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

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An acknowledged circuit conflict now exists on the standard for determining whether an investment adviser has fulfilled its fiduciary duty "with respect to the receipt of compensation for services" under § 36(b) of the Investment Company Act of 1940, 15 U.S.C. § 80a-35(b). Under three circuits' approach, an investment adviser violates § 36(b) when, considering "all pertinent facts," the fee charged "is so disproportionately large" that it "bears no reasonable relationship to the services rendered." *Gartenberg v. Merrill Lynch Asset Mgmt., Inc.*, 694 F.2d 923, 928-30 (2d Cir. 1982). The Seventh Circuit "disapprove[d] the *Gartenberg* approach" and held that, so long as the adviser does not "pull[] the wool over the eyes" of the fund's directors, the board's approval of the adviser's compensation "is conclusive" and the adviser may "accept" whatever the board "agrees to pay." Pet. App. 8a-9a, 14a. In rejecting the prevailing *Gartenberg* standard, the court below created significant confusion on a question of undeniable importance for today's investment sector.[1] Respondent's attempts to deny the conflict and to minimize the decision's importance through a series of deflections are unpersuasive.

[1] This Court often grants certiorari when the court below divides evenly in denying rehearing en banc. *See, e.g., Wright v. West*, 505 U.S. 277, 284 (1992); *ETSI Pipeline Project v. Missouri*, 484 U.S. 495, 499 (1988); *Cornelius v. NAACP Legal Def. & Educ. Fund, Inc.*, 473 U.S. 788, 796 (1985).

ARGUMENT

I. THE DECISION BELOW CONFLICTS WITH DECISIONS OF OTHER CIRCUITS

A. Respondent argues (at 13-14) that the circuits articulate similar "formulations" of the governing standard. It bases that assertion on one sentence, in which the panel suggested that "[i]t is *possible* to *imagine* compensation so unusual that a court will infer that deceit must have occurred," such as where "a university's board of trustees decides to pay the president *$50 million* a year, when no other president of a comparable institution receives more than *$2 million*." Pet. App. 9a (emphases added). But the Seventh Circuit's speculation that one might be able to "*imagine*" inferring a fiduciary breach where an adviser's compensation is *25 times* the next-highest-paid adviser's is not the *Gartenberg* standard in different words. Rather, it is a new standard, under which the size of an adviser's fee would be relevant only in the most egregious, hypothetical case.

Furthermore, respondent's repeated comparisons (at 16, 29) of the phrases "so unusual" (Pet. App. 9a) and "so disproportionate[]" (*Gartenberg*, 694 F.2d at 928) miss a fundamental question – unusual or disproportionate in comparison to what? Under *Gartenberg*, the question is whether the adviser's fee "bears [a] reasonable relationship to *the services rendered*." *Id.* (emphasis added). In the Seventh Circuit, no such comparison between fees and services is relevant. Rather, the board's acceptance of the fee is presumptively fair unless the disparity reaches 25 times or more the next-highest-paid adviser's. The *Gartenberg* court, however, expressly rejected making compensation paid by other mutual funds the sole benchmark under § 36(b). It "disagree[d]" with the district court's conclusion that "the principal factor" is "the price charged by other similar advisers to funds managed by them" and held that "[r]eliance on prevailing industry advisory fees will not satisfy § 36(b)." *Id.* at 929.

Respondent's counsel elsewhere acknowledges that the decision below "poses *a real and substantial conflict* with the *Gartenberg* standard."[2] According to respondent's lawyers, the decision below "*expressly rejected* the widely applied Gartenberg standard for assessing advisers' liability for excessive fees," "*erased*" "*Gartenberg's* 'proportionality' test and the 'factors' that *Gartenberg* established for measuring compliance with that test," and "erected a *new standard*." Litigation Alert at 1 (emphases added). Like respondent's counsel, at least five Seventh Circuit judges and academic commentators recognize that the court below created a circuit conflict. *See* Pet. App. 35a, 42a-43a (Posner, J., dissenting from denial of rehearing en banc); Law Professors *Amicus* Br. 2, 6-7, 11-12; 6 Thomas Lee Hazen, *Law of Securities Regulation* § 20.9[1] (6th ed. 2009) ("The Seventh Circuit takes a different approach than the cases coming out of the Second Circuit."); *see also* Pet. App. 8a ("disapprov[ing]" *Gartenberg*).

B. As Judge Posner concluded, "an important difference" (Pet. App. 41a) between the decision below and *Gartenberg* is that the Seventh Circuit's rule gives no weight to discrepancies between fees paid by an adviser's captive funds and fees paid by its independent clients for comparable services, *see id.* at 13a. Respondent does not dispute that it charged

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[2] Ropes & Gray, *Appeals Court Rejects Mutual Fund Excessive Fee Claims, Adopting New Standard for Evaluation of Fees* 2 (May 20, 2008) ("Litigation Alert") (emphasis added).

the Oakmark funds more than twice what it charged independent investors.[3] But it claims (at 19-21) higher costs to serve the funds, justifying dramatically higher prices.

The courts below made no such finding. The panel "thr[ew] out some suggestions" (Pet. App. 39a (Posner, J.)) – "[d]ifferent clients call for different commitments of time" and "[m]utual funds may grow or shrink quickly," allegedly "complicat[ing] an adviser's task." *Id.* at 13a. But, as Judge Posner explained, such "airy speculation," lacking "an evidentiary or empirical basis," cannot justify the fee differential. *Id.* at 39a, 41a. The district court's offhand statement that respondent provided "more limited" services to its independent clients than to the funds was equally speculative and insufficient to justify summary judgment against petitioners. *Id.* at 16a.

The record refutes the speculation that differences in services account for vastly higher fees charged to the funds. The evidence showed that respondent furnished substantively identical services to its institutional and fund clients and that it cost respondent significantly *more* to serve its institutional clients. *See* C.A. App. A143-A145.[4] That evidence, which

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[3] The "breakpoints" – fee reductions as assets increase – that respondent touts (at 24) are meaningless, because the funds still paid more than twice what respondent's independent clients paid for comparable services. *See* Pet. 6 & n.2.

[4] The petition's statement, which respondent cites (at 20), that "it cost Harris significantly less to serve the institutional clients," Pet. 27 (emphasis omitted), was plainly a typographical error, as the record citation following that statement demonstrated. *See* C.A. App. A145 (citing evidence establishing that "an examination of all of Harris's costs shows that Harris's institutional business is *more costly* to Harris than the Funds in

is not available in all cases, makes this case an especially good vehicle for resolving the question presented.

Respondent relies (at 20) on *Gartenberg*'s statement that fees charged to "large pension funds" could not be compared to "advisory fees for money market funds." 694 F.2d at 930 n.3. But the funds here are not money market funds, which resemble "a bank account" in that money can be invested for "as little as a day." *Id.* at 925; *see* Pet. 16 n.5. And the undisputed evidence showed that the portfolio compensation and daily management of respondent's mutual funds and its independent accounts were virtually the same. *See* C.A. App. A143-A144. Nothing in *Gartenberg* supports rejecting a comparison between the funds and independent accounts in this case, as five Seventh Circuit judges recognized. *See* Pet. App. 41a (Posner, J.). Other courts agree. *See, e.g.*, *Hunt v. Invesco Funds Group, Inc.*, No. H-04-02555, 2006 WL 1581846, at *3 (S.D. Tex. June 5, 2006); *Strigliabotti v. Franklin Res., Inc.*, No. C 04-00883 SI, 2005 WL 645529, at *3-*4 (N.D. Cal. Mar. 7, 2005).[5]

Respondent also cites a journal article claiming that many services provided to mutual funds are not furnished to institutional accounts. *See* Opp. 2, 20-

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relationship to assets under management") (emphasis added). Notably, respondent cites no contrary evidence.

[5] *Strougo v. BEA Associates*, 188 F. Supp. 2d 373 (S.D.N.Y. 2002), incorrectly refused to consider a comparison with institutional clients, reasoning that "[i]t has been held that relevant comparison [sic] must be to other mutual funds, not to non-mutual fund institutional clients," *id.* at 384. *Strougo* cited only *Schuyt v. Rowe Price Prime Reserve Fund, Inc.*, 663 F. Supp. 962 (S.D.N.Y.), *aff'd*, 835 F.2d 45 (2d Cir. 1987) (per curiam), which involved the "unique" context of money market funds, *id.* at 983.

21 (citing John C. Coates IV & R. Glenn Hubbard, *Competition in the Mutual Fund Industry: Evidence and Implications for Policy*, 33 J. Corp. L. 151, 185 (2007) ("Coates & Hubbard")).[6] But the record shows that the funds pay separate fees for those services pursuant to separate agreements. *See* C.A. App. A143-A144. The advisory fees here are for pure portfolio-management services, *see id.*, which allows for the apples-to-apples comparison the article advocates, *see* Coates & Hubbard 186.

C. Respondent does not seriously dispute that the Third and Fourth Circuits follow *Gartenberg*. True, *Migdal v. Rowe Price-Fleming International, Inc.*, 248 F.3d 321 (4th Cir. 2001), "did not adopt *Gartenberg* wholesale," Opp. 21, because it failed to consider other circumstances the Second Circuit found relevant in determining an adviser's compliance with its fiduciary duty under § 36(c). *Compare Migdal*, 248 F.3d at 327, *with Gartenberg*, 694 F.2d at 929-30; *see* Pet. 18. But that lower-court confusion only underscores the need for this Court's review.

Respondent also observes (at 22) that *Krantz v. Prudential Investments Fund Management LLC*, 305 F.3d 140 (3d Cir. 2002), did not cite *Gartenberg*. But respondent does not contest that *Krantz* applied *Migdal*, which in turn rested on *Gartenberg*. Because the decision below focuses on whether the funds' board was "decei[ved]" (Pet. App. 9a) and does not permit an examination of "the relationship between

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[6] The article was funded in part by the mutual-fund industry and co-authored by an expert witness for investment advisers in § 36(b) cases. *See* Coates & Hubbard 151 n.aa1; *cf. Exxon Shipping Co. v. Baker*, 128 S. Ct. 2605, 2626 n.17 (2008) ("declin[ing] to rely on" research that was "funded in part by" a party to the case).

the fees charged and the services rendered by the investment adviser" (*Migdal*, 248 F.3d at 327; *Krantz*, 305 F.3d at 143 (quoting *Migdal*)), it conflicts with the Third and Fourth Circuits' standard.

II. THIS CASE IS AN IDEAL VEHICLE TO RESOLVE THIS IMPORTANT QUESTION

A. Respondent erroneously contends (at 22-25) that this case is an inappropriate vehicle because petitioners would lose under any standard. Petitioners presented ample evidence warranting a trial under a proper standard, *see* Pet. 26-29, and respondent does little to contest that proof.

Respondent claims (at 5-6, 23) that the funds performed well for a three-year period ending in 2004, but ignores that, for the three-year period ending August 31, 2006, which includes almost all of the damages period, the Oakmark Fund was one of the poorest performers in its class and earned a Morningstar Rating of only one star. *See* C.A. App. A127. Regardless, § 36(b) imposes a fiduciary duty with respect to "compensation," not performance. Focusing on the latter would turn § 36(b) into Rule 10b-5, so that poorly performing funds would then be correspondingly vulnerable to suit – a result benefiting neither investment advisers nor investors.

Respondent also asserts (at 21 n.7, 22-24) that the district court denied petitioners' claims under the *Gartenberg* standard. But, while purporting to apply *Gartenberg*, the district court in fact articulated a standard quite similar to the panel's erroneous decision below. Ignoring Congress's finding that "the forces of arm's-length bargaining do not work in the mutual fund industry," S. Rep. No. 91-184, at 5 (1969), the district court granted summary judgment based on its belief that the evidence "indicate[d] that the board as a whole was operating without any conflict that would [have] prevent[ed] it from engaging in arm's-length negotiations" and because Harris's fees were comparable to those paid by other mutual funds. Pet. App. 30a-32a.

In rejecting the relevance of the lower rates charged to independent clients for comparable services, the district court posited "a range of prices that investors were willing to pay" that "extended from a low-end figure below what the institutional clients were paying and a high-end figure beyond the fees that other mutual fund clients paid." *Id.* at 30a. That incorrect analysis would render the independent-client comparison irrelevant in *every* case: if the range of acceptable prices extends beyond what other mutual funds pay, then it does not matter whether independent clients paid lower fees for comparable services – the higher fees charged to the mutual funds will always be upheld. And the district court's reasoning would make excessive fees the norm – defeating § 36(b)'s purpose – because "[t]he governance structure that enables mutual fund advisers to charge exorbitant fees is industry-wide." *Id.* at 41a (Posner, J.).[7]

Respondent further claims (at 24-25) that petitioners opposed *Gartenberg* below. Petitioners asserted that a trial under a properly understood *Gartenberg* standard was appropriate, while opposing misinterpretations of *Gartenberg* positing that fund perform-

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[7] The en banc dissenters' statement that the result here "*may be* correct," Pet. App. 42a (emphasis added), does not suggest they thought it *was* correct. Those judges properly viewed the case as warranting further review and recognized the panel's reasoning to be "weak," "one-sided," and based on "airy speculation." *Id.* at 41a-43a.

ance is paramount. Regardless, in resolving the circuit conflict, the Court will not be limited to any prevailing circuit's approach but instead will articulate the rule that best comports with the statute's text, structure, and history.

B. Respondent contends (at 26-27) that the circuits' different standards do not matter in practice, citing a supposed lack of reported decisions in which plaintiffs have prevailed under § 36(b). But legal rules matter in ways not necessarily reflected in published judicial opinions.

A survey of reported cases would not reveal the extent to which a legal standard motivates defendants to settle factually unfavorable cases. *Gartenberg* has led to "notable settlements wherein defendants have agreed to a prospective reduction in the fee schedule." James D. Cox et al., *Securities Regulation* 1211 (3d ed. 2001). In *Hunt* and *Strigliabotti*, the courts denied defendants' motions to dismiss, and the parties subsequently dismissed the cases with prejudice,[8] indicating settlement. Both courts recognized that a difference between fees charged to mutual funds and fees charged to independent clients for comparable services supports a § 36(b) claim. *See Hunt*, 2006 WL 1581846, at *3; *Strigliabotti*, 2005 WL 645529, at *3-*4. The cases therefore would have come out differently under the Seventh Circuit's standard, which does not permit that comparison. *See* Pet. App. 13a.[9]

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[8] *See* Memorandum and Order, *Hunt v. Invesco Funds Group, Inc.*, No. H-04-02555 (S.D. Tex. Jan. 29, 2007); Stipulation and Order Dismissing Case, *Strigliabotti v. Franklin Res., Inc.*, No. C 04-00883 SI (N.D. Cal. Aug. 9, 2007).

[9] Respondent suggests (at 11, 26) that the question presented is not frequently litigated, but its counsel elsewhere acknowledges that at least "a dozen" cases raising issues "identical" to

Furthermore, the difference in standards implicates primary, private conduct. Respondent does not dispute that, "[f]or advisers and funds in the Seventh Circuit," the panel's "holding could influence the periodic fee-approval process between advisers and independent boards." Litigation Alert at 2; *see* Pet. 31. Whereas the *Gartenberg* standard requires advisers to furnish, and directors to review, information on a variety of factors, the decision below requires only that the adviser not "pull[] the wool over the eyes of the disinterested trustees." Pet. App. 14a.[10]

Respondent also asserts (at 27, 30) that an absence of enforcement activity by the Securities and Exchange Commission means that § 36(b) is never violated. But respondent ignores the more obvious inference that the SEC has devoted its limited resources to other priorities. SEC inaction only underscores the importance of private suits, which "provide a necessary supplement to the Commission's own enforcement authority." Brief for the SEC as Amicus Curiae in Support of Affirmance at 2, *Daily Income Fund, Inc. v. Fox*, 464 U.S. 523 (1984) (No. 82-1200).

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those involved here have been litigated in just "the past several years," with plaintiffs obtaining settlements in half the cases, Litigation Alert at 2; *see also* Pet. 30 n.12 (citing cases).

[10] The statement in *In re Mutual Funds Investment Litigation*, MDL No. 04-MD-15863, 2008 WL 5412407, at *15 (D. Md. Dec. 30, 2008), which respondent cites (at 16-17, 26), that *Gartenberg* and the decision below "lead to the same place" was limited to the unusual market-timing allegations of that case. That court recognized that the Seventh Circuit had "rejected" the *Gartenberg* standard and adopted a "different" approach. 2008 WL 5412407, at *14-*15.

III. THE COURT OF APPEALS MISINTERPRETED THE ACT

Respondent claims (at 30-31) that the decision below is grounded in § 36(b)'s text. But the panel did not base its holding on any analysis of the statutory language. *See* Pet. App. 8a-9a. On the contrary, it poured its preferred economic outcome – abdication to "market[]" forces, *id.* at 7a-8a – into the phrase "fiduciary duty" in § 36(b). And it ignored Congress's conclusion that the conflicts of interest inherent in the fund-adviser relationship require an "independent check[] on excessive fees." *Daily Income Fund, Inc. v. Fox*, 464 U.S. 523, 541 (1984).

The panel's conclusion that a fiduciary may accept whatever compensation is agreed on is palpably incorrect. "If the amount of compensation provided by the terms of the trust is or becomes unreasonably high or unreasonably low, the court may allow a smaller or larger compensation." *Restatement (Third) of Trusts* § 38 cmt. e (2001); *see* Pet. 25. Moreover, as the en banc dissenters recognized, "unreasonable compensation" – including fees twice those charged to independent clients for comparable services – "can be evidence of a breach of fiduciary duty." Pet. App. 41a-42a (Posner, J.). Although other evidence may also establish fiduciary breaches, § 36(b) requires more than that the adviser refrain from "pull[ing] the wool over" the trustees' eyes (*id.* at 14a) or charging fees more than 25 times the next-highest-paid adviser's (*id.* at 9a). Because the question presented raises a significant and recurring issue in an economic climate in which confidence in the securities industry is at a low ebb, this Court's imposition of the correct standard is urgently needed.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted,

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