No. 08-586

IN THE
Supreme Court of the United States

JERRY N. JONES, et al.,

Petitioners,

v.

HARRIS ASSOCIATES L.P.,

Respondent.

On Writ Of Certiorari
To The United States Court Of Appeals
For The Seventh Circuit

BRIEF FOR INDEPENDENT DIRECTORS COUNCIL AS *AMICUS CURIAE* IN SUPPORT OF RESPONDENT

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QUESTION ADDRESSED BY AMICUS

Congress has directed the independent directors of mutual funds to annually evaluate and approve the fund's advisory contract, including fees. Congress has further directed that such director approval must be given appropriate weight in any lawsuit challenging advisory fees. Does the standard proposed by petitioners in this case—under which courts would scrutinize advisory fees *de novo*, without deference to prior director approval—conflict with these congressional directives?

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INTEREST OF *AMICUS CURIAE*[1]

The Independent Directors Council (IDC) serves the mutual fund independent director community and provides a venue to advance the education, communication, and policy positions of mutual fund independent directors so as to promote the highest standards of fund governance. IDC and its predecessor have successfully worked to achieve these goals for over a decade.

The activities of IDC are led by a Governing Council of independent directors from among the 2,000 directors who sit on the boards of the Investment Company Institute (ICI) member funds. As of 2008, ICI's members collectively managed 98 percent of the approximately $10 trillion in U.S. mutual fund assets on behalf of more than 90 million investors in over 50 million households. While IDC is part of ICI, IDC has its own leadership, committees, and dedicated staff, and provides the perspective of fund independent directors on policy matters.

In light of the broad and diverse views of the independent directors it serves, IDC is uniquely positioned to speak to the significant role that independent directors play in evaluating and approving fund

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[1] Pursuant to this Court's Rule 37.3(a), letters of consent from all parties to the filing of this brief are on file or have been submitted to the Clerk. Pursuant to this Court's Rule 37.6, *amicus* states that this brief was not authored in whole or in part by counsel for any party, and that no person or entity other than *amicus* or its counsel made a monetary contribution intended to fund the preparation or submission of this brief. Two members of IDC's Governing Council, Gary N. Wilner and Laura T. Starks, have previous connections to respondent or this litigation. Out of an abundance of caution, these members did not participate in the preparation or approval of this brief for filing.

advisory fees, and the rigorous nature of that business decision. IDC believes that its brief will also assist the Court in understanding the larger practical and policy reasons why investors—the protection of whom is both an overriding goal of the securities laws and the key responsibility of independent directors—would be best served by judicial deference to the business judgment of the independent directors absent proof that the directors' approval was a mere formality, or that there were other deficiencies in the approval process so fundamental that they precluded the board from exercising its business judgment.

SUMMARY OF ARGUMENT

I. Petitioners (and many of their *amici*) have put forth a distorted caricature of the role played by independent directors in fund governance, particularly with respect to the review and approval of advisory fees. Petitioners portray independent directors as mere puppets of the adviser, powerless to participate in a meaningful dialogue regarding fees and related matters, such as fund performance.

This depiction has no basis in reality. On the contrary, the dictates of the Investment Company Act, as amended, coupled with innovation within the industry, have ensured that modern-day fund boards are robustly independent. In fact, the vast majority of fund boards have at least 75 percent independent directors, and an independent chair or independent lead director. And, as the Securities and Exchange Commission (SEC) has repeatedly recognized either expressly or through its increased reliance on fund boards in its regulatory actions, the enhanced independence of board members, together with their conscientiousness and expertise, have successfully protected investor interests.

II. Against this backdrop, the non-existent role that petitioners and their *amici* (with the notable exception of the United States) envision for a board's business judgment cannot be squared with the statutory regime, this Court's decisions, or practical and policy considerations.

Unlike petitioners' "statutory" analysis, which does not even mention Section 36(b)(2) of the Act (*see* Pet. Br. 20-34), this Court must construe all components of Section 36(b). This requires, at minimum, "appropriate" deference to the directors' approval, as warranted under "the circumstances." 15 U.S.C. § 80a-35(b)(2). To give effect to this statutory directive, a court must defer to the independent directors' exercise of their business judgment in approving the advisory fees. In contrast, little or no deference may be due when the directors' approval was a mere formality, or when there were other deficiencies in the approval process so fundamental that they precluded the board from making a business judgment. If (but only if) such fundamental deficiencies are proved, courts may review advisory fees *de novo*, utilizing factors such as those articulated in *Gartenberg* v. *Merrill Lynch Asset Management, Inc.*, 694 F.2d 923 (2d Cir. 1982).

This construction of Section 36(b)(2), unlike petitioners', fully accords with Section 15(c) of the same Act, which entrusts independent directors with the primary responsibility for reviewing and approving advisory contracts, including fees. 15 U.S.C. § 80a-15(c). This statutory structure establishes that while Congress did not envision a system in which independent directors would need to approve the decision to initiate Section 36(b) suits (*Daily Income Fund* v. *Fox*, 464 U.S. 523, 540 (1984)), Congress relied principally, albeit not solely, on independent directors to

protect investors against excessive fees, and tasked courts with deferring to the directors' business judgment absent fundamental deficiencies in the approval process. As this Court has noted, "it would have been paradoxical for Congress to have been willing to rely largely upon 'watchdogs' to protect shareholder interests and yet, where the 'watchdogs' have done precisely that," require that their role be completely or significantly ignored. *Burks* v. *Lasker*, 441 U.S. 471, 484-85 (1979).

The practical and policy considerations for departing from this congressionally mandated deference lack merit. In requiring business decisions to be made in the first instance by non-specialist courts, the non-deferential standard proposed by petitioners would disserve investors. Moreover, its inevitable outcome—permitting a trial in every case—is not an unmitigated good. Extensive litigation over mutual fund fees would only serve to increase those fees, as the costs of litigation will be borne by the very investors on whose behalf it is ostensibly brought. Extensive litigation would also deter highly qualified individuals from serving as independent directors, undermining the governance scheme established by Congress and ultimately harming investors.

ARGUMENT

Congress entrusted independent directors, not courts or litigants, with the "primary responsibility" for protecting investor interests. *Burks* v. *Lasker*, 441 U.S. 471, 484-85 (1979). Modern-day fund boards have scrupulously performed that job, including in matters of advisory fees. There is no reason therefore for this Court to depart from the standard of judicial review of advisory fees set out by Congress, in which the independent directors' approval

receives its due, "appropriate" deference. 15 U.S.C. § 80a-35(b)(2).

I. INDEPENDENT DIRECTORS BEAR PRIMARY RESPONSIBILITY FOR PROTECTING INVESTORS

Registered investment companies—which consist predominantly of "mutual funds"—are subject to a comprehensive and reticulated set of federal and state requirements.[2] Each mutual fund may be established as either a corporation or a business trust (or a series of such a corporation or trust) under state corporate law, and must be registered with the SEC pursuant to the Investment Company Act of 1940. In offering shares to the public, mutual funds and their affiliates must also comply with the Securities Act of 1933 and the Securities Exchange Act of 1934, and each adviser to the mutual fund must comply with the Investment Advisers Act of 1940. Each mutual fund is governed by a board of directors (if a corporation) or trustees (if a trust), again subject to state corporate law. The ICA defines "director" to include trustees. 15 U.S.C. § 80a-2(a)(12).

Modern-day fund directors are also subject to more federal obligations and requirements than any other corporate directors, to the benefit of fund shareholders. And owing to their independence, expertise, and fiduciary duties requiring them to be diligent and informed, fund directors vigorously promote and protect investor interests. The evaluation and approval of advisory fees make no exception.

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[2] U.S. investment companies include open-end funds, closed-end funds, exchange-traded funds, and unit investment trusts. For ease of reference, the term "mutual fund" is here used to refer to registered investment companies governed by a board of directors or trustees that is subject to the Act.

A. Independent Directors Rigorously Review The Fund's Advisory Agreement Each Year

1. A central, if largely unstated, premise of the arguments advanced by petitioners and most of their *amici* is that mutual fund directors are unwilling or unable to protect the interests of investors, warranting judicial intervention in virtually every instance. In petitioners' retelling, fund directors are mere puppets of the adviser who rubber-stamp the advisory fee and other aspects of the contractual relationship between the adviser and fund. Pet. Br. 5 n.3, 36. Only by so denigrating the directors and their role can petitioners and their *amici* contend that courts should give little or no deference to director decisionmaking in a lawsuit brought under Section 36(b) of the 1940 Act.

This premise of petitioners' argument, however, is false. While petitioners repeatedly cite the 1962 "Wharton Report" (10 times) and the 1966 "SEC Report" (11 times), the world has not stood still for the past half century. Although more lenient standards for fund governance and director "independence" existed when those reports issued, Congress addressed those issues in the 1970 Amendments to the Investment Company Act. Those Amendments substantially strengthened the independence standards by adding several categories of persons who could no longer be considered independent, such as "any member of the immediate family" of any natural person who is an officer, director, partner, copartner, or employee of the adviser. Investment Company Act Amendments of 1970, P.L. 91-547, 84 Stat. 1416, Sec. 2(a) (1970); *see also* 15 U.S.C. § 2(a)(19)(B); 15 U.S.C. § 2(a)(3). In addition to these statutory changes, enhanced regulatory safeguards and voluntary compli-

ance with industry best practices have also helped strengthen fund governance. Indeed, in the aftermath of the 1970 Amendments to the ICA, fund governance standards have consistently surpassed general corporate governance standards.

As a result, far from being captive to advisers, modern-day fund boards are robustly independent. For example, while the Act requires that at least 40 percent of directors be independent of the adviser, in practice, independent directors hold an overwhelming majority (75 percent) of board seats in nearly 90 percent of fund complexes participating in the ICI/IDC Directors Practices Study. *See* Overview of Fund Governance Practices, 1994-2006, http://www.ici.org/pdf/rpt_07_fund_gov_practices.pdf ("Overview of Fund Governance Practices"). Contrary to some uninformed suggestions, directors generally set their own compensation, and 97 percent of independent directors have never been employed by the fund complex. *Ibid*. And more than 75 percent of fund complexes have boards that are led by an independent chair or independent lead director. *Ibid*.

Moreover, as required by SEC regulations, it is independent directors, not advisers, who are tasked with selecting and nominating other independent directors. 17 C.F.R. § 270.0-1(a)(7). The SEC's regulations also generally require that any legal counsel for independent directors be "independent legal counsel," that boards conduct annual self-assessments designed to increase their effectiveness, and that independent directors meet in executive session at least quarterly. *Ibid*. (While the SEC mandated these requirements only as a condition of reliance on certain exemptive rules, substantially all funds rely on one or more of these rules, and thus the requirements apply to virtually all funds.)

The effectiveness of fund directors is a product not only of their independence from the adviser, but also of the in-depth knowledge they develop through their sustained and ongoing oversight of numerous aspects of fund operation and management. In addition to reviewing and approving advisory fees and overseeing the performance of the fund, fund boards are also tasked with, among others, approving the auditor and principal underwriter for the fund and making fair value determinations for certain securities held by the fund. SEC rules further require boards to oversee a variety of transactions involving potential conflicts of interest between the fund and its investment adviser or the adviser's affiliates (*e.g.*, transactions involving purchases of securities from or through an affiliate, participation in a joint insurance policy, purchases of a fidelity bond, mergers with an affiliated fund, or usage of fund assets to finance distribution). Boards also oversee the audit and compliance functions, and must approve written compliance policies and procedures designed to prevent violations of federal securities laws. Investment Company Act Release No. 26299 (Dec. 17, 2003). To assist independent directors in performing their responsibilities, the SEC requires a mutual fund's chief compliance officer to report directly to the board of directors. *Ibid*. Boards also must approve the hiring and compensation, and if necessary, firing, of the chief compliance officer. *Ibid*. To facilitate frank discussions, the chief compliance officer is required to meet separately with the independent directors, in addition to submitting an annual written report to the full board. *Ibid*.

These myriad responsibilities required by federal law are discharged within the framework of fiduciary duties established for directors under state corporate

law. As a result of changes in the business judgment rule in the past three decades, directors of funds and corporations alike must perform all their duties in "an informed and deliberate manner." *Smith* v. *Van Gorkom*, 488 A.2d 858, 873 (Del. 1985). Therefore, in order to reach informed decisions, directors devote substantial time and consider large amounts of information related to various aspects of fund operation and management. This, in turn, provides fund directors with the experience and depth of understanding that ultimately allow them to take quick, effective, and flexible action when issues arise.

One of the independent directors' most important responsibilities is to annually evaluate and approve the advisory contract, including the amount of compensation provided to the adviser. The Act requires that a majority of a fund's independent directors annually approve the fund's advisory contract at an in-person meeting called for that purpose. 15 U.S.C. § 80a-15(c). As explained below, the SEC has by regulation further specified the factors that independent directors are to consider during their evaluation.

2. From reading petitioners' brief, the Court might be left with the impression that the independent directors' annual approval of the advisory fee is nothing more than a foregone conclusion, to be afforded little or no consideration in the context of a Section 36(b) lawsuit challenging that very fee. The truth is otherwise. The annual contract approval process involves substantial time commitment and deliberations, and careful consideration of significant amounts of information.

While the statute requires one annual in-person meeting of the independent directors for the purpose

of evaluating and approving the advisory contract, the process of preparing for that meeting takes several months, and often the entire year. Independent directors spend a significant amount of time preparing for, and participating in, numerous other meetings at which they develop questions for the adviser probing the appropriateness of the fee (with particular emphasis on the factors discussed in *Gartenberg* v. *Merrill Lynch Asset Management, Inc.*, 694 F.2d 923 (2d Cir. 1982)), review the answers provided by the adviser, and solicit additional information when the information provided by the adviser is deemed insufficient. In the process, independent directors consider and review hundreds if not thousands of pages of detailed information, some of which is provided by third-party consultants. Should they feel that additional assistance is warranted, directors are free to engage independent legal counsel—and most do so. *See* Overview of Fund Governance Practices at 15-16.

In addition to preparing for and participating in meetings or other board activities that specifically address fee approval, directors spend a significant amount of time throughout the year in performing other duties that inform the fee-approval process. For example, in discharging their obligations to monitor fund performance and oversee the compliance function, directors constantly assess the quality of the services provided by the adviser. Should any of those services need improvement, directors can and do require advisers to provide appropriate additional resources to resolve the issue.

Under Section 15(c) of the ICA, the board must "request and evaluate," and the adviser must furnish, "such information as may reasonably be necessary" for the board "to evaluate the terms" of advi-

sory contracts. 15 U.S.C. § 80a-15(c). Through a disclosure rule, the SEC has required boards to consider "(1) [t]he nature, extent, and quality of the services to be provided by the investment adviser; (2) the investment performance of the fund and the investment adviser; (3) the costs of the services to be provided and profits to be realized by the investment adviser and its affiliates . . . ; (4) the extent to which economies of scale would be realized as the fund grows; and (5) whether fee levels reflect these economies of scale for the benefit of fund investors." Disclosure Regarding Approval of Investment Advisory Contracts by Directors of Investment Companies, 69 Fed. Reg. 39,798, 39,801 (June 30, 2004). These five factors, as the SEC acknowledges, mirror those articulated in *Gartenberg*. *Id*. at 39,801 n.31.

Consideration of each of these factors involves a multi-faceted analysis of several other sub-factors. For example, in evaluating the quality of the services provided by the adviser, boards analyze multiple services, such as investment management, valuation, and compliance. As to compliance alone, boards would typically consider information not only on the adviser's compliance structure, but also on the results of any regulatory, third-party, or self-audits of the adviser, any deficiencies found, and any corrective actions.

The *Gartenberg* factors, as implemented through the SEC's disclosure rule, thus set a floor, not a ceiling, on the type of information boards request from the adviser. And, in light of the breadth of information relevant to each of the factors, they easily encompass most, if not all, other information that can be relevant to analyzing advisory fees. For example, although not a standalone factor, the fees, services, and performance of other mutual fund advisers can

help situate within context the services and performance of the adviser (the first two factors enunciated by the SEC). The SEC requires disclosure of the board's reliance on any such comparison, or on comparisons with the fees and services the adviser provides to "pension funds and other institutional investors." 69 Fed. Reg. 39,801-02. As discussed more fully below, because the portfolio management services provided to retail and institutional investors are typically not comparable, the latter comparison is rarely relevant.

The independent directors' expertise and in-depth knowledge of the funds they oversee also render them uniquely qualified to determine which factors should receive a lesser or greater weight in the evaluation process, in light of the specific circumstances faced by each fund in a particular year or in past years. For example, with respect to fund complexes that include several related funds, individual-fund cost allocations and profitability analyses are generally less helpful than an aggregate cost or profitability analysis, and may receive less weight than other factors. Indeed, petitioners appear to recognize as much. *See* Pet. Br. 32 n.23.

Finally, compliance with the SEC's extant regulations necessitates a rigorous review of the *Gartenberg* factors. The SEC requires that the basis of the board's approval decision be disclosed to shareholders in reports and proxy statements, discussing with specificity the five factors; these reports are filed with the SEC. Under the regulations, mere "conclusory statements or a list of factors will not be considered sufficient disclosure, and . . . a fund's discussion must relate the factors to the specific circumstances of the fund and the investment advisory contract." 69 Fed. Reg. 39,802. That is, the disclosure must

"state how the board evaluated each factor." *Ibid*. For example, it is not sufficient to state that the board considered a factor without "stating *what* the board concluded" about that factor and "*how* that affected its determination that the contract should be approved." *Ibid.* (emphases added).

It also bears noting that, in order to facilitate SEC examiners' "review of whether directors are obtaining the necessary information to make an informed assessment of the advisory contract," the SEC has required "that funds retain copies of the written materials that directors considered in approving an advisory contract." 69 Fed. Reg. 39,799. These documentation requirements make it exceedingly difficult for directors to engage in a perfunctory approval. *Cf. Wolff* v. *McDonnell*, 418 U.S. 539, 565 (1974) ("the provision for a written record helps to insure that administrators, faced with possible scrutiny by [regulators]. . . will act fairly").

3. The SEC regularly examines fund boards' discharge of their statutory obligations, including the approval of advisory fees. In summarizing the results of its examinations, the SEC has concluded that "*most* boards of directors *are* obtaining the necessary information to evaluate the various types of fund fees and expenses, as well as costs not reflected in a fund's expense ratio." Memorandum from Paul F. Roye, Director of the SEC's Division of Investment Management, to Chairman William H. Donaldson, regarding correspondence from Chairman Richard H. Baker, House Subcomm. on Capital Markets, Insurance and Government Sponsored Enterprises (June 9, 2003) ("SEC Response"), at 49 (emphases added). And in a 2000 report on advisory fees, the SEC's Division of Investment Management concluded that "the current statutory framework's primary reliance

on disclosure and procedural safeguards to determine mutual fund fees" is "sound and operates in the manner contemplated by Congress." SEC Div. of Inv. Mgmt., Report on Mutual Fund Fees and Expenses (Dec. 2000) ("SEC Fee Study"), http://www.sec.gov/news/studies/feestudy.htm. That fund directors are trusted to perform a conscientious job is also evidenced by the SEC's increased reliance on fund boards to safeguard investor interests in its regulatory actions.[3]

Against this backdrop, the reliance by petitioners and their *amici* on pre-1970 studies to criticize the independence and effectiveness of fund boards is unwarranted. Rather, as the SEC has observed, the post-1970 changes "have led to stronger, more independent, fund boards, which are today better equipped to deal with conflicts that arise in the management of funds, including the oversight of fund expenses." SEC Response at 49. Petitioners offer nothing credible to the contrary.

B. Independent Directors Have Successfully Safeguarded Investor Interests

Petitioners have chosen to ignore the way independent directors function in the real world, including the SEC's extensive regulation of the contract-

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[3] *See, e.g.*, Mutual Fund Redemption Fees, 70 Fed. Reg. 13,328, 13,330 (Mar. 18, 2005) (relying on directors to determine the propriety of a redemption fee and noting that directors "are better positioned to determine whether the fund needs a redemption fee and, if so, [its] amount"); Paul S. Atkins, Commissioner, SEC, Remarks Before the Independent Directors Council (Nov. 28, 2007) ("independent directors' list of duties is longer than ever as the SEC relies more heavily on them than ever before").

approval process. Instead, according to petitioners, the statutorily mandated annual approval should be disregarded on the sole basis that boards cannot engage in "arm's-length bargaining" because they supposedly lack the power to replace advisers. Pet. Br. 5 & n.3. The only support provided for this key assertion consists of two reports that, among many other faults, should be suspect for no reason other than the fact that they are almost *five decades old*.[4] But, as discussed above, the magnitude of changes wrought by the 1970 Amendments and all the other subsequent changes to fund governance cannot be denied. As a result of these changes, modern-day boards are sufficiently independent to have the power to replace advisers, as appropriate.

Indeed, as the SEC itself has explained, "[t]he infrequency with which fund directors have rejected investment advisory contracts does not necessarily indicate that [directors] . . . have not been forceful enough in representing shareholders' interests." SEC Response at 60. This is because "directors can and frequently do employ means other than contract termination to effect changes in the best interests of funds." *Ibid*. For example, directors can require the investment adviser to increase the quality of its services or take appropriate steps to improve its performance, such as by:

- hiring a new portfolio manager for the fund;

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[4] *See* Public Policy Implications of Investment Company Growth, H.R. Rep. No. 2337 (1966) ("SEC Report"); A Study of Mutual Funds Prepared for the Securities and Exchange Commission by the Wharton School of Finance and Commerce, H.R. Rep. No. 2274, 87th Cong., 2d Sess. 4 (1962).

- moving to a team approach of portfolio management;
- increasing the adviser's investment research capability;
- insisting on retention of a sub-adviser; or
- merging or liquidating the fund.

Ibid.

That directors employ a gradated approach under which they seek a variety of improvements from advisers before considering whether to replace the advisers is entirely consistent with—in fact, required by—their responsibilities to their funds. Because replacing the investment advisers would replace the fund's entire operational personnel, such changes are recognized as costly, disruptive, and thus imprudent unless employed as a measure of last resort. *See, e.g.*, SEC Report at 127 (noting "[t]he possibility of disrupting the fund's operations, the prospect of a bitter and expensive proxy contest and the risk and uncertainty of replacing an entire fund management organization with a new and untested one"). Similarly, while non-fund corporate boards might replace a CEO and one or two other top members of management, they do not, except in extraordinary circumstances, seek to replace the entire operational staff of the organization.

As explained, prudence alone suggests that directors replace advisers only in the most extraordinary of circumstances. But it should also not be forgotten that, when investors become shareholders of a fund, they have made a deliberate decision to select a particular investment manager whom they deem is best skilled to invest their money for them. Accordingly, absent truly extraordinary circumstances in which all other efforts to obtain improvements

within the existing management organization have failed, the selection of the adviser is best left to the individual investor and not the independent directors. *See, e.g.*, Tamar Frankel & Ann Taylor Schwing, The Regulation of Money Managers: Mutual Funds and Advisers § 9.04[D] (2d ed. 2008 Supp.) (directors are not required to shop around for the "cheapest" services; rather, "[o]nly when the adviser's performance or contract terms fall below minimal norms should the disinterested directors look for another").

Given the robust independence of modern-day fund boards, the variety of improvements that directors obtain from advisers, and the fact that, consistent with prudence and investor preferences, termination of the advisory contract should be a rare event, it can hardly be argued that independent directors do not stand in an arm's-length relationship with advisers. In reality, the overall fee-setting process works, as recognized by the SEC and further evidenced by declines in fund fees and expenses as shareholder services have increased. *See* ICI Br. Section II.C.2. Indeed, at least three well-trusted organizations—the SEC, the General Accounting Office and Lipper Analytic Services—have found mutual fund fees and expenses have declined over the years, particularly in the case of the larger and older funds and fund complexes.[5]

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[5] *See* SEC Fees Study; GAO, Mutual Fund Fees: Additional Disclosure Could Encourage Price Competition (June 7, 2000) ("GAO Report") at 48–49, http://www.gao.gov/new.items/gg00126.pdf; The Third White Paper: *Are Mutual Fund Fees Reasonable?*, Lipper Analytic Services (Sept. 1998) ("Lipper Report") at 12.

In addition, directors have a variety of other tools for bringing fees down, such as breakpoints at specified asset levels, fee waivers, outright fee reductions, or service enhancements. For example, if there has been an increase in the number or quality of services provided by the adviser (such as increasing the size of the portfolio management team), the fee for the originally-provided services has in fact decreased, even if the overall amount of the fee (now paid for enhanced services) has stayed the same. Directors consider these, among numerous other factors, in evaluating fees.

Section 36(b) cannot be construed to render all of the foregoing a nullity. Yet that is essentially what petitioners and most of their *amici* propose. They would have courts review fees in the first instance, essentially relegating the independent directors to advisory status at best and to irrelevance at worst. That is not, however, the scheme that Congress enacted or the SEC has overseen since the 1970 Amendments. Section 36(b) must be implemented within that scheme, not as an alternative to it. The next section explains how.

II. SECTION 36(b)(2) DOES NOT AUTHORIZE COURTS TO SUBSTITUTE THEIR BUSINESS JUDGMENT FOR THAT OF FUND DIRECTORS

Concomitantly with strengthening the provisions for director independence, the 1970 Amendments added Section 36(b), which provides a private right of action against mutual fund advisers who have breached their "fiduciary duty" with respect to the receipt of "compensation." 15 U.S.C. § 80a-35(b). That section places the burden to prove such breaches on plaintiffs, and tasks courts to defer to the business judgment of the independent directors

where "appropriate under all the circumstances." *Ibid*.

Petitioners and most of their *amici* (with the exception of the United States) argue, however, that judicial deference to director decisionmaking is never appropriate because boards are allegedly captive to the advisers (Pet. Br. 5 n.3, 36), and that courts should instead engage in *de novo* review of certain *Gartenberg* factors in every instance to determine the appropriateness of advisory fees. *See, e.g.*, Pet. Br. 25 (arguing that even where there is no defect in the fee-approval process, courts should nonetheless scrutinize fees "for fairness"); *see also*, *e.g.*, Br. of NASAA 14 (arguing that courts must determine whether "fees are substantively fair or reasonable" even absent a showing of a defect in the approval process).

Petitioners' proposed standard fails because, as shown above, the independent-directors-as-captive argument is unrealistic, unsupported, and unsound. In addition, non-deferential review is irreconcilable with the text, structure, and legislative history of the statute, which establish that Congress did not intend for courts to substitute their judgment for that of the independent directors absent fundamental deficiencies in the approval process. To be sure, Congress did not intend for courts to defer blindly to the independent directors, either. *See* S. Rep. No 91-184 at 5 (1969) (noting that a "corporate waste" standard would be "unduly restrictive"). Rather, if (but only if) a plaintiff can prove that the board's approval was a mere formality, or that other fundamental deficiencies in the process precluded the board from making a business judgment, courts may review the fee *de novo*, utilizing factors such as those articulated in *Gartenberg*. In the absence of such proven deficiencies, however, the independent directors' review and

approval of the advisory fee is entitled to judicial deference.

A. Congress Directed Courts To Give Appropriate Weight To Director Approval

Section 36(b)(2) expressly provides that approval of adviser compensation by a fund's board of directors "shall be given such consideration by the court as is deemed appropriate under all the circumstances." 15 U.S.C. § 80a-35(b)(2). Petitioners' "statutory" analysis does not even cite this provision (Pet. Br. 20-34), envisioning no role for the court to give to the board's business judgment.

1. Petitioners' proposed non-deferential review cannot be reconciled with the clear text of Section 36(b)(2): If deference is never "appropriate" because of the purported failures in the bargaining process created by the mutual fund structure, then Section 36(b)(2) would be rendered a nullity. This Court must, of course, avoid such an interpretation. *See*, *e.g.*, *TRW Inc.* v. *Andrews*, 534 U.S. 19, 31 (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 and citation omitted).

"Appropriate" deference means that a court must defer to the independent directors' exercise of their business judgment in approving the advisory fees. In contrast, little or no deference may be due when the directors have demonstrably failed to exercise their business judgment—*i.e.*, when the directors' approval was a mere formality, or when there were other deficiencies in the approval process so fundamental that they precluded the board from making a

business judgment. If such fundamental deficiencies are proved, courts may review advisory fees *de novo*, utilizing factors such as those articulated in *Gartenberg*. And, of course, if a fee is not excessive under the *Gartenberg* factors, there is no private cause of action even if the approval process is imperfect.[6]

Indeed, the statutory structure compels this interpretation. As this Court explained in *Burks*, "Congress' purpose in structuring the Act as it did is clear. It 'was designed to place the unaffiliated directors in the role of independent watchdogs,'" and to give them "the *primary* responsibility for looking after the interests of the funds' shareholders." 441 U.S. at 484-85 (emphasis added). If courts were charged with determining in the first instance whether a given fee was "reasonable," without any deference to the expertise of those on whom this "primary responsibility" falls, courts would essentially usurp the "primary" role that Congress envisioned for the independent directors' approval under Section 15(c).

Thus, although petitioners contend that deference to director decisionmaking "renders § 36(b) superfluous in light of § 15(c)" (Pet. Br. 39), it is actually petitioners' proposed *de novo* judicial review of the reasonableness of advisory fees that would render the directors' duties under Section 15(c) meaningless. The better reading, which (unlike petitioners') harmonizes Section 15(c) and Section 36(b)(2), is

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[6] Section 36(b) only provides a private right of action for excessive fees. Thus, if a fee is not excessive, private plaintiffs do not have a cause of action even if there are fundamental deficiencies in the approval process. Such deficiencies may, of course, be addressed by the SEC under its review and enforcement powers. *See* 15 U.S.C. § 80a-41.

to allow non-deferential court review only where Section 15(c) fails to work—*i.e.*, where the directors' approval was a mere formality or there were other deficiencies in the approval process so fundamental that they precluded the board from making a business judgment. In contrast, allowing courts to engage in *de novo* review of the reasonableness of fees without a failure in the 15(c) process would not only render 15(c) superfluous, but would also render the statutory scheme absurd.

Uniquely in the world of corporate governance, Congress charged the independent directors of mutual funds to undertake an annual review and approval of the advisory contract; Section 36(b) cannot be construed to render that express directive meaningless. When it enacted Section 36(b), Congress also enhanced Section 15(c), and the two sections were designed to work together. As this Court has recognized, "it would have been paradoxical for Congress to have been willing to rely largely upon 'watchdogs' to protect shareholder interests and yet, where the 'watchdogs' have done precisely that," require that their role be completely or significantly ignored. *Burks*, 441 U.S. at 484-85.

If there were any lingering doubt that Congress did not intend for courts to substitute their own judgment for that of the independent directors, it would be obliterated by the legislative history of the 1970 Amendments. The Senate Report explains that Congress did not intend for courts to "substitute [their] business judgment for that of the mutual fund's board of directors in the area of management fees." S. Rep. No. 91-184, at 6. Yet that is exactly what petitioners and most of their *amici* urge on this Court.

According to the Senate and House Reports, Section 36(b)(2) requires a court to determine whether the "deliberations of the directors were a matter of substance or a mere formality" and to weigh approval of directors accordingly. S. Rep. No. 91-184, at 15; H. Rep. No. 91-1382, at 37 (same). Thus, while a board's perfunctory approval based on sparse information might be entitled to little weight, an informed board's consideration of the relevant factors warrants substantial deference. Indeed, Congress's clear statement that Section 36(b) "is not intended to shift the responsibility for managing an investment company in the best interest of its shareholders from the [directors] of such company to the judiciary" (S. Rep. No. 91-184, at 7) further confirms that courts should ordinarily defer to a board's determination of the worth of advisory services.

In addition, "[a]ttention must be paid as well to what Congress did *not* do." *Burks*, 441 U.S. at 483 (emphasis in original). Congress rejected an earlier legislative proposal that would have permitted courts to engage in reviewing the reasonableness of fees in the first instance, and later noted that nothing in the 1970 Amendments "is intended to … suggest that a 'cost-plus' type of contract would be required. It is not intended to introduce a general concept of rate regulation as applied to public utilities." S. Rep. No. 91-184, at 5-6. But such rate-regulation is precisely what petitioners' new standard would entail by allowing courts to determine the reasonableness of fees *de novo* and substitute their non-specialist judgment for that of the congressionally sanctioned "watchdogs" operating under the close regulatory supervision of the specialist agency. That is an outcome that both Congress and this Court have eschewed. *See, e.g., Verizon Commc'ns* v. *FCC*, 535 U.S. 467,

539 (2002); *Town of Concord* v. *Boston Edison Co.*, 915 F.2d 17, 25 (1st Cir. 1990) (Breyer, C.J.) ("[H]ow is a judge or jury to determine a 'fair price'?").

Thus, unlike the unduly permissive *de novo* review proposed by petitioners, deferential review comports with—and is required by—Congress's intention to leave business decisions with decision-makers who are specialists in business issues, while at the same time protecting investors in those cases in which the specialist boards have demonstrably failed to exercise their business judgment.

2. Congress's highly deferential standard, under which courts are not to "substitute" their judgment for that of the independent directors, is one of the well-known formulations of abuse-of-discretion review. Under such review, the weight awarded by the board to each particular factor is not ordinarily second-guessed by the court, and thus the business judgment of the board cannot be disturbed even if the court might have reached a different decision. *See, e.g.*, *Gall* v. *United States*, 128 S. Ct. 586, 597 (2007) ("The fact that the . . . court might reasonably have concluded that a different [result] was appropriate is insufficient to justify reversal" of a decision reviewed for abuse of discretion).

"The prospect that perhaps a better bargain could have been driven is a slim justification for allowing courts to substitute their business judgment for the collective judgment of independent directors acting in good faith." Troy A. Paredes, Commissioner, SEC: Remarks Before the Mutual Fund Directors Forum Ninth Annual Policy Conference (May 4, 2009), http://www.sec.gov/news/speech/2009/spch050409tap.htm#14. Accordingly, although an especially large fee might show "that the decision-making

process that produced the fee may be inexcusably tainted, such as by disloyalty or a lack of adequate care . . . . , if careful, conscientious, and disinterested directors agree to the fee, little, if any, room is left for a court to declare that the fee is nonetheless so large that [it] could not be the result of an arm's-length bargain." *Ibid*.

In interpreting Section 36(b), it is important for the Court to give guidance to the lower courts on the appropriate level of deference owed to the independent directors' approval. Although *Gartenberg* recognized that the care and conscientiousness of independent directors are "important" considerations under Section 36(b), it did not elaborate on whether a court would place its own weight on each of the other *Gartenberg* factors, or would defer to the board's consideration of those factors absent a showing that the board's approval was a mere formality, or that there were other deficiencies in the approval process so fundamental that they precluded the board from making a business judgment. Nor does the United States' *current* brief elaborate on this issue, although it similarly recognizes the important role of "the board's receipt of necessary information and its careful consideration of the *Gartenberg* factors," which the United States agrees "can be *strong* probative evidence that the adviser has complied with its fiduciary obligation." U.S. Br. 24 (emphasis added). (In this respect, the United States markedly diverges from petitioners and their other *amici*.)

This Court, however, should not permit courts to weigh (or reweigh) the *Gartenberg* factors anew absent proof of a fundamental deficiency in the approval process. There is simply no way to reconcile such *de novo* review with the type of review envisioned by Congress: that in which the independent

directors' approval receives its due, "appropriate" deference, in which directors have "primary" responsibility to review the fees, and courts are not to "substitute" their business judgment for that of the directors.

Indeed, in contrast to its lukewarm stance in this case, the United States has previously represented to this Court that "shareholder protection" is achieved by deferring to the "business judgment" of the independent directors, and that any other approach would evince "a failure to give proper consideration to the structure and purposes of the Act." Brief for the United States as Amicus Curiae, *Burks* v. *Lasker,* 441 U.S. 471 (1979), 1978 WL 207114, at *2-*3, *7-*9. What the United States said then is equally true today: "[T]he congressional goal of active stewardship by disinterested directors, performing their responsibilities in the best interests of shareholders, can be achieved by applying the traditional business judgment rule within a framework of safeguards." *Id*. at *3; *see also, e.g.,* Paul Roye, Director, SEC Div. of Inv. Mgmt., What Does It Take to Be an Effective Independent Director of a Mutual Fund (Apr. 14, 2000), http://www.sec.gov/news/speech/spch364.htm (a "court will not substitute its judgment for that of the director, provided that the director acted in good faith, rationally believed the action was in the best interest of the fund, and the director was reasonably informed").

3. Perhaps recognizing that the text, structure, and purposes of the Act do not support their position, petitioners rest their "statutory" analysis not on the Act itself, but rather on petitioners' selective analysis of the common law. *See* Pet. Br. 20-29.

Petitioners' common law arguments are largely beside the point. As an initial matter, it is inconceivable that, in enacting a new *federal* cause of action under Section 36(b), in the context of the most regulated sector of the securities industry, Congress intended that courts seek guidance not from the text, structure, and purposes of the Act, but from trust law concepts that were not incorporated into the Act. If anything, Congress's decision to reject the common law approach, under which the burden of proof would have been on the fiduciary, not on the plaintiffs as under Section 36(b), strongly suggests that Congress did not intend to incorporate the common law into the mechanics of federal court proceedings under Section 36(b), even if Congress might have envisioned a role for the common law with respect to other aspects of the 1940 Act.

While this Court sometimes looks to the common law to fill existing statutory gaps, there are no such gaps at issue in this case: Congress has expressly spoken to the role of the directors in both Section 15(c) and Section 36(b)(2) of the Act. The legislative history and Congressional policies underlying the Act could not have been clearer in rejecting an approach in which courts are permitted to determine the reasonableness of advisory fees in the first instance. *See, e.g.*, S. Rep. No. 91-184 at 6 (courts should not ordinarily "substitute" their judgment for those of independent directors "as to management fees").

And even if there were a statutory gap, the mutual fund structure is a hybrid creature of state and federal law that is without likeness at common law. Mutual fund investors are unlike beneficiaries involuntarily stuck with a trust set up by someone else for their benefit. Rather, they have made the voluntary

choice to invest in the mutual fund managed by the adviser, after full and clear disclosure of the fees. Nor can it seriously be said that advisers "control" funds overseen by boards composed predominantly of *independent* directors. Thus, despite the forced attempts by petitioners and their *amici* to fit mutual funds within one of the categories existing at common law, the common law is ultimately unenlightening as it does not address the unique governance structure at issue here.

The Court's decision in *Daily Income Fund* v. *Fox*, 464 U.S. 523, 540 (1984), is not to the contrary. There, the Court held that shareholders need not make a demand on the board prior to initiating a Section 36(b) suit. As Congress had rejected an earlier bill that had required boards to approve such demands, the Court remarked that "Congress decided not to rely *solely* on the fund's directors to assure reasonable adviser fees." *Id*. at 540 (emphasis added). Petitioners repeatedly read this statement out of context, hailing it as a sign that the independent directors' evaluation and approval of advisory fees deserve little or no deference. But there is nothing in the statement that "Congress decided not to rely *solely* on the fund's directors to assure reasonable adviser fees" that would prohibit a system in which, as *Burks* explained, directors have the primary responsibility to protect investor interests, and courts intervene where boards have failed to exercise that responsibility (*e.g.*, an inattentive board).

Nor did the Court in *Daily Income Fund* suggest that in reviewing a Section 36(b) challenge, a court is not to afford "appropriate" deference to the business judgment of the directors. To the contrary, while rejecting the concept that board approval of a suit's *initiation* is required, *Daily Income Fund* recognized

that board approval of adviser *compensation* requires "serious consideration." 464 U.S. at 540. The 1940 Act requires as much; yet petitioners would have courts give *no* consideration to the statutorily required approval of the advisory contract by the independent directors.

* * *

At bottom, petitioners' arguments add up to an attack on the entire mutual fund industry, as currently constituted under a congressionally mandated system. In that system, Congress relied principally, albeit not solely, on independent directors to protect investors against excessive fees, and tasked courts with deferring to the directors' business judgment absent a proven fundamental deficiency in the approval process. Arguments that this system should be changed, or additional substantive or procedural requirements imposed, may appropriately be directed to the political branches but they manifestly are not within the province of the Judiciary. Petitioners ultimately ask this Court to engage in the legislative act of authorizing federal district judges to sit in *de novo* review of business judgments made by independent directors of mutual funds. Since that is not the regime enacted by Congress, this Court cannot grant petitioners' request. *Cf. Tellabs, Inc.* v. *Makor Issues & Rights, Ltd.*, 551 U.S. 308 (2007).

B. Departing From That Congressional Directive Would Disserve Investors

Departure from the congressionally mandated deference owed to board decisions absent a fundamental deficiency in the fee approval process, even if it were within this Court's purview, would not be in the best interests of investors. Without such deference, plaintiffs' lawyers could find a basis to litigate the fees paid by virtually any mutual fund, as mere

disagreement with the amount or type of information the board reviewed or the weight the board placed on certain information would be sufficient to create an issue of fact for trial.

This case is illustrative. Although the independent directors of the Oakmark funds have *already considered* the reasons for the discrepancy between the fees paid by retail investors and those paid by institutional investors, and petitioners have not even attempted to show a fundamental deficiency in the fee-approval process, petitioners and their *amici* would nonetheless have this Court remand the case to the district court to consider this issue in the first instance. *See* U.S. Br. 32. Moreover, while petitioners' question presented focuses only on this one factor (*i.e.*, the purported discrepancy between "retail" and "institutional" fees) in requesting this Court to undo the board's approval, independent directors must consider and weigh a variety of factors and *all* the relevant circumstances before approving, or disapproving, an advisory contract.

For a court to undo the board's approval on remand based solely on one factor would require a court to afford a different weight than that given by the board not only to this factor, but also to the other factors considered by the board. Such second-guessing of the business judgment of the board is not in the best interests of investors. As explained, board approval involves multi-factor, multi-discipline, and often multi-year considerations that boards are best suited to provide. Boards have the time, expertise, and resources to understand and carefully analyze each issue, ask the right questions, and reach the right answer more often, more quickly, and more cheaply than courts. By contrast, it is no secret that the judicial machinery is ill-equipped to

make business judgments or determine fair prices. *E.g.*, *Verizon Commc'ns*, 535 U.S. at 539.

The independent directors of the Oakmark funds did not abuse their discretion in approving the advisory contract after considering the comparison between retail and institutional fees charged by the adviser. A quick perusal of the securities laws alone leaves no doubt that portfolio management services provided to institutional clients are significantly less regulated than portfolio management services provided to retail funds, and thus less costly. And notably, offering retail funds to the public entails a significantly greater litigation risk than offering services to institutional clients. In addition, institutional clients have lower liquidity requirements, and managing portfolios with lower liquidity requirements is less challenging, and thus less costly. *See, e.g.*, John C. Coates & R. Glenn Hubbard, Competition in the Mutual Fund Industry: Evidence and Implications for Policy, 33 J. Corp. L. 151, 185 (2007); ICI Br. Section I.D. Indeed, petitioners nowhere explain why regulatory, litigation, and liquidity-management costs of portfolio management are comparable for retail and institutional clients. *See* Pet. Br. 48-53. Because petitioners, the party bearing the burden of proof at trial, failed to present sufficient evidence creating an issue of fact for trial, the judgment below should be affirmed. Moreover, because many advisory contracts across the industry provide bundled contracts that cover myriad administrative functions or services beside portfolio management, petitioners' narrow focus on portfolio management fees alone has little relevance to a large number of cases.

The vague and overbroad disclosure-oriented test proposed by *Gallus* v. *Ameriprise Financial, Inc.*, 561

F.3d 816 (8th Cir. 2009), and echoed by petitioners, also would be detrimental to investors. Allowing Section 36(b) actions to go to trial based on the plaintiffs' mere disagreement with the amount or type of information the board reviewed—without proof that the directors' approval was a mere formality, or of other deficiencies in the approval process so fundamental that they precluded the board from making a business judgment—would result in excessive and costly litigation, and a disproportionate response to inconsequential mistakes, or even inconsequential misrepresentations, by the adviser. As inconsequential defects can be alleged in virtually every case, meaningful restrictions on the type of defect that could trigger *de novo* review are necessary to protect funds and investors against the costs and distractions of unwarranted litigation.

Indeed, under a contrary test, advisers would "have an incentive to submit a deluge of information that the [board] neither wants nor needs, resulting in additional burdens on the [board's] evaluation" in order to protect themselves against non-disclosure claims. *Buckman Co.* v. *Plaintiffs' Legal Comm.*, 531 U.S. 341, 351 (2001). Such information overload resulting from overdisclosure would not only fail to produce superior board decisions, but would also interfere with the board's efforts to produce informed, timely, and high-quality decisions.

This is not to say that every business judgment is above question, or that excessive fees cause no harm to investors. But federal securities litigation is clearly not the best method for redressing *that* harm. "Securities class actions cannot be justified as providing compensation," and those as to mutual fund fees make no exception. A.C. Pritchard, *Who Cares?*, 80 Wash. U. L. Q. 883, 884 (2002); *see also, e.g.,* In-

terim Report of the Committee on Capital Markets Regulation at 79 (2006) ("the notion that securities class actions do a good job of compensating injured parties is belied by data").

Nor is a deterrence justification warranted. Advisers already face significant deterrents. The SEC, which has broader exposure to the mutual fund industry than federal courts, and is better equipped to detect when a fiduciary is charging excessive fees, already monitors the fee approval process. Indeed, even absent investor complaints, the SEC conducts fund examinations regularly, and those examinations are designed to detect, among others, any improprieties in the fee-approval process. *See* GAO Report at 93. And, unlike private litigation, the SEC can utilize a panoply of remedies to calibrate its response to the seriousness of the conduct, ranging from an informal warning to an enforcement action. *See ibid*. (citing three instances of deficiencies related to the directors' role in reviewing fees uncovered by SEC examinations); *SEC* v. *Am. Birthright Trust Mgmt. Co.*, Litigation Release No. 9266 (Dec. 30, 1980) (directors approved advisory contracts without requesting information reasonably necessary to evaluate the contracts); *In re New York Life Investment Mgmt. LLC*, Litigation Release No. 28747 (May 27, 2009) (adviser did not provide board with information necessary to evaluate fee).

It is questionable whether the benefits of any additional marginal deterrence added by an expansive reading of Section 36(b) would exceed the costs of litigation's non-calibrated approach to punishment and deterrence. In addition, each of the costs will be ultimately borne by innocent investors, as increased fees to the advisers. Expanded litigation and discovery would also distract directors from overseeing the

fund. *See, e.g.*, *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723, 737-41 (1975); *Merrill Lynch, Pierce, Fenner & Smith, Inc.* v. *Dabit*, 547 U.S. 71, 80-82 (2006). As a result, even if directors are not defendants but mere witnesses in Section 36(b) lawsuits, rules that encourage such litigation would "deter" board service by the "qualified individuals" needed to perform the board's independent watchdog function, which would ultimately be detrimental to investors. *Dabit*, 547 U.S. at 81.

CONCLUSION

The judgment of the court of appeals should be affirmed.

Respectfully submitted.

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