

# NOTES

## VOTING WITH THEIR FEET AND DOLLARS: THE ROLE OF INVESTORS AND THE INFLUENCE OF THE MUTUAL FUND MARKET IN REGULATING FEES

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## INTRODUCTION

Investors can and do “vote with their feet and dollars,” Chief Judge Easterbrook argued in *Jones v. Harris Associates L.P.*<sup>1</sup> In the May 19, 2008 decision, the Seventh Circuit rejected the widely used *Gartenberg* standard, which has stood for over twenty-five years as a tool for courts to assess mutual fund advisory fees under section 36(b) of the Investment Company Act of 1940 (the 1940 Act).<sup>2</sup> The *Gartenberg* standard, originating from the 1982 Second Circuit case *Gartenberg v. Merrill Lynch Asset Management, Inc.*,<sup>3</sup> promotes judicial intervention in fee setting through essentially establishing the precedent that a “reasonableness” standard be applied to section 36(b) cases.<sup>4</sup> On the contrary, as the Seventh Circuit held in *Jones*, so long as advisers “make full disclosure and play no tricks” in order to meet their fiduciary duties under section 36(b), investor decisions and market forces are better suited to regulate fees in the mutual fund industry, an arena in which a court is ill-suited to interfere.<sup>5</sup>

This Note urges that the Supreme Court adopt the new standard advanced by the *Jones* decision.<sup>6</sup> This deferential standard is most reflective of the functioning of the current mutual fund industry, and this Note will demonstrate why that is so. The *Jones* standard provides a solid framework for courts’ interactions with the mutual fund industry in taking on section 36(b) litigation. This Note further

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1. 527 F.3d 627, 632 (7th Cir. 2008).

2. *Id.* Mutual funds are professionally managed investment companies placing money obtained from shareholders in varied sectors of the financial market. Investors in these funds receive dividends from their fund shares and may sell those shares back to the companies at net asset value. Mutual funds are managed by investment advisers who receive fees for their services. Such fees must be approved annually by the independent directors of the funds’ boards of trustees. Section 36(b) imposes a fiduciary duty upon investment advisers in relation to their fees. *See* 15 U.S.C. § 80a-35 (2006).

3. 694 F.2d 923 (2d Cir. 1982).

4. *Id.* at 927-29.

5. *Jones*, 527 F.3d at 632.

6. Appellants filed a petition for writ of certiorari on November 3, 2008, and certiorari was granted on March 9, 2009. *Jones v. Harris Assocs. L.P.*, 527 F.3d 627 (7th Cir. 2008), *cert. granted*, 129 S. Ct. 1579 (U.S. Mar. 9, 2009) (No. 08-586). Oral argument is scheduled to be heard on November 2, 2009. Supreme Court of the United States, For the Session Beginning November 2, 2009, [http://www.supremecourtus.gov/oral\\_arguments/argument\\_calendars/MonthlyArgumentCalNovember2009.pdf](http://www.supremecourtus.gov/oral_arguments/argument_calendars/MonthlyArgumentCalNovember2009.pdf) (last visited Sept. 23, 2009).

argues that the standard created in *Jones* might be improved upon, and new, inexperienced investors might be better protected through inclusion in investor account statements of enhanced disclosure in the form of dollar-amount fees paid by the individual investors.

Chief Judge Easterbrook's argument in *Jones* rested on the notion that investors will "vote with their feet," meaning that informed investors will choose advisers based upon fees and return on investment.<sup>7</sup> This voting already occurs through the efforts of experienced investors, who by their decisions create sufficient competition, guiding more inexperienced investors.<sup>8</sup> Additionally, this voting might be encouraged among new and less experienced investors through requiring the additional disclosure mentioned above, which would allow investors to evaluate actual returns against the fees they have paid in a given fund. Thus, investors would be further empowered to "hire" and "fire" advisers.<sup>9</sup> Having access to this information as well as fee information on comparable funds would equip most mutual fund shareholders to make educated decisions on investments and would directly encourage competition in an industry that consists of nearly 9,000 mutual funds to date.<sup>10</sup>

Part I of this Note reviews the judicial and legislative history of section 36(b). It focuses upon the interpretation and reasoning in the *Gartenberg* and *Jones* cases and the importance of resolving the circuit split that *Jones* created. Part II enumerates policy arguments against the *Gartenberg* standard. It analyzes competition in the mutual fund industry and concludes that enough competition exists to regulate fees through market forces. Part III considers the meaning and sufficiency of the fiduciary duty created under section 36(b) in guiding advisers in the setting of fees and looks at the interplay between this duty and the fiduciary duties of the independent directors on mutual fund boards. Finally, Part IV weighs the various suggestions for reform in the industry as they relate to fees and concludes that, although the Supreme Court should adopt the standard set in *Jones*, further reform in the way of mandating

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7. *Jones*, 527 F.3d at 632.

8. See *infra* note 93 and accompanying text.

9. *Jones*, 527 F.3d at 634.

10. See *2009 Investment Company Factbook*, 2009 INV. CO. INST. 15, available at [http://www.ici.org/pdf/2009\\_factbook.pdf](http://www.ici.org/pdf/2009_factbook.pdf) [hereinafter *Investment Company Factbook*].

enhanced disclosure to investors would promote even more competition by educating the average investor.

## I. BACKGROUND

### A. *Section 36(b) and the Gartenberg Precedent*

Section 36(b), enacted by Congress in 1970, provides that an investment adviser is charged with a fiduciary duty with respect to the receipt of compensation for services provided to a mutual fund, and that a private right of action, or suit by the Securities and Exchange Commission (SEC), will exist for breach of that duty.<sup>11</sup> This section of the 1940 Act, as enacted, was not the first attempt to impose such regulations on advisers.<sup>12</sup> The first Senate bill, rejected by the House of Representatives in 1968, included a statutory requirement of “reasonableness” rather than the later adopted fiduciary duty.<sup>13</sup> The Senate report issued with the enacted version of section 36(b) noted an “adequate basis” for this change, finding the fiduciary duty requirement to be more appropriate in regulating advisers.<sup>14</sup>

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11. 15 U.S.C. § 80a-35 (2006). Section 36(b) of the 1940 Act states:

For the purposes of this subsection, the investment adviser of a registered investment company shall be deemed to have a fiduciary duty with respect to the receipt of compensation for services.... An action may be brought under this subsection by the Commission, or by a security holder of such registered investment company on behalf of such company, against such investment adviser ... [w]ith respect to any such action the following provisions shall apply:

(1) It shall not be necessary to allege or prove that any defendant engaged in personal misconduct, and the plaintiff shall have the burden of proving a breach of fiduciary duty.

(2) In any such action approval by the board of directors of such investment company of such compensation or payments, or ... by the shareholders of such investment company, shall be given such consideration by the court as is deemed appropriate under all the circumstances.

*Id.*

12. See S. REP. NO. 91-184 (1969), reprinted in 1970 U.S.C.C.A.N. 4897, 4897-4912 (summarizing the legislative history of section 36(b)).

13. *Id.* at 4897-98, 4902.

14. *Id.* at 4902.

At the time, Congress believed that insufficient competition existed in the mutual fund industry.<sup>15</sup> Without competition, it was thought, little incentive existed for mutual fund companies and advisers to negotiate a fair fee; therefore, it would be necessary for courts to closely scrutinize advisers for unfair dealing.<sup>16</sup> The drafters of section 36(b) created adviser responsibility through imposition of a fiduciary duty, which was aimed to encourage bargaining and accountability for the adviser's fee.<sup>17</sup> One commentator noted, "The enactment of section 36(b) reveals a policy decision to transform the very nature of the investment advisory agreement from a mere contractual interaction between the adviser and the fund into a fiduciary relationship."<sup>18</sup>

Between the time of the enactment of section 36(b) and the issuance of the *Jones* decision, there were no plaintiff victories in mutual fund fee litigation; however, many cases tested the statutory requirement.<sup>19</sup> *Gartenberg* was considered the seminal case and long held sway over most circuit court decisions.<sup>20</sup> In *Gartenberg*,

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15. See, e.g., WHARTON SCH. OF FIN. & COM., A STUDY OF MUTUAL FUNDS, H.R. REP. NO. 87-2274, at 28 (1962); John C. Coates IV & R. Glenn Hubbard, *Competition in the Mutual Fund Industry: Evidence and Implications for Policy*, 33 J. CORP. L. 151, 155-56 (2007).

16. Coates & Hubbard, *supra* note 15, at 203 ("[T]he combination of a mandate ... for shareholder approval of advisory contracts ... and a state law doctrine that effectively barred suits attacking transactions that had been approved by shareholders was said to have resulted in the effective elimination of any fiduciary duty constraint on advisory fees. Section 36(b) was adopted largely in response to these concerns.")

17. *Id.*

18. Lyman Johnson, *A Fresh Look at Director "Independence": Mutual Fund Fee Litigation and Gartenberg at Twenty-Five*, 61 VAND. L. REV. 497, 528 (2008).

19. See JAMES D. COX ET AL., SECURITIES REGULATION: CASES AND MATERIALS 1211 (3d ed. 2001); Johnson, *supra* note 18, at 519 ("[T]hirty-seven years after [section 36(b)]'s enactment and twenty-five years after *Gartenberg*, no investor has obtained a verdict against an investment adviser."); Floyd Norris, *Fund Fees Revisited in Court*, N.Y. TIMES, May 23, 2008, at C1 (remarking that while there have been no judgments for plaintiffs, "there have been some settlements, and the threat of legal action may have lowered some fees"). The recent Eighth Circuit decision in *Gallus v. Ameriprise Financial, Inc.* is considered the first shareholder victory in section 36(b) litigation. See, e.g., Sam Mamudi, *In Fund-Fee Case, Emails May Hold Key*, WALL ST. J., July 17, 2009, at C9; *infra* note 52 and accompanying text.

20. See *Gartenberg v. Merrill Lynch Asset Mgmt., Inc.*, 694 F.2d 923 (2d Cir. 1982); Lori A. Martin & Martin E. Lybecker, *Email Alerts: It's Too Early to Disregard the Gartenberg Factors During Advisory Fee Renewals*, WILMER HALE, May 27, 2008, <http://www.wilmerhale.com/publications/whPubsDetail.aspx?publication=8329> ("The *Gartenberg* approach has shaped ... 15(c) renewals for almost 30 years [and] this process-oriented approach has been applied by district courts in the First, Second, Third, Fourth, Fifth, Eighth, Ninth and Tenth Circuits.")

shareholders of the Merrill Lynch Ready Assets Trust, a large money market fund,<sup>21</sup> claimed that fees “were so disproportionately large as to constitute a breach of fiduciary duty in violation of § 36(b).”<sup>22</sup> These shareholders advocated use of a “reasonableness” standard to evaluate advisers’ adherence to their fiduciary duty.<sup>23</sup> This argument was supported through reference to the unclear legislative history of section 36(b).<sup>24</sup>

The court in *Gartenberg*, although denying a shareholder victory and dismissing the shareholders’ argument, adopted a standard that nevertheless appeared to support the shareholders’ reasoning. *Gartenberg* provided that the test for section 36(b) litigation is “essentially whether the fee schedule represents a charge within the range of what would have been negotiated at arm’s-length in the light of all of the surrounding circumstances.”<sup>25</sup> The court determined, however, that arm’s-length bargaining did not occur in the mutual fund industry.<sup>26</sup> Upon this consideration, the court modified the final test to state that “[t]o be guilty of a violation of § 36(b) ... the adviser-manager must charge a fee that is so disproportionately large that it bears no reasonable relationship to the services rendered and *could not have been* the product of arm’s-length bargaining.”<sup>27</sup>

This phrasing would seem to imply: (1) that competition does not exist between advisers so that arm’s-length bargaining cannot

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21. A money market fund is a type of mutual fund that “invests in low-risk government securities and short-term notes.” BLACK’S LAW DICTIONARY 1045 (8th ed. 2004).

22. *Gartenberg*, 694 F.2d at 925.

23. *Id.* at 928.

24. Congress introduced bills providing for a reasonableness test in 1967 and 1968 which were rejected largely due to protest from the mutual fund industry. *Id.* Consequently, section 36(b) was enacted in its present form in 1970, replacing the reasonableness test with a requirement of a fiduciary duty. *Id.* It has been argued that the change in terminology was “a more semantical than substantive compromise.” *Id.* At the time, Congressman Moss noted, “[t]his [bill], by imposition of the fiduciary duty, would in effect require a standard of reasonableness in the charges.” *Id.* In 1998 Arthur Levitt, then chairman of the SEC, said, “directors don’t have to guarantee that a fund pays the lowest rates. But they do have to make sure that fees fall within a reasonable band.” Norris, *supra* note 19, at C1.

25. *Gartenberg*, 694 F.2d at 928.

26. *Id.* (citing S. REP. NO. 91-184 (1970)).

27. *Id.* (emphasis added).

actually occur;<sup>28</sup> and (2) that a range of reasonableness, between the fee charged and services rendered, must be established by courts so that those fees which are “disproportionately large”<sup>29</sup> may be targeted in section 36(b) litigation. Based on this understanding of the market, the court discouraged reliance upon comparisons to similar funds in assessing the reasonableness of a fee.<sup>30</sup>

Two theories might explain the lack of plaintiff victories under *Gartenberg* precedent: (1) courts have been deferential to the independent directors of mutual funds who approve advisory fees; and (2) despite *Gartenberg*'s teachings, competition and investor decision making have become sufficient to regulate fees, the result being that there have not been any legitimate excessive fee cases brought to trial. Both inferences are likely correct. In general, courts have deferred to the judgment of mutual fund boards in the absence of deceit by the adviser.<sup>31</sup> Sections 36(b), 15(c), and various other regulations under the 1940 Act were established to ensure that mutual fund boards, namely the independent directors, approve fees according to what the boards deem most appropriate for any given fund.<sup>32</sup> Barring fraud or deceit by the adviser, courts should not

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28. *See id.* at 929 (“The fund customer’s shares of the advisory fee is usually too small a factor to lead him to invest in one fund rather than in another or to monitor adviser-manager’s fees.”). This idea that competition does not exist rests on broad assumptions. Most mutual fund companies are created by investment advisers who then contract to advise the funds within the company. Few mutual funds change advisers, so it is assumed that this state of affairs prevents competition in the industry. *Jones v. Harris Assocs. L.P.*, 527 F.3d 627, 631 (7th Cir. 2008).

29. *Gartenberg*, 694 F.2d at 928.

30. *Id.* at 929 (“If rates charged by the many other advisers were an affirmative competitive criterion, there would be little purpose in § 36(b).”).

31. *See supra* note 19 and accompanying text.

32. 15 U.S.C. §§ 80a-35, 80(a)-15(c). Section 15(c) requires directors to consider all information as may be necessary to evaluate renewal of advisory contracts. 15 U.S.C. § 80a-15(c). Echoing the importance of fee approval by a board of directors, Andrew Donohue, Director of the Division of Investment Management of the SEC, commented,

I believe that a detailed 15(c) process minimizes the likelihood of a successful legal challenge. This is because the legislative history of Section 36(b) suggests that courts generally will not substitute their business judgment for that of the independent directors in the area of management fees and an adviser who provides robust information to the directors to enable them to make an informed decision whether to vote to approve the advisory contract obtains the benefit of the directors’ business judgment.

Andrew J. Donohue, Dir., Div. of Inv. Mgmt., Sec. & Exch. Comm’n, Address at the Mutual Fund Directors Forum Second Annual Directors’ Institute (Jan. 15, 2008) (transcript available

interfere with the decisions of mutual fund boards that have undertaken thorough 15(c) processes in setting the exact level of fees.<sup>33</sup> Further, competition and investor decision making are robust processes in today's mutual fund market and tend to pull unjust fees into acceptable ranges. As such, regulation occurs organically, leading courts to conclude their involvement is unwarranted.<sup>34</sup>

Congress rejected judicial fee setting in the creation of section 36(b).<sup>35</sup> Although the government may enact regulations, and courts may provide guidance, influencing steps of the approval process—for instance, the requirement that independent directors approve fees and stipulations concerning the information that must be considered—these bodies should not allow fees, once approved, to be subject to judicial control if the fees do not converge with an amount deemed most appropriate by a court.<sup>36</sup> Section 36(b) indicates that an adviser has a fiduciary duty with respect to the fee it imposes on shareholders.<sup>37</sup> Various other provisions of the 1940 Act monitor the approval process that independent directors, adhering to their own fiduciary duties, must follow in considering fees.<sup>38</sup> Given compliance with these basic provisions, investor decisions and competition between advisers will drive the fund industry in setting fee levels.<sup>39</sup> A court should intervene in this process only when an adviser has breached its fiduciary duty through deceit or fraud in setting fee levels, as clearly set forth in section 36(b) of the 1940 Act, or when a mutual fund board has not undertaken a thorough 15(c) process.<sup>40</sup>

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at <http://www.sec.gov/news/speech/2008/spch011508ajd.htm>).

33. See *supra* note 11; *infra* notes 47-48 and accompanying text. The 15(c) process, named for that section of the 1940 Act, refers to the annual review of the investment advisory contract by a board of directors.

34. See discussion *infra* Part II.B-C.

35. See *infra* notes 66-68 and accompanying text.

36. *Id.*

37. 15 U.S.C. § 80a-35 (2006).

38. See *supra* note 32 and accompanying text.

39. *Jones v. Harris Assocs. L.P.*, 527 F.3d 627, 632-34 (7th Cir. 2008).

40. See *infra* notes 47-48 and accompanying text.



*B. The Jones Standard and Creation of a Circuit Split*

The *Gartenberg* precedent recently came under scrutiny by the Seventh Circuit in *Jones v. Harris Associates*.<sup>41</sup> Appellant shareholders argued that fees in the mutual fund industry “are set incestuously rather than by competition.”<sup>42</sup> The court disagreed. In rejecting the shareholders’ viewpoint and disapproving *Gartenberg*, Chief Judge Easterbrook noted that competition in the mutual fund industry today is robust and that *Gartenberg* relies too little on this competition.<sup>43</sup>

Chief Judge Easterbrook demonstrated the competitive forces currently at work in the industry, commenting:

Holding costs down is vital in competition, when investors are seeking maximum return net of expenses—and as management fees are a substantial component of administrative costs, mutual funds have a powerful reason to keep them low unless higher fees are associated with higher return on investment.... That mutual funds are “captives” of investment advisers does not curtail this competition. An adviser can’t make money from its captive fund if high fees drive investors away.<sup>44</sup>

He noted that although funds rarely change advisers, investors “‘fire’ advisers cheaply and easily by moving their money else-

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41. In his majority opinion, Chief Judge Easterbrook wrote, “[W]e now disapprove the *Gartenberg* approach.” *Jones*, 527 F.3d at 632. In *Jones*, the appellants were shareholders in funds belonging to the Oakmark complex of mutual funds which were managed by the adviser Harris Associates. *Id.* at 629. The funds’ net returns had exceeded the market average, which was followed by concurrent growth in the adviser’s compensation. *Id.* Appellants argued that the inflated fees violated section 36(b). *Id.* The district court, applying *Gartenberg*, granted summary judgment to Harris Associates because it found that the fees were ordinary. *Id.* at 631. The district court observed that the fees were calculated according to a contractual schedule and approved by the Oakmark Board annually after thorough review of fund performance and advisory services. The Board also compared the fees charged by the adviser to those of similar clients and to the fees of similar funds. *Id.* On appeal, the Seventh Circuit upheld the judgment, while extending the reasoning to disapprove *Gartenberg*. *Id.* Before *Jones*, *Gartenberg* was increasingly prone to scrutiny. See Johnson, *supra* note 18, at 519 (“[S]cholars are criticizing *Gartenberg* and its progeny severely and justifiably.”).

42. *Jones*, 527 F.3d at 631.

43. *Id.* at 631-32.

44. *Id.*

where.”<sup>45</sup> This competition, paired with the adviser’s fiduciary duty, is better suited to control advisory fees than a judicially created reasonableness standard under *Gartenberg*.<sup>46</sup> Under the fiduciary duty provided in section 36(b), legal intervention should only take place in the case of fraud or deceit.<sup>47</sup> As a fiduciary, according to *Jones*, the adviser is required to “make full disclosure and play no tricks but is not subject to a cap on compensation.”<sup>48</sup>

Judge Posner,<sup>49</sup> various industry commentators, and finally the Supreme Court in its granting of certiorari have recognized *Jones* as creating a circuit split.<sup>50</sup> In rejecting the *Gartenberg* standard, Chief Judge Easterbrook set forth a new and conflicting standard, which calls for courts to refrain from fee regulation altogether in the absence of deceit.<sup>51</sup>

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45. *Id.* at 634. The opinion noted, “Investors do this not when the advisers’ fees are ‘too high’ in the abstract, but when they are excessive in relation to the results ... [this] depends on the results available from other investment vehicles, rather than any absolute level of compensation.” *Id.*

46. *See id.* at 632 (“Section 36(b) does not say that fees must be ‘reasonable’ in relation to a judicially created standard.”).

47. *Id.*

48. *Id.*

49. Judge Posner stated his position in his dissenting opinion to the denial of the Petition for Rehearing and Rehearing En Banc. *Jones v. Harris Assocs.* L.P. 527 F.3d 627 (7th Cir. 2008), *petition for reh’g and reh’g en banc denied*, 537 F.3d 728, 729-32 (7th Cir. 2008).

50. *See, e.g., id.* at 729-30; *Appeals Court Rejects Mutual Fund Excessive Fee Claims, Adopting New Standard for Evaluation of Fees*, ROPES & GRAY, May 20, 2008, <http://www.ropesgray.com/litigation/alert/?PublicationTypes=0c16784b-f94e-4696-b607-de259b87a13f>; William K. Dodds et al., *Dechert On Point: Seventh Circuit Rejects Gartenberg’s Construction of Section 36(b) of the 1940 Act*, DECHERT, May 2008, [http://www.dechert.com/library/FS\\_11\\_-\\_05-08\\_-\\_Seventh\\_Circuit\\_Rejects\\_Gartenberg%20\(2\).pdf](http://www.dechert.com/library/FS_11_-_05-08_-_Seventh_Circuit_Rejects_Gartenberg%20(2).pdf); *Investment Management Alert: Seventh Circuit Court of Appeals Rejects Gartenberg*, DRINKER BIDDLE, June 2, 2008, <http://www.drinkerbiddle.com/files/Publication/f74b9bc2-9376-4b60-b732-0242868a873c/Presentation/PublicationAttachment/be9e677f-8b35-440a-8b53-022caedb13e0/Gartenberg.pdf>; Lawrence P. Stadulis et al., *Seventh Circuit Rejects Gartenberg Approach to Determining Appropriateness of Mutual Fund Management Fees*, STRADLEY RONON, May 2008, <http://www.stradley.com/newsletters.php?action=view&id=347>.

51. A law firm newsletter sums up the conflict, noting, “In *Gartenberg*, the Second Circuit interpreted an investment adviser’s fiduciary duty ... by focusing on the amount of fee charged by the investment adviser.... *Jones* explicitly ‘disapproves the *Gartenberg* approach,’ observing that, “[a] fiduciary duty differs from rate regulation.” Dodds et al., *supra* note 50.

Some have argued that *Jones* did not necessarily create a split. Lea Ann Copenhefer et al., *Seventh Circuit “Disapproves” Gartenberg, but Is this New Approach Fundamentally Different?*, BINGHAM, May 27, 2008, <http://www.bingham.com/media.aspx?mediaid=7004> (“At the end of the day, the [*Jones*] decision articulates a standard that does not appear to be that different from the *Gartenberg* standard.”). They comport *Jones*’s “so unusual” language with

In the wake of this circuit split, the Eighth Circuit released a decision in litigation under section 36(b) in April 2009. In *Gallus v. Ameriprise Financial, Inc.*, the Eighth Circuit handed a significant victory to shareholders in remanding the case to the district court for consideration of whether there had been a breach of the adviser's fiduciary duty under section 36(b).<sup>52</sup> The court found that the lower court had erred in not considering a comparison of the fees charged to the institutional clients against those charged to mutual fund clients and in not determining whether there was intentional omission by the adviser in presenting information on fees to the funds' board of directors.<sup>53</sup> In reaching its decision, the court adhered to *Gartenberg* principles, but at the same time recognized that *Jones* "highlights a flaw in the way many courts have applied *Gartenberg*."<sup>54</sup> The court adopted principles from both the Second Circuit and Seventh Circuit cases in holding that "the proper approach to § 36(b) is one that looks to both the adviser's conduct during negotiation and the end result."<sup>55</sup>

In its February 2009 Brief in Opposition to the Petition for Writ of Certiorari for *Jones*, Respondent Harris Associates sought to reconcile *Gartenberg* and *Jones*, arguing that the difference in standards is "one of articulation, not substance."<sup>56</sup> Harris Associates posited that any conflict in the standards was academic and that the two standards would produce the same legal outcome.<sup>57</sup>

The court decisions and legal arguments that seek to reconcile the *Jones* standard with the *Gartenberg* standard miss a fundamental premise in *Jones*. The decision in *Jones* rested upon the principle that section 36(b) specifically allows for judicial review of an adviser's fiduciary duty in relation to its fees.<sup>58</sup> Section 36(b) does not textually permit judicial intervention in fee setting as *Gartenberg* arguably might allow through use of the *Gartenberg*

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*Gartenberg*'s "disproportionately large" language. *Id.* In his dissent, however, Judge Posner rebuffed such reasoning, saying that the standards created by the two cases are, in fact, quite different. *Jones*, 537 F.3d 728, 729-32 (7th Cir. 2008).

52. 561 F.3d 816 (8th Cir. 2009).

53. *Id.* at 823-24.

54. *Id.* at 823.

55. *Id.*

56. Brief in Opposition at 13, *Jones v. Harris Assocs. L.P.*, No. 08-586 (U.S. Feb. 2, 2009).

57. *Id.* at 14, 16, 25.

58. See *infra* Part IIA.

factors, essentially creating a reasonableness test.<sup>59</sup> Hence, not only do the standards conflict in terms of understanding competition in the mutual fund market, but also the standards deviate in interpreting the section of the 1940 Act for which they were created to apply. Appropriate application of section 36(b) to management fee litigation cannot be achieved successfully given such divergent interpretations. The argument that the two standards would not produce different legal outcomes on a given case<sup>60</sup> should not dismiss the need to have a consistent interpretation of section 36(b) to guide both future shareholders in bringing actions under that section of the 1940 Act and courts in reviewing those challenges.

## II. POLICY ARGUMENTS AGAINST THE *GARTENBERG* STANDARD

Key policy arguments disfavor the *Gartenberg* standard and lend support to the new standard proposed in *Jones*. The *Gartenberg* standard relies on two central false assumptions. First, it leads courts to wrongly assume that section 36(b) contemplates a reasonableness standard. Second, *Gartenberg's* test relies on underpinnings grounded in the outdated 1960s belief that competition does not exist in the mutual fund industry.<sup>61</sup> The *Jones* standard corrects *Gartenberg's* misguided notions thereby allowing courts to properly apply section 36(b).

### A. Section 36(b) Does Not Provide a Legally Sufficient Basis for a Reasonableness Standard

Legal standards established to determine reasonableness have long perplexed scholars and courts.<sup>62</sup> The parameters that might define a reasonable fee are not set forth in section 36(b), nor should

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59. See *infra* Part II.A.

60. Brief in Opposition, *supra* note 56, at 16.

61. See *supra* notes 15-16 and accompanying text.

62. Coates & Hubbard, *supra* note 15, at 204 n.195 (“The key point is that the word ‘reasonable’ is far from precise; what one ‘reasonable’ person finds ‘reasonable’ another may not. As a result, if courts were charged with determining in the first instance whether a given fee was ‘reasonable,’ the result would be to transfer a substantial amount of discretion over fees from fund directors to judges.”).

they be.<sup>63</sup> The idea of a reasonable fee, if such a concept were to be applied, must then be arbitrarily defined. The management fee of each fund is unique to that fund's make-up and may be influenced by many factors, including the level and kinds of services provided to the fund, the fund's ability to outperform the market, and the types of individuals who might invest in the fund.<sup>64</sup>

Legislative discussions that took place at the time of section 36(b)'s formation leave scholars today with a hazy understanding of the drafters' intent.<sup>65</sup> The discussions do, however, make clear that Congress did not intend to create judicial fee regulation and that reasonableness language would be removed in the final draft of the regulation.<sup>66</sup> The Senate report accompanying section 36(b) states:

This section is not intended to authorize a court to substitute its business judgment for that of the mutual fund's board of directors in the area of management fees. It does, however, authorize the court to determine whether the investment adviser has committed a breach of fiduciary duty in determining or receiving the fee.<sup>67</sup>

Similarly, the Senate report notes, "This section 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."<sup>68</sup> Echoing these remarks, Chief Judge Easterbrook noted in *Jones*, "§ 36(b) does not make the federal judiciary a rate regulator, after the fashion of the Federal Energy Regulatory Commission."<sup>69</sup> These comments reflect the established notion that

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63. The drafters of section 36(b) intentionally removed the concept of a reasonable fee from the section as enacted. *See supra* notes 11, 14 and accompanying text.

64. *Investment Company Factbook*, *supra* note 10, at 64-67. For example, appellants in *Jones* protested the difference in fees for institutional clients. *Jones v. Harris Assocs. L.P.*, 527 F.3d 627, 631 (7th Cir. 2008). Chief Judge Easterbrook responded that the institutional clients, for the most part, demanded less and different kinds of services that justified different fees. *Id.* at 634. He remarked, "different clients call for different commitments of time... [J]oint costs are apportioned by elasticity of demand, not according to any rule of equal treatment." *Id.* at 634-35.

65. In *Jones*, the majority noted that the legislative history of section 36(b) contains "expressions that seem to support every possible position." *Id.* at 633.

66. S. REP. NO. 91-184 (1969), *reprinted in* 1970 U.S.C.C.A.N. 4897, 4897-4903.

67. *Id.* at 4902.

68. *Id.* at 4903.

69. *Jones*, 527 F.3d at 635.

section 36(b) does not allow for judicial fee regulation. A reasonableness standard would naturally depend upon such judicial fee setting since a reasonable fee range has not been established elsewhere.

The *Gartenberg* court imposed the idea of a reasonableness test on section 36(b) in directing courts to consider a fee's "reasonable relationship to the services rendered."<sup>70</sup> A fee must maintain this "reasonable relationship" so as not to be "disproportionately large."<sup>71</sup> *Gartenberg* established certain factors that a court might consider in determining the reasonable fee range, including: (1) advisory fees charged by similar funds; (2) the adviser's costs; (3) the type of services provided and the quality of those services; (4) whether fee levels are reduced as funds grow due to economies of scale; and (5) the number of transactions that the adviser processes.<sup>72</sup> These factors are aimed at providing a court with a foundation from which to determine an appropriate fee range for a fund. Essentially, if a court were to establish this range and find that the fund's fee did not fall within the range, then the court could find that the adviser had breached its fiduciary duty. As such, *Gartenberg* allowed for a reasonableness test.

Support for the reasonableness test promoted in *Gartenberg*, however, is not found in the wording of section 36(b).<sup>73</sup> Although relevant, the factors to be considered in determining a reasonable fee, as spelled out in *Gartenberg*, are peripheral to the fiduciary duty imposed by section 36(b). These factors are better suited, rather, to judicial review of a mutual fund board's considerations during the 15(c) process than to determining whether there was a breach of fiduciary duty by an adviser. Arguably then, there is no statutory basis from which to consider fees under the *Gartenberg* reasonableness standard in section 36(b) litigation.

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70. *Gartenberg v. Merrill Lynch Asset Mgmt., Inc.*, 694 F.2d 923, 928 (2d Cir. 1982).

71. *Id.*

72. See Copenhefer et al., *supra* note 51; see also Steven B. Boehm & Marguerite C. Bateman, *New Path Same Destination: The Effect of Jones v. Harris Associates on 36(b) Litigation*, THE INV. LAW., Aug. 2008, at 12.

73. 15 U.S.C. § 80a-35 (2006).

### *B. Competition in the Mutual Fund Industry*

*Gartenberg* rejected the possibility that competition might exist in the mutual fund industry.<sup>74</sup> The court relied upon a finding recorded in the Senate reports, accompanying section 36(b), that arm's-length bargaining did not occur between advisers and funds.<sup>75</sup> As a result of this reliance on outdated findings, the *Gartenberg* court framed a test incorporating the reasonableness standard discussed above.<sup>76</sup>

In *Jones*, Chief Judge Easterbrook discouraged present day reliance on the Senate report findings, remarking that beliefs about the mutual fund market at the time the reports were issued should not shape treatment of fees today.<sup>77</sup> He insisted, "Congress did not enact its members' *beliefs*; it enacted a text."<sup>78</sup> The view that competition is not an important force in the industry grew out of a study conducted at the Wharton School of Business in 1962, which presented "cutting edge" research that today is "primitive and misleading."<sup>79</sup> This dated view of the industry perceives that advisers and the funds they manage are entangled in a conflict of interest when it comes to setting fees.<sup>80</sup>

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74. The *Gartenberg* court hinted that competition in the mutual fund industry was "virtually non-existent." *Gartenberg*, 694 F.2d at 929.

75. S. REP. NO. 91-184 (1969), *reprinted in* 1970 U.S.C.C.A.N. 4897 ("Since a typical fund is organized by its investment adviser which provides it with almost all management services and because its shares are bought by investors who rely on that service, a mutual fund cannot ... sever its relationship with the adviser. Therefore, the forces of arm's-length bargaining do not work in the mutual fund industry.").

76. *See supra* Part II.A.

77. *Jones v. Harris Assocs. L.P.*, 527 F.3d 627, 633-34 (7th Cir. 2008).

78. *Id.* at 633.

79. Coates & Hubbard, *supra* note 15, at 153.

80. *Id.* at 158. This perceived conflict of interest arises if the adviser has no incentive to maintain low advisory fees and is guaranteed business regardless of the size of its fees. It is argued, "[i]f the 1960s view that conflicts of interest determine adviser fees was true, advisers would have no reason to reduce fees, and fees would steadily grow in the absence of price competition." *Id.* at 174.

Some have remained skeptical, claiming the conflict continues. Professors Freeman, Brown, and Pomerantz introduced the topic in a recent article, remarking:

Anyone looking for a truly good investment should not consider a mutual fund; instead, the choice should be stock in a mutual fund sponsor. Nobel Laureate Paul Samuelson realized this more than forty years ago: "I decided that there was only one place to make money in the mutual fund business-as there is only one place for a temperate man to be in a saloon, behind the bar and not in front

Chief Judge Easterbrook pointed to the dramatic changes that have taken place in the mutual fund industry since the 1960s. He referenced the seventy-three mutual funds that were in existence at the end of World War II, a number that did not expand greatly even in the 1960s.<sup>81</sup> Today, however, there are nearly 9,000 mutual funds with approximately \$9.6 trillion combined in assets.<sup>82</sup> Certainly, such a change in the size and number of mutual funds would affect the level of competition. In fact, management fees have experienced a downward trend since 1980, in part due to competition and economies of scale in the mutual fund market.<sup>83</sup> The *Jones* court recognized that this rise in the level of competition warrants an ease in judicial intervention.<sup>84</sup>

In a recent study on competition in the mutual fund industry, John Coates and Glenn Hubbard concluded that competition does exist and that it tends to regulate fees.<sup>85</sup> Chief Judge Easterbrook referenced this article in his opinion, citing the authors' additional conclusion that judicial regulation can be harmful.<sup>86</sup> Coates and Hubbard alluded to numerous influences that competition has on advisory services and fees, including regulation of fees and encouragement for advisers to provide exceptional services at competitive rates.<sup>87</sup>

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of the bar. And I invested in ... [a] management company."

John P. Freeman et al., *Mutual Fund Advisory Fees: New Evidence and a Fair Fiduciary Test*, 61 OKLA. L. REV. 83, 83 (2008).

81. *Jones*, 527 F.3d at 633. In 1966, for example, there were 379 mutual funds on the U.S. market with \$38.2 billion in assets. Coates & Hubbard, *supra* note 15, at 157.

82. *Investment Company Factbook*, *supra* note 10, at 8, 15.

83. *Id.* at 60-61 ("Ordinarily, such a sharp increase in the demand for fund services would have tended to limit decreases in fund expense ratios. This effect, however, was more than offset by the downward pressure on fund expense ratios from competition among existing fund sponsors, the entry of new fund sponsors into the industry, economies of scale resulting from the growth in fund assets and shareholder demand for lower cost funds.").

84. Chief Judge Easterbrook used the automotive industry as a metaphor, noting, "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?" *Jones*, 527 F.3d at 634.

85. Coates & Hubbard, *supra* note 15, at 153-54. The authors remarked that "[f]rom an economic perspective, competition is the best guardian against excessive fees." *Id.* at 153.

86. *Jones*, 527 F.3d at 634.

87. Coates and Hubbard noted:

Under competition, the desire to maximize profits forces firms to minimize costs in order to survive in the long term. Under competition, the initial desire of a seller to increase prices as high as possible is constrained by the presence of



In order to demonstrate the effect of competition upon fees, one must show how competition actually works in the mutual fund industry. Indeed, some critics continue to insist that competition does not exist.<sup>88</sup> Scholars have primarily focused on investor decision making as the driving force behind competition in an industry that offers investors the choice between thousands of funds.<sup>89</sup> The level of competition rises in tandem with the number of funds available to investors, who at some level make investment choices based on a comparison of fee levels with rates of return.<sup>90</sup> These choices will, in turn, coerce mutual funds to seek competitive advantages over each other, whether that is through lower fee levels or quality and extent of services.<sup>91</sup>

Some scholars have insisted that the majority of investors are unsophisticated and are not discriminating enough to drive competition between funds, leaving the market void of adequate

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other sellers, who will undercut excessive prices. Under competition, the initial desire of buyers, too, to decrease prices as low as possible will be constrained by the fact that sellers must earn enough to cover their costs, including a fair rate of return on their capital, and if they do not, they will exit the market.

Coates & Hubbard, *supra* note 15, at 159.

88. See Norris, *supra* note 19, at C1. (“[The 1940] Act seems to assume an industry structure that is very different from the actual one. It [wrongly] assumes mutual funds are formed by groups of investors.... In the real world, mutual funds are put together by sponsors.... The fund directors are chosen by the sponsor and ratified by the few shareholders who bother to vote.”).

89. Coates & Hubbard, *supra* note 15, at 164 (“The mutual fund industry offers many choices for investors, and with choice comes competition.”).

90. *Id.* at 166-67 (“With thousands of investment choices available ... the likelihood of price collusion is virtually zero. An individual firm gains more from deviating from a price-fixing agreement than by adhering to price collusion, so the likelihood of effective price collusion decreases with the number of firms.”). *But see* Joel B. Ginsberg, *The Dissent in Jones v. Harris Associates—Defending Gartenberg, Requesting Review*, Aug. 28, 2008, <http://www.articlebase.com/print/537424> (“[I]f the entire industry took advantage of the wide discretion offered it by Jones, and all fund advisers charged similar exorbitant fees, consumers would have no alternatives.”).

91. Coates and Hubbard contended, “any attempt by an adviser to charge excessive fees relative to the services offered will fail in the long run as investors move to lower-cost, higher-service or return investments.” Coates & Hubbard, *supra* note 15, at 159. They argued further, “firms have different business models and strategies. Some choose to compete for investors by offering extensive services, incurring higher costs with commensurately higher prices, while others choose to compete with less service, lower overhead, and lower prices.” *Id.* at 167.

competitive pressure.<sup>92</sup> This argument is meritless. First, many experts have acknowledged that even if the majority of investors are unsophisticated, those who are knowledgeable will make discriminating choices among funds, thus creating competitive pressure that regulates fees for the rest.<sup>93</sup> Management fees are a significant and noticeable portion of fund expenses.<sup>94</sup> Studies show average investors are increasingly paying more attention to fees in making their investment decisions.<sup>95</sup> This attention might be evidenced in the increasing popularity of low fee fund complexes, such as Vanguard.<sup>96</sup> Information on fund fees is readily available to potential investors through a number of sources.<sup>97</sup> “Thus, notwithstanding survey data suggesting that many investors are unaware of advisory fees, or theoretical arguments that investors fail to take them into account in a rational way,” the evidence suggests “many investors are aware of and act upon fees, either directly or indirectly.”<sup>98</sup>

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92. *Id.* at 200-01 (commenting that mutual funds, by nature, are popular because they allow the less knowledgeable investor to invest in securities).

93. *Jones v. Harris Assocs. L.P.*, 527 F.3d 627, 634 (7th Cir. 2008) (“It 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.”); 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, 1032-33 (2005) (“[B]ecause mutual fund shares are continually being offered and redeemed, ... any fund adviser seeking to increase assets will have to offer an attractive bundle of skillful portfolio management and credible shareholder protections lest it lose in the marketplace to higher quality competitors.... [C]onventional economic analysis teaches that the less sophisticated consumer will be protected so long as the producer realizes that it must persuade enough sophisticated consumers to purchase the same product.”).

94. Johnson, *supra* note 18, at 503 (“[F]ees paid to investment advisers are quite large in absolute dollar terms and can affect dramatically overall rates of return.”).

95. Coates & Hubbard, *supra* note 15, at 153 (“[E]nough investors are sensitive to advisory pricing that higher fees significantly reduce fund market shares.”).

96. During winter 2008, Vanguard’s homepage displayed an advertisement, stating, “Investment Costs Count. Keep more of what you earn. The average mutual funds charges about six times as much as Vanguard does. The difference can add up over time.” Vanguard Home Page, <http://www.vanguard.com> (last visited Nov. 8, 2008) (advertisement has since been updated); see also Coates & Hubbard, *supra* note 15, at 213.

97. See, for example, financial websites such as [www.morningstar.com](http://www.morningstar.com) and [finance.yahoo.com](http://finance.yahoo.com), individual fund websites such as [www.troweprice.com](http://www.troweprice.com) and [www.fidelity.com](http://www.fidelity.com), and the SEC’s website ([www.sec.gov](http://www.sec.gov)).

98. Coates & Hubbard, *supra* note 15, at 201-02.

*C. Fees Are Best Regulated by the Market (Not a Court)*

The *Jones-Gartenberg* controversy is essentially one focused on judicial intervention and whether that intervention is necessary to control the market and protect investors. One commentator summarized, “[t]he debate comes down to the old question of how much protection government—and the judiciary in particular—should provide consumers who may be vulnerable to market controllers.”<sup>99</sup>

The *Jones* decision implicated two levels of control over advisory fees, which alone adequately regulate the market. First, competition will regulate fee levels to fall within a range that investors are willing to pay.<sup>100</sup> Second, as a check on the market, Congress assigned advisers with a fiduciary duty with regard to their management fees.<sup>101</sup> These two levels of control, *Jones* indicated, will sufficiently regulate advisory fees, leaving little room for judicial intervention.<sup>102</sup> Chief Judge Easterbrook observed, “[t]he trustees (and in the end investors, who vote with their feet and dollars), rather than a judge or jury, determine how much advisory services are worth.”<sup>103</sup>

When section 36(b) was initially enacted, the Senate noted that the section was not a gateway for judicial intervention in fee setting.<sup>104</sup> Additionally, some scholars have cautioned against excessive judicial intervention.<sup>105</sup> They cite the more extensive market knowledge that fund directors and shareholders may have, as compared to the judiciary, in arguing that judges are ill-equipped to set management fees.<sup>106</sup>

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99. Ginsberg, *supra* note 90.

100. *See supra* Part II.B.

101. *See infra* Part III.

102. *See supra* Part I.B.

103. *Jones v. Harris Assocs. L.P.*, 527 F.3d 627, 632 (7th Cir. 2008).

104. *See supra* note 69 and accompanying text.

105. Coates & Hubbard, *supra* note 15, at 154 (“We argue that the evidence of competition in the market for mutual funds suggests caution for legal intervention in setting fees.”).

106. *Jones*, 527 F.3d at 633 (“Competitive processes are imperfect but remain superior to a ‘just price’ system administered by the judiciary. However weak competition may be at weeding out errors, the judicial process is worse—for judges can’t be turned out of office or have their salaries cut if they display poor business judgment.”); Coates & Hubbard, *supra* note 15, at 203 (“Judges are not generally experienced or capable business people, and ... [cannot] be reasonably expected to make better business judgments than disinterested, informed, and reasonably careful directors, who typically are experienced business people.”).

## III. SUFFICIENCY OF THE FIDUCIARY DUTY

A. *The Fiduciary Duty Trumps a Reasonableness Standard in Providing Guidance to Advisers in Setting Fees*

On its face, section 36(b) assigns a fiduciary duty to the adviser.<sup>107</sup> The *Jones* decision stated that this duty is sufficient and placed a check on advisers to maintain appropriate fees.<sup>108</sup> The meaning of the adviser's fiduciary duty in relation to its management fees, however, is not spelled out in section 36(b).

The *Jones* opinion set out to define the adviser's fiduciary duty by looking at the meaning of such a duty in other arenas and concluded that this duty is generally founded upon candor and the use of negotiation in fee setting.<sup>109</sup> Most commentators tend to agree with this interpretation that the fiduciary duty is fulfilled through negotiation of fees "candidly and without deceit."<sup>110</sup>

Perhaps the fiduciary duty in section 36(b) is not solidly defined because Congress wished for the duty to evolve over time to meet the market's needs.<sup>111</sup> In his review of mutual fund fee litigation, written shortly before the *Jones* decision, Lyman Johnson recognized, "[f]iduciary standards in business governance ... are not

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107. See *supra* Part I.A.

108. *Jones*, 527 F.3d at 633 ("Judicial price-setting does not accompany fiduciary duties. Section 36(b) does not call for a departure from this norm.")

109. Chief Judge Easterbrook first considered the law of trusts, referring to the Restatement of Trusts: "A trustee owes an obligation of candor in negotiation, and honesty in performance, but may negotiate in his own interest and accept what the settlor or governance institution agrees to pay." *Id.* at 632 (citing RESTATEMENT (SECOND) OF TRUSTS § 242 & cmt. f (1959)). He commented, "no court would inquire whether a salary normal among similar institutions is excessive." *Id.*

Chief Judge Easterbrook also noted that in corporations, in which independent directors have fiduciary duties in setting executive compensation, "[n]o court has held that this procedure implies judicial review for 'reasonableness' of the resulting salary, bonus, and stock options." *Id.* at 633.

Finally, Chief Judge Easterbrook considered the fiduciary duty of the lawyer. He noted that contested lawyer's fees are judged by whether the client made "a voluntary choice *ex ante* with the benefit of adequate information." *Id.* He noted that competition will win over litigation in determining the fee. *Id.*

110. Copenhaver et al., *supra* note 51.

111. This could be a good or a bad thing, depending on perspective. Lyman Johnson wrote, "fiduciary discourse in the mutual fund industry is hobbled (to the advantage of the investment advisers) by a flawed vocabulary." Johnson, *supra* note 18, at 501.

abstract and fixed principles, but rather exist in particular historical and institutional settings and must continually be informed by 'evolving standards' of expected conduct."<sup>112</sup>

The imposition of a fiduciary duty on the adviser proscribes the use of deceit or fraud in setting management fees.<sup>113</sup> In his dissent, Judge Posner questioned the adequacy of limiting a breach of fiduciary duty as such. He argued that the nature of the adviser-fund relationship complicated the duty and the ways in which it could be breached.<sup>114</sup> Others have suggested that the fiduciary duty requirement may be lacking.<sup>115</sup>

These arguments fail to recognize that the section 36(b) fiduciary duty, in fact, has the potential to guide adviser behavior beyond the boundaries set by a reasonableness test. The fiduciary duty standard requires "more exacting scrutiny" than a reasonableness standard, inviting review of the "totality of adviser conduct."<sup>116</sup> In sum, a court's review of fiduciary conduct will include not only an examination to determine the existence of fraud or deceit but also a general assessment of fiduciary conduct.

### *B. The Interplay Between Advisers' Fiduciary Duty and Independent Directors' Role in Approving Fees*

Although not the focus of this Note, section 36(b) litigation cannot be considered without recognizing the interplay between the section 36(b) fiduciary duty of the adviser and the responsibilities of the mutual fund board, namely the independent directors of the board.<sup>117</sup> The mutual fund board is tasked as the "watchdog"

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112. *Id.* at 529.

113. Chief Judge Easterbrook echoed this in saying that an adviser must "make full disclosure" and "play no tricks." *Jones*, 527 F.3d at 632.

114. Lea Ann Copenhefer et. al., *Dissent in Mutual Fund Advisory Fee Case Makes U.S. Supreme Court Review More Likely*, BINGHAM, Aug. 21, 2008, <http://www.bingham.com/Media.aspx?MediaID=7428> ("[D]irectors and advisers are often too cozy with each other, such that a court would be apt to miss evidence of a breach of fiduciary duty if it were only to assess whether an adviser had misled the board regarding the adviser's compensation.").

115. Johnson, *supra* note 18, at 534 ("[T]he 'fiduciary duty' regulatory approach to advisory fees adopted in Section 36(b) has failed to provide meaningful investor protection.").

116. *Id.* at 519.

117. One of the factors noted for consideration under the *Gartenberg* standard was the role of independent directors in approving management fees. *Id.* at 499.

supervisor of its management firm.<sup>118</sup> Indeed, fund boards have not escaped the kind of scrutiny that advisers have been subjected to. John Bogle, founder of Vanguard Group, once quipped that mutual fund boards often act not as “watchdogs,” but rather as “lap dogs.”<sup>119</sup> Warren Buffett expanded upon this sentiment saying that “‘boardroom atmosphere’ almost invariably sedates their fiduciary genes.”<sup>120</sup>

Despite criticism to the contrary, the SEC has found that most fund boards fulfill their fiduciary duties through careful review of advisers as well as management decisions.<sup>121</sup> Independent directors are required to consider advisory agreements annually, allowing them “the principal source of their leverage in dealing with the investment adviser.”<sup>122</sup> An Office of Economic Adjustment study found that boards significantly made up of independent directors, in contrast to those that are not, are “more likely to make decisions such as negotiating lower adviser fees that may potentially lead to

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118. *Burks v. Lasker*, 441 U.S. 471, 484-85 (1979) (“[The 1940 Act] was designed to place the unaffiliated directors in the role of ‘independent watchdogs,’ ... who would ‘furnish an independent check upon the management’ of investment companies.... In short, the structure and purpose of the [1940 Act] indicate that Congress entrusted to the independent directors of investment companies, exercising the authority granted to them by state law, the primary responsibility for looking after the interests of the funds’ shareholders.”).

119. Tom Lauricella, *Quarterly Mutual Fund Review—Independent Directors Strike Back—Shedding Lapdog Image, Boards Urge Lower Fees*, WALL ST. J., July 5, 2006, at R1.

120. Warren E. Buffett, Letter to the Shareholders of Berkshire Hathaway Inc., Berkshire Hathaway Inc., Annual Report (Form 10-K), at 8 (Feb. 27, 2004).

121. See U.S. GEN. ACCOUNTING OFFICE, GAO-03-763, GREATER TRANSPARENCY NEEDED IN DISCLOSURE TO INVESTORS 22 (2003), available at <http://www.gao.gov/cgi-bin/getrpt?GAO-03-763> [hereinafter G.A.O., GREATER TRANSPARENCY] (“[D]irectors ... review extensive amounts of information during the annual contract renewal process to help them evaluate fees and expenses paid by the fund. For example, they stated that they hire a third-party research organization, such as Lipper, Inc., to provide data on their funds investment performance, management fee rates, and expense ratios as they compare to funds of similar size, objective and style. They also compare ... performance and fees charged by 20 funds with a similar investment objective, including the 10 funds closest in size with more assets than their fund and the 10 funds closest in size with fewer assets. In addition to comparing themselves to peers, they explained that their board reviews the profitability of the adviser, stability of fund personnel or staff turnover, and quality of adviser services. Fund officials stated that their boards receive a large package of information that includes all of the necessary information to be reviewed for the contract renewal process in advance of board meetings.... Based on their review, SEC staff said that they have not generally found problems with mutual fund board proceedings.”).

122. Am. Bar Ass’n, *Fund Director’s Guidebook*, 52 BUS. LAW. 229, 248-49 (1996).

higher returns.”<sup>123</sup> One scholar has suggested that such boards “react somewhat faster and tolerate less underperformance.”<sup>124</sup>

#### IV. SUGGESTIONS FOR REFORM RELATED TO MANAGEMENT FEES

Prior to the decision in *Jones*, scholars and industry participants made numerous proposals for reforming the investment management regulatory scheme in order to better control the market, promote competition, and protect investors.<sup>125</sup> Some of the proposals advocated greater control, suggesting increased governmental and judicial intervention, whereas others suggested improvements in process and disclosure that would further invite investors, rather than the courts and governmental organizations, to participate in competitive processes regulating the market.<sup>126</sup> This Note agrees with the *Jones* decision and argues that judicial intervention in regulating fees is problematic and that competition in the marketplace, along with the fiduciary duty of an adviser, will provide adequate control. It suggests, however, that increases in competition can and should be encouraged by further promotion of investor activism. This can be achieved through requiring investor friendly management fee disclosure, as discussed below.<sup>127</sup>

##### A. A Review of Reform Proposals

Alan Palmiter reviewed the prominent suggestions for reform.<sup>128</sup> One proposal advocates the creation of a self-regulatory organiza-

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123. Johnson, *supra* note 18, at 513.

124. Langevoort, *supra* note 93, at 1040. An instance of such active participation took place in 2005, when the independent directors of the AIM Funds negotiated for \$3 million in fee reductions because they considered fees to be too high in relation to what, at the time, was considered poor performance by some of the funds. One of the directors, Albert Dowden, remarked, “There was a feeling we were now in charge, and we damn well better do the job right.” Lauricella, *supra* note 119, at R1. One source notes that, “In 2005, fees were reduced on 808 mutual funds, while they rose on 263 funds, according to data from Lipper Inc. Three years ago, in 2003, the trend went the other way: Fees rose on 417 funds and fell on 367.” *Id.*

125. See Tamar Frankel, *The Scope and Jurisprudence of the Investment Management Regulation*, 83 WASH. U. L.Q. 939, 953 (2005).

126. See generally Alan A. Palmiter, *The Mutual Fund Board: A Failed Experiment in Regulatory Outsourcing*, 1 BROOK. J. CORP. FIN. & COM. L. 165, 202-06 (2006).

127. See *infra* Part IV.B.

128. Palmiter, *supra* note 126, at 202-06.

tion to oversee the mutual fund industry.<sup>129</sup> Alternatively, the government could establish a mutual fund oversight board, similar to the public company accounting oversight board (PCAOB), that would establish uniform standards for fund governance.<sup>130</sup> Another suggestion posits the SEC mandate the addition of expert directors to fund boards, such as certified financial analysts.<sup>131</sup>

One interesting proposal suggests that mutual funds might be no worse off, and indeed might improve, with no board at all.<sup>132</sup> This concept would call for the creation of Unitary Investment Funds (UIFs), similar to certain European mutual funds.<sup>133</sup> There would be a statutory maximum for management fees covering all fund expenses—this would do away with the need for the board, shareholder voting, and judicial intervention.<sup>134</sup> The SEC staff, however, has dismissed this proposal as not providing “an adequate substitute for board review.”<sup>135</sup> Palmiter noted that “[a] lackadaisical watchdog may be worse than no watchdog at all.”<sup>136</sup>

*B. A Proposal Best Suited to Jones: Disclosure of Dollar Amount Fees Paid by Individual Investors*

As the *Jones* decision established, mutual fund advisory fees are best regulated through market forces and adherence by the adviser to its fiduciary duty as provided for in section 36(b).<sup>137</sup> Although the *Jones* standard is the most appropriate interpretation of section 36(b), as discussed in this Note, Chief Judge Easterbrook’s arguments regarding competition in the mutual fund industry can and should be continually built upon through encouraging investors to become more actively involved in “hiring” and “firing” advisers through their investment decisions.<sup>138</sup> William Armstrong, an

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129. *Id.* at 202.

130. *Id.*

131. *Id.*

132. *Id.* at 203. (“As one reform proponent pointed out a fund without directors would not make ‘an awful lot of difference and would be cheaper to operate.’”).

133. *Id.* at 203-04.

134. *Id.*

135. *Id.* at 204.

136. *Id.* at 208.

137. *See supra* Part I.B.

138. *See Jones v. Harris Assocs. L.P.*, 527 F.3d 627, 633-34 (7th Cir. 2008).



independent director of the Oppenheimer Funds, testified to the Senate Banking Committee: “Along with proper disclosure, competition among funds is likely to give shareholders a fairer and more efficient outcome than imposing additional unnecessary supervision on an industry that is already heavily regulated.”<sup>139</sup>

This Note suggests that the average investor might be better equipped to make investment decisions on management fees through disclosure in account statements of the actual fees paid by the investor.<sup>140</sup> Such disclosure would allow the investor to make a direct comparison of those fees with actual returns. Considering the argument that many investors do not thoroughly review mutual fund prospectuses and shareholder reports, much less Statements of Additional Information, this fee disclosure ideally should be provided to investors in account statements, such as the quarterly statement.<sup>141</sup> The investor is likely to pay more attention to this

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139. *Mutual Fund Regulation: Hearing Before the S. Banking, Housing, and Urban Affairs Comm.*, 108th Cong. 3 (2004) (statement of William L. Armstrong, Independent Director, Oppenheimer Funds).

140. Mutual funds are not currently required to provide individual investors with information on fund costs in specific dollar amounts paid by each investor. U.S. GEN. ACCOUNTING OFFICE, GAO-03-909T, ADDITIONAL DISCLOSURES COULD INCREASE TRANSPARENCY OF FEES AND OTHER PRACTICES 4 (2003), available at <http://www.gao.gov/cgi-bin/getrpt?GAO-03-909T> [hereinafter G.A.O., ADDITIONAL DISCLOSURES]. Enhanced disclosure, it is thought, would allow the *unsophisticated* investor to understand exactly what he is paying and how that relates to a fund's success. Commentators argue that investors are often tricked by advertising and that their misconceptions remain unrepaired as their investments continue. It has been noted:

If improved disclosure has the remedial and protective effects believed to follow from disclosure in capital markets, this change has the potential to be one of the most profound regulatory steps taken by the Commission. To understand why this is so, consider a recent *Forbes Magazine* survey finding that eighty-four percent of the surveyed investors believe that higher fund expenses result in higher performance by the fund.

James D. Cox & John W. Payne, *Mutual Fund Expense Disclosures: A Behavioral Perspective*, 83 WASH. U. L.Q. 907, 909 (2005) (citing Neil Weinberg, *Fund Managers Know Best: As Corporations are Fessing Up to Investors, Mutual Funds Still Gloss Over Costs*, FORBES MAG., Oct. 14, 2002, at 220). People buy into advertising: “[M]arketing not only matters, but matters a lot.” *Id.* at 910.

141. G.A.O., GREATER TRANSPARENCY, *supra* note 121, at 11 (“Quarterly statements, which show investors the number of shares owned and value of their fund holdings, are generally considered to be of most interest and utility to investors.”); see also G.A.O., ADDITIONAL DISCLOSURES, *supra* note 140, at 5 (“In a 1997 survey of how investors obtain information about their funds, [the Investment Company Institute] indicated that to shareholders, the account statement is probably the most important communication that they receive from a mutual fund company and that nearly all shareholders use such statements to monitor their

document, and the account statement presents the ideal format through which to provide individualized fee information. The investor will be able to directly compare fees paid against the amount his investment has earned in a given period. Not only would such disclosure enable the investor to actively promote competition, but it would likely encourage further competition among advisers for investor business.<sup>142</sup>

Various scholars, regulators, and industry participants have advocated enhanced disclosure in various forms and much progress has been made to date.<sup>143</sup> Today, investors shopping for mutual funds have available numerous financial websites, including Morningstar, which readily provide comparative fee information.<sup>144</sup> They may access most fund documents through individual mutual fund websites.<sup>145</sup> The SEC provides tools such as the Mutual Fund Cost Calculator on its website—this allows investors to discover “how costs add up over time” for a given fund.<sup>146</sup> Additionally, SEC rules now require: (1) that mutual fund prospectuses include fee tables showing management fees and charges as a percentage of net assets; and (2) that annual and semi-annual reports include tables showing the cost in dollars of a \$1,000 investment that incurred the fund’s actual return and expenses during the given fiscal period.<sup>147</sup>

The information provided to investors through these mediums is undoubtedly valuable, but questions remain as to whether investors utilize these sources and whether such sources, in turn, adequately equip investors with enough information to make the choice to “hire,” “fire,” or remain with an adviser.<sup>148</sup> James Cox and John

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mutual funds.”).

142. G.A.O., GREATER TRANSPARENCY, *supra* note 121, at 18 (“[W]hen an item is disclosed, investment advisers will likely attempt to compete with one another to maximize their performance in the activity subject to disclosure. Therefore, presenting investors with information on the factors that affect their return and that are within the investment adviser’s control could spur additional competition and produce benefits for investors.”).

143. Coates & Hubbard, *supra* note 15, at 161 (“All fees must be clearly and straightforwardly disclosed to public investors in fund filings with the SEC and in fund documents sent to investors.” (footnote omitted)).

144. *See supra* note 97.

145. *Id.*

146. The SEC Mutual Fund Calculator: A Tool for Comparing Mutual Funds, *available at* <http://www.sec.gov/investor/tools/mfcc/mfcc-intsec.htm>.

147. *See* Palmiter, *supra* note 126, at 178.

148. Cox & Payne, *supra* note 140, at 926, 935 (“Investor ignorance has persisted despite several earlier regulatory efforts.... [T]he format and particularity of the context in which

Payne noted in an article on expense disclosures, “we should question not only whether investors are provided with ample information but whether the information they receive is in a context that makes it processible by them so that their choices among competing funds appears more rational.”<sup>149</sup> The authors agree that *Gartenberg* guidance leads to assumptions concerning reasonableness that may be misguided and thus argue “if a regulatory governor for advisory fees is to be found, it is likely to be through ... enhanced disclosure.”<sup>150</sup> Disclosure of fees paid by an individual investor in dollar amount terms, provided in the quarterly statement, is a clear and straightforward way in which to show the investor how much he is paying in expenses as compared to how much he is making in return.<sup>151</sup>

One concern relating to a mandate of this additional disclosure is that the investor might not be able to utilize this information to compare his fees with those of other funds.<sup>152</sup> This is a valid complaint and a tricky one to confront. Some comparison information is now available to the active investor through the sources previously noted,<sup>153</sup> but it is questionable how many investors will research this information. It has been suggested that funds could provide fee information to the SEC, which would collect the information into a functional database for investor comparisons.<sup>154</sup>

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information is presented has a significant impact in decision-making by investors.”). One source noted, “As it is, funds can quietly take tens of thousands of dollars from an investor’s account yet fulfill disclosure obligations by printing a chart in a prospectus containing hypothetical returns.” Neil Weinberg, *Fund Managers Know Best: As Corporations are Fessing Up to Investors, Mutual Funds Still Gloss Over Costs*, FORBES MAG., Oct. 14, 2002, at 220.

149. Cox & Payne, *supra* note 140, at 911.

150. *Id.* at 925.

151. G.A.O., GREATER TRANSPARENCY, *supra* note 121, at 8 (“[M]utual funds disclose information about their fees as percentages of their assets whereas most other financial services disclose their costs in dollar terms”); *see also id.* at 54 (“Seeing the specific dollar amount paid on their shares could be the incentive that some investors need to take action to compare their fund’s expenses to those of other funds and make more informed investment decisions on this basis. Such disclosures may also increasingly motivate fund companies to respond competitively by lowering fees.”).

152. Cox & Payne, *supra* note 140, at 928 (commenting that an investor with information on the amount paid in fund expenses cannot use that alone to determine if he would pay more or less in a rival fund).

153. *See supra* notes 143-47 and accompanying text.

154. Cox & Payne, *supra* note 140, at 936 (“[F]unds should be required annually to calculate their expense ratio (as well as their net return) relative to other funds within their

Another concern relates to the cost of additional disclosure, tailored to the individual investor, when many shareholders invest through financial intermediaries.<sup>155</sup> A 2003 General Accounting Office (GAO) study, however, concluded that if the costs of implementing this additional disclosure were spread across investor accounts, the additional fee would be so minimal so as to increase the average investor's fee by only 0.000038 percent, which is approximately one-third of a basis point.<sup>156</sup> The study found that this amount equated to adding approximately \$1.07 to the average \$184 paid in fees by the typical mutual fund account containing \$28,000.<sup>157</sup> Furthermore, by providing this information to the investor in a quarterly statement, which is already tailored to the shareholder's investment, mutual funds can avoid the substantial costs that would arise in providing such individualized information in general investment literature such as the prospectus.

This proposed disclosure has been encouraged by scholars<sup>158</sup> and the GAO in its 2003 report on fee transparency.<sup>159</sup> The SEC has previously rejected this particular form of enhanced disclosure, citing the above concerns on cost and the lack of comparable fund information.<sup>160</sup> Given that each of these concerns might be effectively addressed, as discussed above, such concerns do not warrant dismissing the proposal altogether.

Additional disclosure, in the form of dollar amount fees paid by an individual investor, would motivate mutual fund shareholders to more actively participate in encouraging competition among advisers in the mutual fund industry. Although such competition currently exists, as spelled out by Chief Judge Easterbrook in

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comparable investment classification and to file this information with the SEC. Thereafter, the SEC could aggregate the information within discrete categories such that each fund thereafter can be compared on the basis of its expense ratio and net return with similarly classified funds.”).

155. *Id.* at 928-29 (“[F]inancial intermediaries, for example brokers and financial advisers, hold ... the accounts for their customers and would be required in many instances to assemble data supplied from many unrelated fund groups before the customer statements could be forwarded.”).

156. G.A.O., ADDITIONAL DISCLOSURES, *supra* note 140, at 6 n.3.

157. *Id.*

158. See Cox & Payne, *supra* note 140, at 935.

159. G.A.O., GREATER TRANSPARENCY, *supra* note 121, at 8.

160. Palmiter, *supra* note 126, at 178.

*Jones*,<sup>161</sup> it must be constantly fueled by informed investor decisions, which would be aided by such disclosure.

#### CONCLUSION

*Gartenberg* held sway in the mutual fund industry for over twenty-five years, encouraging courts to employ what essentially has become a reasonableness standard under the *Gartenberg* factors. The *Jones* court took issue with this flawed standard and held that section 36(b) of the 1940 Act clearly provides for a fiduciary duty that does not allow for a reasonableness test to guide and control fee setting within a competitive market. Section 36(b) indicates legal intervention may be necessary in the case that the fiduciary duty is breached through fraud or deceit, but it does not indicate that the duty is breached if fees fall outside arbitrarily set judicial boundaries of reasonableness.<sup>162</sup>

The deferential standard set forth in *Jones* is most appropriate for review of the mutual fund industry today, with nearly 9,000 funds vying for investors through offering competitive fees and services.<sup>163</sup> The *Jones* standard details a clear framework through which courts might approach section 36(b) litigation in the future. This Note argues that the *Jones* standard should, therefore, be adopted by the Supreme Court. In addition, this Note concludes that, although the *Jones* standard is most appropriate, it should not preclude further reform in the industry to encourage active investor participation and competition between advisers. The Court should encourage the SEC to adopt a new rule to require that funds provide investors, in their account statements, with disclosure of dollar amount fees paid. This enhanced disclosure will better equip mutual fund investors to make fee based decisions to retain or “fire” advisers.

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161. *Jones v. Harris Assocs. L.P.*, 527 F.3d 627, 633-34 (7th Cir. 2008).

162. *See supra* note 11.

163. *See supra* note 10 and accompanying text.

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