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 Petition for a Writ of Certiorari to the United States Court of Appeals for the Seventh Circuit

BRIEF OF *AMICI CURIAE* LAW PROFESSORS IN SUPPORT OF THE ISSUANCE OF A WRIT OF CERTIORARI

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INTEREST OF *AMICI CURIAE*[1]

Amici are established scholars[2] at American law schools whose research and teaching interests focus on federal securities regulation, business organizations, and the law of investment funds. *Amici* have no financial stake in the outcome of this case but are interested in ensuring a uniform and coherent interpretation of the Investment Company Act of 1940 (the "Company Act"). We file this brief to urge this Court to grant the petition and to clarify the proper scope of the fiduciary duty that investment advisers owe to fund shareholders with respect to the compensation that advisers receive. We are prompted to submit this brief because the decision in this case will have wide-ranging consequences for millions of American investors and the trillions of dollars they entrust to these fiduciaries.

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[1] No counsel for any party has authored this brief in whole or in part, and no person or entity other than *amici curiae* has made a monetary contribution to the preparation or submission of this brief. *See* Sup. Ct. R. 37.6. Counsel of record for all parties received notice of *amici curiae*'s intention to file this brief at least 10 days prior to the due date. *See* Sup. Ct. R. 37.2(a). Counsel for Petitioners filed a letter with the Clerk granting blanket consent to the filing of *amicus* briefs, and a letter reflecting the consent of Respondent to the filing of this brief has been filed with the Clerk. *See id.*

[2] A full list of *amici*, who join this brief as individuals and not as representatives of any institutions with which they are affiliated, is set forth in the Appendix to this brief.

SUMMARY OF ARGUMENT

In its ruling below, the United States Court of Appeals for the Seventh Circuit boldly discarded more than a quarter-century of jurisprudence and substituted in its place an imaginative economic reinterpretation of Section 36(b) of the Investment Company Act of 1940 that elides a critical provision of the statute. In so doing, the court of appeals undermined a key bulwark safeguarding the interests of the ninety million U.S. shareholders of mutual funds, a thirteen-trillion-dollar industry[3] uniquely vulnerable to conflicts of interest and uncommonly impoverished in protective market forces.

Indeed, so striking was this replacement of congressional legislation with only superficial market theory to support it that Judge Richard Posner, one of the foremost judicial and scholarly proponents of economic analyses of law, called the reasoning "one-sided" and "ripe for reexamination" when dissenting from the denial of rehearing en banc. Pet. App. 43a, 37a.

Critical to understanding this case is the fact that mutual funds differ from typical corporations in several important structural ways. These differences explain both why, contrary to the court of appeals' reasoning, the market alone fails to ensure competitive fees and why Congress in the Company Act imposed a fiduciary duty on investment advisers to protect shareholders from excessive fees.

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[3] *See* Investment Company Institute, *2008 Fact Book* 7 (48th ed. 2008) ("*ICI 2008 Fact Book*"), *available at* http://www.icifactbook.org. In addition to the savings of individuals, mutual funds also hold trillions of dollars in tax-deferred savings from 401(k), 403(b), and pension plans. *See id.* at 8-9.

The central participants in the mutual fund field are investment advisers, businesses whose profession is to manage pools of investors' money. Unlike the typical purveyor of professional services, who must win customers in the open market, however, an investment adviser has the ability to create its own clients by forming the very mutual funds to which it provides its services. More importantly for the issues in this dispute, the investment adviser also has the power to appoint the clients' overseers: the board of directors.[4] When the adviser forms a mutual fund, it appoints and thereafter controls the reappointment of the fund's board. Because the investment adviser owns all the fund's shares at this nascence, it has the luxury of appointing whomever it wishes to these positions.[5]

One of the first tasks of the then-newly constituted board is to sign the advisory agreement pursuant to

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[4] Alternatively, if the entity is a business trust, as most mutual funds are, a board of trustees will govern it.

[5] The composition of the board must, however, comport with certain federal requirements. For instance, the Company Act requires that "no more than 60 per centum" of the board may be "interested persons" of the fund; that is, they may not be affiliated with the investment adviser. Company Act §§ 10(a), 2(a)(19), 15 U.S.C. §§ 80a-10(a), 80a-2(a)(19). As a matter of practice, however, most mutual funds obligate themselves to meet a higher threshold of board independence because, in exchange for doing so, Securities and Exchange Commission ("SEC") regulations provide widely sought exemptive relief from onerous restrictions on how the funds may operate. *See, e.g.*, Company Act Rule 12b-1(c), 17 C.F.R. § 270.12b-1(c) (permitting funds to charge a distribution fee – known as a "12b-1 fee" – provided they satisfy the fund governance standards of Company Act Rule 0-1(a)(7), 17 C.F.R. § 270.0-1(a)(7), which require, *inter alia*, that at least 75 percent of the trustees be independent).

which the fund pays the investment adviser to manage the assets of the fund. Not surprisingly, mutual fund boards retain the investment advisers that founded the fund (and practically never fire them). The intimate reciprocity involved in the process of approving the compensation for the advisers in their roles as outsourced executives – albeit ones who own and operate all of the fund's operational infrastructure – explains Congress's "concern with the potential for abuse inherent in the structure of investment companies," which this Court has noted twice when previously considering the Company Act. *Daily Income Fund, Inc. v. Fox*, 464 U.S 523, 536 (1984) (quoting *Burks v. Lasker*, 441 U.S. 471, 480 (1979)) (internal quotation marks omitted).

The ongoing incestuous relationship between the fund and its founding adviser is what prompted Congress to enact the Investment Company Act of 1940 and, more notably, the Investment Company Amendments Act of 1970. The goal of both statutes was to ameliorate the unchecked power of advisers to charge their funds, given that "the 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." S. Rep. No. 91-184, at 5 (1969), *reprinted in* 1970 U.S.C.C.A.N. 4897, 4901.[6] One of Congress's most important attempts to address this structural deficiency was the addition in 1970 of Section 36(b) to the Company Act, which provides that "the investment adviser of a registered investment company shall be deemed to have a fidu-

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[6] *See also* Tamar Frankel, *Advisory Fees: Evolving Theories*, 10 Inv. Law. 22 (2003) (noting the historical transformation of investment advice from an eleemosynary profession to a profit-driven business).

ciary *duty with respect to the receipt of compensation for services.*" 15 U.S.C. § 80a-35(b) (emphasis added).

Twelve years later, in 1982, the Second Circuit explicated the content of Section 36(b) in *Gartenberg v. Merrill Lynch Asset Management, Inc.*, 694 F.2d 923 (2d Cir. 1982), a seminal ruling that has dominated professional, judicial, and regulatory understandings of the fiduciary duty for more than twenty-five years, until now. In *Gartenberg*, the Second Circuit held that, "to be guilty of a violation of § 36(b), . . . the adviser-manager must charge a fee that is so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been the product of arm's-length bargaining." *Id.* at 928. As further guidance, the court enumerated a menu of factors that a board might consider in evaluating the excessiveness of an investment advisory agreement. *Id.* at 930.[7]

Over the past quarter-century, *Gartenberg* has borne ever more weight as the foundation of a sprawling edifice of compliance for Section 36(b). Not only have dozens of courts – including the Third and Fourth Circuits – adopted the *Gartenberg* standard in deciding Section 36(b) cases, but the SEC has endorsed and encoded the *Gartenberg* standards in regulations and disclosure requirements,[8] while the

[7] These *Gartenberg* factors include (1) "rates charged by other advisers of similar funds," (2) "the adviser-manager's cost in providing the service," (3) "the nature and quality of the service," (4) "the extent to which the adviser-manager realizes economies of scale as the fund grows larger," and (5) "the volume of orders which must be processed by the manager." *Gartenberg*, 694 F.2d at 929-930.

[8] *See, e.g.*, Form N-1A, Items 5, 21 & 22(d)(6), 17 C.F.R. §§ 239.15A, 274.11A (requiring fund boards to disclose whether

industry itself has developed a *soi-disant* "*Gartenberg* process," involving the preparation of lengthy reports that compare fund fees and performance for the annual approval of advisory contracts. Most importantly, *Gartenberg* shapes the advice counsel provides boards of trustees in their annual review of advisory contracts. Indeed, *Gartenberg* is the basis for much of what transpires in the boardrooms of the nearly nine thousand registered investment companies.

In its recent ruling, the Seventh Circuit explicitly discarded the precedent and practice of *Gartenberg*. In doing so, it created a harmful split of authority in the courts of appeals. The court introduced an entirely new interpretation of Section 36(b) by ignoring a critical provision of the statute and by asserting that the mutual fund market "come[s] much closer to the model of atomistic competition than do most other markets." Pet. App. 12a. The court cited no authority for this observation. Relying on this conjecture of salutary competition, the court casually "disapprove[d] the *Gartenberg* approach," concluding that the substantive and procedural components of the fiduciary duty were largely irrelevant. *Id.* at 8a. Instead, the court held that, so long as an adviser "make[s] full disclosure" and "play[s] no tricks," a plaintiff cannot prevail on a Section 36(b) claim. *Id.* The court declined to explain why Congress would enact Section 36(b) to accomplish such a result when securities statutes and regulations prohibiting un-

they discussed the *Gartenberg* factors in approving investment advisory contracts and, if not, why not); Disclosure Regarding Approval of Investment Advisory Contracts by Directors of Investment Companies, Investment Company Act Release No. 26,486, 83 SEC Docket 261, § II.B n.31 (June 23, 2004) ("2004 SEC Release") (citing, with approval, the *Gartenberg* approach).

faithful conduct already existed, or what the phrase "with respect to the receipt of compensation for services" in the statute might mean. 15 U.S.C. § 80a-35(b).

This Court should grant the petition for a writ of certiorari to resolve the split of authority between the Seventh Circuit and the Second, Third, and Fourth Circuits and to delineate the proper degree to which the content and scope of the Section 36(b) fiduciary duty and other corporate fiduciary duties may be abdicated in favor of the panacean forces of free-market competition.

REASONS FOR GRANTING THE PETITION

I. THE COURTS OF APPEALS HAVE TAKEN CONFLICTING AND IRRECONCILABLE APPROACHES TO THE FIDUCIARY DUTY CREATED BY SECTION 36(b)

In its opinion below, the Seventh Circuit considered and consciously departed from the analysis of the Second Circuit, stating, "[W]e now disapprove the *Gartenberg* approach." Pet. App. 8a. In doing so, the court swerved away not just from the *Gartenberg* opinion but also from the rulings of *all* other courts of appeals that have analyzed Section 36(b), from the position and regulations of the administrative agency charged with the interpretation and enforcement of Section 36(b), and, indeed, from the well-established practice of investment advisers and boards of trustees.

A. The *Gartenberg* Ruling Has Been Adopted by All Other Courts of Appeals To Rule on This Question

The Second Circuit established the dominant interpretation of Section 36(b) when it ruled on a claim by shareholders of a money market fund that the fund's investment adviser, Merrill Lynch, charged fees that were "so disproportionately large as to constitute a breach of fiduciary duty in violation of § 36(b)." *Gartenberg*, 694 F.2d at 925.

In its analysis, the Second Circuit relied upon the provision's legislative history in construing both a substantive and a procedural element to the Section 36(b) fiduciary duty. The duty could be violated substantively if the adviser charged a fee so large that it "bears no reasonable relationship to the services rendered and could not have been the product of arm's-length bargaining." *Id.* at 928. The court then elaborated upon a process by which trustees – and courts – could make this substantive determination: "all pertinent facts must be weighed." *Id.* at 929. The pertinent facts have since become well known in both jurisprudence and practice as the "*Gartenberg* factors"; they are

(1) the nature and quality of services provided to fund shareholders;

(2) the profitability of the fund to the adviser-manager;

(3) fall-out benefits;

(4) economies of scale;

(5) comparative fees structures; and

(6) the independence and conscientiousness of the trustees.

Id. at 927-934; *see also Krinsk v. Fund Asset Mgmt., Inc.*, 875 F.2d 404, 409 (2d Cir. 1989) (citing and expanding upon *Gartenberg*).

The Second Circuit pointedly noted that the procedure of evaluating these factors, while necessary to discharging the Section 36(b) fiduciary duty, would not alone be sufficient to satisfy the duty. *Garten-*

berg, 694 F.2d at 930. "[E]ven if the trustees of a fund endeavored to act in a responsible fashion, an adviser-manager's fee could be so disproportionately large as to amount to a breach of fiduciary duty in violation of § 36(b)." *Id.* In other words, *Gartenberg* establishes that faithfully discharging the Section 36(b) fiduciary duty requires two independent and necessary elements – one substantive, one procedural.

The Fourth Circuit endorsed the "exhaustive[] analy[sis]" of Section 36(b) contained in *Gartenberg* and adopted the Second Circuit's approach unreservedly when evaluating the claims of two shareholders in funds advised by T. Rowe Price who sued the adviser for breaching its fiduciary duty under Section 36(b). *See Migdal v. Rowe Price-Fleming Int'l, Inc.*, 248 F.3d 321, 326-328 (4th Cir. 2001). The court agreed that, "in order to determine whether a fee is excessive for purposes of Section 36(b), a court must examine the relationship between the fees charged and the services rendered by the investment adviser." *Id.* at 327.

Shortly thereafter, when confronted with a very similarly situated set of plaintiffs to those in *Migdal*, the Third Circuit turned to the *Migdal* opinion – and the rationale therein, which the Fourth Circuit had adopted from *Gartenberg* – as "the case on which [the court] primarily rel[ied] to reach [its] conclusion." *Krantz v. Prudential Invs. Fund Mgmt. LLC*, 305 F.3d 140, 145 (3d Cir. 2002).[9] Thus, with slightly

[9] Both Judge Posner in his dissent from denial of rehearing en banc and Petitioners have pointed out that the Third Circuit's ruling in *Green v. Fund Asset Management, L.P.*, 286 F.3d 682 (3d Cir. 2002), is inapposite to this line of cases because, in *Green*, "the amount of [the adviser's] compensation was not at issue." Pet. App. 35a; Pet. 19.

varying emphases upon the factors to consider, the Fourth and Third Circuits have adopted the *Gartenberg* analysis.

B. The SEC Has Accepted and Implemented the *Gartenberg* Approach

In ways both explicit and implicit, the SEC has also accepted the approach for complying with Section 36(b) set forth in *Gartenberg* and has encoded regulatory provisions that oblige investment advisers to do the same. For example, in a 2004 release, the SEC promulgated rule and form amendments requiring disclosure in proxy statements and annual shareholder reports of the approval process for mutual fund advisory contracts. The SEC also listed five "specific factors" to be discussed, citing *Gartenberg* and noting that "[c]ourts have used similar factors in determining whether investment advisers have met their fiduciary obligations under Section 36(b)." 2004 SEC Release § II.B n.31. The SEC's approval process stands in stark contrast to the market-based approach embraced by the court of appeals in this case.

The new amendments imposed by the SEC included a revision of Schedule 14A of the Securities Exchange Act of 1934 (the "Exchange Act") to require a discussion of the *Gartenberg* factors in proxy statements distributed to the shareholders of investment companies or, if a mutual fund board concludes that any factor "is not relevant to the board's evaluation of the investment advisory contract for which approval is sought, [the board must] note this and explain the reasons why that factor is not relevant." Schedule 14A, Item 22(c)(11), 17 C.F.R. § 240.14a-101.

The amendments also revised Form N-1A[10] to require similar discussions of the *Gartenberg* factors in prospectuses and statements of additional information provided to mutual fund shareholders. *See* Form N-1A, Items 5(a)(1)(iii) & 22(d)(6).

C. The Seventh Circuit's Ruling Sharply Breaks with *Gartenberg* and the SEC

In remarkable contrast to the *Gartenberg* line of cases and the SEC's position, the Seventh Circuit's decision eviscerated the substantive limits that Section 36(b) places upon fees and eliminated entirely a fiduciary's need to engage in any process to determine compensation. The court of appeals instead asserted that investment advisers are "not subject to a cap on compensation." Pet. App. 8a. And, although one might "imagine compensation so unusual that a court will infer that deceit must have occurred," even such a windfall would be acceptable if "similar institutions" imposed similar fees. *Id.* at 9a. As Judge Posner pointed out in voting for rehearing, when excessive fees are "industry-wide," then those fees "become the industry's floor," not its ceiling, and would presumably pass muster under the Seventh Circuit's new standard. *Id.* at 41a.

Under the Seventh Circuit's new rule, the process by which an adviser's compensation is determined would also be irrelevant provided a fiduciary "make[s] full disclosure and play[s] no tricks." *Id.* at 8a. If the Seventh Circuit believed it was putting an end to the "federal judiciary [acting as] a rate regula-

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[10] Corresponding revisions were also made to Form N-2 for closed-end funds and Form N-3 for separate accounts offering variable annuity contracts. *See* Form N-2, Item 9.1.b(4), Instructions 6.e & 6.f to Item 23; Form N-3, Item 6(b)(iii), Instructions 6(v) & 6(vi) to Item 27(a).

tor," its ruling was a solution in search of a problem. *Id.* at 14a. In fact, since the enactment of Section 36(b)'s fiduciary duty thirty-eight years ago, no federal court has ever set a rate "after the fashion of the Federal Energy Regulatory Commission" as the Seventh Circuit apparently feared. *Id.*[11]

The Seventh Circuit's reasoning thus overlooks the substantial value of the *Gartenberg* factors: namely, their healthy impact on the behavior of the fund's trustees in their mandated annual reviews of the advisory contract. *Gartenberg* has positively stimulated procedural protection for shareholders during the renewal of investment advisory contracts. The board, with its independent counsel, systematically reviews the advisory contract through the lens of the *Gartenberg* factors.

Moreover, with a similar lawsuit currently pending in the Eighth Circuit and the possibility of the circuit split hardening or fracturing further,[12] this case provides the Court with an excellent opportunity to clarify the Section 36(b) fiduciary duty and to develop the more robust economic reexamination that Judge Posner believes is warranted by "the creation of a circuit split, the importance of the issue to the mutual fund industry, and the one-sided character of the panel's analysis." *Id.* at 42a-43a.

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[11] *See* James D. Cox et al., *Securities Regulation: Cases and Materials* 1211 (3d ed. 2001).

[12] *See Gallus v. Ameriprise Fin., Inc.*, Civil No. 04-4498 (D. Minn. July 10, 2007), *appeal pending*, No. 07-2945 (8th Cir. argued Apr. 17, 2008).

II. THIS CASE PRESENTS AN EXCELLENT OPPORTUNITY TO CLARIFY THE ROLE AND RELEVANCE OF THE MUTUAL FUND MARKET IN ASSESSING VIOLATIONS OF AN ADVISER'S FIDUCIARY DUTY

With its focus fixed clearly upon the alleged difference between the competitiveness of the mutual fund industry in 1970 and today, the Seventh Circuit has largely ignored the important liminal question whether it or any court may depart from the statutory obligations imposed by Congress in Section 36(b) to address supposed new market conditions. If markets are to be the sole check on excessive advisory compensation, Congress must make that decision, after hearings in which theories such as those postulated by the Seventh Circuit could be advanced and appropriately met by hard evidence to the contrary. But so long as Section 36(b) remains intact – such that the fiduciary duty applies specifically "to the receipt of compensation for services" – no court has grounds to ignore this congressionally enacted language. 15 U.S.C. § 80a-35(b). Even if this Court were also inclined to elide this clause from Section 36(b), however, any frank analysis of the mutual fund market would require a more robust evaluation of the limits of competitive forces than the one sketched by the Seventh Circuit.

A. The Decision Below Ignores the Statutory Requirements of Section 36(b)

Whereas *Gartenberg* and its progeny take pains to evaluate the motivations of Congress through an examination of legislative history, the Seventh Circuit adopted a purely textualist approach, albeit one in which it ignored the critical text. The court eschewed language from the Senate report accompanying the enactment of Section 36(b) as part of the Investment Company Amendments Act of 1970:

> Because of the unique structure of this industry the relationship between mutual funds and their investment adviser is not the same as that usually existing between buyers and sellers or in conventional corporate relationships. Since a typical fund is organized by its investment adviser which provides it with almost all management services and because its shares are bought by investors who rely on that service, a mutual fund cannot, as a practical matter sever its relationship with the adviser. Therefore, the forces of arm's-length bargaining do not work in the mutual fund industry in the same manner as they do in other sectors of the American economy.

S. Rep. No. 91-184, at 5, *reprinted in* 1970 U.S.C.C.A.N. 4901.[13] Refusing to accept this Court's finding of such congressional intent in *Daily Income Fund, Inc. v. Fox*, 464 U.S. 523, 536 (1984), and *Burks v. Lasker*, 441 U.S. 471, 480 (1979), the Seventh Circuit insisted that "Congress did not enact its members' *beliefs*; it enacted a text." Pet. App. 11a. But courts need not always sort through legislative history to draw conclusions about the purpose of a particular statutory provision. The very creation and structure of a statute can, by itself, demonstrate an animating

[13] In several respects, the operation of mutual funds is similar to that of banks: both issue redeemable obligations to the public and use the proceeds for investments in securities (in the case of mutual funds) and loans (in the case of banks). Neither set of obligations is traded on a market; they are simply redeemed to the issuing entities. *See* 1 Tamar Frankel & Ann Taylor Schwing, *The Regulation of Money Managers* § 1.02[B][2][b] (2d ed. Supp. 2006) ("Frankel & Schwing").

intent to curb some perceived abuse, as is the case with Section 36(b).

Even if one were to accede to the Seventh Circuit's decision to focus upon only the text of Section 36(b), one must still conclude that Congress created a new and specific species of fiduciary duty. The use of the language "with respect to the receipt of compensation for services" clearly qualifies this fiduciary duty and requires an investment adviser to vouchsafe good faith, fair dealing, and the other trappings of a fiduciary specifically in conjunction with the fees it charges. 15 U.S.C. § 80a-35(b). The Seventh Circuit completely reads this language out of its analysis. Moreover, the very demand that the advisory contract be approved annually implicitly envisions evaluation of the fairness of the contract's terms. The *Gartenberg* factors at least announce minimal considerations for this mandated inquiry into fairness.

To conclude that this provision means only that a "fiduciary must make full disclosure and play no tricks," as the Seventh Circuit did, renders the provision nugatory and impotent in a regulatory regime already bristling with antifraud provisions. At the time, mutual fund advisers were specifically obliged to provide full disclosure and not to play tricks by Section 34(b) of the Company Act, 15 U.S.C. § 80a-33(b) (making unlawful any untrue statements of material fact in a registration statement or other documents); Section 206 of the Investment Advisers Act of 1940, 15 U.S.C. § 80b-6 (making unlawful any fraud upon clients or prospective clients); Sections 11, 12, and 17 of the Securities Act of 1933, 15 U.S.C. §§ 77k, 77*l*, 77q (imposing civil liability for false registration statements and for noncompliant prospectuses, and making unlawful fraudulent interstate transactions); and Section 10(b) of the Exchange Act, 15 U.S.C. § 78j(b), and Exchange Act Rule 10b-5, 17 C.F.R. § 240.10b-5 (making unlawful the use of any manipulative or deceptive devices). The obvious implication and effect of adding Section 36(b) to this regime was to create a separate and new duty specifically designed to impose a limitation upon the compensation that fiduciaries can charge and receive.

B. The Seventh Circuit's Economic Analysis Is Ripe for Reexamination

Even assuming that the Seventh Circuit was justified in departing from the statutory text of Section 36(b), the new economic analysis the court offers of the state of competition in the mutual fund market is superficial and, as Judge Posner noted, "one-sided." Pet. App. 43a.

The nature of mutual funds and their competitiveness were not issues for decision in the Seventh Circuit; instead, the court sought out evidence of its own – finding just one study (which happened to contradict the court's disapproval of *Gartenberg*) – and deduced the remainder of its analysis. *Id.* at 12a (citing John C. Coates & R. Glenn Hubbard, *Competition in the Mutual Fund Industry: Evidence and Implications for Policy*, 33 Iowa J. Corp. L. 151, 213 (2007)). The choice of this solitary study is curious given the study's singular conclusion that competition has favorably impacted fees, particularly in light of evidence that fees have risen as more entrants have appeared in the field.[14]

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[14] *See, e.g.*, John P. Freeman, Stewart L. Brown & Steve Pomerantz, *Mutual Fund Advisory Fees: New Evidence and a Fair Fiduciary Duty Test*, 61 Okla. L. Rev. 83, 106-122 (2008) (critiquing the Coates-Hubbard study).

The court either did not find or chose not to discuss the contrary findings contained in a multitude of other careful scholarly studies. *See, e.g.*, John P. Freeman & Stewart L. Brown, *Mutual Fund Advisory Fees: The Cost of Conflicts of Interest*, 26 J. Corp. L. 610 (2001); General Accounting Office, *Mutual Fund Fees: Additional Disclosure Could Encourage Price Competition* (June 2000), *available at* http://www.gao.gov/archive/2000/gg00126.pdf; SEC, *Public Policy Implications of Investment Company Growth, reprinted in* H.R. Rep. No. 89-2337 (1966); Wharton School of Finance & Commerce, 87th Cong., *A Study of Mutual Funds* (Comm. Print 1962). The Seventh Circuit thus barely surveyed the literature and reached an erroneous understanding of the operation of the mutual fund industry. And, even allowing *arguendo* that the court's view of the industry and its market were correct, it is for Congress and not the Seventh Circuit to amend Section 36(b). Moreover, even in the absence of a rigorous, two-sided evaluation of the empirical evidence relating to competition in the mutual fund market, a fair-minded court would have many readily available reasons to avoid a credulous, laissez-faire embrace of this industry: *e.g.*, the notorious market-timing investigations that have implicated dozens of mutual fund advisers over the past five years[15]; the rigorous and widespread critique of executive compensation in popular and academic literature[16]; and the spectacular recent

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[15] *See, e.g.*, William A. Birdthistle, *Compensating Power: An Analysis of Rents and Rewards in the Mutual Fund Industry*, 80 Tul. L. Rev. 1401 (2006).

[16] *See, e.g.*, Lucian Bebchuk & Jesse Fried, *Pay Without Performance: The Unfulfilled Promise of Executive Compensation* (2004).

collapse of the nation's lending and financial industries in which, as Judge Posner pointed out, "abuses have been rampant," Pet. App. 38a.

At a cursory glance, the sheer numbers associated with mutual funds – thousands of funds and hundreds of advisers on the supply side and millions of investors and trillions of dollars on the demand side – would seem to guarantee a robust marketplace. But, in fact, many investors "are not arriving at the agora unfettered."[17] Their choices are extremely constrained by inertia and the limited menu of options available in 401(k) and other retirement plans. Many mutual fund shareholders simply do not possess or know how to acquire the information necessary to make an informed movement of their assets.[18] In sum, as the aforementioned studies demonstrate, the mutual fund market is complex and variegated, with some sectors enjoying vigorous price competition while others are largely uncontested.[19]

Declaring that "[i]t won't do," the Seventh Circuit preemptively rejected the criticism that most investors are unsophisticated by claiming that "sophisticated investors who do shop create a competitive pressure that protects the rest." Pet. App. 12a. Of course, such an assertion would turn on the number of those sophisticated investors and the amount of their assets, but the court's reliance on institutional investors to serve as sentinels for average investors

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[17] Birdthistle, 80 Tul. L. Rev. at 1442.

[18] *Id.*

[19] *See generally* James D. Cox & John W. Payne, *Mutual Fund Expense Disclosures: A Behavioral Perspective*, 83 Wash. U. L.Q. 907, 923 (2005) (explaining why, under current practices, investors cannot be expected to make rational choices among funds in the fashion described by the Seventh Circuit).

in mutual funds is badly misplaced. The interests of the two groups might align only if they inhabited the same space, but they do not.

First, when institutional investors invest in the same securities as average shareholders, they do not pay the same fees; institutions receive preferential mutual fund prices through specially issued institutional shares. Second, when institutional investors do pay the same or higher fees as average shareholders, they do not invest in the same securities; hedge funds and mutual funds are radically different investments with totally incompatible risk profiles. *See id.* at 13a. Curiously, the Seventh Circuit was happy to compare similar fees of unrelated investment products – such as those charged by mutual funds versus hedge funds – but unwilling to contrast divergent fees of identical investment products – such as those paid by mutual fund shareholders versus unaffiliated institutional clients.

C. This Court Should Permit Comparisons to the Fees Paid by Institutional Investors

As Judge Posner points out, if the "governance structure that enables mutual fund advisers to charge exorbitant fees is industry-wide" – or even just sector-wide – then the court's ruling would prevent plaintiffs from ever identifying an excessive fee. Pet. App. 41a. By analyzing the lower rates paid by institutional funds, which enjoy a far less structurally intertwined and captive relationship with investment advisers, a plaintiff can demonstrate how far an adviser has strayed from its Section 36(b) fiduciary duty.

Finally, the Seventh Circuit points to the specific success of the investments at issue in this case: "The Oakmark funds have grown more than the norm for comparable pools, which implies that Harris Associates has delivered value for money." *Id.* at 6a. Here, in a rare point of agreement, Judge Posner allows that this may mean the "outcome of this case may be correct." *Id.* at 42a. Yet the Investment Company Institute, which is the advocate of investment advisers, acknowledges that only about forty percent of the industry's aggregate annual growth is due to fund performance.[20] Most of the remaining increase is due simply to growth by sales: new investments flowing into the funds. In order to evaluate whether the fees Harris charged were reasonable or excessive, then, one would need to evaluate whether the adviser was a skilled portfolio manager or merely an outstanding marketer. Only one of those talents benefits fund shareholders.[21]

This Court should use this case to clarify the proper scope of the Section 36(b) fiduciary duty that investment advisers owe to fund shareholders and to elucidate the role and relevance of the mutual fund market in evaluating that duty.

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[20] *See ICI 2008 Fact Book* 7.

[21] *See* 2 Frankel & Schwing § 12.03[C], at 69-70 (2001).

CONCLUSION

For these reasons, *amici* respectfully urge this Honorable Court to grant the petition for a writ of certiorari.

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