No. 08-586

IN THE

Supreme Court of the United States

JERRY N. JONES, MARY F. JONES,
AND ARLENE WINERMAN,

Petitioners,

v.

HARRIS ASSOCIATES, L.P.,

Respondent.

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

BRIEF OF THE SECURITIES INDUSTRY AND FINANCIAL MARKETS ASSOCIATION AS *AMICUS CURIAE* IN SUPPORT OF RESPONDENT

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TABLE OF CONTENTS

TABLE OF AUTHORITIES

CASES Page

TABLE OF AUTHORITIES – continued

TABLE OF AUTHORITIES – continued

TABLE OF AUTHORITIES – continued

OTHER AUTHORITIES

TABLE OF AUTHORITIES – continued

INTEREST OF *AMICUS CURIAE*

The Securities Industry and Financial Markets Association ("SIFMA") brings together the shared interests of more than 600 securities firms, banks, and asset managers locally and globally through offices in New York, Washington, D.C., and London. Its associated firm, the Asia Securities Industry and Financial Markets Association, is based in Hong Kong. SIFMA's mission is to champion policies and practices that benefit investors and issuers, expand and perfect global capital markets, and foster the development of new products and services. More information about SIFMA is available at http://www.sifma.org.

SIFMA has a particular interest in this litigation because of its potential adverse impact on the securities industry. Petitioners seek a construction of the Investment Company Act that would make every case fact-dependent and subject to unwarranted, yet detailed judicial scrutiny. Were the Court to adopt Petitioners' approach, a motion to dismiss would be virtually futile even in the most meritless cases, and litigation costs would increase across the industry. As this Court has recognized, such costs can have significant "ripple effects" that are detrimental to issuers and investors alike. *Cent. Bank of Denver* v. *First Interstate Bank of Denver*, 511 U.S. 164, 189 (1994); see also *Stoneridge Invest. Partners, LLC* v. *Scientific-Atlanta, Inc.*, 128 S. Ct. 761, 772 (2008) (explaining how prospect of "extensive discovery" can enable "plaintiffs with weak claims to extort settlements from innocent companies"). Accordingly, SIFMA respectfully urges this Court to affirm the decision below.[1]

SUMMARY OF ARGUMENT

1. This case presents what should be a straightforward application of Section 36(b) of the Investment Company Act of 1940, 15 U.S.C. § 80a-35(b) ("ICA"). Petitioners are shareholders in a mutual fund. They purchased their shares in arm's-length transactions after the fee rates – which were ordinary for the industry – were fully disclosed to them. Since then, the fee rates were never increased, and Petitioners never had to pay a single penny more than what they agreed to pay at the outset. In no ordinary sense of the word were Petitioners treated unfairly, let alone unlawfully.

Nonetheless, Petitioners contend that the mutual-fund adviser breached a fiduciary duty by maintaining the terms of the original deal, instead of voluntarily decreasing the rates. Petitioners claim that this result is compelled by the common law of trusts. For two reasons, however, Petitioners are mistaken.

First, by its terms, Section 36(b) does not incorporate the law of trusts. The provision makes no mention of trust law; it expressly rejects the trust law rule of imposing the burden of proof on the fiduciary; and it contemplates an active role for independent directors and judicial deference to those directors, a

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[1] Pursuant to this Court's Rule 37.3(a), letters of consent from all parties to the filing of this brief are on file or have been submitted to the Clerk. Pursuant to this Court's Rule 37.6, *amicus* states that this brief was not authored in whole or in part by counsel for any party, and that no person or entity other than *amicus* or its counsel made a monetary contribution intended to fund the preparation or submission of this brief.

construct that is unknown to the common law of trusts. Moreover, Congress was well aware of what it was doing when it enacted the statute. As the legislative history reflects, Congress determined that "the unique structure of mutual funds" made it difficult to apply "traditional fiduciary standards." Congress instead contemplated "federally-created fiduciary dut[ies]" designed with an eye toward "best industry practice" and "business judgment." S. Rep. No. 91-184 (1969), *available at* 1970 U.S.C.C.A.N. 4897, 4898, 4902-03 (1969) ("Senate Report").

Second, even if trust law did apply, it would not support Petitioners' position. Trust law requires "fairness," Pet'r Br. 22, and there is nothing unfair in simply following the terms of an agreement properly struck, fully disclosed, and voluntarily accepted by the shareholders. Under the common law, "a provision in the [trust] instrument is given effect absent extraordinary or special circumstances." *Baltrotsky* v. *Kugler*, 910 A.2d 1089, 1098-99 (Md. 2006). It is thus no surprise that Petitioners and their *amici* fail to cite a single common law trust case suggesting that a fee is unlawful when it is the product of an arm's-length transaction, voluntarily entered into after disclosure of the rate.

2. In any event, even in cases in which the adviser's fee rate increases (which did not occur here), and the shareholder has to pay more than what he initially bargained for, Section 36(b) does not permit judicial rate regulation of the kind advocated by Petitioners. Instead, the statute contemplates a significant role for investment company directors and judicial deference to those directors in light of all the relevant circumstances. Among those circumstances is the state of the marketplace, as the Solicitor General argued. Br. of United States 25-29. Because the

mutual fund market is highly competitive, and the competition provides an extrinsic check on excessive fees, courts should apply a presumption that the fiduciary did not breach its duties by charging an excessive fee. Even in the absence of competition, however, courts should not intrusively second-guess the adviser's fees, but instead adopt an approach that gives full "consideration" to the board of directors' independence, conscientiousness, and compliance with statutory procedures. See ICA § 36(b)(2).

FACTUAL BACKGROUND

1. Over the past four decades, the mutual fund industry has experienced substantial growth that, in tandem with increased competitiveness and technological development, empowers millions of investors to make educated investment decisions. More than ever before, investors have the ability to research the thousands of existing mutual funds, often at little or no cost to the investor, and to find the funds that offer the lowest fees and that otherwise meet the investors' selected criteria. Not coincidentally, over the same time period, total fees have declined across the industry, as investors are able to vote with their feet, both when they enter the market and when they make changes to their portfolios.

a. The industry is far larger today than it was in the 1960s. In the early '60s, fewer than 200 funds existed. And, as late as 1966, only 379 funds managed a total of just over $38 billion. See John Coates & R. Glenn Hubbard, *Competition in the Mutual Fund Industry: Evidence and Implications for Policy*, 33 J. Corp. L. 151, 156-57 (2007).

The number of funds increased substantially over the next forty years: in 2008, there were nearly 9,000 funds in the United States alone. Inv. Co. Inst.

("ICI"), *2009 Investment Company Factbook* 15 (2009) ("*Investment Company Factbook*"), *at* http://www.ici.org/pdf/2009_factbook.pdf. The rapid growth reflects the industry's relatively low barriers to entry, see *id.* at 12-14 & figs.1.5-.8; Coates & Hubbard, *supra*, at 167-70, and the increase in the amount of money invested in mutual funds. By 2008, mutual funds managed almost $10 trillion in investment capital. *Investment Company Factbook*, *supra*, at 9 fig.1.1. Nearly 20 percent of all household financial assets are now held in investment companies. *Id.* at 10 fig.1.2.

b. As competition has expanded, fees and expenses have dropped. Between 1980 and 2008, the asset-weighted average of total fees and expenses (which includes sales loads plus management, 12b-1, and other fees and expenses) fell among bond and stock funds by more than 57 and 63 percent, respectively.[2] ICI, *Trends in the Fees and Expenses of Mutual Funds, 2008*, at 2 fig.1 (2009), *at* http://www.ici.org/pdf/fm-v18n3.pdf. Indeed, the Securities and Exchange Commission ("SEC") has recognized that, accounting for sales loads, the fees and expenses paid by investors have probably declined. *Report on Mutual Fund Fees and Expenses* (Dec. 2000), *at* http://www.sec.gov/news/studies/feestudy.htm.

This decrease is not surprising. Today, thousands of funds compete for investors, and the size of fees is one important basis for distinguishing among the funds. Petitioners' arguments notwithstanding, see Pet'r Br. 42-44, investors today are highly concerned

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[2] It is important to point out that, for regulatory reasons, "expense ratios" do not necessarily describe investors' total costs of ownership. In particular, mutual fund "expense ratios" do not take into account sales loads.

about fees. In fact, a recent survey commissioned by ICI revealed that consumers are more likely to review fees and expenses than any other type of information before purchasing shares in a mutual fund, and most investors continue to monitor fees and expenses after making their purchase. ICI, *Understanding Investor Preferences for Mutual Fund Information* 3 fig.1 (2006), *at* http://www.ici.org/pdf/rpt_06_inv_prefs_full.pdf.

Not only are investors interested in fees and expenses, but they have the technology to sort through thousands of mutual funds according to fees, expenses, and other criteria that they deem most relevant to their investment decisions, such as the risk profile of a particular fund's investment strategies. The SEC and the Financial Industry Regulatory Authority ("FINRA") both provide free online calculators to help prospective investors determine how much investing in a given fund will cost over time. SEC, The SEC Mutual Fund Cost Calculator, http://www.sec.gov/investor/tools/mfcc/mfcc-intsec.htm (last visited Aug. 26, 2009); FINRA, Fund Analyzer, http://apps.finra.org/fundanalyzer/1/fa.aspx (last visited Aug. 26, 2009). Meanwhile, a wide variety of financial service agencies and media outlets, such as theStreet.com, Yahoo Finance, USA Today, and Morningstar, provide free or low-cost research and screening tools that allow prospective investors to determine for themselves which funds best meet their personal investment goals. To take one example, SmartMoney.com, a division of the Wall Street Journal's digital network, provides a free online "Mutual Fund Map" that accounts for the relative sizes and investment classification of thousands of funds, provides links to each, and allows a casual researcher to compare fundamentals such as performance, fees, and turnover. See SmartMoney.com, Mutual Fund Map, http://www.smartmoney.com/fundmap (last visited Aug. 26, 2009). Brokerages may offer additional research and screening to their customers. As a result, investors now enjoy unprecedented ability to select among thousands of different mutual funds according to the investors' own criteria, making it more possible than ever for prospective shareholders to tailor their investments to their personal goals and preferences.

2. Consistent with the industry as a whole, the fee rates for Respondent's funds in question have declined over time. Each of the three funds – Oakmark Fund, Oakmark Equity and Income, and Oakmark Global Fund – has a separate fee schedule with breakpoints. *Jones* v. *Harris Assocs. L.P.*, 527 F.3d 627, 631 (7th Cir. 2008); *Jones* v. *Harris Assocs. L.P.*, No. 04-8305, 2007 WL 627640, at *2 (N.D. Ill. Feb. 7, 2007). The fee rate starts off at one percent or less, depending on the fund, and declines as the fund grows in size. In no instance did Respondent increase the advisory fee rates for any of these funds.

Moreover, Respondent added new breakpoints in 2003 and 2004, potentially lowering the effective rates. Def's Br. in Support of Summ. J. 5-6, No. 04-8305 (N.D. Ill. filed Sept. 12, 2006). Petitioners are thus challenging fee rates that are the same as or lower than the rates Petitioners agreed to pay when they voluntarily bought their shares in the funds. Petitioners selected these funds from among their mutual fund options in arm's-length transactions, and since then Petitioners have not had to pay anything more than what they agreed to pay after disclosure of the fee rates.

ARGUMENT

I. INVESTMENT ADVISERS DO NOT BREACH THEIR FIDUCIARY DUTIES WHEN THEY CHARGE NO MORE THAN THE FEES THAT WERE FULLY DISCLOSED TO SHAREHOLDERS, WHO VOLUNTARILY PURCHASED THEIR SHARES IN ARM'S-LENGTH TRANSACTIONS.

1. As an initial matter, it is important to stress what this case is not about. First, it is not about an increase in fees imposed on shareholders after they bought their shares. In fact, the advisory fee rates for these funds have never grown, and by imposing new breakpoints Respondent permitted a decrease in the fees that shareholders pay over the life of the funds. In no circumstance did any investor pay anything more than what the investor agreed to pay when the investor bought shares in the fund.

Second, this is not an action by the SEC to enforce the many obligations that the ICA imposes on directors and other participants in the mutual fund industry. See, *e.g.*, ICA § 15(c) (imposing duty on directors to request and scrutinize, and on advisers to disclose to directors, information necessary to evaluate the terms of the adviser's contract); *id.* § 36(a) (SEC may enforce fiduciary duty provisions against directors); *id.* § 34(b) (unlawful to make untrue statements in ICA filings); see also *N.Y Life Invest. Mgmt., LLC*, Release Nos. 2883 & 28747, slip op. at 10 (SEC May 27, 2009) (Order Instituting Administrative Cease-and-Desist Proceedings) (respecting, *inter alia*, ICA §§ 9(b), (f), 15(c), 34(b)). The only provision in the ICA that this case implicates is Section 36(b). The Court's decision will not affect the SEC's oversight or authority to initiate enforcement actions under other provisions of the statute or other securities laws.

Directors' and advisers' fiduciary duties under those provisions will remain unchanged.

2. This case thus presents a very narrow question: Do investment advisers breach a fiduciary duty by charging only the fee rates that the shareholders agreed to pay in arm's-length transactions after full disclosure of the rates? To ask the question is to answer it. Because there is nothing unfair in simply preserving the terms of an arm's-length agreement – especially considering the many investment options the shareholders had when they voluntarily chose to invest in Respondent's funds – Respondent did not breach any fiduciary duty under Section 36(b).

Contending otherwise, and seeking rigorous judicial rate regulation, Petitioners purport to invoke the common law of trusts. But their reliance is misplaced for two independent reasons. First, Congress did not import trust law into Section 36(b). Second, even under the common law of trusts, there is nothing unlawful in maintaining the original terms of an arm's-length agreement.

a. Contrary to Petitioners' suggestion, nothing in Section 36(b) incorporates or even references the law of trusts. Petitioners point to the phrase, "fiduciary duty," and note that, when Congress uses a term with a "familiar" and "settled meaning under ... the common law," Congress intends to adopt that established meaning. Pet'r Br. 20 (internal quotation marks omitted) (quoting *Neder* v. *United States*, 527 U.S. 1, 21 (1999)). The phrase "fiduciary duty," however, does not have (and did not have in 1970) a single, settled meaning linked to the law of trusts.

Rather, the term has appeared in diverse settings, reflecting its context-dependent nature. See *SEC* v. *Chenery Corp.*, 318 U.S. 80, 85-86 (1943) ("[T]o say that a man is a fiduciary only begins analysis; it gives direction to further inquiry."); *Konover Dev. Corp.* v. *Zeller*, 635 A.2d 798, 806 (Conn. 1994) (fiduciaries can take the form of "agents, partners, lawyers, directors, trustees, executors, receivers, bailees, and guardians"), Tamar Frankel, *Fiduciary Law*, 71 Cal. L. Rev. 795, 795 (1983) (noting that "various types of fiduciaries have evolved over the centuries," including "[t]rustees ... of ancient origin" and corporate directors, majority shareholders, union leaders, and psychiatrists of much more recent vintage). When the ICA was amended in 1970, there was thus substantial contemporaneous confusion regarding the meaning of the term "fiduciary duty" in the statute. See, *e.g.*, William J. Nutt, *A Study of Mutual Fund Independent Directors*, 120 U. Pa. L. Rev. 179, 191 (1971) ("The 1970 Amendments ... do not define the scope of this [fiduciary] obligation; nor does the legislative history indicate that the Commission and industry spokesmen ever agreed upon a common definition."); *id.* at 202 ("[T]he legislative history of the 1970 Amendments is silent on whether ... section 36(b)'s 'breach of fiduciary duty' standard[] merely recite[s] state law definitions or instead impl[ies] that federal courts should fashion a uniform federal standard."); Note, *Mutual Funds and Their Advisers: Strengthening Disclosure and Shareholder Control*, 83 Yale L.J. 1475, 1478-79 (1974) ("What constitutes a breach of fiduciary duty under this section is, however, enigmatic."); see also *Fogel* v. *Chestnutt*, 668 F.2d 100, 112 (2d Cir. 1981) (describing Section 36(b) as "a lesson in the art of studied ambiguity in drafting of statutes").

In some of the settings in which there is a fiduciary duty, the law of trusts is relevant, and in others, it is not. Compare, *e.g.*, *Cent. States, Se. & Sw. Areas*

Pension Fund v. *Cent. Transp., Inc.*, 472 U.S. 559 (1985) (describing ERISA's roots in the law of trusts), and *Chauffeurs Local 391* v. *Terry*, 494 U.S. 558 (1990) (analogizing union's duty of fair representation to trustee's fiduciary duty), with *Schein* v. *Chasen*, 478 F.2d 817 (2d Cir. 1973) (extending fiduciary duty to tippees of corporate executives for purposes of insider trading liability), *vacated on other grounds sub nom.* 416 U.S. 386 (1974), and *Shlensky* v. *Wrigley*, 237 N.E.2d 776 (Ill. App. Ct. 1968) (refusing to question idiosyncratic decision of corporate executive despite fiduciary duty owed to shareholders).[3]

Likewise, in some settings, courts engage in a substantive fairness review, whereas in others, courts do not. For instance, judges do not assess the substantive fairness of stock transactions between corporate officers and shareholders, despite an officer's fiduciary duty, but instead ask only if the officer disclosed all material information. See, *e.g.*, *Jernberg* v. *Mann*, 358 F.3d 131, 136 (1st Cir. 2004). Similarly, the fiduciary duties of partners "arguably should be less extensive than those in other agency or trust relationships." 2 *Bromberg & Ribstein on Partnership* § 6.07(a) (2009); see also Revised Uniform Partnership Act § 4.04(e)-(f) (2008) (partners allowed to act selfishly without breaching fiduciary duties). This is

[3] Even when a particular fiduciary duty is explicitly linked to the common law of trusts, as in the ERISA context, the law of trusts is not absolutely dispositive of the scope of the duty. *See, e.g., Varity Corp.* v. *Howe*, 516 U.S. 489, 496-97 (1996) (ERISA fiduciary duties "draw much of their content from the common law," but "partly reflect a congressional determination that the common law of trusts did not offer completely satisfactory protection"), *Mertens* v. *Hewitt Assocs.*, 508 U.S. 248, 251-52 (1993) (ERISA assigns fiduciaries duties not known at common law, such as plan administration, investment activities, record-keeping, and disclosure obligations).

due to "the greater availability ... of extrajudicial controls," which include aspects of the partnership relationship that resemble the mutual fund industry, including "the terminability of the relationship, and the alignment of incentives of the partners." 2 *Bromberg & Ribstein*, *supra*, § 6.07(a).

And, in perhaps the most familiar context, courts refrain from substantive review of corporate decisionmaking under the business judgment rule absent a showing of procedural irregularity or self-dealing. See, *e.g.*, *Shlensky,* 237 N.E.2d 776. Like the business judgment rule, the type of fiduciary duty that Congress envisioned in Section 36(b) arises out of a concern that courts not substitute the business judgment of corporate officers with the courts' own *post hoc* judgment. See Senate Report, *supra*, at 4902-03. In any event, these examples of limited substantive review illustrate the fundamental principal that "[s]imply classifying a party as a fiduciary inadequately characterizes the nature of the relationship." *Konover*, 635 A.2d at 806. When reviewing the actions of a fiduciary, such as an investment fund manager, courts account for context. See, *e.g.*, *Rexford Rand Corp*. v. *Ancel,* 58 F.3d 1215, 1219 n.7 (7th Cir. 1995) ("[A] court must examine the relationship between the parties in each case so as to ascertain the standard to be applied to determine whether there has been a breach of a partner's fiduciary duty.") (quoting *Saballus* v. *Timke,* 460 N.E.2d 755, 760 (Ill. App. Ct. 1983)); *Lawrence* v. *Cohn*, 197 F. Supp. 2d 16 (S.D.N.Y. 2002) (requiring general partner, serving as executor, to offer limited partners only a fractional partnership interest, based on circumstances and equities of relationship), *aff'd*, 325 F.3d 141 (2d Cir. 2003).

Petitioners offer no reason why the ICA should be read to have incorporated the strict rules governing trustees rather than the flexible standards governing other fiduciaries. The duties applied to trusts are of the highest magnitude, and for good reason. See, *e.g.*, Restatement (Second) of Trusts § 2 cmt. b (1959) ("The duties of a trustee are more intensive than the duties of some other fiduciaries."); *Meinhard* v. *Salmon*, 164 N.E. 545, 546 (N.Y. 1928) (Cardozo, C.J.) ("A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior."). In general, trustees are practically unencumbered by procedural limits on their discretion, while beneficiaries have little or no ability to influence the trustee's decisions or to remove their funds from the trustee's care. See, *e.g.*, Restatement (Second) of Trusts § 337 (termination of trust through consent of beneficiaries).

The responsibilities ascribed to other types of fiduciaries are more flexible and generally amendable by contract. See, *e.g.*, Restatement (Second) Agency § 376 (1958) (agent's duties determined by parties' agreement, absent fraud, duress, illegality, or incapacity); *id.* § 443 ("If the contract of employment provides for compensation to the agent, he is entitled to receive ... the definite amount agreed upon ...."); Revised Uniform Partnership Act § 401 cmt. 1 (noting default compensation rules are subject to revision by contract). In each case, important nonjudicial checks, such as low barriers to exit, limit strategic behavior without the need for scrutinous judicial review of contractual agreements. See, *e.g.*, 2 *Bromberg & Ribstein*, *supra*, § 6.07(a) ("Fiduciary duties in the partnership arguably should be less extensive than those in other agency or trust relationships because of the greater availability in the partnership of extra-judicial controls, including ... the terminability of the relationship, and the alignment of incentives of the partners ….").

The mutual fund-shareholder relationship is much less similar to the captive relationship between trustee and beneficiary than to the relationship between an agent and principal, or among partners. Unlike trust beneficiaries, investment company shareholders are protected by a board of directors that cabins the discretion of investment company advisers. More importantly, shareholders can exercise a powerful check on advisers' behavior: they can typically redeem their shares and walk away from the adviser, generally without further expense other than taxes. If the funds are held within a tax-exempt account, investors need not even realize capital gains when they exit the fund. In addition, shareholders must approve any increase in fee rates by a majority vote. See ICA § 15(a). Of course, investors also exercise the ultimate discretion in electing not to invest in particular funds in the first instance. In short, unlike beneficiaries of a trust, mutual fund investors are not captive to the acts and decisions of their investment advisers. Nothing in the logic or policy of the ICA suggests the fiduciary duty applied to mutual fund managers should equate to that applied to trustees.

Moreover, it is readily apparent from the text of Section 36(b) that Congress did not intend to import the law of trusts into the statute. Congress knows how to incorporate trust law into legislation, and has done so in other statutes. See 29 U.S.C. § 1103(a) (establishing that all assets of employee benefit plans are to be "held in trust" and further establishing a "trustee" to manage the plans); *id.* § 1346 (requiring reports to "trustee" upon intended termination of a plan); see also *Cent. States*, 472 U.S. at 570 ("[R]ather than explicitly enumerating all of the powers and duties of trustees and other [ERISA] fiduciaries, Congress invoked the common law of trusts to define the general scope of their authority and responsibility.") (emphasis omitted). It did not do so in Section 36(b), which never mentions the word "trust."

Indeed, the text of Section 36(b) is plainly at odds with the common law of trusts. For instance, Section 36(b) places the burden of proof on plaintiffs, reversing the common law's approach to fiduciary duties. See, *e.g.*, *Paramount Commc'ns, Inc.* v. *QVC Network, Inc.*, 637 A.2d 34, 44 (Del. 1994) (fiduciaries bear burden of proof to establish they acted reasonably); *Digiacobbe* v. *Sestak*, No. Civ. A. 14525, 2003 WL 1016985, at *5 (Del. Ch. Mar. 3, 2003) ("The burden of proof in an accounting is generally stated simply as resting upon the party who is required to account."); Conn. Civil Jury Instr. 3.8-2(B) (fiduciary defendant must prove by clear and convincing evidence that the challenged act "was the product of fair dealing, good faith, and full disclosure"). Congress shifted the burden in order to deter costly nuisance suits, like the one filed by Petitioners. See, *e.g.*, H.R. Rep. No. 91-1382, at 8 (1970) (increasing "burden of proof ... to prevent the harassment of investment advisers by ill-founded and nuisance law suits, the so-called strike suit").

In addition, the statute contemplates an active role for independent directors in negotiating and setting fee rates, and expects courts to defer to those business decisions under appropriate circumstances. See ICA §§ 15(c), 36(a), 36(b); see also *Burks* v. *Lasker*, 441 U.S. 471, 485 (1979) ("Congress entrusted to the independent directors ... the primary responsibility for looking after the interests of the fund's shareholders ....”). Assigning a role for a board of directors is unknown in the common law of trusts, which recognizes only the interaction of trustees, beneficiaries, and settlors. See, *e.g.*, Restatement (Second) of Trusts § 3 (defining parties relevant in trust law). Furthermore, the Restatement (Second) of Trusts specifically excludes “business trusts,” a type of entity that includes investment companies such as Respondent, from the scope of its analysis of trust law. *Id.* § 1 cmt. b (“Although many of the rules applicable to trusts are applied to business trusts, yet many of the rules are not applied, and there are other rules which are applicable only to business trusts.”). In light of Congress's failure even to use the word “trust” in Section 36(b), and the ICA's many significant conflicts with the common law of trusts, it is evident that Congress did not incorporate trust law into the ICA.

Finally, the statute's legislative history further undercuts any claim that Congress intended to apply trust law. The Senate Report on which Petitioners rely concluded that “the unique structure of mutual funds has made it difficult for the courts to apply traditional fiduciary duty standards in considering questions concerning management fees.” Senate Report, *supra*, at 4898; *Daily Income Fund, Inc.* v. *Fox*, 464 U.S. 523, 536 (1984) (describing § 36(b) as a “unique right”). So, instead of these traditional duties, the report contemplated “federally-created fiduciary dut[ies].” Senate Report, *supra*, at 4902-03. The scope of these federal duties, the Committee determined, should be determined with an eye toward “best industry practice” and “business judgment.” *Id.* Petitioners' analogy to trust law fails.

b. At any rate, even if the Court were to apply the law of trusts – implicating the highest fiduciary standards – those duties would not require Respondent to reduce the fees that were fully disclosed to the shareholders when they voluntarily bought their shares in arm's-length transactions. As Petitioners note, trust law requires "fairness," Pet'r Br. 22, and there is nothing unfair in simply following the terms of an agreement properly struck, fully disclosed, and voluntarily accepted.

Indeed, the common law of trusts follows a "well established rule" that is essentially the opposite of what Petitioners are advocating here. *Baltrotsky*, 910 A.2d at 1098-99. Under the common law, although "courts have the inherent power to review compensation paid to trustees from trust assets," courts give effect to the provisions in the trust instruments "absent extraordinary or special circumstances." *Id.* (quoting *Bunn* v. *Kuta*, 674 A.2d 26, 30-32 (Md. Ct. Spec. App. 1996)); see also *id.* at 1099 ("Our holding is harmonious with the overarching contract law principle that express contracts are enforced as written."). "It is well settled that where there is a valid agreement between settlor and trustee fixing the terms of the trustee's compensation, courts must ordinarily enforce the terms of the agreement without making an independent determination of whether the terms are reasonable." *In re Duncan Trust*, 391 A.2d 1051, 1055 (Pa. 1978); see also, *e.g., In re Estate of Perlberg*, 694 S.W.2d 304, 306 (Tenn. Ct. App. 1984) ("In Tennessee and in virtually every other jurisdiction that has addressed the issue, where a will specifies that an executor is to receive a certain amount as compensation, or no compensation, for serving as an executor, he, by accepting the appointment, binds himself to the will's terms."); *Ladd* v. *Pigott*, 114 S.W. 984, 987 (Mo. 1908) (rule allowing courts to fix trustees' compensation "is inapplicable where the amount of the compensation to be paid has been fixed by contract"); *Meacham* v. *Sternes & Sheldon*, 9 Paige Ch. 398 (Ch. 1842) ("Where the instrument creating the trust ... fixes a different compensation ... that of course must prevail.").

The Restatement (Second) of Trusts is in accord. See Restatement (Second) of Trusts § 242 cmt. f ("If by the terms of the trust it is provided that the trustee shall receive a certain amount of compensation for his services as trustee, he is ordinarily entitled to that amount ...."). Moreover, as the Restatement explains, after the trust is created, the compensation may be enlarged or diminished by an agreement between the trustee and the beneficiary. *Id.* § 242. It is only when such an agreement "*enlarg*[*es*] the trustee's compensation" that the agreement may be struck down as "unfair." *Id.* § 242 cmt. i (emphasis added). Where, as here, the fee is decreased, courts do not review it for fairness.

Petitioners suggest that mutual fund advisory fees are always extraordinary because "the adviser creates the fund" and does not engage in arm's-length bargaining over compensation at that time. See Pet'r Br. 36 & n.27 (citing Restatement (Second) of Trusts § 242 (providing that adviser is limited to "reasonable" fee when it "induce[s]" an excessive fee by "abus[ing] ... a fiduciary … relationship"), and *Lederman* v. *Lisinksy*, 112 N.Y.S.2d 203, 205-06 (Sup. Ct. 1952) (reducing fees to statutory rate where trustee who drafted the instrument abused pre-existing fiduciary relationship as settlor's attorney)). But Petitioners overlook the subsequent arm's-length transaction between the fund and the shareholder, and the choice the shareholder has not to buy any shares in the fund. Provided that the fee rate is properly disclosed, as it was in this case and as it has to be under the ICA and other securities laws, see, *e.g.*, ICA

§ 34(b); 15 U.S.C. §§ 77g, 77j, the shareholder has no ground for subsequently objecting to the rate to which he freely agreed.[4]

Irrespective of the relationship between the adviser and the fund, the fee is ultimately the result of the shareholder's own investment decision.[5] If the ad-

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[4] Understandably, Petitioners do not contend that the particular fees that Respondent charged – which were never more than one percent and were consistent with fees across the mutual fund industry – were so extravagantly high as to be "extraordinary." Accordingly, the Court need not decide whether a particular fee could be so aberrational as to warrant judicial reduction despite full disclosure of the rate and voluntary acceptance by the shareholders in an arm's-length transaction. *Cf. Jones*, 527 F.3d at 632 (suggesting potential breach of fiduciary duty when "university's board of trustees decides to pay the president $50 million a year, when no other president of a comparable institution receives more than $2 million"); *Raleigh Banking & Trust Co.* v. *Leach*, 86 S.E. 701, 703 (N.C. 1915) (rejecting challenge to fee rate in deed of trust, but suggesting in *dictum* that a fee could be reduced if it is "so large as to be oppressive").

[5] Petitioners understandably do not invoke the "equitable deviation" standard. That equitable principle authorizes courts to alter trust agreements when (a) there is an unanticipated circumstance that prevents or frustrates the fulfillment of the trust's purpose, and (b) the alteration would substantially fulfill the trust's purpose. Restatement (Second) of Trusts § 167(1) (allowing modification to trust owing to change in circumstances). *But see id.* § 167 cmt. b ("The court will not permit or direct the trustee to deviate from the terms of the trust merely because such deviation would be more advantageous to the beneficiaries than a compliance with such direction."); *id.* § 167 cmt. c (authorizing modification to investments "only if[] the accomplishment of the purposes of the trust would otherwise be defeated or substantially impaired"). Petitioners do not allege any such unanticipated circumstance. Nor could they. The amount of the adviser's fees grew only because the funds were successful and grew in size, not because of any rate increase. Success and growth are not unanticipated circumstances that

viser sets its fee too high, the shareholder is free to reject it and to take his money elsewhere. The shareholder's independent decision serves as an arm's-length check on the size of the fee.

Unsurprisingly, Petitioners and their supporting *amici* fail to cite a single case holding that a trustee breaches its duty when it receives only the compensation that was properly established at arm's length, let alone when the compensation is subsequently decreased. And, Petitioners candidly acknowledge that, "[w]hen such arm's-length negotiating occurs between unrelated parties, some cases have enforced that bargain, even if the trustee's compensation appears high compared to what trustees typically receive for similar work." Pet'r Br. 35. The only authority that Petitioners and their *amici* cite for the contrary proposition is the Restatement (Third) of Trusts, the relevant volume of which was published in 2003. See *id.* at 35 n.26 (citing Restatement (Third) of Trusts § 38 cmt. e (2003)); Br. of Profs. Demott & Ascher 12-15 (same). Because the Third Restatement postdates Section 36(b) by more than three decades, and because it cites no case law for its newfangled and counter-intuitive position, it should not be deemed controlling of Congress's intent in enacting Section 36(b) in 1970. See, *e.g.*, *Carcieri* v. *Salazar*, 129 S. Ct. 1058, 1064 (2009) (looking to meaning of word "as understood when [the statute] was enacted"); *Director, Office of Workers' Comp. Programs* v. *Greenwich Collieries*, 512 U.S. 267, 275 (1994) (presuming Congress intended "the meaning generally accepted in the legal community at the time of enactment"); Br. of United States 17 (noting "that the Second Restate-

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frustrate a fund's mission; rather, they are the very purpose of the fund.

ment reflects the state of trust law at the time Congress enacted Section 36(b)").

3. Because a trustee does not breach a fiduciary duty when it merely accepts the arm's-length negotiated fee rate (or, as here, accepts a reduction in the fee schedule), Petitioners' remaining arguments are unavailing. First, Petitioners contend that it is unfair for the adviser to charge mutual funds more than what the advisor charges independent investors. Pet'r Br. 48-51. But, if Petitioners considered the fee rate too high, they should not have elected to invest their money with Respondent in the first place. Plaintiffs should not be allowed to buy into a lawsuit by purchasing shares in a fund, and then, after the fact, be heard to complain that the pre-existing, disclosed fees are too high compared to what other customers are paying.

Moreover, Congress did not require investment advisors to charge every investor the rates obtained by the best negotiator. It is not uncommon for a fiduciary to charge different rates to different clients. Indeed, Petitioners' own attorneys might follow the not-uncommon industry practice of charging different rates. Petitioners voluntarily accepted the fee rates that the investment adviser offered to them, and it is irrelevant whether the adviser charged other investors less.

In any event, the regulatory and commercial contexts of the two types of funds are fundamentally different. See Resp. Br. 39-44. Mutual funds must bear the costs and burdens of federal and state laws that do not apply to institutional funds. Also, large institutional funds typically have their own management structure and retain their own liquidity, requiring fewer services from and costs to investor advisers. See, *e.g.*, Rene Stulz, *Hedge Funds: Past, Present, and*

Future, 21 J. Econ. Perspectives 175 (2007); Joseph Golec & Laura Starks*, Performance Fee Contract Change and Mutual Fund Risk,* 73 J. Fin. Econ. 93 (2004). Any differential in apparent fee rates may simply be due to the different services provided. See, *e.g.*, *Jones*, 2007 WL 627640, at *1 (finding that Harris provided "more limited" services to institutional clients than to mutual fund clients); see also Coates & Hubbard, *supra*, at 184-88; *Gartenberg* v. *Merrill Lynch Asset Mgmt., Inc.*, 694 F.2d 923, 930 n.3 (2d Cir. 1982) ("The nature and extent of the services required by each type of fund differ sharply."). It is therefore inadequate for a plaintiff to allege different rates. Under this Court's recent decisions in *Ashcroft* v. *Iqbal*, 129 S. Ct. 1937 (2009), and *Bell Atlantic Corp.* v. *Twombly*, 550 U.S. 544 (2007), merely alleging a rate differential would not be sufficient to survive a motion to dismiss.

Second, Petitioners and their supporting *amici* argue that an adviser must share economies of scale, and thus have "breakpoints" that automatically reduce fee rates when the fund grows to a certain size. But, when an investor voluntarily buys shares in a fund without breakpoints, he cannot then object to the investment decision he made. Moreover, the presence of breakpoints is not necessarily better for shareholders, let alone more "fair."[6] Breakpoints simply mean that the fee rate declines as the fund

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[6] To take a basic example, an adviser may charge a flat rate of one percent, or he may charge a rate of 1.2 percent up to a breakpoint, and then 0.8 percent thereafter. If he negotiates for a flat rate, then the adviser bears more risk that the fund does not grow, and he reaps more upside if it does. By negotiating for the breakpoint, the adviser transfers both some risk and some reward to the shareholders. But neither option is intrinsically better for shareholders, or more fair than the other.

grows in size; they do not ensure that the initial fee rate is lower, nor do they guarantee that the effective fee rate, after all gradations are taken into account, will be lower than it would absent breakpoints.[7] In any event, all three of Respondent's funds in question had breakpoints, and those breakpoints were reduced in 2003 and 2004. Def's Br. in Support of Summ. J. 5-6.

Third, Petitioners contend that Respondent breached its fiduciary duty by failing to disclose material information. But Petitioners do not allege any failure to disclose the fee rates when Petitioners purchased their shares, and after that the rates never increased. Thus, Petitioners paid no more in fees than what they voluntarily agreed to pay, after full disclosure, when they purchased their shares. Petitioners knew the rates, and they bought the shares.

If Respondent failed to disclose material information in violation of ICA Sections 15(c) or 34(b), the SEC may be able to bring an enforcement action

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[7] Nothing in the legislative history requires advisers to accept breakpoints, even setting aside the inherent infirmities in relying on legislative history. Although the Senate Report indicates that "problems arise" due to economies of scale, the report does not determine that failure to share such economies is a *per se* breach of fiduciary duties. Senate Report, *supra*, at 4902. Rather, the report makes clear that "best industry practice will provide a guide," and that "[t]his section … should not be taken as reflecting any finding by the committee that the present industry level of management fees or that the fee of any particular adviser is too high." *Id.* Moreover, as the SEC has recognized, advisers may share the benefits of economies of scale with investors in many ways other than by adopting breakpoints, including by reducing fees through voluntary waivers or contractual fee reductions or by providing additional services to the fund and fund shareholders. *Report on Mutual Fund Fees and Expenses*, *supra.*

under those provisions. But such non-disclosure would not render the fee rate – which the shareholder accepted in an arm's-length transaction – excessive and actionable under Section 36(b). The private remedy available under Section 36(b) relates only to excessive fees and does not bestow on the plaintiffs' bar broad authority to enforce all of the disclosure obligations under the ICA. This Court should reject Petitioners' attempt to imply a new cause of action by impermissibly expanding an existing one. See generally *Alexander* v. *Sandoval*, 532 U.S. 275, 286-88 (2001).

Finally, it is irrelevant that the shareholders and the board of directors can periodically review an adviser's compensation and seek to impose a different rate. *Contra* Pet'r Br. 36-37. Under the common law of trusts, beneficiaries can likewise renegotiate the trustee's rate, and the compensation may be enlarged or diminished by an agreement between the beneficiary and trustee. See Restatement (Second) of Trusts § 242. As noted above (*supra* p. 18), it is only when such an agreement "*enlarg*[*es*] the trustee's compensation" that the agreement may be struck down as "unfair." Restatement (Second) of Trusts § 242 cmt. i (emphasis added). Where, as here, the fiduciary reduces its fee schedule, the fiduciary does not breach its duty. The law of trusts – the only source on which Petitioners rely – undermines their claim.

II. EVEN IN CASES IN WHICH THE FEE RATE INCREASES, SECTION 36(b)(2) DOES NOT PERMIT JUDICIAL RATE REGULATION BUT INSTEAD CONTEMPLATES A SIGNIFICANT ROLE FOR INVESTMENT COMPANY DIRECTORS AND DEFERENCE TO THOSE DIRECTORS, IN LIGHT OF ALL THE RELEVANT CIRCUMSTANCES.

1. There is no need for the Court to address the merits of an excessive-fee claim raised in the context of a fee increase. As noted, Respondent did not increase the fees in any of the funds in question. However, if the Court chooses to address the merits of such a claim, the Court should reject the judicial rate regulation that Petitioners endorse. Under the ICA, directors – not courts – are assigned the "primary" role in determining compensation. As this Court has explained, "the structure and purpose of the ICA indicate that Congress entrusted to the independent directors of independent companies, exercising the authority granted to them by state law, the primary responsibility for looking after the interests of the fund's shareholders." *Burks*, 441 U.S. at 484-85.

The statute's text supports this construction. Under Sections 15 and 36(a), directors are invested with fiduciary duties, and board approval is required, *inter alia*, when establishing an adviser's compensation. Section 36(b) also provides that "approval by the board of directors ... shall be given such consideration by the court as is deemed appropriate under all the circumstances." ICA § 36(b)(2). And, the legislative history further confirms that Congress did not intend courts to substitute their business judgment for that of directors in setting fees. Senate Report, *supra*, at 4902 ("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.").

2. Judicial rate regulation is especially inappropriate insofar as a mutual fund is subject to competition, which would serve as an external check on excessive fees. See, *e.g.*, *Matsushita Elec. Indus. Co.* v. *Zenith Radio Corp.*, 475 U.S. 574, 591 (1986) ("[W]ithout barriers to entry it would presumably be impossible to maintain supracompetitive prices for an extended period of time."). As explained above, *supra* pp. 4-7, the mutual fund industry has experienced extraordinary growth, reflecting the absence of barriers to entry. During the same period, there has been a steady decline in fee rates, consistent with an increase in competition. *Id.* Accordingly, a failure by a board of directors to hold advisory fees in check would be counter-productive, and the fund would be short-lived. Prospective investors would be less likely to purchase shares in funds with excessive fees, and current investors in such funds could redeem their shares and move their proceeds to alternative investments.

The Court need not make any broad pronouncement regarding the state of the industry. As the Solicitor General suggests, the Court could permit a "case-specific" approach to assessing the level of competition. See Br. of United States 28. But, at the very least, because of the dramatic growth in the industry, and because plaintiffs bear the burden of proof under Section 36(b), competition should at least be presumed.

3. In any event, even if competition were lacking, courts should not rigorously regulate advisory fee rates. Instead, courts should apply a deferential approach that recognizes the directors' "primary" role in managing the fund and determining advisory fees,

Burks, 441 U.S. at 484-85, and the investors' ability to walk away from a mutual fund by redeeming their shares upon demand, and to refuse to invest in a particular fund in the first instance. This is essentially what courts have been doing for decades. See, *e.g.*, *Gartenberg*, 694 F.2d at 928 (examining whether an adviser "charge[s] 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"). And this approach would also serve the interest of judicial economy by leaving to the SEC – which has expertise and experience in these matters – the primary responsibility to regulate funds under the ICA.

As part of this analysis, courts should examine whether the board complied with the ICA's statutory procedures. See, *e.g.*, ICA § 15. Also relevant to any judicial review is the independence and conscientiousness of the directors. This board-centered approach is consistent with the statute's text, which requires courts to apply a level of deference to board decisions that is appropriate under "all the circumstances." *Id.* § 36(b)(2); see also H.R. Rep. No. 91-1382, at 37 (degree of deference depends on "whether the deliberations of the directors were a matter of substance or a mere formality"); Senate Report, *supra*, at 4903 ("[A] responsible determination regarding the management fee by the directors including a majority of disinterested directors is not to be ignored.").

Comparisons to other funds can also provide courts with a useful benchmark for assessing whether the board's decision was a responsible one worthy of deference. But it is essential to compare only similarly situated funds that compete with each other for the same investment dollars. As explained above, the fees charged to institutional investors – whose investments are governed by a different regulatory scheme and require different services – shed no light on what is a lawful fee for a mutual fund. See *supra* pp. 20-21; see also Resp. Br. 39-44; *Gartenberg*, 694 F.2d at 930 n.3; Stulz, *supra*, at 175; Golec & Starks, *supra*, at 93; Coates & Hubbard, *supra*, at 184-88.

CONCLUSION

For the foregoing reasons, the decision of the court below should be affirmed.

Respectfully submitted,

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August 27, 2009

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