No. 08-586

In the Supreme Court of the United States

JERRY N. JONES, ET AL., PETITIONERS

v.

HARRIS ASSOCIATES L.P.

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

BRIEF FOR THE UNITED STATES AS AMICUS CURIAE SUPPORTING PETITIONERS

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QUESTION PRESENTED

Whether a security holder's claim that a mutual fund's investment adviser breached its fiduciary duty by charging an excessive fee—more than twice the fee it charged to clients with which it was not affiliated—is cognizable under Section 36(b) of the Investment Company Act of 1940, 15 U.S.C. 80a-35(b), even if the security holder does not show that the adviser misled the mutual fund directors who approved the fee.

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INTEREST OF THE UNITED STATES

The United States, through the Department of Justice and the Securities and Exchange Commission (Commission or SEC), administers and enforces the federal securities laws. This case concerns Section 36(b) of the Investment Company Act of 1940, 15 U.S.C. 80a-35(b), which provides that the investment adviser to a mutual fund "shall be deemed to have a fiduciary duty with respect to the receipt of compensation for services." Because an action under Section 36(b) may be brought either by a security holder or by the Commission, see *ibid.*, the United States has a substantial interest in this Court's resolution of the question presented.

STATEMENT

1. For decades, Congress has recognized that investment companies (such as mutual funds) require special regulation, different from that applying to other corporations under federal securities laws. See H.R. Rep. No. 1382, 91st Cong., 2d Sess. 2 (1970) ("At least as early as 1935, it was recognized by Congress[] that mutual funds * * * present special features which require attention beyond simply the disclosure philosophy of the Securities Act of 1933."). "[A]n investment company is typically created and managed by a pre-existing external organization known as an investment adviser," which "generally supervises the daily operation of the fund and often selects affiliated persons to serve on the company's board of directors." *Daily Income Fund, Inc.* v. *Fox*, 464 U.S. 523, 536 (1984). As a result, "the relationship between investment advisers and mutual funds is fraught with potential conflicts of interest." *Ibid*. (internal quotation marks omitted).

Congress's concerns about "the potential for abuse inherent in the structure of investment companies" (*Burks* v. *Lasker*, 441 U.S. 471, 480 (1979)) led to the enactment of the Investment Company Act of 1940 (Act or ICA), ch. 686, 54 Stat. 789 (15 U.S.C. 80a-1 *et seq.*). The ICA initiated regulation of "most transactions between investment companies and their advisers," placed limits on "the number of persons affiliated with the adviser who may serve on the fund's board of directors," and required both "the directors and the shareholders of the fund" to approve the fees that the adviser receives "for investment advice and other services." *Daily Income Fund*, 464 U.S. at 536-537 (citing 15 U.S.C. 80a-17, 80a-10, and 80a-15). Section 36 of the ICA authorized the Commission to bring an action for injunctive relief

against any officer, director, board member, or adviser who committed an act of "gross misconduct or gross abuse of trust." 54 Stat. 841.

This Court has previously recounted the years of study and effort—by academics, the SEC, the mutual-fund industry, and congressional committees—that culminated in the Investment Company Amendments Act of 1970, Pub. L. No. 91-547, 84 Stat. 1413. See *Daily Income Fund*, 464 U.S. at 537-541. In brief, the enormous growth of mutual funds in the 1950s and 1960s prompted concerns that the ICA was not sufficiently protecting investors in mutual funds. A 1962 report commissioned by the SEC found that investment advisers tended to charge mutual funds "substantially higher" rates than they charged other clients and that mutual funds lacked effective bargaining power in the establishment of advisers' fees. *A Study of Mutual Funds Prepared for the Securities and Exchange Commission by the Wharton School of Finance and Commerce*, H.R. Rep. No. 2274, 87th Cong., 2d Sess. 29, 30, 34, 66-67 (1962) (*Wharton Report*). In 1966, the Commission issued its own study, which concluded that lawsuits challenging excessive advisory fees had been largely ineffective because courts had applied an unduly permissive standard (relying on ratification by the board and shareholders and asking only whether a waste of corporate assets had occurred). *Report of the Securities and Exchange Commission on the Public Policy Implications of Investment Company Growth*, H.R. Rep. No. 2337, 89th Cong., 2d Sess. 134-138, 141 (1966) (*1966 SEC Report*). The SEC concluded that board and shareholder approval could not protect shareholder interests with respect to advisory compensation because mutual funds

could not, as a practical matter, terminate their relationships with their advisers. *Id.* at 148.

Between 1967 and 1970, Congress considered legislation to address those concerns. See *Daily Income Fund*, 464 U.S. at 538-539. The resulting amendments to the ICA attempted to make mutual-fund boards "more independent of the adviser" and encouraged the boards to exercise "greater scrutiny of adviser contracts." *Id.* at 538 (citing 15 U.S.C. 80a-10(a), 80a-15(c)). But Congress also concluded "that the shareholders should not have to rely solely on the fund's directors to assure reasonable adviser fees, notwithstanding the increased disinterestedness of the board." *Kamen* v. *Kemper Fin. Servs., Inc.*, 500 U.S. 90, 108 (1991) (internal quotation marks omitted). Accordingly, in amending the ICA in 1970, Congress added Section 36(b), 15 U.S.C. 80a-35(b), which created a "new" and "unique right" by giving security holders and the SEC an "independent check[] on excessive fees." *Daily Income Fund*, 464 U.S. at 535, 536, 541.

2. Section 36(b) provides in pertinent part as follows:

> For the purposes of this subsection, the investment adviser of a registered investment company shall be deemed to have a fiduciary duty with respect to the receipt of compensation for services * * * paid by such registered investment company or by the security holders thereof, to such investment adviser or any affiliated person of such investment adviser. An action may be brought under this subsection by the Commission, or by a security holder of such registered investment company * * * for

> breach of fiduciary duty in respect of such compensation[.]

15 U.S.C. 80a-35(b). In an action under Section 36(b), the "approval" of "compensation" by the investment company's board or shareholders "shall be given such consideration by the court as is deemed appropriate under all the circumstances." 15 U.S.C. 80a-35(b)(2). The statute authorizes an award of "actual damages resulting from the breach of fiduciary duty," while providing that damages are not "recoverable for any period prior to one year before the action was instituted" and may not "exceed the amount of compensation or payment received" by the defendant from the investment company. 15 U.S.C. 80a-35(b)(3).

3. a. Petitioners are shareholders of three funds in the Oakmark complex of mutual funds. Pet. App. 16a; J.A. 562-563. Each of those funds is a part of a Massachusetts business trust registered with the SEC under the ICA as an open-end management investment company.[1] J.A. 563. Respondent serves as the investment adviser to the funds in the Oakmark complex pursuant to separate advisory agreements with each fund, which are negotiated with, and approved annually by, a single board of trustees representing the shareholders of the funds. JA. 563-564. Under the fee schedules accompanying the agreements, respondent receives an advisory fee that is calculated as a percentage of each fund's net assets at the end of the preceding month. *Ibid.*

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[1] An "open end" company is required "to redeem its securities on demand at a price approximating their proportionate share of the fund's net asset value at the time of redemption." *United States* v. *National Ass'n of Secs. Dealers, Inc.*, 422 U.S. 694, 698 (1975).

b. In August 2004, petitioners initiated this suit, alleging that respondent had breached its fiduciary duty under Section 36(b) by receiving advisory fees that were disproportionate to the services provided, and by impermissibly retaining savings it realized from economies of scale as the funds grew. J.A. 1, 52-53. Respondent moved for summary judgment, arguing that its advisory fees fell within the "range" of reasonable fees that could result from arm's-length bargaining, pursuant to the standard set out in *Gartenberg* v. *Merrill Lynch Asset Management, Inc.*, 694 F.2d 923 (2d Cir. 1982), cert. denied, 461 U.S. 906 (1983). See Pet. App. 27a, 29a-30a. In opposing that motion, petitioners contended, *inter alia*, that the fees at issue were excessive because they were approximately twice as large as the fees that respondent charged its unaffiliated institutional clients for comparable services. *Id.* at 6a-7a, 30a, 39a.[2]

c. The district court granted respondent's motion for summary judgment. Pet. App. 15a. Invoking *Gartenberg*, the court found that petitioners had failed to raise a triable issue of fact as to "whether the fees charged to the [Oakmark] Funds were so disproportionately large that they could not have been the result of arm's-length bargaining between [respondent] and the board." *Id.* at 29a. The court "assum[ed] for the mere sake of comparison that the services [respondent's unaffiliated] institutional clients received were indistinguishable from those the [Oakmark] Funds received." *Id.* at

[2] Petitioners also filed a cross-motion for summary judgment. The district court denied that motion (Pet. App. 22a-26a), and the court of appeals affirmed in relevant part (*id.* at 2a-4a). In this Court, petitioners do not request a ruling that summary judgment should be entered in their favor. Rather, they argue (Pet. Br. 19) that their "evidence warrants a trial on the merits."

30a. The court found more relevant, however, that "the amounts paid by different parties establish a range of prices that investors were willing to pay" for investment advice. *Ibid.* That broad range extended from "a low-end figure below what the institutional clients were paying" all the way to "a high-end figure beyond the fees that other mutual fund clients paid" their advisers. *Ibid.* Because respondent's fees fell within this spectrum of fees paid by both mutual funds and unaffiliated institutional clients, the court concluded they were not excessive. *Ibid.*

4. The court of appeals affirmed, concluding that respondent had not breached the fiduciary duty imposed by Section 36(b). Pet. App. 1a-14a.

The court of appeals expressly "disapprove[d] the *Gartenberg* approach," based on its view that "[a] fiduciary duty differs from rate regulation." Pet. App. 8a. The court explained that Congress's use of the term "fiduciary duty" in Section 36(b) "summon[s] up the law of trusts." *Ibid.* The court found that "the rule in trust law is straightforward: A trustee owes an obligation of candor in negotiation, and honesty in performance, but may negotiate in his own interest and accept what the settlor or governance institution agrees to pay." *Ibid.*; see *ibid.* ("A fiduciary must make full disclosure and play no tricks but is not subject to a cap on compensation."). The court stated that "when the settlor or the persons charged with the trust's administration make a decision, it is conclusive." *Id.* at 9a. It stated as well that "[f]ederal securities laws * * * work largely by requiring disclosure and then allowing price to be set by competition in which investors make their own choice." *Id.* at 13a. The court of appeals concluded that respondent had satisfied its fiduciary obligations because it had

not "pulled the wool over the eyes of the disinterested trustees or otherwise hindered their ability to negotiate a favorable price for advisory services." *Id.* at 14a.

While generally eschewing substantive reasonableness review of the fees charged by investment advisers, the court of appeals found it "possible to imagine compensation so unusual that a court will infer that deceit must have occurred, or that the persons responsible for decision have abdicated." Pet. App. 9a. The court concluded, however, that no such deviation from the norm could be established in this case because the fees that respondents charge the Oakmark funds "are roughly the same * * * as those that other funds of similar size and investment goals pay their advisers." *Id.* at 6a. Petitioners contended that, because "investment advisers create mutual funds" and "[f]ew mutual funds ever change advisers," the fees paid by other mutual funds typically are not the product of arm's-length bargaining and therefore do not provide a suitable benchmark for determining whether the fees respondent received from the Oakmark funds were excessive. See *ibid*. The court of appeals rejected that contention, stating that mutual funds have a strong incentive to keep fees low in order to attract investors. See *id.* at 7a. The court acknowledged that "beliefs about the structure of the mutual-fund market" were different when Section 36(b) was enacted in 1970. *Id.* at 11a. It concluded, however, that "[a] lot has happened in the last 38 years" and that the mutual fund market is now a competitive one where investors "can and do 'fire' advisers cheaply and easily by moving their money elsewhere." *Id.* at 11a-12a.

The court of appeals rejected petitioners' contention (see Pet. App. 6a, 13a) that the fees respondent charged the Oakmark funds were excessive because they were

substantially greater than the fees it charged unaffiliated institutional clients. The court stated that "[d]ifferent clients call for different commitments of time. Pension funds have low (and predictable) turnover of assets. Mutual funds may grow or shrink quickly and must hold some assets in high-liquidity instruments to facilitate redemptions." *Id.* at 13a. The court did not identify any record evidence in this case bearing on the comparability of the services that respondent provides to its affiliated and unaffiliated clients.

5. The court of appeals denied rehearing en banc, with five judges dissenting. Pet. App. 34a-35a. Judge Posner's opinion for the dissenters (*id.* at 34a-43a) concluded that the panel had erred in rejecting the *Gartenberg* standard based "mainly on an economic analysis that is ripe for reexamination." *Id.* at 37a. The dissenters identified as a "particular concern" that respondent "charg[es] its captive funds more than twice what it charges independent funds." *Id.* at 39a. They noted as well that, while the panel had suggested possible justifications for that disparity, those "suggestions are offered purely as speculation, rather than anything having an evidentiary or empirical basis." *Ibid.*

In the dissenters' view, the disparity between the fees that respondent charged its mutual-fund and unaffiliated clients called into question the panel's conclusion that competition among mutual funds for investors acts as a sufficient check on the compensation their advisers can charge. Pet. App. 40a-41a. For similar reasons, the dissenters disagreed with the panel's view that any excessiveness inquiry must be conducted "solely by comparing the adviser's fee with the fees charged by other mutual fund advisers." *Id.* at 41a. The dissenters explained that "[t]he governance structure that enables

mutual fund advisers to charge exorbitant fees is industry-wide, so the panel's comparability approach would if widely followed allow those fees to become the industry's floor." *Ibid.* The dissenters instead endorsed "the *Gartenberg* approach," under which courts considering the possible excessiveness of fees may consider a broader range of evidence, including petitioners' proposed "alternative comparison" to the fees respondent charges its independent clients. *Ibid.*

SUMMARY OF ARGUMENT

The special "fiduciary duty" in Section 36(b) of the ICA, 15 U.S.C. 80a-35(b), was enacted out of concern that the non-arm's-length relationship between investment advisers and their affiliated investment companies could cause mutual funds to agree to excessive compensation. See *Daily Income Fund, Inc.* v. *Fox*, 464 U.S. 523, 540-541 (1984). Although Congress did not choose to impose rate regulation on advisers, it did intend to create a check on compensation that is "independent" of the requirement that adviser contracts be approved by the funds' directors. *Id.* at 541. The court of appeals' construction of Section 36(b) defeats that purpose and departs from the statute's text.

A. The court of appeals' focus on whether an adviser has "ma[d]e full disclosure and play[ed] no tricks" on the investment company's board (Pet. App. 8a) is inconsistent with the plain text of Section 36(b), the structure of the ICA, the trust-law meaning of the term "fiduciary duty," and the purposes and legislative history of the statute. The statute specifies that the board's approval of compensation "shall be given such consideration by the court as is deemed appropriate under all the circumstances," 15 U.S.C. 80a-35(b)(2), which demonstrates

that a court should engage in a more encompassing inquiry than the court of appeals conducted. By creating a "fiduciary duty," Congress incorporated the established meaning of that term; and under trust law, an agreement about a trustee's compensation is not binding "if the agreement is unfair to the beneficiary." Restatement (Second) of Trusts § 242 cmt. i (1957) (Second Restatement). A disclosure-only test would effectively prevent Section 36(b) from providing the "independent check[]" on compensation that is needed to vindicate the essential purposes of the statute. *Daily Income Fund*, 464 U.S. at 541. That test is also inconsistent with contemporaneous evidence that the 1970 Congress expected Section 36(b) to prevent an adviser from overreaching in the amount of its fee even when a fully informed board consented to it.

B. In a Section 36(b) case, the court should not decide for itself (in the manner of a rate-setting agency) what compensation the adviser should receive, but should determine whether the adviser's fee is within the range of fees that arm's-length bargaining might have produced. That standard for determining the appropriateness of a fee, articulated by the Second Circuit in *Gartenberg* v. *Merrill Lynch Asset Mgmt., Inc.*, 694 F.2d 923, 928 (1982), cert. denied, 461 U.S. 906 (1983), is consistent with the purposes of the statute, the legislative history, and this Court's articulation of the test for a fiduciary breach. See *Pepper* v. *Litton*, 308 U.S. 295, 306-307 (1939). In practice, *Gartenberg* has provided useful guidance for fund boards and has been incorporated into SEC regulations. The *Gartenberg* court's inquiry—an analysis of "all pertinent facts," potentially including the fees charged by the adviser for comparable

services rendered to unaffiliated clients—provides the appropriate way to resolve Section 36(b) cases.

The court of appeals relied too extensively on a comparison between the fees at issue here and those paid by other mutual funds. In light of the structural impediments to arm's-length bargaining between mutual funds and their investment advisers, an adviser's fee cannot automatically be declared lawful simply because it is comparable to fees paid by similar mutual funds. Although the court of appeals cited one study finding that advisory fees are constrained by competition among mutual funds for investors, that conclusion is a matter of ongoing debate. The weight to be given to a comparison with the fees paid by other mutual funds should depend on the evidence introduced in, and surrounding circumstances of, any particular case.

The court of appeals also erred by giving no effect to petitioners' allegations that respondent charges unaffiliated institutional clients half of what it charges mutual-fund clients for comparable services. An evaluation under Section 36(b) of "all the circumstances" should include consideration of any fees the adviser receives for providing comparable services to unaffiliated clients, such as pension funds and other institutional investors. Boards are encouraged to consider such information by industry best practices and SEC regulations, and courts appropriately may consider the same information. In this case, the parties appear to dispute whether the services respondent provides to its unaffiliated clients are comparable to those it provides to its affiliated mutual funds. On remand, the lower courts should determine whether petitioners have presented sufficient evidence to create a genuine issue of material fact and so to survive respondent's motion for summary judgment.

ARGUMENT

TO DETERMINE WHETHER AN INVESTMENT ADVISER HAS BREACHED ITS FIDUCIARY DUTY UNDER SECTION 36(b), A COURT MUST CONSIDER "ALL THE CIRCUMSTANCES," INCLUDING FEES RECEIVED FOR PROVIDING COMPARABLE SERVICES TO UNAFFILIATED CLIENTS

The court of appeals committed two fundamental errors in applying Section 36(b) of the ICA to the record in this case. First, the court viewed the investment adviser's "fiduciary duty" under the statute as limited to the provision of full and accurate information to the mutual fund's board. Second, the court indicated that, assuming Section 36(b) contemplates an inquiry into the substantive reasonableness of an adviser's fee in extreme cases, the fees paid by comparable mutual funds provide the only suitable benchmark for evaluating the fee. Because both of those propositions are wrong, the judgment of the court of appeals should be vacated, and the case should be remanded for further proceedings under the appropriate legal standards.

A. A Mutual Fund's Investment Adviser Violates Its "Fiduciary Duty With Respect To The Receipt Of Compensation" If It Negotiates And Receives An Excessive Fee, Even If It Has Fully Disclosed The Relevant Facts To The Fund's Board

The court of appeals held that an investment adviser's fiduciary duty to a mutual fund is satisfied whenever the adviser has made "full disclosure and play[ed] no tricks" on the board. Pet. App. 8a. The court indicated that, so long as such disclosure occurs, the board's approval is "conclusive" and Section 36(b) imposes no "cap" on the amount of compensation that the adviser may receive. *Id.* at 8a, 9a. The court of appeals' dis-

closure-only approach reflects an unduly limited view of the fiduciary duty created by Section 36(b). The text of Section 36(b) and complementary statutory provisions strongly indicates that a fully informed board's approval of compensation does not guarantee against a fiduciary breach. The statute's trust-law background, purposes, and legislative history reinforce that conclusion.

1. Section 36(b) of the ICA imposes on an investment adviser "a fiduciary duty with respect to the receipt of compensation for services." 15 U.S.C. 80a-35(b). For purposes of any suit to enforce that duty, Section 36(b)(2) specifies that "approval by the [mutual fund's] board of directors * * * of such compensation or payments * * * shall be given such consideration by the court as is deemed appropriate under all the circumstances." 15 U.S.C. 80a-35(b)(2). Thus, when an investment adviser is alleged to have breached his fiduciary duty to the mutual fund by negotiating and receiving a particular fee, the court should consider "all the circumstances" in determining whether a fiduciary breach has occurred. The court of appeals' approach contradicts the statute by making "conclusive" (Pet. App. 9a) the presence of a single "circumstance"—*i.e.*, that the board was apprised of all relevant information before it approved the adviser's fee. The text of Section 36(b) makes clear that Congress intended courts to engage in a fuller inquiry.

Moreover, other provisions of the Act and its companion statute oblige investment advisers to make disclosures and prohibit them from engaging in fraud. See 15 U.S.C. 80a-15(c), 80b-6. Under the court of appeals' disclosure-only approach, Section 36(b) requires no more of the investment adviser than compliance with those other provisions. To be sure, Section 36(b) estab-

lished new enforcement mechanisms, and so would not be wholly superfluous if the fiduciary duty it established merely tracked other statutory requirements. But if Congress had intended only to provide a new cause of action and additional remedies to enforce obligations established by other parts of the statutory scheme, it could have accomplished that purpose much more clearly and directly by authorizing damages suits for violations of the disclosure and anti-fraud provisions.

The language that Congress instead employed—which imposes on an investment adviser "a fiduciary duty with respect to the receipt of compensation for services" provided to a mutual fund, and instructs a court to consider "all the circumstances" in determining whether a breach has occurred—strongly indicates that Section 36(b) expands the substantive obligations imposed on investment advisers. That inference is buttressed by Section 36(b)(1), which states that, in a suit alleging that an investment adviser has breached its fiduciary duty, "[i]t shall not be necessary to allege or prove that any defendant engaged in personal misconduct." 15 U.S.C. 80a-35(b)(1). Failure to disclose all relevant facts to the board could reasonably be regarded as "personal misconduct," particularly when other parts of the statutory scheme require investment advisers to make such disclosures. Section 36(b)(1) thus also suggests that the adviser's fiduciary duty extends further than disclosure.

2. The court of appeals observed that the statute's use of the word "fiduciary" invokes the "law of trusts." Pet. App. 8a. The court of appeals understood general trust-law principles to provide that "[a] trustee owes an obligation of candor in negotiation, and honesty in performance, but may negotiate in his own interest and accept what [compensation] the settlor * * * agrees to

pay." Pet. App. 8a (citing Second Restatement § 242 & cmt. f (1957)). The court was correct that Section 36(b) should be construed to incorporate generally applicable trust-law principles. See, *e.g.*, *Varity Corp.* v. *Howe*, 516 U.S. 489, 502 (1996) (looking to "the common law, which, over the years, has given to terms such as 'fiduciary' * * * a legal meaning to which, we normally presume, Congress meant to refer"); *NLRB* v. *Amax Coal Co.*, 453 U.S. 322, 329 (1981) (explaining that the presumption that Congress intends "to incorporate the established meaning" of terms of art applies to "terms that have accumulated settled meaning under either equity or the common law"). The court, however, misunderstood the trust-law rules that apply to a fiduciary's periodic negotiation of his own compensation.

The annual fee negotiation between a mutual fund and its investment adviser is properly analogized not to the arm's-length negotiation between the settlor and a potential fiduciary at the outset of the relationship, but rather to agreements that the trustee reaches with the trust's beneficiaries after the trust has been established. In that context, a trustee's compensation may "be enlarged or diminished by an agreement between the trustee and the beneficiary," but the agreement will not be binding "if the trustee failed to make a full disclosure of all circumstances affecting the agreement which he knew or should have known *or if the agreement is unfair to the beneficiary*." Second Restatement § 242 cmt. i (emphasis added); see also *id.* § 216(3) & cmt. n. As one prominent commentator explained the underlying principle, the beneficiary's consent does not guarantee the validity of a transaction in which the trustee deals with trust property on his own behalf, because "the transaction is not like one between persons dealing with each

other at arm's length." 2 Austin Wakeman Scott, *The Law of Trusts* § 170, at 1298 (3d ed. 1967). As a result, such a transaction is "voidable if, but only if, the trustee failed to disclose to the beneficiaries the material facts which he knew or should have known, or if he used the influence of his position to induce the consent, or if the transaction was not *in all respects fair and reasonable*." *Ibid*. (emphasis added). In other words, proof of full disclosure will not prevent a court from making a further inquiry into the substantive terms of the transaction.

Although the Second Restatement reflects the state of trust law at the time Congress enacted Section 36(b), the same principle obtains today. "An agreement enlarging the trustee's compensation" will not "bind a consenting beneficiary if the trustee failed to disclose all the relevant circumstances that the trustee knew or should have known, or if the agreement is unfair to the beneficiary." Restatement (Third) of Trusts § 38 cmt. f (2003). Indeed, the current rule is that even when the amount of compensation is established by the terms of a trust—the example invoked by the court of appeals—a court can alter that amount upon finding it to be unreasonably high or low. See *id*. § 38 cmt. e ("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[.]"); *id*. § 38 cmt. e illus. 2 ("The court's authority to modify or disregard a compensation provision is not limited to situations involving unanticipated developments[.]"); National Conference of Commissioners, *Uniform Trust Code* § 708(b)(2) (2005) (providing that a trustee is entitled to be compensated as specified by the terms of the

trust unless "the compensation specified by the terms of the trust would be unreasonably low or high").

In certain respects, Congress departed from generally applicable trust-law principles in crafting the new cause of action established by Section 36(b). Although a trustee normally bears the burden of establishing the fairness of a transaction that is alleged to violate the duty of loyalty,[3] Section 36(b)(1) provides that "the plaintiff shall have the burden of proving a breach of fiduciary duty." 15 U.S.C. 80a-35(b)(1). Congress also imposed limits on recovery, capping "actual damages" at the amount of compensation the investment adviser received, and providing that "[n]o award of damages shall be recoverable for any period prior to one year before the action was instituted." 15 U.S.C. 80a-35(b)(3).[4] Section 36(b) does not, however, contain any language that would preclude the usual inquiry into whether a trustee's compensation agreement is "unfair to the beneficiary." Second Restatement § 242 cmt. i. Thus, contrary to the court of appeals' conclusion (Pet. App. 8a-9a), the law of trusts strongly supports the proposition that courts may consider whether an investment adviser's annual fee is excessive, above and beyond determining that the adviser made full disclosure to the board.

3. The court of appeals' disclosure-only approach is also inconsistent with the purposes and legislative history of Section 36(b). As this Court has previously ex-

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[3] See *Pepper* v. *Litton*, 308 U.S. 295, 306 (1939) (noting the burden on a fiduciary to "show [a challenged transaction's] inherent fairness from the viewpoint of the [beneficiary]"); 2 Scott § 170.1, at 1304 ("[T]he burden of proof is upon the trustee to show that he did not take advantage of his position[.]").

[4] Cf. Second Restatement §§ 205 and 206 (containing no such limits).

plained, Congress intended the new fiduciary duty imposed by Section 36(b) to be a "check[] on excessive fees" that was "independent" of "directorial approval of adviser contracts." *Daily Income Fund*, 464 U.S. at 541. That new, independent check would have added very little if it required only "full disclosure" and the absence of "tricks" on the board (Pet. App. 8a), since other provisions of the ICA and its companion statute require disclosure and prohibit investment advisers from engaging in fraudulent conduct. See pp. 14-15, *supra*.

The legislative history also reveals a contemporaneous understanding—shared by the SEC and the entity representing investment companies and their advisers—that the fiduciary duty imposed by Section 36(b) would extend beyond an obligation to provide full and accurate information to the board. During the House Committee hearings about the bill that became the 1970 ICA amendments, Subcommittee Chairman Moss requested that both the SEC and the private-sector Investment Company Institute (ICI) (whose members held approximately 97.8% of the assets held by all open-end investment companies) provide written submissions about the "legal meaning" of the relevant statutory language. See *Mutual Fund Amendments: Hearings on H.R. 11995, S. 2224, H.R. 13754, and H.R. 14737 Before the Subcomm. on Commerce and Fin. of the House Comm. on Interstate and Foreign Commerce*, 91st Cong., 1st Sess., Pt. 1, at 186, 187, 440 (1969). The memorandum submitted by the SEC concluded that a breach of Section 36(b)'s fiduciary duty "would occur when compensation to the adviser for his services is excessive in view of the services rendered—where the fund pays what is an unfair fee under the circumstances." *Id.* at 190. The memorandum submitted by Robert L. Augen-

blick, the President and General Counsel of the ICI, was to the same effect:

> Many words have been used in attempting to describe how far a fiduciary may go in negotiating his fee without violating his fiduciary relationship. A good way to put it is that he may not overreach in the amount of his fee even though the other party to the transaction, *in full possession of all the facts*, does not believe the fee is excessive.

Id. at 441 (emphasis added). That contemporaneous understanding, held by both the regulator and the regulatees, is directly contrary to the court of appeals' view (Pet. App. 8a-9a) that the board's approval of an adviser's fee is "conclusive" so long as "full disclosure" has occurred.

B. An Investment Adviser's Compensation Should Be Within The Range Of Fees That Might Have Been Negotiated Through Arm's-Length Bargaining, And A Comparison With The Fees The Adviser Charges Unaffiliated Clients For Comparable Services Is Relevant To The Section 36(b) Inquiry

For the foregoing reasons, an investment adviser's fiduciary duty under Section 36(b) extends beyond the obligation to disclose all relevant facts to the board, and includes the duty to refrain from charging an excessive fee. Although the court in a Section 36(b) case is not authorized to decide for itself (in the manner of a rate-setting administrative agency) what the appropriate fee should be, the court should determine whether the compensation received by the adviser is within the range of fees that arm's-length bargaining might have produced. In conducting that inquiry, the court should consider not only fees paid by other mutual funds, but also fees that

the adviser charges unaffiliated clients, so long as the services provided to the adviser's unaffiliated clients and its mutual-fund clients are shown to be comparable.

1. Section 36(b) prohibits an investment adviser from charging fees so disproportionately large that they could not have been negotiated through arm's-length bargaining

a. Before the court of appeals' decision in this case, the seminal case interpreting Section 36(b) was the Second Circuit's decision in *Gartenberg*, *supra*. The court in *Gartenberg* held that, "[t]o be guilty of a violation of [Section] 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." 694 F.2d at 928; see *ibid*. ("[T]he test is essentially whether the fee schedule represents a charge within the range of what would have been negotiated at arm's-length in the light of all the surrounding circumstances."). Consistent with the statute's reference to "all the circumstances" and with the statute's legislative history, the court in *Gartenberg* stressed that "all pertinent facts must be weighed" in making that determination.[5] *Id*. at 929; see S. Rep. No. 184, 91st

[5] The *Gartenberg* court itself considered the following non-exclusive series of factors: (1) the nature and quality of services provided to the fund and shareholders; (2) the profitability of the fund to the adviser; (3) fall-out benefits (including collateral benefits other than advisory fees that accrue to the adviser by virtue of its business with the fund and its shareholders); (4) economies of scale (including whether the adviser fairly shares with the fund and its shareholders any decreases in marginal operating costs owing to increased size); (5) comparative fee structure (meaning a comparison of the fees with those paid by similar

Cong., 1st Sess. 15 (1969) (*Senate Report*) ("[I]t is intended that the court look at all the facts in connection with the determination and receipt of such compensation * * * in order to reach a decision as to whether the adviser has properly acted as a fiduciary in relation to such compensation."); H.R. Rep. No. 1382, 91st Cong., 2d Sess. 37 (1970) (*House Report*) (same).

The core of *Gartenberg*'s standard can be traced directly back to *Pepper*, *supra*, in which this Court observed that "[t]he essence of the test [for a fiduciary breach] is whether or not under all the circumstances the transaction carries the earmarks of an arm's length bargain." 308 U.S. at 306-307; see *id.* at 306 (noting that the transaction is to be examined for its "inherent fairness"). Indeed, that line from *Pepper* was quoted in the district court opinion that the Second Circuit affirmed in *Gartenberg*. See *Gartenberg* v. *Merrill Lynch Asset Mgmt., Inc.*, 528 F. Supp. 1038, 1047 (S.D.N.Y. 1981), aff'd, 694 F.2d 923 (2d Cir. 1982), cert. denied, 461 U.S. 906 (1983). And the Court in *Pepper* drew that standard from "certain cardinal principles of equity jurisprudence." 308 U.S. at 306. It is accordingly part of the "accumulated settled meaning under * * * equity" that Congress "incorporate[d]" into Section 36(b) by using the term *fiduciary*. *Amax Coal Co.*, 453 U.S. at 329.

The *Gartenberg* standard also furthers Congress's core purpose in enacting Section 36(b). Congress recognized that, because of the inherently close relationships between mutual funds and their investment advisers, "the forces of arm's-length bargaining do not work in the mutual fund industry in the same manner as they do

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funds); and (6) the independence, expertise, care, and conscientiousness of the board in evaluating the contract. See 694 F.2d at 930-931.

in other sectors of the American economy." *Senate Report* 5; *House Report* 7 (same); see *Gartenberg*, 694 F.2d at 928 (quoting *Senate Report*). By requiring that the adviser's fee fall within the range that arm's-length bargaining might have produced, the *Gartenberg* standard advances Congress's objective of reducing the potential harm to investors of these non-competitive conditions.[6] Moreover, some of the specific factors that the *Gartenberg* court identified as relevant (see note 5, *supra*) were mentioned, along with other possible considerations, in the congressional committee reports or the SEC's 1966 report. See *Senate Report* 15; *House Report* 37; *1966 SEC Report* 144-145.

b. The SEC's regulations have recognized, and formalized, *Gartenberg*-like factors. In a 2004 rulemaking, the Commission amended several forms to require a specific discussion in proxy statements and shareholder reports of certain factors relevant to the board's approval of advisory fees and other amounts payable to an investment adviser. See *Disclosure Regarding Approval of Investment Advisory Contracts by Directors of Investment Companies*, 69 Fed. Reg. 39,807-39,809 (2004) (amending Schedule 14A and Forms N-1A, N-2, and N-3).[7] In listing the factors to be discussed, the re-

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[6] This is not to say that Congress intended for the SEC to engage in "rate regulation" or for courts to engage in "[j]udicial price-setting." Pet. App. 8a, 10a. Indeed, the legislative history disclaims such a purpose. See *Senate Report* 6. Determining what outcomes fall outside the range that could result from an arm's-length negotiation is not the same as independently setting rates or prescribing a particular standard to produce prices, like a cost-plus model.

[7] A board is permitted to omit any particular factor it concludes is irrelevant to its evaluation of the investment advisory contract, as long as it explains why. 69 Fed. Reg. at 39,801 & n.32.

lease accompanying the amendments cited *Gartenberg* and noted that "[c]ourts have used similar factors in determining whether investment advisers have met their fiduciary obligations under section 36(b)." *Id.* at 39,801 n.31. The SEC's regulations require, *inter alia*, a discussion of any "comparison[] of the services to be rendered and the amounts to be paid under the contract with those under other investment advisory contracts, such as contracts of the same and other investment advisers with other registered investment companies or other types of clients (*e.g.*, pension funds and other institutional investors)." 17 C.F.R. 240.14a-101, Sched. 14A, Item 22, para. (c)(11)(i); 69 Fed. Reg. at 39,807-39,809.

The *Gartenberg* standard—along with its non-exclusive list of potentially relevant factors—has provided useful guidance to fund boards fulfilling their obligation under Section 15(c) of the ICA of evaluating advisers' compensation. See, *e.g.*, Federal Regulation of Securities Committee, ABA, *Fund Director's Guidebook* 31-35 (3d ed. 2006); Mutual Fund Directors Forum, *Best Practices and Practical Guidance for Mutual Fund Directors* 44-47 (July 2004) (*Best Practices*) <http://www.mfdf.com/site/documents/best_pra.pdf>. It also provides guidance for advisers in proposing fees. Moreover, the extent to which the adviser and the board exchange and reflect upon information of this kind helps a court to evaluate how much "consideration" to give a board's approval of an adviser's fee proposal. 15 U.S.C. 80a-35(b)(2). Although a board's approval is not "controlling" (*Senate Report* 15), 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.

c. The *Gartenberg* approach provides the appropriate framework for resolving claims that an adviser has breached its fiduciary duty with respect to compensation. That approach is faithful to the statutory language and purposes, and it is consistent with the traditional trust-law standard for evaluating the conduct of fiduciaries dealing on their own account with entities to which they owe a duty.

Although this Court need not address the potential relevance of each "circumstance[]" that should be evaluated under Section 36(b)(2), two factors warrant further discussion in light of the court of appeals' rationale for rejecting petitioners' claims. As discussed below, in determining whether respondent's fees were consistent with those that could have been the product of arm's-length bargaining, the court of appeals gave too much weight to one factor (the fees paid by other mutual funds to their investment advisers) and too little to another (the fees paid to respondent by unaffiliated institutional clients for portfolio management).

2. In light of the structural impediments to arm's-length bargaining between mutual funds and their investment advisers, an adviser's fee cannot be declared lawful simply because it is comparable to fees paid by similar mutual funds

To the extent the court of appeals looked beyond the board's purportedly "conclusive" approval of respondent's fees, it treated the comparison between respondent's fees and other mutual funds' fees as effectively dispositive. Pet. App. 9a-13a. This comparison is surely relevant to the Section 36(b) analysis. Indeed, such an analysis was identified as one potential consideration (among others) in the SEC's 1966 Report. See *1966 SEC*

Report 144 (listing among "all relevant factors" the "fees paid for comparable services by other financial institutions with pools of investment capital of like size and purpose such as * * * other investment companies"). But the SEC and courts have long understood that comparisons of compensation among mutual funds should be treated with some caution. As the *Gartenberg* court explained, "the existence in most cases of an unseverable relationship between the adviser-manager and the fund it services tends to weaken the weight to be given to rates charged by advisers of other similar funds." 694 F.2d at 929 (citing *1966 SEC Report* 148). "Competition between money market funds for shareholder business does not support an inference that competition must therefore also exist between adviser-managers for fund business." *Ibid.*

The question of whether competition among mutual funds for investors keeps advisory fees in check remains the subject of lively debate. The court of appeals cited "[a] recent, careful study" to support its conclusion that investors subject advisory fees to "competitive pressure" by shopping among thousands of mutual funds. Pet. App. 12a (citing John C. Coates IV & R. Glenn Hubbard, *Competition in the Mutual Fund Industry: Evidence and Implications for Policy*, 33 J. Corp. L. 151 (2007)). Other studies, however, have reached the opposite conclusion. See *id.* at 40a-41a (Posner, J., dissenting from denial of reh'g en banc) (citing John P. Freeman & Stewart L. Brown, *Mutual Fund Advisory Fees: The Cost of Conflicts of Interest*, 26 J. Corp. L. 609 (2001)); see also, *e.g.*, John P. Freeman, Stewart L. Brown, and Steve Pomerantz, *Mutual Fund Advisory Fees: New Evidence and a Fair Fiduciary Duty Test*, 61 Okla. L. Rev. 83, 106-122 (2008) (responding to the

Coates and Hubbard study). After surveying the academic literature about mutual fund expenses, the Department of Labor recently concluded "that the available research provides an insufficient basis to confidently determine whether or to what degree [ERISA plan] participants pay inefficiently high investment prices," but still concluded that "there is a strong possibility that at least some participants, especially IRA beneficiaries, pay inefficiently high investment prices."[8] *Investment Advice—Participants and Beneficiaries*, 74 Fed. Reg. 3842 (2009); see also *id.* at 3840-3842 & nn. 24-31 (citing various articles and briefly describing their differing conclusions). Although not reaching a conclusion on the question, the SEC has similarly recognized that the level of fees charged by investment advisers to mutual-fund clients has become a subject of significant debate. 69 Fed. Reg. at 39,799.[9]

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[8] Mutual-fund advisers' fees have been the subject of litigation under the Employee Retirement Income Security Act of 1974 (ERISA), 29 U.S.C. 1001 *et seq.* Plaintiffs in such cases have alleged that plan fiduciaries breached their fiduciary duties under ERISA, see 29 U.S.C. 1104(a)(1), by allowing plans (or plan participants in individual-account plans) to pay excessive fees by purchasing certain mutual funds at retail rates. See, *e.g.*, *Young* v. *General Motors Inv. Mgmt. Corp.*, No. 08-1532-CV, 2009 WL 1230350, at *1 (2d Cir. May 6, 2009). Because Section 36(b) and ERISA have different statutory language, histories, and purposes, the resolution of this case should not establish the legal standard that should apply to excessive-fee claims against plan fiduciaries under ERISA.

[9] In its brief opposing certiorari (at 28), respondent quoted a document prepared by the SEC's staff as stating that "empirical evidence suggest[s] that there is significant competition based on costs in the fund industry." Memorandum from Paul F. Roye, Div. of Inv. Mgmt., to William H. Donaldson, Chairman 6 (June 11, 2003) <http://financial services.house.gov/media/pdf/061803kanememo.pdf>. That staff-authored paper made clear that "the views expressed in this memorandum

Given that ongoing debate, the weight to be given to a comparison with the fees paid by other mutual funds should depend on the circumstances and evidence in each individual case. One factor to consider is the nature and amount of other probative evidence in the case (such as evidence concerning the fees the investment adviser received from unaffiliated clients for comparable services, see pp. 29-32, *infra*). In addition, case-specific evidence may indicate that competition is a more effective check on excessive advisory fees for the specific fund at issue (*e.g.*, because comparable funds are available and investors face minimal barriers in shifting their assets to those funds). The probative value of evidence concerning the fees paid by other mutual funds will also depend in part on how similar those funds are to the fund at issue in the lawsuit, and whether the services provided by their investment advisers are comparable. A court focusing on the concrete circumstances of an actual case could more confidently assess the extent to which competition for investor dollars provided adequate incentives for a particular adviser to reduce his fees, and thus counteracted the structural hindrances to arm's-length bargaining between the adviser and the mutual fund.

That less sweeping approach would be more faithful to Congress's purposes in enacting and retaining Section 36(b). The court of appeals remarked that "[a] lot has happened" in the mutual-fund market since Section

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may not necessarily reflect [the] views" of the Chairman or other Commissioners. *Id.* at 1. In addition, the staff's treatment was far from conclusive, noting that "it is difficult to measure the extent to which cost-based competition exists in the mutual fund industry," *id.* at 3, and that "the degree to which investors understand mutual fund fees and expenses remains a significant source of concern," *id.* at 12.

36(b) was enacted in 1970. Pet. App. 11a. But one thing that has not happened is any change in Section 36(b)'s statement of fiduciary duty. Congress's imposition of that duty was largely predicated on the assumption that disclosure and the pressures of the marketplace were not fully adequate to protect investors from "the potential for abuse inherent in the structure of investment companies." *Daily Income Fund*, 464 U.S. at 536 (quoting *Burks* v. *Lasker*, 441 U.S. 471, 480 (1979)). If applied globally, the court of appeals' finding that mutual funds' costs are effectively constrained by competition threatens to "eviscerate [Section] 36(b)." *Gallus* v. *Ameriprise Fin., Inc.*, 561 F.3d 816, 823 (8th Cir. 2009); see Pet. App. 41a (Posner, J., dissenting from denial of reh'g) ("The governance structure that enables mutual fund advisers to charge exorbitant fees is industry-wide, so the panel's comparability approach would if widely followed allow those fees to become the industry's floor.").

3. An evaluation under Section 36(b) of "all the circumstances" should include consideration of any fees the adviser receives for providing comparable services to unaffiliated clients

Just as a comparison with the fees paid by other mutual funds may be a relevant circumstance in evaluating an adviser's compensation under Section 36(b), so too may be a comparison with the fees that an adviser receives from clients with which it is not affiliated. Because negotiations for such fees typically occur between independent parties, each of which is subject to competitive pressures, they may provide better evidence of the prices that arm's-length bargaining would produce for the relevant services. For these reasons, such compari-

sons have played a major role in the debate about whether mutual fund fees are excessive. See *Daily Income Fund*, 464 U.S. at 537 (describing the *Wharton Report*'s finding "that investment advisers often charged mutual funds higher fees than those charged the advisers' other clients"). The 1966 SEC report—which initiated the legislative proposals that culminated in the enactment of Section 36(b)—expressly contemplated that the benchmarks for evaluating the reasonableness of investment advisers' fees could include "the costs of investment management services provided to pension and profit-sharing plans and other large nonfund clients." *1966 SEC Report* 145.

Current industry practice itself recognizes the potential relevance of this factor. The Mutual Fund Directors Forum recommended in 2004 that fund directors request and evaluate "meaningful information on the adviser's fee structures for any other comparable investment vehicles, both public and private, and an explanation of any differences from fees charged to the fund." *Best Practices* 45. And for the last several years, the SEC's regulations and forms have required boards to disclose in proxy statements and periodic reports to shareholders the consideration they give to the fees that their advisers charge to other clients. See 69 Fed. Reg. at 39,807-39,809. It would make little sense to preclude courts from considering for purposes of Section 36(b) the same kind of data that boards often consider for purposes of Section 15(c).

Of course, the fees an investment adviser charges unaffiliated clients will be relevant to the Section 36(b) analysis only to the extent that the adviser performs sufficiently comparable services in the two contexts. Here, petitioners claim to have presented evidence that

respondent charged its unaffiliated institutional clients approximately half of what it charged the Oakmark funds for comparable advisory services. Pet. Br. 9-10, 48-49; Pet. App. 6a-7a, 30a, 39a. The district court assumed *arguendo* that the services were in fact comparable, but discounted this evidence, treating as dispositive the similarity between respondents' fees from Oakmark and advisory fees paid by other mutual funds. See *id.* at 30a.[10] The court of appeals similarly slighted the comparison to unaffiliated clients, stating that "[d]ifferent clients call for different commitments of time," and suggesting that the provision of advisory services to mutual funds may be more difficult or time-consuming than the rendering of advice to unaffiliated clients. *Id.* at 13a. But that analysis is flawed on two different levels. First, the court offered no "evidentiary or empirical basis," *id.* at 39a (Posner, J., dissenting from denial of rehearing en banc), even for the generalization that advisory services to mutual funds are more difficult or costly to perform than advisory services to unaffiliated clients. Second, the appropriateness of the benchmark that petitioners advocate does not depend on whether investment advisers *typically* provide comparable services to their

[10] Both the comparison to the fees that respondent charged its unaffiliated institutional clients and the comparison to fees paid by other mutual funds reflect attempts to identify the range of compensation that could have resulted from an arm's-length negotiation. Those competing benchmarks are potentially subject to different infirmities. Compensation paid by other mutual funds provides an imperfect measure of what arm's-length bargaining would have produced because other mutual funds are also related to their investment advisers in ways that may suppress such bargaining. The comparison to fees paid by unaffiliated institutional clients eliminates that concern, but raises the question whether the services provided to different kinds of entities were in fact comparable.

mutual-fund and unaffiliated clients. Rather, if petitioners can show that *respondent* provides comparable services to the two types of clients, a substantial disparity between the fees respondent charges in the two contexts should be given significant weight in the Section 36(b) analysis, whether or not such comparability of services is characteristic of prevailing industry practices.

On remand, the lower courts therefore should consider whether petitioners—who bear the burden of proof, 15 U.S.C. 80a-35(b)(1)—have presented sufficient evidence about the comparability of services respondent provides to mutual-fund clients and unaffiliated clients to defeat respondent's motion for summary judgment.

CONCLUSION

The judgment of the court of appeals should be vacated and the case remanded for further consideration under the appropriate standards.

Respectfully submitted.

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