MUTUAL FUND ADVISORY FEES: AN OBJECTIVE FIDUCIARY STANDARD

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ABSTRACT

Mutual funds are structurally different from other corporations. The corporation or trust is controlled by an external entity: an investment management firm that profits from fees charged to manage the fund's portfolio. Recognizing this fundamental conflict of interest, in 1970 Congress made investment management firms fiduciaries with respect to fees charged their captive funds. In the nearly fifty years since then, the courts have interpreted their fiduciary duty so narrowly that no plaintiff has met the judicially established fiduciary standard. This paper presents and analyzes empirical evidence on advisory and sub-advisory fees and shows how the courts and the Securities and Exchange Commission can better enforce the fiduciary duty imposed on investment management firms.

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I. INTRODUCTION

The Supreme Court has recognized that the forces of arm's length bargaining do not operate in the determination of mutual fund advisory fees.[1] The reason for this is well-known: mutual funds are captives of the investment management firms that bring them into existence and manage their portfolios. As a result, there is an unseverable relationship between investment management firms, also known as fund sponsors, and their captive funds.[2] Essentially, each mutual fund faces a monopoly seller of investment advisory services.[3]

Studies by the Wharton School[4] and the Securities and Exchange Commission[5] in the 1960's showed mutual fund investment management fees much higher than investment management fees on portfolios where arm's length bargaining was present. This led to the 1970 amendments[6] to the ICA[7] whereby Congress made investment management firms fiduciaries with respect to fees and gave fund investors a private cause of action against excessive fees.

Prior to the 1970 amendments, fund investors were unsuccessful in challenging fees principally because the applicable standard was one of corporate waste wherein the fee needed to be so high that it shocked the conscience of the court.[8] Congress made clear that its intent was for

1. Jones v. Harris Assocs. L.P., 559 U.S. 335, 338 (2010) (citing Burks v. Lasker, 441 U.S. 471, 481 (1979)).

2. Gartenberg v. Merrill Lynch Asset Mgmt., 694 F.2d 923, 929 (2d Cir. 1982).

3. The terms "advisory fee" and "investment management fee" are used interchangeably throughout this paper.

4. WHARTON SCH. OF FIN. & COMMERCE, A STUDY OF MUTUAL FUNDS, H.R. REP. NO. 87-2274 (2d Sess. 1962) [hereinafter WHARTON REPORT].

5. U.S. SEC. & EXCH. COMM'N, PUBLIC POLICY IMPLICATIONS OF INVESTMENT COMPANY GROWTH, H.R. REP. NO. 89-2337 (2d Sess. 1966) [hereinafter PPI STUDY].

6. Investment Company Amendments Act of 1970, Pub. L. No. 91-547, 84 Stat. 1413 (1970) (codified as amended at 15 U.S.C. § 80a-35(b) (2006)) [hereinafter *1970 amendments*].

7. Investment Company and Investment Advisor's Act of 1940, Pub. L. No. 76-678, 54 Stat. 789 (1940) (codified as amended at 15 U.S.C. §§ 80a-1 to 80a-*52 (2012)*) [hereinafter *1940 ICA*].

8. *See* Saxe v. Brady, 184 A.2d 602, 610 (Del. Ch. 1962) (evaluating the compensation stipulated by an advisory contract using the corporate waste standard); *see also* PPI STUDY, *supra* note 5, at 142 (discussing that advisory fees will not be challenged

advisory fees to be fairer and that the corporate waste standard was too restrictive. It did not articulate a fiduciary standard for the revised statute because it thought existing fiduciary standards would apply.[9] Instead, after the 1970 amendments, the judiciary established a unique fiduciary standard to gauge the excessiveness of advisory fees under the newly created statute. In doing so the courts effectively ignored the existing corporate fiduciary standard established in *Pepper v. Litton*, stated as whether under all the circumstances "the transaction carries the earmarks of an arm's length bargain."[10]

In *Gartenberg v. Merrill Lynch*, the Second Circuit Court of Appeals, defying the expressed desire of Congress to use the already-established fiduciary standard, established a fiduciary standard that in operation has had an impact similar to the corporate waste standard. The appellate court in *Gartenberg* initially modified the *Pepper v. Litton* fiduciary standard slightly: "the test is essentially whether the fee schedule represents a charge within the range of what would have been negotiated at arm's-length."[11] The notion of a range of fees implicitly introduces a new, mathematical dimension to the *Pepper* standard but is otherwise consistent with the notion of "earmarks of arm's length" negotiations. However, the *Gartenberg* court then determined that the appropriate standard was that "the adviser-manager must charge a fee that is *so* disproportionately large that it bears no reasonable relationship to the services rendered *and* could not have been the product of arm's-length bargaining."[12] The *Gartenberg* standard has proved to be an insurmountable obstacle for plaintiffs in § 36(b) cases. No plaintiffs have ever received an award under the statute.[13] In that sense, the *Gartenberg* standard is indistinguishable from the corporate waste standard that Congress explicitly criticized. As Lyman Johnson has commented: "Either no adviser has breached its fiduciary duty by charging an excessive fee or something is amiss under section 36(b)."[14]

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unless the courts consider them to be shocking).

9. *See* Amy Y. Yeung & Kristen J. Freeman, *Gartenberg, Jones, and the Meaning of Fiduciary: A Legislative Investigation of Section 36(B)*, 35 DEL. J. CORP. L. 483, 488 (2010) (explaining that the statute that provided a private right of action against advisers for breach of fiduciary duties did not actually define "fiduciary duty").

10. Pepper v. Litton, 308 U.S. 295, 306-7 (1939).

11. Gartenberg v. Merrill Lynch Asset Mgmt., 694 F.2d 923, 928 (2d Cir. 1982).

12. *Id.*

13. *See* JAMES D. COX ET AL., SECURITIES REGULATION: CASES AND MATERIALS 1109 (6th ed. 2009) (stating "[s]ubsequent litigation in excessive fee cases has resulted almost uniformly in judgments for the defendants").

14. Lyman Johnson, *A Fresh Look at Director "Independence": Mutual Fund Fee Litigation and Gartenberg at Twenty-Five*, 61 VAND. L. REV. 497, 519 (2008) [hereinafter

There is evidence that advisory fees continue to be substantially above levels of fees established by arm's length bargaining.[15] In addition, recent research shows investment advisory fees over time are essentially constant despite economies of scale and spiraling levels of assets.[16] Moreover, the same research reveals that mutual fund investment management firms earn extraordinarily high rates of return for their owners over very long time periods.[17] This evidence is consistent with the proposition that investment managers earn monopoly profits for owners.

In keeping with Professor Johnson's observation, it follows that something is indeed amiss with § 36(b). The main thesis of this paper is that the *Gartenberg* standard is unfairly punitive to plaintiffs in advisory fee cases because it is subjective and excessively restrictive. The paper's conclusion is that the *Gartenberg* court and subsequent courts interpreting § 36(b) have adopted a pro-industry approach that is not warranted by the history of § 36(b). The purpose of this paper is to develop and apply a fiduciary standard that is empirically based and objective. If applied in advisory fee cases, this standard could result in fairer advisory fees for investors. Although there is some ambiguity in the legislative history of the 1970 amendments, an objective fiduciary standard requiring fairer advisory fees would be far more consistent with the stated intent of Congress than is the present standard.

Until recently, most plaintiffs in § 36(b) cases have compared advisory fees to fees determined by arm's length bargaining, e.g., fees charged to pension funds and other institutional customers. This trend was set in the early 2000s following publication of a paper showing that fees on mutual fund portfolios were roughly double comparable fees on public pension portfolios.[18] While many of these cases settled, plaintiffs have not succeeded in any of those that have come to trial.[19] The most notable of

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Johnson, *Fresh Look*].

15. *See* John P. Freeman & Stewart L. Brown, *Mutual Fund Advisory Fees: The Cost of Conflicts of Interest,* 26 J. CORP. L. 609 (2001) [hereinafter Freeman & Brown, *Mutual Fund Fee Litigation*] (examining "whether the chief product that shareholders buy when they invest in mutual funds—professional investment advice—is being systematically overpriced by fund managers"); *see also* Stewart L. Brown & Steven Pomerantz, *Some Clarity on Mutual Fund Fees*, 20 U. PA. J. BUS. L. 767 (2018) [hereinafter Brown & Pomerantz, *Some Clarity*] (presenting "evidence that investment management fees, a major component of total fees are immune to the forces of competition").

16. Brown & Pomerantz, *Some Clarity*, *supra* note 15, at 812.

17. *Id.* at 810.

18. Freeman & Brown, *Mutual Fund Fee Litigation*, *supra* note 15, at 638.

19. Gallus v. Ameriprise Fin., Inc., 561 F.3d 816, 823 n.4 (8th Cir. 2009); Johnson, *Fresh Look*, *supra* note 14, at 500.

these cases is *Jones v. Harris*[20] in which the Supreme Court affirmed the *Gartenberg* standard, thus allowing the District Court's grant of summary judgment for defendants to stand.[21]

In this line of cases the investment management industry has argued, successfully, that mutual fund and pension fees are not comparable because of higher costs required to manage mutual funds. The industry argues that it is more expensive to manage mutual fund portfolios because of the costs to service large numbers of mutual fund investors and the greater level of cash that must be held to cover potential withdrawals. Recent research effectively debunks these arguments but has not yet been given credence by the judiciary.[22]

Recently, plaintiffs have chosen a different but related line of attack on advisory fees. These cases utilize sub-advisory fees as a comparator to advisory fees. Like pension fees, sub-advisory fees are much lower than advisory fees and are the product of arm's length bargaining. Moreover, such fees are not subject to the defects of pension fees because sub-advisors must deal with the existence of large numbers of customers and the concomitant risk of cash withdrawal. Despite these advantages, initial results are not promising for plaintiffs, largely because courts have applied the subjective *Gartenberg* standard and readily grant summary judgment to defendants. However, there are still some cases pending that might benefit from the application of an objective fiduciary standard.

With that as a beginning point, it would be useful if courts in fee cases had a large a representative sample of fees determined by arm's length bargaining as a benchmark for comparison purposes. Fortunately, there have come into existence in recent years databases that compile such data, one of which is Morningstar Direct. Utilizing that database, this paper presents and analyzes a large sample of actual sub-advisory fee data and compares these numbers to the advisory fees of mutual funds with similar investment objectives. The principal insight is that a large proportion of mutual fund advisory fees are well outside the range of fees determined by arm's length bargaining. The use of the empirically grounded fiduciary standard suggested here greatly clarifies the issues.

The paper is structured as follows: first, an overview of the Wharton

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20. Jones v. Harris Assocs. L.P., 559 U.S. 335 (2010).

21. Jones v. Harris Assocs. L.P., 611 F. App'x. 359, 362 (7th Cir. 2015).

22. Stewart L. Brown, *Mutual Fund Advisory Fee Litigation: Some Analytical Clarity*, 16 J. BUS. & SEC. L. 329 (2016) [hereinafter Brown, *Some Analytical Clarity*]; John P. Freeman & Stewart L. Brown, *Mutual Fund Advisory Fees: The Cost of Conflicts of Interest,* 26 J. CORP. L. 609, 671-73 (2001).

Report and PPI Study results is presented and the testimony of the then SEC Chairman during the hearings leading to the 1970 amendments[23] is surveyed. The testimony includes evidence of then-contemporary empirical data on sub-advisory fees. Next, the relevant sections of the Senate Report underpinning the 1970 amendments to the ICA are examined. Third, the *Gartenberg* standard is presented and discussed as is the subsequent profit margin standard established in *Schuyt*.[24] Fourth, the empirical evidence on sub-advisory fees compared to advisory fees is examined in detail. The analysis includes statistical tests relevant to establishing an objective fiduciary standard. Fifth, the objective standard is applied to a case already decided using the subjective standard: *Kasilag v. Hartford*.[25] This case is notable for the depth and breadth of mutual fund and investment management numbers presented that allow for an

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23. *See Investment Company Act Amendments of 1967: Hearings Before the Subcomm. on Commerce & Fin. of the H. Comm. on Interstate and Foreign Commerce on H.R. 9510 and H.R. 9511, Pt. 1*, 90th Cong. 25 (1967) (statement of Manuel F. Cohen, Chairman, Securities & Exchange Commission) (testifying in support of H.R. 9510 and H.R. 9511); *Investment Company Act Amendments of 1967: Hearings Before the Subcomm. on Commerce & Fin. of the H. Comm. on Interstate and Foreign Commerce on H.R. 9510 and H.R. 9511, Pt. 2*, 90th Cong. 671 (1967) (statement of Manuel F. Cohen, Chairman, Securities & Exchange Commission)(testifying in support of H.R. 9510 and H.R. 9511); *Mutual Fund Legislation of 1967: Hearing Before the S. Comm. on Banking & Currency on Amendment No. 438 to S. 1659,* 90th Cong. 91 (1967) (statement of Manuel F. Cohen, Chairman, Securities & Exchange Commission) (testifying in support of S. 1659); *Investment Company Act Amendments of 1967, Bank and Insurance Company Collective Investment Funds and Accounts: Hearings Before the Subcomm. on Commerce & Fin. of the H. Comm. on Interstate and Foreign Commerce,* 90th Cong. 112 (1968) (statement of Manuel F. Cohen, Chairman, Securities & Exchange Commission) (testifying on H.R. 14742 to amend the Investment Company Act of 1940 in addition to other securities laws). *See also Problems in the Securities Industry: Hearing Before the S. Subcomm. on Securities of the Comm. on Banking & Currency to Ascertain the Views of Hamer H. Budge, Chairman of the Securities and Exchange Commission, on Problems in the Securities Industry*, 91st Cong. 3 (1969) (explaining his position regarding mutual fund bills S. 34 and S. 296, among other matters); *Mutual Fund Amendments: Hearings Before the Subcomm. on Commerce & Fin. of the H. Comm. on Interstate and Foreign Commerce on H.R. 11995, S. 2224, H.R. 13754, and H.R. 14737, Pt. 1*, 91st Cong. 172 (1969) (statement of Hamer H. Budge, Chairman, Securities & Exchange Commission) (speaking in regard to H.R. 11995, S. 2224, H.R. 13754, and H.R. 14737); *Mutual Fund Amendments: Hearings Before the Subcomm. on Commerce & Fin. of the H. Comm. on Interstate and Foreign Commerce on H.R. 11995, S. 2224, H.R. 13754, and H.R. 14737, Pt. 2*, 91st Cong. 853 (1969) (statement of Hamer H. Budge, Chairman, Securities & Exchange Commission) (advocating for legislation that deals with managerial compensation in investment companies).

24. Schuyt v. Rowe Price Prime Reserve Fund, Inc., 663 F. Supp. 962 (S.D.N.Y. 1987).

25. Kasilag v. Hartford Inv. Fin. Servs., LLC, No. 11-1083, 2017 WL 773880 (D.N.J. Feb. 28, 2017), *aff'd,* No. 17-1653, 2018 WL 3913102 (3d Cir. Aug. 15, 2018).

exemplary clarity of analysis. Next, there is an extended discussion and critique of the *Gartenberg* standard, including the conflicting signals sent by Congress to the judiciary during the period leading up to the 1970 amendments. And, last, a summary and conclusions are presented.

II. THE 1970 AMENDMENTS TO THE INVESTMENT COMPANY ACT

The Wharton Report and PPI Study showed that investment management fees on mutual funds were pervasively higher than similar fees that were the product of arm's length bargaining.[26] Both studies attributed this difference to the structure of the mutual fund industry, which involves external management of fund portfolios. Approximately fifty fee cases were filed against the investment management industry because of the Wharton Report.[27] This was a major impetus for Congress to address the issue of advisory fees.[28]

The PPI Study surveyed the litigation filed against investment managers, concluded that investors were insufficiently protected by existing law, and recommended that Congress impose a reasonableness standard, enforceable in court.[29] Congress was unwilling to do this but did make advisers fiduciaries regarding fees and gave investors a private cause of action enforceable in court.[30]

This section of the paper places the corporate waste standard in context and presents the earliest available evidence on the level of sub-advisory fees in the context of advisory fees and the institutional fees presented in the Wharton Report and PPI Study.

III. SUB-ADVISORY FEES IN CONTEXT.

A. The Wharton Report

The Wharton Report found a heavy concentration of advisory fees on open end mutual funds at the 0.5% or 50 basis point level.[31] These mutual funds were managed by external management firms and thus advisory fees were not subject to competitive forces. The study also examined fee rates

26. WHARTON REPORT, *supra* note 4, at 493; PPI STUDY, *supra* note 5, at 115.

27. PPI STUDY, *supra* note 5, at 132.

28. Stewart Brown, *Mutual Funds and the Regulatory Capture of the SEC*, 19 U. PA. J. BUS. L. 701, at 714 (2017); *see also* 114 Cong. Rec. 23309 (statement of Mr. Brooke).

29. PPI STUDY, *supra* note 5, at 143.

30. 15 U.S.C. § 80a-35(b) (2012).

31. WHARTON REPORT, *supra* note 4, at 484.

charged to other clients of the investment management firms and rates charged by mutual funds with internal management.[32] Summary results of those surveys are presented in the first two lines of Table 1:

Table 1					
Mutual Fund Advisory Fees Compared to Fees Subject to Arm's Length Bargaining					
1960-1967					
	Advisory Fee Rates		**Arm's Length Fee Rates**		**Average Portfolio Size**
Wharton Report 1960-Other Customers*	**0.500%**		**0.176%**		**$100+ mm**
Wharton Report 1960-Internally Managed Funds**	**0.500%**		**0.187%**		**$100+ mm**
PPI Report - 1965 Bank Advisory Rates	**0.480%**	***	**0.062%**		**$100 mm**
PPI Report - 1965 Internally Managed Funds	**0.480%**	***	**0.149%**	****	**$100+ mm**
Cohen Testimony - 1967 Sub-Advisory Fees	**0.500%**		**0.114%**		**$100 mm**
*** Distilled from Table VIII-42 on page of 488 of the Wharton Report**					
**** Distilled from Table VIII-40 on page 486 of the Wharton Report**					
***** Median Fees: Page 104 of PPI Study**					
****** Weighted Average of Internally Managed Open-End Funds:Table III-5 on page 103 of PPI Study.**					

The average portfolio size of the funds in the Wharton Report was greater than $100 million.[33] The study found that firms that charged their mutual fund clients 0.5% or 50 basis points charged their non-fund clients 17.6 basis points for essentially the same services.[34] This indicates that a captive fund was charged 2.8 times more in fees than a fund with clients who were in a position to negotiate fees. In other words, fees determined by arm's length bargaining amounted to about 35% of fee rates charged captive funds.

Similarly, the study looked at mutual funds that were internally managed, i.e., the funds hired the personnel who actually managed the funds.[35] The investment management costs of these funds averaged 18.7

32. The results of these surveys are presented in Tables VIII-42, WHARTON REPORT, *supra* note 4, at 488, and VIII-40; *Id.* at 486. The presentation style is somewhat confusing in that they tabulate the number of firms in different fee ranges and asset level ranges. However, by assuming fee and assets levels in the middle of each range it is possible to calculate a weighted average fee level for these two categories. The results of that distillation are presented in Table 1.

33. WHARTON REPORT, *supra* note 4, at 78.

34. *Id.* at 489.

35. *Id.* at 441.

basis points, which is about 37% of the fee rate level paid by customers of externally managed funds.[36]

B. The PPI Study

The PPI Study found similar results. In the years since the Wharton Report, median advisory fees had decreased slightly, to 48 basis points.[37] The PPI Study attributed this to settlements resulting from approximately fifty lawsuits that had been filed after the publication of the Wharton Report.[38] For comparison purposes, the SEC surveyed the fees of banks offering investment management services to pension funds and other clients and queried them for fees to manage a portfolio of $100 million. Five of the six banks would manage $100 million for six basis points and the sixth charged seven basis points.[39] It follows that the average fee rate to manage a $100 million portfolio was about 6.2 basis points as shown in Table 1. Thus, the fee rate charged by banks to manage a $100 million portfolio amounted to about 13% of the rate charged captive mutual fund customers at the time. Similarly, the SEC surveyed fees on internally managed funds and found average investment management costs of 14.9 basis points, about 31% of the rate charged customers of captive mutual funds.[40]

C. Sub-Advisory Fee Rates

Neither the Wharton Report nor the PPI Study mentioned the level of sub-advisory fees. SEC Chairman Manuel Cohen did so in his testimony before congress in 1967.[41] Mr. Cohen introduced a table into evidence showing advisory and sub-advisory fee rates on about twenty mutual funds. Of those, five had a flat 50 basis point advisory fee schedule and corresponding sub-advisory fee schedules showing fee rates at different levels of assets.[42] Sub-advisory fee rates were calculated for those five

36. *Id.* at 484.
37. PPI STUDY, *supra* note 5, at 103-04.
38. *Id.* at 110.
39. *Id.* at 115.
40. *Id.* at 103.
41. *Investment Company Act Amendments of 1967: Hearings Before the Subcomm. on Commerce & Fin. of the H. Comm. on Interstate and Foreign Commerce on H.R. 9510 and H.R. 9511, Pt. 1*, 90th Cong. 197-99 (1967) (statement of Manuel F. Cohen, Chairman, Securities & Exchange Commission).
42. *Id.*

funds based on the assumption that a $100 million portfolio was being managed. The average sub-advisory fee rate under these assumptions was 11.4 basis points as presented in Table 1. Thus, average sub-advisory fee rates to manage a $100 million portfolio amounted to about 23% of the rate ultimately charged retail investors.

Similar to rates charged by banks and to other investment advisory clients, sub-advisory fee rates are the product of arm's length bargaining. The evidence in Table 1 confirms that these rates are all roughly equivalent and a fraction of the advisory fee rates charged retail mutual fund investors. This is evidence of market forces at work where arm's length bargaining is extant and absent where it is not.

When funds are sub-advised, investment advisor profits on the advisory function are the difference between the rate charged retail investors and the rate at which the investment advisor can purchase investment sub-advisory services in the open market.[43] Thus, investment advisors are incentivized to negotiate the lowest rate possible on sub-advised funds to maximize their profits.

Profit margin is one measure of profitability. It is calculated as profit (revenue minus costs) divided by revenue. For the sub-advised funds in Table 1, revenue is 50 basis points times $100 million, or $500,000, and costs are 11.4 basis points times $100 million, or $114,000. Thus, profit is $386,000, or 77% of revenue. The investment advisor's job is to pick stocks for his mutual fund clients. An investment advisor who subcontracts this activity to another firm earns a 77% profit in the transaction. Because investment management firms are fiduciaries with respect to fees charged to mutual fund investors, the fairness or lack thereof of a 77% profit margin is the essence of advisory fee cases. Time and again courts, using the *Gartenberg* standard, have found such arrangement to be fair and not in violation of fiduciary standards.[44]

43. This statement is not strictly true as there may be some small additional costs to the adviser that reduce profit margins slightly. These costs are explored below but the main point of the example is not changed by these small amounts. Also, technically dollar profits are the product of average assets under management and the difference between advisory and sub-advisory fee rates.

44. *See, e.g.*, Kasilag v. Hartford Inv. Fin. Servs., LLC, No. 11-1083, 2017 WL 773880 (D.N.J. Feb. 28, 2017), *aff'd,* No. 17-1653, 2018 WL 3913102 (3d Cir. Aug. 15, 2018) (holding that the investment management fees paid to the funds' administrators were not excessive and within an arm's-length transaction); Sivolella v. AXA Equitable Life Ins. Co., No. 11-cv-4194 (PGS)(DEA), 2016 WL 4487857 (D.N.J. Aug. 25, 2016), *aff'd*, No. 16-4241, 2018 WL 3359108 (3d Cir. July 10, 2018) (holding that burden of proof on Petitioner's § 36(b) claim was not proven); Krinsk v. Fund Asset Mgmt., Inc., 875 F.2d 404 (2d Cir.), *cert. denied*, *493 U.S. 919 (1989*) (finding that investment management fees were

D. *The Corporate Waste Standard.*

The SEC, in the PPI Study and in testimony by Chairman Cohen, highlighted the failure of the legal system to protect fund investors from high fees resulting from the conflict of interest inherent in the structure of the mutual fund industry. The PPI Study revealed more than 50 lawsuits brought by fund shareholders in state and federal courts. Most of these litigations were terminated through settlements providing for future reductions in advisory fee rates.[45] However, three cases were brought to trial and the investment management industry prevailed in all three of these cases.[46] Most notable of these is the decision of the Delaware Court of Chancery in *Saxe v. Brady*[47] in which, as the PPI Study noted,[48]

> The court observed that "based on the 1959 and 1960 figures the profits are certainly approaching the point where they are outstripping any reasonable relationship to expenses and effort even in a legal sense." The court apparently recognized that the defendants had a duty to deal fairly with the fund and that the burden of proving fairness normally would be on the defendants. It held, however, that because the fund's shareholders had ratified the advisory contract, the defendants were relieved of the burden of showing fairness and the plaintiff had to bear the burden of proving affirmatively that the fees were so excessive as to constitute a "waste" of corporate assets.
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> As the court put it:
>
> When the shareholders ratify a transaction, the interested parties are relieved of the burden of proving the fairness of the transaction. *The burden then falls on the objecting stockholders to convince the court that no person of ordinary, sound business judgment would be expected to entertain the view that the consideration was a fair exchange for the value which was given.*

Thus, under the standard prevailing at the time, fund shareholders had

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not disproportionately large); Schuyt v. Rowe Price Prime Reserve Fund, Inc., 663 F. Supp. 962 (S.D.N.Y.), *aff'd*, *835 F.2d 45 (2d Cir. 1987)*, *cert. denied*, (holding a jury trial shouldn't be automatic just because the plaintiff designated the relief she sought as "damages"); Gallus v. Ameriprise Fin., Inc., 497 F. Supp. 2d 974 (D. Minn. 2007) (holding the shareholders did receive a "material benefit" from services by the Defendants to justify the investment management fees paid).

45. PPI STUDY, *supra* note 5, at 132-33.

46. *Id.* at 133.

47. 184 A.2d 602 (Del. Ch. 1962).

48. PPI STUDY, *supra* note 5, at 135 (citations omitted).

an unduly high burden to overcome in order to prevail in advisory fee cases.

IV. THE LEAD UP TO THE 1970 AMENDMENTS TO THE INVESTMENT COMPANY ACT

In the three years leading up to passage of the 1970 amendments to the ICA, Congress debated what standard should be adopted to replace the "corporate waste" standard exemplified by the decision in *Saxe v. Brady*.[49] Bills introduced in the House in 1967[50] and the Senate in 1968[51] adopted the SEC's "reasonableness" standard. These bills failed to pass. Following discussions among the important House and Senate committees, the SEC, and the Investment Company Institute, the 1970 amendments to the ICA gave investors a private right of action, but removed the "reasonableness" standard opposed by the ICI, instead making investment advisers fiduciaries with respect to fees and retaining the provision in the 1940 ICA that placed the burden of proof on the investor.[52]

What seems clear is that the Senate *intended* for the traditional fiduciary standard to apply and to result in fair fees for investors, as was explained during an Executive Session of the Senate Committee on Banking and Currency at the request of the Chairman:

> Mr. Paradise. Last year's bill had a section in it and the bill that was introduced this year that management fees would be reasonable. Now, the SEC and the mutual fund industry has gotten together and what they have really done is put the words "fiduciary duty" in the place of reasonable. The meaning of "fiduciary duty" would be fair, which is the way I see it is practically equivocal to reasonable.
>
> The mutual fund industry said they wanted the "fiduciary duty" in there because it had a more definite meaning in law. That is the big difference. All shareholders would have the right to sue for a breach of fiduciary duty as well as the SEC under this

49. INVESTMENT COMPANY AMENDMENTS ACT OF 1969, S. REP. NO. 91-184, at 3 (1969).

50. *See* H.R. 9510 § 8(d), 90th Cong. (1967) (setting forth factors to consider in determining the reasonableness of the compensation).

51. S. 3724, § 8 (90th Cong. 1968).

52. *See* Investment Company Amendment Act of 1970, Pub. L. No. 91-547, § 35(b), 84 Stat. 1413 (1970) (codified as amended at 15 U.S.C. § 80a-35 (2012)) (explaining that investment advisors are deemed to have a fiduciary duty with respect to compensation for their services).

> proposal. The courts would give some consideration to the approval of the fund's board of directors of the fee and the shareholder ratification would also be considered, but it still would not go back to the corporate waste structure which has always been the problem in shareholders suing [sic].[53]

The language of the Senate Report is consistent with the above interpretation:

> Because of the unique structure of this industry . . . 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. . . . [The provisions of the Investment Company act]. . . did not provide any mechanism by which the fairness of management contracts could be tested in court. Under general rules of law, advisory contracts which are ratified by the shareholders, or in some States approved by a vote of the disinterested directors, may not be upset in the courts except upon a showing of "corporate waste." As one court put it, the fee must "Shock the conscience of the court." [Y]our committee has decided that the standard of "corporate waste" is unduly restrictive and recommends that it be changed. Last year, the Senate passed S.3724 which contained a provision stating that management fees should be "reasonable." The House, however, took no action on the bill. [Y]our committee has decided that there is an adequate basis to delete the express statutory requirement of "reasonableness," and to substitute a different method of testing management compensation. This bill states that the mutual fund investment adviser has a specific "fiduciary duty" in respect to management fee compensation. . . . It also, is in accordance with the traditional function of the courts to enforce such fiduciary duties in similar type relationships.[54]

Thus, from the plain language of the Senate Report, it seems that the Senate was committed to the notion of fairness in advisory fees and that its intention was to make fees fairer. There are indications in the 1970 Senate and House Reports that the Committee assumed "traditional fiduciary standards" for testing whether fiduciary duty would apply, and that it was not necessary to establish a separate standard for the new statute.[55]

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53. Executive Session of the Senate Committee on Banking and Currency (May 14, 1969), 91st Cong., 1st Sess., at 3 (statement of Stephen J. Paradise, Assistant Counsel to the Committee).

54. S. REP. NO. 91-184, at 5-7 (1969).

55. *Id.* at 2, 6; H. Rep. 91-1332, at 8 (1970).

V. THE *GARTENBERG* STANDARD

In *Gartenberg v. Merrill Lynch Asset Mgmt., Inc.,* a case filed against a very large Merrill Lynch money market fund under § 36(b) of the 1970 Investment Company Act, the district court acknowledged that the proper standard to gauge violations of fiduciary duty had been articulated in *Pepper v. Litton*:

> An examination of the case authorities also fails to illumine precisely the path to be followed by the Court in weighing the compensation of the investment adviser of a money market fund under fiduciary standards. Only general concepts have been articulated. The standard of fiduciary duty under Section 36(b) "is concerned solely with fairness and equity." "The essence of the (fiduciary) test is whether or not under all the circumstances the transaction carries the earmarks of an arm's length bargain."[56]

The district court chose to ignore the standard corporate fiduciary test and based its decision on what it determined was fair and equitable. Judge Pollack decided that the proper test of the fairness and equity of the no-bid advisory fee contract being tested in *Gartenberg* was the comparative level of other no-bid advisory fee contracts being offered at the same time:

> The issue of fair compensation becomes ultimately a social or philosophical-and hence a legislative question-when the fee is in harmony with the broad and prevailing market choice available to the investor, the price being paid is disclosed and the services are satisfactorily performed and sufficient disclosure of the scope of the enterprise, its requirements and performance is made to the Fund's directors and investors. As Mr. Justice Collins appositely wrote many years ago in *Heller v. Boylan*: "[T]he particular business before this Court is not the revamping of the social or economic order." There would seem to be no sense to seek to limit by judicial fiat what is satisfactorily performed, sufficiently disclosed and freely available elsewhere in the market place at comparable charges, without penalties or restraint.[57]

On appeal, the Second Circuit disagreed with Judge Pollack's reasoning, affirming that the level of no-bid contracts in the "market" is not a proper comparator for the fairness and equity of a particular fee:

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56. 528 F. Supp. 1038, 1046-47 (S.D.N.Y. 1981) (citation omitted) (quoting Pepper v. Litton, 308 U.S. 295, 306-07, 60 S.Ct. 238, 245-46, 84 L.Ed.2 281 (1939).

57. *Id.* at 1068 (quoting Heller v. Boylan, 29 N.Y.S.2d 653, 669 (Sup. Ct.), aff'd, 263 Ap.Div. 815, 32 N.Y.S.2d 131 (1st Dep't 1941).

> We disagree with the district court's suggestions that the principal factor to be considered in evaluating a fee's fairness is the price charged by other similar advisers to funds managed by them, that the "price charged by advisers to those funds establishes the free and open market level for fiduciary compensation," that the "market price . . . serves as a standard to test the fairness of the investment advisory fee," and that a fee is fair if it "is in harmony with the broad and prevailing market choice available to the investor," 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. The former may be vigorous even though the latter is virtually non-existent. Each is governed by different forces. Reliance on prevailing industry advisory fees will not satisfy § 36(b).[58]

Donald Langevoort has made a similar point regarding the decision of the Second Circuit, although in a more delicate fashion:

> The key case is *Gartenberg* v. *Merrill Lynch Asset Management Inc.*, which reads enigmatically to say the least, but in the end takes a plainly pro-defendant approach. Plaintiffs challenged the advisory fee paid to Merrill Lynch by its massive money market fund as excessive. The district court dismissed on grounds that fees approved by independent directors are valid if deemed fair compared to fees charged by other advisers to similar funds.
>
> On appeal, the plaintiffs argued that this was a foolish test. If the industry remains dominated by conflicts of interest, then excessive fees will be the norm, and the norm should then not be made the benchmark for propriety (citation omitted).[59]

More recently, in *Jones v. Harris Associates,* the Supreme Court agreed, saying that "courts should not rely too heavily on comparisons with fees charged to mutual funds by other advisers. These comparisons are problematic because these fees, like those challenged, may not be the product of negotiations conducted at arm's length."[60]

The Second Circuit in *Gartenberg* did not conclude that fees charged

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58. Gartenberg v. Merrill Lynch Asset Management, Inc., 694 F.2d 923, 929 (2d Cir. 1982) (citations omitted) (quoting Gartenberg v. Merrill Lynch Asset Management, Inc., 528 F.Supp. 1038, 1049 (S.D.N.Y. 1981), aff'd, 694 F.2d 923 (2d Cir. 1982).

59. Donald J. 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, 1023-24 (2015) [hereinafter Langevoort, *Private Litigation*].

60. 559 U.S. 335, 350-51 (2010).

by other funds were totally irrelevant, instead suggesting the "structure of fees" [61] could be used to indicate the extent to which other funds were sharing economies of scale in the form of breakpoints to the fee schedule.

> We do not suggest that rates charged by other adviser-managers to other similar funds are not a factor to be taken into account. Indeed, to the extent that other managers have tended "to reduce their effective charges as the fund grows in size," the Senate Committee noted that such a reduction represents "the best industry practice [which] will provide a guide." However, 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.[62]

The language used by the Second Circuit in adopting the appropriate test to be used by courts to determine whether the advisor-manager breached its fiduciary duty is broken into two sections. First, the court sets out a traditional version of the test:

> In short, the legislative history of § 36(b) indicates that the substitution of the term "fiduciary duty" for "reasonable," while possibly intended to modify the standard somewhat, was a more semantical than substantive compromise, shifting the focus slightly from the fund directors to the conduct of the investment adviser-manager. As the district court and all parties seem to recognize, *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*. . . . The Senate recognized that as a practical matter the usual arm's length bargaining between strangers does not occur between an adviser and the fund, stating: "Since a typical fund is organized by its investment adviser which provides it with almost all management services and because its shares are bought by investors who rely on that service, a mutual fund cannot, as a practical matter sever its relationship with the adviser. Therefore, the forces of arm's-length bargaining do not work in the mutual fund industry in the same manner as they do in other sectors of the American economy."[63]

61. The structure of fees in this case refers to the existence and magnitude of breakpoints of the fees structure of competitive funds.

62. *Gartenberg,* 694 F.2d at 928 (citations omitted) (quoting S.Rep. No. 91-184, *supra,* [1970] U.S.Code Cong. & Ad.News at 4902).

63. *Id.* at 928 (emphasis added) (quoting S. Rep. No. 91-184, *supra*, [1970] U.S. Code

Although the Second Circuit opinion states that the District Court and the parties seem to recognize the appropriate test, the District Court did not apply that test, instead using a test that involved only "fairness and equity"[64] and the generally recognized fiduciary standard articulated in *Pepper*. The initial statement by the Second Circuit is consistent with the *Pepper* standard. Like *Pepper*, it is clear that the standard involves a comparison of the transaction in question to transactions involving arm's length negotiation. The notion of a "range of outcomes" carries a mathematical connotation and recognizes that such comparators may be objectively determinable, i.e., market transactions that are by definition the product of arm's length negotiation.

The Second Circuit, then however, stated: "To be guilty of a violation of § 36(b), therefore, the adviser-manager must charge a fee that is so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been the product of arm's-length bargaining."[65] In this restatement of the standard, the Second Circuit referenced the "range of arm's length negotiation" standard associated with the district court and *Pepper* but then articulates a much more restrictive "disproportionately large" standard.[66] The court uses the transition "therefore,"[67] but the transition is a non sequitur: There is no analysis or reasoning to justify the reformulated and more extreme standard. Moreover, unlike the initial standard, the standard as applied by subsequent courts is totally subjective and divorced from any possibility of an objective determination.

The restated standard involves a two-pronged test: the fee at issue must be "so disproportionately large" *and* "could not have been the product of arm's- length bargaining."[68] As Lyman Johnson notes, "the court illogically framed the first prong in a way that deviates from 'reasonableness' and seemed to require extremeness—'so disproportionately large,' not just 'disproportionately large,' and 'no reasonable relationship,' not just 'unreasonable.'"[69]

Johnson goes on to discuss the corporate fiduciary doctrine and the relevance of the behavior of the fund's trustees. He then suggests that the

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Cong. & Ad. News at 4901).

64. Gartenberg v. Merrill Lynch Asset Management, Inc., 528 F.Supp. 1038, 1047 (S.D.N.Y. 1981), aff'd, 694 F.2d 923 (2d Cir. 1982).

65. *Gartenberg,* 694 F.2d at 928.

66. *Id.*

67. *Id.*

68. *Id.*

69. Johnson, *Fresh Look*, *supra* note 14, at 519.

Second Circuit articulation of the standard may have just been "clumsy":

> Furthermore, given the court's clear acknowledgement that a reasonableness standard is appropriate, its phrase "so disproportionately large that it bears no reasonable relationship to the services rendered" is either a verbose way to express a reasonableness requirement or it wrongly introduces a stricter requirement that contradicts the very reasonableness standard that the court seemingly endorsed. The reading more consistent with legislative history and the rest of the opinion is that the court spoke clumsily.[70]

It seems unlikely that the appellate court spoke clumsily. As discussed below, it is more likely that the court spoke purposefully. The restated standard in practice is no different from the corporate waste standard it replaced, an assessment with which Langevoort agrees:

> This test resembles the state law test for corporate waste, even though the legislative history behind section 36(b) explicitly wanted something more than a waste test, (citation omitted) signaling little promise of success on the merits. Obviously, the court was uncomfortable getting more deeply into the business of fee-setting on its own. . . . Since *Gartenberg,* predictably, plaintiffs have fared poorly in their attacks on fees and 12b-l plans, notwithstanding ample grounds for concern that both tend toward excess industry-wide.[71]

In practice, courts have conflated the two standards and then have applied the subjective *Gartenberg* standard.[72] In the process, courts have ignored the more precise and objective initial *Gartenberg* standard, focusing instead on the subjective standard that follows the "therefore" transition. It is reasonable to conclude that the initial standard should be as applicable as the subjective standard routinely used by the courts. As will

70. *Id.* at 517-18.

71. Langevoort, *Private Litigation, supra* note 59, at 1024 (citations omitted). The important question, unanswered at this point is *why* the judiciary choose this path. It came down squarely on the side of the investment management industry and against the stated wishes of the Congress. Professor Langevoort hints that judicial self-interest might be involved.

72. For instance, in *Jones* the Supreme court conflated the two standards, omitting the "therefore" in *Gartenberg*: "[T]he test is essentially whether the fee schedule represents a charge within the range of what would have been negotiated at arm's-length in light of all of the surrounding circumstances . . . . [T]o be guilty of a violation of § 36(b), . . . the adviser must charge a fee that is so disproportionately large it bears no reasonable relationship to the services rendered and could not have been the product of arm's length bargaining." Jones v. Harris Assocs., 559 U.S. 335, 344 (2010).

be demonstrated below, application of the initial standard can lead to dramatically different conclusions regarding advisory fees.

The most powerful evidence plaintiffs can present in an advisory fee case is to show that the advisory fee in question is higher than fees determined by arm's length bargaining. This was the essence of the argument in the Wharton and PPI reports. Plaintiffs in *Gartenberg* attempted to do this, but they were foiled by a clever investment management industry strategy that involved bringing an anomalous fund to trial in 1980, rather than settling the case.[73] The fund at issue in *Gartenberg* was a huge money market fund that was integrated into the Merrill Lynch brokerage business. Merrill Lynch charged the money fund for time brokers spent processing brokerage orders that also involved money fund transactions. The district court disallowed the comparison of advisory fees to pension fees because Merrill Lynch argued that there were processing costs associated with servicing large numbers of brokerage clients.

Processing costs in the advisory function are anomalous. For all but a few funds in the 1970s and early 1980s, the costs of all interactions with mutual fund investors were handled under separate contracts with the fund's transfer agent or distributor. This remains true today and has enabled the investment management industry to perpetrate the myth that it is more expensive to manage mutual fund than pension portfolios because of the large numbers of mutual fund clients involved. The anomalous processing costs clearly impacted the Second Circuit's decision in *Gartenberg*:

> Our affirmance is not a holding that the fee contract between the Fund and the Manager is fair and reasonable. We merely conclude that on this record appellants failed to prove by a preponderance of the evidence a breach of fiduciary duty. Whether a violation of § 36(b) might be established through more probative evidence of. . . the Broker's processing costs. . . must therefore remain a matter of speculation.[74]

It is difficult to reconcile the above language with the fiduciary standard imposed by the court. In essence, the Second Circuit said, "We don't know if the fee is fair, but we think it appropriate to require future plaintiffs to show that the fee is 'so disproportionately large that it. . . could

73. This is discussed in detail in Brown, *Some Analytical Clarity, supra* note 22.
74. Gartenberg v. Merrill Lynch Asset Management, Inc., 694 F.2d 923, 933 (2d Cir. 1982).

not have been the product of arm's-length bargaining.'"[75]

The processing cost myth persists and found its way into the Supreme Court's decision in *Jones v. Harris Associates* that endorsed the *Gartenberg* standard:

> [T]he *Gartenberg* court rejected a comparison between the fees that the adviser in that case charged a money market fund and the fees that it charged a pension fund. (noting the "[t]he nature and extent of the services required by each type of fund differ sharply"). Petitioners contend that such a comparison is appropriate, but respondent disagrees. Since the Act requires consideration of all relevant factors, we do not think that there can be any categorical rule regarding the comparisons of the fees charged different types of clients. Instead, courts may give such comparisons the weight that they merit in light of the similarities and differences between the services that the clients in question require, but courts must be wary of inapt comparisons. (citations omitted)[76]

The big difference between advisory fees and pension fees in *Gartenberg* was the anomalous processing costs, although in practice there may be other factors/costs that explain some of the differences. Nonetheless, the cost differential for pension fees is far too small to explain the disparity between advisory and pension fees.[77] Moreover, many of the differences are mooted when the plaintiff's theory is that the adviser is charging excess fees relative to sub-advisory fees where the large number of clients involved is irrelevant. These issues are examined in detail below.

In *Gartenberg,* the Second Circuit enumerated six factors to be considered when deciding whether a fee is excessive.[78] One of these, profitability of the fund to the adviser, was indeterminate in *Gartenberg* because of the anomalous processing costs. Various estimates of the costs yielded after tax profit margins ranging from negative to about 40%.[79]

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75. *Id.* at 928.

76. *Jones,* 559 U.S. at 349-50.

77. Freeman, Brown and Pomerantz estimate the difference at about three basis points. John P. Freeman, Stewart L. Brown & Steve Pomerantz, *Mutual Fund Advisory Fees: New Evidence and a Fair Fiduciary Duty Test,* 61 OKLA. L. REV. 83, 109 n.90 (2008).

78. *Gartenberg,* 694 F.2d at 928-30. As listed in *Krinsk v. Fund Asset Management, Inc.,* a subsequent Second Circuit opinion, these factors are (a) the nature and quality of services provided to fund shareholders; (b) the profitability of the fund to the adviser-manager; (c) fall-out benefits, (d) economies of scale; (e) comparative fee structures; and (f) the independence and conscientiousness of the trustees. 875 F.2d 404, 409 (2d Cir. 1989).

79. Brown, *Some Analytical Clarity, supra* note 22, estimated the gross profit margin exclusive of processing costs in *Gartenberg* at about 96%. The plaintiffs calculated the same

Schuyt v. Rowe Price Prime Reserve Fund, Inc.[80] established what has become a profit margin standard for subsequent fee cases. It is based on the *Gartenberg* standard and the business judgment rule.[81] The reasoning of the case is questionable. Unlike *Gartenberg*, the money market fund in *Schuyt* was not integrated into a brokerage firm and had no processing costs. The court chose to ignore expert economic testimony because the economic experts failed to analyze how the fund board negotiated the advisory contract. The court also denied any comparison of the fund's advisory fee with fees charged institutional customers and accepted the profit margin calculation of plaintiff's expert of 77.3%. The subjectivity of the *Gartenberg* standard was in full view in the decision:

> While it cannot be denied that the Adviser earned a significant profit from these services, it does not appear to the Court, in light of all of the facts, that the fees charged by the Adviser were so disproportionately large that they bore no reasonable relationship to the services rendered and could not have been the product of arms-length bargaining.[82]

The court, relying on the business judgment rule to justify its decision, hedged its opinion somewhat in a footnote:

> The Court wishes to make clear that it is not holding that a profit margin of up to 77.3% can never be excessive. In fact, under other circumstances, such a profit margin could very well be excessive. For example, if advisory services being challenged were not of the highest quality and if the directors were not so obviously qualified, fully informed, and conscientious, a similar fee structure could violate section 36(b). This Court is simply holding that on the facts presented here, the fee schedules at issue represent charges within the range of what would have been negotiated at arms-length in the light of all of the surrounding circumstances.[83]

In other words, merely the fact that the board was qualified, fully informed and conscientious was adequate for the court to determine that a

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gross profit margin. *Gartenberg,* 694 F.2d at 930-31.

80. 663 F. Supp. 962 (S.D.N.Y 1987).

81. *See* Eric D. Roiter, *Disentangling Mutual Fund Governance from Corporate Governance*, 6 HARV. BUS. L. REV. 1 (2016) (discussing how use of the business judgment rule in the context of mutual fund governance should difference from its use in the corporate governance context).

82. Schuyt v. Rowe Price Prime Reserve Fund, Inc., 663 F.Supp. 962, 989 (S.D.N.Y. 1987).

83. *Id.* at 989 n. 77.

77.3% profit margin was appropriate. The *Schuyt* "profit margin standard" is devoid of any analysis related to profit margins on arm's length transactions.

VI. ANALYSIS OF ADVISORY AND SUB-ADVISORY FEE DATA.

What is lacking in § 36(b) fee cases is a clear and clean comparison with fees determined by arm's length bargaining. The purpose of this section is to provide such a comparison. It does so by looking at the universe of a large homogeneous sample of mutual funds and comparing level of advisory fees to the corresponding level of sub-advisory fees. The rates charged on sub-advisory fees are a near perfect estimate of market determined fees on investment advisory services. Sub-advisory fees overcome the possible defects mentioned in *Jones v. Harris* where the court cautioned against "inapt" comparisons to pension fees that are also determined by arm's length bargaining:

> [T]here may be significant differences between the services provided by an investment adviser to a mutual fund and those it provides to a pension fund which are attributable to the greater frequency of shareholder redemptions in a mutual fund, the higher turnover of mutual fund assets, the more burdensome regulatory and legal obligations, and higher marketing costs.[84]

Of the factors mentioned, none apply to sub-advisory fees although defendants in sub-advisory fee cases do document some small differences in costs. These will be examined and estimated for an actual case in the next section of this paper. For now, it does no great violence to the analysis to assume that the investment advisory services provided by the sub-advisor are identical to the services provided by the advisor.

Morningstar is a company that collects, collates and analyzes the universe of mutual funds available in the United States and world-wide. As part of the analysis, Morningstar categorizes mutual funds by the types of securities invested in and the strategies followed. The largest single Morningstar Category as measured by total assets under management is that category of mutual funds that limit their choices of investments to large capitalization stocks.[85] As of December 2017, there was about $4.9

84. Jones v. Harris Assocs., 559 U.S. 335, 350 (2010).

85. The capitalization of a company is measured by multiplying the number of common shares of stock it has outstanding in the market times the market price of those shares. Large capitalization stocks are typically defined as those with at least $10 billion in market value.

trillion in about 4,000 fund classes invested in mutual funds categorized as "large cap."

The procedure used here was to access the Morningstar Direct database, identify and analyze the universe of actively managed large cap mutual funds, and download and cull the universe of all large cap funds. About $1.8 trillion of large cap funds are index funds[86] that were eliminated, as were enhanced index funds and fund of funds. The remaining funds represent the universe of actively managed large capitalization mutual funds. About 3600 fund classes were then distilled into individual and discrete mutual funds. The results of that process and analysis is presented in Table 2.

In December 2017, the 986 actively managed large cap mutual funds had total assets of just over $3 trillion. The average fund had just over $3 billion in assets under management and carried a weighted average advisory fee of 0.478% or 47.8 basis points.[87] The simple average advisory fee for these funds was 66 basis points or almost 40% higher.

Table 2

Analysis of Advisory and Sub-Advisory Fees of Actively Managed Large Capitalization Mutual Funds - December 2017

	Total Assets	Count	Average Fund Size	Weighted Average Advisory Fees	Weighted Average Sub-Advisory Fees	Simple Average Advisory Fees	Simple Average Sub-Advisory Fees
All funds	3,027,466,890,501	986	3,070,453,236	0.478		0.660	
All Sub Advised Funds	751,621,424,681	278	2,703,674,190	0.485	0.209	0.632	0.282
All Non-Sub-Advised Funds	2,288,437,480,422	711	3,218,618,116	0.476		0.671	
Subsidiary Sub-Advised Funds	128,569,581,725	33	3,896,047,931	0.570	0.315	0.590	0.310
Co-Branded Sub-Advised Funds	63,672,953,467	71	896,802,162	0.654	0.360	0.684	0.355
Independently Sub-Advised Funds	559,378,889,489	174	3,214,821,204	0.446	0.167	0.618	0.244

The reason for the difference between weighted and simple average advisory fees is not difficult to identify. There are few very large funds and many small funds. As funds grow they are forced to add breakpoints into their advisory fees schedules so as not to exceed the judicially recognized

86. The biggest single category of index funds invest in S&P 500 stocks and these are large cap funds.

87. The Morningstar database contains numbers for both "Management Fees" and "Advisory Fees." Morningstar defines management fees as the "most recently reported actual percentage fees deducted from average net assets" and advisory fees as the "amount charged by managers as represented in the fund's annual report." In practice these reported numbers are usually identical or very close and averages are within small fraction of a basis point. In a very few cases there is a substantial reported difference between these two categories. This paper only presents evidence on advisory fees, but an analysis of management fees yields essentially identical results.

profit margin maximum of about 77%. Thus, large funds, those with high levels of assets under management and lower advisory fees, dominate the asset weighted averages but have far less impact on simple average advisory fees.

Average advisory fees have increased over the years despite large increases in assets. In 1965, when the SEC published the PPI Study, total mutual fund industry assets were about $35 billion, median advisory fees were 48 basis points, and average fees were 45 basis points.[88] In the fifty or so years between 1965 and 2017 total industry actively managed assets increased to about $9.5 trillion by 2015.[89]

At the end of 2017, there was about $750 billion in large cap funds that were sub-advised, comprising about 25% of all actively managed large cap assets. The sub-advised funds were slightly smaller than the overall average. The 278 sub-advised funds averaged about $2.7 billion or about 90% of the size of the overall average. Unsurprisingly, because of their smaller size, these funds had higher weighted average advisory fees of 48.5 basis points. The weighted average sub-advisory fee amounted to 20.9 basis points, less than half of the advisory fee level on the same funds. However, as will be discussed below, this fee level is not indicative of the level of sub-advisory fees determined by arm's length bargaining because some of the sample is corrupted and un-representative.

The 711 non-sub-advised funds had about $2.3 trillion of large cap assets in December 2017. Excluding the sub-advised funds increased the average fund size of this group to about $3.2 billion and decreased the weighted average advisory fee slightly to 47.6 basis points.

The bottom three lines of Table 2 subdivide the sub-advised funds into three categories. In the first category there are about $129 billion in assets sub-advised by subsidiaries of the fund advisor as indicated by the name of the sub-advisor being clearly associated with the advisor.[90] Thirty-three funds were so identified, which resulted in an average fund size larger than

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88. Brown & Pomerantz, *Some Clarity, supra* note 15, at 787.

89. *Id.*; Although the funds in the PPI Study included other than large cap funds and are not completely comparable, average fees between then and 2015 *increased* about 45% in an industry generally acknowledged to exhibit economies of scale. Normally, an increase in assets is associated with a decrease in advisory fees.

90. An advisor is not permitted to enter into a sub-advisory agreement without shareholder approval. However, SEC staff has sometimes granted exemptive relief when the new arrangement did not materially change the terms of a previously approved agreement. *See* Gregory C. Davis et al., *Mutual Fund Use of Sub-Advisers* [July 6, 2015], *in* MUTUAL FUNDS AND EXCHANGE TRADED FUNDS REGULATION § 42:2.2 (Clifford E. Kirsch ed., 2018).

the average non-sub-advised fund of about $3.9 billion. The weighted average advisory fee was 57 basis points, significantly greater than the average of the non-sub-advised funds or 47.6 basis points.

A fund that is sub-advised by a subsidiary obviously does not establish the sub-advisory fee based on arm's length bargaining because it would essentially be negotiating with itself, as is indicated by an above average weighted sub-advisory fee of 31.5 basis points. This category of fund is thus excluded from inclusion in the estimates of sub-advisory fees that follow.

One must, however, ask how it is that such large funds ($3.9 billion on average) can get away with charging such high fees. It should be expected that larger funds would be forced to lower fees because of the profit margin maximums enshrined in *Schuyt*. The answer is simple. Courts have allowed sub-advisory fees as a legitimate expense in calculating profit margins.[91] If a large fund can legally charge inflated sub-advisory fees as a legitimate expense, it can artificially reduce profit margins and charge higher advisory fees. Although this account involves some speculation, it is hard to think of an alternative explanation.

Some mutual funds are co-branded with a sub-advisor. The sub-advisor is named or branded in the title of the mutual fund, as, for example, the Nuveen Santa Barbara Dividend Growth Fund for which Nuveen is the investment manager and Santa Barbara Asset Management the sub-advisor. Typically, co-branding occurs when the advisor does not have the infrastructure/internal talent to manage a particular style of fund. Over the years, Nuveen has specialized in fixed income management and the fund sub-advised by Santa Barbara is an equity fund. The seventy-one co-branded funds were quite small, with, on average, $896 million in assets, weighted average advisory fees of 65.4 basis points, and sub-advisory fees of 36 basis points. It is to be expected that sub-advisors would demand to be compensated for lending their names to the titles of co-branded funds. For that reason, the 36 basis point sub-advisory fees are probably inflated and not representative of a true arm's length negotiation based solely on investment advisory services.

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91. *See, e.g.*, Zehrer v. Harbor Capital Advisors, Inc., No. 14 C 00789, 2018 WL 1293230, at *14 (N.D. Ill. Mar. 13, 2018) (acknowledging that mutual fund profitability reporting is required by GAAP); Kasilag v. Hartford Inv. Fin. Servs.*, LLC*, No. 11-1083, 2017 WL 773880 (D.N.J. Feb. 28, 2017), *aff'd,* No. 17-1653, 2018 WL 3913102 (3d Cir. Aug. 15, 2018) (holding that profitability is inclusive of the sub-advisor's fees); Sivolella v. AXA Equitable Life Ins. Co., No. 11 C 4194, 2016 WL 4487857, at *50-51 (D.N.J. Aug. 25, 2016) (finding that the classification of sub-advisor fees as expenses is an acceptable accounting treatment).

Excluding the first two categories leaves those sub-advised funds whose fees are determined by arm's length bargaining because the advisor and sub-advisor are independent of each other. The 174 such funds average about $3.2 billion in assets under management. Weighted average advisory and sub-advisory fees are 44.6 and 16.7 basis points, respectively.

Weighted averages are useful when it is necessary to assign more importance to certain categories, such as, in the present case, assets under management. Weighted average advisory and sub-advisory fees assign greater importance to a fund's fee if it is based on higher levels of assets. Simple or arithmetic averages, on the other hand, assign equal values to each fund, whether large or small. Simple averages are a measure of central tendency and are calculated by adding up all the values and dividing by the sample size. In Table 2 there are large differences between weighted and simple average fees because there are a relatively small number of large funds and large numbers of small sized funds. Because large funds typically involve lower fee levels, weighted average fees are lower than simple or arithmetic average fees.

It is useful to step back and take a high-altitude view of the numbers in Table 2. When an investment advisor hires a sub-advisor it essentially sub-contracts its core business function, portfolio management, to a subcontractor and profits by the difference between the advisory and sub-advisory fees. The manager has certain duties and responsibilities that may entail some costs. For now, assume that those costs are zero or very small. Weighted average advisory fees for all actively managed large cap funds in Table 2 are 0.478% or 47.8 basis points and the weighted average sub-advisory fee is 16.7 basis points. In other words, absent other costs, the investment manager marked up the sub-advisory fee about 2.7 times on average. That number is nearly identical when looking at simple average advisory and sub-advisory fees. In other words, the baked in *average* profit margin is about 65% (47.8-16.7)/47.8.

Based only on this information and assuming no significant additional costs to investment advisors, it is useful to ask the question: Do the advisory fees in Table 2 carry the earmarks of arm's length negotiation? An unbiased observer would have to answer no. Advisory fees are significantly greater than fees known to be determined by arm's length bargaining. So, applying the traditional corporate standard test of fiduciary duty, the average investment management fee violates fiduciary standards. It is worth noting that sub-advisory fees are negotiated with for-profit firms so that there is a normal profit margin/rate of return also baked into sub-advisory fees.

While interesting, the data and analysis in Table 2 is somewhat distorted by the presence of so many small funds. Standard statistical analysis assumes that variables of interest are normally distributed. A Chi Square test for normality rejects the hypothesis that advisory fees in Table 2 are normally distributed but fails to reject the hypothesis that sub-advisory fees are normally distributed. The reason that advisory fees do not conform to normality is clear. There are far too many small funds with large advisory fees. Examination of the 986 advisory fee data points in Table 2 reveals that 248 of the 986 funds had assets under management of less than $100 million and the total assets managed was just over $10 billion. So, 25% of the funds (248) have about 0.3% of the total assets of actively managed large cap funds. About 36% (352 funds) had managed a total of about $25 billion or less than 1% of total assets under management.

The presence of so many small funds adds unneeded complexity and uncertainty to the analysis of the large funds typically involved in litigation. For fairness and comparability purposes the funds in Table 2 were limited to funds with at least $1 billion in assets under management. Under these assumptions, both advisory and sub-advisory fees conform to normality assumptions. The results of that analysis are presented in Panel A of Table 3.

Table 3

Analysis of Advisory and Sub-Advisory Fees of Actively Managed Large Capitalization Mutual Funds - December 2017

Panel A: All Large Capitalization Funds with Assets of at Least $1 billion

Assets > $1Billion	Assets	Count	Average Fund Size	Weighted Average Advisory Fees	Weighted Average Sub-Advisory Fees	Simple Average Advisory Fees	Simple Average Sub-Advisory Fees	Standard Deviation of Advisory Fees	Standard Deviation of Sub-Advisory Fees
All funds	2,869,534,504,324	373	7,693,121,996	0.462		0.552		0.182	
All Sub Advised Funds	686,675,920,753	111	6,186,269,556	0.468	0.202	0.556	0.243	0.153	0.155
All Non-Sub-Advised Funds	2,182,858,583,571	262	8,331,521,311	0.460		0.551		0.193	
Subsidiary Sub-Advised Funds	125,652,161,471	20	6,282,608,074	0.572	0.316	0.593	0.342	0.115	0.206
Co-Branded Sub-Advised Funds	45,491,493,414	17	2,675,970,201	0.619	0.371	0.645	0.358	0.128	0.128
Independently Sub-Advised Funds	515,532,265,868	74	6,966,652,241	0.429	0.159	0.525	0.189	0.193	0.113
			Upper Confidence Interval		.189 + 2(.113) =		0.416		

Panel B: Analysis of Funds Above and Below 95% Upper Confidence Interval of Sub-Advisory Fees

Assets > $1Billion	% of Count	% of Assets	Assets	Count	Average Fund Size	Weighted Average Advisory Fees	Simple Average Advisory Fees
Advisory Fee <=.416	22.5%	40.8%	1,171,492,393,336	84	13,946,338,016	0.285	0.316
Advisory Fee > .416	77.5%	59.2%	1,698,042,110,988	289	5,875,578,239	0.584	0.623
Totals	100%	100%	2,869,534,504,324	373	7,693,121,996	0.462	0.552

The first thing to note about Panel A is that the level of total assets under analysis has decreased 5.2% from about $3 trillion to $2.87 trillion after the analysis eliminated 618 small funds, or a 62% decrease. The remaining funds, those with at least $1 billion of assets, caused the average fund analyzed to increase from about $3 billion to about $7.7 billion. The impact on weighted average advisory fees was minimal, dropping from 47.8 to 46.2 basis points. The impact on simple average fees was somewhat more pronounced, dropping from 66 to 55.2 basis points. Overall weighted average sub-advisory fees dropped slightly from 20.9 to 20.2 basis points. Simple average sub-advisory fee fell from 24.4 basis points to 18.9 basis points for independently sub-advised funds.

It is inappropriate to apply standard statistical analysis to weighted averages as this violates required normality assumptions. Accordingly, in the analysis that follows only simple averages will be used. The differences between weighted and simple averages of advisory and sub-advisory fees were much reduced when small funds were eliminated from the analysis.

The calculation of simple average sub-advisory fees and the corresponding standard deviation enable the application of a statistical test conforming to the initial objective *Gartenberg* standard, i.e., whether the fee in question is outside of the range of fees determined by arm's length bargaining. The confidence interval, or the 95% confidence interval, is a common statistical tool that conforms very closely to this insight.[92] When variables are normally distributed, 95% of all observations will fall within plus or minus two standard deviations of the arithmetic or simple average of the sample.

As can be observed in Table 3, simple average sub-advisory fees on independently sub-advised funds were 18.9 basis points with a standard deviation of 11.3 basis points. Thus, the upper 95% confidence limit is 18.9 plus two times 11.3 or 41.6 basis points. Funds with fees falling above this limit have advisory fees outside of the range of fees determined by arm's length bargaining and, at minimum, should be investigated further. Because simple average advisory fees are about 55 basis points, there is reason to believe[93] that more than half of all actively managed large

92. *See* Erica Beecher-Monas, *Lost in Translation: Statistical Inference in Court,* 46 ARIZ. ST. L.J. 1057, 1068 (2014) ("A confidence interval is defined as a range of possible (relative risk) values at a given significance level (P-value). A 95% confidence interval means that, over a vast number of repetitions, 95% of the intervals generated would contain the true association if the model were correct. If the model used to compute the confidence interval is correct, the data and the model provide more support for data points inside the limits of the interval than outside. A relative risk of one within the confidence interval does not mean there is no association, because confidence intervals include a range of values. If, for example, we have a 95% CI [1-10], the interval includes the relative risk of one, but it also includes the relative risk of ten. Thus the relative risk is as likely to be ten as it is one.") (citations omitted).

93. When variables are normally distributed, half of the observations will fall below the mean and half above the mean. Because the mean advisory fee is 55 basis points and the

cap funds have advisory fees outside of the range of arm's length bargaining. This is shown to be the case in Panel B of Table 3.

In Panel B, the 373 actively managed funds with at least $1 billion of assets under management are split into two groups, those with fees below the 95% confidence limit of sub-advisory fees and those above the limit. In Panel B, 289 of the 373 funds or 77% had advisory fees greater than the 95% confidence limit of sub-advisory fees. These funds had total assets of $1.7 trillion or 59% of the assets of all actively managed large cap funds with assets of at least $1 billion. The simple average advisory fee on these funds was 62.3 basis points, versus 31.6 basis points for funds with fees below the 95% confidence limit. Weighted average fees were 58.4 versus 28.5 for the corresponding groupings.

Funds with advisory fees below the 95% confidence limit were larger on average than those above the limit; $14 billion versus $5.9 billion. The average level of assets under management was about $7.7 billion. The difference in the average size of the funds in the two groups may explain some of the difference in fees as larger funds typically have lower fees. This argues against a mechanical application of the standard. A more precise application would involve the comparison of fees of funds with similar levels of assets under management.[94]

It is possible to draw some tentative conclusions from the above analysis. It is reasonable to ask if the fee being litigated is outside of the range of fees determined by arm's length negotiation. Application of the statistical test implied by this standard strongly suggests that a very large proportion of the funds in question fall outside of this range. This implies that Professor Johnson's observation that something is amiss with § 36(b) is strongly supported by the analysis. Under the currently applied standard, no investment manager has ever been shown to have charged excess fees. Under the objective standard developed here, a large proportion of large cap advisory fees would fall outside the range of fees determined by arm's length bargaining.

VII. *JONES V. HARRIS* AND ITS AFTERMATH

When an opportunity arose, the Supreme Court, in the face of

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upper confidence limit is 42 basis points, more than half of the funds have advisory fees greater than 42 basis points.

94. A more refined analysis involving a regression of sub-advisory fees on the level of assets could be conducted. The resultant standard error of the regression would allow for the calculation of a confidence interval at different levels of assets.

evidence that competition had not imposed discipline on advisory fees, continued the judiciary's bias against plaintiffs in § 36(b) cases. A Seventh Circuit panel, using research by Coates and Hubbard[95] that was partially sponsored by the Investment Company Institute[96] held that the *Gartenberg* standard was obsolete because competition imposes discipline on advisory fees. However, the notion that competition imposes discipline on advisory fees has been effectively debunked by recent research showing, *inter alia*, that advisory fees are insensitive to massive increases in assets levels and that investment advisory firms earn economic profits for owners.[97]

The full court denied rehearing, but five judges, led by Judge Posner, dissented,

> The panel bases its rejection of *Gartenberg* mainly 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.[98]

The dissent cited considerable research, including that by Freeman and Brown,[99] who showed that mutual fund investment advisory fees are roughly double comparable pension fees that are determined by arm's length bargaining, and concerns about mutual fund corporate governance.

Judge Posner's dissent also referenced research by Camelia Kuhnen,[100] who questioned the independence of independent directors. Johnson has summarized Kuhnen's research:

> Professor Kuhnen found that business connections— specifically the number of times fund directors have sat on boards of any other funds managed by the adviser and a related measure of connectivity between the adviser and a potential new subadviser—foster favoritism in dealings between fund directors and advisers to the detriment of investors. She found that when mutual funds select subadvisory firms to help the primary adviser manage the fund, the greater the connection between such firms and fund directors through past business relationships, the more likely they are to win the management contract. Moreover, the more connected subadvisers and fund directors are, the lower the

95. *See generally* John C. Coates & R. Glenn Hubbard, *Competition in the Mutual Fund Industry: Evidence and Implications for Policy*, 33 J. CORP. L. 151 (2007).
96. Asher Hawkins, *Well-Funded Opinion*, FORBES, May 25, 2009, at 28.
97. Brown & Pomerantz, *Some Clarity*, *supra* note 15, at 767.
98. Jones v. Harris Assocs. L.P., 537 F.3d 728, 731-32 (7th Cir. 2008).
99. Freeman & Brown, *Mutual Fund Fee Litigation, supra* note 15, at 638.
100. *Jones,* 537 F.3d at 730.

> net and risk-adjusted rates of return. Past business connections also play a role in an adviser's selection of directors to serve on new funds sponsored by the adviser. In addition, Professor Kuhnen found that business connections are positive predictors of expense ratios and advisory fees. She also concluded that all measures of business connections are significant negative predictors of the amount of expenses the advisor reimburses to the fund.[101]

Kuhnen's research is consistent with the insights and opinions of many scholars, experts, and judges, as well as with the implications of this paper. SEC Chairman Cohen, an unconflicted public servant attempting to act in the public interest, opined, for example, that it is a myth that unaffiliated directors serve as an effective control over advisory fees.[102]

Two noteworthy industry insiders have also commented on the general failure of mutual fund boards to fulfill their responsibilities under the ICA. Jack Bogle, founder of the Vanguard Group, made the following comment:

> Well, fund directors are, or at least to a very major extent, sort of a bad joke. They've watched industry fees go up year after year, they've added 12b-1 fees. I think they've forgotten, maybe they've never been told, that the law, the Investment Company Act, says they're required to put the interest of the fund shareholders ahead of the interest of the fund adviser. It's simply impossible for me to see how they could have ever measured up to that mandate, or are measuring up to it.[103]

Warren Buffett, famous investor and chairman of Berkshire Hathaway, once made the following comment:

> I think independent directors have been anything but independent. The Investment Company Act, in 1940, made these provisions for independent directors on the theory that they would be the watchdogs for all these people pooling their money.

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101. Johnson, *Fresh Look*, *supra* note 14, at 514.

102. *See Investment Company Act Amendments of 1967: Hearings Before the Subcomm. on Commerce & Fin. of the H. Comm. on Interstate and Foreign Commerce on H.R. 9510 and H.R. 9511, Pt. 1*, 90th Cong. 46 (1967) (statement of Manuel F. Cohen, Chairman, Securities & Exchange Commission) ("the industry insists on propagating the myth that unaffiliated directors have served as an effective control over advisory fees. . . . These statements, however, are flatly contradicted by the sworn testimony of the directors of the largest mutual fund").

103. Amended Complaint Under Investment Company Act of 1940 at 22, Gallus v. Ameriprise Fin., Inc., No. 04-cv-04498 (D. Minn. 2006).

> The behavior of independent directors in aggregate since 1940 has been to rubber stamp every deal that's come along from management—whether management was good, bad, or indifferent. Not negotiate for fee reductions and so on. A long time ago, an attorney said that in selecting directors, the management companies were looking for Cocker Spaniels and not Dobermans. I'd say they found a lot of Cocker Spaniels out there.[104]

Others are also skeptical of the efficacy of fund governance.[105] Palmiter argued that fund independent directors:

> [a]pprove fund transactions with the management firm and ensure compliance with the 1940 Act and implementing SEC rules. Fund directors thus function as outsourced regulators, with their selection and compensation in the hands of the management firm they supervise. . . . Fund boards have been weak and even feckless protectors of fund investors. . . .[106]

Birdthistle found evidence of decisions made by the investment management industry, such as market-timing, portfolio valuation, and late trading that increased investment advisor profits while costing investors billions of dollars.[107]

A decade ago, one District Court excoriated independent directors for engaging in "an elaborate exercise in checking off boxes and papering the file," instead of seeking to obtain "the best possible deal for investors."[108] Nevertheless, the plaintiffs lost the case. Plaintiffs consistently lose such

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104. Haywood Kelly, *A Quick Q & A with Warren Buffett,* Morningstar (May 6, 1998); *cited in* Strougo v. BEA Assoc., 188 F. Supp.2d 373, 383 (S.D.N.Y. 2002).

105. *See* David J. Carter, *Mutual Fund Boards and Shareholder Action*, 3 VILL. J.L. & INV. MGMT. 6 (2002) (questioning the theoretical viability of fund governance due to a belief that the interests of independent mutual fund directors may be closely aligned with those of interested directors); John P. Freeman & Stewart L. Brown, *Mutual Fund Advisory Fees: The Cost of Conflicts of Interest,* 26 J. CORP. L. 609 (2001) (arguing that interests of a fund's board are aligned with the investment adviser, rather than the shareholders); Johnson, *Fresh Look*, *supra* note 14 (sharing inconclusive empirical evidence on the relationship between mutual fund director independence and mutual fund advisory fees); Eric D. Roiter, *Disentangling Mutual Fund Governance from Corporate Governance*, 6 HARV. BUS. L. REV. 1 (2016) (arguing that fundamental differences between mutual funds and corporations necessitate a disentanglement of mutual fund governance from corporate governance).

106. Alan R. Palmiter, *The Mutual Fund Board: A Failed Experiment in Regulatory Outsourcing*, 1 BROOK. J. CORP., FIN. & COM. L. 165, 165 (2006).

107. William A. Birdthistle, *Compensating Power: An Analysis of Rents and Rewards in the Mutual Fund Industry*, 80 TUL. L. REV. 1401, 1451-60 (2006).

108. In re Am. Mut. Funds Fee Litig.*,* No. 04-5993, 2009 WL 5215755, at *3 (C.D. Cal. Dec. 28, 2009).

cases, because checking boxes and papering the file "is what controlling case law and SEC regulations demand, and is sufficient to immunize Defendants against § 36(b) liability so long as the fees charged are not grossly out of line with the range of fees charged in the industry."[109]

In *Jones,* the Supreme Court was asked to resolve a split among the Circuit Courts of Appeal as to the proper standard under § 36(b) for determining if a breach of fiduciary duty had occurred. The Supreme Court found itself on the horns of a dilemma not dissimilar to the binary choice faced by the *Gartenberg* courts. To resolve the conflicting arguments among, first, the Second, Third, and Fourth Circuit, supporting the *Gartenberg* standard, second, Judge Easterbrook and four other Seventh Circuit judges, who would adopt a different standard, and third, Judge Posner of the Seventh Circuit who questioned *Gartenberg,* but on different grounds, it faced an unpalatable choice. If it ruled with Judge Easterbrook, whose opinion was based on questionable research, it would have blown away the *Gartenberg* standard with serious but unknown consequences. If it ruled with Judge Posner, it was sure to unleash a flood of litigation. Ultimately, the Supreme Court embraced the status quo and retained the *Gartenberg* standard:

> The *Gartenberg* standard. . . may lack sharp analytical clarity, but we believe that it accurately reflects the compromise that is embodied in §36(b), and it has provided a workable standard for nearly three decades. The debate. . . regarding today's mutual fund market is a matter for Congress, not the courts.[110]

This statement is disingenuous and revealing. As discussed above, the "compromise" was essentially a sell out to the ICI and the "workable standard" comment belies the voluminous evidence that something is amiss with § 36(b). Suggesting that the problem is one to be handled by Congress makes explicit the refusal of the judiciary to get involved in mutual fund advisory fee matters. Moreover, in rationalizing this decision, the Supreme Court was forced to embrace the *Gartenberg* standard and ignore Judge Posner's considerations regarding mutual fund corporate governance:

> Congress rejected a "reasonableness" requirement that was criticized as charging the courts with rate-setting responsibilities. . . . Congress' approach recognizes that courts are not well suited to make such precise calculations.

109. *Id.*
110. Jones v. Harris Assocs., 559 U.S. 335, 353 (2010).

> *Gartenberg*'s "so disproportionately large" standard, 694 F. 2d, at 928, reflects this congressional choice to "rely largely upon [independent director] 'watchdogs' to protect shareholders interests."[111]

There is much to unpack in the above statement. First, Congress thought that a fiduciary standard was equivalent to a reasonableness requirement and the Second Circuit agreed with that. Thus, Congress did not so much reject a reasonableness standard as recast it as a fiduciary standard. It is incorrect to say that Congress rejected a reasonableness requirement. It was and is the judiciary that rejected and continues to reject a reasonableness requirement. It does so by embracing an extreme and subjective fiduciary standard.

Second, the notion that courts are "unsuited" and "professionally untrained" to determine a fair price reinforces Donald Langevoort's insight that the *Gartenberg* standard was purposefully extreme to relieve the judicial system from having to make such determinations. Also, it is not necessarily true that courts are unsuited to make such determinations. In testimony before Congress in 1967, Judge Friendly, of the Second Circuit Court of Appeals, opined:

> I am glad to give the subcommittee such help as I can on the limited question whether Congress should hesitate to enact a [reasonableness] requirement. . . for fear that the courts could not administer it properly. I think I can sum up my position by saying that while the courts are not looking for any more business, because we have plenty, and Congress keeps us well occupied with new lines of business, I perceive no reason why the courts could not effectively administer [a reasonableness requirement] if Congress should decide that it wants us to do so.[112]

Judge Friendly went on to illustrate several situations where courts had effectively made such determinations. He also opined that uniformity of decision among different courts was a consideration:

> I would have to agree that if uniformity in standards as to the fees of advisers of investment companies was the controlling consideration, that would be better accomplished by requiring

111. *Id.* at 352-53.

112. *Investment Company Act Amendments: Hearings Before the Subcomm. on Commerce & Fin. of the H. Comm. on Interstate and Foreign Commerce on H.R. on H.R. 9510 and H.R. 9511,* Pt. 2, 90th Cong., 609 (1967) (statement of Judge Henry J. Friendly, Second Circuit Court of Appeals).

> any complaint to be presented to the SEC for action, subject only to the usual limited judicial review.[113]

Thus, Judge Friendly envisioned a role for the SEC in enforcing a reasonableness standard as did the SEC itself.[114]

Finally, consider the last sentence from *Jones* quoted above: *Gartenberg*'s "so disproportionately large" standard reflects a congressional choice to "rely largely upon [independent director] 'watchdogs' to protect shareholders interests." The sentence overstates Congress's intent. Although the Senate Report said that "this section is not intended to authorize a court to substitute its business judgment for that of the mutual fund's board of directors in the area of management fees,"[115] Congress was more circumspect in the actual language of the statute. Section 35(b) states that a reviewing court should take into account fund directors' approval of an adviser's management contract by "giving such consideration. . . as is deemed appropriate under all the circumstances."[116] Thus, the Supreme Court overstated the case in asserting that Congress intended for independent directors to be the principal protectors of shareholder interests.

Langevoort argues that *Burks* was pivotal in reducing the level of judicial scrutiny in breach of fiduciary duty cases.[117] The Supreme Court knew or should have known that the business judgment rule is highly suspect, if for no other reason than that Judge Posner brought it to their attention. Yet they chose to ignore Judge Posner's concerns and the inconvenient fact that independent directors are ultimately powerless to influence fees because of the inseverable relationship of the fund with the investment manager. By ducking the hard questions and embracing the status quo, the Supreme Court was and is complicit in the systematic overcharging of ninety million mutual fund investors.

As previously discussed, the Second Circuit in *Gartenberg* cautioned against using the *level* of fees of similar funds to gauge the fees of a specific funds or funds, although it is proper to look at the *structure* of fees, i.e., breakpoints in the fee schedules of comparable funds as a measure of

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113. *Id.* at 611.

114. *See Investment Company Act Amendments of 1967: Hearings Before the Subcomm. on Commerce & Fin. of the H. Comm. on Interstate and Foreign Commerce on H.R. 9510 and H.R. 9511, Pt. 1*, 90th Cong. 44 (1967) (statement of Manuel F. Cohen, Chairman, Securities & Exchange Commission).

115. Investment Company Amendments Act of 1969, S. Rep. 91-184, at 7 (1969).

116. 15 U.S.C. § 80a-35(b)(2) (2012).

117. Donald J. Langevoort, *supra* note 59, at 1017-19 (2015).

sharing of economies of scale. *Jones v. Harris* reinforced that notion.[118]

That all changed, however, with *Gallus v. Ameriprise Financial, Inc.,*[119] a § 36(b) case decided by the Minnesota District Court and reversed by the Eighth Circuit while *Jones v. Harris Associates* was pending before the Supreme Court. After the Supreme Court issued its opinion in *Jones v. Harris Associates,* it granted Ameriprise's petition for certiorari, vacated the Eighth Circuit's opinion, and remanded for further consideration in light of *Jones.*[120] The District Court reinstated its earlier decision and the Eighth Circuit affirmed.[121]

In the District Court, plaintiffs alleged that fees were excessive in relation to fees determined at arm's length, such as pension fees.[122] Defendants admitted that the board of directors looked only at fees of competitors' funds in setting advisory fee rates because they wanted to be "in the middle of the pack."[123] Although the Eighth Circuit in its post-*Jones* decision recognized that "the Supreme Court also clarified that comparisons between the fees that an adviser charges its institutional clients and the fees it charges its mutual fund clients may be relevant,"[124] the court concluded that the plaintiffs had failed to present additional evidence that the fee was outside arm's-length range that would allow plaintiffs to survive a motion for summary judgment, as *Jones* requires.[125] Since *Gallus*, it has become settled case law that "comparative fee structure" means the *level* of fees of comparable funds, an issue that was important in the much more recent case of *Kasilag v. Hartford.*

VIII. KASILAG V. HARTFORD

The most efficient manner to test the proposed objective fiduciary standard is to apply it to an actual case and compare the implications to the actual outcome. *Kasilag v. Hartford* is just such a case.[126] This section of

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118. 559 U.S. 335, 346-47 (2010).

119. Gallus v. Ameriprise Fin., Inc*.,* 497 F. Supp. 2d 974, 981 (D. Minn. 2007), *rev'd and remanded on other grounds*, 561 F.3d 816 (8th Cir. 2009), *cert. granted, judgment vacated*, 559 U.S. 1046 (2010), *and order reinstated sub nom.* Gallus v. Am. Exp. Fin. Corp., 2010 WL 5137419 (D. Minn. Dec. 10, 2010), *aff'd*, 675 F.3d 1173 (8th Cir. 2012).

120. Ameriprise Fin., Inc. v. Gallus, 559 U.S. 1046 (2010).

121. Gallus v. American Express Fin. Corp., No. 04–4498, 2010 WL 5137419 (D. Minn. Dec. 10, 2010), *aff'd*, 675 F.3d 1173 (8th Cir. 2012).

122. *Gallus,* 497 F. Supp. 2d at 984.

123. *Id.* at 976.

124. Gallus v. Ameriprise Fin., Inc., 675 F.3d 1173, 1179 (8th Cir. 2012).

125. *Id.* at 1180-81.

126. Kasilag v. Hartford Inv. Fin. Servs., LLC, No. 11-1083, 2017 WL 773880 (D.N.J.

the paper presents a synopsis of the facts in *Kasilag*, including a distillation of the financial data presented in the case, applies the proposed objective fiduciary standard to the facts and data of the case, and discusses the results and implications.

Section 36(b) cases against investment managers involving sub-advisory fees fall into two general categories: manager of manager cases and reverse manager of manager cases.[127] In manager of manager cases, plaintiffs assert that sub-advisors are performing essentially all the management services but receive only a fraction of the fee paid to the manager. In reverse manager of manager cases plaintiffs assert that a management fee is excessive because the manager charges substantially lower fees to perform essentially identical services when sub-advising funds for other investment managers. *Kasilag* was a manager of manager case.[128]

Two of the *Gartenberg* factors, comparative fee structures and the profitability of the funds to the advisor, are important to an understanding of the decision in *Kasilag.* There was extensive evidence presented in the case concerning comparative performance and costs with peer funds as determined by Lipper Analytical.[129] In general, it was revealed that the Hartford funds were mediocre performers with unexceptional fees as compared to peer funds.[130]

Fees charged by Hartford were high, but profit margins were below the levels considered excessive in *Schuyt*. The case was essentially decided on the level of profits defendants earned on the funds.[131] The judge ruled against the plaintiff's theory that sub-advisory fees were not a proper deduction from revenues in the calculation of profits and found for the defendants on the basis of the subjective *Gartenberg* standard.[132] However, if sub-advisory fees were disallowed as legitimate expenses, profit margins would have exceeded the *Schuyt* ceilings.

Defendants argued that they bore substantial responsibilities and risks

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Feb. 28, 2017), *aff'd,* No. 17-1653, 2018 WL 3913102 (3d Cir. Aug. 15, 2018).

127. SEAN M. MURPHY ET AL., DEVELOPMENTS IN LITIGATION UNDER SECTION 36(B) OF THE 1940 ACT §I (2017), https://www.westlaw.com/Document/Ie9505880cf4c11e79bef99c0ee06c731/View/FullText.html?transitionType=Default&contextData=(sc.Default)&VR=3.0&RS=cblt1.0.

128. Kasilag v. Hartford Inv. Fin. Servs., LLC, 745 Fed.Appx. 452, 454 (3d Cir. 2018).

129. Kasilag, No. 11-1083, 2017 WL 773880, *8-11 (D.N.J. Feb. 28, 2017).

130. *Id.* at *12.

131. *Id.* ("The crux of Plaintiffs case largely turns upon the argument that one should consider the services performed specifically by Defendants as separate and apart from those performed by the sub-advisor.").

132. *Id.* at *14.

that validated the high levels of profits earned.[133] Responsibilities included establishing fund policy, supervising each fund's investment program, providing information to the board of directors, and coordinating matters relating to the custodian, transfer agent, accountants, attorneys, and other parties performing services or operational functions.[134] Risks included entrepreneurial, reputational and regulatory/legal risks.

Application of an objective standard tied to the range of fees determined by arm's length bargaining puts this decision in its proper context. A beginning point is to examine the relevant assets, fees, costs and profits associated with the six funds named in *Kasilag*. The court presented a complete financial analysis over the four-year period from 2010 – 2013. For clarity of analysis and exposition the data is here analyzed for the only the last period, 2013, although the conclusions reached apply to the whole period. The data of interest are presented in Table 4:

Table 4

Analysis of Assets, Fees, Costs and Profits for 2013 in Kasalag v Hartford

	Average Assets	Gross Management Fees	Advisory Fee Rates	Sub-Advisory Fees	Sub-Advisory Fee Rates	Operating Expenses	Operating Expense Rates	Total Expenses	Gross Profits	Profit Margin
Hartford Balanced Fund	627,290,000	4,246,000	0.68%	974,000	0.16%	285,000	0.045%	1,259,000	2,987,000	70.3%
Hartford Capital Appreciation Fund	11,764,413,000	77,255,000	0.66%	29,411,000	0.25%	787,000	0.007%	30,198,000	47,057,000	60.9%
Hartford Floating Rate Fund	6,773,759,000	40,288,000	0.59%	9,483,000	0.14%	562,000	0.008%	10,045,000	30,243,000	75.1%
Hartford Growth Opportunities Fund	2,387,115,000	16,962,000	0.71%	6,454,000	0.27%	346,000	0.014%	6,800,000	10,162,000	59.9%
Hartford Healthcare Fund	578,202,000	5,161,000	0.89%	2,080,000	0.36%	283,000	0.049%	2,363,000	2,798,000	54.2%
Hartford Inflation Plus Fund	1,814,042,000	8,372,000	0.46%	1,197,000	0.07%	338,000	0.019%	1,535,000	6,837,000	81.7%
Averages	3,990,803,500	25,380,667		8,266,500					16,680,667	
Weighted Averages			0.64%		0.21%		0.011%			65.7%
Totals	23,944,821,000	152,284,000		49,599,000		2,601,000		52,200,000	100,084,000	

There were six funds named in the case, which are listed in the left column of Table 4. Morningstar classified two of the six funds, the Hartford Capital Appreciation Fund and the Hartford Growth Opportunities Fund, as Large Cap Funds. It classified the Hartford Balanced Fund as Fund Allocation – 50% to 70% Equity, the Hartford Floating Rate Fund as a Bank Loan Fund, the Hartford Inflation Plus Fund as an Inflation Protected Bond Fund, and the Hartford Healthcare Fund simply as a Health Fund. The funds ranged in size from $587 million to $11.8 billion in average assets in 2013. On average the six funds had about $4 billion in average assets in 2013.

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133. *Id.* at *21.

134. *Id.* at *3.

Total revenues to Hartford on these six funds for 2013 amounted to $152 million, which yielded a weighted average advisory fee rate of 64 basis points. Sub-advisory fee costs to Hartford amounted to about $50 million for the year and the weighted average cost of sub-advising by Wellington Management, the sub-advisor, was 21 basis points.

Hartford incurred operating expenses in addition to sub-advisory fees of about $2.6 million, which amounted to 1.1 basis points.[135] Total expenses amounted to about $52 million or about 22 basis points. The combination of Gross Management fee and sub-advisory and operating expenses yield an overall weighted average profit margin of 65.7%, well below the *Schuyt* profit margin ceiling. A discussion of these results will follow the application of the proposed objective fiduciary standard.

Table 3 shows that at the end of 2017, large cap funds with advisory fees greater than 41.6 basis points were outside of the range of 95% of fees determined by arm's length bargaining, i.e., sub-advisory fees charged to manage large cap portfolios. Data for large cap funds, including the two Hartford large cap funds, were sorted into those with fees above 41.6 basis points and those below that level. The two Hartford funds were in the former group and, for comparison purposes, Table 5 shows those funds and a selected sample of funds with asset levels close to the asset levels of the two Hartford funds. Again, these data are for the end of 2017, four years after the latest period analyzed in *Kasilag*.

135. Plaintiff's expert calculated operating expenses. The profit margins calculated in Table 4 are nearly identical to the profit margins calculated by Hartford. Operating expenses seemed to exhibit significant economies of scale. The largest fund was the Capital Appreciation Fund, whose operating expenses were less than a basis point while the two smallest funds had operating expenses of almost 5 basis points.

Table 5			
Comparison of Hartford Large Cap Fund Fees to Fees of Selected Funds within the 95 % Confidence Interval for Sub-Advisory Fees - December 2017			
Fund Name	**Net Assets 12/17**	**Advisory Fee Rates**	
Panel A Select Large Cap Funds with Advisory Fees < 41.6 Basis Points - December 2017			
Fidelity® Independence Fund	**3,905,040,125**	**0.315**	
JPMorgan Intrepid America Fund	**4,269,393,959**	**0.399**	
Putnam Growth Opportunities Fund	**4,607,931,980**	**0.406**	
Fidelity® Fund	**4,626,949,158**	**0.337**	
TIAA-CREF Large Cap Growth Fund	**4,917,000,697**	**0.409**	
State Farm Growth Fund	**5,043,276,228**	**0.103**	
MFS® Massachusetts Investors Trust	**6,584,965,818**	**0.330**	
TIAA-CREF Growth & Income Fund	**6,831,826,647**	**0.394**	
Lord Abbett Affiliated Fund	**6,852,833,234**	**0.316**	
MFS® Massachusetts Investors Growth Stock Fund	**7,143,395,314**	**0.330**	
TIAA-CREF Large Cap Value Fund	**7,230,613,496**	**0.392**	
Fidelity® Capital Appreciation Fund	**7,361,086,562**	**0.340**	
Averages	**5,781,192,768**	**0.339**	
Weighted Average		**0.340**	
Panel B - Hartford Large Cap Funds December 2017			
Hartford Capital Appreciation Fund	**8,161,276,580**	**0.660**	
Hartford Growth Opportunities Fund	**4,703,068,192**	**0.705**	
Averages	**6,432,172,386**	**0.683**	
Weighted Average		**0.677**	

The principal insight from Table 5 is that several large cap funds with asset levels similar to the two Hartford large cap funds also have significantly lower advisory fees. The 12 non-Hartford funds in Panel A had average assets of about $5.8 billion and average advisory fees of about 34 basis points. In contrast, the two Hartford large cap funds in Panel B had average assets of about $6.4 billion and average advisory fees double the level of the funds in Panel A, 68 basis points.

Thus, unlike the conclusion reached by the court in *Kasilag*, a relatively straightforward application of an objective fiduciary standard leads to the conclusion that the Hartford large cap funds were well outside of the range of advisory fees determined by arm's length bargaining.[136]

136. As shown in Tables 4 and 5, in the interim between 2013 and December 2017, the

The test applied is relatively stringent; Hartford advisory fees are greater than at least 95% of fees determined by arm's length bargaining as represented by sub-advisory fees of similar funds. In fact, the Hartford large cap advisory fees are more than four standard deviations (0.189 + 4 times 0.113 = 0.641) greater than average sub-advisory fees, which means that essentially all of the sub-advisory fees in the large cap universe are less than Hartford large cap fees.

This is not to say that the non-Hartford funds in Panel A carry the equivalent of arm's length determined fees. On the contrary, indications are that they do not. The weighted average sub-advisory fee of large cap funds in Table 3 was about 16 basis points for funds with an average level of assets of about $7 billion, only slightly greater than the average fund in Panel A of Table 5. So, the average advisory fee of the funds in Panel A of Table 5 was double the average sub-advisory fees on sub-advised large cap funds of a similar size. The Hartford large cap fees were quadruple the level of sub-advised large cap funds.

The other four Hartford funds named in the case had different Morningstar Categories that generally contained fewer funds, lower total assets and smaller funds.[137] There was a concomitant decrease in the number of sub-advised funds available for comparison purposes. An analysis parallel to the two large cap funds is presented in Table 6. The results are like the results for large cap funds. In December 2017 there were 189 balanced funds with 50% to 70% equity in the Morningstar database, 31 of which were sub-advised. The average sub-advisory fee was 20.2 basis points and with a standard deviation of 12.8 basis points, yielding an upper 95% confidence interval of 46.3 basis points. The advisory fee on the Hartford Balanced Fund was 66.3 basis points, greater than the 95% upper confidence interval. The balance of Table 6 demonstrates that similar to the large cap and balanced funds, the other three funds named had advisory fees above the 95% confidence interval for fees determined by arm's length bargaining.[138]

Hartford Capital Appreciation fund saw assets decrease from $11.7 billion to $8.1 billion, while its advisory fee was constant at 66 basis points. The Hartford Growth Opportunities Fund grew from about $2.4 billion to $4.7 billion over the same period and its advisory fee fell by about half a basis point.

137. *Kasilag*, No. 11-1083, 2017 WL 773880, *3.

138. Unlike Large Cap Funds, the vast majority of the advisory fees of the funds in Table 6 were greater than the upper limit of the 95% confidence interval.

			Table 6				
Comparison of Hartford Advisory Fees to the 95% Confidence Interval for Sub-Advisory Fees,							
Balanced, Bank Loan, Health and Inflation Protected Funds - December 2017							
	Number of Funds	**Number of Sub-Advised Funds**	**Average Advisory Fee**	**Average Sub-Advisory Fee**	**Standard Deviation of Sub Advisory Fees**	**Upper 95% Confidence Limit of Sub Advisory Fees**	**Hartford Advisory Fee**
Balanced Funds	**189**	**31**	**0.511**	**0.202**	**0.128**	**0.463**	
The Hartford Balanced Fund							**0.663**
Bank Loan Funds	**55**	**12**	**0.594**	**0.252**	**0.063**	**0.377**	
Hartford Floating Rate Fund							**0.602**
Health Funds	**33**	**5**	**0.759**	**0.263**	**0.089**	**0.442**	
The Hartford Healthcare Fund							**0.852**
Inflation Protected Funds	**45**	**6**	**0.365**	**0.152**	**0.078**	**0.308**	
Hartford Inflation Plus Fund							**0.494**

A straightforward application of the objective fiduciary standard developed here clearly indicates that the named funds in *Kasilag* carried advisory fees outside of the range of fees determined by arm's length bargaining. Yet the *Kasilag* court found for the defendants, another indication that something is amiss with judicial interpretations of § 36(b).

IX. APPLICATION OF THE *GARTENBERG* STANDARD IN *KASILAG*

Lost in the arguments about standards and their judicial interpretation is the fundamental fact that mutual funds are *structurally different* from other corporations. The mutual fund corporation or trust is inextricably tied to the investment manager/fund sponsor who cannot be fired. Thus, the fund faces a monopoly seller of investment advisory services. This monopoly is the genesis of the need to compare advisory fees to fees determined at arm's length. If advisory fees are not a reasonable approximation of fees determined by market forces then there is reason to believe that fund investors are overcharged for investment advisory services and that fund sponsors earn monopoly or economic profits, also known as rents.

The Hartford mutual fund complex was "managed" by the Hartford Funds Management Company, LLP. In December of 2018, the complex comprised seventy-two Hartford mutual funds with a total of $116 billion of assets under management, $113 billion or ninety-seven percent of which was sub-advised.[139] Wellington Management Company had responsibility for about $1 trillion in assets and Schroder Investment Management Company was responsible for the balance of about $593.3 billion.[140] Wellington and Schroder were and are for profit companies, and thus it is to be expected that they earned a normal and competitive profit margin or rate of return for the management services they provided (investing).

Given the above information, it can be concluded that Hartford Investment Management Company did not do investment management in the usual sense of the word. The plaintiff's expert calculated that Hartford had the equivalent of about twenty-one full-time employees managing the fifty plus funds in the complex from 2010 to 2013, less than one full-time employee per fund.[141] Thus, Hartford did not employ any of the usual analysts and portfolio managers. As revealed above, investment management of about 97% of Hartford mutual fund assets was sub-contracted out.[142] Hartford was truly a "Manager of Managers."

Consider again the contents of Table 4 above. Hartford received about $152 million in gross management fees from the six funds named in the suit in 2013. The six funds had average assets in 2013 of about $24 billion so that that the weighted average management fee was 64 basis points. There were about $52 million of total expenses composed of $49.6 million in sub-advisory fees paid to Wellington Management and about $2.6 million of internal operating expenses.

It follows that gross profits (revenues minus costs) to Hartford on the six named funds were about $100 million for 2013. In context, Hartford made $100 million on funds for which it had sub-contracted out all the core investment functions: investment analysis, portfolio management, cash

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139. *About Us*, HARTFORD FUNDS, https://www.hartfordfunds.com/about-us.html (last visited Feb. 21, 2019). https://perma.cc/L2ZX-3JGH

140. *About Wellington Management*, HARTFORD FUNDS, https://www.hartfordfunds.com/insights/AboutWellingtonManagement.html (last visited Feb. 21, 2019); *About Schroders*, HARTFORD FUNDS, https://www.hartfordfunds.com/insights/about-schroders.html (last visited Feb. 21, 2019).

141. *Kasilag*, No. 11-1083, 2017 WL 773880 at *13.

142. There were four funds with about 3 percent of the assets "managed" in house by two employees, Vernon J. Meyer, Managing Director and Chief Investment Officer, and Allison Mortensen, Head of Multi-Asset Solutions and Managing Director. Meyer and Mortenson oversaw four asset allocation funds (Checks and Balances, Conservative Allocation, Growth Allocation, and Moderate Allocation), all of which were Fund of Funds, which means that there was no selection of individual securities, just in the proportion of the different funds managed by others. Morningstar shows the advisory fee on these funds as ten basis points plus, presumably, the advisory fees on the sub funds. Current information on all Hartford mutual funds may be found: *Mutual Funds*, Hartford Funds, https://www.hartfordfunds.com/funds.html#fundbasics-tab (last visited Nov. 25, 2018).

management, etc. Wellington Management performed those functions for about $50 million.[143] Included in that $50 million was a normal level of profit to the sub-advising firms. Hartford performed certain oversight, strategic and regulatory functions for which it explicitly expended about $2.5 million.[144]

The threshold question is: how much of that $100 million in profit is justifiable, and how much is economic profit? Common sense suggests that most, if not all of it is economic profit accruing to Hartford because of its monopoly position vis-a-vis its captive funds. Hartford made $100 million for investment management services it did not provide, indeed, given staffing levels, was unable to provide. Nonetheless, the district court in *Kasilag* found:

> Although the costs that were directly incurred by Defendants were low in relation to the gross management fee that was paid, the Court finds that a consideration of all of the services performed, including those performed by sub-advisers, Plaintiffs have not carried the burden of showing that the nature of the services indicates the fees were so disproportionate that they could not have been negotiated at arm's-length. This is particularly so in light of the risks that were also borne by Defendants . . . .[145]

The subjective portion of the *Gartenberg* standard is on full display. The court rationalized its decision by noting the entrepreneurial and reputational risks borne by defendants. This rationale is absurd on its face. Entrepreneurial risk is the risk from starting a new business, and the named funds had been in existence for a long time, two since 1996.[146] All of the named funds were well established with hundreds of millions of assets under management. Four of the six funds had asset levels of more than $1 billion, one more than $10 billion.[147] Similarly, reputational risk is likely to be minimal and unimportant. Yet the court gave much credence to these risks, principally because the defendants viewed them as important.[148]

Application of the *Pepper v. Litton* fiduciary standard would lead to the conclusion that the fees charged by Hartford to "manage" these six funds do not carry the earmarks of an arm's length negotiation. Similarly,

143. Table 4.
144. *Id.*
145. *Kasilag,* No. 11-1083, 2017 WL 773880, at *21.
146. *Mutual Funds*, HARTFORD FUNDS, https://www.hartfordfunds.com/funds.html#performance-tab (last visited Feb. 21, 2019).
147. Table 4.
148. *Kasilag,* No. 11-1083, 2017 WL 773880, *7.

the fees on these funds were outside of the range of fees determined by arm's length bargaining, as demonstrated here in Table 5 and 6. An objective application of the subjective *Gartenberg* standard would similarly lead to the conclusion that the fees in this case were so disproportionately large that they could not have been the product of an arm's length negotiation. Hartford realized profits that were double the level of the costs, essentially all of which were sub-advisory fees for which the sub-advisors earned a normal profit on the revenues involved.

Finally, application of what is essentially the corporate waste standard should have shocked the conscience of the court. That the *Kasilag* court did not recognize the obvious disparity between the fees Hartford charged its captive funds and the costs it incurred seems inexplicable to the author. What it amounts to is that one can believe the *Kasilag* court and by inference the subjective *Gartenberg* standard, or one can conclude that something is indeed wrong with the judiciary's interpretation of § 36(b).

It follows that if the *Kasilag* court and other courts that have used the subjective *Gartenberg* standard were in error, then the independent directors of the subject funds were equally in error. Independent directors are charged as "watchdogs" looking out for the interests of fund shareholders, not fund sponsors. Yet the independent directors had all of the information available to the court and more, and the author believes that they, too, chose to avert their eyes in the face of gross overcharging of fund shareholders.

The paper started with the premise that something was amiss with § 36(b) and that the problem was that the *Gartenberg* standard was overly subjective. The evidence that something is amiss with § 36(b) is also, however, evidence that something is amiss with fund governance. Consider the outcome in *Kasilag*. Hartford subcontracted all investment management duties to a sub-advisor who charged about $50 million for those services and earned normal profits in the process. Hartford realized about $100 million in profit for which it performed minimal oversight and administrative duties and absorbed little real risk. The Hartford fees were clearly greater than the upper 95% confidence limit of sub-advisory fees, an objective fiduciary standard. In some sense the *Kasilag* court was willfully blind to the realities of the fees involved and, similarly, the board of directors was willfully blind.

In defense of the *Kasilag* court and other courts that have applied the subjective *Gartenberg* standard, it would take extraordinary courage to reinterpret almost forty years of precedent and say that the standard set out in *Gartenberg* before the "therefore" is not the same standard as that set out following it and that this objective standard should be applied instead of the subjective standard. Such a finding would effectively involve fee setting by the judiciary and unleash a flood of litigation that could significantly strain the judicial system. It seems unimaginable that the judicial system could have strayed so far from the apparent explicit wishes of Congress that it wanted fairer fees, or at least said it did. The reality is far more complicated.

Application of the objective fiduciary standard developed here and applied to an actual case is compelling evidence in support of the proposition that the *Gartenberg* standard is punitive to plaintiffs in § 36(b) cases. The next section of the paper develops a theory that explains this apparent anomaly.

X. THE *GARTENBERG* STANDARD: A THEORY

"Laws, like sausages, cease to inspire respect in proportion as we know how they are made."[149] The 1970 amendments to the ICA were no exception, following a torturous path from hearings begun in 1967 to passage in 1970. The legislation is generally viewed as a both a political and cosmetic compromise between the SEC, the public interest, and the Investment Company Institute, representing the investment management industry.[150] In its operation, the ICA has been a clear win for the investment management industry, hence the observation by Johnson and this paper that something is amiss with § 36(b).

In the 1920s and 1930s, the mutual fund industry suffered from a multitude of abuses including self-dealing, excessive fee levels, improperly valued securities, and misleading advertising and accounting practices.[151] The 1940 ICA dealt effectively with most of these problems.[152] Congress included in the 1940 ICA a provision directing the SEC to study the impact of investment company growth and submit a report to Congress at a later date.[153] In 1958, the SEC commissioned the Wharton School of Finance to prepare a study of the effects of the growth in the industry. The Wharton

149. Attributed to John Godfrey Saxe, THE DAILY CLEVELAND HERALD, Mar. 29, 1869 (and often wrongly attributed to Otto von Bismarck). *See* Fred R. Shapiro, *Quote . . . Misquote* (July 21, 2008), https://www.nytimes.com/2008/07/21/magazine/27wwwl-guestsafiret.html, https://perma.cc/3R7B-TMC2 (tracing the often-misrepresented quotation back to its origin).

150. Jones v. Harris Assocs., 559 U.S. 335, 340 (2010).

151. Amy B. R. Lancellotta, et al., *Fund Governance: A Successful, Evolving Model*, 10 VA. L. & BUS. REV. 455, 458-89 (2016).

152. S. Rep. No. 184, 91st Cong., 2nd Sess. (1970).

153. 15 U.S.C. § 80a-14(b) (2012)

Study[154] and a subsequent SEC report[155] included legislative recommendations.

The essence of the Wharton and PPI empirical findings are presented above in Table 1. Both studies found that mutual fund investors are overcharged relative to fees determined by arm's length bargaining. Both studies attributed this overcharging to the structural anomaly of mutual fund organizations where there exists an inseverable relationship between the fund and the fund sponsor/investment management firm. Importantly, both studies identified a systemic problem: fees were too high in the whole industry as compared to fees determined by arm's length bargaining. As the Letter of Transmittal from the SEC to Congress of the PPI Study states:

> The report concludes that mutual fund shareholders need protection against incurring excessive costs in the acquisition and management of their investments and that, given the structure and incentives prevailing in the industry, neither competition nor the few elementary safeguards against conflict of interest deemed sufficient in 1940 and contained in the Investment Company Act presently provide this protection in adequate measure. . . . It is recommended that the statute be amended to expressly require that the compensation received by persons affiliated with investment companies, including their management organizations, for services furnished to an investment company be reasonable, and that this standard be enforceable in the courts.[156]

The SEC recommendation met with immediate pushback from the industry.[157] The outline of the disagreement became obvious very early in the process where, during a 1967 House hearing, the SEC outlined its position.[158] A key element was the finding that unaffiliated/independent directors of mutual funds were not in a position to discipline advisory fees, as stated in testimony by Manuel Cohen, Chairman of the SEC:

> [N]egotiations between unaffiliated directors and fund advisers over fees lack an essential element of arm's length bargaining – the threat of terminating negotiations and contracting with other

154. WHARTON REPORT, *supra* note 4.

155. PPI STUDY, *supra* note 5.

156. *Id.* at viii. The Wharton and PPI Reports were also skeptical of the ability of fund directors to meaningfully impact on the level of advisory fees.

157. Brown, *Some Analytical Clarity*, supra note 22, at 339 (2016).

158. *Investment Company Act Amendments of 1967: Hearings Before the Subcomm. on Commerce & Fin. of the H. Comm. on Interstate and Foreign Commerce on H.R. 9510 and H.R. 9511, Pt. 1*, 90th Cong. 43-44 (1967).

> parties. . . . Nevertheless, the industry insists on propagating the myth that unaffiliated directors have served as an effective control over advisory fees. For example, only recently during the hearings on this Bill before the Senate Committee on Banking and Currency the president of one of the largest Advisory organizations, appearing on behalf of the Investment Company Institute, testified that unaffiliated directors have "real power over the advisers", "have substantial influence over the management policies of the company" and "are well equipped to make" a judgement as to the reasonableness of fees. These statements, however, are flatly contradicted by the sworn testimony of the directors of the largest mutual fund managed by this individual's own company contained in the public court records of an action against the fund, alleging that the advisory fees paid by the fund were unreasonable and excessive.[159]

The SEC believed that when given a clear mandate, enforceable in court, that fees be reasonable, mutual fund boards would be effective in negotiating reasonable fees.[160] For those instances where fees continued to be unreasonable the SEC envisioned that it would have a role in assisting the judiciary:

> But, since our proposal will not eliminate the basic conflict of interest inherent in the typical investment company structure, an adequate means of enforcement of the standard is essential. In this respect the availability of judicial review will provide an indispensable deterrent to unreasonable fees and will, we believe, greatly assist in preventing such fees. In the few cases in which it does not do so, actions to enforce the statutory standard of reasonableness in the courts could be brought by the Commission in or, under well-established judicial precedent, by the investment company itself or by a shareholder on its behalf. To assist the courts in an orderly development of the law governing the statutory standard of reasonableness the Commission would be authorized to intervene in all private litigation brought to enforce the standard.[161]

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159. *Investment Company Act Amendments of 1967: Hearings Before the Subcomm. on Commerce & Fin. of the H. Comm. on Interstate and Foreign Commerce on H.R. 9510 and H.R. 9511, Pt. 1*, 90th Cong. 41, 46 (1967) (citations omitted) (statement of Manuel F. Cohen, Chairman, Securities & Exchange Commission).

160. *Id.* at 44 ("We believe that most Investment company directors can be expected to heed the Congressional mandate that advisory fees and other charges for services made by investment advisers and other affiliated persons must be reasonable.").

161. *Id.*

Chairman Cohen also outlined the then current state of case law and the inability of plaintiffs to prevail in fee cases because of the prevailing corporate waste standard.[162]

The Investment Company Institute had a different view of the proposed reasonableness standard. Here is a condensation of the 1967 House testimony of Mr. John R. Haire, chairman-elect, Investment Company Institute:

> I would like to emphasize first that in these two critical areas, sales charges and management fees, we are not dealing with the regulation of dishonesty or mismanagement. We are dealing with proposals to regulate prices and profits in an industry which is free of monopoly, in an industry into which competition can entry freely, in an industry which fully discloses its charges to the public, in an industry which offers the public the widest range of. . . management fees. . . . Under the [proposed bill] various courts would be asked to determine whether a management fee is reasonable in the light of. . . vague and general standards. . . . [The bill] imposes on the judge the duty to evaluate the reasonableness of the fee itself, attaching no particular weight to the evidence of the good faith and careful deliberation of the directors or the approval by the fund's shareholders who pay the fee. It in effect constitutes the judge as a "super-director" charged with substituting his own judgment for the business judgment of the directors who have an intimate knowledge of the fund's operation. The SEC thus in our judgment proposes a true rate making statute.[163]

These statements distill the essence of the disagreement between the SEC, acting in the public interest, and the Investment Management Industry, acting to defend its interests. The initial results were a stalemate. Bills introduced in 1967 and 1968 that would have required that fees be reasonable were defeated, a testament to the political power of the investment management industry.[164]

Between the end of the 1968 legislative session and the holding of

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162. *Investment Company Act Amendments of 1967: Hearings Before the Subcomm. on Commerce & Fin. of the H. Comm. on Interstate and Foreign Commerce on H.R. 9510 and H.R. 9511, Pt. 1*, 90th Cong. 105-06 (1967) (Statement No. 2 of Hon. Manuel Cohen, Chairman, Securities and Exchange Commission).

163. *Investment Company Act Amendments of 1967: Hearings Before the Subcomm. on Commerce & Fin. of the H. Comm. on Interstate and Foreign Commerce on H.R. 9510 and H.R. 9511, Pt. 1*, 90th Cong. 233, 242 (1967) (statement of John R. Haire, Chairman-elect, Investment Company Institute).

164. S. 1659, 90th Cong. § 8 (1967); S. 3724, 90th Cong. § 8 (1968).

additional Congressional hearings in 1969, members of the House and Senate committees drafting revised legislation met several times with officers of the Investment Company Institute.[165] As a result, the 1970 amendments to the ICA removed the "reasonableness" standard opposed by the ICI, made investment advisers fiduciaries with respect to fees,[166] and gave investors a private cause of action.[167]

As discussed above, the Senate in its deliberations and the final report of the Committee on Banking and Currency seemed to make clear that it wanted fairer fees and replacement of the corporate waste standard. Making fund sponsors fiduciaries with respect to fees was the supposed vehicle to achieve this result. However, as clear as that seemed, in the balance of the report the Senate included language that essentially endorsed the status quo:

> In reporting this bill, your committee recognizes the importance of permitting adequate compensation and incentives so that men of ability and integrity will continue to be attracted to the mutual fund industry. . . . Your committee recognizes the fact that the investment adviser is entitled to make a profit. . . . It is not intended to introduce general concepts of rate regulation as applied to public utilities. . . . This section is not intended to authorize a court to substitute its business judgment for that of the mutual fund's board of directors in the area of management fees. . . . This provision does not represent a finding by the committee as to the level of fees in the industry. Your committee does not believe itself qualified to make such judgments. Nor is it contemplated that the Commission will seek a general reduction of fees on an industrywide basis.[168]

165. *Hearings on S. 34 and S. 296 Before the S. Comm. on Banking and Currency*, 91st Cong. 8 (statement of Hugh F. Owens, Commissioner, SEC); *see also Hearings on H.R. 11995, S. 2224, H.R. 13754, and H.R. 14737 Before the H. Comm. on Commerce and Fin. of the Comm. on Interstate and Foreign Commerce*, 91st Cong. 172 (1969) (statement of Hamer H. Budge, Chairman, SEC) (saying "Chairman Sparkman stated that this bill was worked out between the industry and the Commission as well as with members of his committee.")

166. *See* Investment Company Amendment Act of 1970, Pub. L. No. 91-547, § 35(b), 84 Stat. 1413 (1970) (codified as amended at 15 U.S.C. § 80a-35 (2012)) (explaining that investment advisors are deemed to have a fiduciary duty with respect to compensation for their services).

167. *Id.*

168. INVESTMENT COMPANY AMENDMENTS ACT OF 1969, S. REP. NO. 91-184, at 4-7 (1969). The legislation also provided for a one-year look-back period for damages. This effectively limited monetary penalties and ignored the general principle that the damages period should conform to the period of wrongdoing.

To observe that the Senate Report sends conflicting signals is an understatement. While bowing in the direction of fairer fees and eschewing the corporate waste standard, the report also essentially repudiates the findings of the Wharton and PPI reports. What is clear is that in the end the Congress folded under intense political pressure from the ICI. It had to appear to do something, hence the statutory change making investment managers fiduciaries. However, at the same time, it neutered the SEC going forward and, despite SEC objections, endorsed the notion that mutual fund boards could be trusted to discipline fees.[169] It also signaled that profit levels were inviolate and that the overall level of fees in the industry was not to change.

What the Congress did in 1970 was what politicians always do—they crafted a political compromise that had the appearance of solving the problems at hand. However, laws passed by legislatures cannot repeal the laws of economics, and the overcharging documented by the Wharton Report and PPI Study did not disappear. What Congress did was pass the whole contradictory mess on to the judiciary to sort out.

A political compromise cannot paper over the fundamental fact that the choices faced by the judiciary were binary in nature. It is impossible to have both fairer fees and maintain the status quo of fees.

Fast forward to 1980. The Second Circuit in *Gartenberg* had to deal with the binary choice outlined above. It could have followed the recommendations of the financial experts at Wharton and the SEC and found that the fees at issue did not carry the earmarks of arm's length negotiation. As the Second Circuit correctly said in *Gartenberg*, there is no essential difference between a fiduciary standard and a reasonableness standard and, in the final analysis, both involve something like rate regulation.[170] But Congress clearly signaled it did not want rate regulation.

Instead, the Second Circuit crafted a fiduciary standard so stringent

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169. *Id.* The language that a court is not authorized to substitute its business judgment for that of the mutual fund's board of directors in the area of management fees adopted a long-standing common law rule. *See* cases cited in Lasker v. Burks, 404 F.Supp. 1172, 1179 (S.D.N.Y. 1975) (holding that "absent fraud or corruption or other disqualifying factor, the good faith business judgment of the directors not to bring suit is final") and subsequently approved in *Burks v. Lasker*, 441 U.S. 471, 474-75 (1979) (upholding the use of the business judgment rule to dismiss derivative suits). The rule contradicts the stubborn fact that fund boards are unable to negotiate fees because they cannot fire the investment manager.

170. Gartenberg v. Merill Lynch Asset Mgt., Inc., 694 F.2d 923, 928 (2d Cir. 1982). It will be argued in the summary and conclusions that the concern about rate regulation is overblown and, with the help of the SEC, a less cumbersome and much simpler procedure could be put in place to achieve the same result.

and subjective that no plaintiff could be expected to or has overcome it, which leads to speculation on why the Second Circuit crafted such a stringent standard. Assuming the court recognized the political pressure on Congress and the economic reality underpinning it, it had to choose between protecting the public interest or protecting the mutual fund industry. The Senate Report provided some cover for either position. The court chose the latter.[171]

There is perhaps a more insidious motivation for the decision in *Gartenberg*. Recall that Langevoort considered that the test set out in *Gartenberg* resembles the state law test for corporate waste, despite Congress's stated desire for something more than a waste test.[172] It was "obvious" to Langevoort that the court did not want to get into the business of fee setting on its own. This reinforces the notion that the choice was binary in nature: either the Second Circuit could establish a very restrictive standard or the courts would be in the fee setting business with little support from the SEC, which had been effectively neutered by the Senate Report and would thus not be available to provide its expertise to the courts. The Langevoort comment, while apparently innocuous, suggests a motive of self-interest on the part of the judiciary. What this implies is that for almost forty years, acting at least partially in self-interest, the judiciary has been biased against plaintiffs in § 36(b) cases. The fact that most cases have been settled or dismissed, that very few cases have gone to trial, and that no plaintiff has ever received an award under the § 36(b), is consistent with this observation.

XI. SUMMARY AND CONCLUSIONS

John Adams famously said that "[f]acts are stubborn things."[173] It is fundamental that mutual funds are structurally different from other corporations. The corporation or trust is controlled by an external entity: the fund sponsor. From this immutable circumstance flow all the legal, political and economic issues surrounding mutual fund advisory fees. Fund sponsors are monopolists and charge fees substantially greater than fees determined by arm's length bargaining. Fund boards are impotent because they cannot fire fund sponsors.

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171. INVESTMENT COMPANY AMENDMENTS ACT OF 1969, S. REP. NO. 91-184, at 4-7 (1969).

172. Langevoort, *Private Litigation, supra* note 59, at 1024.

173. WILLIAM GORDON, 1 THE HISTORY OF THE RISE, PROGRESS, AND ESTABLISHMENT, OF THE INDEPENDENCE OF THE UNITED STATES OF AMERICA 296 (1788).

Monopolists earn economic profits or rents. It took willful blindness on the part of the *Kasilag* court not to recognize that the $100 million in profits earned by Hartford for doing essentially very little or nothing was excessive by any reasonable standard. Hartford is a microcosm of the mutual fund investment management industry. A recent paper estimated that the industry overcharges mutual fund investors about $30 billion per year.[174] If that estimate is anywhere near accurate it implies that since *Gartenberg* investors have been cumulatively overcharged hundreds of billions of dollars in excess fees.

Economic profits have vastly enriched the shareholders of investment management firms. In the same paper referenced above, the authors identified the universe of publicly traded mutual fund investment management firms. They constructed an index of the stock prices of those firms and tracked its returns from 1980 through 2016. The compound average rate of return on S&P 500 stocks over that period was an annual 8.5%.[175] Over the same period, the compound average annual return on the index of mutual fund managers was 18.7%, more than double.[176] Putting this in context, an investment of $1 in the S&P 500 in 1980 would have grown to $20.74 by 2016, while an investment in the index of fund sponsors would have grown to $563.59. Mutual fund investment management is a very profitable business.

The profits from managing mutual funds have given the investment management industry an outsized influence on the political process. Mancur Olson, in his book "The Logic of Collective Action" posited that some groups have a larger impact on government policies than others.[177] In a democratic system, people with common interests will generally band together to achieve common goals. However, if the benefits of a political outcome are concentrated in the hands of a few and the costs are diffused among many, the beneficiaries are motivated to influence the political process in their favor. At the same time, those who bear the costs have little incentive to organize to protect their interests. Thus, because of extraordinarily high profits, the investment management industry is incentivized to influence the political process. On the other hand, the $30 billion in excess fees mentioned above is currently spread among about ninety million investors so that on average each investor pays about $300 per year in excess fees. With the SEC effectively captured by the

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174. Brown & Pomerantz, *Some Clarity*, *supra* note 15, at 807.
175. *Id.* at 811.
176. *Id.*
177. MANCUR OLSON, THE LOGIC OF COLLECTIVE ACTION 127-28 (1965).

investment management industry, there is currently no effective voice speaking in the public interest in the political process.

This was not always the case. The main impetus for the 1970 amendments to the ICA was the legislative recommendation of the SEC in the PPI Study. Congress was forced to deal with the SEC's proposed reasonableness standard. Congress handled it by endorsing the concept of fairer fees while simultaneously singing the praises of men of ability and integrity in the mutual fund industry and signaling to the SEC to keep its hands-off mutual fund fees. After sending clear signals of its intent, Congress turned over the problem of excessive fees to the judiciary.

The 1970 amendments to the ICA made investment managers fiduciaries with respect to fees. Ostensibly, this was consistent with a reasonableness standard and with fairer fees. Simultaneously, however, Congress signaled that it wanted to maintain the status quo. There was enough ambiguity in the Senate Report that the *Gartenberg* court could have gone the other way and established a fiduciary standard imposing lower fees at the margin. As Professor Langevoort opined, this would have put the judiciary in the fee setting business, which the judiciary was reluctant to do absent the participation of the SEC. Consequently, the *Gartenberg* standard in operation has been indistinguishable from the corporate waste standard. The investment management industry has profited handsomely from the situation and investors have been cumulatively overcharged hundreds of billions of dollars.

It is a truism that if you subsidize something, you will get more of it. In 1965, when the PPI Study was published, total mutual fund assets were about $35 billion. By 1980, when the *Gartenberg* case was filed, assets totaled about $135 billion. At the end of 2017, open end mutual fund assets totaled $18.7 trillion.[178] Neither Congress nor the judiciary could have foreseen the phenomenal growth in mutual funds. By imposing an extreme fiduciary standard in 1982, the judiciary is caught in a trap of its own design. In spite of accumulating evidence that advisory fees are too high, the judiciary must avert its eyes because to reverse itself would cause disruption in the financial system and effectively put the judiciary in the fee setting business. The judicial system is riding a horse it can't get off.

Under current circumstances, it is difficult to visualize a resolution of the problem. Given the outsized political influence of the investment management industry, it is unrealistic to expect a legislative solution.

178. INVESTMENT COMPANY INSTITUTE, 2018 INVESTMENT COMPANY FACT BOOK 208 (58th ed. 2018), http://www.icifactbook.org/deployedfiles/FactBook/Site%20Properties/pdf/2018/2018_factbook.pdf. [https://perma.cc/M5AD-SY3R].

Armed with the objective fiduciary standard developed here, it is possible but unlikely that a federal court could refuse to avert its eyes to evidence of excess mutual fund advisory fees. Ideally, but equally unlikely, the SEC could escape capture from the investment management industry and use its standing to sue. It could choose an egregious example of excess advisory fees and litigate to a resolution.

The SEC is the ideal institution to resolve the advisory fee problem because it could do so in a manner that minimizes the disruption to the investment management and mutual fund industries. The infrastructure is already in place for an orderly and non-disruptive decrease in advisory fees in reports routinely received by mutual funds' boards pursuant to § 15(c) of the 1940 ICA.[179] Similar to the last column of Table 4, boards of directors routinely monitor the profit margins of the funds they represent to ensure that levels do not exceed the maximum levels recognized in *Schuyt*.

The proposed solution would not involve rate regulation in any meaningful sense. Rate regulation in the public utility arena is shorthand for rate of return regulation. The idea is to allow public utilities, which are natural monopolies, to earn a rate of return on invested capital like the rates of return on invested capital of firms where such rates are determined in the marketplace, i.e., by arm's length bargaining. Public utility rate regulation is cumbersome and expensive because it involves public utility commissions and extensive public hearings to affect any sort of change in rates. This would not be the case for mutual funds.

The SEC-initiated litigation could establish precedent of a new, market-based profit margin standard. The unrealistically high profit margin standard in place (*Schuyt*) is routinely monitored by fund boards to ensure compliance with existing case law. The goal of the SEC in litigation would be to introduce into evidence a range of profit margins of firms managing portfolios where the fees are determined by arm's length negotiation, i.e., pension and mutual fund sub-advised portfolios. The revised profit margin standard would be lower than the current *Schuyt* standard.[180] A revised profit margin standard would empower independent

179. Section 15 of the 1940 ICA governs the terms of continuing, amending and terminating the advisory contract. Investment Company Act of 1940 § 15, 15 U.S.C. § 80a-15(c) (2012). As part of the annual contract renewal process, boards receive what are known as 15(c) reports. In renewing the advisory contract annually, boards are required to consider the advisory fee in the context of the *Gartenberg* factors, including the profitability of the contract to the fund advisor.

180. This should be obvious because sub-advisory fees are a relatively small fraction of advisory fees for performing essentially the same functions. The Wharton Report looked at operating expense ratios (costs as a percent of revenue) for 86 investment management

directors in a manner originally envisioned by the SEC in the 1960s. Independent directors would have the duty and leverage to reduce advisory fees to levels consistent with arm's length bargaining. The revised standard would recognize that investment management firms are entitled to make a profit and would not introduce rate regulation in the same sense that public utilities are subject to rate regulation. The new, reduced level of profitability, consistent arm's length bargaining, would reduce or eliminate economic profits.

This method would not be a one-size-fits-all fee setting procedure. Appropriate adjustments could be made for, *inter alia*, cost differentials related to risk premiums, the size of the portfolio, and the investment objective involved, as well as the cost structure of the investment management firms involved.

The beauty of this approach is that it facilitates a smooth transition with a minimum of disruption to existing procedures. The SEC could announce a grace period for funds to come into compliance with the new standard. Independent directors armed with the new standard could negotiate lower fees over time and there would be a minimum need for further litigation. In all likelihood judiciary caseloads would decrease. The ultimate result would be fairer fees for investors.

corporations and found that "total operating expense ratios are sharply higher in those cases where income is received from both investment company and noninvestment company clients than in cases where the adviser is managing investment company assets only." WHARTON REPORT, *supra* note 4, at 495. Sharply higher operating ratios implies sharply lower profit margins.