

Mutual fund advisers fees and executive compensation

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ABSTRACT The case of *Jones v. Harris* (2008a) that is currently before the Supreme Court poses issues with regard to mutual fund managers' fees and expense (Advisory Fees). However, the case may signal the direction courts will take in reviewing management compensation of large corporations as well. Advisory Fees pose a number of fundamental issues that appear in many fiduciary relationships. First, why do the fees and compensation of fiduciaries raise unique problems? Second, what are the solutions to the fee problem? Third, what is the role of the courts in the determination of Advisory Fees? Fourth, what are the tests that the courts or the boards of the mutual funds should apply in determining Advisory Fees? Fifth, how did the Seventh Circuit decision in *Jones v. Harris* determine these questions? Sixth, what are the implications of *Jones v. Harris*? In conclusion, by analyzing these questions we might uncover guidelines to the issues with regard to corporate executive compensation as well.

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WHY DO THE FEES AND COMPENSATION OF FIDUCIARIES RAISE UNIQUE PROBLEMS?

Advisers to funds, fund directors and corporate management are fiduciaries. They may have

different tasks and be subject to somewhat different laws. Their compensation poses problems unique to fiduciary relationship. Therefore we start with outlining their fiduciary status.

What constitutes fiduciary relationship?

There are a number of features that characterize fiduciary relationships. First, fiduciaries are people and institutions that offer services. These services are important to the society,

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such as healthcare, legal representation, and business and financial services. It takes years to acquire expertise to master these services. To avoid wasteful duplication, it is in the interests of society to induce its members to use the services of these experts.

Second, in order to perform these services the service givers–fiduciaries must be entrusted with property or power or both. A money manager cannot manage the investors’ money without being entrusted with the money and controlling it. A physician cannot perform surgery without controlling the patient’s body. Lawyers cannot represent the clients’ cases before a court without receiving a power of attorney to do so. Trustees cannot manage trust property and distribute it without being entrusted with assets. Directors and officers of a corporation cannot manage the corporation without entrusted power and money.

Thus, those experts who hold other people’s money or assets received them for the purpose stated in the entrustment, and for the benefit of those named in the entrustment. In fact, people who are allowed to fully benefit from the entrusted money or power are not fiduciaries but the receivers of a gift.

If the fiduciaries use entrusted assets or power for their own benefit or deviate from the entrustment directives, the fiduciaries are in fact misappropriating what does not belong to them. They are liable to pay damages, and sometimes punitive damages. They must account for their illicit profits, if any, and sometimes be punished by imprisonment.

Fiduciary rules are designed to discourage misuse of entrusted property and power by reducing the fiduciaries’ temptations. For example, fiduciaries who wish to buy entrusted property must disclose their conflicts of interest to the entrustors, offer them full information and receive their consent to the transactions.

The problem of fiduciaries’ compensation

Fiduciaries are entitled to make a living. The payment they receive in exchange for their

services is their own. They can do with their pay as they wish. The problem arises when the fiduciaries’ compensation is determined either by themselves or under their strong influence. In many cases the compensation is not negotiated at arm’s length. In these cases the result is a ‘contract’ in which one party – the fiduciary – dictates how much money it would receive from the other party. Advisory fees can be very expensive to long-term investors, calculated as compound interest.

Advisory Fees are offered on a ‘take it or leave it’ basis. In the case of publicly held mutual funds and corporations, shareholders cannot deal with their advisers in arm’s-length negotiations. Fiduciaries to publicly held mutual funds offer investors their services on ‘take or leave it’ terms, including Advisory Fees. One could argue that this offer is similar to contract offers of assets at fixed non-negotiable prices. However, in the case of fiduciary services, investors are in a somewhat different position than shoppers. First, investors cannot evaluate their fiduciaries’ services accurately. The services are to be performed in the future. In addition, fiduciaries are the experts. No matter how much information investors receive they cannot evaluate their fiduciaries’ performance. Even if money managers contributed to higher mutual fund securities prices it is not clear how the rising prices have occurred. Such a rise could have been the result of higher risk-taking that long-term investors pay for dearly.

In addition, after entrustment is made, investors are no longer in a position of shoppers. Their money is now in the hands of their fiduciaries. To be sure, investors in open-end funds can terminate the relationship by redeeming their shares – demanding the pro rata value of their shares.¹ However, termination can be costly for investors, in terms of taxes, time and learning efforts as well as payment to a broker for reinvestment. Therefore, the shopping example is only partially applicable to investors in mutual funds.

More importantly, fiduciaries’ compensation is not subject to market competition. Unlike the sellers of products, who might compete by lowering



their products' prices, fiduciaries do not compete by offering to lower their fees. Rarely do mutual fund advisers advertise: 'We charge the lowest fees for our services'. In fact, the buyers of fiduciary services do not generally look for the least expensive fiduciaries. A patient who can afford surgery does not seek the least expensive surgeon. Investors look for producing and honest managers – not for the least expensive. Successful, expert traders are likely to have more demand on their time and talents. They can raise their fees accordingly. Another reason for avoiding the cheapest fiduciaries is linked to entrustment. If they are so inexpensive, and have control over the investors' assets, perhaps they would be tempted to help themselves to some of the entrusted assets or reduce their attention to performing their tasks. Most importantly, few investors understand the impact of the Advisory Fees on the investors' returns. These fees can amount to enormous percentages when accurately calculated as compound interest. But the idea and the implication are hard to explain.

The danger to the system of mutual funds. Mutual funds, like other financial institutions, are exposed to the danger of runs. When, for incompetence or unrelated reasons, fiduciaries' performance is disappointing, investors might rather withdraw from all advisers rather than seek advisers who charge lower fees. In such an environment as well, Advisory Fees do not play the most important role in the investors' decision, even if they should. Therefore, even though Advisory Fees can be tremendously costly to long-term investors, these fees are not subject to reduction as other fees or asset prices usually are in the markets.

WHAT ARE THE SOLUTIONS TO THE FEE PROBLEM?

The legislative and judicial solution for mutual fund investors

In the 1930s, as investors fled the financial markets, mutual funds dwindled. The Investment Company Act of 1940 was passed, among other

reasons, to raise investors' trust in mutual fund management. The Act established a corporate structure and a board of directors (including a percentage of directors that are unaffiliated with the advisers), to represent the investors' interests. The managers' investment discretion is limited to particular investment policies described in the company's registration statement (15 U.S.C. §§ 80a-8(b), -35(a), 2006). The advisers' contract with the funds must be approved by the majority of the independent directors (15 U.S.C. § 80a-15(c), 2006). Advisers must bear heavy disclosure duties to the directors with respect to the contract (15 U.S.C. § 80a-15(c), 2006).

The passage of section 36(b)

In the 1970s the securities market prices fell and with them the size and number and amounts managed by mutual funds shrank. It was during that period that the industry did not strongly object to controlling its fees. Its need for investors' trust was greater. In 1970, Congress added a detailed provision regarding the managers' fees and expenses. Section 36(b) of the Investment Company Act of 1940 (15 U.S.C. § 80a-35(b), 2006) imposed a fiduciary duty on the managers with respect to 'excessive' fees and expenses. This section is unique. *It imposes a fiduciary duty on advisers with respect to the Advisory Fees.* It requires the funds' directors to negotiate the fees. And it authorizes the shareholders to sue directly rather than derivatively, subject to certain limitations. Pursuant to claims under this section, a number of courts outlined for mutual fund directors the considerations and information that they should seek and examine before they approve the managers' fees and expenses (Gartenberg, 1982; *Krinsk v. fund Asset Mgmt., Inc.*, 875 F.2d 404 (2d Cir. 1989). 1989). The outline was followed by many courts, although some were more demanding of the directors (Gallus, 2009, pp. 823–824)² and some less limiting (Freeman and Brown, 2001, pp. 644–650).³ This section was enacted notwithstanding the fact that investors could redeem their shares.

THE ROLE OF THE COURTS UNDER SECTION 36(B) OF THE INVESTMENT COMPANY ACT OF 1940

The fees that fund advisers charge are traditionally measured as a percentage of the assets under management. This measure was similar to that charged by trustees (Frankel and Schwing, 2001 and Supp. 2009, vol. 2, § 12.03[A], pp. 12–59). The measure is designed to give incentive to the advisers to increase performance and share in the rich results.

From the 1940s to the 1960s, the courts applied corporate law principles to investors' complaints about high advisory fees by fund advisers. Investors could succeed only if they showed that the fees were unconscionable and shocked the conscience. None of the courts found such an offensive degree of fees charges; however, after the Plaintiffs lost the cases, the parties usually agreed to lower the fees at cutoff points as the funds grew larger (Frankel and Schwing, 2001 and Supp. 2009, vol. 2, § 12.03[C], pp. 12–74 to –76). Sales and performance fed the funds assets, but in the 1970s mutual funds assets shrank with the falling prices of equities. At this point Congress passed a number of amendments to the Act, and among them introduced section 36(b) (Investment Company Amendments Act of 1970, 1970; 15 U.S.C. § 80a-35(b), 2006; Frankel and Schwing, 2001 and Supp. 2009, vol. 2, § 12.03[D], pp. 12–76 to –77). This section provides:

(b) Compensation or payments as basis of fiduciary duty; civil actions by Commission or security holder; burden of proof; judicial consideration of director or shareholder approval; persons liable; extent of liability; exempted transactions; jurisdiction; finding restriction. For the purposes of this subsection, the investment adviser of a registered investment company shall be deemed to have a fiduciary duty with respect to the receipt of compensation for services, or of payments of a material

nature, paid by such registered investment company, or by the security holders thereof, to such investment adviser or any affiliated person of such investment adviser. An action may be brought under this subsection by the Commission, or by a security holder of such registered investment company on behalf of such company, against such investment adviser, or any affiliated person of such investment adviser, or any other person enumerated in subsection (a) of this section who has a fiduciary duty concerning such compensation or payments, for breach of fiduciary duty in respect of such compensation or payments paid by such registered investment company or by the security holders thereof to such investment adviser or person. With respect to any such action the following provisions shall apply:

(1) It shall not be necessary to allege or prove that any defendant engaged in personal misconduct, and the plaintiff shall have the burden of proving a breach of fiduciary duty.

(2) In any such action approval by the board of directors of such investment company of such compensation or payments, or of contracts or other arrangements providing for such compensation or payments, and ratification or approval of such compensation or payments, or of contracts or other arrangements providing for such compensation or payments, by the shareholders of such investment company, shall be given such consideration by the court as is deemed appropriate under all the circumstances.

(3) No such action shall be brought or maintained against any person other than the recipient of such compensation or payments, and no damages or other relief shall be granted against any person other than the recipient of such compensation or payments. No award of damages shall be recoverable for any period prior to one year before the action was instituted. Any



award of damages against such recipient shall be limited to the actual damages resulting from the breach of fiduciary duty and shall in no event exceed the amount of compensation or payments received from such investment company, or the security holders thereof, by such recipient

(c) Corporate or other trustees performing functions of investment advisers. For the purposes of subsections (a) and (b) of this section, the term ‘investment adviser’ includes a corporate or other trustee performing the functions of an investment adviser.

There is no doubt that fund directors are fiduciaries to the funds, and indirectly to their shareholders. If section 36(b) requires fund directors to evaluate whether the Advisory Fees and expenses are excessive under section 36(b), the courts have a role of evaluating the directors’ performance. Had only corporate law applied to fund directors, there is doubt whether the courts would have rigorously evaluated the directors’ decision. Courts have tended to adopt a ‘hands off’ attitude to the directors’ decisions, provided the directors had no conflicts of interest and were not negligent in reaching their decisions (*In re Caremark Int’l Inc. Derivative Litig.*, 1996). The courts’ reluctance to interfere in the directors’ decision is especially strong when the issue involves a business judgment such as an evaluation of prices.

However, the ‘Business Judgment Rule’ was not strictly adopted in the case of mutual funds. First, the directors’ mandate extends to the entire relationship with the fund adviser. They are the ones that sign the contract with the advisers. The contract terms are regulated by section 15 of the Investment Company Act. The adviser is required to offer particular information to the board of directors, and the majority of the independent directors must approve the contract terms (15 U.S.C. § 80a-15, 2006; Frankel and Schwing, vol. 2, § 12.01[B], at 12-7 to -12). Thus, unlike corporate directors’ decisions, directors’ decisions regarding the relationship

of the funds with the adviser are regulated, and the fund directors’ decision under section 36(b) is further singled out with respect to excessive Advisory Fees and expenses. The section seems to reflect the important role of the directors as agents for the funds and indirectly their investors. At the same time, the Business Judgment Rule may apply to mutual funds.

A view of the negotiating power of the directors as against incumbent management reveals a fundamental weakness. The weakness that directors face in their negotiations is that management will leave. Even though CEOs do not own the operational mechanisms of corporations, as advisers to mutual funds do, the CEOs’ departure must be planned for a smooth transition, especially if the corporation has not prepared an alternative to the leaving CEO. Nonetheless, there are many candidates for the position from both inside and outside the organization, and the board is not entirely helpless.

The directors of mutual funds face a far more serious issue. Even though they have the authority to terminate or not renew the contract between the funds and the advisers, they might cause serious harm to the funds’ shareholders.

Unlike most other non-financial and financial corporations, *fund advisers own the entire operational support and management of the mutual funds.* The fund advisers and not the boards control the management and sales mechanisms of the shares. Introducing other managers and their systems of operations may not be a single day’s smooth operation. Leaving portfolios without a directing hand may cause investors serious damage. In addition, hiring other advisers can destroy the funds. Advisers may have different communications systems, different contacts with the investors and personnel. When advisers are terminated the entire infrastructure of the funds is gone. Funds that hold equities cannot be left without management for even a short while. The time required to change the communication and investment contact systems of the mutual funds could cause funds

without management significant losses. The investors' cost of such termination may be too high. Therefore it is not satisfaction with the adviser but the consequences of terminating the advisers that may keep advisers at the helm.⁴ At the same time, the threat of termination and the threat of public arguments on the fee issue may lead to investors' reaction and withdrawal. This prospect is not palatable to the fund advisers. Therefore, the directors are not entirely helpless in their negotiations.

Be that as it may, section 36(b) established (1) a fiduciary duty of the advisers with respect to Advisory Fees, (2) the directors' function in evaluating the fees, and (3) a judicial role in supervising the directors in their decision with regard to the Advisory Fees. The courts' role is demonstrated by providing investors with a direct cause of action to argue that the advisers violated their fiduciary duties with respect to the Advisory Fees. The door to the courts cannot be closed by characterizing the investors' cause of action as derivative, thus allowing the courts to send the investors back to the board.

What Are the Tests that the Courts or the Boards of the Mutual Funds should Apply in Determining Advisory Fees? The *Gartenberg v. Merrill Lynch Asset Management, Inc.* Case and Its Progeny

In 1984 the Federal Second Circuit Court faced squarely the issue of interpreting section 36(b) in the case of *Gartenberg v. Merrill Lynch Asset Management, Inc.* (1982). The court took an active role in the evaluation of the Advisory Fees and outlined for the fund directors a list of factors to consider in determining whether the Advisory Fees and expenses were excessive. This case was followed by other courts, all of which have given the directors guidelines on making the fee determination. There were variations among these guidelines, but none was drastic.

Under *Gartenberg* the directors had to consider the following factors: the nature and quality of the services, the profitability of the adviser, the fall-out benefits to the adviser from the management of the mutual fund, the economies of scale that the size of the fund assets produced and whether the adviser has appropriated all these economies or shared them with the funds, and the nature of the directors' decision-making in terms of the directors' expertise, the information that they received, and the degree of care and conscientiousness with which they performed their duties.⁵ Most cases that followed focused on these guidelines. Some courts, however, were more intrusive.

The Eighth Circuit,⁶ for example, held that fund directors ought to seek information about the fees that the advisers charge to other than mutual funds for the same service, such as the charges to pension funds that have a stronger bargaining position.

The Case of *Jones v. Harris*

History

Jones v. Harris (2008a) is a case brought pursuant to section 36(b) of the Investment Company Act of 1940, claiming that the adviser charged the investor excessive fees. One of the arguments of the Plaintiffs in this case was that the directors, who approved the fees, failed to take into consideration the difference between the charges that the mutual fund shareholders paid as compared to far lower charges on pension funds *for precisely the same services*. In addition, the Plaintiff argued that the *Gartenberg* guidelines were too narrow and that the directors should have included additional considerations as one would in an arm's-length bargain (Jones, p. 631).

The District Court denied the Plaintiff's claim, and the Plaintiff appealed to the Court of Appeals of the Seventh Circuit (Jones, 2008a).⁷ The Seventh Circuit denied the Plaintiff's claim, and the Plaintiff sought a rehearing. The court denied the Plaintiff's request for a rehearing and



the Plaintiff sought an appeal to the Supreme Court. The Supreme Court granted *certiorari*. The Court usually receives about 10000 requests a year and chooses about 80 cases for a hearing (Supreme Court of the United States, n.d.).⁸ The *Jones v. Harris* case was one of the chosen 80. There were a number of briefs (*amici* briefs) by academics, supporting one or the other party, and one brief by the government in support of the Plaintiff's position.

The rationale of the Seventh Circuit's decision

In *Jones v. Harris* the majority in the Seventh Circuit did not follow the *Gartenberg* analysis and approach. In fact the Seventh Circuit declared *Gartenberg* to be dead. Further, the majority of the court knowingly rejected the directives of section 36(b), holding that

1. courts should not set fees;
2. the Investment Company Act of 1940 statute is old, and today's environment allows the shareholders to vote with their feet;
3. fiduciary relationships are contracts that shift the duty to disclose material facts to the other party (the fiduciary);
4. competition among mutual funds – the market for fund shares – will contain Advisory Fees. After all, investors have a choice among 8000 competing funds; they can shop around for the cheapest fund;
5. relying on one research suggesting that investors know and evaluate the prospectus materials they receive and available information, the majority implied that there is no need for directors' determination or for judicial directives to the directors. Consequently, the board of directors does not have a role to play in the fee saga. The market will take care of the fee issue.

Each of these conclusions is faulty

- (1) *Courts should not set fees.*

The Seventh Circuit held that courts do not set prices. That is true, unless the legislature

specifically and clearly so provides. The tendency in this country is to avoid setting prices and to rely on the markets (Jones, 2008a, pp. 632–633).⁹ Hence, the court's decision comports with the general policy.

However, section 36(b) does not require nor suggest that the courts should set Advisory Fees. The determination of the amount of fees is left with the board of directors. The courts are required to evaluate the directors' decision and determine whether they, as fiduciaries, have done their duties. This is what the *Gartenberg* decision in fact does. It guides the directors in their decision regarding the fees.

(2) *The court discounted the legislative history both because it is unclear and mainly because of the passage of time and the differences in the marketplace and the number of the mutual funds* (Jones, 2008a, p. 633).

The majority of the court emphasized that the Investment Company Act of 1940 statute is old, and today's environment enables fund shareholders to vote with their feet. This argument is unacceptable. Even though the Investment Company Act of 1940 is old in our system the courts are not the ones to determine whether acts of Congress should be ignored because of age. Indeed, courts have the power to strike acts of Congress, but not because they are old (Paulsen, 1993).¹⁰

(3) *Fiduciary relationships are contracts that shift the duty to disclose material facts to the other party.*

Fiduciary relationships are not contracts that shift the duty to disclose material facts to the other party. The court relied on a historian scholar's opinion that fiduciary law is a contract, citing to the nineteenth-century scholar (Jones, 2008a, p. 632).¹¹ This citation is surprising in light of the court's rejection of a 60-year-old American statute. Fiduciary duties are far more extensive (Frankel, 2008). Their violations are stricter, including punitive damages as well as imprisonment.¹² The opinion of the majority of the Seventh Circuit is not shared by most other courts (Jones, 2008b, p. 729, Posner, J., dissenting, citing cases). It also

carried a strong dissent by one of the founders of the law and economics movement, Judge Richard Posner (Jones, 2008b, pp. 729–733, Posner, J., dissenting).

The nature of the disclosure that the majority of the Seventh Circuit suggests may not lead to relieving fund advisers. There are two questions – not one – that potential buyers of services may ask advisers. First, How much will the service cost *me*? Second, How much does the provision of the service cost *you*? What are your profits? In this respect fiduciary relationships differ from the sale of assets. Section 36(b) and the *Gartenberg* case seem to focus on the second question. The Seventh Circuit decision seems to eliminate the second question and focus on the first. Advisers, in this court's view, are businesses-selling commodities (Frankel, 2006/2007). It is the information about 'how much you are charging me' that allows the investors in 'the market' to determine whether to buy or redeem the shares of the investment company – to vote with their feet. The profits of the adviser are not relevant. In fact, fund advisers will be entitled to make as much profits as they can subject to antifraud rules. Further, it is fund advisers who determine what services to offer the shareholders and charge for the 'market price' regardless of how much the services cost to the adviser.¹³ Thus, advisers have the right to offer services of any kind, charge the market price and no one may ask them about their profits.

Assuming that this is one result of the *Jones* case, fund advisers must disclose properly and fully (1) the amounts they charge the funds and perhaps (2) the services for which the amounts are charged, unless the adviser provides a lump sum 'for everything'. And perhaps, although that is less certain from the Seventh Circuit decision, the fund advisers must (3) tell the shareholders how much the usual market price for such services is. This condition is less certain if advisers can make 'hard bargains' or offer their services on a 'take it or leave it' basis.¹⁴ Investors will then compare this information with the one that is offered by other advisers.

When the services differ, more evaluation is required to determine the true charge.

Consequences for funds that have a board of directors. Regardless of the validity of the approach and its consequences, the Seventh Circuit decision results in implications to the independent directors and to the examiners of the Securities and Exchange Commission. A careful negotiator who is not willing to succumb to an adviser's 'hard bargain' will try to find out whether and how much the fiduciary gains, and not only how much it charges. If so, the board might have to continue asking all the *Gartenberg* questions in order to determine whether the fees are reasonable. There are a number of reasons for the duty, and broadening the practice. First, the services that the adviser might add to the menu and with additional charges may, in the opinion of the board, be unnecessary and could be eliminated in light of the price. Second, the benefits to the adviser from certain services should be reduced because indirectly the shareholders pay for them. For example, fund payments to brokers for the sale of fund shares should be re-assessed to determine what the shareholders receive for the payments as compared to what the advisers received for the payments. Thus, it behooves the boards to continue to ask the *Gartenberg* questions because the board (not the court) is not fully responsible for representing the shareholders in 'hard bargains' with the adviser.

(4) *Competition among mutual funds – the market for fund shares – will contain Advisory Fees*

After all, investors have a choice among 8000 competing funds; 8000 funds compete on business and will reduce the fees to attract investors.

The court misread the market for mutual funds and the nature of the fund advisers' competition. To be sure, there are about 8000 funds. However, the number of funds that are of the same kind and could be competitors is far smaller, as they have different purposes and involve different costs. Comparing the fees charged by thousands of funds is time-consuming. Moreover, there are obstacles to



voting with dollars. What holds the investors from voting with their dollars is not necessarily happiness and satisfaction with fund Advisory Fees. Investors may be bound by tax discounts (Choi and Kahan, 2007, p.1023, n. 19)¹⁵ of certain plans, by the tax payments on the sale of their shares (Choi and Kahan, 2007, p. 1023; I.R.C. § 1001, 2009).¹⁶ Investors may be constrained under the limiting terms of plans, such as pension plans (I.R.C. § 401(a), 2009).¹⁷ These are the major deterrent to sale of fund shares.

Further, investors can indeed 'vote with their feet' and redeem their shares. (Warburton, 2008). However, if they do, they may destroy not only the mutual fund operators but the securities markets as well. On the other hand, the vision of the Seventh Circuit court is the scariest of all its other points. No one, not even that court, should ever hope for investors to vote with their feet. As effective and wonderful as markets are, they do not provide protection for the financial system. If a large number of investors who are foolish enough not to know how much they pay for fund management and how much it truly costs them begin to doubt the fund manager's trustworthiness, and if investors believe that fund advisers are striking 'hard bargains' and charge excessive fees, shareholders may create an avalanche of redemption and truly vote with their feet. The markets will indeed be effective and efficient: they will cease to exist. If the current experience of vanishing liquidity did not teach us this lesson, then what will? The assumption that markets means orderly, balanced markets is not borne in reality.

The required information substituting for fiduciary duties may impose significant burden on fund advisers. Perhaps the Seventh Circuit did not reduce the burden of fund advisers to provide relevant information to the shareholders (who can vote with their feet). It may be assumed that the same burden would also lie towards the board of directors who sign the advisory contract.

It is unlikely that the Seventh Circuit eliminated the duty of the adviser to provide the

relevant information to the board (Jones, 2008a, at 632).¹⁸ The court may have disavowed its own function of evaluation of the fees and expenses but not that of the board (although it emphasized the 'vote' of the shareholders). Presumably, the difference between two market actors on the one hand and negotiations between actors and fiduciaries on the other is to shift the burden to ask for information (caveat emptor) and impose a duty on the fiduciary fund advisers to provide the information. If that is the case, what information should a fund adviser provide without being asked? And what information should the board seek, which the adviser has to provide?¹⁹

Under the Seventh Circuit decision, investors will be entitled to information on the number of dollars and perhaps a percentage of dollars they hold, representing the cost of the services they are getting. They can then compare the information with the cost in other funds.

(5) *Relying on one research suggesting that investors know and evaluate the materials they receive in the prospectus, the majority implied that there is no need for directors' determination or for judicial directives to the directors.*

The Seventh Circuit rejected the *Gartenberg* approach (Jones, 2008a, p. 632). In essence the court made a fundamental change to the approach, from which all other changes followed. If the market evaluates Advisory Fees then whether fees are excessive is not an issue for the court nor for the board of directors to decide. 'Hard bargains' by an adviser do not violate the directives of the Act. Investors examine the fees, the court held, relying on a recent careful study (Jones, 2008a, p. 634).²⁰ Market pressures on the fees are high enough.

This conclusion is not borne in reality. Fund advisers do not compete on their fees. They compete on performance (United States General Accounting Office, 2000). Besides, most fund shares are not traded. They are redeemed. Therefore, the information about the fees is not represented by market prices but must be gleaned from comparisons among funds.

Investors who have bargaining power, such as pension funds, do bargain for lower fees *for the same services*, but their bargains are not necessarily public.

Therefore, it seems that the Seventh Circuit did not reduce the burden of the fund adviser to provide relevant information to the shareholders (who can vote with their feet) (Jones, 2008a, p. 632).²¹ It may be assumed that the same burden would also lie towards the board of directors who sign the advisory contract. The court disavowed a judicial evaluation of the fees and expenses but not that of the board (although it emphasized the ‘vote’ of the shareholders). Presumably, the difference between two market actors and negotiations between actors and fiduciaries is the shift of the burden to ask for information (caveat emptor) to the duty of the fiduciary to provide it. If that is the case, the question is what information must the adviser provide without being asked, and what information can the board ask for, which the adviser has to provide.²²

The result of the *Harris* decision may be to tighten and raise the duties and liabilities of independent directors of mutual funds. That is, unless the Supreme Court determines that, in this fiercely competitive market that drives the advisers to highlight their fees and reduce them, the shareholders do not need board representation, and that the boards’ duties should be reduced accordingly.

CONCLUSION

Jones v. Harris is important beyond the context of mutual fund managers because it poses a general question on the role of the courts in guiding boards of directors with respect to the compensation of CEOs and top management of large corporations. With respect to corporate executive compensation there is no statute similar to section 36(b) of the Investment Company Act. In the past the courts withdrew from interfering with the corporate directors’ discretion. There developed a practice of hiring third-party experts on whom the directors have relied. Rules following the

recent Sarbanes–Oxley Act (2002) require the establishment of a special directors’ committee to deal with this subject.²³ But the courts have rarely interfered in the judgment of this committee (Melbinger, 2007). Nonetheless, there are public arguments that management’s compensation is too high, and that the judgment of many directors is biased on this issue because they themselves were and are managers.

These days the government is involved in the compensation issue because it is a significant shareholder of very large corporations that needed the handout of the taxpayers’ money (Goldfarb, 2009).²⁴ Even so, some banks and corporations that have received government support have repaid the money owed to the government to free themselves of the constraints on paying management handsomely (Kouwe, 2009).²⁵ Bank of America’s consent to paying high bonuses to acquired Merrill Lynch top management is currently investigated by the Attorney General of New York, and was perhaps one of the causes for the retirement of Bank of America’s CEO (Augstums and Bernard, 2009). In this case the court took the unusual step of denying the settlement of the SEC and the bank (SEC, 2009).²⁶ *Jones v. Harris* brings the issue before the Supreme Court.

NOTES

- 1 Investors in closed-end companies can sell their shares to other investors, depending on the market price of the shares (which may be below the pro rata value of the shares).
- 2 The case held that the lower court ‘erred in rejecting a comparison between the fees charged to [adviser’s] institutional clients and its mutual fund clients’ and that ‘[the adviser’s] conduct must be evaluated independent from the result of the negotiation’.
- 3 The article summarizes post-*Gartenberg* cases (Freeman and Brown, 2001, pp. 644–650). ‘Post-*Gartenberg* courts have ... denied the relevance of advisory fee structures actually set by arm’s-length bargaining ...’ (Freeman and Brown, 2001, p. 651).



4 Mutual fund advisers view the operation as their own business, and to some extent they are correct. They started the advisory business, took the risk of failure and own the infrastructure of the funds. Therefore, they are not likely to easily and happily hand over the controls of the funds' managements to others, regardless of the decision of the funds' boards.

5 See also Krinsk (1989).

6 As the Eighth Circuit has recently held, in the nation's first-ever ruling in favor of a mutual fund shareholder in section 36(b) litigation, the impact of these economic infirmities can readily be observed and addressed when a court considers the actual operations of funds. See Gallus (2009).

7 The 2008 decision reversed the District Court decision (Jones, 2007).

8

The Court's caseload [is] more than 10 000 cases on the docket per Term Plenary review, with oral arguments by attorneys, is granted in about 100 cases per Term. Formal written opinions are delivered in 80 to 90 cases. Approximately 50 to 60 additional cases are disposed of without granting plenary review.

9 The opinion provides examples.

10 '[W]e have numerous statutes that are 100 or 200 years old. They ... remain valid whether or not Congress would adopt them afresh today. Age alone does not repeal consent'.

11 527 F.3d at 632. The opinion cites Langbein (1995), which quotes Maitland (1936/1909).

12 Frankel (1995).

13 This is the same attitude that the Court took in *Wsol* (2001), holding that, as a result, there may be a breach of fiduciary duty without remedy.

14 To be sure, under the Advisers Act of 1940 and the 'Brochure Rule' that registered advisers must provide potential clients a brochure, the advisers must also state whether their charges are higher than the

market charges (set at 3 per cent) (17 C.F.R. § 275.204-3, 2009) (incorporating by reference Form ADV. pt. II, <http://www.sec.gov/about/forms/formadv-part2.pdf>, accessed 16 October 2009)). However, because the Investment Company Act does not make such a requirement, it is doubtful whether disclosure by a fiduciary should include how much others (its competitors) are charging. The shareholders have enough information and 8000 funds that fiercely compete with each other will make this information available to investors.

15 '[C]apital gains from the redemption of mutual funds held in a qualified pension plan or an individual retirement account are not taxable' (citing I.R.C. §§ 401(a), 408, 408A, 2009).

16 Section 1001 of the Internal Revenue Code determines the amount of and recognition of gain or loss on disposition of property (I.R.C. § 1001, 2006). Investors 'face ... adverse tax consequences if they redeem shares in mutual funds' (Choi and Kahan, 2007, p. 1032) (citing I.R.C. § 1001, 2006).

17 The subsection sets out requirements for qualification for qualified pension, profit-sharing and stock bonus plans.

18 'A fiduciary must make full disclosure and play no tricks but is not subject to a cap on compensation'.

19 Although the court may eliminate the duty to disclose under section 36(b), section 15(c) remains to impose some duties on the adviser (15 U.S.C. § 80a-15(c), 2006).

20 The court cited Coates and Hubbard (2007).

21 'A fiduciary must make full disclosure and play no tricks but is not subject to a cap on compensation'.

22 Although the court may eliminate the duty to disclose under section 36(b), section 15(c) remains to impose some duties on the adviser (15 U.S.C. § 80a-15(c), 2006).

23 The Act required the SEC to 'direct the national securities exchanges and national securities associations to prohibit the listing

- of any security of an issuer that is not in compliance with the requirements of' the audit committee standards of the Act (Sarbanes–Oxley Act, pp.116 Stat. at 775–76 (codified at 15 U.S.C. § 78j-1(m), 2006); Securities and Exchange Commission, 2003a (codified as amended at 17 C.F.R. § 240.10A-3, 2009) (SEC rule), The NYSE standards 'require[...] each issuer to have a compensation committee composed entirely of independent directors that, either as a committee or together with the other independent directors, determines and approves the CEO's compensation'. The Nasdaq standards generally 'require[...] the compensation of the CEO and other executive officers of an issuer to be determined or recommended to the board for determination either by a majority of independent directors or by a compensation committee comprised solely of independent directors' (Securities and Exchange Commission, 2003b).
- 24 '[T]he economic crisis has left the US government as the part-owner or controller of an unprecedented array of financial companies'.
- 25 Four billion dollars in profits have been 'collected from eight of the biggest banks that have fully repaid their obligations to the government'; profits 'spurred hopes that the government could soon get out of the banking business'.
- 26 This case is before the court awaiting trial (SEC, 2009, ★15) (directing parties to file 'a jointly proposed Case Management Plan that will have this case ready to be tried on 1 February 2010').

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