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ABSTRACT

In the 1960s, the Securities and Exchange Commission (SEC) attempted to correct an oversight in the Investment Company Act of 1940 (ICA) that allowed investment management firms to overcharge investors, namely, the absence of enforceable protections over excessive fees. Congress, in the 1970 amendments to the ICA,[1] was influenced by the investment management industry and the resultant legislation sent ambiguous signals to the judicial system. Lacking clear guidance from Congress, in the seminal fee case Gartenberg v. Merrill Lynch,[2] the Second Circuit fashioned a fiduciary standard favorable to the investment management industry. Under this standard, no plaintiff has ever won an award under the revised ICA. Recently, the U.S. Supreme Court affirmed the Gartenberg standard and, in the process, amplified the original errors of the Gartenberg court. The economics underpinning advisory services have not changed, the overcharging persists, and the judiciary is forced into increasingly extreme rulings to maintain the fiction that advisory fees are reasonable.

In the forty years since Gartenberg, the judicial system and independent directors have systematically failed to protect mutual fund investors from excessive advisory fees. In Jones v. Harris Associates L.P.,[3] the U.S. Supreme Court acknowledged the lack of "analytical clarity" of Gartenberg and implicitly invited a resolution of the problem by sorting out the differences between advisory fees and fees determined by arm's length bargaining. The judicial system and Congress have shown no inclination to take up the challenge. Fortunately, the 1970 amendments to the ICA empower independent directors to address the problem. This paper explores these issues and proposes a path forward restoring mutual fund governance to its intended role of protecting mutual fund investors.

INTRODUCTION

Something is wrong with mutual fund fee litigation and mutual fund governance. Despite exponential growth in assets and economies of scale,

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1. *See generally* Investment Company Amendment Act of 1970, Pub. L. No. 91-547, 84 Stat. 1413 (1970) (codified as amended at 15 U.S.C. §§ 80a-1 – 80a-64 (2018)).
2. Gartenberg v. Merrill Lynch Asset Mgmt., Inc., 694 F.2d 923, 928 (2d Cir. 1982).
3. Jones v. Harris Assocs. L.P., 559 U.S. 335, 353 (2010) (Thomas, concurring).

management fees have been essentially constant for fifty years.[4] There has been a systemic failure to protect mutual fund investors from unfair fees. The blame falls squarely on the judicial system and fund governance.

Funds are captives of investment management firms that bring them into existence and manage their portfolios. Insulated from competitive forces, sponsors overcharge funds. An oversight by Congress in the Investment Company Act (ICA) unintentionally neutered fund governance with respect to advisory fees. Advised of these problems by the SEC, in 1970 Congress passed the 1970 amendments to the ICA making fund sponsors fiduciaries with respect to fees.[5] Since about 1970, directors have been on notice that mutual fund management fees are out of line with fees determined by arm's length bargaining.[6] The addition of § 15(c) to the statute was a clear attempt by Congress to empower independent directors.[7]

Gartenberg v. Merrill Lynch is the seminal case interpreting § 36(b), which established the legal framework adopted and applied by courts for the past forty years. The District Court found that fund trustees were reliable watchdogs of the interests of fund shareholders, creating a template that relieved subsequent courts of the obligation to scrutinize fees closely.[8] On appeal, the Second Circuit articulated what has become known as the *Gartenberg* standard: "To be guilty of a violation of § 36(b), therefore, the adviser-manager must charge a fee that is so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been the product of arm's-length bargaining."[9]

The *Gartenberg* standard has proved difficult for courts to apply and an unsurmountable obstacle for plaintiffs at trial. No plaintiff has ever received an award under § 36(b).[10] Analyzing fund governance, Palmiter characterizes trustees as "weak and even feckless"[11] and annual approval of the

4. Stewart Brown & Steven Pomerantz, *Some Clarity on Mutual Fund Fees*, 20 U. PA. J. BUS. L. 767 (2018). Some terms like investment management firm and plan sponsor are used interchangeably depending on context as are the terms trustees and directors and management and advisory fees.

5. Investment Company Amendment Act of 1970, Pub. L. No. 91-547, § 36(b), 84 Stat. 1413 (1970) (codified as amended at 15 U.S.C. § 80a-35 (2018)).

6. Investment Company Amendments Act of 1969, S. Rep. No. 91-184, at 5 (1969)

7. Investment Company Amendment Act of 1970, Pub. L. No. 91-547, 84 Stat. 1413, § 15(c) (1970) (codified as amended at 15 U.S.C. §§ 80a-15(c) (2018)). The 1970 ICA requires that a majority of the disinterested directors approve the investment advisory contract or underwriting contract after obtaining from the investment advisor and evaluating any information reasonably necessary to evaluate the terms of the contracts.

8. Gartenberg v. Merrill Lynch Asset Mgmt., Inc., 528 F. Supp. 1038, 1058 (S.D.N.Y. 1981), *aff'd*, 694 F.2d 923 (2d Cir. 1982).

9. Gartenberg, 694 F.2d, at 928.

10. *See* JAMES D. COX ET AL, SECURITIES REGULATION: CASES AND MATERIALS 1109 (6th ed. 2009) (stating "[s]ubsequent litigation in excessive fee cases has resulted almost uniformly in judgments for the defendants").

11. Alan R. Palmiter, *The Mutual Fund Board: A Failed Experiment in Regulatory Outsourcing*, 1 BROOK. J. CORP. FIN. & COM. L. 165, 165 (2006).

management contract as "empty ritual."[12] The Palmiter insights are apt but incomplete. Under current interpretations of the statute and case law, the power of trustees to negotiate fees appears to be limited.

The *Gartenberg* precedent was integral to bringing about the current state of mutual fund fees and fund governance. Its framework provided directors with boxes to check (the so-called *Gartenberg* factors) rather than forcing them to apply actual analysis and discretion. The *Gartenberg* interpretation of § 36(b) resulted in an outcome that has significantly favored the investment management industry at the expense of fund shareholders. Ultimately, *Gartenberg* is the source of the current overcharging of management fees by tens of billions of dollars annually.[13] This paper offers compelling evidence of the veracity of these charges, and, in the process, casts doubt on the whole edifice of post-*Gartenberg* fee litigation and fund governance.

The *Gartenberg* court and trustees knew or should have known of publicly available information on several funds with average assets a fraction of the size and average fees substantially lower than the named fund. In light of these competitors, the fees on the fund sponsored by Merrill Lynch in *Gartenberg* were so disproportionately large that they could not have been the product of arm's length bargaining. The sketchy fee information presented by the court directly conflicts with the information presented here. Moreover, the *Gartenberg* court stressed the diligence of trustees in surveying all information about competing funds. This cannot be true.

The District Court, with the aid of an anomalous fund described below, managed to obfuscate what should have been a clear win for plaintiffs. In the process the court inserted itself aggressively into trustee deliberations, corrupting all subsequent fund governance and case law. The Second Circuit, in a decision rife with ambiguity and logical fallacies, affirmed the District Court's decision. In 2009, the US Supreme Court reaffirmed *Gartenberg* as the appropriate standard in § 36(b) cases.[14] The opinion, written by Justice Samuel Alito, made it even more difficult for plaintiffs to prevail in § 36(b) cases. A pivotal ruling of the decision was supported by a single study commissioned by the Investment Company Institute.[15]

Following the Supreme Court's adoption of a revised *Gartenberg* standard, the structural causes of high fees have not disappeared. The judicial system issues increasingly implausible and extreme rulings to maintain the fiction that mutual fund fees are fair and reasonable and that trustees are faithful guardians of shareholder interests.

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12. *See id.* at 166.

13. Brown & Pomerantz, *supra* note 4, at 771.

14. *Jones*, 559 U.S. 335, 336 (2010).

15. Asher Hawkins, *Well-funded Opinion*, FORBES (May 8, 2009, 10:00 AM), https://www.forbes.com/2009/05/07/mutual-funds-fidelity-columbia-business-school-personal-finance-hubbard.html?sh=1e2d30312bea.

Recent rulings involving sub-advisory fees are emblematic of this. Plaintiffs argue that advisory fees are substantially greater than sub-advisory fees for the same services. Courts nevertheless allow defendants to rationalize the differences because fund sponsors are subject to "litigation risk."[16] Essentially, defendants argue: "We should be allowed to charge high fees because we bear the risk of being sued for high fees." Leaving aside the obvious circularity of reasoning, litigation risk is vague and unquantifiable. Litigation costs, when they occur, are a proper deduction from investment management profits, but to pre-emptively pad fees in anticipation of such costs is ludicrous on its face.

In keeping with common sense, fund trustees should negotiate the best deal possible for fund shareholders. Not so, according to the judiciary. In *Kennis v. Metro. W. Asset Mgmt*, a recent § 36(b) case, the court looked to the board chair (an independent director) who testified that "it wasn't the Board's responsibility to negotiate the amount of fees"; rather, all the board had to do was make sure "the fees were fair and reasonable."[17] Similarly, another court held that "[i]t is well settled that [the Investment Company Act] does not require negotiation between a board of trustees and fund investment adviser."[18] Fees are fair and reasonable according to the federal courts if they are consistent with the vague and subjective fiduciary standard established in *Gartenberg*.

The dispute boils down to a simple question—are management fees determined by market forces? It is well known that mutual fund management fees are systematically higher than fees on portfolios established by arm's length negotiation, e.g., pension and sub-advised accounts. This is not in dispute. What is in dispute, is an explanation for the differential.

The industry position is that market forces cause fees to reflect risk premiums and services bundled with management fees that are not provided to institutional accounts. The principal thesis of this paper is that the mutual fund investment management industry has successfully manipulated the political, judicial, regulatory,[19] and fund governance systems to maintain high fees.

16. *See, e.g.*, Sivolella v. AXA Equitable Life Ins. Co., No. 11CV4194PGSDEA, 2016 WL 4487857, at *42 (D.N.J. Aug. 25, 2016), *subsequently aff'd sub nom.* Sivolella for use & benefit of EQ/Common Stock Index Portfolio v. AXA Equitable Life Ins. Co., 742 F. App'x 604 (3d Cir. 2018); Chill v. Calamos Advisors LLC, 417 F. Supp. 3d 208, 234–35 (S.D.N.Y. 2019); Kennis v. Metro. W. Asset Mgmt., LLC, No. CV 15-8162-GW(FFMX), 2019 WL 4010747, at *28 (C.D. Cal. July 9, 2019), *adopted*, No. CV 15-8162-GW-FFMX, 2019 WL 4010363 (C.D. Cal. Aug. 5, 2019), *aff'd*, 821 F. App'x 895 (9th Cir. 2020).

17. Kennis, 2019 WL 4010747, at *9.

18. Chill v. Calamos Advisors LLC, No. 15 CIV 1014, 2018 WL 4778912, at *14 (S.D.N.Y. Oct. 3, 2018).

19. Stewart L. Brown, *Mutual Funds and the Regulatory Capture of the SEC*, 19 U. PA. J. BUS. L. 701 (2017).

The paper is organized as follows: Part II provides an overview of the ICA and the 1970 Amendment. Part III analyzes the seminal case law precedents implementing the fiduciary standard imposed by the 1970 amendment. Part IV briefly examines three subsequent cases which shaped the litigation environment prior to *Jones v. Harris*. It also surveys two important academic studies leading to *Jones v. Harris*. Part V scrutinizes the *Jones v. Harris* decision and Part VI analyzes its impact by reviewing subsequent sub-advisory fee cases. Part VII is an in-depth look at mutual fund governance and Part VIII summarizes the paper and arrives at certain conclusions.

I. THE ICA AND THE 1970 AMENDMENTS TO THE ICA

The origin of the current management fee disagreement is rooted in the 1940 ICA and the 1970 amendments. Congress refereed a dispute between the SEC, representing the public interest, and the investment management industry, incentivized to maximize profit for owners. Congress performed poorly.

In his 1967 testimony before Congress, SEC Chairman Cohen highlighted the conflict of interest at the center of the fee controversy:

> With respect to the fixing of investment advisory or management fees . . . an obvious conflict of interest exists between fund managers who staff and control the fund and whose representatives sit on the board of the fund, on the one hand, and the shareholders of the investment company on the other . . . [A] sellers' market exists in which the investment adviser, wearing one hat, sets his own fee without fear that the fund's board, on which he wears his other hat, can or will bargain effectively with him . . . [T]he 'few elementary safeguards' placed in the statute in 1940—requirement of approval by unaffiliated directors and confirmation by shareholders—have thus far been applied in such a way as to shield the fees from judicial scrutiny.[20]

In 1940, management fees were not viewed as presenting a serious problem. The investment management industry was so small that computing fees based on fund assets was unlikely to produce excessive fees. The industry claimed that liquidity constraints would "absolutely take care of this situation, and . . . there will never be an open-end investment trust with assets like life insurance companies and large banks."[21] This turned out not to be

20. *See Investment Company Act Amendments of 1967: Hearings on H.R. 9510 and H.R. 9511 Before the Subcomm. on Commerce & Fin. of the H. Comm. on Interstate and Foreign Commerce, Pt. 1*, 90th Cong. 34 (1967) [hereinafter *Investment Company Act Amendments of 1967 Hearings*] (statement of Manuel F. Cohen, Chairman, Securities & Exchange Commission).

21. *Mutual Fund Legislation of 1967: Hearings on S. 1659 Before the Comm. on Banking & Currency*, 90th Cong. 135 (1967) [hereinafter *Mutual Fund Legislation of 1967 Hearings*]. Cohen noted that in 1967 Congress thought that fund size was limited by the ability of securities markets to absorb large blocks of securities. *See Investment Company Act Amendments of 1967 Hearings*,

true: U.S. investment companies, including mutual funds, now manage over $29 trillion.

Congress included in the ICA provisions that neutered the ability of independent directors to police advisory fees. Essentially, by requiring shareholder approval, § 15(a) of the ICA[22] makes it impossible for independent directors to fire the adviser and hire another. Incumbent advisers are in a strong position to prevail in proxy contests because of the close association of the fund and the adviser, shareholder expectations, and information asymmetries. This is the core of the argument made by the SEC leading to the 1970 amendments to the ICA.

Congress included in the 1940 ICA a provision directing the SEC to study the impact of investment company growth and submit a report to Congress at a later date.[23] In 1958, the SEC commissioned the Wharton School of Finance to prepare a study of the effects of the growth in the industry. The "Wharton Study"[24] and a subsequent SEC report[25] included legislative recommendations. Both studies found that fund assets had grown substantially, but that advisory fees had not exhibited a commensurate decline.

The essence of the Wharton Study and PPI empirical findings are presented in Table 1.

Both studies found that mutual fund investors are overcharged relative to fees determined by arm's length bargaining. Both studies attributed this overcharging to the structural anomaly of mutual fund organizations in which there is an inseverable relationship between the fund and the fund sponsor/investment management firm. Neither the Wharton Report nor the PPI Study mentioned the level of sub-advisory fees. SEC Chairman Manuel Cohen did so in his testimony before Congress in 1967 and this evidence is summarized at the bottom of Table 1.

supra note 20, at 91. The thought at the time was that mutual fund liquidity put an upper limit on fund size of about $1 billion. As securities markets grew in size and volume, this turned out not to be a constraint. As highlighted by the SEC in 1965, large funds realized economies of scale but failed to pass along these economies to fund shareholders. *Id.* at 104.

22. Investment Company Act of 1940 § 15(a), 15 U.S.C. § 80a-15(a) (2018).

23. Investment Company Act of 1940, Ch. 686, 54 Stat. 789, § 14(b) (1940).

24. *See generally* WHARTON SCH. OF FINANCE AND COMMERCE, A STUDY OF MUTUAL FUNDS, H.R. REP. NO. 87-2274 (1962), http://sechistorical.org/museum/papers/1960/ [hereinafter Wharton Study].

25. *See generally* U.S. SEC. & EXCH. COMM'N, PUBLIC POLICY IMPLICATIONS OF INVESTMENT COMPANY GROWTH, H.R. REP. NO. 89-2337 (1966), http://www.sechistorical.org/museum/papers/1960/ [hereinafter PPI Report].

Table 1
Mutual Fund Advisory Fees Compared to Fees
Subject to Arm's Length Bargaining
1960-1967

	Advisory Fee Rates	Arm's Length Fee Rates	Average Portfolio Size
Wharton Report 1960-Other Customers*	**0.50%**	**0.176%**	**$100+ mm**
Wharton Report 1960-Internally Managed Funds**	**0.50%**	**0.187%**	**$100+ mm**
PPI Report - 1965 Bank Advisory Rates	**0.48%*****	**0.062%**	**$100 mm**
PPI Report - 1965 Internally Managed Funds	**0.48%*****	**0.149%******	**$100+ mm**
Cohen Testimony - 1967 Sub-Advisory Fees	**0.50%**	**0.114%**	**$100 mm**

* Distilled from WHARTON SCH. OF FINANCE AND COMMERCE, A STUDY OF MUTUAL FUNDS, H.R. REP. NO. 87-2274, 488, TABLE VII-42 (1962), http://sechistorical.org/museum/papers/1960/

** Distilled from WHARTON SCH. OF FINANCE AND COMMERCE, A STUDY OF MUTUAL FUNDS, H.R. REP. NO. 87-2274, 486, TABLE VII-40 (1962), http://sechistorical.org/museum/papers/1960/

*** U.S. SEC. & EXCH. COMM'N, PUBLIC POLICY IMPLICATIONS OF INVESTMENT COMPANY GROWTH, H.R. REP. NO. 89-2337, 104 (1966), http://www.sechistorical.org/museum/papers/1960/ (median fees)

**** U.S. SEC. & EXCH. COMM'N, PUBLIC POLICY IMPLICATIONS OF INVESTMENT COMPANY GROWTH, H.R. REP. NO. 89-2337, 103, Table III-5 (Weighted Average of Internally Managed Open-End Funds (1966), http://www.sechistorical.org/museum/papers/1960/.

Overall, the evidence in Table 1 shows that competitively determined fees were a fraction of the advisory fee rates charged to retail mutual fund investors. This was evidence of market forces at work where arm's length bargaining is extant and absent where it is not. Importantly, these studies identified a systemic problem: fees were too high in the industry as a whole, as compared to fees determined by arm's length bargaining.

The Wharton Report was critical of fund governance, finding that unaffiliated directors "may be of restricted value as an instrument for providing effective representation of mutual fund shareholders in dealings between the fund and its investment adviser."[26] Similarly, the SEC was highly critical of fund governance, arguing that trustees were beholden to fund management and ultimately ineffective in policing fees because of the inability to fire the investment manager.[27] The numbers in Table 1 support these observations.

Basically, the 1970 amendments to the ICA were the result of a political contest between the SEC representing the public interest and a rent-seeking investment management industry. A boxed-in Congress came down squarely on both sides of the issue, although leaning heavily toward the investment management industry.

In its report to Congress, the SEC "recommended that the statute be amended to expressly require that the compensation . . . to an investment company be reasonable, and that this standard be enforceable in the courts."[28] Unsurprisingly, the Investment Company Institute (ICI) had a different view. The following are excerpts from the 1967 House testimony of Mr. John R. Haire, ICI Chairman-elect:

> …we are not dealing with the regulation of dishonesty or mismanagement. We are dealing with proposals to regulate prices and profits in an industry which is free of monopoly, in an industry into which competition can enter freely, in an industry which fully discloses its charges to the public . . . Under the [proposed bill] various courts would be asked to determine whether a management fee is reasonable in the light of . . . vague and general standards. [The bill] imposes on the judge the duty to evaluate the reasonableness of the fee itself, attaching no particular weight to the evidence of the good faith and careful deliberation of the directors or the approval by the fund's shareholders who pay the fee. It in effect constitutes the judge as a "superdirector" charged with substituting his own judgment for the business judgment of the directors who have an intimate knowledge

26. Wharton Study, *supra* note 24, at 34.
27. PPI Report, *supra* note 25, at viii.
28. *Id.*

> of the fund's operation. The SEC thus in our judgment proposes a true rate making statute.[29]

Congress found these arguments persuasive. Prohibitions against rate regulation were conspicuous in the Senate Report underpinning the legislation.[30] Motivated to avoid the complexity of rate regulation, the judicial system embraced the prohibition. The investment management industry successfully propagated the myth that a reasonableness standard was analogous to public utility rate regulation.

The analogy is false. Public utilities are subject to rate regulation to protect the public interest. Mutual funds have independent board members tasked to protect shareholder interests. The ICI falsely claimed that independent directors were effective in the role. The SEC believed that when given a clear mandate, enforceable in court, that fees be reasonable, mutual fund boards would be effective in negotiating reasonable fees.[31] For those instances where fees continued to be unreasonable, the SEC envisioned that it would have a role in assisting the judiciary:

> But, since our proposal will not eliminate the basic conflict of interest inherent in the typical investment company structure, an adequate means of enforcement of the standard is essential. In this respect the availability of judicial review will provide an indispensable deterrent to unreasonable fees and will, we believe, greatly assist in preventing such fees. In the few cases in which it does not do so, actions to enforce the statutory standard of reasonableness in the courts could be brought by the Commission or, under well-established judicial precedent, by the investment company itself or by a shareholder on its behalf.[32]

The final "compromise" solution was to make plan sponsors fiduciaries with respect to fees. The statute signals caution about fund governance, validating the SEC position:[33]

> The investment adviser of a registered investment company shall be deemed to have a fiduciary duty with respect to compensation for services . . . an action may be brought under this subsection . . . for breach of fiduciary duty. . . In any such action approval by the board of directors . . . shall be given

29. *Investment Company Act Amendments of 1967 Hearings*, *supra* note 20, at 242 (statement of John R. Haire, Chairman-elect, Investment Company Institute).

30. S. REP. NO. 91-184, *supra* note 6, at 6.

31. "We believe that most investment company directors can be expected to heed the Congressional mandate that advisory fees and other charges for services made by investment advisers and other affiliated persons must be reasonable." *Mutual Fund Legislation of 1967 Hearings*, *supra* note 21, at 140. *See also Investment Company Act Amendments of 1967 Hearings*, *supra* note 20, at 46 (statement of Manuel F. Cohen, Chairman, Securities & Exchange Commission).

32. *Investment Company Act Amendments of 1967 Hearings*, *supra* note 20, at 44.

33. Importantly, in addition to adding § 36(b), Congress added § 15(c), which was meant to strengthen the role of independent directors. Generally, independent directors have failed to utilize § 15(c) and this is discussed *infra*.

> such consideration by the courts as is deemed appropriate under all circumstances.[34]

Parts of the Senate Report also validate the SEC position:

> Because of the unique structure of this industry . . . [t]he forces of arm's length bargaining do not work in the mutual fund industry in the same manner as they do in other sectors of the American economy . . . [Y]our committee has decided that there is an adequate basis to delete the express statutory requirement of "reasonableness," and to substitute a different method of testing management compensation. This bill states that the mutual fund investment adviser has a specific "fiduciary duty" in respect to management fee compensation . . . It also is in accordance with the traditional function of the courts to enforce such fiduciary duties in similar type relationships. [35]

The last sentence is important. It signals that Congress may have intended that traditional fiduciary standards be applied to mutual fund fees. This view was explained during an Executive Session of the Senate Committee on Banking and Currency at the request of the Chairman:

> Last year's bill had a section in it and the bill that was introduced this year that management fees would be reasonable. Now, the SEC and the mutual fund industry has gotten together and what they have really done is put the words "fiduciary duty" in the place of reasonable. The meaning of "fiduciary duty" would be fair, which is the way I see it is practically equivocable to reasonable.
>
> The mutual fund industry said it wanted the "fiduciary duty" in there because it had a more definite meaning in law. That is the big difference. All shareholders would have the right to sue for a breach of fiduciary duty as well as the SEC under this proposal. The courts would give some consideration to the approval of the fund's board of directors of the fee and the shareholder ratification would also be considered . . . [36]

"A more definite meaning in law" would clearly imply use of the existing fiduciary standard, discussed infra. This position is supported by what is not in the statute as well as what is in it. The amendments changed fee litigation by requiring that plaintiffs bear the burden of proof, as opposed to traditional fiduciary litigation where the opposite is true. Given this change, had Congress wanted a new fiduciary standard to apply, it would have specifically included that in the legislation. It did not.

The Senate, in its deliberations and the final report, seemed to make it clear that it wanted fairer fees. Making fund sponsors fiduciaries with respect

34. Investment Company Amendment Act of 1970, Pub. L. No. 91-547, § 36(b), 84 Stat. 1413 (1970) (codified as amended at 15 U.S.C. § 80a-35 (2018)).

35. S. REP. NO. 91-184, *supra* note 6, at 5–6.

36. Executive Session of the Senate Committee on Banking and Currency (May 12, 1969), 91st Cong., 1st Sess., at 3 (statement of Stephen J. Paradise, Assistant Counsel to the Committee).

to fees was the ostensible vehicle to achieve this result. However, in the balance of the report, the Senate included language which essentially endorsed the status quo:

> In reporting this bill, your committee recognizes the importance of permitting adequate compensation and incentives so that men of ability and integrity will continue to be attracted to the mutual fund industry . . . Your committee recognizes the fact that the investment adviser is entitled to make a profit . . . It is not intended to introduce general concepts of rate regulation as applied to public utilities . . . This section is not intended to authorize a court to substitute its business judgment for that of the mutual fund's board of directors in the area of management fees . . . This provision does not represent a finding by the committee as to the level of fees in the industry. Your committee does not believe itself qualified to make such judgments. Nor is it contemplated that the Commission would seek a general reduction of fees on an industrywide basis.[37]

The ambiguities are glaring. The forces of arm's length negotiation do not operate in regard to mutual fund fees, but Congress wants adequate compensation for men of ability and integrity. Courts are not to depend too much on fund governance but are not to substitute their judgment for that of directors.[38] Rate regulation is not permitted, and the committee does not think overall fees are too high. Finally, the SEC has standing to sue but is not to seek a general reduction of fees on an industrywide basis.[39] The overall message is clear: fund sponsors are fiduciaries in name only.[40]

The revised ICA and the Senate Report sent conflicting signals, allowing Congress to straddle the issues and escape the political box it was in. In the process, it neutered the SEC with respect to fees and effectively gave the judicial system the job of sorting it all out.

The ICA as amended in 1970 combined with the Wharton and PPI Reports is quite clear. Congress wanted fairer fees and acknowledged that the forces of arm's length bargaining do not operate in the mutual fund industry. The proposed solution was to make fund sponsors fiduciaries and there are

37. S. REP. 91-184, *supra* note 6, at 4–7. The legislation also provided for a one year look back period for damages. This effectively limited monetary penalties and ignored the general principle that the damages period should conform to the period of wrongdoing.

38. A further ambiguity is that ICI and the 1940 ICA referred to the whole board of directors. Boards were dominated by (up to 60 percent) individuals loyal to fund sponsors. The Wharton Report and SEC argued that disinterested (independent directors) directors were ineffective in controlling fees because of an inability to fire sponsors. The statute did tighten slightly the rules concerning who could serve as an "independent" director. These issues are discussed below.

39. S. REP. 91-184, *supra* note 6, at 4–7.

40. The ambiguity has been noted elsewhere. Well-known authors have commented that "[t]he language of subsection (b) is a lesson in the art of studied ambiguity in drafting of statutes." RICHARD W. JENNINGS & HAROLD MARSH, SECURITIES REGULATION CASES AND MATERIALS, 1394, 1397 (4th ed. 1977).

indications that Congress expected the existing fiduciary norm to apply.[41] Given that Congress had said that the forces of arm's length bargaining do not operate for advisory fees and given the Wharton and SEC empirical findings summarized in Table 1, mutual fund advisory fees clearly did not carry the "earmarks of arm's length bargaining." There was no need to establish a unique fiduciary standard for mutual fund advisory fees.

The judiciary faced an essentially binary choice. Either the statute would restrain fees or it would not. Any restraint on fees must involve standards in some form and it would fall to the judiciary to enforce such standards. Congress said it wanted fair fees and did not think an industry-wide reduction of fees was necessary. It is impossible to have both. The judiciary had to choose, and the 1970 ICA amendments and the Senate Report were ambiguous enough to support either choice. Instead of applying the existing fiduciary standard, the judicial system established the new and unique *Gartenberg* standard. Its subjective nature and pro-industry orientation resulted in pro-industry case law precedents that are increasingly extreme and nonsensical. Case law is examined next.

II. ADVISORY FEE CASE LAW PRECEDENT

With the passage of the 1970 amendments to the ICA, the investment management industry faced two problems. It needed to rehabilitate fund governance and obviate the Wharton/PPI/Cohen comparison of advisory fees to fees determined by arm's length bargaining. The industry carefully selected cases to bring to trial and thereby successfully muddled, confused, and corrupted the litigation landscape.[42] Of these, *Burks* and *Gartenberg* are the most important.

A. *BURKS V. LASKER*

At its core, mutual fund governance can be viewed as schizophrenic, the result of the anomalous legal structure of mutual funds. Funds are created and operated by external entities, the fund sponsors, and those sponsors are effectively monopoly providers of advisory services. The ICA attempted to mitigate the impact of the conflicts of interest inherent in this relationship and tasked unaffiliated (independent) trustees as "watchdogs" with the primary responsibility to ensure compliance with the act. These trustees are responsible for governing the fund and its operations consistent with traditional corporate law principles under state law. Trustees are fiduciaries,

41. The fiduciary norm established in *Pepper v. Litton*, 308 U.S. 295, 307 (1939) was effectively whether the transaction carried "the earmarks of an arm's length transaction."

42. *See* Burks v. Lasker, 441 U.S. 471 (1979); Gartenberg v. Merrill Lynch Asset Mgmt., Inc., 694 F.2d 923 (2d Cir. 1982); Krinsk v. Fund Asset Mgmt., Inc., 875 F.2d 404 (2d Cir. 1989); Schuyt v. Rowe Price Prime Rsrv. Fund, Inc., 663 F. Supp. 962 (S.D.N.Y.), *aff'd*, 835 F.2d 45 (2d Cir. 1987); and Kalish v. Franklin Advisers, Inc., 742 F. Supp. 1222 (S.D.N.Y. 1990), *aff'd*, 928 F.2d 590 (2d Cir. 1991).

and fiduciaries should "negotiate" the best deal possible for fund shareholders under traditional state law concepts of fiduciary duties.[43] However, because of the unique corporate structure, trustees lack the necessary tools to fulfill their traditional corporate governance roles.

In the 1967 hearings, SEC Chairman Manuel Cohen testified that "negotiations between unaffiliated directors and fund advisers over fees lack an essential element of arm's length bargaining–the threat of terminating negotiations and contracting with other parties . . . Nevertheless, the industry insists on propagating the myth that unaffiliated directors have served as an effective control over advisory fees."[44]

Cohen argued that trustees are unable to fulfill traditional corporate governance roles because, structurally, they do not have the power to do so. This has nothing to do with personal failings of trustees, it is inherent in the structure of mutual funds. The SEC's solution to this problem was a reasonableness standard that would give trustees the bargaining leverage to fulfill its traditional role.

The Cohen statement is unequivocal. However, Congress trapped itself by stating that courts were not to second guess the business judgment of trustees. Thus, the proviso in the 1970 amendment provides: "In any such action approval by the board of directors . . . shall be given such consideration by the courts as is deemed appropriate under all circumstances."[45] The Congressional straddling of the issue is the genesis of the current vagueness involving traditional corporate governance and the "watchdog" role. It allowed the industry and judiciary to focus solely on the watchdog role.

The rehabilitation was accomplished in 1979, in *Burks v. Lasker*.[46] The Supreme Court agreed to review the lower court decision to resolve issues concerning the intersection of state and federal law. The ruling itself focused on the issue of whether independent directors could properly dismiss a derivative suit against the advisor involving the purchase of Penn Central notes for the fund. The Supreme Court ruled that the judicial system should defer to the business judgment of the independent trustees. In the process, it noted that "Congress' purpose in structuring the Act as it did is clear. It 'was designed to place the unaffiliated directors in the role of 'independent watchdogs.'" [47] Specifically, the unaffiliated watchdogs were to ensure compliance with the ICA including the 1970 amendments.

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43. There may be no legal requirement for fund trustees to negotiate but there certainly is the perception, buttressed by common sense, that they should do so. *See, e.g.*, Jones v. Harris Assocs. L.P., 559 U.S. 335, 339 (2010). *See also,* Ryan Bollman & Mark Andreu, *Jones v. Harris L.P.: The Search for Investor Protection Continues*, 65 U. MIAMI L. REV. 717, 729–30 (2011).

44. *Investment Company Act Amendments of 1967 Hearings*, *supra* note 20, at 108 (statement of Manuel F. Cohen, Chairman, Securities & Exchange Commission).

45. Investment Company Amendment Act of 1970, Pub. L. No. 91-547, § 36(b), 84 Stat. 1413 (1970) (codified as amended at 15 U.S.C. § 80a-35 (2018)).

46. *Burks*, 441 U.S. 471 (1979).

47. *Id*. at 484.

The view that *Burks* was pivotal in fee litigation is not extreme. Professor Langevoort argues that after *Burks*, "[c]ourts increasingly seized on the presence of 'disinterested' directors on mutual fund boards . . . as reason to reduce the level of judicial scrutiny to allegations of breach of fiduciary duty" and that as a result, cases became harder for plaintiffs to win.[48] Further "exploring some of the unique features of mutual fund governance shows why judges and policymakers should not even try to reason by analogy to governance in other kinds of corporations."[49]

B. *GARTENBERG*

1. The Big Picture

Despite the ambiguity in the ICA and the Senate Report, judges understood that Congress wanted to maintain the status quo. To do so, it was necessary to finesse two inconvenient facts. First, as documented by Wharton,[50] the SEC,[51] and Commissioner Cohen,[52] management fees were (and are) greater than fees determined by arm's length bargaining. Second, independent trustees were powerless to negotiate fees because the adviser cannot be fired.

Gartenberg is the principal judicial interpretation of the 1970 amendments. Trustees are charged with enforcing the standard established in that case, as modified by the Supreme Court in *Jones v. Harris Associates*.[53] The judicial and governance embrace of the watchdog theory accomplished a feat of legal jujitsu: mutual fund governance was decoupled from normal corporate governance and trustees became de facto allies of plan sponsors. The determination that fees are "fair and reasonable" is achieved by applying the *Gartenberg* fiduciary standard. The District Court in *Gartenberg*[54] was aggressive, clumsy, and obvious in its desire to maintain the status quo. It ignored inconvenient publicly available information and mischaracterized the deliberations of independent trustees. Unfortunately, the District Court's errors have endured and have been embraced by subsequent courts. The Second Circuit explicitly disagreed with the District Court's fairness standard but ultimately affirmed the decision while conjuring the subjective fiduciary standard that exists today.

48. Donald C. Langevoort, *Private Litigation to Enforce Fiduciary Duties in Mutual Funds: Derivative Suits, Disinterested Directors and the Ideology of Investor Sovereignty*, 83 WASH. U. L.Q. 1017, 1017–18 (2005).

49. *Id.* at 1019.

50. Wharton Study, *supra* note 24, at 493–94.

51. PPI Report, *supra* note 25, at viii.

52. *Investment Company Act Amendments of 1967 Hearings*, *supra* note 20, at 108 (statement of Manuel F. Cohen, Chairman, Securities & Exchange Commission).

53. Jones v. Harris Assocs. L.P., 559 U.S. 335 (2010).

54. Gartenberg v. Merrill Lynch Asset Mgmt., Inc., 528 F. Supp. 1038 (S.D.N.Y. 1981), *aff'd*, 694 F.2d 923 (2d Cir. 1982).

There are two overarching but little-noticed facts that permeate the case. First, the named fund was a unique type of money market fund. Money market funds did not exist in 1970 when the statute was amended. Moreover, the specific money fund had distinctive attributes which made it a poor candidate to establish seminal case law for all mutual funds. The investment management industry was especially astute and clever in allowing this particular fund to be brought to trial because of structural corporate anomalies which allowed the sponsor and the courts to successfully fog up issues of profitability and economies of scale. These are discussed below.

Second, both opinions essentially ignored the Wharton and PPI documentation of the differences between mutual fund fees and fees determined by arm's length bargaining even though those reports were the proximate cause of the statutory change. Plaintiffs argued for the comparison but were disregarded. The few instances where pension fees are mentioned are peremptorily dismissed without discussion and with only the flimsiest explanation. The Second Circuit, in a striking example of the fallacy of composition, disallowed the pension comparison for all funds based on the anomalous and narrow facts of the fund in question.

Professor Langevoort offered insightful observations concerning the decision:[55]

> The key case is *Gartenberg v. Merrill Lynch Asset Management Inc.*, which reads enigmatically to say the least, but in the end takes a plainly pro-defendant approach. Plaintiffs challenged the advisory fee paid to Merrill Lynch by its massive money market fund as excessive. The District Court dismissed on grounds that fees approved by independent directors are valid if deemed fair compared to fees charged by other advisers to similar funds.
>
> On appeal, the plaintiffs argued that this was a foolish test. If the industry remains dominated by conflicts of interest, then excessive fees will be the norm, and the norm should then not be made the benchmark for propriety . . . This test resembles the state law test for corporate waste, even though the legislative history behind section 36(b) explicitly wanted something more than a waste test, signaling little promise of success on the merits. Obviously, the court was uncomfortable getting more deeply into the business of fee-setting on its own. Since *Gartenberg*, predictably, plaintiffs have fared poorly in their attacks on fees and 12b-1 plans, notwithstanding ample grounds for concern that both tend toward excess industry-wide (citations omitted).

Professor Langevoort's insights are cogent and consistent with the core propositions of this paper, especially: "Obviously, the court was uncomfortable getting more deeply into the business of fee-setting on its own." It suggests that the judicial system viewed fee litigation in a public utility fee-setting context with the concomitant complexity and case load.

55. Langevoort, *supra* note 48, at 1023–24.

The Senate Report effectively excluded the SEC from involvement in fee litigation and this left the judiciary "on its own."

2. The District Court Decision

The Ready Assets Trust (RAT), the named fund, was a money market fund sponsored and managed by Merrill Lynch Asset Management (MLAM) but also integrated with Merrill Lynch Pierce, Fenner & Smith (MLPF&S) brokerage operations.[56] MLAM and MLPF&S were wholly owned subsidiaries of Merrill Lynch & Co Inc. (ML&C), a New York Stock Exchange traded company.[57]

MLPF&S developed the generic concept whereby a money market fund was paired with a brokerage account and proceeds of sales and purchases of securities were swept into or out of the money market fund. This was a period in the late 1970s and early 1980s when interest rates were at historic highs and banks were forbidden to offer market rates of interest. Merrill Lynch's innovation was an enormous marketing success. At trial, the RAT was the largest money fund in existence and had experienced phenomenal growth from its inception in February 1975. By April 1976 it had grown to $100 million in assets and $2 billion by April 1979. It reached $19 billion at the trial date near the end of 1981.

The plaintiffs contended that fees were disproportionately high in relation to the level of assets and that Merrill Lynch enjoyed substantial "fall-out benefits" from the synergy created by the marriage of the money fund and brokerage accounts.[58]

i. The District Court's Interpretation of the Statute

In interpreting the ICA, the District Court began with its interpretation of legislative intent. It is interesting both for what it includes and what it fails to include. Overall, it signals the court's intent to favor the investment management industry's position as opposed to the SEC:

The Intention of the Legislation

56. The RAT was one of two large money market funds offered by ML&C at the time. Customers opening a RAT account also automatically opened a brokerage account with MLPF&S and the two accounts were effectively married. The other fund, the Cash Management Account (CMA) money fund also carried check writing privileges and was sponsored and managed by Fund Asset Management (FAM) inc., a subsidiary of MLAM.

57. Gartenberg v. Merrill Lynch Asset Management, Inc., 528 F. Supp. 1038, 1040 (S.D.N.Y. 1982).

58. According to the court, plaintiffs "claim that the fall-out benefits to the Broker from opening accounts and servicing the money market fund needs of the investors should be considered as an offset to the expense of the Broker in processing the orders of the shareholders of the fund." *Gartenberg*, 528 F. Supp., at 1044. Plaintiffs also complained that the fee was greater than "pension fund managers are paid which plaintiffs say is only a fraction of the compensation which the Fund pays." *Id.* Thus, the trial court peremptorily dismissed the institutional comparison prominent in the Wharton and PPI reports.

1. What is intended: That the investment adviser is entitled to make a profit.

2. What is not intended:

(a) That a cost-plus type of contract is required.

(b) That general concepts of rate regulation as applies to public utilities are to be introduced.

(c) That the standard of "corporate waste" is to be applied.

(d) That management fees should be tested on whether they are "reasonable".

(e) That a congressional finding has been made that the present industry level or that the fee of any particular adviser is too high.

(f) That the Court is authorized to substitute its business judgment for that of the directors.

(g) That the responsibility for management is to be shifted from directors to the judiciary.

(h) That economies of scale are necessarily applicable at every stage of growth of the Fund.

3. The test of fairness is to be made by the Court, in part:

(a) By reference to industry practice.

(b) By reference to industry level of management fees.

4. The Court shall determine whether:

(c) The attention of directors was fixed on their responsibilities.

(d) The directors requested and obtained information reasonably necessary to evaluate the terms of the management contract.

(e) The directors having the primary responsibility for looking after the best interests of the Fund's shareholders, have evaluated such information accordingly.[59]

Attention is directed to 2(h), and 3(b). Congress voiced concern about economies of scale being equitably shared with shareholders, yet the *Gartenberg* court opined that the legislation was *not* intended to imply that "economies of scale are necessarily applicable to every stage of growth of the fund."[60] A search for a statement remotely related to this assertion in the Senate Report as well as the related hearings would be in vain. This erroneous distortion of legislative intent was pivotal to the District Court's ruling that the fund's advisory fee was not disproportionate to the level of assets involved. It has also distorted § 36(b) case law for forty years.

Similarly, the record does not support the assertion that Congress intended to test fairness "by reference to industry level of management fees."[61] This was also invented to support the District Court's theory and was eventually rejected by the appellate court.

59. *Id.* at 1046 (emphasis added).
60. *Id.*
61. *Id.*

Finally, the omissions are instructive. There is no mention of the Wharton and SEC comparisons of advisory fees to pension and sub-advisory fees. Similarly, there is no acknowledgment that in 1970 Congress found that the forces of arm's length bargaining do not operate in mutual fund markets. In 1940, Congress may have intended that directors look after the best interests of fund shareholders, but the inability to fire advisers overrides their ability to do so. This omission laid the foundation for forty years of fund governance failure.[62]

There are four interrelated aspects of the District Court's case that merit attention and analysis because they directly bear on subsequent case law. These are: fall-out benefits, economies of scale, comparative fees, and fund governance. These issues are intertwined and complex. Moreover, anomalous processing costs muddled the court's deliberations.

ii. Fall-Out Benefits

The late 1970s was a period of high inflation and sharply rising interest rates. Merrill Lynch profited handsomely from these trends, offering the RAT, which generated market rates of interest at a time when banks were unable to do so. Astutely, MLPF&S automatically opened a brokerage account with each new RAT account and these accounts generated substantial brokerage commissions. A Peat, Marwick Mitchell study of accounts opened during 1979 calculated that 38% of RAT accounts did some other form of business with ML&C during the first quarter of 1980.[63] A later, internal Merrill Lynch study found that when the fund had reached $17 billion in size, the president of MLAM said, "Approximately 30% of these shareholders 'do no business with Merrill Lynch other than purchasing and redeeming (Fund) shares.'"[64] The clear implication is that 70% of fund shareholders did do other business with Merrill Lynch.[65]

For internal accounting purposes, the RAT was integrated with MLPF&S brokerage operations. The short explanation for what happened is that the court allowed processing costs from the brokerage operation to flow to the mutual fund but disallowed the (uncertain) revenues (fall-out benefits, brokerage commissions, etc.). This dramatically reduced the calculated

62. The *Gartenberg* court's fund governance insights are only tangentially related to the 1970 legislation. The idea that "The directors having the primary responsibility for looking after the best interests of the Fund's shareholder, have evaluated such information accordingly" was distilled from the 1940 ICA via the Supreme Court ruling in *Burks*. The 1970 amendments were ambiguous about the effectiveness of independent directors.

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

64. *Gartenberg*, 528 F. Supp., at 1063.

65. Overall, Merrill Lynch did very well. When the fund experienced its phenomenal growth (1977 to 1981) the Earnings Per Share (EPS) of Merrill Lynch & Co increased from $1.25 to $5.14, an increase of more than 300%. EPS in 1982 increased further to $7.48. Over the same time period, the price of Merrill Lynch stock increased from $15 per share to $33.125, an increase of more than 100%. The price was $60 at the end of 1982. These numbers were obtained from Compustat.

profitability of the fund to MLAM and corrupted trustees' view of economies of scale.

In all but a few funds at the time and in all funds today, order processing costs are handled by a fund's transfer agent and billed separately.[66] The Merrill fund had a transfer agent and plaintiffs argued that it could have handled all the money fund transactions at a lower cost. The court disallowed this argument.[67]

The court conceded that there were fall-out benefits but offered as a principal reason for not crediting them against processing costs the inability to accurately quantify the benefits. According to the court, the testimony of experts "demonstrates that any study of the benefits to Merrill Lynch as a result of the Fund's existence would be difficult, time-consuming, and expensive, and probably entirely inconclusive. . ."[68]

Even the Second Circuit had reservations concerning the District Court's ruling on fall-out benefits:

> Although the independent trustees may have been aware of these benefits, we are unpersuaded by the district court's suggestion that they cannot be measured or quantified . . . It would not seem impossible, through use of today's sophisticated computer equipment and statistical techniques, to obtain estimates of such "fall-out" and "float benefits" which, while not precise, could be a factor of sufficient substance to give the Funds' trustees a sound basis for negotiating a lower Manager's fee.[69]

The Second Circuit ruled that the burden was on appellants to produce evidence of fall-out benefits, which they did not do.

A complicating factor is that the case occurred at a time when the SEC allowed plan sponsors to charge marketing fees, also known as distribution or 12b-1 fees. As part of Rule 12b-1, the SEC required plan sponsors to have a written plan and to strictly segregate distribution revenues and costs from advisory fees and costs.[70] An issue in the case was whether the marriage of the money fund and brokerage operations constituted a marketing scheme that benefitted MLPF&S's brokerage operations.

Plaintiffs argued that processing costs should not count as fund costs because they were essentially marketing costs and that Merrill Lynch derived huge "fall-out" benefits from the existence of the fund, which, in effect,

66. Sec. & Exch. Comm'n, S.E.C. Release No. 34-76743, *Advance Notice of Proposed Rulemaking, Concept Release, and Request for Comment on Transfer Agent Regulations*, 80 Fed. Reg. 81948, 81990-92 (Dec. 31, 2015).

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

68. *Gartenberg*, 528 F. Supp., at 1056.

69. *Gartenberg*, 694 F.2d 923, at 932. Note how the Second Circuit leans on "independent trustees" to justify its decision to ignore fall out benefits.

70. 17 C.F.R. § 270.12b-1 (2020).

increased brokerage commissions resulting from the marketing success of the program. The District Court ruled against plaintiffs on this point.[71]

iii. Economies of Scale

Plaintiffs contended that fees were disproportionately high in relation to the level of assets. At trial in 1981, the fund was the largest money fund in existence with assets of about $19 billion. The trial centered on the fee during the calendar year 1980 and the approval of the fee going forward. At that time, there was a fee schedule of 0.5 percent on assets up to $500 million, scaled down in six increments to 0.275 percent on assets over $2.5 billion. Fees in 1980 totaled about $33 million and the effective fee rate based on average assets of about $11.2 billion was 0.296 percent. Details are presented in the following table distilled from the case.[72]

Table 2

Analysis of Ready Assets Trust (RAT) Profitability

Period	**Calendar Year 1980**	**Profit Margin**	**Cost Per Order**
Average Net Assets	$11,160,000,000		
Fees	$33,008,020		
Direct Expenses	$1,567,847		
Operating Income	$31,440,173	95.3%	
Processing Costs			
Order Volume	4,949,200		
Incremental Costs	$8,813,800		$1.78
Costs with ML Branch Estimates	$25,042,952		$5.06

71. *Gartenberg*, 528 F. Supp., at 1057.

72. Profitability numbers are presented on a pre-tax basis consistent with subsequent case law. The case also presented numbers for the fiscal year ending June 1981. *See* Stewart L. Brown, *Mutual Fund Advisory Fee Litigation: Some Analytical Clarity*, 16 J. BUS. & SEC. L. 329, 361 (2016).

Peat Marwick Mitchell Estimates	$36,970,524		$7.47
Operating Income with Processing Costs			
Incremental Costs	$22,626,373	68.5%	
ML Branch Estimates Costs	$6,397,221	19.4%	
Peat Marwick Mitchell Estimates	$(5,530,351)	-16.8%	

Source: Gartenberg v. Merrill Lynch Asset Mgmt., Inc., 694 F.2d 923 (2d Cir. 1982).

During 1980, MLAM experienced direct fund expenses of about $1.6 million or 0.014 percent (1.4 basis points) of average assets. This corresponded to a gross profit margin, exclusive of processing costs, of about 95 percent. Thus, according to Merrill Lynch's own numbers, it was able to perform all core investment management functions: portfolio management, research, salaries etc., for $1.6 million. For performing these services, it received $33 million in revenue and gross profits of about $31.4 million.

Exclusive of processing costs, the fund was massively profitable to MLAM. Further, the 95% profit margin is consistent with substantial economies of scale.[73] Absent the confounding and anomalous processing costs, the plaintiffs' contention that fees were disproportionate relative to the size of the fund was clearly correct.

Before the beginning of litigation, trustees attempted to act in the best interests of fund shareholders. When assets reached about $2 billion, they proposed additional breakpoints in the fee schedule. They were refused. Merrill Lynch's rationale for not lowering fees was disingenuous:

> MLAM does not propose to introduce additional breakpoints at assets levels over $2.5 billion because it believes the economies of scale applicable at lower asset levels tend to diminish when the fee rate reaches 0.275% . . .

73. *See* Stewart L. Brown, *Mutual Fund Advisory Fee Litigation: Some Analytical Clarity*, 16 J. BUS. & SEC. L. 329, 361-363 (2016); *see also* Stewart L. Brown, *Mutual Fund Advisory Fees: From Gartenberg to Jones* (April 22, 2021) (unpublished working paper) (on file at https://ssrn.com/abstract=3832369).

> [T]his "diminishing return" occurs largely because the costs of MLAM and Merrill Lynch associated with processing orders and administering shareholder accounts have not diminished as assets increase beyond the $2.5 billion level.[74]

The court agreed:

> That processing costs do not significantly diminish as Fund assets increase accords with logic and common sense. While it may be almost as easy to invest a block of $100 million as a block of $10 million, it requires substantially more time, money, and personnel to process 1 million shareholder orders than 100,000 orders . . . In any event, even if there do exist economies of scale, the present structure of MLAM's fee means that its effective fee has decreased as the size of the Fund has grown.[75]

The court's misleading statement about economies of scale in the legislative intent section dovetails neatly with Merrill's rationale for not sharing economies of scale. Processing costs unique to the RAT enabled the court to cast doubt on the existence of economies of scale for all mutual funds, not just this specific anomalous fund. This mistake has gone unnoticed and has contaminated fee litigation since.

Furthermore, the last sentence above has served as a template in fee litigation going forward. The mere presence of breakpoints is sufficient to satisfy courts that economies of scale have been shared adequately. No numerical analysis of the equitable sharing of economies with fund investors is ever conducted.

Three estimates of processing costs were introduced, each corresponding to a different estimated level of profitability. Incremental costs are costs that would disappear if the RAT were not in existence and corresponded to a profit margin of 68.5 percent. These costs were estimated at $1.78 per order. An internally conducted cost study added a portion of the estimated Merrill Lynch branch office costs. It was initiated before the lawsuit and yielded about $5 per order cost and a profit estimate of 19.4%. Finally, in conjunction with the lawsuit Merrill Lynch hired Peat, Marwick Mitchell (PMM) to do a detailed study of processing costs which involved looking at the time Merrill Lynch employees spent processing money fund orders. This yielded a profit margin of negative 16.8%.[76]

74. *Gartenberg*, 528 F. Supp. at 1055.

75. *Id.*

76. Each of the different processing cost estimates produced a different profit margin estimate and so *Gartenberg* was unable to produce a unique profit margin to establish a standard for subsequent courts. Absent the anomalous processing costs the gross profit margin of about 95% would have seemed clearly excessive.

iv. Comparative Fees

At trial, there was publicly available information significantly at variance with the District Court's presentation of comparative fees. Data compiled by Wiesenberger "Investment Companies" are summarized in Table 3.[77] The two numerical columns show year-end assets and advisory fee rates for the RAT and money funds with at least $500 million in assets. There were seven money funds with advisory fees lower than the RAT and 22 funds with fees greater than the RAT. Two of the seven funds were sub-advised and the fees listed are the sub-advisory fee rates.

The RAT had assets of $11.2 billion at the end of 1980 and the corresponding fee calculated from the fee schedule was 29.6 basis points. By contrast, the seven funds with fees lower than the RAT had average assets of about $1.8 billion with an average advisory fee of 17 basis points. Thus, the RAT had about five times the average assets level of the seven funds with about 75% higher average fees. Fees on the two sub-advised funds were the product of arm's length bargaining and the average fee on the other five funds was slightly lower (15.6 v. 20.3 basis points).

Table 3
Compilation of Advisory Fees for Money Funds with at Least $500 Million in Assets, 1980 *

Fund	Assets (millions)	Advisory Fees
Merrill Lynch Ready Assets Trust (RAT)	$11,255	0.297%
Funds with Fee Lower than Ready Assets Trust (RAT)		
Cash Reserve Management Inc	$3,221	0.137%
Moneymart Assets Inc.	$1,762	0.135%
Paine Webber Cash Fund	$2,428	0.159%
Temporary Investment Fund	$2,174	0.153%

77. WIESENBERGER INV. COS. SERV., INVESTMENT COMPANIES 1981, at 504–35.

Trust For Short Term Federal Securities	$556	0.168%
Averages	**$2,028**	**0.150%**
Sub-Advised Funds		
Shearson Daily Dividend* *	$2,343	0.201%
Webster Cash Reserve Fund **	$599	0.204%
Averages	**$1,471**	**0.203%**
Overall Averages	**$1,819**	**0.170%**
22 Funds with Fees Greater than Ready Assets Trust (RAT) - 1980		
Averages	**$1,503**	**0.413%**

* Source: WIESENBERGER INV. COS. SERV., INVESTMENT COMPANIES 1981, at 504-535.

** Sub-Advised by Dreyfus

It follows that the court knew or should have known of publicly available information on funds with significantly lower assets and fees, and that the court knew or should have known that the RAT fee was unfair and unreasonable. It was so disproportionately large that it could not have been the product of arm's length bargaining.

The court's actual fee comparisons are a model of omission, misdirection, and obfuscation. The most definitive declaration was: "It cannot be gainsaid herein that the rate of fees are thoroughly in line with the market; the trial exhibits are conclusive on this score."[78] The statement is literally true but profoundly and deliberately misleading on two levels.

First, it is true that there were funds charging higher advisory fees as well as lower fees. However, this ignores the gargantuan size of the RAT in comparison to other available funds. The RAT was at least three times bigger than the next nearest low fee fund (Cash Reserve Management, Inc.) and carried a fee more than 50% higher.[79]

Second, the fees on the RAT were positioned between two disparate groups of funds but the statement implicitly assumes they are similar. All

78. *Gartenberg*, 528 F. Supp. at 1052 (S.D.N.Y. 1981).

79. The Intercapital Liquid Assets fund had assets of $4.1 billion at the end of 1980 and had an advisory fee of 34.1 basis points.

were managing money market portfolios, but those in the lower fee group accepted profit margins similar to margins determined by arm's length bargaining. Witness the similarity of fees with fees on sub-advised funds. The higher fee group with similar average asset levels took advantage of the lack of arm's length bargaining and charged higher fees. To state that the fee on the RAT was thoroughly in line with the market suggests that the higher fees funds rates were market-determined.

The court's presentation on fees relative to other mutual funds is sketchy and conflicts with the evidence presented above:

> At the time of trial, the Fund had triple the net assets of the next largest fund not sponsored by Merrill Lynch . . . The record shows that . . . only the Temporary Investment Fund, which had an effective rate of 0.231%, was charging at a lower rate than the Fund. The Union Cash Management Fund, with an effective rate of 0.20%, is internally managed, and therefore cannot be properly compared . . . At least 16 funds of all types had higher expense ratios, while five had lower ratios.[80]

The case was about advisory fees, not expense ratios, so the expense ratio evidence is of questionable relevance. It is approximately true that the RAT "had triple the net assets of the next largest fund."[81] It is also true that the Temporary Investment Fund had a lower advisory fee than the RAT, but Wiesenberger has the fee at 15.3 basis points, not the 23.1 basis points stated by the court.[82] The court fails to mention that at least six other funds with at least $500 million in assets had lower fees than the RAT.

The Union Cash Management Fund[83] is included in the Wiesenberger publication, with $367 million in assets and a 45-basis point advisory fee.[84] It is difficult to explain the inclusion of this information except as a gratuitous comment disallowing any comparison with internally managed portfolios.

v. Fund Governance

The *Gartenberg* court created a fictional narrative that independent trustees were dutiful watchdogs of shareholder interests and then falsely equated the fictional dutifulness with fairness, relieving subsequent courts of the responsibility to objectively gauge the fairness of fees. The reality was that independent directors were passive and failed in their fiduciary duty to protect the interests of shareholders.

Using processing costs as an excuse, Merrill Lynch refused to lower fees in the April 1979 meeting. Trustees became aware of the Gartenberg

80. *Gartenberg*, 528 F. Supp. at 1048–49.

81. *See* the Cash Reserve Management Fund in Table 3 above.

82. WIESENBERGER, *supra* note 77, at 531; Gartenberg, 528 F. Supp. at 1048.

83. The fund was managed by J.W Seligman & Co. In 1982 its name was changed to Seligman Cash Management Fund, Inc.

84. WIESENBERGER, *supra* note 77, at 533.

litigation in July 1979, and the case focuses on contract approvals in May 1980, and especially May 1981. Before trial, trustees were advised, in a memo "dated April 15, 1981 (like information was furnished in earlier years),"[85] of their duties in regard to the contract:

> It was emphasized to the Trustees that "[i]n making their determination in this area, the independent trustees must be fully informed in an impartial manner of all relevant factors with respect to the advisory agreements and, after a thorough review of all relevant factors, must reach agreement with the Fund's investment adviser on the basis of arm's length bargaining." (Emphasis in original). They were told that the major consideration would be their analysis of the reasonableness of the proposed advisory fee under prevailing facts and circumstances. To underscore this mention was made of the fact that two suits were already pending affecting the Fund. These were reviewed and their contentions exposed; namely, that the charges against MLAM included breach of fiduciary duty by receiving advisory fees which were excessive and disproportionate to the services rendered . . .[86]

Thus, independent trustees became active participants in the ongoing litigation. They approved the contract, and the court deliberately mischaracterized the approval as consistent with the fiction of the above memo.

It is clear from the court's narrative that trustees dutifully discussed fee issues in detail. There are certain Potemkin-like aspects to deliberations. For instance, the case tells us the trustees were provided with information that they had "bargaining power generated by the Fund's enormous size."[87] Clearly, the bargaining power was of no use in lowering fees. We are told that trustees were furnished with "an impressive amount of documentary material"[88] running to several hundred pages per meeting. Again, to what effect? In the May 1980 and 1981 meetings, trustees dutifully discussed the possibility of managing the portfolio internally or changing investment managers. Further:

> In the summer of 1981, the independent Trustees had the opportunity again to consider and expressly approved the schedule of compensation to MLAM. On that occasion every argument and its minutiae made now by the plaintiffs was fully before the Trustees. The occasion was the plaintiffs' demand on July 14, 1981 (for the first time) that the Trustees commence this suit. No claim could thereafter be made that the Trustees lacked this or

85. *Gartenberg*, 528 F. Supp. at 1058. Presumably, the memo came from fund counsel.

86. *Id.* at 1058–59. It seems clear that the memo was prepared in anticipation of the ongoing litigation. At any rate, the memo instructs independent trustees to accomplish the impossible, i.e., reach agreement of fees based on arm's length bargaining. In fact, Merrill Lynch had previously refused to bargain, and the fee schedule remained in place throughout the legal proceedings. Trustees never weighed in on the reasonableness of fees. Instead, what they ultimately did was to approve the contract; a binary decision for which they had no reasonable alternative.

87. *Id.* at 1059.

88. *Id.*

> that piece of information as now thrust into this record or were misled in their consideration of the compensation. All of the plaintiffs' selective analyses and convenient inferences were made to and turned aside by the Trustees. This was not "post litem motam" consideration. It was an evaluation made after depositions had been taken on a specific complaint and proposed findings of fact which were prepared and ventilated by plaintiffs in these lawsuits (footnote omitted).[89]

It is slightly surreal and far removed from ordinary deliberations to have trustees read depositions and then be offered the opportunity to re-affirm the renewal of a contract.

As the above discussion makes clear, the decision to renew the contract was unrelated to any business judgment by trustees. They approved a demonstrably unfair contract. They went along with the renewal, and the court surrounded this decision with a fictional narrative that has survived for decades. As long as trustees appear dutiful, look at reams of information, and discuss the information, courts are persuaded the trustees have determined that fees are fair and reasonable. The court found, "The ultimate decision of the Trustees was objectively reasonable, as the total fee was fair to the Fund."[90] In the end, the court concluded: "It is appropriate, therefore, to weight heavily the approval of the investment advisory agreement by the Trustees . . . in determining the fairness to the Fund of the compensation which it paid."[91]

Independent trustees failed in their fiduciary duty to fund shareholders. They knew or should have known that the fee was unfair. The court stressed that trustees were "adequately informed at all times of the structure and price being paid by the Fund [and] the going price in the market of comparable services. . ."[92] Further, the trial court said that independent trustees considered the "fee structure and expense ratio compared to the rest of the industry."[93] Information in Table 3 demonstrates that this cannot be true. They knew or should have known that the fee was disproportionately greater than fees on other funds readily available in the market.

Independent trustees should consider economic substance and are not limited by legal technicalities. Despite the failure to measure precisely, it was patently obvious that Merrill Lynch was attaining large fall-out benefits from the existence of the money fund and that on balance the overall program was profitable. Under the assumption that processing costs and fall-outs benefits were a wash, the trustees knew that the money fund, with a 95% profit margin, was massively profitable. The litigation inspired the PMM study of

89. *Id.* at 1064.

90. *Id.* at 1055. The court's statement is a non sequitur. The court found that the fee was fair, not the trustees, who were silent on the issue of reasonableness and fairness.

91. *Id.* at 1064.

92. *Id.* at 1058.

93. *Id.* at 1062.

processing costs effectively said that the program had too many customers and was therefore unprofitable. This was absurd on its face.

The amended § 15(c)[94] gave independent trustees some power to influence fees, but there is no indication that any effort was made to utilize the power. Such an effort would have been hard and perhaps have upset the harmony of the board. All indications are that independent trustees took the easy path and approved the contract. In the process, fund shareholders were overcharged millions of dollars in excess advisory fees. The independent trustees did what was easy and not what was right.

The District Court in *Gartenberg* effectively conflated the fictional diligence of independent trustees with fairness. This has allowed courts to avoid hard decisions by invoking the business judgment rule, i.e., an unwillingness to second guess the deliberations of (supposedly) fully informed independent trustees. Subsequent decisions have effectively negated the idea of comparing advisory fees to fees determined by arm's length bargaining and ignored the proximate cause of the 1970 amendments.

vi. The District Court's "Fairness" Standard

The District Court reviewed the fiduciary language of the statute and legislative intent as summarized above. It also presented its interpretation of case law precedent:

> The net intent of the legislation . . . would seem to leave it to the federal courts to interpret compliance with "fiduciary duty" in the common law tradition . . . An examination of the case authorities also fails to illumine precisely the path to be followed by the Court in weighing the compensation of the investment adviser of a money market fund under fiduciary standards. Only general concepts have been articulated. The standard of fiduciary duty under Section 36(b) "is concerned solely with fairness and equity." "The essence of the [fiduciary] test is whether or not under all the circumstances the transaction carries the earmarks of an arm's length bargain."[95] (citations omitted).

Here the case goes off the rails. Having correctly identified the essence of the fiduciary test as congruence with the "earmarks of an arm's length bargain," the court ignored available evidence of fees established by arm's length bargaining. Rather, the District Court devised a fiduciary test that it thought was fair and equitable:

> The market price—freely available and competitively set—serves as a standard to test the fairness of the investment advisory fee under the facts shown in this record. . . The issue of fair compensation becomes ultimately a social or philosophical—and hence a legislative question—when the fee is in harmony with the broad and prevailing market choice available to the

94. 15 U.S.C. § 80a-15(c) (2018).
95. *Gartenberg*, 528 F. Supp. at 1046–47.

> investor. . . There would seem to be no sense to seek to limit by judicial fiat what is satisfactorily performed, sufficiently disclosed and freely available elsewhere in the marketplace at comparable charges, without penalties or restraint.[96]

The Senate Report clearly states that the "forces of arm's length bargaining" do not operate in the mutual fund arena.[97] Competitive forces are inoperative because advisory contracts are no-bid contracts. The District Court opined that the proper fiduciary test of fees on no-bid contracts is the level of fees on other no-bid contracts available to consumers. Given the evidence from Wiesenberger presented above, the fee on the RAT failed the very fairness test embraced by the District Court.

3. The Second Circuit's Gartenberg Standard and Factors

The Second Circuit rejected the District Court's fairness standard but affirmed the decision. It fashioned a substitute fiduciary standard which has proven impossible for plaintiffs to overcome. The reasons for this are speculative, but the court likely wanted to support the Congressional desire to maintain the status quo while minimizing judicial system involvement in a complex and potentially high judicial case load arena. As part of the decision, the Second Circuit included the *Gartenberg* factors, which are tainted by the fund's anomalous processing costs.

The Second Circuit crafted an ambiguous two-step test that effectively straddled the issues:

> In short, the legislative history of § 36(b) indicates that the substitution of the term "fiduciary duty" for "reasonable," while possibly intended to modify the standard somewhat, was a more semantical than substantive compromise . . . As the district court and all parties seem to recognize, *the test is essentially whether the fee schedule represents a charge within the range of what would have been n e g o t i a t e d at arm's-length in the light of all of the surrounding circumstances*.[98] (emphasis added)

The initial statement by the Second Circuit is consistent with the *Pepper* Standard.[99] The court then states: "To be guilty of a violation of § 36(b), therefore, the adviser-manager must charge a fee that is so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been the product of arm's-length bargaining."[100]

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96. *Id.* at 1067–68.

97. S. REP. NO. 91-184, *supra* note 6, at 5–6.

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

99. Pepper v. Litton, 308 U.S. 295, 306–07 (1939) ("The essence of the [fiduciary] test is whether or not under all the circumstances the transaction carries the earmarks of an arm's length bargain.")

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

The court uses the transition "therefore," between the first and second steps but the transition is a non sequitur: there is no analysis or reasoning to justify the reformulated and more extreme standard. Moreover, the second leg of the two-step process effectively negates the first. Semantically, the Second Circuit disingenuously references the extant fiduciary standard while finessing its actual application.

The Second Circuit dealt with the pension comparison peremptorily in a footnote:

> Appellants' argument that the lower fees charged by investment advisers to large pension funds should be used as a criterion for determining fair advisory fees for money market funds must also be rejected. The nature and extent of the services required by each type of fund differ sharply. As the district court recognized, the pension fund does not face the myriad of daily purchases and redemptions throughout the nation which must be handled by the Fund, in which a purchaser may invest for only a few days.[101]

The Second Circuit's rejection of the pension comparison was clouded by its belief that the "nature and extent of the services" on the subject fund included anomalous processing costs (discussed below). What was true for the RAT is not true for funds in general. Absent those costs, the blanket rejection of the pension comparison is highly questionable. Subsequent courts have generalized this to all pension comparisons, even the apples-to-apples comparison of equity portfolios to equity portfolios. This is the fallacy of composition on its face and has effectively negated and permanently overridden the Wharton and PPI reports.

In rejecting the District Court's fairness standard, the Second Circuit introduced important language:

> We disagree with the district court's suggestions that the principal factor to be considered in evaluating a fee's fairness is the price charged by other similar advisers to funds managed by them . . . Competition between money market funds for shareholder business does not support an inference that competition must therefore also exist between adviser-managers for fund business. The former may be vigorous even though the latter is virtually non-existent. Each is governed by different forces. Reliance on prevailing industry advisory fees will not satisfy § 36(b) . . . We do not suggest that rates charged by other adviser-managers to other similar funds are not a factor to be taken into account. Indeed, to the extent that other managers have tended "to reduce their effective charges as the fund grows in size," [it represents] "the best industry practice."[102]

This is the meaning of Professor Langevoort's statement that "[i]f the industry remains dominated by conflicts of interest, then excessive fees will

101. *Id.* at 930.
102. *Id.* at 929.

be the norm, and the norm should then not be made the benchmark for propriety."[103]

The issue of comparing fees on litigated funds to other mutual funds comes up time and again in subsequent litigation. The Second Circuit was unambiguous in stating that "[r]eliance on prevailing industry fees will not satisfy 36(b)."[104] This is consistent with the Wharton and SEC finding that advisory fees were systematically higher than fees resulting from arm's length bargaining. It is also consistent with the Senate's observation that the forces of arm's length bargaining do not occur in mutual fund markets.

The Second Circuit used the language "taken into account" in reference to economies of scale and "best industry practice."[105] Unfortunately, the ambiguity of the "taken into account" statement has licensed subsequent courts to use fees on comparable mutual funds to justify pro-defense decisions.

In addition to the *Gartenberg* Standard, the court identified six factors to be considered in evaluating a claim for excessive fees: (1) the nature and quality of the services provided to fund shareholders; (2) the profitability of the fund to the adviser/manager; (3) economies of scale of operating the fund; (4) comparative fee structures; (5) fall-out benefits, and (6) the independence and conscientiousness of the fund's directors.[106]

There is no indication that the Second Circuit recognized that the subject money fund and surrounding circumstances were anomalous and unrepresentative of mutual funds in general. For instance, the disallowed fall-out benefits offsetting processing costs are unique to the case. Under normal circumstances, processing costs are handled by the fund's transfer agent and billed separately from advisory fees.

Similarly, the 1970 amendments and Senate Report[107] only state that profits are not to be limited. The Second Circuit finding that adviser profitability is relevant also implies, in some sense, that there is a profit level above which fees are excessive. In other words, it implies a profitability standard. There was no such standard articulated or implied in the ICA or Senate Report. A profitability standard depends importantly on the profitability measure chosen for comparison purposes. The Second Circuit found that:

103. Langevoort, *supra* note 48, at 1023–24.

104. *Gartenberg*, 694 F.2d at 929.

105. *Id.*

106. In determining if a fee is reasonable, Chairman Cohen suggests three factors to be considered: (1) economies of scale, (2) extent and quality of services provided, and (3) value of all other benefits received. *Mutual Fund Legislation of 1967 Hearings*, *supra* note 21, at 22. The Second Circuit's inclusion of "fall-out" benefits is similar to Cohen's third factor but the use of plaintiffs' characterization of fall-out benefits associated with processing costs is specific to the case and continues to confuse judicial decision-making.

107. S. REP. 91-184, *supra* note 6, at 6.

> Appellants' contention that since the Manager's own administrative expenses did not increase proportionately . . . after 1978, its profit margin was 96% for the 12-month period ending September 30, 1981, is unrealistic. . . Proceeding on the erroneous theory that only the administrative costs incurred by the Manager itself may be considered, appellants ignore the heavy costs incurred by other Merrill Lynch affiliates in processing the increased volume of purchases and redemptions of Fund shares . . .

The Second Circuit gave no reason for finding that the 96% profit margin was unrealistic or why the underpinning theory was erroneous. In fact, Merrill Lynch had direct costs and performed all core investment management functions for about 4% of revenue. The 96% profit margin was realistic and not uncommon in the mutual fund industry, as shown *infra*.[108]

Economies of scale are one of the *Gartenberg* factors. Subsequent courts have mimicked the District Court's ruling that breakpoints are sufficient evidence that economies of scale have been equitably shared.

Finally, the Second Circuit was ignorant of or chose to ignore the District Court's fictional depiction of fund governance. The independence and conscientiousness of trustees are gauged in subsequent case law by the amount and nature of the materials discussed. The absence of meaningful fee negotiation by independent trustees is nowhere recognized.

Ultimately, the Second Circuit opined: "In view of these circumstances, we cannot label clearly erroneous the district court's finding that no breach of fiduciary duty was shown."[109]

Forty years of precedent hinge on a decision the Second Circuit could not label as "clearly erroneous." In fact, as demonstrated above, it was clearly erroneous and led to billions of dollars of questionable fees charged the investing public. Subsequent courts have embraced the Second Circuit's tepid endorsement of the District Court's decision and sharply favored the industry.

III. BETWEEN *GARTENBERG* AND *JONES*

Three cases shaped the fee litigation arena between *Gartenberg* and *Jones*. Two of the three cases involved money market funds and thus solidified the *Gartenberg* Standard and factors without confronting the pension/institutional fee comparison for non-money market funds. The third case partially finessed the issue by obfuscating and disallowing the comparison of mutual fund fees with fees offered by funds of the Vanguard Group.

108. A profit margin calculated using only direct expenses corresponds to what is commonly called "Gross Profit Margin." It is the clearest and cleanest measure of sponsor profitability. The 95% gross profit margin in Table 2 is for the calendar year ending December 21, 1980.

109. *Gartenberg*, 694 F.2d at 931.

In addition to the three cases outlined, this section reviews two academic studies which shaped the litigation landscape and led to conflicting opinions at the Seventh Circuit and ultimately to the Supreme Court's decision in *Jones v. Harris*.

Working with the muddled *Gartenberg* precedent, the courts continued with questionable rulings and unseemly legal contortions. A very brief synopsis is presented here.[110]

A. THREE CASES

1. Schuyt v. Prime Reserve Fund

Schuyt is the seminal profit margin case and established the precedent that operating profit margins as high as about 77% are consistent with acceptable fee rates in a *Gartenberg* context. Similar to *Gartenberg*, the subject fund was a money market fund, so the court did not have to confront the pension comparison.[111]

Plaintiffs estimated gross profit margins from 90 to 95% using an incremental cost analysis.[112] The *Schuyt* court rejected this analysis and agreed with the sponsor's calculation of profit margin which included estimates of corporate overhead as a cost of operating the fund.[113] This effectively established Operating Profit Margin as the case law standard in future litigation.

2. Krinsk v. Merrill Lynch

As in *Gartenberg*, the named fund in *Krinsk* was a Merrill Lynch money market fund, the CMA Money Fund. The *Krinsk* court chose to analyze the case from the perspective of Merrill Lynch as a whole, rather than Fund Assets Management, the investment management subsidiary. Trustees were complicit and the resulting analysis, like *Gartenberg*, was hopelessly confused and corrupted.

Importantly, *Krinsk* established the precedent that trustees had no duty to negotiate with the adviser:

> Krinsk proposes that the trustees had a duty to negotiate for the Fund the "best deal" possible. However, the standard to apply in determining whether compensation for managing a mutual fund violates the fiduciary duty imposed by section 36(b) is "whether the fee schedule represents a charge within the range of what would have been negotiated at arm's-length in light of all the surrounding circumstances." . . . To violate section 36(b), the

110. A detailed analysis is available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3832369.

111. Schuyt v. Rowe Price Prime Rsrv. Fund, Inc., 663 F. Supp. 962, 963 (S.D.N.Y.), *aff'd*, 835 F.2d 45 (2d Cir. 1987).

112. *Id.* at 977.

113. *Id.* at 978.

> adviser-manager must charge a fee that is so disproportionately large that it bears no reasonable relationship to the services rendered."[114] (citations omitted)

This ruling formally untethered mutual fund governance from standard corporate governance. Absent a duty to negotiate, trustees gauge the fairness of fees in light of the *Gartenberg* Standard and factors with their concomitant subjectivity and ambiguity.

3. Kalish v. Franklin

The fund in *Kalish* was a GNMA fund that potentially offered an apples-to-apples comparison with Vanguard advisory fees, which are sub-advised. By emphasizing comparative Vanguard expense ratios and ignoring Vanguard advisory fees, the Kalish court was blind to the excessively high advisory fee on the Franklin GNMA Fund.[115] Moreover, the blanket rejection of the Vanguard comparison was subsequently adopted by other courts.

B. DUELING ACADEMICS

The cases surveyed defined the fee litigation landscape until early in this century. No case came to trial explicitly testing the pension/institutional comparison highlighted in the Wharton and PPI studies. The situation changed with the publication of a law review article in 2001 updating those results and demonstrating that the 1970 amendments had been unsuccessful in eliminating the fee differences.[116] This led to fee litigation and a competing law review article commissioned by the Investment Company Institute rationalizing the differences.[117] In 2009, the U.S. Supreme Court weighed in, further confusing the issues. This section of the paper surveys the two law review articles leading to the decision in *Jones v. Harris*.

1. The Freeman and Brown Study

John Freeman and Stewart Brown (FB) updated the Wharton and PPI studies (the FB Study). They contacted the 100 largest public pension plans and asked for fee information on equity portfolios managed by external investment advisory firms. Information was presented on a total of 220 individual actively managed pension portfolios totaling about $100 billion in assets. The assets and fees on the pension portfolios were compared to the assets and fees of similar mutual funds and the results confirmed and

114. Krinsk v. Fund Asset Mgmt., Inc., 875 F.2d 404, 409 (2d Cir. 1989).

115. Kalish v. Franklin Advisers, Inc., 742 F. Supp. 1222, 1231 (S.D.N.Y. 1990), *aff'd*, 928 F.2d 590 (2d Cir. 1991).

116. John P. Freeman & Stewart L. Brown, *Mutual Fund Advisory Fees: The Cost of Conflicts of Interest*, 26 J. CORP. L. 609, 614 (2001).

117. Hawkins, *supra* note 15.

amplified the Wharton and PPI observation that mutual funds pay higher investment management fees than institutional investors.

The average pension portfolio in the FB study had $443 million in assets and an asset-weighted average fee of 28 basis points. The average mutual fund managed about $1.4 billion in assets and carried a weighted average fee of 56 basis points. Viewed another way, asset managers charged about $1.15 million (26 bp on $443 million) to manage a pension portfolio and about $7.4 million (56 bp on $1.3 billion) for similar services to mutual funds.

The difference between average pension fees and average mutual fund fees was understated because of the size differential in assets managed. If the largest mutual funds were excluded to calibrate similar sized portfolios, the weighted average mutual fund advisory fee was 68 basis points compared to a similar-sized pension portfolio fee of 26 basis points. The difference is 42 basis points. Size adjusted, the average mutual fund fee was two and a half times the average pension fee.[118]

Like the Wharton and PPI studies, FB concluded that the differential resulted from a lack of arm's length bargaining of mutual fund advisory fees. This constituted empirical evidence that the 1970 amendments to the ICA had been ineffective in restraining fees. The FB Study made waves[119] and triggered calls for reform.[120] The publication coincided with the market timing and late trading scandals of the early 2000s. Over 500 class actions and derivative suits were filed against mutual fund advisers, and cases involving mutual funds accounted for almost 10% of all federal securities class actions in 2003 and 2004.[121] This led to push back from the industry which funded a study arguing that mutual fund fees are not excessive.

2. The Coates and Hubbard Study

The Coates & Hubbard (CH) paper[122] was funded by the Investment Company Institute.[123] The main thrust of the paper is the assertion that the

118. Freeman & Brown, *supra* note 116, at 633.

119. *See, e.g.*, Tom Lauricella, *This Is News?: Fund Fees Are Too High, Study Says*, WALL ST. J., Aug. 27, 2001, at C1, C19. The article quotes Don Phillips, head of Morningstar, the mutual fund industry's leading performance and expense tracking company, saying: "[T]he [Freeman-Brown] study is dead-on in its methodology and findings . . . This study is very damning . . . It shows that retail mutual funds are not competitively priced."

120. For instance, former SEC Chairman Arthur Levitt testified before a House Subcommittee and confirmed Freeman-Brown's findings and demanded radical reform. He testified: "The largest mutual funds pay money management advisory fees that are more than twice those paid by pension funds." *Mutual Funds: Who's Looking out for Investors?: Hearing Before the H. Comm. on Fin. Servs. on the Subcomm. on Capital Mkts., Ins. and Gov't Sponsored Enters.*, 108th Cong. 42–43 (2003) (statement of Arthur Levitt, Chairman, Securities Exchange Commission), *available at* https://www.govinfo.gov/content/pkg/CHRG-108hhrg92982/pdf/CHRG-108hhrg92982.pdf.

121. James N. Benedict, et al., *The Aftermath of the Mutual Fund Crisis*, 38 REV. SEC. & COMMODITIES REG. 261, 261 (2005).

122. John C. Coates & R. Glenn Hubbard, *Competition in the Mutual Fund Industry: Evidence and Implications for Policy*, 33 J. CORP. L. 151 (2007).

123. Hawkins, *supra* note 15.

competitive forces ensure that advisory fees cannot be excessive. "[W]e find that price competition is in fact a strong force constraining fund advisers . . ."[124] Essentially, the paper finds that the trial court in *Gartenberg* got it right and that the forces of arm's length bargaining do operate in mutual fund markets. The paper found the Wharton and PPI Reports to be in error, as, by implication, was Congress and was the Second Circuit in *Gartenberg*. "Stuck in the Sixties" is how they phrase it.[125]

It is notable that CH never explicitly state that mutual fund fees are "market prices." Rather, they make vague statements like "structural conditions are consistent with and conducive to the presence of price competition."[126] The "price competition is strong force constraining" statement above is similar. In fact, mutual fund fees are not subject to the normal price discovery process necessary for truly competitive markets. Mutual fund fees more closely resemble what are known as "administered prices"[127] and are the result of (alleged) "negotiation" between the adviser and the independent directors. Viewed from this perspective, the CH position that fees are driven by investor choices is meaningless. There is a disconnect between investors and the fund, and no price discovery is possible. Independent directors face monopoly sellers of advisory services and no competing contracts are considered.

CH articulate their core proposition as follows:

> Given a sufficient number of buyers engaging in a price search for a given quality of product and service, willing and able to switch to competitors, fund advisers must price competitively for their funds to retain price-sensitive customers. Competitive prices benefit all funds investors, price-searching and non-price-searching, tax constrained, or tax-free, alike.[128]

This argument is flawed for two reasons. First, the argument is based on fees generically, meaning expense ratios. But advisory fees are only a component of expense ratios and not economically relevant to investors. Second, with profit margins as high as 77%, investment advisers are not incentivized to lower advisory fees for all of their customers to retain price-sensitive customers.[129]

CH dismiss the FB results for failure to pass a purity test:

> But Freeman and Brown did not compare pure portfolio management fees at retail mutual funds with pension plan external portfolio manager fees.

124. Coates & Hubbard, *supra* note 122, at 153.
125. *Id.* at 158.
126. *Id.* at 163.
127. The definition of "administered prices" is "a price determined by the conscious price policy of a seller rather than by impersonal competitive market forces." *Administered prices*, MERRIAM-WEBSTER DICTIONARY, https://www.merriam-webster.com/dictionary/administered%20price (last visited Mar. 30, 2021).
128. Coates & Hubbard, *supra* note 123, at 199.
129. *See Mutual Fund Legislation of 1967 Hearings*, *supra* note 21.

> They could not isolate pure portfolio management costs for mutual funds. Indeed, they could not distinguish between administrative and management costs in some cases, and within management costs they could not isolate the pure cost of equity research and portfolio management that constitutes the primary service that investment advisers provide to pension funds. . .

Purity tests, by their nature, are impossible to overcome. There are indeed some cost differences in providing investment management services to mutual funds and pension funds. These are amenable to quantification. In a subsequent publication, the authors estimated the difference at about 3 basis points, far too low to rationalize the overall fee differences. No court has ever troubled itself to rigorously examine or rule on these issues.

The CH study presents itself as objective research by well-credentialed academics. In truth, it was designed and intended to inoculate the investment management industry in fee litigation.

IV. JONES V. HARRIS

Jones v. Harris[130] was one of the first § 36(b) cases to come to trial involving non-money market funds. Three named Harris funds carried a weighted average advisory fee of 0.82% or 82 basis points.[131] Harris also sub-advised three similar mutual funds with a weighted average sub-advisory fee of 0.41% or 41 basis points, half the fee rate Harris was charging its retail customers.[132]

A. THE TRIAL COURT DECISION

The trial court granted the defense motion for summary judgment based on a misinterpretation of *Gartenberg* and a misunderstanding of the relationship between mutual fund investment advisors and directors:

> As Gartenberg makes clear, the fees charged in the mutual fund industry are the product of a negotiation, wherein both sides engage in a process of taking some things while giving up others. Consequently, there is no single outcome that can be expected; instead, there is a range of acceptable results.[133] (citation omitted)

Plaintiffs argued that the sub-advisory fee comparison was dispositive. The trial court disagreed:

130. Jones v. Harris Assocs. L.P., 559 U.S. 335 (2010).

131. Joint Appendix, Preliminary Expert Report, Edward S. O'Neal, Ph.D., at 445–49, Jones v. Harris Assocs. L.P., 559 U.S. 335 (2010).

132. These rates are calculated using the assets levels of the Harris funds and the fee schedule of the sub-advised funds.

133. Jones v. Harris Assocs. L.P., No. 04 C 8305, 2007 WL 627640, at *7 (N.D. Ill. Feb. 27, 2007), *aff'd*, 527 F.3d 627 (7th Cir. 2008), *vacated and remanded*, 559 U.S. 335 (2010), and *aff'd*, 611 F. App'x 359 (7th Cir. 2015).

> However, making all inferences in favor of the Plaintiffs does not mean we must ignore the undisputed fact that shareholders in at least nine other mutual funds investors were paying fees at the same level that the Funds were . . . [T]he amounts paid by different parties establish a range of prices that investors were willing to pay . . . Harris's fees fell within this range, thus preventing a conclusion that the amount of fees indicates that self-dealing was afoot.[134]

The trial court explicitly used fees on other mutual funds for comparative purposes, which was consistent with the fairness standard used by the trial court in *Gartenberg*. Notably, the Second Circuit in *Gartenberg* disagreed with this approach, however, and it is inconsistent with the Wharton, PPI, and Senate Reports, which held that the forces of arm's length bargaining do not operate in mutual fund markets.

B. THE SEVENTH CIRCUIT

The *Jones* plaintiffs appealed to the Seventh Circuit. Judge Easterbrook, writing for the panel, issued a potentially game-changing ruling. Based in large part on the CH research, the panel rejected the *Gartenberg* approach:

> That mutual funds are 'captives' of investment advisers does not curtail… competition. An adviser can't make money from its captive fund if high fees drive investors away … So just as plaintiffs are skeptical of *Gartenberg* because it relies too heavily on markets, we are skeptical about *Gartenberg* because it relies too little on markets.[135]

And referencing CH:

> A recent, careful study concludes that thousands of mutual funds are plenty, that investors can and do protect their interests by shopping, and that regulating advisory fees through litigation is unlikely to do more good than harm … It won't do to reply that most investors are unsophisticated and don't compare prices. The sophisticated investors who do shop create a competitive pressure that protects the rest.[136] (citation omitted)

Regarding the comparison of institutional and mutual fund fees:

> Harris Associates charges a lower percentage of assets to other clients, but this does not imply that it must be charging too much to the Oakmark funds. Different clients call for different commitments of time. Pension funds have low (and predictable) turnover of assets. Mutual funds may grow or shrink quickly and must hold some assets in high-liquidity instruments to facilitate redemptions.[137]

134. *Id.* at *8.
135. Jones v. Harris Assocs. L.P., 527 F.3d 627, 632 (7th Cir. 2008).
136. *Id.* at 634 (citing Coates & Hubbard, *supra* note 135).
137. *Id.*

The Seventh Circuit ruled that as long as the fiduciary made full disclosure and played no tricks, then a cap on compensation ala *Gartenberg* was inappropriate.[138] This was a radical departure from the *Gartenberg* Standard.

One judge called for a vote on the suggestion for rehearing en banc, but a majority did not favor rehearing. Five judges dissented from the denial of rehearing en banc. Judge Posner wrote the dissent, in which he noted: "The panel bases its rejection of *Gartenberg* mainly on an economic analysis that is ripe for reexamination on the basis of 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."[139] In response to the assertion that an adviser cannot make money from a captive fund if high fees drive investors away, Judge Posner cited FB:

> That's true; but will high fees drive investors away? "[T]he chief reason for substantial advisory fee level differences between equity pension fund portfolio managers and equity mutual fund portfolio managers is that advisory fees in the pension field are subject to a marketplace where arms-length bargaining occurs. As a rule, [mutual] fund shareholders neither benefit from arm's-length bargaining nor from prices that approximate those that arm's-length bargaining would yield were it the norm."[140]

In May 2009, an article in Forbes Magazine revealed that the Coates Hubbard article had been commissioned by the Investment Company Institute.[141] This tainted the research and called into question the Seventh Circuit's radical liberalization of the fiduciary standard. This was the state of affairs prior to oral arguments in November 2009.

C. U.S. SUPREME COURT DECISION

The district court in Jones broke from the Second Circuit's ruling in *Gartenberg* that fees on comparable mutual funds are an inappropriate metric to gauge the excessiveness of a litigated fee. On appeal, the Seventh Circuit ratified the district court's ruling, finding, consistent with the Coates and Hubbard study that fees are competitively determined, and fee litigation is unnecessary. Five judges dissented from a denial of rehearing and the Supreme Court accepted the case to resolve the conflict between the Second and Seventh Circuits. The decision to grant review was made in the context of a wave of fee litigation that threatened to seriously disrupt the investment management industry and increase the number of fee litigation cases in an already overstretched judicial system.

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138. *Id.*
139. *Jones*, 527 F.3d 728, 730 (7th Cir. 2008).
140. *Id.* at 731–32.
141. Hawkins, *supra* note 15.

Although camouflaged and hedged, the Supreme Court ratified the district court ruling. In the process, the *precedent* was significantly changed, making it effectively impossible for plaintiffs to prevail in fee cases going forward. In an operational sense, the re-interpretation of *Gartenberg* is equally as radical as the Easterbrook interpretation and both are consistent with the discredited Coates Hubbard study. Moreover, at oral argument, justices raised questions of material facts involving the comparability of the litigated fees to fees associated with arm's length bargaining. The decision effectively elides these considerations.

The decision, written by Justice Alito, was deliberately and artfully constructed. Justice Alito was a logical choice to write the court's opinion because, unlike the balance of the court, he had significant experience in mutual fund fee litigation.[142]

The discussion proceeds from an overview of oral arguments to an analysis of the arguments and a discussion of the ruling and its implication.

1. Oral Arguments[143]

Prior to oral arguments, respondent explicitly disavowed Judge Easterbrook's market approach that said so long as the process was fair, any fee is okay. It is unclear why Respondent would disavow such a radically favorable ruling, but the most likely reason is that the Coates Hubbard article, the primary justification for Judge Easterbrook's ruling, had been discredited by the Forbes article.

i. Overview

Oral arguments were inconclusive and confused. Justices asked probing questions but were confounded by the ambiguity of the statute, case law, and the complexity of the issues.[144]

142. Justice Alito has considerable experience and knowledge of the issues surrounding mutual fund fees. He was a named Solicitor General attorney in *Daily Income Fund*, another well-known money market mutual fund case, which held that no pre-suit demand on the board of directors of mutual funds is required, as the requirements of F.R.C.P. 23.1 do not apply to actions under § 36(b) of the ICA. Daily Income Fund v. Fox, 464 U.S. 523 (1984).

143. Jones v. Harris Assocs. L.P., 559 U.S. 335 (2010). Counsel for the parties at oral argument were David C. Frederick for petitioners, Curtis E. Gannon for the Solicitor General in support of petitioners and John D. Donovan on behalf of the respondent.

144. There are numerous instances illustrating this point. For instance, the following exchange occurred concluding a discussion of fund governance:

JUSTICE SCALIA: Let's assume you have a disinterested board of directors, which is what the statute requires. You tell me even though they are disinterested, they can't fire the adviser. It seems to me, while they can't fire him, they can say: We are going to cut your fee in half. Whereupon they don't have to fire him. He will pack up and leave, and they will get a new adviser. Doesn't that work?

MR. FREDERICK: There is actually no evidence in any record I am aware of where that has actually happened. The directors have no leverage. And that's the problem the Court—this Court recognized in the Daily Income Fund case.

Oral argument at 17, *Jones*, 559 U.S. 335 (2010).

ii. The Fiduciary Standard

Justices spent time exploring fiduciary responsibilities in a mutual fund context. The discussion was free ranging but ultimately inconclusive. Petitioners explicitly argued that the *Pepper v. Litton* standard was applicable. The Justices seemed unwilling to accept this definition. Mr. Frederick struggled to address their concerns. The following is one example:

> JUSTICE KENNEDY: Is Harris a fiduciary in the same sense as a corporate officer and a corporate director? Or does his fiduciary duty differ? Is it higher or lower, same with a guardian, same with a trustee?
>
> MR. FREDERICK: . . . Here, the investment adviser has appointed the members of the board. As this Court said in the Daily Income Fund case, the earmarks of an—of an arm's-length transaction are absent precisely because–
>
> JUSTICE KENNEDY: I just want to know, is the fiduciary duties the same? Is the fiduciary standard the same, without getting into how its applied?[145]

Collectively, the Justices who asked questions had significant reservations concerning the Pepper Standard.

iii. The Institutional Fee Comparison

Plaintiffs alleged that portfolio management fees on the Harris funds were double those Harris was charging other mutual funds it was sub-advising. Harris countered that the comparison was inapt because it provided services to its captive mutual funds that were not provided to the sub-advised funds. Essentially it was an "apples to apples" versus "apples to oranges" argument.

> MR. GANNON: [A]t the summary judgment stage, the Respondent stated that it disputed how comparable the relevant services were.
>
> The district court and the court of appeals considered that dispute immaterial because, instead of comparing, instead of determining whether this investment adviser is selling the same services at half the price to its unaffiliated clients who actually can engage in arm's length bargaining, those courts simply said that if it—if it falls within the range that is charged by other mutual funds, that would be acceptable.[146]
>
> MR. DONOVAN: the argument is made that services are the same. In fact, that is not the record. And if you look at page 161 of the Joint Appendix and following, there is a list of services . . . the investment adviser gave to the

145. *Id.* at 4.
146. *Id.* at 23.

> trustees in this case, about all of the services that they did for their fee in the case.[147]
>
> JUSTICE SCALIA: Surely that's a disputed fact, isn't it? And you want us to dispose—or you want this to be disposed of on summary judgment. The other side says the services aren't that much different.[148]

Justice Sotomayor also noted that there were significant disputed facts that made summary judgment inappropriate.[149]

iv. Analysis

The respondent emphasized information on page 161 of the joint appendix. Examination of that document reveals a subterfuge that would have been uncovered by a competent plaintiff's attorney at trial.

Mutual fund expense ratios are the sum of three components: investment management fees, distribution or marketing fees and administrative fees. The subterfuge involved administrative fees which are fees deducted from fund assets to pay for services obtained under contracts separate from investment management contracts. Typical components are transfer agent fees, custodial fees, and trustee fees. At trial it could be proved that these services were separately compensated, and the Statements of Additional Information in the Joint Appendix confirms this.

Factual context is useful in exposing the subterfuge. At the end of 2004, assets of the three named Harris funds were about $15 billion and investment management fees were about $125 million or 82 basis points (rounding). At the same time Harris was sub-advising three mutual funds for other investment management firms with assets of about three quarters of a billion dollars for about 41 basis points, which corresponded to about $3 million in investment management fees.[150]

On the surface, it appears to be fundamentally unfair that Harris was selling its investment management expertise to captive funds for $125 million while selling the same expertise in the open market for about $3 million. The difference is explained by the level of assets managed. Harris was collecting 40 times higher fees for managing 20 times the level of assets. Note that if Harris were to manage $15 billion of *sub-advised accounts* for the same 41 basis points it would have charged $61.5 million. Therefore, if Harris were providing extra services to its captive mutual funds, the services would have had a value in the neighborhood of $60 million.

Item C-1 on page 161 of the joint appendix is labelled "Description of the advisory, administrative and other material services rendered by HALP for each fund." The items listed under Investment Advisory Services include

147. *Id.* at 33.
148. *Id.* at 33–34.
149. *Id.* at 34–35.
150. *See* Joint Appendix at 447–49, *Jones*, 559 U.S 335 (2010) (expert report of Edward O'Neal).

Research, Stock Selection, Portfolio Construction, Testing and monitoring compliance with investment restrictions, Performance and related attribution calculations, Investor Conference Calls, and Proxy Voting. These would apply equally to retail and sub-advised portfolios and are largely not objectionable.[151]

Item C-1 includes more than 6 single spaced pages of items listed under Administrative Services. This is the subterfuge. What is listed are administrative services related to managing contract negotiations and oversight, monitoring and coordination of administrative contracts. These terms are ubiquitous throughout the 6 pages of the document. It is absurd on its face to attribute $60 million of extra costs for the activities of negotiating, overseeing, monitoring, and coordinating service provider contracts.

That is not the whole story. There are a few items listed which involve costs for mutual funds but not for sub-advised portfolios. For instance, Item IV on page 165 is Trustee Support. Trustees are compensated separately, but the manager must provide support staff to prepare § 15(c) and other materials necessary to conduct meetings. It strains credulity to suggest that such activities require extra compensation of about $60 million for the three funds involved.

The argument is not that mutual fund management fees and fees determined by arm's length bargaining are perfectly comparable; they are not. The argument is that the magnitude of the service differences is small and immaterial in relation to the magnitude of the management fees differences. The overarching point is that the costs of the different services involved are discoverable and measurable for a court willing to look at the evidence objectively.

Finally, plaintiffs in *Jones* alleged that certain independent trustees were compromised. They were overruled.[152] However, truly independent, and competent trustees would have seen through the subterfuge associated with Item C-1.

2. The Decision

The District Court ruled that fees on other mutual funds were appropriate comparators in determining the range of arm's length bargaining. The Supreme Court effectively accepted this approach and thus made it more difficult for plaintiffs to prevail in fee cases. As noted in oral argument at the Supreme Court, there were disputed material facts that made summary

151. The notion of "investor conference calls" would apply to institutional but not retail accounts. Mutual fund managers are insulated from individual investors and these costs are covered in distribution and transfer agent contracts. This suggests it would cost more to manage an institutional than a retail account.

152. Jones v. Harris Assocs. L.P, No. 04 C 8305, 2007 WL 627640, at *5 (N.D. Ill. Feb. 27, 2007).

judgment inappropriate. Examination of the evidence of those disputed facts strongly suggests that plaintiffs were likely to prevail at trial.

The Supreme Court's decision embraced the *Pepper* Standard and focused the *Gartenberg* Standard on the range of fees determined by arm's length negotiation, including mutual fund fees. Simultaneously, it deemphasized the necessity to gauge the reasonableness of mutual fund fees.

i. The Revised Gartenberg Standard

Prior to *Jones*, courts consistently emphasized the subjective "so disproportionately large" interpretation of *Gartenberg* and essentially ignored the "range of arm's length bargaining" interpretation consistent with the *Pepper* Standard. Justice Alito flipped that. He noted that the parties disagreed about the interpretation of trust law and said: "We find it unnecessary to take sides in this dispute. In *Pepper* v. *Litton*, 308 U.S. 295 (1939), [w]e . . . explained: *The* es*sence of the test is whether or not under all the circumstances the transaction carries the earmarks of an arm's length bargain.* If it does not, equity will set it aside."[153]

There was considerable disagreement about the *Pepper* Standard in oral arguments. Paradoxically, although resolution of the issue in this manner was consistent with petitioner's oral argument, the *Pepper* test was used to support the District Court's improper inclusion of mutual fund fees in the benchmark range. Embracing the *Pepper* Standard allowed Justice Alito to rationalize the inclusion of mutual funds within the range of arm's length bargaining:

> The District Court assumed that it was relevant to compare the challenged fees with those that Harris Associates charged its other clients. But in light of those comparisons as well as comparisons with fees charged by other investment advisers to similar mutual funds, the Court held that it could not reasonably be found that the challenged fees were outside the range that could have been the product of arms-length bargaining.[154] (citation omitted)

By not explicitly rejecting the mutual fund fee comparison, Justice Alito endorsed it by default. What took place in plain sight was a radical departure from 30 years of case law that contradicted the Wharton and PPI Reports and was supported by a single study commissioned by the Investment Company Institute.[155]

Then, in an apparent attempt to camouflage the radical implications of the ruling, Justice Alito straddled the issue:

153. Jones v. Harris Assocs. L.P., 559 U.S. 335, 346–47 (2010).

154. *Id.* at 341–42.

155. Hawkins, *supra* note 15. The ruling does not explicitly cite the CH study but does reference the Seventh Circuit's opinion that advisory fees are the product of competitive forces. The CH study is the only new information Justice Alito had to support his radical ruling.

> By the same token, courts should not rely too heavily on comparisons with fees charged to mutual funds by other advisers. These comparisons are problematic because these fees, like those challenged, may not be the product of negotiations conducted at arm's length . . . *Gartenberg, supra*, at 929 ("Competition between money market funds for shareholder business does not support an inference that competition must therefore also exist between [investment advisers] for fund business. The former may be vigorous even though the latter is virtually non-existent").[156]

It is hypocritical to admonish courts to not rely too heavily on fees charged by other investment management firms while simultaneously licensing courts to consider such fees.[157] The issue is binary and the covert blessing of fee comparisons with other mutual funds is unambiguous despite the qualifications involved. Further, it is not clear that the other Justices understood the implications and would have endorsed the ruling had they clearly understood its radical implications.

ii. The Institutional Fee Comparison

The institution fee comparison as articulated by Justice Alito directed attention from sub-advised funds, at issue in *Jones*, to pension funds, which were not present in *Jones*:

> [W]e do not think that there can be any categorical rule regarding the comparisons of the fees charged different types of clients. Instead, courts may give such comparisons the weight that they merit in light of the similarities and differences between the services that the clients in question require, but courts must be wary of inapt comparisons . . . [T]here may be significant differences between the services provided by an investment adviser to a mutual fund and those it provides to a pension fund which are attributable to the greater frequency of shareholder redemptions in a mutual fund, the higher turnover of mutual fund assets, the more burdensome regulatory and legal obligations, and higher marketing costs.[158] (citation omitted)

On the surface this appears to be a major concession to plaintiffs in fee cases, suggesting that courts may consider fees on institutional accounts but must "beware of inapt comparisons." Fair enough, but in a footnote this concession is effectively nullified. "Only where plaintiffs have shown a large disparity in fees that cannot be explained by the different services in addition to other evidence that the fee is outside the arm's-length range will trial be appropriate.[159] The fee differences must not only be "large"; they must be outside of the arm's length range which include fees on mutual funds that the

156. *Jones,* 559 U.S. 335, at 350–51.

157. Although Justice Alito was unwilling to explicitly endorse the District Court's ruling, his approach softened but ultimately endorsed the ruling.

158. *Jones*, 559 U.S. 335, at 349–50.

159. *Id.* at 349–50.

Supreme Court now allows but cautions against relying upon. Further, the pension comparison by Justice Alito is a red herring. Unlike pension funds, sub-advised mutual fund accounts are sub-advised for other mutual funds and thus subject to the same "myriad of daily purchases and redemptions throughout the nation" as the similar mutual funds Harris was advising for double the fees. The upshot is that the principal reason the court gave for rejecting the mutual fund/institutional comparison was irrelevant in the case against Harris.[160] Strangely, the court also ruled that while fees on other mutual funds are useful comparators, fees on portfolios determined by arm's length bargaining are problematic.

The admonition to be "wary of inapt comparisons" invites comparison of mutual fund and institutional fees while simultaneously licensing the judicial system to disregard the comparison. Subsequent courts regularly equate any minor difference between mutual fund and institutional fees as evidence of an "inapt comparison" and summarily reject the comparison. Evidence of this was recently provided by a district court judge who said that:

> to the Court's knowledge, no court has *ever* held that the fees charged to an investment adviser's institutional or sub-advised accounts are even apt comparators for the fees charged to mutual funds such that a disparity between those fee structures constitutes evidence of a lack of arm's-length bargaining. Rather, as far as the Court can tell, every court to have considered this issue on the merits has come to the exact opposite conclusion.[161]

iii. Jones v. Harris–The Ruling

In *Jones* the Supreme Court had the opportunity to replace *Gartenberg's* tortured interpretation of the standard courts should apply in § 36(b) cases. It was not up to the task. Using Congressional intent as cover, it tepidly affirmed the *Gartenberg* standard while simultaneously acknowledging its failings:

> The *Gartenberg* standard . . . may lack sharp analytical clarity, but we believe that it accurately reflects the compromise that is embodied in § 36(b), and it has provided a workable standard for nearly three decades. The debate . . . regarding today's mutual fund market is a matter for Congress, not the courts.[162]

It is curious and revealing that the Justice Alito felt compelled to gratuitously recognize the analytical failings of Gartenberg while affirming

160. There may be more burdensome regulatory and legal obligations managing retail funds, but these costs are likely to be small, discoverable, and measurable at trial. Marketing costs on retail funds are separately compensated by distribution fees but must be absorbed by management fees by institutional accounts.

161. Chill v. Calamos Advisors LLC, 417 F. Supp. 3d 208, 270 (S.D.N.Y. 2019).

162. *Jones*, 559 U.S. 335, at 353.

its applicability in fee cases. The reasoning behind this concession is opaque but the observation is consistent with the principal insights of this paper.

In practice the *Gartenberg* interpretation of § 36(b) favors the interests of "men of ability and integrity" over the interests of the investing public. As such, it reflects not so much a compromise as a capitulation to the industry that allowed it to escape the reasonableness standard advocated by the SEC. Essentially, what *Jones* says is that, despite a lack of analytical clarity and a long history favoring the industry, *Gartenberg* is consistent with Congressional intent. The "debate" is a matter for Congress, not the courts.

Similarly, Justice Alito's opinion that *Gartenberg* has provided a "workable standard" is true only in the sense that it has allowed the investment management industry to maintain high fees, also consistent with Congressional intent, while avoiding any liability for those high fees. It was well-known at the time Justice Alito wrote his opinion that no plaintiff had ever received an award under the revised statute.

Ultimately, the reasoning in J*ones* is transparently political. The *Gartenberg* standard reflects a tortured and muddled interpretation of the statute which allows the industry to maintain high fees. The Supreme Court refused to change that despite analytically clear evidence of excessive management fees.

iv. Jones v. Harris–Aftermath

In subsequent cases, the judiciary has explicitly embraced the most radical interpretation of *Jones.* The Seventh Circuit's interpretation on remand was extreme: "[T]he Supreme Court's approach does not allow a court to assess the fairness or reasonableness of advisers' fees; the goal is to identify the outer bounds of arm's length bargaining and not engage in rate regulation."[163] This was the same Seventh Circuit panel that ruled that market forces negated the necessity of any standard if the adviser played no tricks. Under this interpretation it is no longer necessary or allowed for courts to assess the fairness or reasonableness of advisers' fees and the *Gartenberg* factors are irrelevant.

Similarly, in a recent § 36(b) case, Judge Ramos of the Southern District of New York interpreted *Jones* even more stringently than the Seventh Circuit:

> [N]or can Plaintiffs prevail by demonstrating *solely* that the Fees are higher, even much higher, than those charged by third parties to peer funds. It is neither the province nor the duty of federal courts to "assess the fairness or

163. Jones v. Harris Assoc. L.P., 611 Fed. Appx. 359, 360 (7th Cir. 2015). Note that the Seventh Circuit did not bother to caution courts not to rely too heavily on fees charged to mutual funds by other advisors. It is also notable that the Seventh Circuit explicitly embraced the canard that restrictions on fees are tantamount to rate regulation.

> reasonableness of advisers' fees; the goal is to identify the outer bounds of arm's length bargaining and not engage in rate regulation."[164]

The interpretation in other circuits has been mixed. For instance, the *Kasilag* court, discussed *infra,* interpreted the decision literally and was cautious not to give too much weight to fees on other funds and to beware inapt comparisons.[165] That court seemed unaware of or chose to ignore the implied ability to decide based solely on comparison of fees on similar funds.

Overall, it is not difficult to understand why no plaintiff has ever received an award under the original or revised *Gartenberg* standard. The precedent has proven impossible to overcome.

V. SUB-ADVISORY FEE CASES AFTER JONES

The Supreme Court ruling that there cannot be "any categorical rule regarding the comparisons of the fees charged different types of clients"[166] was interpreted as a sign that subsequent courts might be open to such comparisons. Sub-advisory fees were chosen as the best comparator because they are the subject of arm's length bargaining and not as prone to "inapt" comparisons as were pension fees. Several such cases have come to trial since *Jones*.

Section 36(b) cases against investment managers involving sub-advisory fees fall into two general categories: manager of manager cases and reverse manager of manager cases.[167] In manager of manager cases, plaintiffs assert that sub-advisors are performing essentially all the management services but receive only a fraction of the fee paid to the manager. In reverse manager of manager cases, plaintiffs assert that a management fee is excessive because the manager charges substantially lower fees to perform essentially identical services when sub-advising funds for other investment managers. *Jones v. Harris* was a reverse manager of manager case.

A prominent feature of sub-advisory fee cases is the industry contention that risk and risk premiums are a relevant explanation for fee differences between mutual fund and sub-advised portfolios. Courts often uncritically

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164. Chill v. Calamos Advisors LLC, 15 Civ 1004, 2018 WL 4778912, at *17 (S.D.N.Y. Oct. 3, 2018).

165. Kasilag v. Hartford Inv. Fin. Servs., LLC, No. 11-1083, 2017 WL 773880 (D.N.J. Feb. 28, 2017) ("Indeed, a fulsome reading of the section of the *Jones* opinion explicitly reveals that comparative fee structures, when the circumstances are appropriate, should be considered . . ."); *see also* Gallus v. Ameriprise Financial, Inc., 675 F.3d 1174 (8th Cir. 2012), quoting from its earlier opinion ("The record reflected that the negotiation focused on the advisory fees charged by peer mutual funds and that the outcome was 'a fee arrangement that, broadly speaking, was comparable to the rates paid by shareholders of other mutual funds throughout the industry.'" Gallus v. Ameriprise Financial, Inc., 561 F.3d 816, 819 (8th Cir. 2009).

166. *Jones*, 559 U.S. 335, at 349.

167. SEAN M. MURPHY ET AL., DEVELOPMENTS IN LITIGATION UNDER SECTION 36(B) OF THE 1940 ACT § I (2017), https://www.westlaw.com/Document/Ie9505880cf4c11e79bef99c0ee06c731/View/FullText.html?transitionType=Default&contextData=(sc.Default)&VR=3.0&RS=cblt1.0.

accept these explanations without regard to accepted theory and doctrine of risk in the literature. This theory is examined next.

A. ECONOMIC THEORY OF RISK AND RISK MODELS

Merriam-Webster defines risk as "possibility of loss or injury: peril . . . the chance of loss or the perils to the subject matter of an insurance contract, *also***:** the degree of probability of such loss."[168] The dictionary definition of risk captures the essential idea that risk is associated with some chance or probability. This underscores the central idea of the modern theory of risk: it is quantifiable. The genesis of this insight is attributed to Frank Knight who formalized a distinction between risk and uncertainty in his 1921 book, *Risk, Uncertainty, and Profit.*[169] According to Knight, risk applies to situations where we do not know the outcome of a given situation but can accurately measure the odds or probability. Uncertainty, on the other hand, applies to situations where we cannot know all the information needed to set accurate odds in the first place.

> Uncertainty must be taken in a sense radically distinct from the familiar notion of Risk, from which it has never been properly separated . . . The essential fact is that 'risk' means in some cases a quantity susceptible of measurement, while at other times it is something distinctly not of this character; and there are far-reaching and crucial differences in the bearings of the phenomena depending on which of the two is really present and operating . . . It will appear that a measurable uncertainty, or 'risk' proper, as we shall use the term, is so far different from an unmeasurable one that it is not in effect an uncertainty at all.[170]

The Frank Knight theory of risk is widely accepted in the economics profession. The notion that risks properly considered must always be quantifiable and quantified is well established. However, this insight is routinely ignored in fee litigation.

B. KASILAG V. HARTFORD

Kasilag was a § 36(b) case against Hartford Investment Financial Services decided in 2017. Plaintiffs argued that Hartford charged fund investors far more than it was paying sub-advisers to manage the funds. [171] The case is unusual because of the level of financial detail provided. The court published average assets, gross management and sub-advisory fees and

168. *Risk*, MERRIAM-WEBSTER DICTIONARY, https://www.merriam-webster.com/dictionary/risk (last visited Mar. 30, 2021).

169. *See generally* F.H. KNIGHT, RISK, UNCERTAINTY, AND PROFIT (1921).

170. *Id.* at 9.

171. Kasilag v. Hartford Inv. Fin. Servs., LLC, No. 11-1083, 2017 WL 773880 (D.N.J. Feb. 28, 2017).

operating expenses for the 2010-2013 timeframe. These data allow for an exceptionally clear examination of the underlying issues.

The analysis here is limited to 2013. At the end of 2013, the Hartford complex was composed of 52 mutual funds totaling $89 billion in assets. All funds were sub-advised, most by Wellington Capital Management and a few by Schroder Capital Management.[172]

It is a notable feature of this case that even though Hartford was an investment management firm, it did no investment management per se. It employed no analysts or portfolio managers. The case disclosed that at the end of 2013 there were a total of 21 Hartford employees handling $89 billion in funds, about half an employee per fund.[173] Essentially, all core investment management functions were performed by sub-advisors. The six named funds were managed by Wellington.[174]

A synopsis of financial results for the six named funds for 2013 is presented in Table 4. The funds had total assets of about $24 billion. Gross management fees totaled about $152 million, and the weighted average advisory fee was 0.636% or 63.6 basis points. Sub-advisory fees totaled $49.6 million, and the weighted average sub-advisory fee rate was 0.207% or 20.7 basis points. In addition to sub-advisory costs, Hartford operating expenses were about $2.6 million or 1.1 basis points. Expenses totaled about $52 million so operating profits were about $100 million or 65.7%.

Table 4
Assets, Fees, Costs and Profits for 2013 in Kasilag v Hartford
Averages and Totals for Six Named Funds

	Assets (Millions)	Gross Advisory Fees (Millions)	Advisory Fee Rates	Sub-Advisory Fees (Millions)	Sub-Advisory Fee Rates
Weighted Avgs.			**0.64%**		**0.21%**
Total	**$23,944**	**$152**		**$49.60**	
Source: Kasilag v. Hartford Inv. Fin. Servs., LLC, No. 11-1083, 2017 WL 773880 (D.N.J. Feb. 28, 2017)					

172. *Id.* at *5.
173. *Id.* at *13.
174. *Id.* at *5.

Table 4 (Continued)
Assets, Fees, Costs and Profits for 2013 in Kasilag v Hartford
Averages and Totals for Six Named Funds

	Operating Expenses (Millions)	Operating Expense Rates	Total Expenses (Millions)	Operating Profits (Millions)	Profit Margin
Weighted Avgs.		**0.01%**			**65.7%**
Total	**$2.60**		**$52.20**	**$100.10**	

Plaintiffs put forth a "Retained Fee" theory, which argued that sub-advisory fees were not a legitimate expense when calculating profitability in a *Gartenberg* context.[175] Using this theory, plaintiffs estimated Hartford's profits in excess of 98%,[176] well in excess of the case law precedent of 77% established in *Schuyt*. The court rejected the "Retained Fee" theory.[177] Hartford's weighted average operating margin was about 66%, end of argument. Except, there was a problem! Hartford earned $100 million on the named funds for doing what, exactly? It was clear that Hartford did no investment management, indeed given the staffing levels Hartford could not do investment management.

Hartford argued that it provided services to the funds such as formulating strategy and monitoring service providers. Hartford did not attempt to directly quantify the costs of these services. However, a reasonable assumption is that the costs were covered by the $2.6 million of operating expenses allocated to the funds in Hartford's profitability calculations.

The *Kasilag* court obfuscated important issues mainly involving fee comparisons. It used, but misinterpreted, the *Jones* decision:

> Plaintiffs are certainly correct that courts should be wary of giving undue weight to fees charged by other mutual funds . . . Contrary to Plaintiffs' position, however, "not relying too heavily" on comparisons does not mean "not relying at all." Indeed, a fulsome reading of the section of the Jones opinion explicitly reveals that comparative fee structures, when the circumstances are appropriate, *should* be considered . . . Wariness of inapt comparisons and an instruction not to rely too heavily upon fee comparisons does not equal an outright bar to the consideration of comparative fee analyses under Jones.[178] (citations omitted)

175. *Kasilag*, 2017 WL 773880, at *12.
176. *Id.* at *14.
177. *Id.* at *22.
178. *Id.* at *23.

By page count, about 25% of the decision was about fees and performance comparisons. It is clear that because of *Jones*, the court relied on fee and performance comparisons despite what the Second Circuit had said in *Gartenberg*. *Jones* cautioned against inapt comparisons in reference to institutional/pension fees, but the *Kasilag* court conflated these with other mutual fund comparisons.

The court compared Hartford fees and services to Wellington fees and services obliquely. These comparisons are interesting. For instance, in footnote 13, the court said: "It is generally undisputed that Wellington's profit margin was lower than defendants', a fact that is not that significant or surprising given the businesses are different."[179] (citation omitted)

Similarly, in footnote 40 of its opinion, the court said it was "unpersuaded that the proper course is to compare the profit margins of defendants to Wellington, as Plaintiffs urge. Although Wellington's profit margin is lower than defendants', as defendants point out, the Court is in receipt of little evidence that the profitability of a sub-adviser with a different role and different risks, among other differences, can be compared." (citations omitted).[180]

It is unclear how the court determined that Wellington's profit margins were lower than defendants although the observation is consistent with common sense. With one-third the fee rates and competitive pricing, it is likely that this is a correct observation. However, the statement unintentionally supports the idea that Hartford's fees are too high. In a sense, the opinion that the businesses are different is correct because Wellington was an investment manager and Hartford did no investment management although it is unlikely that the court meant it in that sense. Ultimately, the court just declared that there was no comparison.

Hartford argued that that $100 million in profits was just compensation for the risks it faced: specifically, legal/regulatory, entrepreneurial, and reputational risks.

To its credit, the *Kasilag* court did not succumb to the nonsensical legal/regulatory risk argument. It gave credence to the testimony of a plaintiff's expert who explained that liability-related clauses in the investment management agreements basically say, "as long as they behave themselves and don't steal and act very grossly negligent, they're held harmless."[181] However, the court noted that the expert "did not address the types of risk, such as entrepreneurial risk or reputational risk, *which defendants view to be important*"[182] (emphasis added).

179. *Id.* at *5 n. 13.
180. *Id.* at *22 n. 40.
181. *Id.* at *7.
182. *Id.* at *8.

Entrepreneurial risk is the risk that a startup business will fail, and startup costs will be lost. Attributing the $100 million in annual profits on the six funds as compensation for entrepreneurial risk is absurd for two reasons.

First, the named funds were well established with average assets of about $4 billion. The funds had been in existence for many years. The youngest Hartford fund was 12 years old when *Kasilag* was decided in 2017, the oldest was 34 years old. Second, the cost to start a mutual fund is low. For instance, Premier Fund Solutions, a firm providing comprehensive services for the mutual fund industry, estimates that it costs about $125,000 to start and operate a mutual fund.[183] Other start-up cost estimates range from $25,000 to $350,000, averaging about $150,000.[184] Clearly, it does not cost much to start a mutual fund and in this sense, entrepreneurial risk to a large company like Hartford is minimal.

The idea of reputational risk is, by its very nature, vague and casual. The Hartford CIO testified that "if the funds fail to deliver what the shareholders are expecting, their name is at risk because it is associated with the funds."[185] That this "definition" is not a model of clarity is obvious . There is no reasonable basis upon which the concept can be quantified and therefore it is better labeled "reputational uncertainty."

Ultimately, the *Kasilag* court gave great weight to the risk argument:

> Although the costs that were directly incurred by Defendants were low in relation to the gross management fee that was paid, the Court finds that a consideration of all of the services performed, including those performed by sub-advisers, Plaintiffs have not carried the burden of showing that the nature of the services indicated that fees were so disproportionate that they could not have been negotiated at arm's length. This is particularly so in light of the risks that were also borne by Defendants. . . [186]

A high-altitude view of the decision suggests that the *Kasilag* court was myopic as were the trustees of the Hartford funds who approved the investment management contracts.[187] Hartford profited by about $100 million

183. PREMIER FUND SOLUTIONS, *Cost*, http://www.pfsfunds.com/cost.html (last visited May 10, 2021).

184. *See, e.g.*, Terry Lane, *How to Start a Private Mutual Fund*, ZACKS (updated Jan. 28, 2019), https://finance.zacks.com/start-private-mutual-fund-11680.html; *Can Anyone Create a Mutual Fund?*, MOTLEY FOOL (updated Nov. 27, 2016, 10:44 PM), https://www.fool.com/knowledge-center/can-anyone-create-a-mutual-fund.aspx; *see also Mutual Funds: Economies of Scale*, FORBES (Feb. 6, 2009, 06:00 PM), https://www.forbes.com/2009/02/05/mutual-fund-startup-intelligent-investing_0206_mutual_fund.html#40102f5e77e1; Tracey Longo, *Starting Your Own Mutual Fund*, FINANCIAL ADVISOR (May 1, 2006), https://www.fa-mag.com/news/article-1393.html; and Dennis Hartman, *Can Anyone Create a Mutual Fund*, POCKETSENSE (Apr. 19, 2017), https://pocketsense.com/can-anyone-create-mutual-fund-2535.html.

185. *Kasilag*, at *7.

186. *Id.* at *21.

187. The court held that "substantial weight" would be granted to independent director approval. Kasilag v. Hartford Inv. Fin. Servs., LLC, No. CV 11-1083 (RMB/KMW), 2016 WL 1394347, at *14 (D.N.J. Apr. 7, 2016), *aff'd,* 745 F. App'x 452 (3d Cir. 2018).

on the named funds for doing essentially very little or nothing. The named risks were minuscule in relation to the profits involved. All the core investment management functions were performed by Wellington. Hartford was an investment management firm but did no investment management.

A closer look at the decision suggests some sympathy for the dilemma the court faced. Having ruled against the plaintiff's "Retained Fee Theory", the decision was preordained by case law precedent. Hartford's average profit margins were less than the *Schuyt* precedent and none of the other *Gartenberg* factors covered the contingency of investment managers not managing anything. The subjective nature of the *Gartenberg* Standard offered the court a convenient off-ramp to avoid a difficult decision. Ultimately, the problem is not the *Kasilag* court but the case law precedent that enabled it and, incidentally, independent trustees, to hide behind questionable judicial decisions.

C. RISK CATEGORIES AND OTHER SUB-ADVISORY FEE CASES

In many ways, the *Kasilag* decision is exemplary in its simplicity and clarity. Several § 36(b) cases involving sub-advisory fees have come to trial since *Jones*, and the fundamental issues are similar to *Kasilag*, i.e., fees on mutual fund portfolios are substantially higher than fees on sub-advised portfolios where services are similar, and negotiation is present. However, financial disclosure is lacking, and the decisions are noticeably muddled and messy. One commonality is the reliance on, and proliferation of, different risk categories used to rationalize fee differences. For instance, *Sivolella* mentions business, market, operational, litigation, regulatory, reputational, and entrepreneurial risks.[188] *Kennis* talks about reputational, financial, litigation, regulatory, business, and cybersecurity risks.[189] *Blackrock* discusses financial, reputational, and regulatory risks.[190] *Chill* ruled on litigation, legal, regulatory, operational, and entrepreneurial risks.[191] With the exception of *Blackrock*, each of these cases explicitly mentions the patently absurd litigation risk as relevant to explaining fee differences. None of the cases required defendants to quantify the risks involved. Courts casually accept risk and risk differences as appropriate rationales despite plaintiff's highlighting of economic theory. The *Chill* court cited *Sivolella*, which

188. Sivolella v. AXA Equitable Life Ins. Co., No. 11CV4194PGSDEA, 2016 WL 4487857, at *42 (D.N.J. Aug. 25, 2016), *subsequently aff'd sub nom.* Sivolella for use & benefit of EQ/Common Stock Index Portfolio v. AXA Equitable Life Ins. Co., 742 F. App'x 604 (3d Cir. 2018). Kasilag and Sivolella were manager of manager cases. *Kennis* and *Chill* were reverse manager of manager cases.

189. Kennis v. Metro. W. Asset Mgmt., LLC, No. CV 15-8162-GW(FFMX), 2019 WL 4010747, at *12 (C.D. Cal. July 9, 2019), *adopted*, No. CV 15-8162-GW-FFMX, 2019 WL 4010363 (C.D. Cal. Aug. 5, 2019), *aff'd*, 821 F. App'x 895 (9th Cir. 2020).

190. In re BlackRock Mut. Funds Advisory Fee Litig., No. CV141165FLWTJB, 2019 WL 1387450, at *11 (D.N.J. Feb. 8, 2019), *aff'd,* 816 F. App'x 637 (3d Cir. 2020).

191. Chill v. Calamos Advisors LLC, 417 F. Supp. 3d 208, 269–70 (S.D.N.Y. 2019).

concluded "that the investment adviser 'was not required to quantify the risk in order to justify a portion of its fee' and finding that the board of trustees 'nonetheless considered the risk that [the adviser] faces, even though there was no specific cost assigned to it.'"[192] The court, "in line with the others to have considered this issue, agrees that Calamos need not have 'quantified' the differences in services and risks between its clients and that the Independent Trustees need not have asked for such quantifications."[193]

The discussion is not meant to imply that risk considerations are inapplicable or irrelevant in fee litigation. Empirically based and quantified risk measures could contribute to the discussion.[194] The main point is that as currently applied in litigation, risk considerations are casual and unquantified.

D. SUMMARY–FORTY YEARS OF FAILURE

This paper began with the statement: "Something is wrong with mutual fund fee litigation and mutual fund governance." This conclusion seems inescapable. How else to explain the $100 million of Hartford investment management profits when Hartford could not do investment management? Or the Supreme Court's muddled ruling in *Jones v. Harris*? Or the frequent and absurd rulings rationalizing high fees as just compensation for litigation risk?

"Because of the unique structure of this industry . . . [t]he forces of arm's length bargaining do not work in the mutual fund industry in the same manner as they do in other sectors of the American economy."[195] That was true in 1970 and it is true today.

Mutual fund investors are and have been systematically overcharged for investment management services. There is a systematic failure to protect investors from excessive fees. It is fair to ask how this can be true fifty years after Congress ostensibly fixed the problem.

Individuals and institutions respond to incentives. The investment management industry skillfully manipulated judicial and fund governance incentives to maximize profits for their owners. The two institutions designed to protect investors from conflicts of interest have responded to perverse incentives in a manner that is both expedient and self-serving.

The investment management industry convinced Congress and the judicial system that a reasonableness standard was equivalent to public utility

192. *Id.* at 257.

193. *Id.*

194. Commonly used models of risk are variations of the "expected value" model, which is the probability weighted average of possible numerical outcomes. HOSSEIN PISHRO-NIK, INTRODUCTION TO PROBABILITY, STATISTICS, AND RANDOM PROCESSES, 3.2.2 Expectation, PROBABILITYCOURSE.COM, https://www.probabilitycourse.com/chapter3/3_2_2_expectation.php (last visited May 10, 2021).

195. S. REP. NO. 91-184, *supra* note 6, at 5–6.

rate regulation. Beginning with *Gartenberg*, the judicial system has systematically failed to protect mutual fund investors from high fees. Similarly, fund governance is broken, although perhaps not irretrievably. Independent directors have the power to fix the problem. What has been lacking is the willingness of directors to look clearly at the problem and fulfill their statutory and fiduciary duties.

VI. MUTUAL FUND GOVERNANCE

STATUTORY AND FIDUCIARY DUTIES OF INDEPENDENT DIRECTORS

As part of the 1970 amendments to the ICA, Congress added §15(c):

> [I]t shall be unlawful for any registered investment company . . . to enter into, renew, or perform any contract or agreement . . . unless the terms of such contract or agreement . . . have been approved by the vote of a majority of directors, who are not parties to such contract or agreement . . . It shall be the duty of the directors of a registered investment company to request and evaluate, and the duty of an investment adviser to such company to furnish, such information as may reasonably be necessary to evaluate the terms of any contract . . .[196]

The Independent Directors Council defines and discusses fiduciary duty as follows:

> Directors have the fiduciary duty to represent the interests of the fund's shareholders and are subject to state law duties of loyalty and care . . . Fundamental to the duty of loyalty is the avoidance of self-dealing and of conflicts of interest that are detrimental to the fund. . . The duty of care requires directors to perform their duties in good faith, in a manner reasonably believed to be in the best interests of the fund . . . [197]

The crux of the fund governance problem is that independent directors fulfill statutory and fiduciary obligations by evaluating fee contracts in a *Gartenberg* context. The annual evaluation process, known as the "15(c) process," focuses on the *Gartenberg* Standard and factors with its case-law baggage and ambiguity.

An exhibit in a recent webinar hosted by the Mutual Fund Directors Forum illustrates this:[198]

Guidance Available to the Board

196. 15 U.S.C. § 80a-15(c) (2018).

197. INDEP. DIR. COUNCIL, FUNDAMENTALS FOR NEWER DIRECTORS 10 (2021), https://www.ici.org/system/files/attachments/pdf/idc_11_fundamentals.pdf.

198. MUT. FUND DIR. FORUM, WEBINAR, ASSET MANAGEMENT FIRM PROFITABILITY TRENDS INCLUDING Q1 2020 MARKET VOLATILITY (May 28, 2020). On file with the author.

Profitability review is driven by the industry-standard *Gartenberg*[199] factors that have not changed:

- Profitability should be evaluated excluding marketing and distribution.
- No court has found profitability of an adviser to be excessive, but no court has found that a specific level of profitability is per se permissible.
- High profits earned by the adviser are not necessarily indicative of an excessive fee, this does not mean that such a profit margin could never be excessive.
- A fee must not be so disproportionately large that it bears no reasonable relationship to the services provided.
- The fees must not be so excessive that they could not reflect the results of arm's length bargaining.
- There are no guidelines or generally accepted accounting principles to arrive at profitability calculations.
- Because there are no standards on allocation models, there is also no comparable fund-by-fund data.

The Supreme Court's observation that *Gartenberg* lacks "analytical clarity" is on full display. What is labeled as "Guidance Available to the Board" is so larded with ambiguity as to be functionally useless. For instance: "High profits earned by the adviser are not necessarily indicative of an excessive fee, this does not mean that such a profit margin could never be excessive"[200] constitutes no guidance at all.

It should be clear that what is commonly billed as business judgment is in fact almost entirely a legal judgment made in a legal context. Further, because *Gartenberg* is settled case law, the decision to approve the contract in a *Gartenberg* context is safe, easy, and pre-ordained.

B. PROFILING "INDEPENDENT" DIRECTORS

The statutory requirements to qualify as a disinterested/independent director are loose. In general, individuals cannot be immediate family or close business associates or have had a financial relationship with the adviser in the past two years.[201] Independent directors are appointed by the adviser and thus, "most fund boards are composed of industry-friendly, highly paid,

199. The complete discussion of the *Gartenberg v. Merrill Lynch Asset Management* (1982) and related cases can be supplemented with Gartenberg case documents in addition to board's counsel memorandum in connection with the 15(c) meeting. This deck should not be considered as legal opinion on specific facts or as a substitute for legal counsel.

200. *Id.*

201. Lyman Johnson, *A Fresh Look at Director "Independence": Mutual Fund Fee Litigation and Gartenberg at Twenty-Five*, 61 VAND. L. REV. 497, 507–08 (2008) details the requirements.

long-serving directors."[202] The lack of independence of mutual fund directors, even those who carry the label "not interested" has long been an open secret."[203]

The author accessed and tabulated data from the Statements of Additional Information (SAIs) for the 50 largest fund complexes for the 2019 fiscal year.[204] These complexes managed a total of about $8.5 trillion in active assets, averaging about $170 billion per complex. Among other data, SAIs contain information about funds supervised, committee structure, individual directors/trustees, their compensation, and a brief bio. Other tabulated information will be described infra.

A perusal of the SAIs suggests that the investment management industry populates fund boards with demonstrably high quality and capable individuals from a broad cross-section of the population. Generally, directors come from the top of their individual fields. Roughly 75% are from the business community with a plurality of those from some form of asset management. The balance come from academia, government, military, and other non-business pursuits. Women are well represented. There is no information on minority representation, but it is to be assumed they are well represented. In general, there is no reason to doubt collectively or individually the honesty and integrity of independent directors.

C. FUND GOVERNANCE BY THE NUMBERS

Table 5 contains a useful broad-brush profile of independent trustees and an overview of the average board structure. The average trustee was 67 years old and received about $330,000 a year for a part-time job, typically attending 5 meetings a year. The average fund board had about 10 directors, about 85 percent of which were classified as independent. The chairman of the board was independent for most (75%) of the fund families. The numbers in Table 5 coupled with the biographical information allow for some powerful insights into mutual fund governance.

202. Emily D. Johnson, *The Fiduciary Duty in Mutual Fund Excessive Fee Cases: Ripe for Reexamination*, 59 DUKE L.J. 145, 152–53 (2009).

203. Alan R. Palmiter, *supra* note 11, at 170 (2006).

204. *See, e.g.,* Putnam Income Fund, Registration Statement Under the Investment Company Act of 1940, Statement of Additional Information, Form N-1A, Part B, at 1 (Dec. 02, 2019), https://www.sec.gov/Archives/edgar/data/0000081264/000092881620000211/a_income485b.htm.

Table 5
Profile of Independent Directors and Fund Governance
50 Largest Mutual Fund Families -2019

Independent Directors	**Averages**
Age	67.3
Annual Compensation	$330,914
Open End Funds in Family	76.6
Portfolios Supervised	85.3
Board Structure	
Number of Independent Directors	8.52
Number of Interested Directors	1.70
Total Board Size	10.22
Proportion of Independent Directors	85%

Source: Statements of Additional Information, 2019 (Available on Edgar, https://www.sec.gov/edgar/searchedgar/mutualsearch.html)

1. Span of Control

Span of control is a management concept that involves the number of employees a manager can effectively supervise. It is a useful concept when applied to fund governance.

The typical fund board must deal with a large number of funds, about 80 on average.[205] This is usually presented as an efficiency measure because fund governance costs are spread among a large number of funds and thus the costs to each fund are minimal. However, the statute requires that each fund operate with a written contract evaluated and renewed annually by the board.

Annual meetings are dominated by the § 15(c) process. Operationally this means that each fund must be evaluated separately, and the evaluation process is conducted in a *Gartenberg* context. Directors scrutinize the

205. Most fund families utilize a unitary board structure where the same board supervises all of the funds offered by the complex. Others have cluster boards where subsets of funds are managed by different or partially different boards. The number of funds supervised shown in Table 5 should be viewed as a close approximation but not as perfectly representative. There are multiple reasons for possible errors. Often fund complexes offer Exchange Traded and Closed-end Funds and these are not counted in Table 5 although they may be within the span of control of a unitary board. Also, when there are multiple boards in the same complex it is necessary to sample different funds and average the number of funds supervised. Finally, many fund complexes have their unitary board supervise non-fund customers such as pension and separately managed accounts.

Gartenberg factors for each fund.[206] Ultimately, they gauge whether the advisory fee is so disproportionately large that it could not have been the product of arm's length bargaining.

Moreover, this process must be undertaken with no dedicated staff. Directors must rely on adviser personnel to produce exhibits that are boilerplate out of necessity. Additionally, fund directors have duties far beyond mere contract approval. The 1940 Act and SEC regulations charge directors with many other responsibilities, including:

- overseeing not only the adviser, but all of the fund's other service providers (transfer agent, fund accountant, auditors, etc.)
- overseeing the fund's compliance program under Rule 38a-1
- overseeing the daily NAV calculation and pricing of every security held by each fund
- overseeing the fund's liquidity program to ensure the fund can satisfy daily shareholder redemptions
- reviewing, approving, and signing the fund's prospectus, shareholder reports (including financial statements), and other SEC filings[207]

Summarizing, fund directors have a vast span of control, a multitude of duties, no staff, and a limited number of meetings to fulfill their responsibilities. Overall, these insights support the Palmiter assertion that the annual approval process involves an "empty ritual."[208] It could hardly be otherwise.

2. Independent Directors

In perusing SAIs, it is not difficult to identify directors with an "industry-friendly" orientation. For instance, Joseph S. DiMartino is an independent director and Chairman of the Board of the BNY Mellon Funds. He has held the position for more than 20 years. His annual compensation is about $1.25 million. In August 1994, BNY Mellon acquired the Dreyfus family of funds. From 1971 through 1994, Mr. DiMartino held various positions at Dreyfus including Chief Operating Officer and President.[209]

206. In a litigation context, in order to be found independent and conscientious, directors must meet and thoroughly discuss fees on each fund individually, which is difficult to do in a few days for a large number of funds.

207. By the SEC's count, the fund board is called on under the 1940 Act and its rules to review and approve fund transactions in twenty-seven different situations, some of which are delegated to the full board, while others are delegated only to independent directors. Wallace Wen Yeu Wang, *Corporate Versus Contractual Mutual Funds: An Evaluation of Structure and Governance*, 69 WASH. L. REV. 927, 956–58 (1994).

208. Alan R. Palmiter, *supra* note 11, at 166.

209. BNY Mellon, BNY Mellon Family of Funds, Supplement to Current Summary Prospectus and Statement of Additional Information (Apr. 30, 2021), pf. I-1, I4, https://im.bnymellon.com/us/en/individual/funds/ebook/05587K105/693287?sci=05587K105&file=/us/en/documents/complianceDocs/sai/adhoc/group03_sai.pdf#zoom=page-width

Similarly, George Putnam, III, is an independent director of the George Putnam Fund. Before June 2007, Mr. Putnam was President of the Putnam Funds. His annual compensation in 2020 was $360,000.[210]

A third example comes from the *Sivolella* case. Mr. Gary Schpero was the Lead Independent Trustee for AXA variable annuity funds. For 22 years he practiced law with a firm "which represented mutual funds, independent directors and investment advisers."[211] Mr. Schpero was quoted extensively in the case and was viewed as credible. He testified that the board is "extremely focused on the ultimate goal here, which is to make sure the fee is fair and reasonable, and in the exercise of our business judgment . . . is going to be satisfactory to the investor."[212] The statement is lawyerly and vague. The goal of a fair, reasonable, and satisfactory fee is totally subjective and there is no attempt to compare fees to those determined by arm's length bargaining.

The existence of industry-friendly independent directors has consequences. Judge Posner in his dissent in *Jones* voiced concerns and referenced a paper by Camelia Kuhnen[213] who questioned the independence of independent directors. Johnson has summarized Kuhnen's research as follows:

> Professor Kuhnen found that business connections—specifically the number of times fund directors have sat on boards of any other funds managed by the adviser and a related measure of connectivity between the adviser and a potential new subadviser—foster favoritism in dealings between fund directors and advisers to the detriment of investors. She found that when mutual funds select subadvisory firms to help the primary adviser manage the fund, the greater the connection between such firms and fund directors through past business relationships, the more likely they are to win the management contract. Moreover, the more connected subadvisers and fund directors are, the lower the net and risk-adjusted rates of return. Past business connections also play a role in an adviser's selection of directors to serve on new funds sponsored by the adviser. In addition, Professor Kuhnen found that business connections are positive predictors of expense ratios and advisory fees. She also concluded that all measures of business connections are significant negative predictors of the amount of expenses the advisor reimburses to the fund.[214] (footnotes omitted)

Langevoort suggests that industry insiders, including independent directors, are likely to view the § 15(c) process as something of an exercise

210. Putnam Investments, Putnam Income Fund Summary Prospectus, I-10 (Feb. 28, 2021), https://urldefense.com/v3/__https://www.putnam.com/static/html/fund_documents/624.htm.

211. Sivolella v. AXA Equitable Life Ins. Co., No. 11CV4194PGSDEA, 2016 WL 4487857, at *10 (D.N.J. Aug. 25, 2016).

212. *Id.* at *27.

213. Camelia M. Kuhnen, *Business Networks, Corporate Governance and Contracting in the Mutual Fund Industry*, 64 J. FIN. 2185 (2019).

214. Johnson, *supra* note 202, at 514.

in formalism. This view arises from commonly held views of consumer sovereignty.

> If shareholders are responsible for their own choices, directors are less likely to feel obliged to act aggressively on their behalf. Net inflows of money are the proper metric for testing product quality, not the directors' subjective impression of a fair price. That is to say, they do not see themselves as there to engage in serious bargaining with the sponsors as shareholder representatives, because that is not needed; that, in turn, absolves them from the otherwise uncomfortable exercise of serious fiduciary control.[215]

The existence of large numbers of industry-friendly "independent" directors is important but it is not the whole story. Representative of the overall quality are two retired military people.

Frank L. Bowman is a retired US Navy Admiral with 38 years of active-duty service including Director of the Nuclear Propulsion Program and Chief of Naval Personnel. He was knighted as Honorary Knight Commander of the Order of the British Empire and awarded the Officier de l'Orde National du Merite by the French Government.[216]

Serving with Admiral Bowman on the Morgan Stanley board were a mutual fund investment management consultant, a former Managing Director of Blackrock, a venture fund and Victory Fund director, a former Vice Chairman of the Board of Governors of the Federal Reserve System, and Assistant Treasury Secretary, a senior adviser in an investment consulting firm and a managing director of an alternative investment firm.

The Morgan Stanley SAI reveals that Admiral Bowman was paid $340,000 for his services in 2019. He was responsible for the oversight of 79 funds in the complex and Morgan Stanley managed about $230 billion in active assets as of the end of 2019.

Similarly, James G. Stavridis is an independent director of the Neuberger Berman family of funds. He is a retired US Navy Admiral and former Supreme Allied Commander, NATO. He is also the former Dean of the Fletcher School of Law and Diplomacy of Tufts University.[217]

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215. Langevoort, *supra* note 48, at 1038. *See also id.* at n. 122, "This plainly is the way those inside the industry view the directors' role, which makes it likely that the director selection process will seek those who agree. For a good illustration of the tension between this vision and the stronger image of the director as the shareholders' faithful bargaining agent, see Mercer E. Bullard, Context and Commentary, *The Mutual Fund Summit: Context and Commentary*, 73 MISS. L.J. 1129, 1141–46 (2004) (describing panel discussion)."

216. Morgan Stanley Institutional Fund, Inc. Statement of Additional Information, at 68 (Apr. 30, 2021), https://morganstanley.prospectus-express.com/summary.asp?doctype=sai&clientid=morganstll&fundid=61756E594.

217. NEUBERGER BERMAN, NEUBERGER BERMAN EQUITY FUNDS STATEMENT OF ADDITIONAL INFORMATION, at 90–92 (Dec. 15, 2020), https://www.nb.com/handlers/documents.ashx?item_id=c4e46bf0-0762-4ab1-9155-dfaffa8fcf2e.

Serving with Admiral Stavridis on the Neuberger Berman Board were a former president of GE Asset Management, former VP and General Counsel of Fidelity Investments, a former president of Prudential Asset Management, a former business school dean, a member of a wealth management practice and university professor, another adjunct professor, a former CEO of Charles Schwab, a private investor and insurance industry consultant, and a retired Ford Motor Company executive.[218]

Admiral Stavridis was paid $217,500 for his services in 2020 and was responsible for the oversight of 51 funds. Neuberger Berman managed about $190 billion of active assets as of the end of 2019.

The investment management industry is well represented among the other independent members of both boards. However, it is important to note that all the directors are people of substance. Obviously, directors are people of integrity; decent, honorable, accomplished, and honest. There is no evidence that they could not put aside their personal experiences and act responsibly in their role as fiduciaries. There is an apparent disconnect between the obvious quality of mutual fund members and the decisions which emanate from their deliberations.

D. DUTIES OF INDEPENDENT DIRECTORS

The duties of independent directors are dictated by case law and the ICA. A common, high altitude judicial characterization of these duties is that they "negotiate and approve" that annual advisory fee contract. These concepts are analyzed separately, and the analysis reveals stark differences between reality and the judicial view of the process.

1. Fee Negotiation

The ICA is silent on the issue of negotiation. The District Court in *Gartenberg* created a negotiation fiction that has endured. If mutual funds were normal corporations, directors would negotiate on behalf of shareholders. Mutual funds are not normal corporations, but the view that fees are somehow "negotiated" by fund boards is endemic in the judicial system, even at the U.S. Supreme Court.[219] It is also wrong.

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218. *Id.* at 95–98.

219. According to BLACK'S LAW DICTIONARY, negotiation is "a consensual bargaining process in which the parties attempt to reach agreement on a disputed or potentially disputed matter" that usually "involves complete autonomy for the parties involved, without the intervention of third parties." *Negotiation*, BLACK'S LAW DICTIONARY (11th ed. 2019). The concept of negotiation as articulated in *Jones* is very different:

> Where 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. See *Burks* . . . (unaffiliated directors serve as "independent watchdogs"). Thus, if the disinterested directors considered the relevant factors, their decision to approve a particular fee agreement is entitled to considerable weight, even if a court might weigh the factors differently.

Jones, 559 U.S. 335, 351 (2010) (citations omitted).

In fact, meaningful fee negotiation by mutual fund directors is non-existent. To assert otherwise is to directly contradict the SEC and the U.S. Senate reports, both of which emphasized that the forces of arm's length bargaining do not operate in the mutual fund arena. Indeed, that was the whole rationale for the 1970 amendments to the ICA. Today, the situation is unchanged.

Recent case law supports this idea. Several courts have ruled that independent directors have no duty to negotiate fees.[220] Similarly, the Investment Company Institute notes that: "Directors are not required to negotiate for the absolute lowest rate with the adviser. Instead, regulators and the courts recognize that directors must balance a number of considerations, including the nature, extent, and quality of the services provided by the adviser."[221]

A perusal of the Fund Director's Guidebook[222] reinforces the idea that negotiation is not in directors' toolkit. There are literally hundreds of books written about negotiation techniques, but, in the author's experience, no mention of negotiation in the Handbook. Similarly, there is no mention of negotiation techniques or policies in any of the SAIs of the 50 largest funds families.

Empirical evidence supports the notion that meaningful negotiation is absent in mutual fund markets. Here the emphasis is on the term "meaningful." Recent research shows that management fees dropped only slightly over the 1994 to 2018 period while assets increased almost 700% and distribution and administrative fees fell about 50% each.[223] Given the well-known economies of scale in the advisory function, meaningful negotiation by directors would have forced a greater decrease in fees.

In *Jones* negotiation is inferred from the process and no evidence of actual consensual bargaining is required. Board consideration of the relevant factors and contract approval is adequate evidence of a "robust" process and is sufficient for courts to afford deference to the outcome. Board members demonstrate their conscientiousness by "considering" relevant information, including the *Gartenberg* factors. Considering is very different from negotiating. Negotiation is a missing step between consideration and contract approval. At least one federal court has been critical of contract renewal procedures, noting that "although the directors were represented by counsel and were provided with detailed materials to which they and defendants can point to and say "see how thorough and careful we were" the entire process seems less a true negotiation and more an elaborate exercise in checking off boxes and papering the file." In re Am. Mut. Funds Fee Litig., No. CV 04-5593 GAF (RNBX, 2009 WL 5215755, at *3 (C.D. Cal. Dec. 28, 2009), *aff'd sub nom.* Jelinek v. Cap. Rsch. & Mgmt. Co., 448 F. App'x 716 (9th Cir. 2011).

220. Krinsk v. Fund Asset Mgmt., Inc., 875 F.2d 404 (2d Cir. 1989); Schuyt v. Rowe Price Prime Rsrv. Fund, Inc., 663 F. Supp. 962 (S.D.N.Y.), *aff'd,* 835 F.2d 45 (2d Cir. 1987); Kennis v. Metro. W. Asset Mgmt., LLC, No. CV 15-8162-GW(FFMX), 2019 WL 4010747, at *28 (C.D. Cal. July 9, 2019); *but see* Chill v. Calamos Advisors LLC, 417 F. Supp. 3d 208, 234–35 (S.D.N.Y. 2019).

221. INDEP. DIR. COUNCIL, FUNDAMENTALS FOR NEWER DIRECTORS 20 (2021).

222. ABA, FED. REG. SEC. COMM., FUND DIRECTOR'S GUIDEBOOK (4th ed. 2015).

223. Stewart L. Brown & Steven Pomerantz, *Mutual Fund Advisory Fees: Sponsors Game the System as Watchdogs Slumber*, OHIO ST. BUS. L.J. (forthcoming 2021)

Palmiter provides an example of a negotiation ritual at the AIM family of funds:

> In 2005, management proposed a fee reduction of $17 million. When independent directors demanded further cuts of $3 million, management "winced" and agreed. These amounts, however, pale in comparison to the $742 million in annual revenues for the fund group on $64 billion in assets under management.[224] (footnotes omitted)

On balance, the evidence shows that to the extent there is any negotiation, the amounts at issue are trivial in relation to the overall level of fees involved. Truly meaningful negotiations would involve a comparison of advisory fees to fees determined by arm's length negotiation. This does not happen.

In summary, management fee negotiation by independent directors is fiction. There is no functioning mechanism to align management-proposed fees with fees determined by arm's length bargaining.

2. Fee Approval

The judicial understanding of the duties of independent directors has developed since the Supreme Court's decision in *Burks*. In *Jones*, the Supreme Court said that "*Gartenberg*'s 'so disproportionately large' standard reflects this congressional choice to 'rely largely upon [independent director] 'watchdogs' to protect shareholders interests.'"[225]

Exactly how the Supreme Court in *Burks* arrived at this interpretation of the ICA, written in 1940, is opaque. To the extent the "watchdog" analogy is relevant, it must be congruent with the 1970 amendments and § 15(c):

> it shall be unlawful for any registered investment company . . . to enter into, renew, or perform any contract . . . unless the terms of such contract . . . have been approved by the vote of a majority of directors, who are not parties to such contract … (citations omitted)

Paraphrasing, sponsors cannot renew a contract unless independent directors "approve" the terms of the contract. But manifestly, "approve" is binary with "disapprove." Independent directors essentially never disapprove advisory contracts. The whole idea of watchdogs and of congressional reliance on independent directors to protect shareholders is meaningless. It does not happen.

Moreover, the Supreme Court's "watchdog" analogy is obviously incorrect. Clearly, what watchdogs do is watch and presumably alert authorities to problems. Whom exactly do the watchdogs alert? Themselves? The Adviser? According to the Supreme Court, they have the primary responsibility to protect shareholder interests. How exactly does that operationalize? The fundamental truth is that sponsors are basically never

224. Palmiter, *supra* note 11, at 173.
225. *Jones*, 559 U.S. 335, at 353.

fired. It follows that negotiation is toothless and contract renewal preordained. Fund governance is broken where fees are concerned. This is not a unique view.

Two notable public figures have commented on the general failure of mutual fund boards to fulfill their responsibilities: Jack Bogle, founder of the Vanguard Group has testified:

> Well, fund directors are, or at least to a very major extent, sort of a bad joke. They've watched industry fees go up year after year, they've added 12b-1 fees. I think they've forgotten, maybe they've never been told, that the law, the Investment Company Act, says they're required to put the interest of the fund shareholders ahead of the interest of the fund adviser. It's simply impossible for me to see how they could have ever measured up to that mandate or are measuring up to it.[226]

When a person of Mr. Bogle's stature opines that fund directors are sort of a "bad joke," it should be taken seriously. Note that his comments are directly related to fees and how they have gone up year after year.

Similarly, Warren Buffett has commented:

> I think independent directors have been anything but independent. The Investment Company Act, in 1940, made these provisions for independent directors on the theory that they would be the watchdogs for all these people pooling their money. The behavior of independent directors in aggregate since 1940 has been to rubber-stamp every deal that's come along from management—whether management was good, bad, or indifferent. Not negotiate for fee reductions and so on. A long time ago, an attorney said that in selecting directors, the management companies were looking for Cocker Spaniels and not Dobermans. I'd say they found a lot of Cocker Spaniels out there.[227]

Others are skeptical of the effectiveness of fund governance. Palmiter remarked that "Fund boards have been weak and even feckless protectors of fund investors."[228] Similarly, Birdthistle noted that the market-timing, portfolio valuation, and late trading scandals cost investors billions of dollars but went unchecked by fund governance.[229]

Independent directors are made fully aware of their duties and responsibilities. According to the Fund Director's Guidebook, "it is the independent directors' responsibility to represent the interests of fund

226. Amended Complaint Under Inv. Co. Act of 1940 at 22, Gallus v. Ameriprise Fin., Inc., No. 04-cv-04498 (D. Minn. 2006).

227. Strougo v. BEA Assoc., 188 F. Supp.2d 373, 383 (S.D.N.Y. 2002) (citing Haywood Kelly, *A Quick Q & A with Warren Buffett*, MORNINGSTAR (May 6, 1998), https://www.morningstar.com/articles/1939/a-quick-q-a-with-warren-buffett).

228. Palmiter, *supra* note 11, at 165 (2006).

229. William A. Birdthistle, *Compensating Power: An Analysis of Rents and Rewards in the Mutual Fund Industry*, 80 TUL. L. REV. 1401, 1451–60 (2006).

shareholders where those interests might be in conflict with those of the adviser."[230] Further:

> The SEC encourages directors to be an 'independent force in fund affairs' rather than passively accept the recommendations of management. The SEC has urged fund directors to bring to the boardroom 'a high degree of rigor and skeptical objectivity to the evaluation of management and its plans and proposals,' particularly when evaluating conflicts of interest. Directors should be 'highly skeptical' of arguments that merely rationalize the resolution of conflicts in favor of the fund adviser, the SEC has stated, and should seek results that advance the best interest of fund shareholders.[231]

The Mutual Fund Director's Forum has similar advice for new directors:[232]

> Directors are expected to exercise their reasonable "business judgment" in overseeing the Fund's performance and that of its service providers. Directors' two key duties are: (1) a duty of care, which requires the level of care that a "reasonably prudent person" would exercise with respect to his or her own business; and (2) a duty of loyalty, which requires Directors to put the interests of the Fund and its shareholders ahead of their own interests and those of the Fund's management or its service providers.

Directors have been on notice for a long time that there are issues involving mutual fund advisory fees as compared to institutional/sub-advisory fees. In 2004, the MFDF published a report including a recommendation to consider: "meaningful information on the adviser's fee structures for any other comparable investment vehicles, both public and private, and an explanation of any differences from the fees charged to the fund."[233]

Similarly, in 2004 the SEC proposed a rule to increase disclosure in the § 15(c) process. Commentators stated that the release emphasized SEC concerns about fund directors' "perfunctory" participation in the 15(c) process, and that fund fees were "higher than those charged by the same advisers to pension plans and other institutional clients."[234]

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230. *See* FUND DIRECTOR'S GUIDEBOOK, *supra* note 222, at 1.

231. *Id.* at 70–71.

232. MUT. FUND DIRS. F., NEW DIRS. TRAINING MANUAL 1 (2013).

233. MUT. FUND DIRS. F., BEST PRACTICES AND PRACTICAL GUIDANCE FOR MUTUAL FUND DIRS. 44-47 (2004). The recommendation to consider fee structures on other product lines has been often repeated since 2004. In 2013, the MFDF recommended that independent directors look at "Fees Charged by the fund's adviser to other clients for similar services." MUT. FUND DIRS. F., PRACTICAL GUIDANCE FOR MUTUAL FUND DIRS. 14 (2013). Similarly, the May 2020 MFDF Webinar encouraged independent directors to discuss "Product level profitability (mutual fund vs. institutional products, etc.)." MFDF Webinar, *supra* note 198, at 11.

234. PAUL WEISS, PROPOSED SEC RULE: DISCLOSURE REGARDING APPROVAL OF ADVISORY CONTRACTS BY DIRECTORS OF INVESTMENT COMPANIES 3 (Feb. 19, 2004), https://www.paulweiss.com/media/2352427/discadvconap.pdf (citing to Freeman & Brown, *supra* note 116, and H. Norman Knickle, *The Mutual Fund's Section 15(c): Jones v. Harris, the SEC and Fiduciary Duties*

Finally, in *Jones* the Supreme Court highlighted the crux of the issue:

> [W]e do not think that there can be any categorical rule regarding the comparisons of the fees charged different types of clients . . . Instead, courts may give such comparisons the weight that they merit in light of the similarities and differences between the services that the clients in question require, but courts must be wary of inapt comparisons.[235] (citations omitted)

Unlike *Gartenberg*, *Jones* does not deny the institutional/mutual fund comparison. It cautions against *inapt* comparisons and invites a resolution of the issues.

E. A PROPOSED SOLUTION

It is generally known that the forces of arm's length bargaining do not operate in mutual fund markets like they do in other markets. It is also generally known that management fees are significantly lower on portfolios where bargaining is present. These facts are not in dispute and are the direct result of our broken model of fund governance. Independent directors do not negotiate fees, always approve fee contracts, and systematically ignore plainly obvious differences between advisory and institutional fees. It is not difficult to identify the incentives involved. Fund directors are in a comfortable, legally protected, and lucrative sinecure facing an essentially binary and easy decision. Independent directors willingly play along with (or are played by) the investment management industry's charade of conscientious governance. They lend credentials to an essentially rigged system. The Bogle and Buffett characterizations are spot on. Independent directors have systematically failed to protect mutual fund investors from high fees. The same directors have the power to fix the problem.

Balanced against this is the power in ritual, familiarity, and inertia. Independent directors, especially those with no business or asset management background, are strongly incentivized to go along with the way things are normally done (or may know no better). Business is ordinarily conducted in the *Gartenberg* framework, which provides an easy check-the-boxes approach to governance with all of the questions and answers laid out for directors by the adviser. The manager's staff does all of the work and directors are paid a lot of money to read a voluminous amount of material and attend (typically) five meetings a year. Group dynamics strongly mitigate against asking difficult questions.

It is unlikely that directors, even industry friendly directors, fully understand the issues involved. For instance, they likely comprehend something about *Gartenberg* and the *Gartenberg* factors from the legal memoranda provided by the adviser, but they may not understand that their

of Directors, 31 REV. BANKING & FIN. L. 265, 266 (2011) (citing *Special Report: Perils in the Savings Pool – Mutual Funds*, THE ECONOMIST, at 65 (Nov. 8, 2003)).

235. Jones v. Harris, 559 U.S. 335, 349–50.

discretion as fiduciaries is not bound by case law or even state or federal statutes. Their standards of conduct are imposed by state law fiduciary standards, but no law specifies the manner in which fund directors are required to go about overseeing an investment adviser's fee.[236] The otherwise powerful discretion granted to directors to manage as they see fit has been neutered by the industry into an unimaginative and repetitive dance intended to achieve the same result every year: renewal of an advisory contract on the precise terms proposed by the adviser. The industry has successfully manipulated the case law through the results it has obtained in § 36(b) cases, and it has used the resultant case law to lull directors into a fiduciary slumber. Directors with industry backgrounds know this and play the game; uninitiated directors are unlikely to know the game they are playing is rigged.

While directors may be vaguely aware that the SEC encourages them to be an "independent force in fund affairs," or that the Fund Director's Guidebook states that "it is the independent directors' responsibility to represent the interests of fund shareholders where those interests might be in conflict with those of the adviser,"[237] it is likely still difficult for many directors to apply these principles in practice, especially given the control an adviser has over the facts provided to the board. Yet, § 15(c) makes the duties of directors unambiguously clear:

> "It shall be the duty of the directors of a registered investment company to request and evaluate, and the duty of an investment adviser to such company to furnish, such information as may reasonably be necessary to evaluate the terms of any contract . . ."[238]

There is no ambiguity in the statute. Directors have the duty to request information necessary to evaluate the contract. Directors may reasonably request cost and fee information on the adviser's different product lines. They are not limited to perusing only the *Gartenberg* factors.

Independent directors can accomplish what courts have been unwilling to do: rationally and objectively evaluate the fees, risks, and costs of advisory services to different clientele. The overall goal should be to negotiate mutual fund management fees that are reasonable and reasonably congruent with fees charged clients where arm's length negotiation is present.

Circumstances will differ for each investment management firm. The manager should be tasked to provide information and analyze it subject to guidelines crafted by the board. The analysis should proceed based on certain general principles.

The beginning point is a side-by-side comparison of average fees across product lines. The analysis can proceed with increasing granularity: fixed

236. My thanks to Aaron Morris for this insight.
237. *See* FUND DIRS. GUIDEBOOK, *supra* note 222, at 1.
238. 15 U.S.C. § 80a-15(c) (2018).

income, equity, international, etc. Fee differences should be analyzed in light of different services, risks and asset levels involved.

In litigation much is made of services sometimes included in mutual fund contracts that are not covered in institutional contracts. These differences should be identified and analyzed carefully. The costs of different services should be meticulously quantified. It is seldom noted that institutional contracts often cover services not in mutual fund contracts. Chief among these is distribution. Mutual fund distribution is covered by 12b-1 fees, but the institutional side of the business must compensate sales personnel out of management fees. Percentage sales costs should be calculated and deducted from institutional fees to make them comparable to mutual fund management fees.

Economies of scale and risk differences are best analyzed by comparing profit margins. Similar to fees, profit margins across product lines may be analyzed with varying degrees of granularity. The 15(C) process requires directors to look at operating profit margins which include corporate overhead as one of the allowed costs. However, gross profit margins which include only direct management costs allow for the cleanest analysis of economies of scale and risk premiums.

Armed with an analysis of fee and margin differences across product lines, independent directors can conduct proper negotiations with fund sponsors. If the parties cannot arrive at a reasonable mutually agreeable outcome, independent directors are not duty bound to approve the contract. The clear intention of Congress was to empower independent directors by revising the statute in 1970. Independent directors should have the courage and fortitude to test that proposition.

SUMMARY AND CONCLUSIONS

Mutual funds are unlike normal corporations. Each mutual fund is created, managed, and controlled by another corporation–a sponsoring investment management firm. This gives rise to a well-recognized structural conflict of interest. Independent mutual fund directors face monopoly providers of investment management services who know that, functionally, they will never be fired.

As a result, it has been recognized by the SEC, Congress, and the U.S. Supreme Court that the forces of arm's length bargaining do not operate on mutual fund investment management fees. It is also well-known that management fees are systematically greater than fees subject to arm's length bargaining, e.g., pension and sub-advisory fees. The central focus of this paper has been to explore various explanations for these fee differences.

Mutual fund markets have many characteristics of perfect competition, i.e., a large number of buyers and sellers, unhindered entry and exit, and a

reasonably homogeneous product.[239] Conventional wisdom and current case law precedent are consistent with the idea that management fees are determined by market forces. If this view is correct and management fees reflect market forces, then there must be an alternative explanation for fee differentials across product lines. The industry argues that there are services bundled with mutual fund management fees not provided to institutional accounts. Further, it is argued that higher fees are appropriate compensation for the higher risks experienced by fund sponsors, i.e., risk premiums.

This paper challenges the perfect competition argument and develops an alternative explanation for fee differentials: the mutual fund investment management industry successfully manipulated the political, judicial, regulatory and fund governance systems that facilitate a systematic overcharging of mutual fund investors. The overcharging has been ongoing for forty years, and absent significant changes, will continue.

The political manipulation underpinning the 1970 amendments to the ICA was obvious. There should have been no contest between the SEC representing the public interest and the Investment Company Institute protecting the profits of the investment management industry. Congress equivocated. Recognizing that independent directors lacked leverage, they modified § 15(c) to increase their power. Offsetting that, while making fund sponsors fiduciaries, Congress also made it clear that rate regulation was off the table and that it wanted adequate compensation for "men of ability and integrity." Congress also neutered the SEC with respect to management fees and left it to the judicial system to sort out the ambiguities.

The industry falsely propagated the myth that restrictions on management fees were tantamount to public utility rate regulation. The judiciary was thus mistakenly incentivized to avoid the complexity of rate regulation and the associated case load. Further, the judiciary understood that Congress favored fund sponsors over the interests of the investing public. The courts crafted case law precedents strongly favoring the industry and punitive to plaintiffs in fee cases.

As discussed above, three cases have defined the litigation and fee landscape for forty years. First, *Burks* defined the duties of independent directors as watchdogs enforcing the federal statutes. This effectively de-coupled mutual fund governance from normal corporate governance. Independent directors essentially became functionaries rubber-stamping whatever fund management proposed.

Gartenberg established the fiduciary standard imposed by the 1970 amendments to the ICA. The district court created a false narrative that independent directors negotiated a fair and reasonable fee when in fact the fees in question were demonstrably unfair. The Second Circuit crafted an

239. There is only one seller of investment management services at the individual fund level and no entry is possible.

ambiguous and permissive fiduciary standard that has proved impossible for plaintiffs to overcome in § 36(b) cases.

Most recently, in *Jones v. Harris*, the U.S. Supreme Court adopted *Gartenberg*, and permitted courts to consider benchmarks for fees based on similarly conflicted mutual funds.

Following *Jones*, several § 36(b) cases involving sub-advisory fees resulted in uniform failure for plaintiffs. There are currently (late 2021) no active § 36(b) cases against mutual fund investment management firms. At least for the time being, the plaintiff's bar has rationally thrown in the towel. The overall conclusion is that the mutual fund investment industry has successfully manipulated the judicial system where management fees are concerned.

The SEC is missing in action on the same issue. The genesis of this inaction is the Senate Report underpinning the 1970 amendments to the ICA: "Nor is it contemplated that the Commission would seek a general reduction of fees on an industrywide basis."[240] Despite its standing to sue under the statute, in the fifty plus years since the 1970 amendments the SEC has filed exactly one inconsequential management fees case.[241]

The SEC has the power to rectify forty years of judicial and fund governance failure to police management fees. Using the statute, the SEC could litigate a fee case to conclusion. In the process it could quantify and approximate the differential costs and risks associated across product lines. The results would ripple through the judicial and fund governance systems relatively quickly and cause management fees to reflect the underpinning economic realities.

A policy change of this magnitude would require approval of the Commission and is highly unlikely. The SEC is thoroughly politicized and effectively captured by the industry. This is unlikely to change.[242]

Fund governance, the institution specifically designed to protect fund shareholders is also missing in action. Independent directors systematically ignore fiduciary responsibilities because federal case law effectively disconnects mutual fund governance from normal corporate governance. Nowhere is this more problematic than the idea that independent directors "negotiate" management fees. Under normal corporate governance this would be a given. Not so for mutual fund governance.

240. S. REP. 91-184, *supra* note 6, at 4–7.

241. S.E.C. v. Am. Birthright Trust Mgmt. Co., Inc., No. 80-3306, 1980 WL 1479 (D.D.C. Dec. 30, 1980).

242. The Commission is, by statute, a 3-2 commission with no more than three members allowed to be from the same political party. Functionally, the investment management industry has the ear of Commissioners on both sides of all issues. Further, it is common practice to appoint as SEC Commissioners from the staffs of politicians who sit on SEC oversight committees. Roberta S. Karmel, *Little Power Struggles Everywhere: Attacks on the Administrative State at the Securities and Exchange Commission*, 72 ADMIN. L. REV. 207 (2020). *See also* Brown, *Regulatory Capture, supra* note 19.

The ICA is silent on the issue of fee negotiation. In *Burks v. Lasker*, the U.S. Supreme Court interpreted the ICA as tasking independent directors as "watchdogs" specifically to ensure compliance with federal statutes. Federal case law has determined that there is no "duty" to negotiate fees by independent directors.[243] Consistent with this determination, there is no evidence of meaningful fee negotiation by independent directors. This is instrumental in the industry's ability to maintain high levels of management fees.

The absence of fee negotiation by independent directors violates common sense. Independent directors are fiduciaries and fiduciaries should act in the best interest of those they are tasked to protect. It is manifestly in the best interests of fund shareholders to have their representatives negotiate lower fees.

Moreover, the issue of fee negotiation is the source of confusion at the highest judicial levels where it is common currency that independent directors somehow negotiate with fund sponsors.[244] Even securities regulators seem to believe this. The SEC tells us that: "One of the most significant responsibilities of a fund's board of directors is to negotiate and review the advisory contract between the fund and the investment adviser to the fund, including fees and expense ratios."[245]

Although perhaps inadvertently, the SEC makes a relevant point. There is a difference between the "duty" to negotiate and the "responsibility" to negotiate. The term "duty" is freighted with legal implications as in "dereliction of duty." Responsibility, on the other hand, is not. To "shirk responsibility" is common but "dereliction of responsibility" is not. Individuals are obliged to fulfill duties; responsibilities are voluntarily assumed. Independent directors may not have the duty to negotiate under current case law but by assuming the role of directors they do have the responsibility. Federal case law disconnects directors from the duty but cannot negate the responsibility to negotiate.

There are no legal or operational constraints limiting the ability of independent directors to negotiate fees. Directors can and should negotiate the best deal possible for fund shareholders. The addition of § 15(c) to the statute in 1970 substantially increased the leverage of directors and properly utilized, could result in management fees much closer to competitively determined fees.

Moreover, directors are more powerful now than fifty years ago when the statute was changed. Proxy battles with management are far less likely when adverse publicity would impact billions of dollars of assets in fund

243. *See* case cited *supra* note 42.

244. *See* case cited *supra* note 220.

245. U.S. SEC. EXCH. COMM'N, *Investor Bulletin: Mutual Fund Fees and Expenses*, INVESTOR.GOV (May 12, 2014), https://www.investor.gov/introduction-investing/general-resources/news-alerts/alerts-bulletins/investor-bulletins-20.

families rather than just one fund. Directors have a strong hand to play—if only they would play it.

Mitigating against this is custom, comfort and inertia. Negotiation is hard, time consuming and stressful. It is much easier to check the *Gartenberg* factor boxes than to confront the uncertain path of negotiating on behalf of those to whom is owed a fiduciary duty. Fund shareholders are remote and voiceless; fund sponsors are close and vocal.

Independent directors should ask the hard questions about fee and profit margin differences across product lines. Directors should not accept the generic explanation that the "businesses are different." They are not. Investment management is about constructing portfolios, essentially a mental process. There are no important cost differences between constructing portfolios for mutual funds and other clients.

Mutual fund boards are populated with honorable and accomplished individuals operating within the legal framework as they currently understand it. They largely do not know it, but they are not bound by that framework. They have almost unlimited discretion as fiduciaries to advance the interests of the investors they represent. This generous mandate, combined with the tools provided by § 15(c), creates an opportunity for principled directors that largely goes ignored. This paper argues that the current case law framework is a windfall to the industry and harms investors to the tune of billions of dollars annually. The next generation of mutual fund directors should take ownership of their fiduciary responsibilities and redefine what it means to protect and advance the interests of investors.