A.2d 257, 264 (Del. 2002) (noting that the business judgment rule gives way to an entire fairness analysis in circumstances involving self-dealing); *Valeant Pharms. Int'l v. Jerney*, 921 A.2d 732, 748-749 (Del. Ch. 2007) (stating that, "where the pricing terms of a transaction that is the product of an unfair process cannot be justified by reference to reliable markets . . . , the burden of persuading the court of the fairness of the terms will be exceptionally difficult.").

In a broader trend, Delaware courts in recent years have generally enhanced the suite of corporate fiduciary duties. For instance, the duty of loyalty has recently incorporated a duty of good faith, with the consequence that corporate fiduciary duties now "expand the potential scope of director liability"[18] for inappropriate behavior. *See*, *e.g.*, *Lyondell Chem. Co. v. Ryan*, 970 A.2d 235, 239-240 (Del. 2009); *DeSi-*

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[18] Andrew S. Gold, *The New Concept of Loyalty in Corporate Law*, 43 U.C. Davis L. Rev. at 6 (forthcoming 2009), *online at* http://ssrn.com/abstract=1406207 ("Recent precedents now suggest that unconflicted directors may be charged with disloyalty in cases where they are sincerely motivated to benefit shareholders and the corporation.").

mone v. Barrows, 924 A.2d 908, 933 (Del. Ch. 2007) (stating that directors may have violated their fiduciary duties when they have "consciously taken action beyond their authority" even if "their motives were not necessarily selfish"); *Stone ex rel. AmSouth Bancorp. v. Ritter*, 911 A.2d 362, 370 (Del. 2006) (absorbing the fiduciary duty of good faith into the duty of loyalty). Commentators believe that, although this "incorporation of the duty of good faith into loyalty" has reduced the number of duties from three to two, it has nevertheless "significantly expanded the potential circumstances in which a successful loyalty claim might be brought."[19]

The Seventh Circuit fundamentally misapplied the applicable principles of corporate law, which impose robust fiduciary duties in circumstances such as these. Although the Section 36(b) duty may be new and distinctive in the Company Act, as this Court has noted in *Daily Income Fund*, 464 U.S. at 541, fiduciary duties have long been a venerable and vital concept in business organizations and they possess far more significance than the merely duplicative and generic antifraud provision set forth in *Jones*. With even a fraction of the force of analogous corporate duties, the Section 36(b) fiduciary conception would play a discrete but critical role in safeguarding mutual fund shareholders from the most egregious violations by their fiduciaries.

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[19] *E.g.*, *id.* at 14.

II. MARKET FORCES ALONE ARE INSUFFICIENTLY COMPETITIVE TO COMPENSATE FOR A NUGATORY FIDUCIARY DUTY OR TO IMPOSE DISCIPLINE ON MUTUAL FUND ADVISORY FEES

In the ruling below, the court of appeals failed to take seriously the need for a fiduciary duty with force because it took all too seriously the quaint and anachronistic claim – renounced by Congress – that self-correcting market forces by themselves effectively discipline advisory fees. Such a ruling implicitly requires a court to assume, in the absence of any statutory or historical evidence, that Congress intended the Section 36(b) fiduciary duty to seesaw in an inverse relationship with the level of market competition. Moreover, in order to apportion a minimal level of duty in such a dynamic system, a court would first need to conclude that truly competitive market forces do abound.

Yet, as Judge Posner and others have demonstrated, the economic analysis propping up such jurisprudence is "one-sided" and "ripe for reexamination." *Jones*, 537 F.3d at 733, 730. The recent financial crisis has taught the clear and painfully learned lesson that an uncritical embrace of panacean forces of rational actors and unsupervised markets is profoundly irresponsible. A closer and more sophisticated examination of the economic governance structures of mutual funds reveals a market suffering serious flaws whose shareholders do, indeed, "stand in special need of legal protection" from a meaningful fiduciary duty. S. Rep. No. 91-184, at 3, *reprinted in* 1970 U.S.C.C.A.N. 4899.

A. The Structure of Mutual Funds, Which Prompted Congress To Enact the Section 36(b) Fiduciary Duty, Remains Conflicted

In the ruling below, the Seventh Circuit pivoted from disparaging the need for a fiduciary duty to celebrating the salutary forces of competition via a dubious trio of arguments. In order to embrace market competition, the court first had to overcome legislative history that clearly criticized the "structure of the mutual-fund market at the time." *Jones*, 527 F.3d at 633. The court overran this obstacle by characterizing that legislative history as indeterminate (it "contain[s] expressions that seem to support every possible position"); then by dismissing all legislative history in favor of a supposedly textualist approach ("Congress did not enact its members' *beliefs*, it enacted a text."), albeit one in which it ignored the critical text; and finally by conducting a "living Constitution" analysis of the state of market competition ("A lot has happened in the last 38 years."). *Id.* As we have already presented the decidedly clear state of Section 36(b)'s legislative history[20] and do not aspire to debate the question of legislative history more generally, the only remaining claim to address concerns the state of competition today.

The Seventh Circuit's assertion that competition is now vibrant in mutual funds, whatever legislators may have thought four decades ago, is fallacious in several ways. First, the court's evidence for such an argument – which was not provided by the parties but assembled solely by the bench – relies on statistics regarding the *size* of the industry and not at all on changes in the *structure* of the industry. Nowhere

[20] *See supra* Part I.B.

in the legislative history, or indeed the enacted text, does Congress bewail an insufficient number of funds, channels for investment, or assets under management, all of which the Seventh Circuit celebrated in 2008. *See id.* at 633-634. Rather, Congress enacted the Section 36(b) fiduciary duty because it feared the "structure" of the mutual fund industry, its "conflicts of interest," and the absence of "arm's-length bargaining." S. Rep. No. 91-184, at 5, *reprinted in* 1970 U.S.C.C.A.N. 4901. Growth in the number of mutual funds and advisors may be less a sign of health than a symptom of the infestation of commissions, trail payments, and revenue sharing arrangements that arrogate investors' 12b-1 fees to provide brokers and other intermediaries with an incentive to promote investments without regard for the underlying fees that shareholders must bear.[21] These structural and systemic faults remain unchanged to this day, and arguments regarding the size of the industry do nothing to ameliorate them.

B. The Economic Governance Structure of Mutual Funds Is Far Weaker Than That of Corporations

The court below also assumed that the market dynamics of mutual funds are healthy and competitive because they are equivalent to those of business corporations. *See*, *e.g.*, *Jones*, 527 F.3d at 632 ("Things work the same for business corporations"); *id.* at 632-

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[21] *See*, *e.g.*, General Accounting Office, *Mutual Fund Fees: Additional Disclosure Could Encourage Price Competition* 7 (June 2000), *online at* http://www.gao.gov/archive/2000/gg00126.pdf (concluding that, notwithstanding the presence of thousands of mutual funds, "competition in the mutual fund industry may not be strongly influencing fee levels" because advisors do not compete "on the basis of the fees they charge").

633 ("Publicly traded corporations use the same basic procedures as mutual funds"); *id.* at 634 (comparing shares in mutual funds to automobiles). Even though the legal dynamics of both business entities are similar, the structural and operational differences between funds and corporations undermine facile economic comparisons.

The standard theoretical account of effective governance in corporations identifies and lauds the cooperative efforts of a panoply of mutually reinforcing mechanisms. The combined forces of efficient capital markets, stock options, markets for corporate control, short selling, and influential institutional investors, *inter alia*, are thought to impose a healthy discipline on agency costs between managers and shareholders.[22] Critically, the presence of such mechanisms – and therefore the force of such theory – is vastly diminished in mutual funds.

As Professor Donald Langevoort has pointed out, many of the most important of these devices simply do not exist or do not operate effectively within the idiosyncratic structure of mutual funds:

> Because mutual funds are not traded in an organized market, arbitrage opportunities cannot work to keep prices in line with rational expectations. Mutual fund prices are simply the product of net asset value at the time of purchase or redemption. Insider compensation is largely based on assets as well, which creates the conflict rather than aligns insider-shareholder interests, and directors are typically paid all or mostly in cash. Institutional shareholder voice does not

[22] *See, e.g.*, Jonathan R. Macey, *Corporate Governance: Promises Kept, Promises Broken* 50 (2008).

> exist in the fund area, and there is no external market for corporate control at all because shareholders can only sell their shares back to the fund.[23]

Accordingly, any judicial attempt to graft general economic governance theory onto mutual funds fundamentally misunderstands the distinctive nature of funds.

The solitary remaining governance constraint with any applicability in the mutual fund context is shareholder exit. As the court below correctly noted, "An adviser can't make money from its captive fund if high fees drive investors away." *Jones*, 527 F.3d at 632. Of course, as Judge Posner noted, the premise of this assertion is questionable: "That's true; but will high fees drive investors away?" *Jones*, 537 F.3d at 731. If, as the evidence demonstrates, investors do not exit despite high fees – because of limited options in their 401(k) plans, adverse tax consequences, search costs, redemption fees, or other limitations – then advisors can make a great deal of money.[24] Effective shareholder exit relies upon faithful disclosure by advisors and prudent investment by shareholders. In mutual funds, exit is handicapped by the

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[23] Langevoort, *supra* note 12, at 1031-1032.

[24] *See*, *e.g.*, Stephen Choi & Marcel Kahan, *The Market Penalty for Mutual Fund Scandals,* 87 B.U. L. Rev. 1021, 1023 (2007) ("But investors, for a variety of reasons, may fail to redeem shares in response to managerial wrong-doing. They may be unaware of any managerial wrong-doing . . . . They may (if the funds are not held in a tax-exempt account) face adverse tax consequences if they redeem shares in mutual funds. Investors may also have to pay a fee when shares are redeemed.").

proven vulnerabilities of both participants in this investment dyad.[25]

Investment advisors have spent much of the past five years reeling from regulatory investigations and private lawsuits into their malfeasant practices in the operation of mutual funds, such as late trading and failing to disclose market timing,[26] for which they have paid billions of dollars in fines, settlement fees, and restitution funds.[27] Meanwhile, investors, encumbered with ever-greater responsibility for their own retirement savings as 401(k) plans eclipse pension funds, have demonstrated little behavioral capacity to invest rationally: many investors fail to enroll in retirement plans, leave their contributions uninvested, or allocate their savings too rarely, riskily,

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[25] Informational intermediaries and investment brokers are of little help in facilitating these transactions. *See* Jill E. Fisch, *Fiduciary Duties & the Analyst Scandals*, 58 Ala. L. Rev. 1083, 1097-1098 (2007) (discussing the conflicts of interest and questionable independence of mutual fund analysts).

[26] *See generally*, *e.g.*, Birdthistle, *Compensating Power*, *supra* note 10; Tamar Frankel & Lawrence A. Cunningham, *The Mysterious Ways of Mutual Funds: Market Timing*, 25 Ann. Rev. Banking & Fin. L. 235 (2006); Mercer E. Bullard, *The Mutual Fund as a Firm: Frequent Trading, Fund Arbitrage and the SEC's Response to the Mutual Fund Scandal*, 42 Hous. L. Rev. 1271 (2006).

[27] Many of the best known investment advisors in the retirement savings industry have paid eight- and nine-figure settlements over the past five years, including, *inter alia*, Bank of America ($675 million), Alliance Capital Management ($600 million), and Bear Stearns ($250 million). *See*, *e.g.*, Josh Friedman, *FleetBoston, BofA to Pay $675 Million*, L.A. Times, Mar. 16, 2004, at C1; Tom Lauricella, *Alliance to Cut Fees 20%*, Wall St. J., Dec. 16, 2003, at C1.

or rapidly.[28] The Seventh Circuit's assumption that high fees will "drive investors away" thus ignores the enfeebled state of shareholder exit in mutual funds.

C. Market Forces Do Not Ensure Competitive Advisory Fees in Mutual Funds

The court below retreated to three final economic claims to prop up its overarching claim that market forces ensure competitive advisory fees in mutual funds. First, even if mutual fund shareholders are unsophisticated, the presence of sophisticated investors will protect them, *see Jones*, 527 F.3d at 634; second, the price for products such as automobiles receives no judicial review, so mutual fund advisory fees should not, either, *see id.*; and, third, a single academic study concluded that this market is competitive, *see id.* None of these claims survives serious examination.

First, the Seventh Circuit attempted to preempt critique of its conclusion that the mutual fund market is competitive by stating that

> [i]t won't do to reply that most investors are unsophisticated and don't compare prices. The sophisticated investors who do shop create a competitive pressure that protects the rest.

Id. But, as with the court's previous claim that advisors could not make money if high fees risked driving

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[28] *See*, *e.g.*, Alan R. Palmiter & Ahmed E. Taha, *Mutual Fund Investors: Divergent Profiles*, 2008 Colum. Bus. L. Rev. 934, 974-975 (citing scholarly demonstrations of deleterious investor behavior); James D. Cox & John W. Payne, *Mutual Fund Expense Disclosures: A Behavioral Perspective*, 83 Wash. U. L.Q. 907, 926-927 (2005) (same); Mahoney, *supra* note 9, at 168-172 (same); Richard H. Thaler & Cass R. Sunstein, *Libertarian Paternalism Is Not an Oxymoron*, 70 U. Chi. L. Rev. 1159, 1169-1170 (2003) (same).

away investors, an argument that is theoretically debatable in the corporate context is simply inapplicable to mutual funds. Just as the unique governance structure of mutual funds prevents high fees from driving away investors, the unique operational structure of mutual funds prevents sophisticated investors from creating a competitive pressure in mutual funds. Empirical studies and, indeed, the industry's investment offerings and overt marketing demonstrate that investment advisors intentionally segregate institutional and individual investors into separate mutual fund products.[29] Investment advisors commonly offer different funds or different classes of shares with far more advantageous pricing to institutional and sophisticated shareholders.

Second, the Seventh Circuit compared mutual fund shareholders to the buyers of products and wondered why they should receive a different degree of judicial oversight:

> Judges would not dream of regulating the price of automobiles, which are produced by roughly a dozen large firms; why then should 8,000 mutual funds seem "too few" to put competitive pressure on advisory fees?

Id. This question reveals a fundamental conflation of the governance dynamics of mutual funds with an ordinary products market. The price of automobiles is not judicially actionable because the buyers of automobiles are neither shareholders nor the beneficiaries of a congressionally enacted fiduciary duty. Fully aware of these distinctions and cognizant of the

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[29] *See* Langevoort, *supra* note 12, at 1033 ("The theory does not work, however, if the market can be segmented with similar but different products, with inferior products being marketed to the less sophisticated.") (citing Mahoney, *supra* note 9, at 168-169).

particular vulnerabilities of mutual funds, Congress decreed investors in those funds to be both. Accordingly, Congress enacted the Company Act and Section 36(b) to rectify the disadvantaged situation of mutual fund shareholders by raising them as much as possible to a position similar to that of purchasers in competitive and unconflicted product markets. Congress may very reasonably have concluded that the manner in which investors save for their retirement is ultimately of far greater consequence than the price of any given widget. Absent a recategorization by Congress of mutual fund shareholders as mere purchasers and no longer the beneficiaries of a fiduciary duty, the judiciary must enforce legislation designed to protect them, not engage in reverse boot-strapping to undermine further their already-impoverished governance circumstances.

Third, in seeking support for its conclusion, the court found support from only one academic study. *See Jones*, 527 F.3d at 634 (citing John C. Coates & R. Glenn Hubbard, *Competition in the Mutual Fund Industry: Evidence and Implications for Policy*, 33 Iowa J. Corp. L. 151 (2007)). The citation of this lone study is curious given its singular conclusion that competition has favorably impacted fees notwithstanding evidence that fees have risen as more entrants have appeared in the field.[30] Moreover, the overwhelming preponderance of careful scholarly studies report contrary conclusions, which the court either did not find or chose not to consider. *See*, *e.g.*, John P. Freeman, Stewart L. Brown & Steve Pomer-

[30] *See*, *e.g.*, John P. Freeman, Stewart L. Brown & Steve Pomerantz, *Mutual Fund Advisory Fees: New Evidence and a Fair Fiduciary Test*, 61 Okla. L. Rev. 83, 106-122 (2008) (critiquing the Coates-Hubbard study).

antz, *Mutual Fund Advisory Fees: New Evidence and a Fair Fiduciary Test*, 61 Okla. L. Rev. 83, 106-122 (2008); Alan R. Palmiter & Ahmed E. Taha, *Mutual Fund Investors: Divergent Profiles*, 2008 Colum. Bus. L. Rev. 934; Camelia M. Kuhnen, *Social Networks, Corporate Governance and Contracting in the Mutual Fund Industry* 18-28 (Mar. 1, 2007), *online at* http://ssrn.com/abstract=849705; John P. Freeman & Stewart L. Brown, *Mutual Fund Advisory Fees: The Cost of Conflicts of Interest*, 26 J. Corp. L. 610 (2001); General Accounting Office, *Mutual Fund Fees: Additional Disclosure Could Encourage Price Competition* (June 2000), *online at* http://www.gao.gov/archive/2000/gg00126.pdf; SEC, *Public Policy Implications of Investment Company Growth*, *reprinted in* H.R. Rep. No. 89-2337 (1966); Wharton School of Finance & Commerce, 87th Cong., *A Study of Mutual Funds* (Comm. Print 1962). The Seventh Circuit thus barely surveyed this consistently critical literature in reaching its erroneous understanding of the operation of the mutual fund industry.

III. WITH A GREATER APPRECIATION FOR THE STRUCTURE AND OPERATION OF MUTUAL FUNDS, THIS COURT SHOULD EMPHASIZE COMPARISONS BETWEEN RETAIL AND INSTITUTIONAL FEES IN THE SECTION 36(b) FIDUCIARY DUTY

The key indicium of a lack of competitiveness in mutual funds is the material and systemic discrepancy between the fees that advisors charge ordinary retail shareholders in captive mutual funds and the fees that advisors charge institutional clients to whom they owe no fiduciary duty. Across mutual funds, retail investors pay fees twice the size of those paid by institutional clients – when those higher rates are applied to the larger pools of assets in retail funds, advisors make six times as much money from ordinary investors for providing the same service.[31] Yet this discordant fact is the one piece of evidence that courts have omitted from their menus of salient factors, even though "the expressed Congressional intent" was that "all pertinent facts must be weighed." *Gartenberg*, 694 F.2d at 929, 931 & n.3.

None of the other *Gartenberg* factors alone or in concert provides so much probative value on the issue of fee excessiveness. Only by analyzing the lower rates paid by institutional funds, which enjoy a far less structurally intertwined and captive relationship with investment advisors, can a plaintiff demonstrate how far an advisor has strayed from its Section 36(b) obligations. This fee comparison – which is a "proxy for fairness" and uniquely free from "self-dealing"[32] – should lie at the heart of this Court's efforts to fashion a meaningful standard for the fiduciary duty.

Despite rejecting the illuminating comparison of fees that a single advisor charges its retail and institutional investors, the court below followed *Gartenberg* by permitting comparisons of fees that different advisors charge retail investors in separate mutual funds. *Jones*, 527 F.3d at 631 (citing *Gartenberg*, 694 F.2d at 929). Allowing a comparison only between advisors but not between investors is willfully myopic.

[31] *See* Freeman & Brown, 26 J. Corp. L. at 631 (reporting an average fee of 56 basis points for retail investors and 28 basis points for institutional investors, notwithstanding the fact that the retail funds were three times as large as the institutional funds).

[32] Emily D. Johnson, *The Fiduciary Duty in Mutual Fund Excessive Fee Cases: Ripe for Reexamination*, 59 Duke L.J. at 36 (forthcoming 2009), *online at* http://ssrn.com/abstract=1382001.

As Judge Posner has pointed out, if the "governance structure that enables mutual fund advisers to charge exorbitant fees is industry-wide" – or even just sector-wide – then ignoring the relevant comparison between fees paid by different investors will effectively prevent any plaintiff from successfully claiming that a fee is excessive. *Jones*, 537 F.3d at 732.

The court in *Jones* nevertheless declined to examine the fee discrepancy between institutional and retail investors. Advisors have long complained that, because not all clients are perfectly identical, a comparison of their fees is fruitless. Of course, any court – or board of trustees – could ask the advisor to conduct the simple arithmetic to account for any additional costs to service the retail fund and then compare fees.

In the case below, the Seventh Circuit provided a non sequitur on this issue, pointing out that sophisticated investors pay more to invest in hedge funds than retail investors pay to invest in mutual funds. *Jones*, 527 F.3d at 634. That fact may very well be true, but fee comparisons are relevant only to the extent that they compare similar services. Hedge funds (which are not subject to Section 36(b)) and mutual funds are radically different investments with totally incompatible risk profiles. Institutional investors may pay more than retail investors pay for many things – office space, letterhead, automobiles – but the only relevant issue is the price the two types of investors pay when buying the same service.

Indeed, institutional investors do not pay more than retail investors for identical investment services from advisors. When institutional investors invest in separate accounts that are clones of the funds of average shareholders, they receive preferential and lower fees. Curiously, the Seventh Circuit was eager to compare comparable fees of unrelated investment products (hedge funds and mutual funds) but unwilling to contrast divergent fees of identical investment products (institutional and retail rates in mutual funds).

Since the publication of the decision below, however, jurists and commentators have begun to embrace the critical utility of comparing retail and institutional fees in what might be styled a *Gartenberg*-plus analysis. First, in his dissent from the denial of rehearing en banc in *Jones*, Judge Posner focused on this issue:

> A particular concern in this case is the adviser's charging its captive funds more than twice what it charges independent funds. . . . The panel opinion throws out some suggestions on why this difference may be justified, but the suggestions are offered purely as speculation, rather than anything having an evidentiary or empirical basis.

Jones, 537 F.3d at 731. Second, the Eighth Circuit in *Gallus* focused intensively on the fee discrepancy between institutional and retail investors in Ameriprise funds. The court overrode the advisor's objections, which relied on dicta in *Gartenberg* to dismiss such comparison on the grounds that the investments are not readily comparable and that any variances are justified by the greater costs associated with advising retail investors. Citing the expert report of Professor Charles Murdock, the court pointed out that the retail and institutional funds at issue "had identical investment objectives" and "very similar stock holdings," and that the advisor admitted in an internal email that it possessed no good justification for the difference: "we should have a reply," wrote an Ameriprise employee, "though it may or may not be convincing." *Gallus*, 561 F.3d at 819. Although Ameriprise ultimately produced a reply in the form of a report, the court questioned its "veracity and completeness." *Id.* The Eighth Circuit thus embraced an expanded notion of *Gartenberg* that more resolutely enforces the language and intent of Section 36(b).

Commentators have echoed these judicial statements, generally admonishing boards to be more demanding and empirically inquisitive of their advisors:

> Broadening *Gartenberg*'s comparative fee structure factor to include a comparison between the fees paid by mutual funds and institutional investors would introduce arm's-length bargaining, a proxy for fairness, into mutual fund excessive-fee cases.[33]

Another has noted that this Court "has an outstanding opportunity to endorse the more nuanced and sophisticated approach of Posner, which takes far greater account of the behavioral biases and distortions of investors."[34]

This relatively minor doctrinal modification, in conjunction with a far more sophisticated understanding of the operational and governance structures of mutual funds, would greatly enhance the quality of Section 36(b) jurisprudence. The ruling below constitutes a deliberate and radical departure from mutual fund precedent and from the congressionally enacted language of Section 36(b). With a moderate but vital enhancement of the *Gartenberg* doctrine, this Court can remind the investment

[33] Johnson, *supra* note 32, at 40.

[34] Birdthistle, *Investment Indiscipline*, *supra* note 3, at 50.

advisory industry that the language of Section 36(b)'s fiduciary duty has meaningful force. By policing the duty's outer border, the federal courts can monitor the contours of any inflated fees while allowing the market to determine competitive rates.

CONCLUSION

For these reasons, *amici* respectfully urge this Honorable Court to reverse the ruling of the United States Court of Appeals for the Seventh Circuit.

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