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## *Jones V. Harris Associates L.P.*: The Search For Investor Protection Continues ...

Ryan Bollman

Mark Andreu

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# **Jones v. Harris Associates L.P.: The Search for Investor Protection Continues . . .**

RYAN BOLLMAN\* & MARK ANDREU†

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In the midst of one of the most severe financial meltdowns, Judge Frank Easterbrook could have made matters worse for investors in an industry described as a multi-trillion dollar “trough from which fund managers, brokers and other insiders are steadily siphoning off an excessive slice of the Nation’s household, college and retirement savings.”<sup>1</sup> Furthermore, Judge Easterbrook’s potential death blow was based on what some describe as “an economic analysis that is ripe for reexamina-

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\* J.D. Candidate, 2011, University of Miami School of Law; B.S.B.A., Duquesne University. I would like to thank each of my family members, especially my parents and Gavin, as well as Natalie, for their unwavering support and encouragement. I also would like to thank my advisor, Professor Robert E. Rosen.

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1. John P. Freeman et al., *Mutual Fund Advisory Fees: New Evidence and a Fair Fiduciary Duty Test*, 61 OKLA. L. REV. 83, 140 n.219 (2008) (quoting Senator Peter G. Fitzgerald).

tion.”<sup>2</sup> Fortunately, the United States Supreme Court mitigated much of the potential impact that Judge Easterbrook’s opinion in *Jones v. Harris Associates L.P.*<sup>3</sup> could have had on investor interests. However, it has yet to be shown if the standard approved by the Supreme Court will actually protect those interests.

In Judge Easterbrook’s defense, the controversy surrounding section 36(b) of the Investment Company Act of 1940<sup>4</sup> (“section 36(b)”) was in full swing well before the Seventh Circuit’s decision in *Jones*. The story of section 36(b) takes place in a unique sector of the financial world: an industry in which the adviser who creates and operates a mutual fund,<sup>5</sup> at a considerable charge to investors,<sup>6</sup> also selects the members of the board charged with negotiating that adviser’s fee on behalf of the investors.<sup>7</sup> And, if that were not enough, investors are nearly powerless to replace the creator of a fund due to the insurmountable amount of dependency that investors have upon fund creators.<sup>8</sup> For decades, critics have been concerned about the inherent conflicts of interest in such an industry.<sup>9</sup> In fact, section 36(b) was created to ease those concerns.<sup>10</sup> But, throughout its past, section 36(b) has been tossed from one interpretation to another with one thing remaining constant:

2. *Jones v. Harris Assocs. L.P.*, 537 F.3d 728, 730 (7th Cir. 2008) (en banc) (Posner, J., dissenting).

3. 527 F.3d 627 (7th Cir. 2008), *vacated*, 130 S. Ct. 1418 (2010).

4. 15 U.S.C. § 80a-35(b) (2006).

5. A mutual fund is a management company. The company combines “money from many separate investors and then invests the whole in a portfolio consisting of stocks, bonds, and the like.” *Jones v. Harris Assocs. L.P.*, No. 04-C-8305, 2007 WL 627640, at \*4 (N.D. Ill. Feb. 27, 2007), *aff’d*, 527 F.3d 627 (7th Cir. 2008), *vacated*, 130 S. Ct. 1418 (2010).

6. *See Freeman et al.*, *supra* note 1, at 91 (noting that, as of November 2006, “annual payments for fund [advisers] and their affiliates and service providers totaled more than \$90 billion”).

7. *See John C. Coates IV & Glenn Hubbard, Competition in the Mutual Fund Industry: Evidence and Implications for Policy*, 33 J. CORP. L. 151, 158 (2007) (“A mutual fund is created and operated by the fund’s investment adviser, who also appoints the fund’s initial board of directors.”).

8. Mutual fund investors are so dependent upon fund advisers that there is almost no risk of termination. *See Freeman et al.*, *supra* note 1, at 84 (“[A]dvisers fac[e] virtually no risk of getting fired.”); *see also, Jones v. Harris Assocs. L.P.*, 537 F.3d 728, 731 (7th Cir. 2008) (en banc) (Posner, J., dissenting) (noting that the adviser who created the fund, in 1991, has been reselected by the board of directors every year).

9. *See Coates & Hubbard, supra* note 7, at 155–56 (noting that the *Wharton Report*, issued in 1962, along with a Securities and Exchange Commission report, issued in 1966, were issued in response to concerns regarding fees in the mutual fund industry).

10. *See SEC, REPORT ON PUBLIC POLICY IMPLICATIONS OF INVESTMENT COMPANY GROWTH*, H.R. REP. NO. 2337, at 125–49, 154 (2d Sess. 1966); *see also Migdal v. Rowe Price-Fleming Int’l, Inc.*, 248 F.3d 321, 326–27 (4th Cir. 2001) (noting that section 36(b) was enacted, in large part, due to concerns that savings from economies of scale were not being passed along to investors).

Under section 36(b), the investors always lose.<sup>11</sup>

This note argues that section 36(b) in its current form, as well as the Seventh Circuit's decision in *Jones*, fail to protect investors. It proposes that in drafting section 36(b), Congress passed the buck to the courts and overlooked both the secretive nature of the mutual fund industry and the motivating force that led to section 36(b)'s enactment. It also argues that the Seventh Circuit crafted an unfair test for determining whether an adviser breached its fiduciary duty under section 36(b). Furthermore, while the standard approved by the Supreme Court in its review of *Jones* was a step in the right direction, it still utilizes unworkable factors and will require congressional action to be effective. Part I of this note discusses the structure of a mutual fund and its inherent conflicts of interest. Part II analyzes the standards applied in excessive fee cases, prior to the Seventh Circuit's decision in *Jones*, and emphasizes the common struggle investors faced in those suits. It also traces the legislative history forming the backdrop to the *Gartenberg* opinion; and focuses on how different courts have applied the "*Gartenberg* factors"<sup>12</sup> for assessing a breach of fiduciary duty claim under section 36(b). Part III examines the Seventh Circuit's choice in *Jones* to abandon the *Gartenberg* factors and instead determine if a breach of fiduciary duty has occurred based on the adviser's honesty during fee negotiations. Part IV analyzes the Supreme Court's review of *Jones* which approved the *Gartenberg* factors and rejected the Seventh Circuit's approach. Part V argues that due to the inherent conflicts of interest discussed in Part I, a new standard for evaluating whether advisory fees are excessive is necessary. A recommended test is set forth that incorporates only two factors: (1) fees the adviser charges its institutional clients;<sup>13</sup> and (2) the economies of scale.<sup>14</sup> It then explores an industry-wide reform, which would allow section 36(b) to achieve its intended purpose. Finally, Part VI considers the future of section 36(b) claims after the Supreme Court's review of *Jones*.

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11. See Freeman et al., *supra* note 1, at 86 ("[N]o plaintiff has ever won a fee case brought under section 36(b).").

12. In *Gartenberg v. Merrill Lynch Asset Management, Inc.*, 694 F.2d 923 (2d Cir. 1982), the Second Circuit "analyzed § 36(b) and created the framework that has served as the starting point for interpreting a fund adviser's fiduciary duty." *Gallus v. Ameriprise Fin., Inc.*, 561 F.3d 816, 821 (8th Cir. 2009).

13. Institutional funds include pension plans, trusts, etc. Unlike mutual funds, institutional funds are not "captives" of their adviser because the adviser does not create the fund and subsequently appoint and control up to sixty percent of the fund's board of directors. See discussion *infra* Part I.B.

14. "Economies of scale" pricing is an economic theory that as a fund's assets increase, its advisory fees per capita should decrease. Freeman et al. *supra* note 1, at 97 n.49. The theory acknowledges that "it is not ten times more difficult for [an adviser] to decide to buy 100,000 shares of a company's stock rather than 10,000 shares." *Id.*

## I. MUTUAL FUNDS: AN ADVISER'S BALLGAME

Before diving into the controversial world of excessive fee jurisprudence, an overview of the structure and common practices of mutual funds is necessary. A mutual fund is created by an adviser who sells shares of the fund to investors, pooling the sums invested and purchasing various securities.<sup>15</sup> In turn, the adviser charges the investors a fee for servicing the fund.<sup>16</sup> As previously mentioned, the adviser also selects the initial board of directors, who are charged with negotiating the adviser's fee on behalf of the investors.<sup>17</sup> Fees charged by the adviser are subject to the board of directors' annual approval<sup>18</sup> and are usually based on a percentage of the net assets of a particular fund regardless of performance.<sup>19</sup> But just how large are those fees?

### A. Adviser Fees: A Great Deal—For Advisers

Adviser fees in the mutual fund industry are considerable to say the least. In a study of the best-performing American stocks over a twenty-five year period,<sup>20</sup> two of the top three performing stocks were from mutual fund advisers.<sup>21</sup> One of those advisers, Franklin Resources, had an overall return of 64,224% while the other, Eaton Lance, had an overall return of 38,444%.<sup>22</sup> During that same period, the overall return of the S&P 500<sup>23</sup> was only 2000%.<sup>24</sup> Even software giant Microsoft's overall return of 29,266% paled in comparison to the returns of leading advisers.<sup>25</sup>

Adviser fees have an even greater impact than executive compensation on investors' returns and should be cause for greater concern to

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15. See Coates & Hubbard, *supra* note 7, at 158; see also Samuel S. Kim, *Mutual Funds: Solving the Shortcomings of the Independent Director Response to Advisory Self-Dealing Through Use of the Undue Influence Standard*, 98 COLUM. L. REV. 475, 479 (1998) ("Mutual funds are defined as funds operated by investment companies that gather money from shareholders to invest in stocks, bonds, and other securities.").

16. See Coates & Hubbard, *supra* note 7, at 158.

17. See *id.*

18. See *id.*

19. See Kim, *supra* note 15, at 475–76. This payment structure also potentially perverts advisers' duties to investors by encouraging advisers to maximize a fund's net assets even if an increase in net assets does not benefit or is detrimental to individual investors. See Lyman Johnson, *A Fresh Look at Director "Independence": Mutual Fund Fee Litigation and Gartenberg at Twenty-Five*, 61 VAND. L. REV. 497, 504 (2008).

20. The study focused on the period beginning in 1983 and ending in 2008. See Freeman et al., *supra* note 1, at 90.

21. *Id.*

22. *Id.*

23. The S&P 500 is an index of the prices of large-cap common stocks and is intended to be representative of the industries in the American economy.

24. See Freeman et al., *supra* note 1, at 90.

25. *Id.*

investors. Although adviser fees are, in many ways, a type of executive compensation paid to external management, adviser fees have a much more substantial and direct impact on the returns of investors.<sup>26</sup> While executive compensation typically has only a minor impact on the price of a company's stock—if any impact at all—adviser fees come directly from investors' returns.<sup>27</sup> Thus, by raising an adviser's fee even by a fraction of a percentage, investors' returns will be reduced by an equal amount.<sup>28</sup>

To fully appreciate the controversy in the mutual fund industry, one must also understand investors' practical concerns.

### B. *Mutual Fund Advisers: Here to Stay*

Mutual fund advisers, as creators and operators of the fund, hold the fund "captive."<sup>29</sup> In a typical business, a firm's management is free to hire or fire outside service providers.<sup>30</sup> But, in the mutual fund industry, the arrangement is much different. Rather than the typical internal management structure, mutual fund advisers have de facto control of the fund and its board.<sup>31</sup> This arrangement is known as "external management" in the mutual fund industry, and nearly all mutual funds are captives of this structure.<sup>32</sup> The Senate Report accompanying the amendments to the Investment Company Act of 1940 ("ICA"), which created section 36(b), stated that:

Because of the unique structure of [the mutual fund] industry the relationship between mutual funds and their investment adviser is not the same as that usually existing between buyers and sellers or in conventional corporate relationships. 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, as a practical matter sever its relationship with the adviser. Therefore, the forces of arm's-length bargaining do not work in the mutual fund industry in the same man-

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26. See William A. Birdthistle, *Investment Discipline: A Behavioral Approach to Mutual Fund Jurisprudence*, U. ILL. L. REV. at 29–30 (forthcoming 2010), available at <http://ssrn.com/abstract=1412878>.

27. "Even an admittedly vast sum [of executive compensation] is still almost sure to be insignificant in comparison to the overall revenues of the corporation and thus to the growth or income associated with the company's stock." *Id.*

28. *Id.*

29. Even the United States Supreme Court has recognized that mutual funds are "captive." See Freeman et al., *supra* note 1, at 84 n.5 (citing *Burks v. Lasker*, 441 U.S. 471, 481 (1979) (noting that a fund "cannot, as a practical matter sever its relationship with the adviser").

30. *Id.* at 87.

31. *Id.*

32. *Id.*

ner as they do in other sectors of the American economy.<sup>33</sup>

In fact, mutual funds have been described as “captive shells” because of the substantial amount of control that advisers exercise over them—including the day-to-day management of the funds.<sup>34</sup> Advisers often even supply a fund with the necessary office space to conduct business.<sup>35</sup>

In light of substantial amount of control advisers exercise over a fund, investors should be concerned with their advisers’ motivations. Advisers, as external managers, are legally distinct from the funds they manage, possessing their own boards of directors and answering to their own shareholders.<sup>36</sup> Therefore, advisers are conflicted in that they owe a fiduciary duty in respect to receipt of compensation<sup>37</sup> and are also obligated to maximize profits on behalf of their own shareholders. As industry expert John C. Bogle<sup>38</sup> explained, one almost always finds a mutual fund

operated by external . . . management companies which seek to earn high returns for fund investors, to be sure, but seek at the same time to earn the highest possible returns for themselves. Some of these companies are publicly-held, in which case their shares are held by investors who own their shares for the same reason that investors own Microsoft or General Motors: To make money for themselves.<sup>39</sup>

Problems of reliance upon advisers, though, are not the only concerns faced by investors of mutual funds.

### C. *Mutual Fund Board of Directors: Investors’ Paper Tiger*

Investors seeking refuge from their captor advisers should be cautious in placing any reliance upon their fund’s board of directors. In many mutual funds, the members of the board of directors also serve on the boards of other mutual funds with the same adviser,<sup>40</sup> and many are handsomely compensated for their membership.<sup>41</sup> Members of the board

33. Birdthistle, *supra* note 26, at 12 (citing S. REP. NO. 91-184, at 5 (1970)).

34. See John A. Otoshi, *Class Action Treatment of Shareholders’ Suits Under Section 36(b) of the Investment Company Act*, 83 COLUM. L. REV. 2039 (1983).

35. *Id.*

36. See Kim, *supra* note 15, at 475.

37. See 15 U.S.C. § 80a-35(b) (2006).

38. John C. Bogle is the founder and former CEO of the Vanguard Group, one of the largest investment management companies in the United States.

39. Freeman et al., *supra* note 1, at 88.

40. See Migdal v. Rowe Price-Fleming Int’l, Inc., 248 F.3d 321, 328 (4th Cir. 2001) (“[M]embership on the boards of several funds within a mutual fund complex is the prevailing practice in the industry.”).

41. See *id.* (citing Krantz v. Fidelity Mgmt. & Research, 98 F. Supp. 2d 150, 157 (D. Mass. 2000)) (noting that compensation for directors, in some instances, ranges between \$220,500 and \$273,500 per year).

of directors, therefore, are doubly conflicted in that they are handpicked by the adviser and have a substantial financial stake in preserving their employment. To illustrate some of the effects of this financial conflict, in a study conducted by Morningstar, an independent investment research company,<sup>42</sup> directors who received compensation in excess of \$100,000 approved advisory fee agreements with an average of fifteen more basis points<sup>43</sup> in expenses than directors who received lesser compensation.<sup>44</sup> Therefore, it seems that the greater the financial stake of the board, the more willing the board becomes to approve to higher fees.

Directors' financial incentives are not the only reasons why investors should not rely upon their board of directors to safeguard their investment interests. Under the ICA, mutual fund directors are also permitted to have questionable connections to their fund's adviser.<sup>45</sup> For example, a person who is a brother-in-law, son-in-law, or grandson of the investment adviser's CEO is not statutorily precluded from serving as a director for a mutual fund of that adviser.<sup>46</sup> In addition, mutual fund directors are often influenced by their past business relations with advisory firms. A study focusing in part on the selection process that occurs when a fund needs to hire outside assistance, known as a subadviser, to aid the primary adviser in managing the fund came to some suspicious results. The study found that the more past business relations between a fund's directors and a particular subadviser, the more likely the directors were to select that subadviser to aid in managing the fund.<sup>47</sup> Furthermore, it also found that past business relations played an important factor in the adviser's selection of directors for the adviser's newly formed funds.<sup>48</sup> Past business connections also proved to be a positive predictor of both expense ratios and advisory fees.<sup>49</sup> These numbers should come as no surprise, and instead reinforce the skepticism surrounding directors' independence.

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42. Morningstar's mutual fund rating system is quoted in the *Wall Street Journal*, the *New York Times*, and other financial publications and was launched on the "belief that everyone should have equal access to reliable, comprehensive investment information." See Kim, *supra* note 15.

43. Basis points are equal to 1/100th of a percentage point, or 0.01%.

44. See Kim, *supra* note 15, at 497.

45. 15 U.S.C. § 80a-35(b) (2006).

46. See Johnson, *supra* note 19, at 526. Cases have arisen in which a director has had family ties to the adviser. See, e.g., *In re Emerging Commc'ns, Inc.*, 2004 WL 1305745, at \*34 (Del. Ch. May 3, 2004).

47. Camelia M. Kuhnen, *Business Networks, Corporate Governance and Contracting in the Mutual Fund Industry* 4-6, 24 (Mar. 1, 2007) (unpublished manuscript) (on file with Vanderbilt Law Review), available at <http://ssrn.com/abstract=849705>; see also Johnson, *supra* note 19, at 514.

48. See Johnson, *supra* note 19, at 514.

49. This means that the more past business relations between a particular subadviser and the board, the greater the adviser fee as compared to the assets of the fund. *Id.*



Unfortunately for investors, concerns regarding the questionable relationships between advisers and directors are complicated by yet another aspect of the interaction of the adviser and the board—how much influence directors actually exercise over the conduct of the adviser. As one mutual fund director observed:

Independence is a reflection of how you got on the board and how you can be taken off the board. Who puts you there and who keeps you there? Who can push you off? If the answer to those questions is the management company, then you are not independent of the management company. And if you are not independent of the management company, the notion that you can act effectively in an arm's-length bargaining capacity, vis-à-vis the management company, is silly.<sup>50</sup>

Some mutual fund directors have attempted to stand up for investors only to find themselves out of a job. For example, directors from the Navellier Series Fund found themselves in a dispute with their fund's adviser, Navellier Management Inc. ("NMI"), regarding NMI's failure to provide the board with certain information pertaining to a proposed merger.<sup>51</sup> During this dispute, NMI's annual contract expired and the board voted against renewal of the contract in favor of hiring a new adviser, Massachusetts Financial Services.<sup>52</sup> The board also voted for the removal of NMI's president, Louis Navellier, from the fund's board of directors.<sup>53</sup> However, NMI and its president were not willing to go quietly. Mr. Navellier filed a shareholder derivative suit<sup>54</sup> against the directors alleging a breach of the directors' fiduciary duties.<sup>55</sup> Perhaps the most significant aspect of the suit is that the directors were forced to reach into their own pockets to pay their legal expenses.<sup>56</sup> Although the directors eventually prevailed in the suit,<sup>57</sup> the tactics of Mr. Navellier and his company undoubtedly took a heavy financial toll on the directors.<sup>58</sup> In addition to the shareholder derivative suit, NMI began a proxy

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50. See Kenneth E. Scott, *What Role Is There for Independent Directors of Mutual Funds?*, 2 VILL. J.L. & INV. MGMT. 1, 4 (2000). Kenneth E. Scott is a director at American Century Funds and Dresdner RCM Capital Funds. See *id.* at 1.

51. See David A. Sturms, *Enhancing the Effectiveness of Independent Directors: Is the System Broken, Creaking or Working?*, 1 VILL. J.L. & INV. MGMT. 103, 106 (1999).

52. *Id.*

53. *Id.*

54. A shareholder derivative suit is lawsuit brought by a shareholder on behalf of a corporation against a third party, oftentimes someone within the corporation.

55. See *McLachlan v. Simon*, 31 F. Supp. 2d 731 (N.D. Cal. 1998).

56. See Sturms, *supra* note 51, at 106.

57. *Id.*

58. Many wondered why the Securities and Exchange Commission ("SEC") did not step in to support the directors. C. Meyrick Payne, a senior partner at Management Practice, a New York consulting firm, stated that "in this case, the Navellier directors did precisely what they were

battle to reinstate NMI as the fund's adviser and to remove the dissenting directors from the board.<sup>59</sup> Unfortunately for the directors, by the end of the dispute, there were not enough shareholder votes to oust the adviser, and the directors were forced to resign.<sup>60</sup>

The Navellier case is not the only example of directors losing their jobs after challenging the adviser. Directors at the Yachtman Fund also questioned the actions of their fund's adviser, Yachtman Asset Management ("Yachtman"), and, like the directors from the Navellier Series Fund, paid the price for their dissidence. Specifically, the directors were concerned about an apparent deviation in investment technique and violations by Yachtman employees of the mutual fund's code of ethics.<sup>61</sup> The directors also expressed concern regarding the disappointing performance of the fund.<sup>62</sup> In response, Yachtman sent the directors a letter stating that if the directors did not resign then they would be faced with a proxy battle seeking their replacement.<sup>63</sup> The letter also threatened personal financial repercussions to the directors if they attempted to challenge the proxy statement.<sup>64</sup> The directors, however, refused to resign.<sup>65</sup> In response, Yachtman filed suit to force a special meeting of shareholders to remove the directors from the board.<sup>66</sup> The directors, like the directors from the Navellier Series Fund, were forced to pay their legal fees from their own pockets.<sup>67</sup> The directors appealed to the SEC to intervene by asserting that they were being punished by Yachtman for fulfilling their duties as watchdogs of the fund.<sup>68</sup> The directors also claimed that Yachtman was attempting to take control of the fund and that if Yachtman were successful then its actions would have a chilling effect on directors at other funds.<sup>69</sup> Unfortunately for the directors, the SEC did not come to their aid, and Yachtman was able to obtain enough votes from the proxy battle to remove the directors from the board.<sup>70</sup>

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supposed to do . . . . But there was a moment when you wondered whether the SEC should have been a little more supportive." Edward Wyatt, *Empty Suits In the Board Room: Under Fire, Mutual Fund Directors Seem Increasingly Hamstrung*, N.Y. TIMES, June 7, 1998, at 31.

59. A proxy battle or proxy contest is a struggle between two corporate factions to obtain the votes of uncommitted shareholders. BLACK'S LAW DICTIONARY 1263 (8th ed. 2004).

60. See Sturms, *supra* note 51, at 107.

61. *Id.* at 109.

62. *Id.*

63. *Id.*

64. *Id.* at 109-10.

65. *Id.*

66. See David J. Carter, *Mutual Fund Boards and Shareholder Action*, 3 VILL. J.L. & INV. MGMT. 1, 28 (2001).

67. *Id.*

68. See Sturms, *supra* note 51, at 110.

69. *Id.*

70. *Id.*

Considering the outcomes of both the Yachtman and Navellier disputes, investors can hardly be expected to rest easy by relying on the power of the board.

In light of directors' financial conflicts, the oftentimes questionable relationships between advisers and directors, and advisers' ability to force out directors who attempt to meddle with their control, it is no wonder that many industry experts criticize the protection of the board. For example, industry expert John C. Bogle described mutual fund boards as "lapdogs" to their advisers rather than "watchdogs" for investors.<sup>71</sup> Mr. Bogle was not alone in his criticism of the effectiveness of mutual fund boards of directors. Financial expert Warren Buffett buttressed Bogle's assertion by stating that the "boardroom atmosphere almost invariably sedates [directors'] fiduciary genes."<sup>72</sup>

## II. EXCESSIVE FEE JURISPRUDENCE: DIFFERENT STANDARDS, SAME RESULTS

Investors, therefore, are presented with equally unappealing choices: continue dealing with the initial adviser and allow the board of directors to negotiate fees with their "boss"<sup>73</sup> or look for an alternative fund in an industry in which nearly all funds have the same conflicted management structure. Understandably, the conflicted relationship between advisers and investors has set the stage for a bevy of litigation regarding excessive fees.<sup>74</sup>

### A. *The Waste Test: The Wrong Standard for the Job*

Prior to the enactment of section 36(b), if an investor sought to invalidate an excessive fee, the investor would have to deal with the state courts' "waste test."<sup>75</sup> The waste test was proffered in *Saxe v. Brady*.<sup>76</sup> The investors in *Saxe* claimed that their adviser, Investment Management Company ("IMC"), violated its duty to the investors by charging an excessive fee despite gaining approval of the fee agreement

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71. Anna Leist, *Voting with Their Feet and Dollars: The Role of Investors and the Influence of the Mutual Fund Market in Regulating Fees*, 51 WM. & MARY L. REV. 261, 282 (2009) (citation omitted).

72. *Id.* (citation omitted).

73. See Daniel D. Birk, *Jones v. Harris Associates L.P. and the Limits of Public Choice Textualism* 20 (April 24, 2009) (unpublished manuscript), available at <http://ssrn.com/abstract=1392562> (noting that due to inherent conflicts of interest, "[t]he person agreeing to the fee . . . is essentially in the employ of the person demanding it.>").

74. See Coates & Hubbard, *supra* note 7, at 155 (noting that cases involving mutual funds accounted for nearly ten percent of all federal securities class action suits in 2003 and 2004).

75. See Freeman et al., *supra* note 1, at 124–25.

76. 184 A.2d 602 (Del. Ch. 1962).

from the directors and a majority of investors.<sup>77</sup> The investors argued that the fees charged were so excessive that they constituted an illegal waste of the fund's assets, which required unanimous investor approval.<sup>78</sup> Additionally, the investors claimed that the directors of the fund failed to protect investors' interests due to a conflict of interest, which resulted from certain directors owning stock in the parent company of IMC.<sup>79</sup> According to the investors, those directors who owned stock in IMC's parent company manipulated the other directors and the investors by inappropriately allocating costs and understating profits in order to gain approval of the agreement.<sup>80</sup>

The standard that the court set out proved to be exceedingly difficult. Because the investors had ratified the fee agreement, they had to prove that the fee agreement was an illegal waste.<sup>81</sup> To show that the agreement was an illegal waste the investors had to prove that the agreement was one that "no person of ordinary, sound business judgment would be expected to entertain in view that the consideration [of advisory services rendered] was a fair exchange for the value which was given."<sup>82</sup> Conversely, all that IMC had to show to defend against the claim was that any reasonable person would view the agreement as a fair exchange.<sup>83</sup> In applying the standard, the court relied heavily on fees charged to investors in other funds as well the investors' approval of the fee agreement despite the fact that the fee had quadrupled in just eight years.<sup>84</sup> After conceding that "the [adviser's] profits are certainly approaching the point where they are outstripping any reasonable relationship to expenses and effort even in a legal sense,"<sup>85</sup> the court concluded that the fee agreement was not unreasonable.<sup>86</sup>

*Saxe* illustrates the near impossibility of prevailing under the waste test. The waste test is premised on the notion that courts should not second guess the decisions of directors because directors are negotiating

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77. *Id.* at 604.

78. The fee agreement was not approved by every investor. Therefore, if the investors could prove that such agreement was an illegal waste, the investor ratification, which was not unanimous, would not have saved IMC from liability. *See id.* at 605.

79. The affected directors owned stock in Long Inc., the parent company of IMC. *Id.*

80. The investors claimed that Long Inc., IMC's parent company, had inappropriately allocated some of its own expenses, in the amount of \$978,416, to IMC in order to deceive investors of the true profitability of the fund. *Id.* at 606.

81. *Id.* at 605.

82. *Id.* at 606; Freeman et al., *supra* note 1, at 124-25; *see also* Kim, *supra* note 15, at 483 (citing Steiner v. Meyerson, Civ. A. No. 13139, 1995 WL 441999, at \*1 (Del. Ch. July 19, 1995)).

83. *Saxe*, 184 A.2d at 606.

84. *Id.* at 611 (noting that between 1952 and 1960, the fee grew from \$680,000 to \$2,780,000).

85. *Id.* at 616.

86. *Id.* at 618.

in the best interests of investors.<sup>87</sup> If the directors are conflicted, the waste test “cures” the conflict by requiring investor ratification of the directors’ actions. Investors who still believe that they are being charged an excessive fee despite investor ratification, like the investors in *Saxe*, must then prove an illegal waste of fund assets. To defend against such a claim an adviser needs only to demonstrate that *any* reasonable person might conclude that the deal made sense.<sup>88</sup>

The problem with applying the waste test in the mutual fund industry stems from the industry’s unique structure. In reality, boards of directors are created and controlled by their adviser.<sup>89</sup> Directors can be further conflicted by other substantial conflicts, such as ownership in the parent company of their fund’s adviser.<sup>90</sup> And, even if directors attempt to stand up for investors they typically lack the power to effectuate real changes in the behavior of their adviser which was illustrated by the *Navellier* and *Yachtman* cases.

Investors and Congress<sup>91</sup> soon realized that investor interests were not adequately represented in the fee negotiation room.<sup>92</sup> Specifically, concerns grew that advisers were not passing along the savings that resulted from economies of scale—the cost advantages that a business obtains due to expansion—to investors.<sup>93</sup> The SEC commissioned a study by the Wharton School of Finance and Commerce.<sup>94</sup> The *Wharton Report* was subsequently published in 1962.<sup>95</sup> The study found that “the structure of the [mutual fund] industry, even as regulated by the [Investment Companies] Act, had proven resistant to efforts to moderate advi-

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87. See Birk, *supra* note 73, at 20 (“Corporate waste is built upon an assumption that the board in most circumstances is negotiating in the best interests of the beneficiaries.”).

88. See Freeman et al., *supra* note 1, at 125.

89. See *id.* (“[T]he board is for all intents and purposes the creation of the adviser. . . . [F]und directors often sit on the boards of twenty or thirty of the funds organized by the same adviser . . .”).

90. In *Saxe*, certain directors on the fund’s board were also shareholders in the adviser’s parent company. See *Saxe*, 184 A.2d at 604.

91. See Freeman et al., *supra* note 1, at 125 (“Congress determined that, because ‘marketplace forces are not likely to operate as effectively,’ in the mutual fund industry, the corporate waste test was ‘unduly restrictive’ and needed to be relaxed.”) (citing S. REP. NO. 91-184, at 5 (1970)).

92. See Birk, *supra* note 73, at 20 (“[T]he independent board structure had also proved inadequate to resolve conflicts of interest leading to excessive fees . . .”).

93. See *id.* at 19–20 (noting that the SEC and Congress began to “fear that fund advisers were failing to pass along economies of scale to the fund customers.”). Economies of scale cause the average cost per unit to fall as scale is increased. Thus, a service provider, like a mutual fund adviser, can spread the same fixed costs over more investors’ accounts and incur less cost per account.

94. 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. 1962).

95. *Id.*

sor compensation.”<sup>96</sup> The *Wharton Report*, therefore, became the impetus for abandoning the waste test and providing investors with greater protection.

B. *Section 36(b): A Failed Attempt to Level the Playing Field*

In response to these growing concerns, Congress enacted section 36(b).<sup>97</sup> Under section 36(b), an adviser has a fiduciary duty with respect to the receipt of fees.<sup>98</sup> In addition, section 36(b) grants investors a cause of action against advisers for a breach of fiduciary duty.<sup>99</sup> With respect to such cause of action, an investor is not required to allege personal misconduct on the part of the adviser.<sup>100</sup> Most importantly, the investor is required to carry the burden of proving a breach.<sup>101</sup>

In drafting section 36(b), Congress left much to be decided by the courts. As stated above, section 36(b) places a fiduciary duty upon advisers with respect to the receipt of fees.<sup>102</sup> Congress’s formulation of the adviser’s duty in section 36(b) does little more than state the existence of a fiduciary duty without expounding any of the specifics of such duty. The term “fiduciary duty” can mean anything from the most minimal requirements of a bailee to the far more onerous responsibilities of an executor.<sup>103</sup> Justice Felix Frankfurter summarized the ambiguity of the term:

But to say that a man is a fiduciary only begins the analysis; it gives direction to further inquiry. To whom is he a fiduciary? What obligations does he owe as a fiduciary? In what respect has he failed to discharge these obligations? And what are the consequences of his deviation from duty?<sup>104</sup>

Presumably, Congress intended to incorporate the familiar common-law principles associated with fiduciary duty into section 36(b). It is the “well-established rule of construction that [w]here Congress uses terms that have accumulated settled meaning under . . . the common law, a court must infer, unless the statute otherwise dictates, that Congress means to incorporate the established meaning of these terms.”<sup>105</sup> Under

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96. *Id.* at 28–30, 34, 66–67.

97. *See id.*

98. *See* 15 U.S.C. § 80a-35(b) (2006).

99. *See id.*

100. *See id.* (“It shall not be necessary to allege or prove that any defendant engaged in personal misconduct . . .”).

101. *See id.* (“[P]laintiff shall have the burden of proving a breach of fiduciary duty.”).

102. *See* 15 U.S.C. § 80a-35(b).

103. *See* Birdthistle, *supra* note 26, at 35.

104. *Id.* at 35–36.

105. Brief for Petitioners at 20, *Jones v. Harris Assocs., L.P.*, 130 S. Ct. 1418 (2010) (No. 08-586) (quoting *Neder v. United States*, 527 U.S. 1, 21 (1999)).

the common law, a fiduciary has a strict duty of loyalty to act in the best interests of the beneficiary.<sup>106</sup> If a fiduciary negotiates with its beneficiary in a situation in which the fiduciary has an interest in the negotiation, the fiduciary must comply with two requirements.<sup>107</sup> First, the fiduciary must provide full and accurate disclosure of all the material facts.<sup>108</sup> And, second, the fiduciary must be fair to the beneficiary.<sup>109</sup> If the beneficiary fails to provide full and accurate disclosure of all the material facts or acts unfairly towards the beneficiary, then any agreement entered into is not binding on the beneficiary.<sup>110</sup>

By failing to elaborate upon the details of an adviser's fiduciary duty, Congress seems to have paid lip service to reform while passing the buck along to the courts to address the issue. For that reason, section 36(b) has failed to achieve its intended purpose of investor protection and has forced courts to fashion interpretations that yield entirely one-sided results. The failure of section 36(b) is due, in large part, to the secretive nature of the mutual fund industry. Investors in section 36(b) suits are expected to carry the burden of proof by proffering evidence that even the SEC is unable to obtain.<sup>111</sup> Section 36(b) also failed to address the issue of calculating the savings from economies of scale—the motivating force in section 36(b)'s enactment.<sup>112</sup> Therefore, despite being interpreted under multiple frameworks, section 36(b) suits do not present investors with a realistic chance to prevail.

### C. *The Gartenberg Standard*

In *Gartenberg v. Merrill Lynch Asset Management, Inc.*,<sup>113</sup> the court attempted to outline an adviser's fiduciary duty under section 36(b) by crafting what are now known as the "*Gartenberg* factors." In *Gartenberg*, investors in a mutual fund sued their adviser, Merrill Lynch, alleging the company violated its fiduciary duty under section 36(b) by collecting excessive fees.<sup>114</sup> The district court held that Merrill Lynch had not breached its fiduciary duty because it charged fees com-

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106. *Id.*

107. *Id.* at 21–22.

108. *Id.* (citing RESTATEMENT (SECOND) OF TRUSTS § 2 cmt. b. (2003)).

109. *Id.*

110. *Id.* at 23 (citing RESTATEMENT (SECOND) OF TRUSTS § 170 (2003)).

111. The mutual fund industry is so protective of its financial information that even the SEC's former Chief Economist, Erik Sirri, was unable to obtain the necessary data to conduct revenue, costs, and profitability analyses of the industry while serving in the SEC. See Freeman et al., *supra* note 1, at 131.

112. The SEC is also unable to obtain the necessary information to calculate the savings that advisers enjoy from economies of scale. See *id.* at 131 n.188.

113. 528 F. Supp. 1038 (S.D.N.Y. 1981), *aff'd*, 694 F.2d 923 (2d Cir. 1982).

114. *Id.* at 1040.

parable to those charged throughout the mutual fund industry.<sup>115</sup> The court rejected the investors' contention that the standard for determining a breach of fiduciary duty under section 36(b) should be whether the adviser charged "reasonable" fees.<sup>116</sup> Instead, the court focused primarily on whether the fees were "fair" in relation to the fees charged by other advisers to other money market funds.<sup>117</sup>

On appeal, the Second Circuit took a different approach to finding a breach of fiduciary duty under section 36(b). The court began its analysis by noting the competitive shortcomings among mutual funds.<sup>118</sup> As a result of these shortcomings, the court held that the test for a fee was whether it "represents a charge within the range of what would have been negotiated at arm's-length in light of all the surrounding circumstances."<sup>119</sup> In doing so, the appellate court explicitly rejected the district court's suggestion that reliance on prevailing industry advisory fees will satisfy the fiduciary duty found in section 36(b).<sup>120</sup> The court then listed six factors (now known as the *Gartenberg* factors) for assessing whether the fee negotiation took place at arm's length:

- (1) the nature and quality of the services provided by the adviser; (2) the profitability of the mutual fund to the adviser; (3) the extent to which "fall-out" benefits inured to the adviser; (4) the economies of scale realized by the adviser; (5) the fee structures of comparable funds; and (6) the independence and conscientiousness of the board of directors.<sup>121</sup>

After applying these factors, however, the Second Circuit reached the same result as the lower court—Merrill Lynch did not breach its fiduciary duty.<sup>122</sup>

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115. *Id.* at 1068.

116. *Id.* at 1045–53.

117. *Id.* A money market fund is comparable to a mutual fund. The main difference between the two is that money market funds, such as the fund in *Gartenberg*, invest primarily in short-term money market securities. *Id.* at 1040. A mutual fund, on the other hand, is likely to invest in a broader portfolio of stocks and bonds. *See Jones v. Harris Assocs. L.P.*, No. 04-C-8305, 2007 WL 627640, at \*4 (N.D. Ill. Feb. 27, 2007). However, the same excessive advisory fee analysis may be used regardless of the fund type. *See, e.g., Gartenberg v. Merrill Lynch Asset Mgmt., Inc.*, 694 F.2d 923, 925 (2d Cir. 1982), *cert. denied*, 451 U.S. 906 (1983) (pronouncing what would come to be known as the "Gartenberg factors" for analyzing a claim that a money market fund adviser charged excessive fees); *Migdal v. Rowe Price-Fleming Int'l, Inc.*, 248 F.3d 321 (4th Cir. 2001) (applying the *Gartenberg* factors in a case involving a mutual fund).

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

119. *Id.* at 928.

120. *Id.* at 929.

121. *Id.* at 928–31.

122. *Id.* at 934.



#### D. *The Gartenberg Factors: Consistently Inconsistent*

Since the pronouncement of the *Gartenberg* factors in 1982, courts have struggled to determine their proper application. For example, the Eighth Circuit, took a broad view of the *Gartenberg* test in *Gallus v. Ameriprise Financial, Inc.*<sup>123</sup> In analyzing investors' excessive fee claim,<sup>124</sup> the court stated that "[t]he *Gartenberg* case demonstrates one way in which a fund adviser can breach its fiduciary duty; but it is not the only way."<sup>125</sup> The court went on to hold that an adviser may also breach its fiduciary duty by lying or concealing information during fee negotiations.<sup>126</sup> In essence, the Eighth Circuit crafted its own, two-part test for excessive fee cases: (1) satisfaction of the *Gartenberg* factors; and (2) "a duty to be honest and transparent throughout the negotiation process."<sup>127</sup> While the Eighth Circuit's newly added prong is beneficial to investors in theory, the decision demonstrates the inconsistency of the application of *Gartenberg* and, in practice, does little to expand disclosure.

In *Migdal v. Rowe Price-Fleming International, Inc.*,<sup>128</sup> the Fourth Circuit applied *Gartenberg*,<sup>129</sup> but nonetheless failed to analyze all six factors. The facts of the case were substantially similar to those in *Gartenberg*; mutual fund investors sued their advisor under section 36(b).<sup>130</sup> The investors alleged that Rowe Price charged excessive fees because the adviser managed to increase its earnings by more than twenty percent even though the fund was underperforming.<sup>131</sup> However, the Fourth Circuit only analyzed the investor's breach of fiduciary duty claim under the first *Gartenberg* factor.<sup>132</sup> The court in effect found the plaintiffs' failure "to allege sufficient facts about the services that defendants offered in return for [advisory fees]"<sup>133</sup> to be dispositive.<sup>134</sup> Thus, the case was dismissed for failure to state a claim.<sup>135</sup>

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123. 561 F.3d 816 (8th Cir. 2009). Although the *Gallus* decision was not rendered prior to *Jones*, it is a notable example of a subsequent court applying the *Gartenberg* factors. *Id.*

124. *Id.* at 818.

125. *Id.* at 823.

126. *Id.*

127. *Id.*

128. 248 F.3d 321 (4th Cir. 2001).

129. *Id.* at 327.

130. *Id.* at 325. The investors also made allegations regarding violations of other provisions of the ICA, but failed to overcome the statutory presumptions of those claims. *Id.* at 331.

131. *Id.* at 327.

132. *Id.* ("[I]n order to determine whether a fee is excessive for purposes of Section 36(b), a court must examine the relationship between the fees charged and the services rendered by the investment adviser.").

133. *Id.*

134. *Id.*

135. *Id.* at 328.

The court's reasoning in *Migdal* illustrates the difficulty investors often experience in section 36(b) suits under *Gartenberg*. By requiring an investor to make allegations regarding a mutual fund's finances (such as the relationship between the fees charged and the services rendered), the *Gartenberg* factors ignore the difficulty of obtaining information in the mutual fund industry.<sup>136</sup>

### III. THE JONES DECISION: GARTENBERG HAS JUST LEFT THE BUILDING

Federal securities laws, of which the Investment Company Act is one component, work largely by requiring disclosure and then allowing price to be set by competition in which investors make their own choices. Plaintiffs do not contend that Harris Associates pulled the wool over the eyes of the disinterested trustees or otherwise hindered their ability to negotiate a favorable price for advisory services.

— Chief Judge Easterbrook<sup>137</sup>

Both investor concerns over excessive fees and the *Gartenberg* factors were also addressed in *Jones v. Harris Associates L.P.*<sup>138</sup> In *Jones*, Harris Associates (“Harris”) served as investment adviser to a complex of mutual funds.<sup>139</sup> The plaintiffs were shareholders of three funds (“the funds”) in the complex.<sup>140</sup> Pursuant to advisory contracts, Harris received a fee that was approved annually by the funds’ board of directors.<sup>141</sup> For the fiscal year ending in September 2004, Harris charged the funds over \$46 million more than the previous year.<sup>142</sup> Additionally, during the relevant time period,<sup>143</sup> Harris charged plaintiffs significantly more than its institutional clients with similar investment strategies.<sup>144</sup>

In August 2004, plaintiffs brought suit, alleging that Harris breached its fiduciary duty under section 36(b) by charging excessive advisory fees.<sup>145</sup> Specifically, the investors alleged that Harris had impermissibly retained the savings that resulted from economies of scale

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136. Even if an investor is lucky enough to obtain the necessary information, the investor will then have to deal with dueling expert analyses. See Freeman et al., *supra* note 1, at 86 (“*Gartenberg* demands fund shareholders prove their case with evidence that is usually hidden and, once found, subject to bitter disputes between the parties’ experts.”).

137. *Jones v. Harris Assocs., L.P.*, 527 F.3d 627, 635 (7th Cir. 2008).

138. No.04-C-8305, 2007 WL 627640 (N.D. Ill. Feb. 27, 2007).

139. *Id.* at \*1.

140. *Id.*

141. *Id.*

142. Respectively, the three funds were charged an additional \$13,577,704; \$23,529,291; and \$9,263,669 over the previous year. *Id.* at \*1–2.

143. See *id.* at \*1 n.2 (noting that Section 36(b) of the ICA limits damages to the year preceding the commencement of the action).

144. *Id.* at \*1–2.

145. *Id.* at \*2.

as the fund grew.<sup>146</sup> The investors—like the investors in *Migdal*—were unable to proffer the necessary evidence. In particular, the investors were unable to calculate precisely how much Harris had saved by way of economies of scale.<sup>147</sup>

The lower court employed the *Gartenberg* factors to determine if the fees charged by Harris were the product of arm's-length bargaining.<sup>148</sup> The court considered the fees Harris charged its institutional clients but found that “the amounts paid by different parties establish a range of prices that investors were willing to pay” for advice.<sup>149</sup> This range included institutional clients at the low end and mutual fund clients at the high end.<sup>150</sup> Because Harris's fees “fell within this spectrum of fees paid by both mutual funds and unaffiliated institutional clients,” the court concluded they were not excessive.<sup>151</sup> The court also noted the absence of evidence regarding the alleged savings that Harris enjoyed as a result of economies of scale.<sup>152</sup> Thus, Harris's motion for summary judgment was granted.<sup>153</sup>

The Court of Appeals for the Seventh Circuit affirmed.<sup>154</sup> Nevertheless, in doing so, the court explicitly disapproved the *Gartenberg* factors.<sup>155</sup> The court claimed that the “fiduciary duty” required by section 36(b) did not impose rate regulation; rather, it required an adviser's honesty and candor during fee negotiations.<sup>156</sup> As long as an adviser was honest throughout the process, it did not violate section 36(b).<sup>157</sup>

The Seventh Circuit then left the door open to fee comparisons among like funds in extraordinary circumstances.<sup>158</sup> Even under such extraordinary circumstances, however, the comparison was to be limited to other mutual funds—not institutional funds.<sup>159</sup>

The court of appeals denied a petition for rehearing en banc.<sup>160</sup> Five

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146. *Id.* at \*6–7.

147. *Id.* at \*7.

148. *Id.*

149. *Id.* at \*8.

150. *Id.*

151. *Id.*

152. *Id.*

153. *Id.* at \*9.

154. *Jones v. Harris Assocs. L.P.*, 527 F.3d 627, 635 (7th Cir. 2008).

155. *Id.* at 632 (“Having had another chance to study this question, we now disapprove the *Gartenberg* approach.”).

156. *Id.* (“A fiduciary must make full disclosure and play no tricks but is not subject to a cap on compensation.”).

157. *Id.*

158. *Id.* (“It is possible to imagine compensation so unusual that a court will infer that deceit must have occurred . . . but no court would inquire whether a salary normal among similar institutions is excessive.”).

159. *See id.* at 634.

160. *Jones v. Harris Assocs. L.P.*, 537 F.3d 728, 729 (7th Cir. 2008) (en banc).

judges dissented.<sup>161</sup> The dissenters stated that the panel based its “rejection of *Gartenberg* mainly on an economic analysis that is ripe for reexamination.”<sup>162</sup> They were also concerned with “growing indications that executive compensation in large publicly traded firms often is excessive because of the feeble incentives of boards of directors to police compensation.”<sup>163</sup> The dissenters asserted that, pursuant to *Gartenberg*, Harris’s fee should have been compared with both the fees charged by other mutual fund advisers and the fees Harris charged its institutional clients.<sup>164</sup>

#### IV. SUPREME COURT’S REVIEW OF *JONES*: WELCOME BACK *GARTENBERG*

The Supreme Court agreed to review *Jones* in March 2009.<sup>165</sup> In the opinion, the Supreme Court noted that “until the Seventh Circuit’s decision [in *Jones*], something of a consensus had developed regarding the standard set forth over 25 years ago in *Gartenberg*.”<sup>166</sup> According to the Supreme Court, “both petitioners and respondent generally endorse the *Gartenberg* approach, although they disagree in some respects about its meaning.”<sup>167</sup>

The first point of contention was whether comparisons to the fees charged to institutional clients were a pertinent factor under *Gartenberg*.<sup>168</sup> The Supreme Court decided that under 36(b) there was no “categorical rule regarding the comparisons of the fees charged [to] different types of clients.”<sup>169</sup> Therefore, the Supreme Court welcomed comparisons to the fees charged to institutional clients so long as the comparisons are given “the weight that they merit in light of the similarities and differences between the services that the clients in question require . . . .”<sup>170</sup> The Supreme Court warned that “[i]f the services rendered are sufficiently different that a comparison is not probative, then courts must reject such a comparison.”<sup>171</sup>

The next issue the Supreme Court addressed was the weight to be given to board approval of a fee agreement. In the Supreme Court’s view, a reviewing court must take into account “both procedure and sub-

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161. *Id.*

162. *Id.* at 730 (Posner, J., dissenting).

163. *Id.*

164. *See id.* at 732.

165. Sam Mamudi, *Government Takes Side of Investors*, WALL ST. J., June 26, 2009, at C11.

166. *Jones v. Harris Assocs. L.P.*, 130 S. Ct. 1418, 1425 (2010).

167. *Id.*

168. *Id.* at 1428.

169. *Id.*

170. *Id.*

171. *Id.* at 1429.

stance.”<sup>172</sup> When a board’s “process for negotiating and reviewing investment-adviser compensation is robust, a reviewing court should afford commensurate deference to the outcome of the bargaining process.”<sup>173</sup> On the other hand, “where the board’s process was deficient or the adviser withheld important information, the court must take a more rigorous look at the outcome.”<sup>174</sup> However, regardless of the sufficiency of the process implemented in approving a fee agreement, a reviewing court could still invalidate the fee if it “‘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>175</sup>

Finally, the Supreme Court disapproved of the standard set forth by the Seventh Circuit. In the eyes of the Supreme Court, the Seventh Circuit erred “[b]y focusing almost entirely on the element of disclosure . . . .”<sup>176</sup> Although *Gartenberg* may “lack sharp analytical clarity,” it “accurately reflects the compromise that is embodied in [Section] 36(b) and . . . has provided a workable standard for nearly three decades.”<sup>177</sup> But the Supreme Court declined to address whether the mutual fund industry is competitive, as Judge Easterbrook asserted, reasoning that “the debate . . . is a matter for Congress, not the courts.”<sup>178</sup> After the Supreme Court’s review of *Jones*, courts should implement the *Gartenberg* factors but allow for comparisons to institutional clients in light of the similarities and differences of the funds as a part of the analysis of “the fee structures of comparable funds.”<sup>179</sup>

## V. ANALYSIS: THE PROPER APPROACH TO EVALUATING EXCESSIVE ADVISORY FEES

Although the Supreme Court’s review of *Jones* is a step in the right direction, it will still require a reviewing court to analyze unworkable factors. The Supreme Court should have adopted a new test, which focuses solely on two points of interest: (1) compare the fees an adviser charges its mutual fund versus its institutional clients; and (2) determine whether the adviser has properly adjusted its fees based on the economies of scale. But to make this hypothetical test effective, the mutual

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172. *Id.*

173. *Id.*

174. *Id.* at 1430.

175. *Id.* at 1429–30 (quoting *Gartenberg v. Merrill Lynch Asset Mgmt., Inc.*, 694 F.2d 923, 928 (2d Cir. 1982)).

176. *Id.* at 1430.

177. *Id.*

178. *Id.* at 1431.

179. *See Gartenberg*, 694 F.2d at 928–31.

fund industry will need to undergo certain reforms that expand the current disclosure requirements.

A. *Applying the Gartenberg Factors in Their Entirety Has Proven To Be Unworkable*

The *Gartenberg* court provided some guidance in excessive advisory fee cases, but it established a test that has yielded inequitable results. Specifically, four of the six *Gartenberg* factors have proven to be unworkable and thus should be disregarded. Each of the four uniquely flawed factors have either been misapplied or, more commonly, rendered ineffective by the courts.

1. THE NATURE AND QUALITY OF THE SERVICES PROVIDED  
BY THE ADVISER

The first problematic *Gartenberg* factor is the nature and quality of the services provided by the adviser. As part of this analysis, the court begins by considering exactly what types of services the adviser provides to the fund.<sup>180</sup> Does the adviser limit its services to investment-related strategies, or (as is becoming more prevalent) does it also provide non-investment services, such as accounting? After determining what services the adviser provides, the court must assess the quality of those services.<sup>181</sup> Although this analysis may seem reasonable in theory, there is no way for courts to gauge the true value of either investment-related or ancillary services. Consequently, advisers are given significant latitude to justify their fees.<sup>182</sup>

For example, advisers have successfully defended the relationship between fees charged and investment-related services by pointing to a mutual fund's strong overall performance.<sup>183</sup> Conversely, however, courts have discounted the weight to be given to a fund's poor performance by stating that "[w]hile performance may be marginally helpful in evaluating the services which a fund offers, allegations of underperformance alone are insufficient to prove that an investment adviser's fees are excessive."<sup>184</sup> This treatment is indicative of courts' willingness to favor an adviser's fee justifications when funds over-perform while still giving it the benefit of the doubt when funds

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180. Caroline J. Dillon, *Survey: Do You get what You Pay for? A Look at the High Fees and Low Protections of Mutual Funds*, 2006 COLUM. BUS. L. REV. 281, 294 (2006).

181. *See id.* at 295.

182. *See id.*

183. *Krinsk v. Fund Asset Mgmt.*, 875 F.2d 404, 409 (2d Cir. 1989) (noting that the services provided by the adviser had been "only of the highest quality" because the fund "had the third best performance out of 56 prime money funds").

184. *Migdal v. Rowe Price-Fleming Int'l, Inc.*, 248 F.3d 321, 327 (4th Cir. 2001).

underperform. Additionally, advisers seeking to explain away ancillary fees can find refuge in SEC Rule 12b-1.<sup>185</sup> Courts have interpreted the rule as allowing advisers to boost current service fees in order to cover previous expenses.<sup>186</sup> Thus, advisers can justify potential disparities between fees charged and secondary services rendered by simply referencing expenses incurred in the past.<sup>187</sup>

## 2. THE FUND'S PROFITABILITY TO THE ADVISER

The second *Gartenberg* factor, the fund's profitability to the adviser, is equally troublesome. To determine an adviser's profits, courts are charged with the "virtually impossible task" of calculating the adviser's costs in servicing the fund.<sup>188</sup> Unfortunately, such data is not published.<sup>189</sup> The SEC's Chief Economist has gone so far as to admit that this necessary data is unobtainable.<sup>190</sup> Moreover, even when some data is available, disputes often arise over cost allocation issues.<sup>191</sup> For instance, when advisers provide multiple services to a fund, there is considerable room for disagreement over the cost of each separate function. The *Gartenberg* court itself encountered this problem. In *Gartenberg*, the Second Circuit considered three estimates of processing costs.<sup>192</sup> The first estimate showed a 38.4% profit, the second estimate showed a 9.8% profit, and the third estimate showed a \$7.7 million loss.<sup>193</sup> Similarly, in a subsequent excessive fees case, the Second Circuit heard contrasting expert testimony indicating that an adviser either enjoyed a \$47.5 million profit or incurred a \$77 million loss.<sup>194</sup> Presented with such gaping estimates, it is unreasonable for courts to somehow assign an accurate cost to advisers' services.

Additionally, even when an adviser is proven to have experienced extreme profits, courts have effectively rendered this factor inconsequential by refusing to set an upward limit on profit margins. In particular, the Second Circuit has held that a profit margin of over 77% did not render an advisory fee excessive.<sup>195</sup> The court articulated that such a

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185. 17 C.F.R. § 270.12b-1 (2010).

186. See *ING Principal Prot. Funds Derivative Litig.*, 369 F. Supp. 2d 163, 169 (D. Mass. 2005).

187. See Dillon, *supra* note 180, at 295.

188. *Schuyt v. Rowe Price Prime Reserve Fund, Inc.*, 663 F. Supp. 962, 978 (S.D.N.Y. 1987), *aff'd*, 835 F.2d 45 (2d Cir. 1987).

189. *Freeman et al.*, *supra* note 1, at 131.

190. *Id.*

191. *Id.*

192. *Gartenberg v. Merrill Lynch Asset Mgmt., Inc.*, 694 F.2d 923, 931 (2d Cir. 1982).

193. *Id.*

194. *Krinsk v. Fund Asset Mgmt., Inc.*, 715 F. Supp. 472, 489 (S.D.N.Y. 1988).

195. *Schuyt v. Rowe Price Prime Reserve Fund, Inc.*, 663 F. Supp. 962, 988 (S.D.N.Y. 1987), *aff'd*, 835 F.2d 45 (2d Cir. 1987). The 2d Circuit did not technically render this holding but

profit margin, without more, was not dispositive on the issue of whether the adviser had breached its fiduciary duty.<sup>196</sup> Hence, the question remains—why analyze a fund’s profitability to an adviser at all if this factor carries no bite?

### 3. FALL-OUT BENEFITS

The third *Gartenberg* factor requires consideration of the fall-out benefits that an adviser realizes as a result of its relationship to a fund.<sup>197</sup> Again, the inefficacy of this factor is evidenced in the *Gartenberg* decision itself. In *Gartenberg*, the investors alleged that the adviser gained significant “fall-out” financial benefits “in the form of commissions on non-Fund securities business generated by Fund customers.”<sup>198</sup> “Non-fund” business is equity security business—conducted between investors in a mutual fund and the fund’s adviser—that is unrelated to the mutual fund.<sup>199</sup> The court found that up to 38% of fund customers did non-fund business with the adviser.<sup>200</sup> Nonetheless, the court held that the investors had failed to meet their burden of showing that the commissions earned from this additional business were substantial enough to constitute a breach of fiduciary duty under section 36(b).<sup>201</sup> In essence, while proving that the adviser had realized fall-out benefits, the investors could not quantify their actual value.

Unfortunately, it is difficult for investors to ever quantify the value of fall-out benefits. The *Gartenberg* court surmised that “[i]t would not seem impossible, through use of today’s sophisticated computer equipment and statistical techniques, to obtain estimates of such [benefits].”<sup>202</sup> However, public disclosures of advisers’ various business interactions with a fund lack necessary detail.<sup>203</sup> The disclosures typically only summarize business dealings, making it nearly impossible for investors to ferret out useful data.<sup>204</sup> Moreover, advisers can always argue that a certain percentage of fund customers would have done non-

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rather upheld the lower court’s conclusion. The court qualified its holding in a footnote by stating: “The Court wishes to make clear that it is not holding that a profit margin of up to 77.3% can never be excessive. In fact, in other circumstances, such a profit margin could very well be excessive. For example, if advisory services being challenged were not of the highest quality and if the directors were not so obviously qualified, fully informed, and conscientious, a similar fee structure could violate Section 36(b).” *Id.* at 989 n.77.

196. *Id.*

197. Dillon, *supra* note 180, at 297.

198. *Gartenberg v. Merrill Lynch Asset Mgmt., Inc.*, 694 F.2d 923, 932 (2d Cir. 1982).

199. *See id.*

200. *Id.*

201. *Id.*

202. *Id.*

203. Freeman et al., *supra* note 1, at 137.

204. *See id.*



fund business with the adviser in any event. That is, there is no way to quantify the fund customers that would have inevitably sought out the adviser for non-fund business in the absence of a prior relationship.

Even if quantified, investors face an additional hurdle in proving that fall-out benefits result in a breach of fiduciary duty. Once fall-out benefits have been calculated, courts subtract the costs incurred in providing the additional services.<sup>205</sup> Courts then determine whether the remaining fall-out benefits, when combined with "other circumstances," are sufficiently excessive to violate Section 36(b).<sup>206</sup> What does and does not constitute an "other circumstance," however, has yet to be articulated. In light of the practical difficulties of obtaining and calculating information on fall-out benefits, this factor should be abandoned.

#### 4. THE INDEPENDENCE AND CONSCIENTIOUSNESS OF THE BOARD OF DIRECTORS

The final unworkable *Gartenberg* factor focuses on the independence and conscientiousness of the board of directors.<sup>207</sup> Courts have stated that the "expertise of the [board of directors], whether they are fully informed, and the extent of care and conscientiousness with which they perform their duties are among the most important factors to be examined in evaluating the reasonableness of compensation under Section 36(b)."<sup>208</sup> Assessing a director's *expertise* is usually a simple task. For example, it is rather effortless for courts to explore a director's educational and business background.<sup>209</sup> Determining whether directors are *fully informed* and exercise *care and conscientiousness*, on the other hand, is considerably more challenging. This inquiry necessarily involves looking into whether the directors participated actively in the advisory fee negotiations by demanding information relating to costs and revenues, selecting an accounting firm to analyze such information, etc.<sup>210</sup> Unfortunately, directors have been permitted to disclose their participation level in vague terms.<sup>211</sup> They often recite the many factors

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205. See *Krinsk v. Fund Asset Mgmt., Inc.*, 715 F. Supp. 472, 494-96 (S.D.N.Y. 1988).

206. *Id.* at 496.

207. *Gallus v. Ameriprise Fin., Inc.*, 561 F.3d 816, 826 (8th Cir. 2009).

208. *Krinsk v. Fund Asset Mgmt., Inc.*, 875 F.2d 404, 412 (2d Cir. 1989) (citation omitted).

209. See *Schuyt v. Rowe Price Prime Reserve Fund, Inc.*, 663 F. Supp. 962, 978 (S.D.N.Y. 1987) ("[The directors were] well-educated and well-regarded members of the financial community.").

210. See *Dillon*, *supra* note 180, at 300; see also *Freeman et al.*, *supra* note 1, at 138 (explaining that it was over twenty years after the lower court's ruling in *Gartenberg* when the SEC began to require mutual fund boards to disclose the material factors they considered in approving advisory contracts).

211. *Freeman et al.*, *supra* note 1, at 138 (noting that the SEC did not require boards to disclose the factors they considered in approving advisory contracts until over twenty years after the original *Gartenberg* decision).

considered but do not elaborate on how those factors were actually analyzed prior to settling on a fee.<sup>212</sup> This superficial analysis by directors comes as no surprise considering the fate of the directors of the Navelier and Yachtman cases who lost their jobs as a result of meddling in the affairs of their adviser. Thus, courts seeking to analyze this unworkable *Gartenberg* factor are merely reviewing a well-rehearsed script between the board and their adviser.

### B. Institutional Clients' Fees Provide the Necessary Benchmark

In *Jones*, the court of appeals dismissed the plaintiffs' complaint because Harris did not "pull the wool" over the eyes of the funds' board of directors during fee negotiations.<sup>213</sup> Ironically, however, courts have "pulled the wool" over their own eyes by ignoring the uncompetitive nature of the mutual fund industry.<sup>214</sup> Due to this lack of competition, it is aimless to compare the advisory fees of one mutual fund to those of another in assessing potential breaches of fiduciary duty under section 36(b). Courts should instead compare the fees an adviser charges its mutual fund clients to the fees it charges its institutional clients—for whom the adviser must compete in an open market.

Institutional funds (pension plans, trusts, etc.) comprise a competitive market for comparison because they are free from advisers' control.<sup>215</sup> Institutional funds are independent from advisers because unlike mutual funds, an adviser does not appoint their boards of directors. An independent board of directors eliminates potential conflicts of interest, allowing for arm's-length fee negotiations on the open market. A comparison to these funds would show that in charging "captive" mutual funds substantially more, an adviser abstains from arm's-length bargaining and thus breaches its fiduciary duty under Section 36(b).<sup>216</sup>

Critics of a fee comparison to only institutional clients advance two prevailing arguments. First, they claim that the fees paid by mutual fund and institutional clients establish a broad spectrum of what investors are

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212. *Id.*

213. *Jones v. Harris Assocs., L.P.*, 527 F.3d 627, 635 (7th Cir. 2008) ("Plaintiffs do not contend that Harris Associates pulled the wool over the eyes of the disinterested trustees or otherwise hindered their ability to negotiate a favorable price for advisory services.").

214. See discussion *supra* Part I.A.

215. Freeman et al., *supra* note 1, at 141; see also Brief for the United States as Amicus Curiae Supporting Petitioners at 29, *Jones v. Harris Assocs. L.P.*, 130 S. Ct. 1418 (2010) (No. 08-586) ("Because negotiations for [advisory fees to be charged institutional clients] typically occur between independent parties, each of which is subject to competitive pressures, they may provide better evidence of the prices that arm's-length bargaining would produce for the relevant services.").

216. See Freeman et al., *supra* note 1, at 141–42.

willing to pay.<sup>217</sup> The theory is that although institutional clients may pay less, they merely account for the lower-end of the spectrum.<sup>218</sup> If there is a range of fees that different investors are willing to pay, institutional investors paying a lower amount than mutual fund investors simply indicates that one investor is not willing to pay as much as the other.

The flaw in this argument is that it hinges on a faulty premise—that the market for mutual funds is competitive. Indeed, Judge Easterbrook's analysis in the Seventh Circuit *Jones* decision exemplifies this misconception. Judge Easterbrook contends that the mutual fund industry is competitive due to the sheer number of funds, as well as their relative ease of access.<sup>219</sup> He argues that thousands of funds compete and investors can readily search for them via the Internet.<sup>220</sup> But again, because the entire industry is contaminated by conflicted boards, there is no true competition.<sup>221</sup> Although investors may have a choice among funds, the funds come with an adviser—who can control the board of directors—already strapped to them.<sup>222</sup> The existence of a plethora of mutual funds merely establishes that there is a surplus in captivity. Hence, institutional funds do not form a segment of a broader competitive spectrum—they are the spectrum.

The second argument critics assert is that advisers charge institutional clients different amounts because they perform different services for them.<sup>223</sup> The court of appeals in *Jones* reasoned that different services mean “different commitments of time.”<sup>224</sup> However, in both mutual and institutional funds an adviser manages a complex of stocks. That the stocks may require marginally different services does not explain a sizeable gap in rates. After all, stocks are “not inherently harder to manage because the legal owner is a pension fund as opposed to being a mutual fund.”<sup>225</sup>

Comparing the fees an adviser charges its mutual funds versus its institutional clients provides the necessary framework under Section

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217. See *Jones v. Harris Assocs. L.P.*, No.04-C-8305, 2007 WL 627640, at \*8 (N.D. Ill. Feb. 27, 2007) (“[T]he [fees] paid by different parties establish a range of prices that investors [are] willing to pay.”).

218. *Id.*

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

220. *Id.* Judge Easterbrook attempts to bolster his argument by comparing the current state of the industry to that of the past. *Id.* (“At the end of World War II, there were 73 mutual funds registered with the Securities and Exchange Commission holding \$1.2 billion in assets. By the end of 2002, over 8,000 mutual funds held more than \$6 trillion in assets.”) (quoting Paul G. Mahoney, *Manager-Investor Conflicts in Mutual Funds*, 18 J. ECON. PERSP. 161, 161 (2004)).

221. See discussion *supra* Part I.C.

222. See discussion *supra* Part I.B.

223. Coates & Hubbard, *supra* note 7, at 185.

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

225. Freeman et al., *supra* note 1, at 110.

36(b). The alternative—comparing one mutual fund’s rates to another—is to assess breaches in fiduciary duty via reference to a commonly-flawed pool.

### C. *Adjusting Fees To Reflect the Economies of Scale*

Assessing the economies of scale is a second way for courts to determine if an adviser charges excessive fees under Section 36(b). “Economies of scale” pricing is an economic theory that as a fund’s assets increase, its advisory fees per capita should decrease.<sup>226</sup> The theory acknowledges that “it is not ten times more difficult for [an adviser] to decide to buy 100,000 shares of a company’s stock rather than 10,000 shares.”<sup>227</sup> This is especially true among mutual funds because unlike other types of funds, mutual funds rarely trade securities in their portfolios.<sup>228</sup> Moreover, shareholders in mutual funds tend to be long-term investors.<sup>229</sup> As a result, only marginal shareholder activity is likely to occur on any given day.<sup>230</sup> Each of these factors contributes to make the cost of managing a large fund substantially similar to the cost of managing a small fund.

The presence of economies of scale in the mutual fund industry was first documented by the *Wharton Report* in 1962.<sup>231</sup> The *Wharton Report* found that “[t]he relatively high rates commonly charged open-end companies by investment advisers do not appear to be a consequence of extensive services rendered to, or expenses incurred on behalf of, mutual funds.”<sup>232</sup> Further, the study determined that advisers had effectively concealed their realization of economies of scale by reporting the cost of servicing individual investors rather than reporting costs in the aggregate.<sup>233</sup> Shortly after the *Wharton Report* was published, the SEC conducted a similar study.<sup>234</sup> The SEC study supported the major findings of the *Wharton Report*. It reiterated that mutual fund advisers consistently failed to pass the benefits of economies of scale on to investors.<sup>235</sup>

Perhaps the overriding critique of the economies of scale theory is

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226. *See id.* at 97 n.49.

227. *Id.*

228. William P. Rogers & James N. Benedict, *Money Market Fund Management Fees: How Much is Too Much?*, 57 N.Y.U. L. REV. 1059, 1120 (1982).

229. *Id.*

230. *Id.*

231. Freeman et al., *supra* note 1, at 104.

232. Rogers & Benedict, *supra* note 228, at 1120 (citation omitted).

233. *Id.*

234. *See* SECURITIES AND EXCHANGE COMM’N, PUBLIC POLICY IMPLICATIONS OF INVESTMENT COMPANY GROWTH, H.R. REP. NO. 89-2337 (1966).

235. Rogers & Benedict, *supra* note 228, at 1080.

that it does not account for increased input.<sup>236</sup> Critics argue that as more money is invested, more advisers must be compensated, which leads to additional fees.<sup>237</sup> Stated differently, they contend that the advisory fee increases because the cost of input—i.e., labor—increases.

Still, this argument is defeated when an adviser's actual job function is considered. The adviser is constantly deciding how to invest a lump sum of money.<sup>238</sup> Indeed, the whole purpose of a mutual fund is to pool together separate shares.<sup>239</sup> Therefore, whether the fund consists of \$100 million or \$200 million in assets, the adviser has to make an identical investment decision. Of course, as a fund's net value increases, so does its potential losses. Critics may argue that an increase in potential losses necessarily prompts an advisory firm to perform additional analysis before making an investment decision. However, funds with the ability to charge excessive advisory fees are so large to begin with that they already perform extensive research and analysis before committing to an investment. Thus, compensating additional advisers as a fund grows is superfluous, because regardless of the fund's size, the necessary research and analysis has already been performed.

Even if it is conceded that a larger fund does somehow require more advisers than a smaller fund, the increased cost of labor would not justify a significant hike in advisory fees. Note that if a fund is charged a 1% fee, the fund is charged ten times more if it grows from \$10 million to \$100 million. However, allocating additional advisers to the growing fund does not substantially increase the advisory firm's costs. First, overhead costs are, for the most part, already in place. The cost of rent, lighting, etc. only increases marginally with each additional adviser that is employed. Second, the alleged necessity for "additional" advisers does not mean that ten times as many advisers are necessary. After all, it is not as if an additional adviser is employed for every dollar invested. At a certain point there can only be so many cooks in the kitchen. Hence, if the advisory firm only slightly increases its cost, it should only slightly increase its fee.

It is somewhat startling that more courts have not incorporated the economies of scale into their analysis. Data comparing fees charged to actual costs should not be ignored. Rather, courts should assess whether an adviser's fee properly accounts for the economies of scale the adviser realizes.

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236. See Coates & Hubbard, *supra* note 7, at 188.

237. *Id.* (arguing that economies of scale do not explain whether actual costs are declining).

238. See Freeman et al., *supra* note 1, at 130.

239. See *id.*

#### D. *Expanding Disclosure Requirements*

As the Supreme Court noted, the debate over whether the mutual fund industry is competitive is “a matter for Congress, not the courts.”<sup>240</sup> To make the comparisons to institutional clients and the analysis of the economies of scale useful, Congress must heed the Supreme Court’s call and require the mutual fund industry to expand its current disclosure requirements. With this sort of industry-wide reform, which draws upon the common-law principles of fiduciary duty,<sup>241</sup> section 36(b) (and its new two-pronged test) could be turned into the investor protection for which it was intended. In order to achieve this goal, Congress will need to address a major shortcoming of section 36(b), which is demonstrated by both the *Gartenberg* standard and the Seventh Circuit’s decision in *Jones*.

The continuing theme in the struggle for finding an effective interpretation of section 36(b) is an industry-wide lack of disclosure. Investors under both the *Gartenberg* and Seventh Circuit’s interpretation of section 36(b) are unable to make sound allegations regarding calculations that are pertinent to their claims.<sup>242</sup> If the burden in section 36(b) suits is to be carried by investors, advisers should provide investors with the necessary information to carry that burden.

Under the current law, advisers are only required to present potential investors with operating costs of servicing a fund, shown as a percentage of the fund’s net assets.<sup>243</sup> Once an investor purchases a share of the fund, the investor will no longer receive expense information.<sup>244</sup> Investors are only supplied with quarterly reports, which show the beginning and ending number of shares as well as the value of each share—without any indication of the amount of operating expenses already netted against such value.<sup>245</sup> Without itemizing the expenses that are used in arriving at the net value, investors never know how

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240. *Jones v. Harris Assocs. L.P.*, 130 S. Ct. 1418, 1431 (2010).

241. As previously discussed, under common-law principles, fiduciary duty in the context of a fiduciary negotiating with its beneficiary when the fiduciary has an interest in the negotiation requires the fiduciary to comply with two requirements. First, the fiduciary must provide complete disclosure. And, second, the fiduciary must act fairly towards the beneficiary. See discussion of common-law fiduciary duty, *supra* Part II.B; see also RESTATEMENT (SECOND) OF TRUSTS § 2 cmt. b (2003).

242. See, e.g., *Migdal v. Rowe Price-Fleming Int’l, Inc.*, 248 F.3d 321, 327 (4th Cir. 2001) (noting that investors failed to offer calculations regarding the relationship between fees and services rendered); *Jones v. Harris Assocs. L.P.*, No. 04 C 8305, 2007 WL 627640, at \*6–7 (N.D. Ill. Feb. 27, 2007) (noting that investors failed to offer calculations regarding economies of scale).

243. See U.S. GEN. ACCOUNTING OFFICE, MUTUAL FUND FEES ADDITIONAL DISCLOSURE COULD ENCOURAGE PRICE COMPETITION 13 (2000).

244. *Id.*

245. *Id.*

much they are paying for an adviser's services. If investors are to play any role in the safeguarding of their investments, whether in the context of deciding where to invest or whether or not to file suit for excessive fees, then they must be informed of what they are paying for the servicing of their fund through expense disclosure reports.

In particular, advisers should be required to provide investors with regular reports detailing the costs incurred in servicing a fund. These reports should indicate the individual fees paid by each investor.<sup>246</sup> The expense information regarding these fees should also detail the various expenses calculated in arriving at the total operating cost of servicing a fund.<sup>247</sup> Additionally, the reports need to calculate the reduction in the cost per unit of servicing the fund which occurs due to savings from economies of scale as the fund grows—the motivating force in Section 36(b)'s enactment. Therefore, under the new two-pronged test, investors would have a point of reference in assessing the savings that their adviser enjoyed as a result of economies of scale and whether or not that savings was passed on to them.

Most importantly, the reports should be conducted by independent auditing firms, which are forbidden to provide any other services to the adviser, including auditing other funds.<sup>248</sup> The lead partners of the independent auditing firm which audit a particular fund should be required to rotate every five years with another partner so that the auditors' independence is not jeopardized by a lengthy relationship with the adviser.<sup>249</sup> With such a restriction in place, the independent auditors would not become merely another paper tiger<sup>250</sup> like mutual funds' boards of directors.<sup>251</sup> Once the auditors have conducted thorough audits and have drafted a report detailing their findings, the reports should be compiled

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246. Currently, advisers are not required to disclose to investors the adviser fees paid by an individual investor. See Leist, *supra* note 71, at 285; see also U.S. GEN. ACCOUNTING OFFICE, *supra* note 243, at 13.

247. See John P. Freeman & Stewart L. Brown, *Mutual Fund Advisory Fees: The Cost of Conflicts of Interest*, 26 J. CORP. L. 609, 669–70 (2001).

248. A major concern of investors is the fact that compensation consulting firms, which aid in the fee-setting process, are often conflicted since they offer other services to the adviser. See *Jones v. Harris Assocs. L.P.*, 537 F.3d 728, 730 (7th Cir. 2008) (Posner, J., dissenting).

249. The accounting profession is subject to a similar restriction under the Sarbanes-Oxley Act of 2002. See Sarbanes-Oxley Act of 2002, Pub. L. 107-204, § 103, 116 Stat. 745 (2002) ("It shall be unlawful for a registered public accounting firm to provide audit services to an issuer if the lead (or coordinating) audit partner (having primary responsibility for the audit), or the audit partner responsible for reviewing the audit, has performed audit services for that issuer in each of the 5 previous fiscal years of that issuer.").

250. Paper tiger is the English translation of an ancient Chinese phrase used to describe something that appears powerful but in reality is weak.

251. In *Migdal*, investors were concerned about the members of the board of directors serving on between twenty-two and thirty-eight other boards of the same adviser. See *Migdal v. Rowe Price-Fleming Int'l, Inc.*, 248 F.3d 321, 325 (4th Cir. 2001). Restricting independent auditors to

into a listing with reports from other funds. These listings should be published and distributed publicly to any interested investor.

By requiring an outside auditor to supply the reports, Congress would mitigate the likelihood of biased reporting and increase investor confidence while fostering competition among advisers. As *Midgal* and *Jones* demonstrate, investors are not confident in the mutual fund structure.<sup>252</sup> Therefore, requiring self-disclosure would not ease investors' concerns. If disclosure comes from an outside auditor, investors would be less likely to question the findings. Additionally, an outside auditor's expense calculations would provide an unbiased account of the costs incurred and would mitigate the dueling-experts problem that occurred in *Gartenberg*.<sup>253</sup> Investors would also act as an additional oversight in the mutual fund structure by simply reviewing the unbiased reports. Furthermore, the compilation of each fund's expense report into a consolidated listing and the availability of these listings to any interested investor would foster competition. With a convenient comparison of each adviser's fee, investors would be provided with information that would enable them to "vote with their feet" by investing with the adviser who charges the lowest fee relative to performance, thereby increasing price competition among advisers.

Any change in the mutual fund industry will undoubtedly face opposition. Although critics of reform—presumably advisers (and their lobbyists)—may assert that the case has not been made that the mutual fund industry is in need of change,<sup>254</sup> both investors and advisers would benefit from unbiased disclosure. Requiring advisers to make available the information that is critical in justifying their fees is hardly a radical change and is not so onerous as to restrict or cap fees. It is merely requiring what consumers expect in nearly all transactions—an understanding of what they are paying for. And, considering the profits that advisers are enjoying in the mutual fund industry, a detailed explanation of the fees that generate those profits is warranted.<sup>255</sup> Undoubtedly,

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auditing only one fund and requiring partner rotation every five years will help to alleviate investor concerns about the relationship between the auditor and the adviser.

252. Investors in both *Migdal* and *Jones* filed suit despite approval of the fee agreements by the boards of directors. See *id.* at 327; *Jones v. Harris Assocs. L.P.*, 527 F.3d 627, 630 (7th Cir. 2008).

253. In *Gartenberg*, testimony from expert witnesses created doubt whether the adviser had enjoyed profit margins of either 38.4% or 9.8%, or suffered a loss of \$7.7 million. *Gartenberg v. Merrill Lynch Asset Mgmt., Inc.*, 694 F.2d 923, 931 (2d Cir. 1982).

254. See, e.g., Coates & Hubbard, *supra* note 7, at 213 ("Radical shifts in existing law, or for sweeping new laws and regulations, are unwise on the ground that the case has not been made that the existing framework for regulation of funds and advisory fees is intrinsically flawed.").

255. See Freeman et al., *supra* note 1, at 90 (noting that from 1983 to 2008, two of the top three performing American stocks were mutual fund advisers).



some financial calculations are susceptible to multiple interpretations, and the disclosure reports will be no exception. But providing an investor (and possibly a court) with an unbiased look at the costs of an adviser will allow for a point of reference, which could be deviated from if presented with persuasive evidence to the contrary. Also, whether or not the mutual industry is competitive, advisers could enjoy a reduction in litigation fees if such disclosure indicates that their fees are not excessive.<sup>256</sup> Although these reports will be an added expense to the operations of the adviser, it is a necessary cost to ensure fair dealing.

By mandating unbiased disclosure, Congress would give section 36(b) and the hypothetical two-pronged test the firepower it needs to achieve its intended purpose. Although the Supreme Court's review of *Jones* is a step in the right direction, unbiased disclosure is essential for investors to fully air their grievances under any framework of section 36(b).

## VI. CONCLUSION

In *Jones v. Harris Associates L.P.*, the Seventh Circuit created an unfair standard for determining whether a mutual fund adviser has breached its fiduciary duty in charging fees to investors. Under the court's relaxed standard—merely requiring honesty during fee negotiations—investors faced an incredible challenge in bringing a successful action against their fund's adviser.<sup>257</sup> The principal flaw in the court's analysis is that it does not account for the lack of competitive forces among mutual funds or the lack of disclosure in the mutual fund industry. Consequently, it fails to acknowledge that even if individual advisers are honest during fee negotiations, all advisers can still breach their fiduciary duties by charging excessive fees.

The Supreme Court acted prudently in vacating the Seventh Circuit's decision. However, in doing so the Court should not have resurrected the *Gartenberg* factors. Four of the six *Gartenberg* factors have proven to be unworkable and thus should be disregarded entirely.<sup>258</sup> The

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256. In 2003 and 2004, investors filed over 500 class actions and derivative suits against mutual fund advisers. *See id.* at 155.

257. *See Jones*, 527 F.3d at 632 (“A fiduciary must make full disclosure and play no tricks but is not subject to a cap on compensation.”). This is especially true given that only one investor ever made any headway in an action where a court applied the more stringent *Gartenberg* factors. *See generally Gallus v. Ameriprise Fin., Inc.*, 561 F.3d 816 (8th Cir. 2009) (holding that the lower court erred by rejecting a comparison between the fees charged to the adviser's institutional clients and its mutual fund clients). However, the plaintiffs in that case may have only won a battle and not the war. On remand, the defendant adviser, Ameriprise, will be afforded an opportunity to explain the disparity between the fees charged to its mutual fund clients and the fees charged to its institutional clients.

258. *See discussion supra* Part V.A.

correct analysis in excessive fees cases should proceed under a modified *Gartenberg* test. The only two factors that should be considered are: (1) whether the adviser charges its mutual fund clients a fee comparable to what it charges its institutional clients—for whom the adviser must compete for in an open market; and (2) whether the adviser has passed on to investors benefits realized based on the economies of scale. But this new test will only be effective if advisers provide investors with expansive expense disclosure.

As it stands, the future of section 36(b) claims for investors is bleak. Investors are forced to use unworkable tests to make allegations with information that they are unable to obtain. But if investors were provided with a proper test, focusing on meaningful comparisons and factors, along with the necessary information, section 36(b) might achieve the reform for which it was intended.

