No. 08-586

IN THE

Supreme Court of the United States

JERRY N. JONES, MARY F. JONES, AND ARLINE WINERMAN,

Petitioners,

v.

HARRIS ASSOCIATES L.P.,

Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

BRIEF FOR THE INVESTMENT COMPANY INSTITUTE AS AMICUS CURIAE SUPPORTING RESPONDENT

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QUESTION PRESENTED

Amicus curiae Investment Company Institute will address the following question:

Whether the Court should endorse the longstanding framework established by the Second Circuit in *Gartenberg* v. *Merrill Lynch Asset Management, Inc.*, 694 F.2d 923 (1982)—under which courts review an investment adviser's fee in light of a variety of factors and give considerable weight to independent directors' approval of the fee—as the proper way to assess claims that the adviser has breached its fiduciary duty with respect to the receipt of compensation in violation of Section 36(b) of the Investment Company Act of 1940.

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INTEREST OF AMICUS CURIAE[1]

The Investment Company Institute (ICI) is the national association of registered investment companies in the United States. ICI has three core missions: encouraging adherence to high ethical standards by all industry participants; advancing the interests of investment companies and their shareholders, directors, and investment advisers; and promoting public understanding of mutual funds and other registered investment companies. As part of its mission to promote public understanding of mutual funds, ICI pursues an extensive research program and is the primary source of aggregate industry data relied on by government regulators, industry participants, and independent observers.

As of 2008, ICI's members managed 98 percent of the roughly $10 trillion in mutual funds on behalf of more than 90 million investors in over 50 million households. Because of their ability to provide investors with diversified portfolios and a wide array of services, including professional investment management, mutual funds have proven to be the most convenient and cost-effective way for average Americans to achieve their retirement and savings goals. Mutual funds are comprehensively regulated and offer investors a high level of protection. Funds, their investors, and their advisers all have benefitted from the strong regulatory scheme set forth in the Investment Company Act of

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[1] Counsel for any party did not write this brief, in whole or in part. No person or entity other than amicus, its members, and its counsel has made a monetary contribution intended to fund the preparation and submission of this brief. This brief is filed with the written consent of all parties.

1940 (ICA), the Investment Advisers Act of 1940, the other major federal securities laws, and related rules of the U.S. Securities and Exchange Commission (SEC). ICI and its members have a strong interest in ensuring that this system of regulation, as intended by Congress, continues to serve both mutual funds and fund investors effectively.

This case involves Section 36(b) of the ICA, 15 U.S.C. § 80a-35(b), which provides that the investment adviser of a mutual fund "shall be deemed to have a fiduciary duty with respect to the receipt of compensation for services." ICI and its members have decades of experience applying Section 36(b) in ensuring that fund advisers meet this duty. As explained below, ICI's experience is that the standard set forth in *Gartenberg* v. *Merrill Lynch Asset Mgmt., Inc.*, 694 F.2d 923 (2d Cir. 1982), especially as implemented in subsequent cases, represents the appropriate approach to judicial review of adviser compensation and is consistent with Congress's objectives in enacting the 1970 amendments to the ICA.

SUMMARY OF ARGUMENT

I. The proper standard for evaluating claims for a breach of fiduciary duty under Section 36(b) of the Investment Company Act (ICA) is that articulated in *Gartenberg* v. *Merrill Lynch Asset Mgmt., Inc.*, 694 F.2d 923, 928 (2d Cir. 1982). This standard has been consistently applied by the lower courts until the court of appeals decision in this litigation, and provides that a court should determine whether the fee received by an investment adviser "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." *Gartenberg* has provided useful

guidance for investment advisers, fund directors, courts, and even the SEC for almost 30 years.

The *Gartenberg* court identified several factors to assist in determining whether a fee is so excessive as to constitute a breach of fiduciary duty, but also made clear that those factors were not exclusive, and that some might be more significant than others. During almost three decades of experience with *Gartenberg*, fund directors and courts have found, not surprisingly, that a central part of their analysis focuses on the nature and quality of the services investors are receiving and the price that investors could be expected to pay to other advisers that manage similar mutual funds providing comparable services.

Although petitioners and their *amici* nominally endorse *Gartenberg*, they in fact argue that courts should reject a comparison of fees charged by advisers to comparable mutual funds in favor of a comparison to fees paid by a fundamentally different type of client—and one that typically receives fundamentally different services from the adviser. Petitioners further argue that when engaging in a Section 36(b) analysis, courts should decide for themselves whether an advisory fee is "fair." This Court should reject those arguments. They rest on a highly inaccurate equating of mutual funds and non-mutual fund institutional accounts. They also disregard regulatory enhancements to mutual fund governance and fee-approval decisions that Congress, the SEC, independent directors, and the industry have put in place, as well as Section 36(b)(2), which instructs courts to give appropriate consideration to the fee-approval decisions of independent fund directors.

II. At bottom, petitioners' arguments in favor of a dramatically expanded role for the courts in scrutiniz-

ing advisory fees rest on a misapprehension about the state of the mutual fund industry. Petitioners describe it as uncompetitive, dysfunctional, and unresponsive to the interests of investors. The reverse is true in every respect. The mutual fund industry is virtually a textbook case of a competitive market, with many firms vying for cost-conscious investors. The industry has flourished over the past four decades because it has met these competitive challenges by providing investors with more investment choices and more services, all with declining costs.

ARGUMENT

Mutual funds operate under a regulatory regime arguably more comprehensive than that governing any other financial product. Funds must register with the SEC under the Investment Company Act of 1940 (ICA), and their securities must be registered under the Securities Act of 1933. Their investment advisers must register with the SEC under the Investment Advisers Act of 1940. These and other federal securities laws and related SEC rules impose upon funds and advisers detailed requirements relating to fund organization, governance, and capital structure, the disclosures funds and advisers must make, the offer and sale of fund shares to the public, and funds' daily operations.

In 1970, Congress amended the ICA to provide greater protection for investors against excessive adviser compensation. A centerpiece of this regime is Section 15(c) of the ICA, which requires substantive scrutiny by fund boards of investment advisory contracts and their terms, and further requires that advisory fees be approved by a majority of independent directors. In addition, the 1970 amendments strengthened the requirements for director independence. *See*

15 U.S.C. §§ 80a-2(a)(19), 80a-10. Section 36(b) was also added, in which Congress created a unique cause of action that allows fund shareholders or the SEC to proceed directly against an investment adviser for the alleged breach of a fiduciary duty with respect to the receipt of excessive compensation for advisory services. *See generally Daily Income Fund, Inc.* v. *Fox*, 464 U.S. 523 (1984). Congress directed courts, in actions under Section 36(b), to give such consideration to the fund board's approval of the advisory fee as is "appropriate under all the circumstances." 15 U.S.C. § 80a-35(b)(2).

In the picture painted by petitioners and their *amici*, these and other regulatory protections built up over 30 years have been largely ineffective, and fund advisers unconstrained by any market forces take advantage of a captive, supine investor base. This picture is so distorted as to be unrecognizable. As we explain below, the courts have adopted a sensible and contextual framework for analyzing claims of excessive advisory fees that appropriately protects the interests of investors while steering clear of an unworkable *de novo* judicial scrutiny of adviser compensation. Nor are lawsuits the only protection afforded to investors: the improvements Congress made to fund governance are robust, and they operate to ensure that directors carefully and objectively scrutinize advisory fees. Appropriately, therefore, courts have generally given considerable weight to the decisions of independent fund directors to approve advisory fees. Evidence suggests that all of this has redounded to the benefit of investors; the mutual fund industry is highly competitive. Cost-conscious investors, with a world of information and choices available to them, have seen fit to trust funds with trillions of dollars of their money. And they have been rewarded, as the total cost of investing in

mutual funds has experienced a decades-long decline. Although petitioners contend that, because of market failure, much greater judicial intervention is needed to protect investors from advisers' supposed depredations, they have utterly failed to make a case for such a dramatic change in the legal standards governing adviser compensation.

I. THE *GARTENBERG* DECISION ARTICULATES THE APPROPRIATE FRAMEWORK FOR ASSESSING FEE CLAIMS UNDER SECTION 36(b)

A. This Court Should Adhere To *Gartenberg*'s Well-Tested Framework

In *Gartenberg* v. *Merrill Lynch Asset Management, Inc.*, 694 F.2d 923, 928 (1982), the Second Circuit held that "to be guilty of a violation of Section 36(b)," a fund adviser "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." As respondent explains, that standard is consistent with the text, purpose, and legislative history of both Section 36(b) and the ICA as a whole. *See* Resp. Br. 26-30. The *Gartenberg* standard also draws from this Court's articulation of general fiduciary duty principles in *Pepper* v. *Litton*, 308 U.S. 295, 306-307 (1939), and appropriately tailors them to the unique context of mutual funds. *See* Resp. Br. 27-28. The United States would seem to concur in respondent's view of *Gartenberg*. U.S. Amicus Br. 11. Courts also have overwhelmingly agreed; until the court of appeals decision in this litigation, the *Gartenberg* standard had been consistently applied in cases

alleging that a fund adviser had breached its fiduciary duty under Section 36(b).[2]

The *Gartenberg* decision also sets forth a flexible analytical framework that courts have found useful in Section 36(b) cases. The Second Circuit's opinion identified several factors that may be important in "determining whether a fee is so excessive as to constitute a 'breach of fiduciary duty.'" *Gartenberg*, 694 F.2d at 930; *see also* pp. 9-12, *infra*. The court nevertheless made clear that the factors it identified were not exclusive, 694 F.2d at 929 (noting that "all pertinent facts must be weighed"), and that certain factors might be more significant than others, *id.* at 930.

The salient point about the *Gartenberg* framework is that it is sensitive to context, and so it allows a court hearing a Section 36(b) claim to decide which factors are most relevant to the case before it. *See, e.g.*, *Amron* v. *Morgan Stanley Investment Advisors, Inc.*, 464 F.3d 338, 344 (2d Cir. 2006); *see generally* Martin, *Litigation Under the Investment Company Act of 1940*, in 2 Kirsch, *Mutual Fund Regulation* 26-11 (2d ed. 2009) ("In weighing whether a fee is excessive, courts consider all facts and circumstances surrounding the receipt of compensation[.]"). As the courts have gained

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[2] *See, e.g.*, *Amron* v. *Morgan Stanley Inv. Advisors, Inc.*, 464 F.3d 338, 340-341 (2d Cir. 2006); *Krantz* v. *Prudential Invs. Fund Mgmt. LLC*, 305 F.3d 140, 143 (3d Cir. 2002) (per curiam); *Migdal* v. *Rowe Price-Fleming Int'l*, 248 F.3d 321, 326 (4th Cir. 2001); *Forsythe* v. *Sun Life Fin., Inc.*, 417 F. Supp. 2d 100, 114 (D. Mass. 2006); *In re Dreyfus Mut. Funds Fee Litig.*, 428 F. Supp. 2d 342, 349 (W.D. Pa. 2005); *Zucker* v. *AIM Advisors, Inc.*, 371 F. Supp. 2d 845, 848 n.5 (S.D. Tex. 2005); *Krantz* v. *Fidelity Mgmt. & Research Co.*, 98 F. Supp. 2d 150, 158 (D. Mass. 2000); *King* v. *Douglass*, 973 F. Supp. 707, 722 (S.D. Tex. 1996).

experience with Section 36(b) claims over the decades, they have generally concluded that certain factors identified in *Gartenberg* are more likely to be relevant than others, while not closing the door as a matter of law to considering other factors, whether listed in *Gartenberg* or not. *See* pp. 9-12, *infra*.

The result has been the development of a remarkably stable and cohesive body of law that has provided welcome guidance, in particular, to advisers and to fund boards tasked with evaluating advisory fee proposals. As the United States notes, "[t]he *Gartenberg* standard—along with its non-exclusive list of potentially relevant factors"—offers guidance to both "fund boards fulfilling their obligation under Section 15(c) of the ICA of evaluating advisers' compensation" and "advisers in proposing fees." U.S. Amicus Br. 24. Indeed, the SEC itself has incorporated "*Gartenberg*-like" factors into its regulations requiring disclosure in fund shareholder reports and proxy statements of the basis for the directors' decision to approve the fund's advisory contract and the adviser's fee. *Id.* at 23. In the SEC's view, this transparency regarding the fees paid under advisory contracts encourages "boards to engage in vigorous and independent oversight of advisory contracts." *Disclosure Regarding Approval of Investment Advisory Contracts by Directors of Investment Companies*, 69 Fed. Reg. 39,798, 39,799 (June 30, 2004). *Gartenberg*, as implemented through these SEC disclosure requirements, establishes a framework that provides directors with useful guidance about the categories of information that they should request and scrutinize when reviewing the fund's advisory contract and has led to meaningful improvements in that review process. *See generally* IDC Amicus Br. 11-13.

The *Gartenberg* standard also allows courts to weed out meritless claims before trial while providing real and substantial protection to investors—both by reinforcing and clarifying boards' obligations to review advisory fee proposals thoroughly, and by holding open the prospect of a judicial recovery should a plaintiff be able to show that the advisory fee "bears no reasonable relationship to the services rendered and could not have been the product of arm's-length bargaining." 694 F.2d at 928. That standard is demanding, as it should be—especially when the fund's board has properly carried out its obligations of reviewing the fee proposal—but it is not insuperable. Petitioners' *amici* suggest that the *Gartenberg* standard is inadequate to protect investors because plaintiffs have never prevailed on the merits in a litigated Section 36(b) case (*see* Law Prof. Amicus Br. 4; NASAA Amicus Br. 3; NASCAT Amicus Br. 15), but they ignore that only a handful of Section 36(b) cases have been litigated to final judgment since *Gartenberg*, whereas numerous Section 36(b) cases have been resolved by the parties without dismissal on dispositive motion or trial, and some of those settlements have included an agreement to lower fees. These results severely undermine the contention that the *Gartenberg* standard is inadequate to protect investors.

B. Past Experience Is Instructive As To The Relative Weight To Be Accorded To The *Gartenberg* Factors

Courts analyzing Section 36(b) claims have generally focused on three factors: (1) the nature and quality of the services provided by the fund adviser (*i.e.*, what fund investors get for what they pay), (2) the fees charged by comparable mutual funds, and (3) the ex-

pertise, care, and conscientiousness of the fund's independent directors who evaluated and approved the advisory fee. *See, e.g.*, *Migdal* v. *Rowe Price-Fleming Int'l*, 248 F.3d 321, 326 (4th Cir. 2001); *Kalish* v. *Franklin Advisers, Inc.*, 742 F. Supp. 1222, 1229 (S.D.N.Y. 1990), *aff'd*, 928 F.2d 590 (2d Cir. 1991); *Schuyt* v. *Rowe Price Prime Reserve Fund*, 663 F. Supp. 962, 974-977 (S.D.N.Y. 1987), *aff'd*, 835 F.2d 45 (2d Cir. 1987); *see also* Martin, *supra*, at 26-16 to 26-17.

It is entirely sensible that these factors should be the most useful ones in reviewing Section 36(b) claims. Although courts are not expert in investment management and should give considerable weight to the board's business judgment regarding an adviser's services, performance, and fees, in the end the fundamental question under Section 36(b) is whether investors are receiving services and performance that bear a "reasonable relationship" to what advisers are charging them.[3]

Courts have found a useful benchmark against which to measure advisory fees to be the fees charged by other mutual fund advisers for those services that are comparable in scope and quality. Likewise, in the fee-approval process, boards have found that compari-

[3] Courts have recognized, however, that underperformance of a fund generally is not sufficient by itself to establish that an advisory fee was excessive. *See Migdal*, 248 F.3d at 327-328 ("Accepting plaintiff's invitation to permit discovery … because the funds underperformed would make it possible for other plaintiffs to state a claim in limitless actions filed under Section 36(b)"); *see also* Pet. Br. 51 ("Regardless, § 36(b) imposes a fiduciary duty with respect to 'compensation,' not performance. Focusing on the latter would make poorly performing funds especially vulnerable to suit, a result benefiting neither investment advisers nor investors.").

son to be central to their inquiry. When (as appears to be true in this case) the advisory fee, services offered, and performance are well within the range offered by competitors, it should be difficult for a court to conclude that the fee "could not have been the product of arm's-length bargaining."

By contrast, courts have generally found other factors less useful in determining whether advisory fees are within the range that could have been negotiated through arm's-length bargaining. For example, the profit that an adviser earns from managing a particular fund—although mentioned in the *Gartenberg* decision—has been of limited use in evaluating whether advisory fees are excessive.[4] In addition, although the *Gartenberg* decision included them as factors, courts since *Gartenberg* have not found the existence of so-called

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[4] Calculating the profitability of a single fund in a multiple-fund complex is enormously complicated and is especially difficult when, as is often the case, an adviser provides multiple services to a fund and the exact allocation of payments to each function is uncertain, or when advisory services to the fund are only one element of a larger financial product or package of financial services offered by an adviser or its affiliates. *See, e.g.*, *Krinsk* v. *Fund Asset Mgmt., Inc.*, 715 F. Supp. 472, 489 (S.D.N.Y. 1988), *aff'd*, 875 F.2d 404 (2d Cir. 1989) ("Calculation and allocation of costs against different product lines or, in this case, among different segments of the same product, is an art rather than a science. Little certainty exists in this field where different, albeit rational, methodologies lead to widely disparate results."); *Schuyt*, 663 F. Supp. at 978 (characterizing the "task of calculating the [fund adviser's] exact cost of servicing" the fund as "virtually impossible"); *see also* Martin, *supra*, at 26-12. The legislative history, moreover, makes clear that "[an] investment adviser is entitled to make a profit. Nothing in [Section 36(b)] is intended to imply otherwise or to suggest that a 'cost-plus' type of contract would be required." S. Rep. No. 91-184 (1969), *reprinted in* 1970 U.S.C.C.A.N. 4897, 4902-4903.

"fall-out benefits" to the adviser, or the extent to which the adviser shares economies of scale with investors, to be particularly instructive in evaluating Section 36(b) claims.

Ultimately, the *Gartenberg* decision identified factors as guideposts that might be considered in a diverse range of cases. That decision did not suggest that each factor must be given weight, much less equal weight, in every case. And since *Gartenberg*, courts have demonstrated that they are capable of applying those factors in a sensible way. This cohesive body of case law has served investors and the industry well.

C. A Court Deciding A Section 36(b) Claim Normally Should Give Considerable Weight To The Fee-Approval Decision Of The Fund's Independent Directors

The *Gartenberg* court remarked that the experience, care, and conscientiousness of the independent directors who reviewed and approved a fund's advisory fee should be an "important" factor guiding a court's evaluation of a claim that the adviser had charged an excessive fee. *Gartenberg*, 694 F.2d at 930. That observation was well-taken.[5] Section 36(b) does not stand alone in providing protection to investors against excessive adviser compensation; rather, the *first* line of investor protection against such fees is a unique system of fund governance. That system emphasizes the inde-

[5] The Solicitor General agrees, for she notes that "the board's receipt of necessary information and its careful consideration of the *Gartenberg* factors prior to approving compensation can be strong probative evidence that the adviser has complied with its fiduciary obligation." U.S. Amicus Br. 24.

pendence of fund boards and the role of the independent directors, who form the "cornerstone of the ICA's effort to control conflicts of interest." *Burks* v. *Lasker*, 441 U.S. 471, 482 (1979). Congress in fact "entrusted to the independent directors … the *primary responsibility* for looking after the interests of the funds' shareholders." *Id.* at 484-485 (emphasis added).

Amendments adopted in 1970 along with Section 36(b) strengthened the standards under which directors would be deemed to be "independent" of the fund's adviser, and greatly expanded the role of fund boards and their independent directors in evaluating and approving adviser compensation. Section 10(a) of the ICA, 15 U.S.C. § 80a-10(a), requires that not less than 40 percent of a fund's board of directors be independent of the adviser; in practice, most funds go well beyond this mark.[6] Congress also significantly enhanced Section 15(c), *id.* § 80a-15(c), by imposing an affirmative duty on the board to request (and a corresponding duty on the fund adviser to provide) all information that "may reasonably be necessary to evaluate the terms" of the advisory contract. Section 15(c) further requires the fund's independent directors to approve the fee to be paid to the adviser. The SEC has since required fund shareholder reports and proxy statements to discuss factors related to that approval, including certain

[6] According to a 2006 survey, independent directors made up at least three quarters of the board at eighty-eight percent of fund complexes participating in the survey, and seventy-eight percent of fund complexes had an independent board chair or an independent lead director. *See* ICI & IDC, *Overview of Fund Governance Practices 1994—2006*, at 6 (2007). *See generally* IDC Amicus Br. 6-8.

factors based on *Gartenberg*. *See* 69 Fed. Reg. at 39,801 & n.31.[7]

Given Congress's strengthening of the role of the independent directors, it is not surprising that Congress also expressly required, in Section 36(b)(2), that courts give "such consideration … [to board decisions under Section 15(c)] as is deemed appropriate under all

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[7] Petitioners and their *amici*, seeking to dramatically expand the courts' appropriate scope of inquiry in Section 36(b) cases, suggest that Section 36(b) imposes a freestanding obligation on the adviser of "full disclosure" to the board that would provide an alternative basis for liability, even in cases where a failure to disclose certain information has no demonstrated impact on the adviser's fee. *See* Pet. Br. 33; AARP Amicus Br. 4; *see also Gallus* v. *Ameriprise Fin., Inc.*, 561 F.3d 816 (8th Cir. 2009), *petition for cert. pending*, No. 09-163. That contention is not properly presented in this case, where petitioners have not alleged that respondent violated Section 36(b) with respect to the disclosure it provided to the board. Should this Court reach that question, it should conclude that Section 36(b) does not provide a private right of action on this theory. To conclude otherwise would contravene the statutory text, which expressly limits the private right of action to a breach of an adviser's fiduciary duty with respect to the "receipt of compensation for services." *See Migdal*, 248 F.3d at 328 ("Section 36(b) is sharply focused on the question of whether the fees themselves were excessive[.]"); *Forsythe* v. *Sun Life Fin., Inc.*, 417 F. Supp. 2d 100, 115 (D. Mass. 2006) ("[Section] 36(b) is not a general vehicle for bringing claims for any and all purported breaches of fiduciary duty; claims under the statute must allege some connection between the wrongs alleged and excessive compensation of an investment adviser or affiliated persons."). The United States appears to agree. *See* U.S. Amicus Br. 15 (noting that Congress "could have accomplished [such a] purpose much more clearly and directly by authorizing damages suits for violations of the disclosure and anti-fraud provisions" and that "[f]ailure to disclose … could reasonably be regarded as 'personal misconduct' " enforceable solely by the SEC under ICA § 36(a)).

the circumstances." 15 U.S.C. § 80a-35(b)(2).[8] Petitioners virtually ignore this provision when they argue that the Court should interpret Section 36(b) to require, in effect, *de novo* judicial review of every fee approval decision for "fairness." But the approach that is more faithful to the *entire* statutory text, as well as more likely to yield a reasonable balancing of the interests of investor protection, judicial economy, and deterrence of meritless lawsuits, is the one followed by the lower courts since *Gartenberg*: giving considerable weight to the fee-approval decision of the fund's independent directors.[9]

D. The Fees Paid By An Adviser's Non-Mutual Fund Institutional Clients Generally Deserve Little Weight

Despite paying lip service to *Gartenberg*, petitioners and some of their *amici* seek to fundamentally alter its framework by suggesting that a disparity between the fees an adviser receives from a mutual fund and those it receives from its non-mutual fund institutional clients is dispositive or "highly probative" in most cases. Pet. Br. 18, 30, 51; NASAA Amicus Br. 4. Indeed, petitioners claim that a violation of Section 36(b) can be established solely upon evidence that a fund's

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[8] The legislative history is in accord: Congress cautioned that Section 36(b) was "not intended to authorize a court to substitute its business judgment" for that of the fund's board. S. Rep. No. 91-184, at 7 (1970).

[9] *See, e.g., Krinsk* v. *Fund Asset Mgmt.*, 875 F.2d 404, 412 (2d Cir. 1989); *Kalish*, 742 F. Supp. at 1241; *Schuyt*, 663 F. Supp. at 977; *Pfeiffer* v. *Bjurman, Barry & Assocs.*, No. 03 Civ. 9741, 2004 WL 1903075, at *4 (S.D.N.Y. Aug. 26, 2004); *see also* Fidelity Amicus Br. 6-9.

advisory fee is "significantly higher for *comparable* services" than the fees paid by the adviser's non-mutual fund institutional clients. Pet. Br. 18 (emphasis added). The fundamental flaw in petitioners' assertions is that, in reality, these are very different types of advisory clients, and the services those clients receive generally are *not* comparable. In fact, comparisons between the fees paid to an adviser by mutual funds and by non-mutual fund institutional clients can be highly misleading, for several reasons.

First, the services offered to mutual fund investors and to non-mutual fund institutional clients are generally quite different, reflecting the different clienteles to which they are provided. Mutual funds are often offered to the public with very low minimum initial investment requirements, sometimes $500 or less; fund investors consequently have vastly lower account balances, on average, than non-mutual fund institutional clients. *See* ICI, *Mutual Funds and Institutional Accounts: A Comparison* 4 (2006) (average balance in a long-term retail fund account is less than $27,000; average balance in a non-mutual fund institutional account is more than $41 million). At the same time, fund investors have come to expect a more varied array of services than non-mutual fund institutional clients generally receive. Advisers often provide mutual fund investors with around-the-clock customer support, extensive websites, check-writing privileges, automatic investment programs, and tax reporting services, in addition to professional portfolio management. Services for non-mutual fund institutional clients are tailored to their more limited needs, and usually focus principally on portfolio management.

In addition, the business of advising mutual funds involves significantly greater entrepreneurial risk than

advising non-mutual fund institutional clients. The mutual fund model—in which the firm holds itself out to the public and seeks to attract a large number of relatively small investors—requires an adviser to take on substantial entrepreneurial risk and make a long-term commitment of capital. Advisers often heavily subsidize a fund until it attracts enough investors to be profitable. By contrast, non-mutual fund institutional clients usually invest a significant block of assets upfront, and frequently commit to invest with the adviser for several years.

Even portfolio management—the one feature mutual funds and institutional accounts generally have in common—differs significantly between the two. Mutual fund advisers must manage fund assets with a constant eye to investors' daily share purchases and redemptions. By contrast, institutional accounts often have more predictable cash flows.[10] A mutual fund's more frequent cash flows complicate portfolio management by requiring more purchases and sales of securities and additional rebalancing of the fund's portfolio. *See* ICI, *Mutual Funds and Institutional Accounts: A Comparison* 6-7 (2006). Advisers also face regulatory requirements that uniquely affect mutual fund portfolios, such as diversification requirements, limitations on leverage, and specific restrictions on certain types of investments. Mutual fund investors are also more likely than non-mutual fund institutional clients to be

[10] Flows in non-mutual fund institutional accounts are often predictable because the terms of the arrangement may restrict the institutional client's ability to make redemptions or require it to provide advance notice of large redemptions or purchases. Such terms are included precisely because of the complexities involved in managing large unexpected cash flows.

invested through taxable accounts. Consequently, mutual fund advisers are more likely to take tax effects into account in their portfolio transactions. Due to all these additional requirements, managing a mutual fund portfolio is generally more complicated than managing a non-mutual fund institutional account.

Finally, the legal structures governing mutual funds and non-mutual fund institutional accounts are entirely different. Mutual fund advisers incur substantial costs in creating and maintaining a compliance and regulatory support infrastructure that allows them to operate in their highly regulated environment. They prepare prospectuses, shareholder reports and other disclosures for which they have liability under the securities laws. And they oversee securities pricing, custody and shareholder transaction processing operations, which often involves contracting with and supervising fund accountants, custodians, auditors, transfer agents, and other service providers. Advisers to institutional accounts are able to operate with a far less elaborate infrastructure and without many of the costs that an adviser to mutual funds must incur.

For all of these reasons, courts have recognized in a number of instances, based on an assessment of the facts of particular cases, that the fees charged by an adviser to its non-mutual fund institutional clients were not a relevant benchmark in evaluating whether the compensation the adviser received from the fund was excessive under Section 36(b). *See, e.g.*, *Baker* v. *American Century Inv. Mgmt., Inc.*, No. 04-4039-CV-C-ODS, Order 1 (W.D. Mo. filed July 18, 2006); *Strougo* v. *BEA Assocs.*, 188 F. Supp. 2d 373, 384 (S.D.N.Y. 2002). The United States also appears to recognize that a comparison to fees paid by the adviser's non-mutual fund institutional clients may be inapt. *See* U.S.

Amicus Br. 31 n.10 ("The comparison to fees paid by unaffiliated institutional clients … raises the question whether the services provided to different kinds of entities were in fact comparable."). This Court need not conclude that such a comparison is *per se* irrelevant, but given the considerable differences between mutual funds and non-mutual fund institutional accounts, that comparison will rarely, if ever, be useful to a fund board, or to a court deciding a Section 36(b) case.[11]

II. THE MUTUAL FUND INDUSTRY IS A DYNAMIC, COMPETITIVE INDUSTRY THAT PROVIDES SUBSTANTIAL BENEFITS TO INVESTORS

For nearly three decades, the *Gartenberg* framework has provided fund boards and advisers with useful guidance, ensured investor protection, and served judicial economy by not embroiling the courts in technical disputes over business judgment. Petitioners nevertheless urge a significant change in the relevant legal regime. They contend that, under the common law of trusts, courts would have exercised their own independent judgment as to whether a trustee's compensation was "fair" or "reasonable," and so courts hearing Section 36(b) claims should too. Underlying this sub-

[11] As explained in the IDC Amicus Brief (at 12, 30-31) and the Fidelity Amicus Brief (at 11-20), a fund's directors are best positioned to make the determination, based on the information presented to them, whether a comparison of mutual funds and non-mutual fund institutional account fees is relevant in a particular case, and courts generally should defer to their judgment on that point. As the United States points out, SEC regulations require boards to disclose in proxy statements and shareholder reports the consideration, if any, they give to the fees that their advisers charge to other clients. *See* U.S. Amicus Br. 30.

mission is a contention that the mutual fund industry presents a case of dramatic market breakdown, in which investors can learn little about how much they are paying and what they are paying for, and fund advisers consequently have free rein to take advantage of them. *See, e.g.*, Pet. Br. 43; Bogle Amicus Br. 29-30; Litan Amicus Br. 7-15, 18-21.

Respondent and other *amici* address more directly the doctrinal flaws with petitioners' argument, in particular the errors in their contention that Congress intended to import wholesale the common law of trusts into Section 36(b). It bears emphasis, as well, that petitioners surely have the burden of proving that the dramatic departure from settled law that they propose is in fact needed. Not only has that case not been made; it is refuted by a factual review of the mutual fund industry. Contrary to petitioners' distorted picture of the mutual fund industry as uncompetitive and dysfunctional, the industry is in fact competitive and vibrant and provides significant benefits to investors—as demonstrated by the enormous growth in popularity of mutual fund investing over the last four decades.

A. Petitioners Misunderstand The Fundamental Economic Relationship Between A Fund And Its Adviser

A key assumption that petitioners and their *amici* make is that competition does not exist among mutual funds because fund boards rarely replace fund advisers. *See, e.g.*, Pet. Br. 26; Bogle Amicus Br. 9, 30; AARP Amicus Br. 15-20. This argument is premised on the assumption that fund boards, rather than fund investors, are the key fund "customers." This inaccurate assumption obscures the business and economic realities

of what a mutual fund is and how competition arises in the industry.

Legally, a mutual fund is a corporation or business trust that pools the assets of a large number of investors to provide them with diversification and professional management. As a practical matter, however, a mutual fund operates as a vehicle through which an investment adviser can offer those services to the fund's investors. The adviser makes the long-term commitment of capital required to create and sustain the costly and complex infrastructure that a fund needs to operate, and also bears the associated entrepreneurial risk. The adviser typically undertakes research and development, incurs the expense of setting up the fund and complying with applicable laws and regulations, provides the fund's start-up capital, and arranges for both its promotion and sale to the public and for the provision of numerous support services to its investors. The adviser also usually provides, directly or indirectly, the portfolio managers, accountants, lawyers, office space, computers, internet connections, telephone systems, securities trading systems, and backup facilities necessary to allow a mutual fund to provide services to investors.

Indeed, investors usually choose a mutual fund precisely for the benefit of the totality of the adviser's services.[12] And fund investors themselves can and do "re-

[12] This understanding of the economic relationship between a fund and its adviser has informed the ICA from its inception. As one of the ICA's drafters noted, "[T]he board of directors does not act in a vacuum.... [The] stockholders either have chosen the existing management or they have bought their shares in probable reliance on such management. Presumably, they have confidence in the management and would not expect the directors to take ac-

place" investment advisers by redeeming their shares and taking their money to another fund or another investment product. Focusing narrowly on the relationship between the adviser and the fund *board* thus misses the essence of mutual fund activity: to survive and flourish, advisers must provide acceptable services at an acceptable price to *investors*, and (as explained below) investors have no hesitation in going elsewhere if advisers fail to meet their expectations.

B. Petitioners Likewise Mischaracterize The Mutual Fund Marketplace

Petitioners and their *amici* suggest that more intrusive judicial review of advisory fees is needed because investment advisers generally do not compete for the business of managing the investments of particular mutual funds. *See* Pet. Br. 26; Bogle Amicus Br. 7-8, 29. What this argument overlooks is that competition among mutual fund advisers to manage investors' dollars is vigorous. Investors, typically with the assistance of brokers or other financial advisers, can shop for the best deal before they make an initial purchase in a fund. On any given business day, if shareholders are dissatisfied with the investment performance, fees, or services of a given fund, they can easily redeem their shares for cash and invest elsewhere.

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tion to change it except in unusual circumstances." *See* Jaretzki, Jr., *Duties and Responsibilities of Directors of Mutual Funds*, 29 Law & Contemp. Probs. 777, 786 (1964).

1. The mutual fund marketplace is highly competitive

The market in which fund advisers compete to manage investors' dollars is highly competitive.[13] A standard textbook model of a competitive market is that the market comprises a large number of consumers and firms, is not dominated by any one firm or group of firms, and has low barriers to entry and exit. This is an apt description of the market for mutual funds in the United States.

The fund marketplace has a large number of investors, funds, and advisory firms sponsoring funds. In 2008, an estimated 92 million individual investors in 52.5 million households owned mutual funds. *See* ICI, *Investment Company Fact Book* 73 (49th ed. 2009) ("*Fact Book*").[14] These investors could choose from 8,022 funds offered by 717 advisory firms. All these firms compete on the basis of a variety of factors, in-

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[13] Regardless of how one interprets Section 36(b), we agree with Judge Easterbrook that "[m]utual funds come much closer to the model of atomistic competition than do most other markets." *Jones* v. *Harris Assocs. L.P.*, 527 F.3d 627, 634 (7th Cir. 2008). The value of comparing one mutual fund's fees with another's, as *Gartenberg* contemplates, and as was emphasized in the opinion below by Judge Easterbrook, is all the more apparent in light of the highly competitive nature of the mutual fund industry.

[14] ICI's *Fact Book*, which has been published for 49 years, is an annual compendium of information about mutual funds and other registered investment companies, derived in large part from primary data provided by ICI member firms. The *Fact Book* is widely cited by fund advisers and boards, policymakers, academics, and the media as an authoritative source of information about mutual funds. ICI has been analyzing trends in mutual fund fees and expenses year-by-year since 1996.

cluding price, performance and services. No advisory firm dominates the U.S. fund business: the largest five firms manage slightly more than one third of mutual fund assets, and the top ten manage only about one half. *Id.* at 21. A standard measure used to assess industry competitiveness indicates that the mutual fund market is well in the competitive range.[15]

The industry also has low barriers to entry and exit, hallmarks of a competitive market. *See Matsushita Elec. Indus. Co.* v. *Zenith Radio Corp.*, 475 U.S. 574, 591 (1986). Potential opportunities in the fund industry have induced many new advisers with innovative products to enter the market. According to one measure, the number of fund advisers almost tripled from 1985 to 2004. *See* Coates & Hubbard, *Competition in the Mutual Fund Industry: Evidence and Implications for Policy*, 33 J. Corp. L. 151, 165 (2008); Law & Finance Amici Br. 20. In 2008 alone, thirty-five new advisers entered the market. Because firms can easily enter and exit the market, no one firm can charge fees above a competitive level—a level in large part determined by the total value of services and performance the adviser makes available through a particular fund.

There also is a clear Darwinian winnowing out of less competitive advisers from the fund marketplace.

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[15] The Herfindahl-Hirschman Index (HHI), a standard measure of industry concentration, clearly indicates that the market for mutual funds is unconcentrated. An index level below 1000 generally indicates that an industry is unconcentrated. *See* Dep't of Justice & FTC, *Horizontal Merger Guidelines* § 1.51 (rev. 1997), *available at* http://www.usdoj.gov/atr/public/guidelines/hmg.htm. The index level for the mutual fund market was 433 in December 2008. *See Fact Book* 21.

In 2008 alone, thirty-seven advisers left the market, and several dozen left in each of the previous seven years. Moreover, the largest, most successful firms have had to compete intensely to stay there; of the firms that were among the twenty-five largest in 1985, only *ten* remained in that position in 2008. *Id.* at 21. Individual funds also commonly come and go, in response to investors' preferences. In this decade, fund advisers have on average created 689 new mutual funds each year and liquidated 277. *Id.* at 14. Almost 600 new funds were created in 2008 alone, and nearly 300 were liquidated. *Id.*

2. Investors have ready access to a wealth of information about every mutual fund, including its fees

Competition in the fund industry has been greatly facilitated by investors' ready access to information necessary to compare fund fees. Indeed, the information that mutual funds disclose, either by law or choice, is far greater than that available for other investment products, including the types of non-mutual fund institutional accounts petitioners argue must be used as the point of comparison.

SEC regulations have long required mutual funds to make clear and detailed disclosures to investors about their fees. As early as 1988, the SEC began requiring funds to include fee information in a standardized tabular format at the front of their prospectuses. *See Consolidated Disclosure of Mutual Fund Expenses*, 53 Fed. Reg. 3192, 3196-3197 (Feb. 4, 1988). In 1998, this fee table was included in the newly added prospectus risk/return summary—an " 'executive summary' of key information about the fund in a standardized, easily accessible place that investors could use to

evaluate and compare the fund to others." *See Registration Form Used by Open-End Management Investment Companies*, 63 Fed. Reg. 13,916, 13,919 (Mar. 23, 1998). More recent SEC rules require a summary section in the front of each prospectus and permit the use of a "summary prospectus," both of which prominently feature this information. *See Enhanced Disclosure and New Prospectus Delivery Option for Registered Open-End Management Investment Companies*, 74 Fed. Reg. 4546, 4589-4590 (Jan. 26, 2009).

Information about fund fees is also readily available elsewhere. Advisers generally provide on their websites detailed information about the funds they sponsor, including the funds' fees. Brokers and other financial advisers often provide their clients with similar information. *See* ICI, *Ownership of Mutual Funds Through Professional Financial Advisers, 2007*, at 1 (2008). Information about funds and their fees is widely provided on popular Internet websites.[16] Morningstar and Lipper offer comprehensive research coverage and fee and performance analyses of almost the whole universe of funds. In addition, the popular press frequently features articles on fund fees. *See, e.g.*, Damato, *How Well Do You Know … Fund Expenses?*, Wall St. J., July 8, 2009, at R22. And all of this does not even take into account information on funds provided by brokers and mutual fund "supermarkets," which are brokerage platforms that provide investors with access to funds from a wide range of fund families.

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[16] *See, e.g.*, Yahoo Finance Page: http://finance.yahoo.com; Google Finance Page: http://www.google.com/finance; CNNMoney.com: http://money.cnn.com/; and Marketwatch.com: http://www.marketwatch.com.

3. Investors have demonstrated a high degree of sensitivity to the level of fund fees

Investors demand good performance from their mutual funds. Because fund fees can significantly influence fund performance, investors are keenly sensitive to fund fees. Indeed, survey data indicate that for a majority of investors, one of the most important factors they consider before purchasing a mutual fund is its fees. *See* ICI, *Understanding Investor Preferences for Mutual Fund Information: Summary of Research Findings* 3 (2006). These findings directly contradict certain *amici*'s assertions that investors are effectively unable to learn or understand what fees are charged by mutual funds. *See* Law Prof. Amicus Br. 25-26; Litan Amicus Br. 7-15.

The surest sign that investors are responsive to fund fees is to compare what they buy with what the market offers for sale. Although some investors select funds with shareholder services or investment performance that may command higher fees, investors generally gravitate towards lower-cost funds. For example, in the ten-year period ending in 2008, funds with below-average prices attracted money from investors, whereas funds with above-average prices saw investors withdraw money. *See Fact Book* 62-63.

Further evidence that investors are sensitive to fees is that they vote with their feet, moving money between advisers in response to various factors, including fees and performance. For example, in any given year between 1990 and 2008, between twenty-five percent and seventy percent of fund advisers experienced net outflows in total across all the funds that they advised. *Fact Book* 14. As a result, fund advisers feel intense

pressure to offer funds with performance, services, and fees that meet investors' needs.

Other studies confirm that investors respond to fund fees. A recent study found that, controlling for other relevant factors, a ten percent increase in fees decreases a fund's total net assets by as much as twenty-eight percent. Coates & Hubbard, *supra*, at 183. Another study found that "[p]rice competition is an effective way of obtaining market share" and that fund investors "do pay attention to price." *See, e.g.*, Khorana & Servaes, *Conflicts of Interest and Competition in the Mutual Fund Industry* 20 (July 2004) (last revised Mar. 22, 2009) (unpublished working paper) *available at* http://ssrn.com/abstract=240596.

To be sure, investors do not always choose the least costly mutual fund, nor necessarily even the least costly fund in a given category. Other factors may come into play, such as superior after-fee returns, various fund features (*e.g.*, different minimum initial investment requirements), services offered by the fund and its adviser, and the investor's relationship with a financial adviser—all of which can produce a dispersion of fees across funds, even though the market is keenly competitive.

C. The Competitive Mutual Fund Marketplace Benefits Investors By Giving Them A Wide Choice Of Funds At Low Cost

1. Investors benefit from choices

Petitioners and their *amici* describe the mutual fund marketplace as bereft of benefits to investors. That characterization is unfounded. Over the last forty years, mutual funds have greatly expanded the range of investments they offer investors. For example, in 1970

there were just 361 mutual funds, the great majority of which were "large-cap" U.S. stock funds. *Fact Book* 112-114. By 2008, investors could choose from 8,022 different mutual funds with a broad variety of investment objectives, including large-, medium-, and small-cap funds, international stock and bond funds, funds that invest in technology companies or health-care companies, and others.

Competition among advisers to manage investors' dollars has also spurred the development of new types of funds beyond traditional stock and bond funds. Since 1970, fund advisers have introduced innovative products such as money market funds, index funds, municipal bond funds, tax-exempt money market funds, socially conscious funds, tax-managed funds, emerging markets funds, target-date funds, and exchange-traded funds. The emergence of these new products provides investors with more choices to better achieve their investment objectives and encourages all fund advisers to offer the best possible products at the lowest cost possible.

Changes in technology and the ways mutual funds are sold have made it increasingly easy for investors to pick and choose the funds that best meet their needs. Investors can, at little or even no cost, switch between mutual funds offered by different fund advisers through employer-sponsored retirement plans, financial advisers, and full-service and discount brokers.[17] They

[17] Petitioners and their *amici* also contend that competition among mutual funds is constrained by investors' potential capital gains tax liabilities for redeeming fund shares. *See, e.g.*, Pet. Br. 42; Law Prof. Amicus Br. 22. The brief for the Law and Finance Amici explains (at 15-17) why such claims are greatly overstated.

can also purchase fund shares directly from fund sponsors.

Mutual funds also offer substantial benefits to 401(k) plan participants, including a wide variety of investment choices. For example, the average 401(k) plan now offers plan participants eighteen different investment options including mutual funds. *See* Profit Sharing/401k Council of America, *51st Annual Survey of Profit Sharing and 401(k) Plans Reflecting 2007 Plan Experience* 26 (2008). In addition, employers who sponsor 401(k) plans can and do include mutual funds with lower fees. *See* ICI, *The Economics of Providing 401(k) Plans: Services, Fees, and Expenses, 2008*, at 12-13 (Aug. 2009).[18] Finally, investors who leave an employer generally have the option of rolling their 401(k) assets into an IRA in any fund or funds they choose.

2. Fund investors have benefited from a decades-long decline in the total cost of fund investing

Brisk competition among advisers for investors' business has supported a decades-long decline in the overall cost of investing in a mutual fund. For example, the total cost of investing in stock mutual funds fell from 2.32 percent in 1980 to 0.99 percent in 2008, a decline of nearly 60 percent (Figure 1). ICI, *Trends in the*

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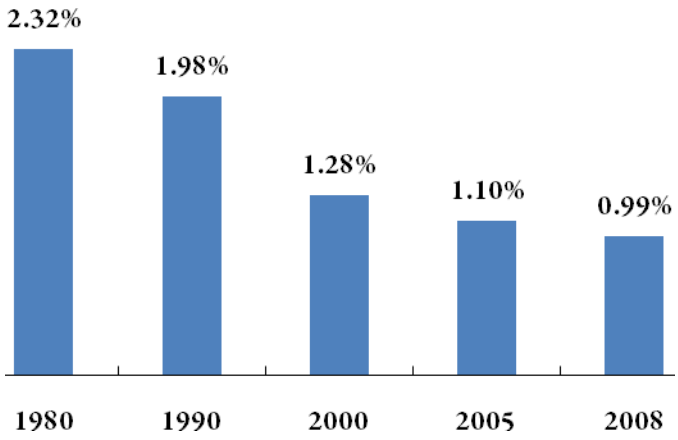
[18] Petitioners argue that 401(k) plans generally include "high-priced" funds, relying on a statement in a proposed Department of Labor (DOL) rule that 401(k) participants pay fees that are 11.3 basis points "higher than necessary." *See* Pet Br. 42 & n.30. In adopting the final rule, however the DOL expressly retracted that conclusion. *See Investment Advice—Participants and Beneficiaries*, 74 Fed. Reg. 3822, 3840 (Jan. 21, 2009) (the estimate "lacks adequate basis and should be disregarded").

Fees and Expenses of Mutual Funds, 2008, at 2 (Apr. 2009).[19] For bond mutual funds, the total cost of investing fell from 2.05 percent to 0.75 percent over the same period, a decline of 63 percent. *Id.*

Figure 1: Total Cost of Investing in a Stock Fund Has Declined By Nearly Sixty Percent Since 1980
(paid by investors as a percent of fund assets)



Source: Investment Company Institute

This sharp decline occurred despite a huge increase in the demand for mutual funds. In 1980, just 4.6 million households invested in mutual funds. By 2008, that figure had increased to 52.5 million households. With each household typically opening several mutual fund accounts, the number of accounts that mutual funds managed rose from 12.1 million in 1980 to 264.5 million

[19] According to some studies, the fees paid by U.S. mutual fund investors are now among the lowest in the world. *See, e.g.*, Rekenthaler et al., *Global Fund Investor Experience* 13 (Morningstar Fund Research May 2009) (U.S. equity fund fees lowest of 16 countries studied).

in 2008. Basic economics suggest that all else equal, such a massive increase in demand normally should have led to an increase in fees. Fees instead declined as existing and new advisers offered more funds and as these advisers competed by seeking out and passing through cost savings, evidence that competition prevails in the fund industry.

In addition, as investors increasingly turned to mutual funds as their investment vehicle of choice, they demanded a greater array of services, and fund advisers competed to offer these services. For example, web-based and around-the-clock toll-free telephone access to fund information was virtually unheard of twenty years ago, but is commonplace today. *See* ICI, *Competition in the Mutual Fund Business* 4 (Jan. 2006). Although the cost of these additional services puts implicit upward pressure on total fund fees, investors in fact paid less. Stiff competition led advisers to provide enhanced services more efficiently and reduce fund expenses in order to attract investors.

CONCLUSION

The Court should reject petitioners' effort to replace *Gartenberg's* flexible approach with a simplistic comparison of the fees an adviser receives from a mutual fund with those received from its non-mutual fund institutional clients. Instead, the Court should conclude that *Gartenberg* articulates the appropriate standard for assessing claims under Section 36(b). Under that standard, the district court properly granted summary judgment to respondent. Accordingly, the judgment of the court of appeals should be affirmed.

Respectfully submitted.

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