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No. 08-586

IN THE
Supreme Court of the United States

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

HARRIS ASSOCIATES L.P.,
Respondent.

**On Writ of Certiorari
to the United States Court of Appeals
for the Seventh Circuit**

BRIEF FOR PETITIONERS

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QUESTION PRESENTED

Congress enacted the Investment Company Act of 1940 to mitigate the conflicts of interest inherent in the relationship between investment advisers and the mutual funds they create and manage. *See Daily Income Fund, Inc. v. Fox*, 464 U.S. 523, 536 (1984). Section 36(b) of that Act imposes on investment advisers "a fiduciary duty with respect to the receipt of compensation for services" and authorizes fund shareholders to bring a claim for "breach of [that] fiduciary duty." 15 U.S.C. § 80a-35(b). The Act further provides that, in such an action, "approval by the board of directors" of the fund is not conclusive, but "shall be given such consideration by the court as is deemed appropriate under all the circumstances." *Id.* § 80a-35(b)(2). The question presented is:

Whether a shareholder's claim that the fund's investment adviser breached its fiduciary duty by charging an excessive fee – more than twice the fee it charged to funds with which it was not affiliated – is cognizable under § 36(b), even if the shareholder does not show that the adviser misled the fund's directors who approved the fee.

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INTRODUCTION

This case involves the conflicts of interest arising from the close relationship between investment advisers and mutual funds created and run by those advisers. When an investment adviser seeks compensation for services it provides to the mutual fund, the adviser's incentive to maximize its income conflicts with its fiduciary duty to the funds to maximize their return.

Congress and this Court have long recognized "the potential for abuse inherent in the structure" of mutual funds. *Daily Income Fund, Inc. v. Fox*, 464 U.S. 523, 536 (1984). To protect investors from such abuse, Congress enacted the Investment Company Act of 1940 ("ICA" or "Act"). Several decades of practice under the ICA, however, convinced Congress that investment advisers continued to charge their funds excessive fees for investment-advisory services, despite structural safeguards in the original ICA. In 1970, Congress added § 36(b) to the Act to impose on investment advisers "a fiduciary duty with respect to the receipt of compensation for services" and to create a right of action for "breach of [that] fiduciary duty." 15 U.S.C. § 80a-35(b).

Because the term "fiduciary duty" derives from the common law, this Court infers that Congress intended to incorporate its settled meaning. A fiduciary entering into a transaction with the person to whom it owes the fiduciary duty must comply with two basic requirements. First, the fiduciary must fully and accurately disclose all material facts relating to the transaction. Second, the transaction must be fair to the one to whom the duty is owed, including being comparable to an arm's-length deal. Interpreting § 36(b) to incorporate those familiar common-law

principles gives meaning to the text Congress enacted and comports with the statute's purposes.

The Seventh Circuit announced a rule of law that an adviser charging excessive fees for advisory services is not liable for breach of fiduciary duty under § 36(b) unless the adviser also misled the fund's board of directors in obtaining their approval of the compensation. *See* Pet. App. 8a-9a. The court adopted that standard even though § 36(b) expressly provides both that approval of the fee by the fund's directors "shall be given such consideration by the court" only as "deemed appropriate under all the circumstances" and that an investor need not "allege or prove that any defendant engaged in personal misconduct." 15 U.S.C. § 80a-35(b)(1)-(2). The court also brushed aside evidence that the fees charged in this case were approximately twice what the investment adviser charges for comparable services in arm's-length transactions with clients it does not control. *See* Pet. App. 6a; *see also id.* at 39a (Posner, J., dissenting from denial of rehearing). The Seventh Circuit reached that result by relying on policy considerations inconsistent with the Act's text and history. The judgment below therefore should be reversed and the case remanded for further proceedings.

OPINIONS BELOW

The court of appeals' opinion (Pet. App. 1a-14a) is reported at 527 F.3d 627. The district court's opinion (Pet. App. 15a-33a) is not reported but is available at 2007 WL 627640.

JURISDICTION

The court of appeals entered its judgment on May 19, 2008, and denied a petition for rehearing on August 8, 2008. *See* Pet. App. 34a-43a. The petition for a writ of certiorari was filed on November 3, 2008,

and was granted on March 9, 2009 (129 S. Ct. 1579). This Court's jurisdiction rests on 28 U.S.C. § 1254(1).

STATUTORY PROVISIONS INVOLVED

Relevant provisions of the Investment Company Act of 1940, 15 U.S.C. § 80a-1 *et seq.*, are reproduced at Pet. App. 44a-64a.

STATEMENT

A. Statutory and Regulatory Background

1. The funds at issue here are open-end investment companies registered under the ICA – more commonly known as mutual funds. Mutual funds are "typically created and managed by a pre-existing external organization known as an investment adviser." *Daily Income Fund*, 464 U.S. at 536 (citing *Burks v. Lasker*, 441 U.S. 471, 481 (1979)). Investment advisers form mutual funds because they "hope to profit from providing management services to them."[1] The adviser "generally supervises the daily operation of the fund and often selects affiliated persons to serve on the [fund]'s board of directors." *Id.* The relationship between a fund and its adviser is thus "fraught with potential conflicts of interest." *Id.* (internal quotation marks omitted).

In 1940, Congress enacted the ICA to mitigate those conflicts of interest. *See Burks*, 441 U.S. at 480-81; 15 U.S.C. § 80a-1(b)(2) (declaring that "the national public interest and the interest of investors are adversely affected" when mutual funds are managed "in the interest of . . . investment advisers," rather than shareholders). Congress imposed a number of structural safeguards on the industry. Specifically, "Congress established a scheme that

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[1] *Public Policy Implications of Investment Company Growth*, H.R. Rep. No. 89-2337, at 127 (1966) ("SEC Report").

regulates most transactions between investment companies and their advisers, 15 U.S.C. § 80a-17; limits the number of persons affiliated with the adviser who may serve on the fund's board of directors, § 80a-10; and requires that fees for investment advice and other services be governed by a written contract approved both by the directors and the shareholders of the fund, § 80a-15." *Daily Income Fund*, 464 U.S. at 536-37.

Congress, regulators, and scholars continued to monitor the mutual-fund industry as it grew exponentially in the ensuing decades.[2] In 1958, the Securities and Exchange Commission ("SEC") charged the University of Pennsylvania's Wharton School of Finance and Commerce with producing a study on the industry. *See A Study of Mutual Funds*, H.R. Rep. No. 87-2274 (1962) ("Wharton Report"). The Wharton Report, submitted to the SEC and Congress in August 1962, found that "investment advisers often charged mutual funds higher fees than those charged the advisers' other clients and further determined that the structure of the industry, even as regulated by the Act, had proven resistant to efforts to moderate adviser compensation." *Daily Income Fund*, 464 U.S. at 537 (citing Wharton Report 34). The Wharton Report explained that "the lower rates charged other [non-mutual fund] clients have little to do with differences in expenses." Wharton Report 493. Rather, the "principal reason for the differences

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[2] *See* SEC Report, Letter of Transmittal at vii ("[N]et assets [of mutual funds] increased from $450 million at the end of 1940 to about $38.2 billion at June 30, 1966. . . . In 1940 less than 300,000 Americans held mutual fund shares. By the end of 1965 there were more than 3½ million mutual fund investors.").

in rates" was that "competitive factors which tend to influence rates charged other clients have not been substantially operative in fixing the advisory fee rates paid by mutual funds." *Id.* at 493-94. The Wharton Report also concluded that the unaffiliated directors mandated by the ICA were "of restricted value as an instrument for providing effective representation of mutual fund shareholders in dealings between the fund and its investment adviser." *Id.* at 34, *quoted in Daily Income Fund*, 464 U.S. at 537.

The Wharton Report prompted an SEC investigation, resulting in a report to Congress in December 1966. The SEC's report found that the typical mutual fund managed by an external investment adviser paid "substantially higher" fees for advisory services than did pension plans and other individual and institutional non-fund clients. SEC Report 11; *see id.* at 114-18, 119-21. The Commission attributed that disparity to the captive structure of the typical mutual fund: while investment advisers engage "in active competition with each other for the accounts of pension and profit-sharing plans and other nonfund advisory clients," they "seldom, if ever, compete with each other for advisory contracts with mutual funds." *Id.* at 126.[3]

The SEC further observed that investment advisers were generally compensated on the basis of a fixed percentage of the fund's assets, without regard

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[3] *See also* SEC Report 12 ("The ability of unaffiliated directors to bargain at arm's length is seriously hampered because they are seldom free as a practical matter to terminate a long established management relationship solely because of differences over fee rates. Under these circumstances, the essential element of arm's length bargaining – the freedom to terminate negotiations and to bargain with other parties – is lacking.").

to services rendered or actual expenses. *See id.* at 89. It found that "increases in the assets of a fund do not lead to a commensurate increase in the cost of furnishing it with investment advice and other managerial services." *Id.* at 94. The SEC concluded that, "as a fund's assets grew, this form of payment" – a percentage of net assets – "could produce unreasonable fees in light of the economies of scale realized in managing a larger portfolio." *Daily Income Fund*, 464 U.S. at 537 (citing SEC Report 94, 102). The SEC further noted that, in response to "pressures generated by the Wharton School Study and the pendency of stockholder litigation," some advisers had instituted fee reductions as assets exceeded a certain level (now commonly referred to as "breakpoints"), but found that "these reductions are not substantial in the light of the increases in fund assets." SEC Report 102.

The SEC also concluded that "lawsuits by security holders challenging the reasonableness of adviser fees had been largely ineffective due to the standards employed by courts to judge the fees." *Daily Income Fund*, 464 U.S. at 537 (citing SEC Report 132-43). Relying on the statutorily required approval of the adviser's contract by unaffiliated directors and shareholders, courts required plaintiffs to show "a 'waste' of corporate assets," meaning that fees could be challenged only if they were "unconscionable" or "shocking." SEC Report 12, 142; *see Daily Income Fund*, 464 U.S. at 540 & n.12. Under federal law, courts denied recovery unless investors could show a "gross abuse of trust." SEC Report 143; *see Daily Income Fund*, 464 U.S. at 540 & n.12.[4]

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[4] Congressional testimony echoed the SEC's criticism of the prevailing legal standards. For example, Judge Henry Friendly described the "waste" standard as requiring investors to prove

2. After considering a broad range of information, Congress enacted the Investment Company Amendments Act of 1970, Pub. L. No. 91-547, 84 Stat. 1413. Recognizing that structural safeguards alone would not protect investors and cognizant of the inadequacy of existing legal standards for challenging excessive adviser fees, Congress added § 36(b) to the ICA. Section 36(b) imposes on investment advisers "a fiduciary duty with respect to the receipt of compensation for services." 15 U.S.C. § 80a-35(b). It also grants shareholders a private right of action. *Id.* Congress specified that, in a shareholder suit under § 36(b), director approval of the adviser's compensation would not be conclusive but, rather, "shall be given such consideration by the court as is deemed appropriate under all the circumstances." *Id.* § 80a-35(b)(2). Section 36(b) further provides that it is "not . . . necessary to allege or prove that any defendant engaged in personal misconduct" and that the plaintiff has "the burden of proving a breach of fiduciary duty." *Id.* § 80a-35(b)(1).

The 1970 amendments also strengthened the ICA's structural protections by requiring that at least 40% of a fund's directors be persons who are not "interested" in the adviser. *Id.* § 80a-10(a); *id.* § 80a-2(a)(19)(B)(iii). The Act as amended requires that a majority of the "noninterested" (or disinterested) directors annually approve the adviser's compensation agreement "at a meeting called for the purpose of voting on such approval." *Id.* § 80a-15(c).

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the fee was "unreasonably unreasonable" and the federal standard as requiring proof that the compensation was "excessively excessive." *Mutual Fund Amendments (Part 1): Hearings Before the Subcomm. on Commerce and Finance of the H. Comm. on Interstate and Foreign Commerce*, 91st Cong. 794-95 (1969) ("1969 Hearings").

B. Proceedings Below

Petitioners own shares in several mutual funds – the Oakmark Fund, the Oakmark Equity & Income Fund, and the Oakmark Global Fund – all of which are part of the Oakmark family of funds. Respondent Harris Associates serves as the investment adviser for the Oakmark funds. *See* Pet. App. 1a. Harris created the funds, manages their daily operations, and provides the funds' office space and equipment. *See id.* at 39a-40a. In addition, Harris selected each member of the funds' joint board of trustees. *See* JA122-23. The Oakmark funds are thus "controlled" or "captive" mutual funds – exactly the type of fund that Congress had in mind when it enacted the ICA and the 1970 amendments. Pet. App. 39a-40a.

1. On August 17, 2004, petitioners sued Harris in federal district court, alleging that Harris breached its fiduciary duty with respect to compensation under § 36(b). *See* JA1, 29-53. Petitioners requested damages under § 36(b), *see* 15 U.S.C. § 80a-35(b)(3), and rescission of the investment-advisory agreements between Harris and the funds, *see id.* § 80a-46(b) (providing that a contract that violates a provision of the ICA is subject to rescission). *See* JA34-35 (¶ 16), 52 (¶ 55), 53 (¶ 59, Prayer for Relief).

Harris moved to dismiss the complaint for failure to state a claim upon which relief could be granted. In denying that motion, the district court found petitioners' allegations that the fees Harris charged to the funds had increased significantly in recent years and that "other clients receive like services at significantly lower rates" sufficient to state a claim under § 36(b). JA26. The court also rejected Harris's contention that a § 36(b) claim cannot be based on an adviser's failure to share the benefits of economies

of scale generated as a fund's assets increase. *See* JA27 ("[I]f the money Harris is receiving can be fairly characterized as a fee and it is in essence something for nothing, clearly that would represent an actionably disproportional relationship between the fees paid and the services rendered."). Finally, the court rejected Harris's argument that petitioners' request for rescission should be stricken, explaining that the plain language of § 36(b), which refers to "damages *or other relief*," 15 U.S.C. § 80a-35(b)(3) (emphasis added), "refutes Harris's contention that the only remedy to be had is monetary." JA27.

After discovery, petitioners and Harris each moved for summary judgment. Harris argued that there was no genuine issue of material fact regarding its compliance with § 36(b), largely because its fees were in line with those paid by other captive mutual funds and had been approved by the funds' board of trustees. In opposing Harris's motion, petitioners presented evidence of multiple breaches of fiduciary duty by Harris.[5]

First, petitioners showed that Harris failed to deal fairly with the funds. Harris receives from the funds fees for investment-advisory services that are based on a percentage of each fund's net assets. In percentage terms, those fees are nearly twice as much as or more than what Harris charges its independent, non-fund clients for comparable services. *See* JA352-56 (¶¶ 19-23); *see also* Pet. App. 39a (Posner, J.); *id.* at 6a, 17a-18a. If Harris had applied the fee sched-

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[5] The Court views the facts in the light most favorable to petitioners, against whom summary judgment was granted below. *See, e.g.*, *Pennsylvania State Police v. Suders*, 542 U.S. 129, 134 (2004); *Howlett v. Birkdale Shipping Co.*, 512 U.S. 92, 94 (1994).

ules used for comparable independent clients to the funds, the effective fee percentages for the funds would have been approximately half of what they were charged (less than half for the Oakmark Fund, far less than half for the Oakmark Equity & Income Fund, and just over half for the Oakmark Global Fund). *See* JA446-49; *see also* JA418. In dollar terms, the funds would have saved between $37 million and $58 million in one year alone under the fee schedules applicable to Harris's independent clients. *See* JA355-56 (¶ 23), 394-96.[6] Further, the disparity in the actual amounts paid by the two sets of clients is striking. For example, Harris charged the Oakmark Fund an effective rate of 0.88% on assets of $6.3 billion, and it charged an independent client with a comparable investment objective an effective rate of 0.45% on assets of $160 million. *See* JA447; *see also* JA171. Thus, the Oakmark Fund paid approximately $55 million in fees, while the independent client paid only $720,000 for essentially the same services.

Petitioners proffered evidence of additional unfair dealing by Harris. Documents and expert testimony showed that Harris was enjoying significant and increasing economies of scale, exacerbating the discrepancy between its fees and the cost of providing the services it rendered. *See* JA346-47 (¶¶ 11-12), 437-45, 452-60. From 2000 to 2003, assets in the Oakmark funds grew from approximately $5.7 billion to $26.7 billion, while personnel, occupancy, and

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[6] The relevant damages period is August 17, 2003, through the present. *See* 15 U.S.C. § 80a-35(b)(3) ("No award of damages shall be recoverable for any period prior to one year before the action was instituted."). The district court erroneously limited the damages period to the year preceding the filing of the complaint. *See infra* note 11.

operating costs decreased from 41% of total costs to only 15% of total costs. *See* JA346-47 (¶ 11), 453 (¶ 28). For the fiscal year ended September 30, 2003, Harris charged the funds more than $63 million in investment advisory fees, and for the fiscal year ended September 30, 2004, Harris charged the funds more than $109 million in investment advisory fees. *See* JA89, 104. Harris resisted instituting breakpoints (decreases in the fee percentage as assets exceed a certain amount). It indicated it would close one of the funds to new investors rather than implement breakpoints that would affect adversely its profits, even though its profit margins on advisory services exceeded 90% by some estimates (excluding profit-sharing payments from costs). *See* JA342-43 (¶ 6), 349-52 (¶¶ 15-18), 485-86; *see also* JA322-25 (¶¶ 10-11), 510-11, 517-20, 537, 539, 541.[7] Harris also improperly shifted distribution and research expenses from itself to the funds. *See* JA360-62 (¶¶ 28-30).

Second, petitioners presented evidence that Harris failed to provide the funds' board and shareholders with full and accurate disclosure of the material facts relating to its compensation. For example, Harris misinformed the board about the extent and cost of the services it provided to its other clients in comparison to the mutual funds. *See* JA356-57 (¶ 24).

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[7] The breakpoints added by Harris to the fee schedule did not reduce Harris's compensation for the upcoming year. *See* JA323-25 (¶ 11); *see also* JA88-89, 99-101. As of September 30, 2004, the Oakmark Global Fund still had not reached any of its breakpoints. *See* JA324 (¶ 11); *cf.* JA508-09 (testimony of fund trustee that "[w]e don't scientifically know exactly what we're doing when we put those breakpoints in" and that he did not "think [the board] would know" if the breakpoints were set too high).

And it provided the funds' trustees with inaccurate and incomplete information regarding its profitability and the extent to which it realized economies of scale. *See* JA339-46 (¶¶ 2-10), 347-48 (¶ 13), 381-88 (¶¶ 167-170, 175-177), 392-93, 399-415, 424-30. In addition, Harris failed fully to inform the board about its use of a Harris affiliate to double-charge the funds for commissions. *See* JA359-60 (¶ 27), 377-80 (¶¶ 30-36).

Third, petitioners contended that Harris breached its fiduciary duty under § 36(b) by accepting compensation in violation of the ICA's structural safeguards. For example, Victor Morgenstern, the chair of the funds' joint board and one of the designated disinterested trustees, was a former Harris partner who received deferred compensation from Harris worth hundreds of thousands of dollars per year. Yet, he participated in the statutorily mandated disinterested-trustee meetings at which Harris's fee agreements were reviewed and approved. *See* JA72 (¶ 13), 73-75 (¶¶ 21-23), 82 (¶ 48), 116-17, 363 (¶ 31); Pet. App. 2a-3a; 15 U.S.C. § 80a-15(c) (requiring a majority of disinterested directors to approve adviser compensation "at a meeting called for the purpose of voting on such approval"); *see also* JA110-11.[8] Further, the funds' registration statements did not disclose Morgenstern's financial interest in Harris, as the Act requires. *See* JA83 (¶ 51); Pet. App. 3a; 15 U.S.C. § 80a-33(b) (making it unlawful "to omit to state" in "any registration statement" or similar document "any fact necessary in order to prevent the statements made

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[8] A disinterested fund trustee testified that it was important for disinterested trustees to meet outside the presence of the interested trustees, who have "some ability to benefit from" the adviser's compensation. JA136.

therein, in the light of the circumstances under which they were made, from being materially misleading").[9] In addition, petitioners put forth evidence of numerous additional conflicting business and personal relationships among the trustees and Harris personnel, none of which was disclosed to the funds' shareholders, the investing public, or the SEC. *See*, *e.g.*, JA76 (¶ 28) (one designated disinterested trustee profited from a real estate transaction involving a Harris partner), 80 (¶¶ 42-44), 83 (¶ 52) (three designated disinterested trustees invested in hedge funds managed by a Harris corporate affiliate); *see also* Pet. App. 18a; JA75-80 (¶¶ 26-41), 81 (¶¶ 45-47), 364-68 (¶¶ 32-38).

2. The district court granted Harris's motion for summary judgment and dismissed the case. The court opined that "the only question we need consider is whether [the funds' board] could have agreed to the fee schedule in the advisory contracts after engaging in good-faith bargaining." Pet. App. 31a. The court answered that question in the affirmative, because 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 with Harris," *id.*, and because Harris's fees were comparable to those paid by other mutual funds, *id.* at 30a-32a. In the court's view, it did not matter whether Harris's independent clients paid far less for services that were "indistinguishable" from those the Oakmark funds received. *Id.* at 30a.[10]

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[9] Several of the funds' disinterested trustees were unaware of the specifics of Morgenstern's deferred compensation arrangement with Harris. *See* JA125-26, 132-33, 134.

[10] In rejecting petitioners' summary-judgment motion, the district court reasoned that an adviser's fiduciary duty under

3. a. The Seventh Circuit affirmed the district court's judgment. The court "disapprove[d]" the Second Circuit's "*Gartenberg* approach," Pet. App. 8a, under which an adviser violates § 36(b) when it charges a fee that exceeds "'the range of what would have been negotiated at arm's-length in the light of all of the surrounding circumstances,'" *id.* at 5a (quoting *Gartenberg v. Merrill Lynch Asset Mgmt., Inc.*, 694 F.2d 923, 928 (2d Cir. 1982)). It instead held that an allegation that an adviser charged excessive fees for advisory services is not actionable under § 36(b). *See id.* at 8a. The court reasoned that "[a] fiduciary must make full disclosure and play no tricks but is not subject to a cap on compensation." *Id.* 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." *Id.* at 8a-9a, 13a-14a.

The court allowed that it is "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." *Id.* at 9a. But it held that such an inference could never be drawn where the adviser's compensation is "normal among similar institutions" – here, other mutual funds. *Id.* Accordingly, the court of appeals, like the district court, gave no weight to Harris having charged more to the funds than to its independent clients. *See id.* at 13a. (It also speculated, without reference to

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§ 36(b) does not include compliance with the structural provisions of the ICA on which petitioners relied. *See* Pet. App. 24a-26a. It also concluded that the statutory violations were essentially harmless because the board would have approved Harris's fees anyway. *See id.*

record evidence, that the Oakmark funds required more of Harris's time. *See id.*)

To support its interpretation of § 36(b), the court analogized investment-adviser fees to compensation of corporate managers and lawyers. It asserted that courts do not review what corporate boards or clients pay officers or attorneys and drew the conclusion that the "existence of the fiduciary duty does not imply judicial review for reasonableness." *Id.* at 10a. The court viewed its deregulatory approach as good policy, asserting that the large number of mutual funds reflects competition that invariably must constrain adviser compensation. *See id.* at 11a-13a.

The court briefly addressed petitioners' evidence that Harris violated its fiduciary duty with respect to compensation by failing to comply with the ICA's structural safeguards. It concluded that the financial relationship between Morgenstern (the supposedly disinterested trustee) and Harris would violate 15 U.S.C. § 80a-15(c) only if, taking away Morgenstern, the disinterested trustees who voted to approve Harris's compensation would not have made up a majority of all disinterested trustees. *See* Pet. App. 3a-4a. Similarly, the court concluded that the funds' shareholders could not recover for the failure to disclose Morgenstern's financial ties to Harris, unless Morgenstern's vote to approve Harris's fees was outcome-determinative. *See id.* at 3a.[11]

[11] Petitioners appealed the district court's holding that the applicable damages period for this case is limited to the year preceding the filing of the complaint (Pet. App. 17a n.2) as inconsistent with 15 U.S.C. § 80a-35(b)(3). *See Gallus v. Ameriprise Fin., Inc.*, 561 F.3d 816, 825 (8th Cir. 2009). Because the Seventh Circuit did not reach that issue, it remains an open question on any remand from this Court.

b. The Seventh Circuit's active judges split five-to-five on whether to grant rehearing en banc, with one judge recused. Lacking a majority, the court of appeals denied rehearing. *See* Pet. App. 34a.

Judge Posner, joined by Judges Rovner, Wood, Williams, and Tinder, dissented from the denial of rehearing en banc. *See id.* at 35a-43a. Judge Posner explained that the court's "rejection" of the *Gartenberg* standard was based on "an economic analysis that is ripe for reexamination on the basis of growing indications that executive compensation in large publicly traded firms often is excessive because of the feeble incentives of boards of directors to police compensation." *Id.* at 37a (citing authorities). "Competition in product and capital markets can't be counted on to solve the problem," he wrote, "because the same structure of incentives operates on all large corporations and similar entities, including mutual funds." *Id.* at 38a; *see id.* at 40a-41a. After all, Judge Posner observed, "[m]utual funds are a component of the financial services industry, where abuses have been rampant." *Id.* at 38a.

Turning to this case, Judge Posner explained that "there is no doubt that the captive funds are indeed captive" and that the "Oakmark-Harris relationship matches the arrangement described in the Senate Report accompanying § 36(b): a fund 'organized by its investment adviser which provides it with almost all management services.'" *Id.* at 39a (quoting S. Rep. No. 91-184, at 5 (1969)); *see id.* at 40a. Judge Posner emphasized that a "particular concern" was Harris's practice of "charging its captive funds," in which petitioners invested, "more than twice what it charges independent funds." *Id.* at 39a. And he rejected as "airy speculation" the court's "suggestions on why this difference may be justified" – suggestions

he described as lacking "an evidentiary or empirical basis." *Id.* at 39a, 41a.

SUMMARY OF ARGUMENT

I. Under § 36(b), investment advisers such as Harris have "a fiduciary duty with respect to the receipt of compensation for services." 15 U.S.C. § 80a-35(b). That fiduciary duty imposes two basic requirements with which an investment adviser must comply in obtaining its compensation. First, the adviser must fully and accurately disclose all material facts relating to its compensation. Second, the compensation must be fair to the fund, meaning that it comports with what would be bargained for in an arm's-length transaction. Those two mandates flow directly from the common-law meaning of the words "fiduciary duty," a meaning that Congress is presumed to have incorporated when it used those words in § 36(b).

That two-part fiduciary-duty standard fulfills Congress's purposes in enacting § 36(b). Congress enacted § 36(b) in response to the problem of excessive investment-adviser compensation. After considering investigations of scholars and the SEC and conducting its own hearings, Congress found that the forces of arm's-length bargaining were absent in the relationship between an investment adviser and a typical captive mutual fund. It further concluded that courts relied too heavily on approval by the boards of mutual funds in rejecting investors' challenges to adviser compensation. Accordingly, Congress added § 36(b) to provide an effective mechanism to ensure the fairness of adviser compensation, and it chose a familiar legal standard, imposing on investment advisers a fiduciary duty.

From the early 1980s until recently, the prevailing interpretation of § 36(b) was the standard set forth in the Second Circuit's decision in *Gartenberg*. That case correctly held that an investment adviser violates its fiduciary duty when it charges a fee that exceeds what could be obtained in an arm's-length transaction. Over the years, however, other courts have misunderstood certain aspects of the *Gartenberg* ruling, leading to decisions that depart from the proper interpretation of § 36(b). Under the correct standard, a § 36(b) violation can be established when an adviser charges its captive funds fees that are significantly higher for comparable services than those charged in arms-length transactions with independent clients.

II. The Seventh Circuit adopted a standard that finds no support in the statute's text or purposes. Under that standard, approval of the investment adviser's compensation by the fund's directors is "conclusive," unless the adviser "play[ed] . . . tricks" or "pulled the wool over" the directors' eyes. Pet. App. 8a-9a, 13a-14a. Although the court purported to look to the common law in fashioning its test, it misunderstood the pertinent common-law principles. Those principles establish that a fiduciary dealing with beneficiaries – as an investment adviser must do annually under the Act when seeking its compensation – must make full disclosure and ensure that the dealings are fair. Further, the Seventh Circuit's reliance on director approval conflicts with § 36(b)'s language and Congress's intent to supplant such reliance.

To support its interpretation of the statute, the Seventh Circuit sought to draw analogies to other sources of law and relied on policy arguments about

the state of competition in the mutual-fund industry, while disregarding § 36(b)'s plain text. In so doing, the court misunderstood the relevance of the other sources of law to which it looked and the ability of market forces to constrain investment-adviser compensation. Further, although the court suggested that the legislative history of § 36(b) supported its approach, in fact that history demonstrates that regulators and the industry agreed that § 36(b)'s fiduciary duty included a substantive check on adviser compensation.

Under a proper standard, petitioners' evidence warrants a trial on the merits. Petitioners have shown that Harris charges the funds approximately twice what it charges independent clients for comparable services. Such evidence alone suffices to establish a genuine issue of material fact for trial. In addition, petitioners have presented evidence that Harris failed to provide full and accurate disclosure of the material facts relating to its compensation and breached its obligation to deal fairly with the funds in multiple other respects.

ARGUMENT

I. SECTION 36(b) REQUIRES FULL DISCLOSURE AND FAIRNESS

A. Under An Established Canon Of Statutory Interpretation, § 36(b)'s Fiduciary Duty Incorporates Traditional Common-Law Requirements Of Full Disclosure And Fairness

Section 36(b) imposes on investment advisers "a fiduciary duty with respect to the receipt of compensation for services." 15 U.S.C. § 80a-35(b). In employing the phrase "fiduciary duty" in § 36(b), Congress incorporated the familiar common-law principles that phrase embodies. This Court repeatedly has applied the "well-established rule of construction that '[w]here Congress uses terms that have accumulated settled meaning under . . . the common law, a court must infer, unless the statute otherwise dictates, that Congress means to incorporate the established meaning of these terms.'" *Neder v. United States*, 527 U.S. 1, 21 (1999) (quoting *Nationwide Mut. Ins. Co. v. Darden*, 503 U.S. 318, 322 (1992)) (alterations in original).[12] As this Court has recognized, the phrase "fiduciary duty" is exactly the type of well-known common-law term whose meaning Congress is presumed to have adopted. *See Varity Corp. v. Howe*, 516 U.S. 489, 502 (1996) (explaining that "the common law" has "given to terms such as 'fiduciary'" a "legal meaning to which, we normally presume, Congress meant to refer").

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[12] *Accord*, *e.g.*, *NLRB v. Amax Coal Co.*, 453 U.S. 322, 329 (1981); *see Evans v. United States*, 504 U.S. 255, 259 (1992) ("[A] statutory term is generally presumed to have its common-law meaning.") (internal quotation marks omitted).

Under the well-settled common law both before and after enactment of the 1970 amendments, a fiduciary has a strict duty of loyalty to act in the beneficiary's best interests. *See*, *e.g.*, *Restatement (Second) of Trusts* § 2 cmt. b (1959) ("A person in a fiduciary relation to another is under a duty to act for the benefit of the other as to matters within the scope of the relation."); IIA Austin W. Scott & William F. Fratcher, *The Law of Trusts* § 170, at 311 (4th ed. 1987) ("*Scott on Trusts*") ("The most fundamental duty owed by the trustee to the beneficiaries of the trust is the duty of loyalty. . . . It is the duty of a trustee to administer the trust solely in the interest of the beneficiaries.").[13]

When the fiduciary negotiates with a beneficiary regarding a transaction in which the fiduciary has an interest – for example, regarding the fiduciary's fee – the fiduciary must comply with two fundamental requirements. First, the fiduciary must provide full and accurate disclosure of all material facts relating to the transaction. Second, the transaction must be fair to the beneficiary. *See*, *e.g.*, *Restatement (Second) of Trusts* § 2 cmt. b ("If the fiduciary enters into a transaction with the other and fails to make

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[13] *See also* George G. Bogert & George T. Bogert, *The Law of Trusts and Trustees* § 543, at 217 (rev. 2d ed. 1993) ("*Bogert's Trusts and Trustees*") ("Perhaps the most fundamental duty of a trustee is that he must display throughout the administration of the trust complete loyalty to the interests of the beneficiary and must exclude all selfish interest and all consideration of the interests of third persons."); *Meinhard v. Salmon*, 164 N.E. 545, 546 (N.Y. 1928) (Cardozo, J.) ("Many forms of conduct permissible in a workaday world for those acting at arm's length, are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior.").

a full disclosure of all circumstances known to him affecting the transaction or if the transaction is unfair to the other, the transaction can be set aside by the other."); *Restatement (Third) of Trusts* § 2 cmt. b (2003) (same); *Restatement (Second) of Trusts* § 170(2) ("The trustee in dealing with the beneficiary on the trustee's own account is under a duty to the beneficiary to deal fairly with him and to communicate to him all material facts in connection with the transaction which the trustee knows or should know."); *Restatement (Third) of Trusts* § 78(3) (2007) (same); *Restatement (Second) of Trusts* § 170 cmt. w (trustee must ensure that beneficiary has "knowledge of his legal rights and of all material facts" and that "the transaction [is] fair"); *Restatement (Third) of Trusts* § 78 cmt. g ("in addition to complying with the requirement of full disclosure," the transaction "must be *fair* to the beneficiary and the trust," including "that the transaction is for a fair and adequate consideration").[14]

Those requirements of full disclosure and fairness apply specifically to a fiduciary's dealings regarding

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[14] *See also* IIA *Scott on Trusts* § 170.25, at 436 ("Where [the trustee] deals directly with the beneficiaries, the transaction may stand, but only if the trustee makes full disclosure and takes no advantage of his position and the transaction is in all respects fair and reasonable."); III *id.* § 216.3, at 347-48 (because the fiduciary and the beneficiary are in "a fiduciary relation" and "are not dealing at arm's length," the transaction can "be set aside if it is not a fair transaction"; it is "essential" that the transaction "be at a price that is fair and reasonable"); *Bogert's Trusts and Trustees* § 544, at 493, 496-97 (fiduciary owes a duty of "fair play in the direct dealing with his principal," which requires both "full and frank disclosure" and "consideration" that is "fair and adequate"); *Weinberger v. UOP, Inc.*, 457 A.2d 701, 711 (Del. 1983) ("fair price" is a "basic aspect[]" of the "concept of fairness" in fiduciary law).

compensation. A trustee may seek to "enlarge[] or diminish[]" its compensation "by an agreement between [itself] and the beneficiary." *Restatement (Second) of Trusts* § 242 cmt. i. But such an agreement "will not bind the beneficiary" if either "the trustee failed to make a full disclosure of all circumstances affecting the agreement" or "the agreement is unfair to the beneficiary." *Id.* (citing *Restatement (Second) of Trusts* § 170); *accord Restatement (Third) of Trusts* § 38 cmt. f. Indeed, the rule that a trustee can negotiate with the beneficiary regarding its compensation so long as it provides full disclosure and deals fairly is an exception to the general rule that fiduciaries are "strictly prohibited from engaging in transactions that involve self-dealing or that otherwise involve or create a conflict between the trustee's fiduciary duties and personal interests." *Restatement (Third) of Trusts* § 78(2). That strict prohibition against self-dealing "do[es] not apply to the trustee's taking of *reasonable* compensation for services rendered as trustee." *Id.* cmt. c(4) (emphasis added). No comparable exception exists, however, for *unreasonable* compensation. A fiduciary taking *un*reasonable compensation simply engages in prohibited self-dealing.[15]

This Court's decisions recognize those fiduciary principles. In *Pepper v. Litton*, 308 U.S. 295 (1939),

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[15] The Court cites the *Restatements of Trusts*, *Scott on Trusts*, and *Bogert's Trusts and Trustees* as reliable authorities on the common law. *See, e.g.*, *Kennedy v. Plan Adm'r for DuPont Sav. & Inv. Plan*, 129 S. Ct. 865, 872 (2009); *Harris Trust & Sav. Bank v. Salomon Smith Barney Inc.*, 530 U.S. 238, 250, 252 (2000); *Firestone Tire & Rubber Co. v. Bruch*, 489 U.S. 101, 111-12 (1989); *see also Field v. Mans*, 516 U.S. 59, 70 n.9 (1995) (the Court construes statutes "to incorporate the general common law" and "the dominant consensus of common-law jurisdictions, rather than the law of any particular State").

for example, the Court explained that a fiduciary's dealings with its beneficiary "are subjected to rigorous scrutiny." *Id.* at 306. The fiduciary must act in "good faith," and the transaction must be "fair[] from the viewpoint of the" beneficiary. *Id.* "The essence of the test is whether or not under all the circumstances the transaction carries the earmarks of an arm's length bargain." *Id.* at 306-07; *see Geddes v. Anaconda Copper Mining Co.*, 254 U.S. 590, 599 (1921) ("[W]here the fairness of [transactions between a corporate fiduciary and the corporation] is challenged the burden is upon those who would maintain them to show their entire fairness and where a sale is involved the full adequacy of the consideration.").[16] And "[c]ourts have imposed on a fiduciary an affirmative duty of utmost good faith, and full and fair disclosure of all material facts, as well as an affirmative obligation to employ reasonable care to avoid misleading his clients." *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 194 (1963) (internal quotation marks and footnotes omitted).[17]

In the aftermath of the 1970 amendments, the Second Circuit construed § 36(b) in light of those

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[16] In congressional hearings leading to § 36(b)'s enactment, *Pepper* and *Geddes* were quoted with approval in discussing the fiduciary-duty standard. *See* 1969 Hearings 190 (SEC Memorandum), 199-200 (testimony of Hon. Hamer H. Budge, SEC Chairman).

[17] Notwithstanding statements that a fiduciary bears the burden of proving the fairness of a transaction with the beneficiary, *see*, *e.g.*, *Geddes*, 254 U.S. at 599, § 36(b) provides that "the plaintiff shall have the burden of proving a breach of fiduciary duty," 15 U.S.C. § 80a-35(b)(1). Here, petitioners adduced ample evidence that Harris breached its fiduciary duty, including evidence that it charges the funds twice as much as it charges independent clients for comparable services.

same common-law principles. The court explained that "Congress, in imposing a fiduciary obligation on investment advisers, plainly intended that their conduct be governed by the traditional rule of undivided loyalty implicit in the fiduciary bond." *Galfand v. Chestnutt Corp.*, 545 F.2d 807, 811 (2d Cir. 1976).[18] The Second Circuit held that, as a fiduciary, the investment adviser must fully disclose to the fund (its beneficiary) information regarding the adviser's compensation: "It is axiomatic, therefore, that a self-dealing fiduciary owes a duty of full disclosure to the beneficiary of his trust." *Id.* The court further explained that, "even where a fiduciary has made full disclosure, it is the duty of a federal court to subject the transaction to rigorous scrutiny for fairness." *Id.* at 811-12 (citing *Pepper*, 308 U.S. at 306-07). In an appeal decided after this Court granted certiorari in this case, the Eighth Circuit articulated a similar, two-part fiduciary standard in interpreting § 36(b). *See Gallus v. Ameriprise Fin., Inc.*, 561 F.3d 816, 823-24 (8th Cir. 2009).

B. Interpreting § 36(b) To Incorporate Traditional Common-Law Principles Serves Congress's Purposes

Congress enacted § 36(b) to protect investors from excessive adviser compensation. It fulfilled that purpose by using language that incorporated traditional principles of fiduciary-duty law designed to protect the beneficiary in its dealings with the fiduciary. The 1970 amendments grew out of a lengthy delib-

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[18] This Court has quoted *Galfand* with approval in recognizing that "the '"relationship between investment advisers and mutual funds is fraught with potential conflicts of interest."'" *Daily Income Fund*, 464 U.S. at 536 (quoting *Burks*, 441 U.S. at 481, quoting in turn *Galfand*, 545 F.2d at 808).

erative process involving analysis of the mutual-fund industry and a focus on replicating the results of true arm's-length bargaining.

1. Spurred by the thorough investigations of the mutual-fund industry conducted by the Wharton School and the SEC, congressional committees held hearings over a multi-year period and considered multiple versions of proposed legislation. *See supra* pp. 4-6 (describing background); S. Rep. 91-184, at 1-4 (same); H.R. Rep. No. 91-1382, at 2-3 (1970) (same). From that extensive record, Congress found 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," because "a mutual fund cannot, as a practical matter[,] sever its relationship with the adviser." S. Rep. 91-184, at 5; *accord* H.R. Rep. 91-1382, at 7; *Burks*, 441 U.S. at 481. In particular, "problems [had] arise[n] due to the economies of scale attributable to the dramatic growth of the mutual fund industry" – economies that advisers had not always "shared with investors." S. Rep. 91-184, at 6. Section 36(b) was intended in part to ensure that investors would "share equitably . . . in the economies available as a result of the growth and general acceptance of mutual funds." *Id.* at 4; *see also id.* at 3 (recognizing that mutual funds "and those who entrust their savings to such [funds] stand in special need of legal protection").

Those perceived market failures led Congress to re-examine the legal standards for protecting mutual-fund investors. Although the 1940 Act had placed some structural requirements on the industry, it "did not provide any mechanism by which the fairness of management contracts could be tested in court." *Id.* at 5. Under the 1940 Act, courts required investors

challenging investment-adviser fees to prove a "gross abuse of trust." And the existing state-law standard of corporate waste could be satisfied only if the adviser's fees were "unconscionable." *See Daily Income Fund*, 464 U.S. at 540 & n.12; *supra* p. 6. That standard drew substantial criticism for being "unduly restrictive" as applied to the mutual-fund industry. S. Rep. 91-184, at 5; *see* H.R. Rep. 91-1382, at 7; *Daily Income Fund*, 464 U.S. at 534 n.10, 537, 540-41 & n.12.

Section 36(b) was enacted to impose on investment advisers "a specific 'fiduciary duty' in respect to management fee compensation" and to "provide a mechanism for court enforcement of this duty." S. Rep. 91-184, at 5-6. Put differently, § 36(b) "authorize[s] the court to determine whether the investment adviser has committed a breach of fiduciary duty in determining or receiving the fee." *Id.* at 6. Under § 36(b), "the ultimate test" – "even if the compensation or payments [have been] approved by the directors and stockholders" – is not whether the compensation "involves a 'waste' of corporate assets," but "whether the investment adviser has fulfilled his fiduciary duty to the mutual fund shareholders in determining the fee." *Id.* at 15-16; *accord* H.R. Rep. 91-1382, at 38.[19] The Senate report explained that § 36(b) was "in accordance with the traditional function of the courts to enforce such fiduciary duties in similar type relationships." S. Rep. 91-184, at 6; *see*

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[19] *See also* H.R. Rep. 91-1382, at 87 (SEC Memorandum) ("It would be anomalous indeed for Congress to declare that the investment adviser has a fiduciary duty with respect to his fee and then to turn around and say that he can breach that duty with impunity, no matter how outrageous the breach, if directors and shareholders who have no other choice, approve the contract. This is contrary to the basic law of fiduciary duty.").

id. at 7 (stating that § 36(b) "is designed" "to provide a means by which the Federal courts can effectively enforce the federally-created fiduciary duty with respect to management compensation").

2. This Court's cases have recognized that Congress intended § 36(b) to serve those purposes and that Congress sought to permit claims under § 36(b) even when the fund's disinterested directors have approved the adviser's compensation. *See Kamen v. Kemper Fin. Servs., Inc.*, 500 U.S. 90, 108 (1991) ("Congress added § 36(b) to the ICA in 1970 because it 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.'") (quoting *Daily Income Fund*, 464 U.S. at 540)). The *Daily Income Fund* Court explained that "Congress intended security holder and SEC actions under § 36(b), on the one hand, and directorial approval of adviser contracts, on the other, to act as independent checks on excessive fees." 464 U.S. at 541. That conclusion arose, in part, from the SEC's contention that § 36(b) "reflects a congressional determination that, due to conflicts of interest in assessing the fairness of compensation paid to a company's investment adviser, courts cannot defer to the business decisions of investment company directors." Brief for the SEC as Amicus Curiae in Support of Affirmance at 9, *Daily Income Fund, Inc. v. Fox*, 464 U.S. 523 (1984) (No. 82-1200).

Thus, this Court's cases and the legislative history recognize Congress's understanding that arm's-length bargaining was absent from the usual captive mutual-fund structure and that investment advisers were obtaining economies of scale that should be shared with fund shareholders. The history further

demonstrates that Congress's purpose in enacting § 36(b) was to replace the unduly restrictive corporate waste standard for challenging adviser fees with a more effective standard anchored in familiar principles of fiduciary-duty law.

C. *Gartenberg* Correctly Articulates The Fairness Requirement Of The Fiduciary-Duty Standard, But Subsequent Cases Have Distorted It

In *Gartenberg*, the Second Circuit expounded on the second prong of the fiduciary standard – the requirement of fairness. The court held that "the 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 of the surrounding circumstances." 694 F.2d at 928. The *Gartenberg* court's reference to approximating the results of true arm's-length bargaining comports with the fairness requirement recognized in the common-law authorities discussed above.

Gartenberg also correctly held that one of the least probative "factor[s] to be considered in evaluating a fee's fairness is the price charged by other similar advisers to funds managed by them." *Id.* at 929. "Reliance on prevailing industry advisory fees will not satisfy § 36(b)," the court explained, because "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." *Id.* (citing SEC Report 131, 148); *see id.* ("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."); *see also* Pet. App. 38a, 40a-41a (Posner, J.); *Gallus*, 561 F.3d at 824.

Other aspects of the *Gartenberg* decision, however, are in tension with traditional common-law principles or have been applied by subsequent courts in at least three ways inconsistent with those principles.

First, courts have misread *Gartenberg* in holding that a comparison between the fees an adviser charges to its captive mutual funds and those it charges to independent clients is irrelevant as a matter of law in a § 36(b) suit.[20] *Gartenberg* "rejected" a comparison between the fees charged to the money-market fund at issue there and the fees charged "to large pension funds." 694 F.2d at 930 n.3. But that money-market fund operated "like a bank account" in that "[i]dle money [could] be invested in the Fund for as little as a day and put to work earning interest." *Id.* at 925. The large pension funds being compared did not "face the myriad of daily purchases and redemptions throughout the nation which must be handled by" the money-market fund. *Id.* at 930 n.3. The Second Circuit thus rejected that comparison based on the particular characteristics of the entities before it. The court did not suggest that a comparison of fees charged for like services provided to different clients (*e.g.*, a mutual fund and an institutional client with the same investment objective) would be irrelevant.[21]

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[20] *See*, *e.g.*, *Strougo v. BEA Assocs.*, 188 F. Supp. 2d 373, 384 (S.D.N.Y. 2002).

[21] *See Gallus*, 561 F.3d at 824. The money-market fund in *Gartenberg* was unusual in that the brokerage function was integrated into the advisory function, *see Gartenberg*, 694 F.2d at 926, making inapt a comparison to advisory services provided to other accounts that did not include the brokerage service.

In fact, such a comparison is highly probative in assessing whether the result of a transaction between an adviser and a fund is fair to the fund. It enables the court to determine whether the price charged by the adviser-fiduciary to the fund is comparable to an arm's-length transaction. Judge Posner recognized the evidentiary value of such a comparison when he criticized the court below for ignoring the "comparison of the fees that Harris charges independent funds with the much higher fees that it charges the funds it controls." Pet. App. 41a; *see id.* at 39a ("A particular concern in this case is the adviser's charging its captive funds more than twice what it charges independent funds."); *see also Gallus*, 561 F.3d at 824 ("The purpose of an inquiry into the fees paid by institutional, non-fiduciary clients is to determine what the investment advice is worth."). Thus, evidence of fees charged to an adviser's independent clients for comparable services is highly pertinent in a § 36(b) case.

Second, although the *Gartenberg* court correctly identified the "test" as whether the fee is comparable to an "arm's-length" deal, it added the erroneous additional concept that, "[t]o be guilty of a violation of § 36(b)," the adviser "must charge a fee that is so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been the product of arm's-length bargaining." 694 F.2d at 928; *cf.* Pet. App. 5a (describing these as "two variations on a theme"). That formulation – in particular, the "so disproportionately large" language – is inconsistent with the proper comparison to arm's-length transactions and traditional fiduciary principles, and subsequent courts have been led astray by it.

In addition, although the *Gartenberg* court correctly recognized that "all of the surrounding circumstances" are relevant in determining whether the fee is comparable to an arm's-length bargain, 694 F.2d at 928,[22] subsequent courts have erroneously translated the facts in *Gartenberg* into a rigid checklist of factors on which plaintiffs must produce evidence in a § 36(b) case. *See*, *e.g.*, *Krinsk v. Fund Asset Mgmt., Inc.*, 875 F.2d 404, 409 (2d Cir. 1989) (listing six factors). Evidence on many of those issues is within the adviser's exclusive control and, even with full discovery, can generate complicated factual disputes.[23] Analysis of those factors thus creates needless confusion when more probative proof is available.

An example of that error arises when courts assess whether the adviser received so-called "fall-out benefits" – additional revenue from providing other services to investors in the fund. *See id.* at 411. If investors can show that an adviser charged its captive fund significantly higher fees than in an arm's-length transaction, it should not matter whether they can prove that the adviser also received fall-out benefits but took no account of them in determining the fee

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[22] *See* S. Rep. 91-184, at 15 (courts should "look at all the facts in connection with the determination and receipt of such compensation . . . to reach a decision as to whether the adviser has properly acted as a fiduciary in relation to such compensation"); H.R. Rep. 91-1382, at 37 (same).

[23] Moreover, undue focus on factors such as "the profitability of the fund to the adviser-manager," *Krinsk*, 875 F.2d at 409, threatens to transform § 36(b) into the type of cost-based rate-making statute that Congress sought to avoid. *See* S. Rep. 91-184, at 6.

it charged to the fund.[24] When combined with the refusal to recognize the relevance of fees charged to independent clients, such an analysis strays far from the fiduciary principles that properly govern § 36(b) claims.

Third, some courts have read *Gartenberg* to mean that the *only* type of claim cognizable under § 36(b) is one alleging that the adviser charged "excessive" fees.[25] The claim at issue in *Gartenberg* focused on excessive fees, but the Second Circuit did not purport to hold that § 36(b)'s "fiduciary duty" excludes the traditional requirement of full disclosure. Indeed, neither *Gartenberg* itself nor any subsequent Second Circuit case casts doubt on *Galfand*, in which the Second Circuit recognized the adviser's disclosure obligation. *See Gallus*, 561 F.3d at 823-24 & n.3.

In sum, *Gartenberg*'s core holding – that an adviser breaches its fiduciary duty under § 36(b) when it charges a fee that exceeds what could be obtained in an arm's-length transaction – correctly interprets § 36(b) in accordance with traditional fiduciary principles. Some of the gloss that subsequent courts have placed on *Gartenberg* is, however, unmoored from the common-law foundations of § 36(b)'s fiduciary duty and thus should be rejected.

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[24] If an adviser received fall-out benefits but those benefits were ignored in setting the adviser's fee, that would be relevant in determining the adviser's compliance with its fiduciary duty.

[25] *See Migdal v. Rowe Price-Fleming Int'l, Inc.*, 248 F.3d 321, 328 (4th Cir. 2001) ("Section 36(b) is sharply focused on the question of whether the fees themselves were excessive"); *see also Bellikoff v. Eaton Vance Corp.*, 481 F.3d 110, 118 (2d Cir. 2007) (per curiam) (under § 36(b), plaintiff "must allege excessive fees, rather than fees that might simply be described as 'improper'") (citing *Gartenberg*, 694 F.2d at 928).

II. THE SEVENTH CIRCUIT'S RADICAL REVISION OF § 36(b) CONFLICTS WITH THE STATUTE'S TEXT AND PURPOSES

Under the Seventh Circuit's approach, approval of the investment adviser's compensation by the fund's directors is "conclusive," unless the adviser "play[ed] . . . tricks" or "pulled the wool over" the directors' eyes. Pet. App. 8a-9a, 13a-14a. That standard enables an adviser to take as much as it can get. The court's dramatic departure from the prevailing interpretation of § 36(b) finds no support in the statute's text or purposes. Instead, it is premised primarily on analogies to other sources of law and policy arguments about the competitive state of the mutual-fund industry. Such arguments provide no basis for deviating from the statute's plain text. In any event, the court misunderstood the relevance of the other sources of law to which it looked and the ability of market forces to constrain investment-adviser compensation. Under a proper standard, petitioners' evidence warrants a trial on the merits.

A. The Seventh Circuit Misunderstood The Applicable Common-Law Principles

The court of appeals properly looked to the common law in interpreting § 36(b). *See* Pet. App. 8a (noting that "fiduciary" is "a familiar word; to use it is to summon up the law of trusts"). But the court misunderstood the pertinent common-law principles. In particular, it erroneously analogized the approval of adviser compensation to arm's-length bargaining that precedes the creation of a trust. And it unduly limited the adviser's duty of disclosure.

1. The analogy to arm's-length bargaining over the creation of a trust is inapt

The Seventh Circuit suggested that, under trust law, an investment adviser should be able to "negotiate in his own interest and accept what" the fund's board agrees to pay. Pet. App. 8a. The authorities it cited (*see id.* at 8a-9a) address a quite different situation, however. They address the standard applicable when the document creating the trust establishes a trustee's compensation. Such compensation can be the product of an agreement between the settlor (the person who creates the trust) and the trustee. A potential settlor and a prospective trustee can, before the creation of the trust, engage in arm's-length bargaining over the fee that the potential trustee would receive if it agreed to accept the duties and responsibilities of a trustee. When such arm's-length negotiation occurs between unrelated parties, some cases have enforced that bargain, even if the trustee's compensation appears high compared to what trustees typically receive for similar work. *See Restatement (Second) of Trusts* § 242 cmt. f; *cf.* John H. Langbein, *The Contractarian Basis of the Law of Trusts*, 105 Yale L.J. 625 (1995) (arguing that a trust instrument generally may vary most fiduciary duties imposed by trust law).[26]

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[26] Professor Langbein acknowledges that, even where the trust instrument is the product of arm's-length bargaining, the instrument does not control in all circumstances. *See* Langbein, 105 Yale L.J. at 651 & n.134 ("If the settlor directs an objectively stupid investment policy, the court will direct deviation even though the settlor anticipates the circumstance."); *see also Restatement (Third) of Trusts* § 38 cmt. e ("[i]f 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"). Professor Langbein also

But that rule has no application for the typical captive mutual fund, where the adviser creates the fund and engages in no ex ante bargaining over its compensation. The adviser is in a fiduciary relationship to the fund from the outset. The analogy to arm's-length bargaining between a settlor and a potential trustee is therefore inapt, because the potential trustee ordinarily owes no fiduciary duty to a settlor when negotiating the terms of the trust.[27]

Further, the agreement between the adviser and the fund setting the adviser's compensation is renewed annually. *See* 15 U.S.C. § 80a-15(a)(2). Section 36(b) requires the adviser to behave as a fiduciary during that process. The adviser must provide full disclosure of all material facts – an obligation not imposed on parties negotiating at arm's length – and, even when full disclosure has been made, the transaction must be fair to the fund. *See supra* pp. 21-25. The common law recognizes that negotiations between the trustee and the beneficiary regarding the trustee's compensation trigger those obligations. *See Restatement (Second) of Trusts* § 242 cmt. i (an agreement with the beneficiary regarding the trustee's compensation "will not bind the beneficiary . . . if the

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admits that his analysis, based on the primacy of contract, deviates from traditional understandings of trust law. *See*, *e.g.*, Langbein, 105 Yale L.J. at 644-45 (noting that the traditional "doctrinal account of the trust remains inimical to recognizing the contractarian basis of the trust" and that "present-day doctrine embrace[s] an anticontractarian account").

[27] In the unusual case where a fiduciary relationship does exist between the settlor and the potential trustee, the potential trustee has a duty to ensure that the trust instrument does not provide for unreasonable compensation. *See Restatement (Second) of Trusts* § 242 cmt. f; *Lederman v. Lisinsky*, 112 N.Y.S.2d 203, 205-06 (Sup. Ct. 1952).

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") (citing *Restatement (Second) of Trusts* § 170, the provision governing transactions between trustee and beneficiary).

2. *The court misstated the adviser's duty of disclosure*

The Seventh Circuit stated that § 36(b) requires only that the investment adviser refrain from "play[ing] . . . tricks" or "pull[ing] the wool over" the trustees' eyes. Pet. App. 8a, 13a-14a. That depiction misstates the common-law requirement that § 36(b) incorporates. A fiduciary's duty of disclosure mandates more than the avoidance of "tricks" and other fraudulent behavior. It requires the adviser to communicate "*all material facts* in connection with the transaction." *Restatement (Second) of Trusts* § 170(2) (emphasis added).[28]

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[28] *See*, *e.g.*, *Fogel v. Chestnutt*, 533 F.2d 731, 745 (2d Cir. 1975) (Friendly, J.) ("an investment adviser is 'under a duty of full disclosure'" in "'every area where there was even a possible conflict of interest between [its] interests and the interests of the fund'"; "'[t]he only question can be whether the matter is one that could be thought to be of possible significance'"; and "the communication of information must be 'effective,' bearing in mind that the independent directors are not full-time employees") (quoting *Moses v. Burgin*, 445 F.2d 369, 376-77 (1st Cir. 1971)); *Wendt v. Fischer*, 243 N.Y. 439, 444 (1926) (Cardozo, J.) ("[T]he disclosure to be effective must lay bare the truth, without ambiguity or reservation, in all its stark significance.") (citations omitted); *Restatement (Second) of Agency* § 390 cmt. a (1958) (agent must "disclose to the principal all relevant facts fully and completely" before dealing with the principal, and a "fact is relevant if it is one which the agent should realize would be likely to affect the judgment of the principal in giving his consent").

B. The Court Below Erroneously Treated Board Approval As "Conclusive"

The Seventh Circuit also indicated that, absent evidence that the adviser "pulled the wool over" the trustees' eyes, the fund board's decision to approve the adviser's compensation ordinarily should be treated as "conclusive" under § 36(b). Pet. App. 9a, 13a-14a. That conclusion cannot be squared with § 36(b)'s language and purposes or the common-law principles it incorporates.

Giving conclusive weight to board approval contradicts the express statutory mandate that director approval should be afforded only "such consideration by the court as is deemed appropriate under all the circumstances." 15 U.S.C. § 80a-35(b)(2). Indeed, as this Court has recognized, Congress intended to ensure that director approval *not* be given conclusive weight in litigation challenging the adviser's fee. *See supra* pp. 26-28. Further, the common law recognizes that the beneficiary's consent to a transaction with the fiduciary – which is analogous to director approval – is not conclusive where the beneficiary was not aware of "the material facts" or the transaction "involved a bargain which was not fair and reasonable." *Restatement (Second) of Trusts* § 216(2)(b), (3); *see also id.* cmt. n; III *Scott on Trusts* § 216.3, at 347-48 ("[I]t is not enough that the beneficiary had full knowledge of all the facts and of his legal rights, and that his consent was not improperly induced by the trustee. It is essential also that the [transaction] should be at a price that is fair and reasonable.").

The statute's structure reinforces that conclusion. The ICA requires annual board approval of the adviser's compensation. *See* 15 U.S.C. § 80a-15(a)(2). The 1970 amendments added a requirement that the

adviser provide to the board "such information as may reasonably be necessary to evaluate the terms of any contract whereby a person undertakes regularly to serve or act as investment adviser of such company." *Id.* § 80a-15(c). The Seventh Circuit's conclusion that § 36(b)'s fiduciary duty requires only that the adviser obtain the fund board's approval of the fee after some level of disclosure renders § 36(b) superfluous in light of § 15(c).

Moreover, the facts here illustrate Congress's wisdom in not giving director approval conclusive effect. During much of the relevant period, the chairman of the funds' board of trustees (Victor Morgenstern), who was supposedly a disinterested trustee, was a former partner of Harris with a continuing financial interest in Harris worth hundreds of thousands of dollars per year. *See supra* p. 12.[29] The funds' trustees and Harris personnel also shared numerous conflicting business and personal relationships. *See* JA75-81 (¶¶ 26-47), 364-68 (¶¶ 32-38). As Judge Posner explained, when, as here, "'directors and the management are more connected, advisors capture more rents and are monitored by the board less intensely.'" Pet. App. 40a (quoting Camelia M.

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[29] Although designated as a disinterested trustee, Morgenstern in fact met the ICA's definition of an "interested person" of an investment adviser, which includes "any person who knowingly has any direct or indirect beneficial interest in . . . *any security* issued either by such investment adviser . . . or by a controlling person of such investment adviser." 15 U.S.C. § 80a-2(a)(19)(B)(iii) (emphasis added). The Act broadly defines a "security" as "any note, . . . evidence of indebtedness, . . . or participation in any profit-sharing agreement." *Id.* § 80a-2(a)(36). That definition encompasses Morgenstern's deferred compensation, which is contingent on Harris's revenues. *See* JA73-75 (¶¶ 21-23), 119-22, 128-30 (describing Morgenstern's interest).

Kuhnen, *Social Networks, Corporate Governance and Contracting in the Mutual Fund Industry* (Mar. 1, 2007), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=849705); *see id.* at 38a-39a.

C. The Lower Court's Analogies To Other Sources Of Law Do Not Support The Standard It Adopted

The Seventh Circuit sought to bolster its interpretation of § 36(b) by drawing analogies to other sources of law. But those analogies are unpersuasive.

The court first compared investment-adviser fees to corporate executives' compensation. *See* Pet. App. 9a-10a. Because Congress enacted § 36(b) in response to the inadequacy of existing state corporate-law standards governing excessive-compensation claims – standards that often required a showing of "corporate waste," *Daily Income Fund*, 464 U.S. at 540 n.12 – reliance on those same standards to *narrow* the statute's scope would subvert Congress's purpose. Indeed, Congress's greater concern over the compensation of investment advisers compared to corporate officers' reflects its recognition of the prevailing market forces. As courts and scholars have recognized, conflicts of interest "occur[] much more frequently in the relations between a mutual fund and its investment adviser than in ordinary business corporations." *Fogel v. Chestnutt*, 533 F.2d 731, 745 (2d Cir. 1975) (Friendly, J.); *see* Donald C. Langevoort, *Private Litigation To Enforce Fiduciary Duties in Mutual Funds: Derivative Suits, Disinterested Directors and the Ideology of Investor Sovereignty*, 83 Wash. U. L.Q. 1017, 1032 (2005) ("[t]hinking about mutual funds . . . as a species of 'corporations' . . . is completely misguided").

The Seventh Circuit's analogy to lawyer compensation, *see* Pet. App. 10a, is likewise misplaced. "A

lawyer may not charge a fee larger than is reasonable in the circumstances." *Restatement (Third) of Law Governing Lawyers* § 34 (2000). And special rules apply where a fee agreement is reached "after the lawyer began to serve." *Id.* cmt. c. That standard is the appropriate analogy here because the adviser creates the fund and renews its compensation agreement annually. Fee agreements between lawyer and client reached during the representation "are subject to special scrutiny" and must be "fair and reasonable to the client under the circumstances in which [they were] entered." *Id.* § 18 cmt. e. Further, in determining the reasonableness of a lawyer's fee, courts consider fees agreed to in arm's-length bargains struck at the outset of the representation. *See id.* § 34 cmt. c (courts ask whether "the contract provide[s] for a fee within the range commonly charged by other lawyers in similar representations"); *see also Blum v. Stenson*, 465 U.S. 886, 895 (1984) (holding that "'reasonable fees' under [42 U.S.C.] § 1988 are to be calculated according to the prevailing market rates in the relevant community"). Here, the appropriate point of comparison is arm's-length transactions between investment advisers and unaffiliated clients, not compensation agreements reached during an adviser's relationship with its captive fund.

D. The Seventh Circuit Ignored Congressional Intent

1. The court below also believed that Congress's intentions in enacting § 36(b) were irrelevant: what Congress thought "about the structure of the mutual-fund market" in 1970 should be ignored because "[t]oday thousands of mutual funds compete." Pet. App. 11a. In the court's view, competition among

mutual funds for shareholders constrains adviser fees. *See id.* at 7a, 11a-13a. The Seventh Circuit's reasoning is flawed.

First, courts are not permitted to substitute their own economic analysis for Congress's. If competition in the mutual-fund industry truly has progressed such that § 36(b)'s fiduciary-duty standard does more harm than good, the appropriate remedy is through congressional amendment, not judicial fiat. *See TVA v. Hill*, 437 U.S. 153, 185 (1978) ("It is not for us to speculate, much less act, on whether Congress would have altered its stance had the specific events of this case been anticipated."); *see also General Motors Corp. v. Tracy*, 519 U.S. 278, 308 (1997) ("[T]he Court is institutionally unsuited to gather the facts upon which economic predictions can be made, and professionally untrained to make them.").

Second, the Seventh Circuit's reasoning rests on what Judge Posner described as "an economic analysis that is ripe for reexamination." Pet. App. 37a. As a practical matter, several considerations restrict investors' ability to switch mutual funds in response to high fees. If an individual has owned a particular fund for a sufficient length of time, selling her shares likely would trigger adverse tax consequences. Such considerations might not apply to investors in tax-advantaged plans such as 401(k) accounts. Even so, 401(k) plans and similar investment vehicles often have a limited menu of investment choices that restrict the investor's options to high-priced funds.[30]

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[30] *See* Fiduciary Requirements for Disclosure in Participant-Directed Individual Account Plans, 73 Fed. Reg. 43,014, 43,020 & n.13 (proposed July 23, 2008) (to be codified at 29 C.F.R. pt. 2550) ("A review of the relevant literature suggests that [401(k)]

Third, behavioral economists have demonstrated that most mutual-fund investors do not rationally process fee information, so that the market does not punish high-priced funds in the way the Seventh Circuit speculated it should.[31] Studies show that mutual funds are sold primarily based on past performance, rather than costs, even though costs dramatically affect investors' returns over time.[32]

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plan participants on average pay fees that are higher than necessary by 11.3 basis points per year.") (citing sources).

[31] *See*, *e.g.*, James J. Choi, David Laibson & Brigitte C. Madrian, *Why Does the Law of One Price Fail? An Experiment on Index Mutual Funds* 5 (Mar. 26, 2009) (forthcoming in *The Review of Financial Studies*) (finding that MBA students and undergraduates in elite educational institutions failed to minimize fees when selecting among S&P 500 index funds), http://www.som.yale.edu/faculty/jjc83/fees.pdf; Brad M. Barber, Terrance Odean & Lu Zheng, *Out of Sight, Out of Mind: The Effects of Expenses on Mutual Fund Flows*, 78 J. Bus. 2095, 2098 (2005) (demonstrating that "there is at best no relation, and at worst a perverse positive relation, between fund flows and operating expenses"); *see also* Alan R. Palmiter & Ahmed E. Taha, *Mutual Fund Investors: Divergent Profiles*, 2008 Colum. Bus. L. Rev. 934, 989 (discussing empirical research showing that "many investors still do not make expenses a major factor in their fund choices"); Langevoort, 83 Wash. U. L.Q. at 1033, 1035-36.

[32] *See* U.S. General Accounting Office, *Mutual Fund Fees: Additional Disclosure Could Encourage Price Competition* 72 (June 2000) ("[W]hen evaluating funds, investors generally gave greater consideration to several other factors before considering fund fees. The primary factor investors used in selecting mutual funds was generally the fund's performance."), http://www.gao.gov/archive/2000/gg00126.pdf; U.S. Securities and Exchange Comm'n, Division of Investment Management, *Report on Mutual Fund Fees and Expenses* 3-4 (Dec. 2000) (recognizing that mutual fund expenses are "important because they can have a dramatic impact on an investor's return" – "[f]or example, a 1% increase in a fund's annual expenses can reduce an investor's

Finally, the lower court's economic analysis ignored that brokers distribute most funds.[33] Advisers entice brokers and other intermediaries – through outright payments and indirect compensation – to place investors in their funds.[34] Those payments to brokers, which are often financed by fees charged to fund shareholders (known as "12b-1" fees),[35] significantly affect investors' mutual-fund choices.[36]

2. In declining to follow congressional intent, the Seventh Circuit also suggested that Congress had considered and rejected "language that would have authorized review of rates for reasonableness." Pet. App. 10a-11a. It is true that Congress considered, but did not enact, bills explicitly requiring adviser fees to be "reasonable." But that is beside the point. The pertinent legislative history confirms that Congress intended to incorporate the common-law mean-

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ending account balance in that fund by 18% after twenty years"), http://www.sec.gov/news/studies/feestudy.htm.

[33] One study found that, in 2004, 64% of funds were distributed primarily through brokers. *See* Daniel Bergstresser, John Chalmers & Peter Tufano, *Assessing the Costs and Benefits of Brokers in the Mutual Fund Industry* 6-7 (Sept. 26, 2007) (forthcoming in *The Review of Financial Studies*), http://www.people.hbs.edu/dbergstresser/dbjchpt.pdf.

[34] *See*, *e.g.*, Laura Johannes & John Hechinger, *Conflicting Interests: Why a Brokerage Giant Pushes Some Mediocre Mutual Funds*, Wall St. J., Jan. 9, 2004, at A1.

[35] 12b-1 fees are paid out of fund assets to market the fund to potential investors. *See* William A. Birdthistle, *Investment Indiscipline: A Behavioral Approach to Mutual Fund Jurisprudence* 21-22, 2010 U. Ill. L. Rev. (forthcoming) (discussing 17 C.F.R. § 270.12b-1), http://ssrn.com/abstract=1412878.

[36] *See* Bergstresser at 18 ("sales effort, measured by compensation to brokers through front loads and 12b-1 fees, is positively associated with" investments in funds).

ing of fiduciary duty, which requires full disclosure and substantive fairness in fee agreements.

In its 1966 report that led to the 1970 ICA amendments, the SEC proposed amending the Act to require that all adviser compensation be "reasonable." *See* SEC Report 144. Proposed amendments to ICA § 15 – the provision requiring adviser compensation to be set forth in contracts approved by the fund's board – would have required all adviser compensation to be "reasonable."[37] The investment-company industry opposed the SEC's proposal, and it was not enacted.[38]

In April 1969, one Senator suggested during hearings that the SEC and industry representatives consider whether they could submit a joint proposal based on a fiduciary-duty standard.[39] That suggestion led to extensive negotiations between the SEC and industry representatives, culminating in the submission to Congress of a compromise position, which imposed a fiduciary duty on investment advisers in lieu of the reasonableness requirement that

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[37] *See*, *e.g.*, H.R. 9510, 90th Cong. § 8(d) (1967).

[38] *See Mutual Fund Legislation of 1967: Hearings Before the S. Comm. on Banking and Currency*, 90th Cong. 298-99 (1967) (statement of Joseph Welch on behalf of the Investment Company Institute ("ICI")) (expressing concern about the "vagueness" and "uncertainty of judicial interpretation" of the reasonableness standard); S. Rep. 91-184, at 5 (noting Senate passage of a bill containing reasonableness requirement but that the House took no action on it).

[39] *See* 115 Cong. Rec. 13,646, 13,648 (1969) (statement of Sen. McIntyre); 1969 Hearings 185 (testimony of Hon. Hamer H. Budge, SEC Chairman); *Investment Company Amendments Act of 1969: Hearings Before the S. Comm. on Banking and Currency*, 91st Cong. 193-94 (1969).

initially had been proposed.[40] As both the SEC and industry representatives explained, the fiduciary-duty provision differed from the proposed reasonableness standard in two respects. First, the fiduciary-duty standard placed the focus on the investment *adviser* to fulfill its duty to the fund and the fund's shareholders; the industry had expressed concern that the reasonableness standard would make fund *directors* a target of litigation challenging adviser fees.[41] Second, proponents thought the switch from reasonableness to fiduciary duty would avoid concerns that the legislation was authorizing cost-based rate regulation of the type imposed on public utilities.[42]

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[40] *See* 1969 Hearings 138 (SEC Memorandum), 184-85 (testimony of Hon. Hamer H. Budge, SEC Chairman; Phillip A. Loomis, Jr., SEC General Counsel; and Solomon Freedman, Director of the SEC Division of Corporate Regulation).

[41] *See* 1969 Hearings 188-89 (SEC Memorandum) ("The reasonableness standard was not agreeable to the ICI, although they did not object to the proposition that management fees should be reasonable, because the ICI argued that the earlier standard would focus any court action which might arise on the conduct of the fund directors. The ICI wanted to shift the focus of any litigation in the fee area to the investment adviser. To accomplish this the reasonableness standard was replaced by the standard in H.R. 11995 which specifies that the investment adviser has a fiduciary duty with respect to management fee compensation."); *id.* at 441 (Letter from Robert L. Augenblick, President and General Counsel of the ICI) (fiduciary-duty provision "differs from the 'reasonableness' approach first in a procedural way" – a suit may be brought "only against the adviser or other person who received the compensation").

[42] *See* 1969 Hearings 441 (ICI Letter) (fiduciary-duty standard "not intended to imply that the investment adviser is not entitled to make a profit or to suggest that any type of 'cost plus' contract would be required"); *see also id.* at 189 (SEC Memorandum) ("Investment advisers, like other corporate fiduciaries, such as banks, are entitled to make a profit[.]").

Significantly, both the SEC and industry representatives told Congress that they expected courts to apply traditional fiduciary-duty principles in interpreting the new provision, and both recognized that those principles required not only full disclosure but also substantive fairness. During a committee hearing on a bill containing the fiduciary-duty standard, members of Congress asked the SEC and industry representatives to submit their views on the fiduciary-duty standard and how, if at all, it differed from prior bills containing a reasonableness test.[43] In response, the SEC explained that "a breach of fiduciary duty involving management fees 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."[44] The President and General Counsel of the Investment Company Institute similarly wrote that a fiduciary "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."[45]

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[43] *See* 1969 Hearings 187, 440.

[44] 1969 Hearings 190 (SEC Memorandum); *see also*, *e.g.*, *id.* at 188 ("[t]he Commission views [the fiduciary-duty standard] as a significant and meaningful improvement over the existing law and at least as helpful as the reasonableness standard [in a prior bill]"); *id.* at 190 n.4 (quoting with approval an Illinois Supreme Court decision stating, in the context of defining "fairness," that courts consider "'whether there was full disclosure – *although neither disclosure nor shareholder assent can convert a dishonest transaction into a fair one*'") (quoting *Shlensky v. South Parkway Bldg. Corp.*, 166 N.E.2d 793, 802 (Ill. 1960)) (emphasis added in 1969 Hearings).

[45] 1969 Hearings 441 (ICI Letter); *see also id.* (stating ICI's belief that "the court will look to the general law of fiduciary

Thus, Congress considered but rejected a provision that some feared would have licensed the SEC and the courts to impose a cost-based rate structure on the mutual-fund industry. It instead enacted a statute that, all agreed, directed courts to apply familiar fiduciary-duty principles to investment advisers' compensation.

E. Under A Proper Standard, Petitioners' Evidence Warrants A Trial On The Merits

Petitioners' evidence was more than sufficient to raise genuine issues of material fact for trial.[46]

1. Harris undisputedly charged the Oakmark funds nearly twice as much as or more than it charged independent clients. *See supra* pp. 9-10. The lower court "thr[ew] out some suggestions" (Pet. App. 39a (Posner, J.)) to justify that disparity, saying that "[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 summary judgment for Harris. *Id.* at 39a, 41a.

In fact, the record refutes the speculation that differences in services justify the vastly higher fees

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relationships" and that "[t]he court would undoubtedly consider" both "whether the investment adviser has acted fairly and diligently in supplying information to the Board of Directors of the investment company" and "the substance and quality of the negotiations which led to the contract").

[46] The remanded proceedings would be a bench trial. Courts have held that there is no right to a jury trial in cases under § 36(b), *see, e.g.*, *Kalish v. Franklin Advisers, Inc.*, 928 F.2d 590, 591-92 (2d Cir. 1991) (per curiam), and neither party has requested a jury trial.

charged to the funds. The evidence showed that Harris furnished substantively identical services to its institutional and fund clients. *See* JA353-54 (¶¶ 20-21), 416-17, 449, 475-76.[47] Indeed, expert testimony demonstrated that it in fact costs Harris *more* to serve its institutional clients. *See* JA354-55 (¶ 22), 431-34, 493-96.

An oft-cited journal article claims that many services provided to mutual funds are not furnished to institutional accounts. *See* 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"). That article was funded in part by the mutual-fund industry and co-authored by an expert witness for investment advisers in § 36(b) cases, and therefore its objectivity is unreliable.[48] Regardless, the record in this case refutes the article's supposition that all funds receive additional administrative services in exchange for a higher advisory fee. The evidence shows that the funds pay separate fees for adminis-

[47] *See also* JA505-06 (testimony of Harris's director of research that managers of the mutual funds and the independent accounts share equally all work done by the research department), 512 (testimony of Harris fund manager that, when he buys a stock, he buys it for all mutual funds and independent accounts with the same investment objective); 513-14 (testimony of Harris fund manager that "all of our analysts do research for all of our clients"), 318 (testimony of Harris fund manager that the funds maintain sufficient cash to handle redemptions without having to liquidate securities positions).

[48] *See* Coates & Hubbard 151 n.aa1; *see also* Asher Hawkins, *Well-Funded Opinion*, Forbes (May 8, 2009), http://www.forbes.com/2009/05/07/mutual-funds-fidelity-columbia-business-school-personal-finance-hubbard.html; *cf. Exxon Shipping Co. v. Baker*, 128 S. Ct. 2605, 2626 n.17 (2008) ("declin[ing] to rely on" research "funded in part by" party to the case).

trative services pursuant to separate agreements. *See* JA352-53 (¶ 19).[49] 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.[50] Moreover, even accepting at face value Harris's assertions that it provides additional services to the funds (and ignoring the evidence that the services provided to the institutional clients are more costly), the cost of those additional services is negligible compared to the difference in fees. *See* JA354-55 (¶ 22), 432-33.

In addition, the court below was simply wrong to rely on comparisons between fees paid by the Oakmark funds and other mutual funds. *See* Pet. App. 9a, 30a. Comparing fees paid by two captive mutual funds, neither of which bargains at arm's length with

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[49] JA543-47, 551-55 (transfer agency and service agreement), 556-57 (custodian agreement), 558-60 (administration agreement); *see also* JA531 (investment advisory agreement for Oakmark Fund providing that "the Adviser may receive compensation from the Trust for other services performed by or for the Trust which are not within the scope of the duties of the Adviser under this agreement").

[50] The district court's offhand statement that Harris provided "more limited" services to its independent clients than to the funds (Pet. App. 16a) provided no basis on which to justify summary judgment against petitioners in light of the conflicting evidence. *See*, *e.g.*, *Anderson v. Liberty Lobby, Inc.*, 477 U.S. 242, 249 (1986) ("'[A]ll that is required'" to raise a genuine issue of fact precluding summary judgment "'is that sufficient evidence supporting the claimed factual dispute be shown to require a jury or judge to resolve the parties' differing versions of the truth at trial.'") (quoting *First Nat'l Bank of Arizona v. Cities Serv. Co.*, 391 U.S. 253, 288-89 (1986)). Indeed, the district court also recognized that "the evidence [plaintiffs] have adduced establishes at most that others paid different amounts for *similar services*." Pet. App. 32a (emphasis added).

its adviser, says very little about whether the fees are fair and comparable to what would be charged in an arm's-length transaction. *See Gartenberg*, 694 F.2d at 929; *supra* pp. 29-30. Moreover, giving dispositive weight to that comparison in every case "would be to eviscerate § 36(b)." *Gallus*, 561 F.3d at 823; *see also* Pet. App. 38a, 40a-41a (Posner, J.).

The district court also placed great weight on the funds' performance, focusing solely on the three-year period ending in 2004. *See* Pet. App. 32a. But it ignored that, for the three-year period ending August 31, 2006, which includes most of the damages period, the funds' performance declined significantly. Indeed, the Oakmark Fund was one of the poorest performers in its class over that period, earning a Morningstar Rating of only one star. *See* JA335.[51] Regardless, § 36(b) imposes a fiduciary duty with respect to "compensation," not performance. Focusing on the latter would make poorly performing funds especially vulnerable to suit, a result benefiting neither investment advisers nor investors.

When, as here, there is evidence that an adviser charges its captive funds substantially higher fees than it charges independent clients for comparable services, that disparity between the compensation paid by the captive fund and the compensation negotiated through actual arm's-length bargaining suffices to create a genuine issue of material fact as to whether the adviser has breached its fiduciary duty with respect to compensation.

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[51] The district court refused to consider post-2004 performance because it had concluded, erroneously, that the damages period ended when the complaint was filed. *See supra* note 11.

2. In addition, petitioners adduced substantial other evidence of Harris's breaches of fiduciary duty under § 36(b), *see supra* pp. 9-13, including:

- failing accurately and fully to disclose information about its profitability and economies of scale, *see* JA339-49 (¶¶ 2-14);
- resisting breakpoints on fees, *see* JA349-52 (¶¶ 15-18);
- providing inaccurate and incomplete information about the extent and cost of the services provided to its other clients compared to the mutual funds, *see* JA356-58 (¶¶ 24-25);
- failing to inform the board about the use of a Harris affiliate to double-charge the funds for commissions, *see* JA359-60 (¶ 27);
- causing the funds to pay increased distribution payments to intermediaries who sold shares of the funds, *see* JA360-62 (¶¶ 28-29);
- failing to disclose that one supposedly disinterested trustee earned more than $1.6 million in profits from a real estate transaction involving a Harris partner, *see* JA76 (¶ 28); and
- failing to disclose that three supposedly disinterested trustees were heavily invested in hedge funds managed by a corporate affiliate of Harris, *see* JA80 (¶¶ 42-44), 83 (¶ 50).

Petitioners also demonstrated that Harris violated the ICA's structural protections in multiple ways. *See supra* pp. 12-13, 39 & n.29. They showed that Harris had secured approval of its fees from a group of supposedly disinterested trustees that in fact included a former Harris partner (Morgenstern) who had a continuing financial interest in Harris worth hundreds of thousands of dollars per year, in

violation of § 15(c) of the ICA, 15 U.S.C. § 80a-15(c). Petitioners also demonstrated that Harris had failed to report to the SEC and the investing public its continuing financial relationship with the board's supposedly disinterested chair, in violation of § 34(b) of the ICA, 15 U.S.C. § 80a-33(b).[52]

By failing to discuss that evidence in analyzing petitioners' § 36(b) claim, the Seventh Circuit implicitly deemed it irrelevant (or at least insufficient to raise a triable issue of fact) under the standard the court adopted. For this reason, the lower court's holding is doubly pernicious. It erroneously required shareholders to prove that the adviser "pulled the wool over the eyes of the disinterested trustees" who approved the adviser's compensation, Pet. App. 13a-14a, and then it ignored substantial evidence that Harris engaged in the types of "tricks" that the court suggested would sustain a § 36(b) claim, *id.* at 8a. By upholding summary judgment for respondent, the Seventh Circuit articulated and applied a standard that renders § 36(b) a dead letter.

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[52] The Court need not decide whether a violation of ICA § 15(c) or § 34(b) alone establishes a breach of fiduciary duty under § 36(b) (an issue the court below did not directly address, although it was properly presented). At a minimum, evidence of violations of those provisions is relevant to whether an adviser has breached its fiduciary duty under § 36(b). *See Krinsk*, 875 F.2d at 409 (explaining that trustees' independence is a factor in applying the *Gartenberg* standard); *Gartenberg*, 694 F.2d at 929 (under § 36(b), "all pertinent facts must be weighed"); S. Rep. 91-184, at 15 (courts should "look at all the facts in connection with the determination and receipt of such compensation," including "whether the deliberations of the directors were a matter of substance or a mere formality"); H.R. Rep. 91-1382, at 37 (same).

CONCLUSION

The judgment of the court of appeals should be reversed.

Respectfully submitted,

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