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ARE MUTUAL FUNDS ROBBING RETIREMENT SAVINGS?

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"When trillions of dollars are managed by Wall Streeters charging high fees, it will usually be the managers who reap outsized profits, not the clients."

– Warren Buffet, 2017 Letter to Shareholders[1]

"The mutual fund industry is the world's largest skimming operation."

– U.S. Senator Peter G. Fitzgerald[2]

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1. Aaron Hankin, *Warren Buffet's Annual Shareholder Letter for 2017*, INVESTOPEDIA (Feb. 25, 2017), http://www.investopedia.com/news/warren-buffetts-annual-shareholder-letter-2017-brka-aapl/.

2. *Oversight Hearing on Mutual Funds: Hidden Fees, Misgovernance and Other Practices that Harm Investors: Hearing Before the Subcomm. on Fin. Mgmt., the Budget, and Int'l Sec. of the S. Comm. on Governmental Affairs*, 108th Cong. 3 (2004), https://www.gpo.gov/fdsys/pkg/CHRG-108shrg91038/html/CHRG-108shrg91038.htm [hereinafter Oversight Hearing on Mutual Funds].

INTRODUCTION 144
I. MUTUAL FUNDS AND HOW THEY ROSE TO PROMINENCE 148
A. *The Size and Scope of the Industry* 148
B. *The Origins and Growth of Mutual Fund* 153
II. FEDERAL REGULATION OF FUNDS 154
A. *The Great Reforms of the 1930s*................ 154
B. *The Two '40 Acts* 156
C. *New Concerns During the Post-War Stock Surge* . 158
D. *The 1970 Amendments* 159
III. EXCESSIVE FEES AFTER THE 1970 AMENDMENTS ... 161
A. *The* Gartenberg *Precedent* 161
B. *The Impact of the Market-Timing and Late-Trading Scandals* 163
C. *The Fitzgerald Hearings*....................... 165
D. Harris v. Jones............................. 166
E. *The* Janus *Case* 168
F. Northstar 170
IV. MUTUAL FUND FEES AND THE DIRECTORS WHO AUTHORIZE THEM 174
A. *Adviser Compensation* 174
B. *Directors and What They Are Paid* 181
CONCLUSION: SHAREHOLDER LITIGATION AS THE EFFECTIVE REMEDY 183

INTRODUCTION

Almost all Americans who want to grow their savings entrust them to various financial institutions promising monetary returns.[3] Mutual funds,[4] "commonly defined as pools of stocks, bonds, or other investment securities,"[5] are among the most popular of those. There are now more than 16,000 mutual

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3. *See generally*, TAMAR FRANKEL & KENNETH E. BURDON, INVESTMENT MANAGEMENT REGULATION 1–7 (5th ed. 2015).

4. For general information about the regulation of mutual funds, *see* U.S. Securities and Exchange Commission (SEC), *Investment Company Registration and Regulation Package,* www.sec.gov/divisions/investment/invcoreg121504.htm.

5. Quinn Curtis & John Morley, *The Flawed Mechanics of Mutual Fund Litigation*, 32 YALE J. ON REG. 1, 4 (2015). The U.S. Supreme Court has given this definition of a mutual fund: ". . . a pool of assets, consisting primarily of [a] portfolio [of] securities, and belonging to the individual investors holding shares in the fund." Burks v. Lasker, 441 U.S. 471, 480 (1979).

funds cumulatively holding in excess of $18 trillion in assets[6] that belong to over 90 million investors.[7] The managers of these holdings and their affiliates are paid an astronomical amount for their services—$100 billion annually—all of which comes from the funds of their investors.[8]

Because self-funded retirement plans like 401(k)s[9] and IRAs[10] have in large measure replaced defined benefit pensions that companies used to provide for their employees, individuals have increasingly turned to these investment programs to build resources to sustain them after their working years.[11] As a result, mutual funds have grown prodigiously in both numbers and assets during the last several decades.[12]

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6. An interesting comparative figure here is the national debt which is slightly higher than this amount, $20.5 trillion. U.S. Department of the Treasury, Bureau of the Fiscal Service, TREASURY DIRECT, http://www.treasurydirect.gov/NP/debt/current (last visited Nov. 16, 2017).

7. INVESTMENT COMPANY INSTITUTE, 2016 INVESTMENT COMPANY FACT BOOK 6 (2016), https://www.ici.org/pdf/2016_factbook.pdf.

8. *See infra* note 189 and accompanying text. An interesting comparative figure here is the cost to society of incarcerating the 2.3 million people who are currently in U.S. prisons and jails. One study found that the aggregate price of incarceration for 40 participating states was $39 billion annually. *See* Peter Wagner & Bernadette Rabuy, *Mass Incarceration: The Whole Pie 2017*, *in* PRISON POLICY INITIATIVE (Mar. 14, 2017), www.prisonpolicy.org/ reports/ pie2017.html; Christian Henrichson & Ruth Delaney, *The Price of Prisons: What Incarceration Costs Taxpayers*, VERA INSTITUTE OF JUSTICE (2012), http:// archive.vera.org/sites/defaul/files/resources/downloads/price-of-prisons-udated-version-021914.pdf.

9. 26 U.S.C. § 401(k). These are "tax sheltered retirement plans. Funds placed in them are not taxable to the employee and are deductible by the company; contributions and earnings increase tax-free until they are withdrawn." CHARLES J. WOELFEL, THE FITZROY DEARBORN ENCYCLOPEDIA OF BANKING AND FINANCE (10th ed. 1996).

10. 26 U.S.C. § 408(a), 26 C.F.R. § 1.408-2. These are pension plans that allow "annual sums to be set aside from earnings free of tax and accumulated in a fund, which pays interest. Basic-rate tax is payable once the saver starts to withdraw from the account, which must be done no later than the participant's 70th birthday." *Individual Retirement Account (IRA)*, OXFORD DICTIONARY OF FINANCE AND BANKING (4th rev. ed. 2008).

11. *See* Barbara A. Butrica, Howard M. Iams, Karen E. Smith & Eric Toder, *The Disappearing Defined Benefit Pension and its Potential Impact on the Retirement Incomes of Baby Boomers*, 69 SOC. SECURITY BULL. NO. 3 (2009). Among other findings, this study reports that the percentage of workers participating in traditional pensions declined from 38% to 20% from 1980 to 2008.

12. INVESTMENT COMPANY INSTITUTE, *supra* note 7.

The companies providing these financial services have features that many find attractive. They afford a form of "mass-produced"[13] investment advice to individuals who are not typically able to afford such personalized services. In lieu of individualized guidance, mutual funds also give those with limited nest eggs the ability to pool their resources with others to buy shares in a portfolio containing various types of securities. Such an aggregation is said to provide small investors with significant benefits like diversification, expert management, and economies of scale.[14]

Consequently, it is important that firms offering these opportunities be run honestly and effectively and that the funds committed to them be administered with care. However, as with all situations where individuals hold and manage the money of others, the possibilities for overcharging and, even worse, outright fraud, are ever present.[15] In the 1930s and 40s, therefore, the federal government set up a system to regulate these firms and has amended it over the years to assure that those who commit their resources to mutual funds will not be cheated.[16]

For some time, this industry was perceived to be conservatively managed and fairly run. So, in the last decade it came as a shock that some of the most prominent of these funds were involved in a series of "market-timing" and "late-trading" scandals.[17] While that misconduct brought a swift response from regulators,[18] it would be a mistake to assume that all is now well with this crucial segment of our economy. Concerns persist because of how these firms are structured. They are set up in a way that seems to invite conflicted loyalties and allow their managers to charge fees that drain away the savings of their investors. These fees amount to an astounding $100 billion an-

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13. FRANKEL & BURDON, *supra* note 3, at 9.

14. *Id.* at 9–10.

15. The seminal work there is LOUIS BRANDEIS, OTHER PEOPLE'S MONEY AND HOW THE BANKERS USE IT (1914).

16. *See infra* notes 78–105 and accompanying text.

17. For a fine description of such scandals *see* ANDREW PETERSON, WHITE COLLAR CRIME IN THE MUTUAL FUND INDUSTRY (2012). *See also infra* note 145 and accompanying text.

18. For a list of SEC actions brought in that wake of market-timing and late-trading scandals, *see* H. Norman Knickle, *The Investment Company Act of 1940: SEC Enforcement and Private Actions,* 23 ANN. REV. BANKING & FIN. L. 777 (2004).

nually which, necessarily, must come out of the money entrusted to the funds.[19] As a well-regarded financial journalist put it, "Wall Street is bleeding savers dry."[20]

While investment companies began with their own staffs, they are now primarily run by outside firms which serve as their advisers under contracts with the funds' directors. This Article will discuss how this external model functions,[21] how the law has sought to regulate it, and how courts have reacted to allegations that such advisers engage in reprehensible conduct. Such allegations typically involve claims that the advisers have charged excessive and unjustifiable fees[22] or have, with the complicity of their directors, acted in other harmful ways that diminish the value of their funds.[23]

The best way to combat these injurious practices is for shareholders to hold those advisers accountable in litigation. This Article will therefore discuss ways in which this can be done effectively.[24] It will also focus on the potential liability of fund directors who continue to renew the contracts of adviser/managers even as the advisers are breaching the fiduciary duties they owe investors.[25] As a prelude to that discussion, this Article will present relevant background information about the mutual fund industry.

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19. *See infra* note 137 and accompanying text. The fees taken from mutual fund investors continue to grow. A report from a few years earlier put them at $88 billion. Jeff Sommer, *Fees on Mutual Funds Fall. Thank Yourself.*, N.Y. TIMES, May 9, 2015, at BU3. The fees on these actively managed funds have been desribed as "one of the great gravy trains in financial history." Landon Thomas, Jr., *Why Are Mutual Fund Fees So High? This Billionaire Knows*, N.Y. TIMES (Dec. 30, 2017), https://www.nytimes.com/2017/12/30/business/why-are-mutual-fund-fees-so-high-this-billionaire-knows.html.

20. Eduardo Porter, *Americans Aren't Saving Enough for Retirement, but One Change Could Help*, N.Y. TIMES (Mar. 3, 2015) *quoted in* WILLIAM A. BIRDTHISTLE, EMPIRE OF FUNDS 50 (2016).

21. *See infra* notes 47–49 and accompanying text.

22. *See infra* notes 124–133 and accompanying text.

23. *See infra* notes 140–146 and accompanying text.

24. *See infra* notes 151–88, 247–48 and accompanying text.

25. *See infra* notes 244–247 and accompanying text.

I.
MUTUAL FUNDS AND HOW THEY ROSE TO PROMINENCE

A. *The Size and Scope of the Industry*

The most common type of U.S. mutual fund is the open-end investment company,[26] a firm which exists to hold and trade securities issued by other entities.[27] It funds its operations by daily selling its own shares to the public.[28] If its investors so desire, it must also buy them back at the end of each business day at the net asset value (NAV) of the securities it is then holding.[29] An open-ended investment company therefore expands or contracts daily based on its assets.[30] This immediate redemption feature, a special right of exit, gives investors valuable liquidity. Other investment vehicles like hedge[31]

26. John Morley, *Collective Branding and the Origins of Investment Fund Regulation,* 6 Va. L. & Bus. Rev. 341, 354 (2012) [hereinafter Morley, *Collective Branding*]. As that author elsewhere states, "Mutual funds are sometimes called 'open-end' funds to distinguish them from 'closed-end' funds." (*See infra* notes 34–35 and accompanying text). John Morley, *The Separation of Funds and Managers: A Theory of Investment Fund Structure and Regulation,* 123 YALE L.J. 1228, 1235 (2014) [hereinafter Morley, *The Separation of Funds and Managers*]. According to the last report of the Investment Company Institute, open-end funds have $15.6 trillion of the $18.1 trillion currently held by investment companies. INVESTMENT COMPANY INSTITUTE, *supra* note 7, at 9.

27. Curtis & Morley, *supra* note 5, at 5.

28. *Id.* at 4.

29. Morley, *Collective Branding, supra* note 26, at 352. The name "open-end" indicates that almost immediate right of exit. Elsewhere that author asserts that such liquidity is a feature of mutual funds which is compatible with investors having little control over those companies. *Id.* at 1233. *See also* BIRDTHISTLE, *supra* note 20, at 26.

30. Since a good bit of the compensation that fund advisers make is based on a percentage of the assets they manage, this gives them substantial incentives to grow the size of their funds. For the problems that may cause fund investors *see infra* notes 121–123 and accompanying text. *See also* Steven Fox, *Your Financial Advisor May Not Be Looking Out for You*, EXPERIENCE, June–July 2017, https://www.americanbar.org/groups/senior_lawyers/ publications/experience/2017/june-july/your-financial-advisor-may-not-be-looking-out-you.html.

31. These are typically structured as unit trusts (*see infra* notes 36–38 and accompanying text) that attempt to achieve large gains by exploiting market anomalies. "These funds are often high-return and are regarded as speculative." *Hedge Fund*, OXFORD DICTIONARY OF FINANCE AND BANKING (4th ed. 2008). They are subject to much less regulation than traditional mutual funds because they only accept contributions from "accredited investors," a

or private equity funds[32] lack this feature, so they are primarily sold only to wealthy individuals or institutions who can take the risk of a long-term illiquid investment.[33]

There are two other types of investment companies, but these are much less prevalent and contain far fewer assets than open-end companies. The first are closed-end funds, which sell shares to the public only once and do not stand ready to repurchase them like open-end firms. Instead, their stockholders can only exit by selling their shares to others in the market.[34] Closed-end funds must also distribute their income to investors every year, which can make them less advantageous than open-end firms in two ways. First, the annual distribution requirement can result in tax consequences for their share-

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term defined under Securities Act Rule 501, 17 C.F.R. § 230.501, to only include individuals with high net worth or annual incomes. Hedge funds allow only limited redemptions (monthly or quarterly), unlike mutual funds which allow investors to withdraw their contributions daily. Morley, *The Separation of Funds and Managers*, *supra* note 26, at 1235.

32. These are investment firms that attempt to "make high returns by (1) obtaining a controlling interest in a target company. . . . (2) subjecting it to radical financial and organizational restructuring . . . . and (3) selling the revitalized company or floating it on the stock exchange." *Private Equity Firm*, OXFORD DICTIONARY OF FINANCE AND BANKING (4th rev. ed. 2008). Private equity firms do not allow their investors to withdraw their contributions. "Instead, they exist for terms of years—usually around five or ten years—after which they wind up by distributing their assets or by selling them and distributing the proceeds." Morley, *The Separation of Funds and Managers*, *supra* note 26, at 1236.

33. *See id.* at 1235.

34. As Professor Morley describes them: "Closed-end funds are similar to mutual funds [open-end funds] in many respects. They are pools of investment securities, they sell interests widely to the public, and they must comply with the ICA [The Investment Company Act, *see infra* note 84 and accompanying text]. The primary difference is that closed-end funds do not allow shareholders to redeem. Rather than redeeming, closed-end fund shareholders dispose of their shares by selling them on stock exchanges, just as they might do with shares of operating companies." *Id.* Elsewhere Professor Morley provides a good description of how closed-end funds dominated the investment industry until the 1929 market crash when many became insolvent—particularly those that were leveraged and traded below their NAVs. By the mid-1930s however open-end funds that redeemed their shares daily at their NAVs became much more attractive to investors and they have come to dominate the industry to this day. *See id.* at 348–54.

holders, and second, such payments will automatically diminish the assets of those funds.[35]

The second alternative to open-end funds is the Unit Investment Trust. It is typically established for a set duration and begins with a portfolio of shares that does not change.[36] Therefore, unlike the other two types of investment companies, it does not require an investment manager.[37] Investors can redeem their shares daily as in an open-end company or wait until the trust terminates and receive their proportionate payouts at that time.[38]

Exchange-Traded Funds (ETFs) should also be included in this group of investment vehicles. These are essentially participations in a basket of stocks traded on an exchange.[39] Their values are therefore based on the shares in a particular index which provide a broad exposure to the market. Like mutual funds,[40] they also offer diversified investment opportunities. ETFs are commonly structured as open-end companies or unit trusts and their shares are typically traded on an exchange.[41] Unlike mutual funds, however, they are not just redeemable at the end of each day, but can be bought or sold at any point in time.[42]

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35. Professor Morley, suggests that this different treatment arose because the mutual fund industry lobbied for it, knowing that it would promote its interests at the expense of closed-end funds. The payments they must make drain resources away and discourage new investments. Open-end funds, by contrast, do not suffer such losses in their assets. In addition, they do not have to deal with the tax disadvantages that result from those required distributions which may scare away new investors. *See id.* at 346.

36. *See* INVESTMENT COMPANY INSTITUTE, *supra* note 7, at 20.

37. FRANKEL & BURDON, *supra* note 3, at 15.

38. *See* INVESTMENT COMPANY INSTITUTE, *supra* note 7, at 20.

39. *See* BIRDTHISTLE, *supra* note 20, at 179–80. *See also* U.S. SECURITIES AND EXCHANGE COMMISSION, Fast Answers, https://www.sec.gov/answers/etf.htm. Among other things that discusses one type of ETF known as "Spiders" or "SPDR"s which invest in all the stock in the S&P Composite Stock Price Index.

40. *See* Michael Chamberlain, *What's the Difference? Mutual Funds and Exchange Traded Funds Explained,* FORBES, Jul. 18, 2013.

41. *See* U.S. SECURITIES AND EXCHANGE COMMISSION, *supra* note 39.

42. *See* Chamberlain, *supra* note 40. ETFs also have tax advantages over mutual funds. When shareholders redeem their stock from mutual funds they may have to pay capital gains tax. The sale of an ETF by contrast does not result in the sale of the underlying securities so no gain arises. *Id.*

Although ETFs are increasing in popularity,[43] open-end companies continue to comprise the largest portion of the mutual fund industry. At the close of 2015 there were 9,520 of them in the United States compared to 558 closed-end funds, 5,188 unit investment trusts, and 1,594 ETFs.[44] In dollar amounts, open-end companies at that point in time had holdings valued at $15.6 trillion, while closed-end funds, unit investment trusts, and ETFs respectively had assets of $261 billion, $94 billion, and $2.1 trillion.[45] Since open-end firms thus comprise the lion's share of the investment company market, this Article will focus on them and refer to them synonymously as "mutual funds."[46]

Although there are thousands of U.S. mutual funds, many of them have the same financial service company as their common sponsor. They are therefore usually referred to as complexes or families of funds.[47] Some of those fund advisers run other operations as well, such as insurance, banking, and brokerage operations.[48] Seventy-nine percent of the complexes, however, are run by independent fund advisers that operate no other businesses, and those firms manage 67% of all the money held by investment companies.[49]

In fact, five fund families hold 45% of all mutual fund assets,[50] and two of the largest— Fidelity and Vanguard—are so well known that they are household names.[51] Additionally, the industry is highly concentrated, with the 25 largest complexes controlling 75% of the assets held by all U.S. mutual funds.[52]

These families typically offer a variety of funds that provide diverse investment opportunities. Overall, equities (i.e. long-term investments in U.S. corporations) comprise the ma-

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43. At the end of 2015 there was double the number of ETFs than at the same time in 2009. INVESTMENT COMPANY INSTITUTE, *supra* note 7, at 22.
44. *Id.*
45. *Id.* at 9.
46. *See* Chamberlain, *supra* note 40.
47. Morley, *The Separation of Funds and Managers*, *supra* note 26, at 1239.
48. *Id.* at 1238.
49. INVESTMENT COMPANY INSTITUTE, *supra* note 7, at 15.
50. *Id.* at 17.
51. Their gigantic size gives them that status. For instance, the Vanguard Total Stock Market Index Fund holds stock in more than 3,700 companies and is valued at $350 billion. BIRDTHISTLE, *supra* note 20, at 25.
52. INVESTMENT COMPANY INSTITUTE, *supra* note 7, at 17.

jority (56%) of their assets.[53] In fact, mutual funds hold 25–26% of the outstanding stock in U.S. companies.[54] Bonds, money-market and commodity investments make up most of their remaining assets.[55]

Importantly, 22% of the assets of U.S. households are invested in mutual funds,[56] a percentage that has been steadily increasing over the last thirty years. A large portion of U.S. household savings are held in 401(k)s, IRAs, and other retirement accounts.[57] Since 80 million baby boomers are expected to retire over the next two decades at a rate of 10,000 per day,[58] Americans will become even more dependent on mutual funds for their livelihood in the years to come.

Many of these retirees will be living longer, since the life expectancy in this country has increased by more than a decade over the last 25 years.[59] Yet, it looks like many of those seniors will have only meager resources on which to live during their elongated life spans. The average monthly social security benefit for a retired person is just $1,259[60] and workers today between the ages of 55 and 64 shockingly have a median balance of only $111,000 in their personal retirement accounts.[61]

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53. *Id.* at 8.

54. *Id.* at 14.

55. *Id.* at 8.

56. *Id.* at 11.

57. *Id.* at 12. *See also* PETERSON, *supra* note 17, at 3. For a good discussion of the decline of pensions formerly provided by companies to their employees and the rise of these self-funded retirement programs to take their place, *see* BIRDTHISTLE, *supra* note 20, at 1–11.

58. BIRDTHISTLE, *supra* note 20, at 7. Boomers hold roughly $10 trillion in these tax-deferred savings accounts. Vipal Monga & Sarah Krouse, *Pulling Retirement Cash, but Not by Choice,* WALL ST. J. (Jan. 16, 2017), https://www.wsj.com/articles/pulling-retirement-cash-but-not-by-choice-1484568043. According to consumer reports, an average two-income couple will pay more than $150,000 in fees on their 401(k) plans during their lifetimes. Tobie Stranger, *Be a Gold Medal Winner When It Comes To Your Personal Finances*, CONSUMER REPORTS (Aug. 6 2016), https://www.consumerreports.org/personal-finance/be-gold-medal-winner-when-it-comes-to-personal-finances/.

59. BIRDTHISTLE, *supra* note 20, at 7. *See also* Monga & Krouse, *supra* note 58.

60. SOC. SEC. ADMIN., MONTHLY STATISTICAL SNAPSHOT, SEPT. 2017 https://www.ssa.gov/policy/docs/quickfacts/stat_snapshot/.

61. BIRDTHISTLE, *supra* note 20, at 11.

B. *The Origins and Growth of Mutual Fund*

Mutual funds were invented by Dutch merchants in the late 1770s,[62] and grew to prominence in the next century when English and Scottish investment trusts began offering to the public shares of stock in companies which owned shares in other firms.[63] Those investments were attractive to investors because they promised small savers expertly managed broad holdings.[64] The idea soon caught on in the United States, where its spread was fueled by the rapid economic growth and frequent stock issuances that occurred during the late 1800s.[65] The first American investment companies took the form of closed-end funds, which gave individuals with limited resources a way to participate in those offerings while ostensibly affording them the advisory services of investment professionals as well.[66]

In 1924 the first American open-end fund, the Massachusetts Investment Trust, was created.[67] It was structured as a business trust[68] under Massachusetts state law and was run by its own trustees and staff.[69] Closed-end firms continued to dominate during the boom years of the late 1920s,[70] when public

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62. PETERSON, *supra* note 17, at 2.

63. *Id.*

64. FRANKEL & BURDON, *supra* note 3, at 10.

65. *Id.* at 8.

66. *Id.* Morley, *Collective Branding*, *supra* note 26, at 350–54, describes how closed-end funds boomed from then until the Great Crash of 1929 and were eclipsed by mutual funds in the 1930s.

67. PETERSON, *supra* note 17, at 3.

68. This is an unincorporated business organization created by an instrument of trust empowering trustees to hold and manage property by trust for the benefit of those who hold beneficial interests in the trust estate. As a recent case stated: "One of the significant features that distinguishes a Massachusetts trust from the ordinary or private trust 'lies in the manner in which the trust relationship is created; investors in a business trust enter into a voluntary, consensual and contractual relationship, whereas the beneficiaries of a traditional private trust take their interests by gift from the donor or settlor.'" Northstar Financial Advisors v. Schwab Investments, 779 F.3d 1036, 1040 (9th Cir. 2015) (citation omitted). As that case found, "[s]uch a trust today is a preferred form of organization for mutual funds and asset securitizations." *Id.* at 1040 (citation omitted).

69. PETERSON, *supra* note 17, at 3.

70. Morley, *Collective Branding*, *supra* note 26, at 350–54.

investors became enthusiastic about investment companies and the supposed "financial genius" of their management.[71]

These companies were originally structured as "trusts" with the understanding that their management was subject to fiduciary duties. That notion, however, soon gave way to a new arrangement, the "investment corporation," which allowed its operators to run things under a more pliant legal regime.[72] Those firms were set up not to be run by their own internal managers, but by external operating companies whose primary loyalties lay with their owners.[73] That bifurcation of ownership and management increased the potential for conflicts of interests and self-dealing.[74]

The market crash of 1929 hit investor funds hard, with holders of shares in those firms witnessing their capital contribution diminished by 90%.[75] A study by the Securities and Exchange Commission (the "SEC" or the "Commission") made several years later found that those losses were caused not only "by the decline in security value," but also by "unscrupulous mismanagement" made possible because many of those companies had their assets in cash and marketable securities which could easily be "looted."[76] Such improvident and fraudulent practices caused shareholders in investment companies to lose more than $1 billion by the early 1930s[77]—an incredibly large sum at that time.

II.
FEDERAL REGULATION OF FUNDS

A. *The Great Reforms of the 1930s*

The stock market crash of 1929 and the ensuing Great Depression provided the impetus for national financial regula-

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71. FRANKEL & BURDON, *supra* note 3, at 11 (quoting JOHN KENNETH GALBRAITH, THE GREAT CRASH, 1929, 46–55 (1988)).
72. *Id.* at 10.
73. *Id,* at 11. PETERSON, *supra* note 17, at 3.
74. PETERSON, *supra* note 17, at 3.
75. FRANKEL & BURDON, *supra* note 3, at 12.
76. Remarks of Commissioner Robert E Healey, Securities and Exchange Commission, *Investment Trust Study, Investment Company Act of 1940 and Investment Advisers Act of 1940, H.R. Rep. No. 76-2639.*
77. William P. Rogers & James N. Benedict, *Money Market Fund Management Fees: How Much is Too Much?,* 57 N.Y.U. L. REV. 1059, 1068 (1982).

tion.[78] President Franklin Roosevelt was swept into office in 1932 promising wide-scale reforms of investment firms that he claimed had betrayed their "sacred trust."[79] As part of FDR's famed "100 days" of legislation, Congress passed the Securities Act of 1933 (the "Securities Act")[80] which brought significant changes to the way securities were bought and sold.[81] The Act requires that, absent an exemption, all offers and sales of securities be registered[82] with a federal agency, the SEC.[83] Shares in mutual funds offered to the public are included in that mandate and such funds must therefore file a registration statement that makes full disclosure of all relevant information about their offerings.[84]

The next year, Congress passed a companion piece of legislation to expand its reform of the financial industry, the Securities and Exchange Act of 1934 (the "Exchange Act").[85] The Exchange Act is designed to regulate the trading of securities and the markets where such trading occurs.[86] As part of that process, all companies whose shares are held by the public

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78. LOUIS LOSS AND JOEL SELIGMAN, FUNDAMENTALS OF SECURITIES REGULATION 28 (4th ed. 2001).

79. President Franklin D. Roosevelt, First Inaugural Address, (Mar. 4, 1933).

80. Securities Act of 1933, 15 U.S.C. §§ 77a–77aa (2012).

81. *See generally,* James M. Landis, *The Legislative History of the Securities Act of 1933*, 28 GEO. WASH. L. REV. 29 (1959).

82. The relevant provisions are contained in Section 5 of the Securities Act of 1933. 15 U.S.C. § 77e (2012).

83. The SEC was created by Section 4 of the Securities Exchange Act of 1934. 15 U.S.C. §78d (2012). It is an independent federal regulatory agency. For more on the SEC and its mission, see *What We Do*, U.S. SECURITIES AND EXCHANGE COMMISSION, https://www.sec.gov/about/whatwedo.shtml (last visited Sept. 29, 2017).

84. *See* U.S. SECURITIES AND EXCHANGE COMMISSION, *supra* note 83. The Investment Company Act of 1940, (ICA), 15 U.S.C. §§ 80a-1-80a-64 (2012), mandates this requirement. While requiring a separate registration for those firms, it includes provisions allowing certain information and documents already filed in a Securities Act registration to be part of an ICA registration statement or for certain parts of it to be filed in lieu of an ICA registration statement. 15 U.S.C. §§ 80a-8(b)(5), 80a-8(c)(1) (2012).

85. 15 U.S.C. §§ 78a–78mm.

86. *See generally,* U.S. SECURITIES AND EXCHANGE COMMISSION, *supra* note 83.

must publicly file extensive periodic reports about their operations.[87] Those requirements likewise apply to mutual funds.[88]

B. *The Two '40 Acts*

Yet it soon became apparent that those two cornerstone laws of securities regulation (which have disclosure as their fundamental purpose[89]) would not be enough to protect investors in mutual funds from the unfairness produced by mutual funds' structures.[90] Examples of such unfairness include self-dealing and breaches of fiduciary duties by insiders, as well as embezzlement and other deceptive practices specific to these actors.[91]

Congress therefore gave the SEC a mandate to study the industry and propose additional reforms.[92] The Commission followed up with a report[93] which found that the national interest required further legislation geared particularly toward mutual funds. It would require that a fund present complete information about the nature of its investments and mandate that its operators and affiliates put the concerns of investors ahead of their own. The SEC's report also found that federal policy should limit concentrations of power in investment companies and prohibit them from engaging in discriminatory practices and excessive borrowing. It also determined that legislation was needed to ensure that investment companies be adequately capitalized and keep accurate books and records.[94]

87. Sections 12(b) and 12(g) of the Exchange Act, 15 U.S.C. §§ 78l(b), (g) mandate that public companies register with the SEC and bring into play requirements under Section 13(a), 15 U.S.C. § 78(o) that companies so registered file various period reports with the Commission. Among those are annual, quarterly and current reports.

88. As is the case with information and documents filed in Securities Act registration statements, *see supra* note 84, the Investment Company Act (ICA) includes provisions allowing that materials filed under the Exchange Act be part of an ICA registration statement, Investment Company Act §§ 8(b)(5), (c)(1). For those separate registration requirements under the ICA see *What We Do*, *infra* note 83 and accompanying text.

89. Knickle, *supra* note 18, at 783–84.

90. FRANKEL & BURDON, *supra* note 3, at 12.

91. Knickle, *supra* note 18, at 781.

92. FRANKEL & BURDON, *supra* note 3, at 11.

93. SEC, PUBLIC POLICY IMPLICATIONS OF INVESTMENT COMPANY GROWTH, H.R. REP. NO. 89-2337 (1966).

94. *See supra* note 80 and accompanying text; FRANKEL & BURDON, *supra* note 3, at 12–14.

The Commission's study led to the enactment of two additional pieces of legislation in 1940—The Investment Company Act[95] (the "ICA") and the Investment Advisers Act (the "IAA").[96] The ICA and the IAA are designed to address issues unique to those firms. The ICA set up a legal framework for the federal regulation of mutual funds that responded to the SEC's concerns. Chief among its reforms is a requirement that investment companies register with the Commission.[97]

Among other things, the registration has to include general information about the company, along with certified financial statements. Those disclosures must be updated each year in an annual report.[98] The ICA also mandates that funds provide their shareholders with full information about all aspects of their investments and comply with particular rules of operation which, among other things, are designed to prevent fund distributors from charging large commissions.[99]

To further its reform of investment companies, Congress enacted the IAA as a companion piece of legislation. It federally regulates those who receive compensation for giving investment advice, including those who publish information for that purpose. Its goal is to prevent harmful activity by which advisers enrich themselves at the expense of their clients.[100]

For the first twenty years of its existence, however, the IAA only required that investment advisers register with the Commission, which one commentator derided as "little more than a census of investment advisers."[101] Since that time it has been amended to add specific substantive provisions[102] to protect the public from fraudulent practices such as scalping, where an adviser purchases a security herself before urging the public to buy it and then sells the security at the higher price resulting from her recommendation.[103]

95. *See supra* note 88 and accompanying text.
96. Investment Advisers Act, 15 U.S.C. §§ 80b-1 to -21.
97. Investment Company Act § 8; *see supra* notes 98, 99 and accompanying text.
98. Knickle, *supra* note 18, at 784.
99. PETERSON, *supra* note 17, at 3.
100. FRANKEL & BURDON, *supra* note 3, at 33.
101. *Id.*
102. *Id.*
103. Sec. Exch, Comm'n v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 181 (1963).

In addition, the IAA gained importance as investment companies came to be run more and more by the external managers who set them up.[104] In that process the external managers appoint directors for their funds and then receive their authority to operate them from contracts which they enter into with those very same directors. That conflicted situation was formally recognized by Congress in 1970, when it amended the IAA to make it specifically applicable to advisers of investment companies.[105]

C. *New Concerns During the Post-War Stock Surge*

As confidence in the stock market returned in the post-World War II era, mutual funds grew in popularity. With the generalized prosperity that was in full swing by the 1960s, they saw prodigious increases in their assets.[106] Questions then arose, however, about whether investors were getting a fair shake, since funds were coming to be controlled more and more by their advisers in what one commentator called a relationship of "business incest."[107]

Responding to that concern, the Wharton School of Business published an influential study on the growth of the mutual fund industry, and found that its inbred management structure led to excessive fees for retail investors.[108] While institutional clients could bargain to reduce those charges, the ordinary, individual shareholder lacked that negotiating power and was stuck with higher costs.[109]

The SEC then built on the Wharton study and issued its own report in 1966 about the lack of any meaningful competi-

104. *See supra,* notes 73-74, and accompanying text.

105. FRANKEL & BURDON, *supra* note 3, at 64.

106. H. Norman Knickle, *The Mutual Fund's Section 15(c) Process: Jones v. Harris, The SEC and Fiduciary Duties of Directors,* 31. REV. OF BANKING AND FIN. L. 265, 268 (2011–12).

107. Note, *The Mutual Fund and its Management Company, An Analysis of Business Incest,* 71 YALE L.J. 137 (1961). John C. Bogle, the founder of the Vanguard family of funds, used the same language in his testimony before the Fitzgerald committee to describe the relationship between mutual fund directors and their investment advisers. *See supra* note 2 and accompanying text.

108. H.R. Rep. No. 87-2274 (1962). *See also,* D. Bruce Johnsen, *Myths about Mutual Fund Fees: Economic Insights on Jones v. Harris,* 35 J. CORP. L. 561 (2010).

109. Knickle, *supra* note 106, at 268.

tion in awarding contracts to advisers and controlling their fees. It found that fund directors, even independent ones, were powerless to meaningfully negotiate those arrangements. One reason for that was their part-time status. As outsiders, they had to rely on their colleagues who were affiliated with the company for information about fund policies and appropriate fees.[110]

Even more troubling to the SEC, however, was that advisers had become so imbedded in the operation of their funds that their removal, or even the *threat* of their termination, was virtually impossible.[111] Compounding that problem of accountability, the case law had, in the words of one commentator, "all but immunized" directors for their decisions to renew their advisers' contracts and approve their fees.[112]

To that end, a leading case found that such charges could not be excessive if they were disclosed, ratified by shareholders, and in line with industry averages.[113] That ruling seemed consistent with statutory history, which required that plaintiffs challenging such compensation show that it was wasteful.[114] In addition, the case went on to say that a finding of excessive fees could only be made if the adviser's services "were of such inadequate value that no person of ordinary judgment . . . would deem them worth what the mutual fund paid."[115]

D. *The 1970 Amendments*

The SEC thus urged Congress to amend the '40 Acts to mandate that adviser fees be "reasonable." Mutual fund companies opposed the SEC, claiming that such language would authorize the courts to set fees.[116] In an apparent response to mutual fund lobbying, Congress avoided using that term. It decided instead to impose strict duties on directors in their

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110. *See supra* note 93.
111. *Id.* at 148.
112. Cynthia L. Kahn, Note, *Direct not Derivative: Recovering Excessive Investment Advisor Fees in Mutual Funds,* 71 GEO. L.J. 1595, 1609, n. 84 (1983).
113. Saxe v. Brady, 184 A.2d 602, 612 (Del. Ch. 1962).
114. S. REP. NO. 91-184, at 4901 (1969).
115. Colin B. Davis, *Nudging Mutual Fund Fees Downward: Using Default Rules to Combat Excessive Advisory Fees,* 47 SAN DIEGO L. REV. 185, 204 (2010) (citing Saxe v. Brady, 184 A.2d 602, 611 (Del. Ch. 1962)).
116. Knickle, *supra* note 106, at 269.

approval of contracts and fees with the funds' advisers[117]—a distinction that a leading Court called "more semantical than substantive."[118] Congress did note, however, that the new legislation would abrogate the "waste" standard because it was "unduly restrictive."[119]

In its 1970 amendments Congress also added requirements that would ostensibly facilitate the exercise of those duties by fund directors—a mandate that the directors be furnished material information on the fee issue[120] and that they evaluate it appropriately, meeting in person annually to do so.[121] In addition, Congress imposed a fiduciary duty on the adviser itself "with respect to the receipt of compensation for [its] services"[122] and specifically authorized the SEC to bring enforcement actions for any breaches of fiduciary duty by individuals connected with an investment company.[123] For good

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117. Section 15(c) of the ICA provides in part: "It shall be unlawful for any registered investment company having a board of directors to enter into, renew, or perform any contract or agreement, written or oral, whereby a person undertakes regularly to serve or act as investment adviser of, or principal underwriter for, such company, unless the terms of such contract or agreement and any renewal thereof have been approved by a vote of a majority of directors . . . cast in person at a meeting called for the purpose of voting on such approval."

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

119. S. Rep. No. 91-184, at 5 (1969).

120. Section 15(c) of the ICA provides in part: "It shall be the duty of the directors of a registered investment company to request and evaluate, and the duty of an investment adviser to such company to furnish, such information as may reasonably be necessary to evaluate the terms of any contract whereby a person undertakes regularly to serve or act as investment adviser of such company."

121. *See* Knickle *supra* note 106, at 270.

122. Section 36(b) of the ICA provides: "For the purposes of this subsection, the investment adviser of a registered investment company shall be deemed to have a fiduciary duty with respect to the receipt of compensation for services, or of payments of a material nature, paid by such registered investment company, or by the security holders thereof, to such investment adviser or any affiliated person of such investment adviser."

123. Section 36(a) of the ICA provides: "The Commission is authorized to bring an action. . .alleging that a person. . .serving or acting [as an adviser, depositor, or principal underwriter] has engaged. . .or is about to engage in any act or practice constituting a breach of fiduciary duty involving personal misconduct in respect of any registered investment company."
The language about "personal misconduct" here has led most courts to require a showing of fraud or self-dealing in these actions. *See* William K. Sjos-

measure, it also created another right of action in favor of the SEC or any shareholder to redress breaches of fiduciary duty by an investment adviser in its receipt of compensation.[124]

III.
Excessive Fees after the 1970 Amendments

A. *The* Gartenberg *Precedent*

The 1970 amendments thus put the problem of excessive fees front and center and furnished an express remedy that could be sought by either the SEC or private investors. Aggrieved shareholders responded with a number of suits alleging just that, and many of them were successful, producing settlements that avoided trials on the merits.[125] That favorable trend, however, was cut short in 1982 by a major decision from the U.S. Court of Appeals for the 2nd Circuit: *Gartenberg v. Merrill Lynch*.[126]

The plaintiffs in that case were shareholders in a large money market fund affiliated with a major brokerage house. They alleged that the fund's manager, Merrill Lynch, had breached its fiduciary duties by charging excessive fees based on a percentage of the fund's net assets. The net assets had grown substantially during the previous decade when new money came into the fund because the returns it offered increased as interest rates rose. The end result of such an enlargement of the fund's assets was therefore more revenue for Merrill Lynch, the advising manager.

The fund's independent trustees had correspondingly negotiated a reduction in its adviser's compensation rate. The shareholders alleged, however, that since the fund was a captive of its manager, its fees were too high. To support that contention they pointed to Merrill Lynch's massive bargaining power and other indirect remuneration it received, such as the

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trom, Jr., *Tapping the Reservoir: Mutual Fund Litigation Under Section 36(A) (sic) of the Investment Company Act of 1940*, 54 U. Kan. L. Rev. 251 (2005).

124. Section 36(b) of the ICA. Directors of the fund are included here as potential defendants in these suits by a reference in this subsection to their listing in Section 36(a).
Unlike the preceding subpart, this provision does not require a showing of "personal misconduct" for liability. ICA Section 36(b)(1).

125. Knickle, *supra* note 18, at 310.

126. Gartenberg v. Merrill Lynch Asset Management, Inc. 694 F.2d 923 (2nd Cir. 1982).

likelihood that fund shareholders would open other accounts with Merrill Lynch's brokers.

The lower court held that the adviser could breach its fiduciary duty if its fees were unfair to the fund and its shareholders. That in turn depended on assessing factors like the nature and extent of the services the advising manager offered and the fees charged by advisers to other money market funds.[127] After conducting that inquiry, however, the District Court found that the relationship of Merrill Lynch to the fund's shareholders was not unfair and dismissed the action.

The Appellate Court affirmed, but used a different standard of review. It started out by holding that a test of "reasonableness," not "fairness," should be used to determine whether an adviser's fees were excessive. In addition, it recognized that "a mutual fund cannot as a practical matter sever its relationship with the adviser" and 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."[128] It therefore disagreed with the District Court's ruling that the fees charged by similar advisers should be relevant. Such findings, said the Appellate Court, would not necessarily support an inference that competition existed "between adviser-managers for fund business."[129]

Yet despite such comments expressing skepticism about the reasonableness of adviser fees, the panel went on to set what has been called a "notorious" standard for recovery in an excessive fees case.[130] "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."[131] (*Emphasis added*). That language appeared to set a high bar for a shareholder to meet in order to prevail.

In what seemed to be an afterthought, however, the *Gartenberg* court went on to list six non-exclusive considerations that would have a bearing on whether or not a fee is excessive. Those included the quality of the services provided,

127. *Id.* at 927.
128. *Id.* at 928.
129. *Id.* at 929.
130. Knickle, *supra* note 106, at 273.
131. Gartenberg, 649 F.2d at 923.

the profitability of the adviser including its collateral benefits, the independence and expertise of the fund's board, and strangely, a comparison to the fee structures of other funds.[132] That last point appeared to belie the Court's earlier suspicion of that factor as an appropriate concern, particularly when the panel had acknowledged that the reality of "arm's-length" bargaining over an adviser's fees was problematic.[133]

Gartenberg's six factor test appeared to create legitimate criteria that a shareholder could use to challenge a fund's fee structure. Yet the damage was done by the court's "disproportionately large" language, which was set up as the ultimate requirement for a shareholder to recover. After *Gartenberg* it therefore became quite difficult for shareholders to prevail in excessive fee cases.[134]

Concerns about wrongdoing in mutual funds, however, did not subside. The SEC focused on Section 15(c) of the ICA, which detailed the process that fund directors must follow in their annual review of the investment adviser's contract.[135] It re-enforced them in a 2004 rule requiring that the annual reports filed by funds discuss the factors that their directors consider in approving advisers' contracts.[136] Issues also arose in several post-*Gartenberg* decisions about whether the business judgment rule would automatically protect fund directors from any liability arising from those deliberations.[137]

B. *The Impact of the Market-Timing and Late-Trading Scandals*

Even more significant, however, were the market-timing and late-trading scandals that erupted in the early years of the last decade.[138] Up until then, the mutual fund industry en-

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132. *Id.* at 930.

133. *See supra* note 131 and accompanying text.

134. Jones v. Harris Assocs. L.P., 537 F.3d 728 (7th Cir. 2008) (Posner, J., dissenting from denial of rehearing en banc) (per curiam). *See also* Knickle, *supra* note 106, at 276. A law review article written in 2007 reported that "in the twenty-five years since *Gartenberg*, no plaintiff ever has obtained a reported judgment under Section 36(b)." Lyman Johnson, *A Fresh Look at Director 'Independence': Mutual Fund Fee Litigation and* Gartenberg *at Twenty-Five*, 61 VAND. L. REV. 497, 500 (2007).

135. Knickle, *supra* note 106, at 294–95.

136. Investment Company Act Release No. IC-26486 (June 23, 2004) (amending Form N-1A).

137. Knickle, *supra* note 106, at 304–07.

138. *See generally* Knickle, *supra* note 18, at 798–805.

joyed a reputation for honesty due to the clean record it had seemed to compile due to the integrity of its operations.[139] All of that ended when 160 brokerage firms were investigated for illegal market-timing and late-trading practices. Stiff sanctions ensued, including fines and prison terms for fund executives and traders.[140]

Such wrongdoing was widespread and had been occurring for some time, giving those who were gaming the system an unfair advantage over the long-term shareholders of a fund. The possibility for such illegal activities arose because the execution price for transactions in mutual funds during any trading day is set at 4:00 pm when the market closes. Purchases or sales after that time are supposed to be made at the price existing at 4:00 pm the following day, but late traders were allowed to have their orders executed at the earlier closing price before the market opened the next day. They therefore had knowledge of subsequent events that might affect the share's price, unfairly benefitting them in the same way as someone who is permitted to "[bet] on a horse race after the race has been run."[141]

For instance, suppose that after the trading day ends, good news is announced which will favorably impact the market when it opens the next day. Someone who can then purchase stock at its earlier price will dishonestly profit because other shareholders will have to pay a higher price when they buy. This "late trading" is also called "forward trading" and is specifically made illegal by the ICA.[142]

"Market timing," a strategy in which an investor trades back and forth to take advantage of short term fluctuations in share prices, is not illegal in and of itself. Its success, however, is highly questionable and mutual fund prospectuses typically state that they restrict it because it usually increases a fund's administrative expenses, thereby harming all of its investors.[143]

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139. PETERSON, *supra* note 17, at 4; *see also* BIRDTHISTLE, *supra* note 20, at 10.

140. PETERSON, *supra* note 17, at 7; BIRDTHISTLE, *supra* note 20, at 11 ("Twenty of the country's oldest and most renowned fund complexes paid out unprecedented settlements to government regulators.").

141. PETERSON, *supra* note 17, at 7 (quoting New York Attorney General Eliot Spitzer).

142. Investment Company Act Rule, 17 C.F.R. § 270.22-c-1 (2016).

143. PETERSON, *supra* note 17, at 8–9.

Some funds, however, violated their own representations in their prospectuses by allowing privileged customers to trade more frequently than permitted. In addition, some managers also alerted favored clients when the fund was planning to make a large trade in a particular stock. That gave them inside information which could be used to procure an unfair advantage in their trades.[144]

C. *The Fitzgerald Hearings*

The late-trading and market-timing scandals propelled a one-term Republican Senator, Patrick Fitzgerald, to call hearings to explore a host of concerns in the mutual fund industry. Experts agreed that those illegal practices were prohibited by existing laws. Senator Fitzgerald, however, wanted to investigate what he called "the full panoply of mutual fund fees and other abusive practices"[145] that he said were "eating away at the savings of many Americans."[146]

During the hearings, other senators and witnesses helped Fitzgerald substantiate his case by exposing various hidden arrangements that funds had with the brokerage houses which sold their shares.[147] They also called into question the accuracy of expense ratios published by funds because they excluded other fees and costs paid by investors.[148] Most importantly, they charged that the compensation arrangements for funds, which all came out of investor contributions, were hidden from investors and were exacerbated by the inherently conflicted way those companies were organized.[149]

Although the Fitzgerald Hearings did not produce any new legislation, they did highlight serious problems in the mutual fund industry, and thus may have provided the impetus

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144. BIRDTHISTLE, *supra* note 20, at 11.

145. Oversight Hearing on Mutual Funds, *supra* note 2, at 2. Senator Fitzgerald said the market timing and late trading scandals were "a blessing in disguise" because "[t]he growth of the mutual fund industry has been so rapid during the past 20 years that the industry has managed to escape the thorough review and oversight that it merits." *Id.*

146. Fitzgerald, *supra* note 2, at 3.

147. One of Senator Fitzgerald's key witnesses was John C. Bogle, the founder of the Vanguard family of funds who testified about the exorbitant fees charged investors in those investments. *See supra* notes 107 and accompanying text.

148. Oversight Hearing on Mutual Funds, *supra* note 2, at 2–3.

149. Oversight Hearing on Mutual Funds, *supra* note 2, at 15.

for another round of litigation revolving around new claims about how fund officials were breaching their fiduciary duties. What ultimately became the most prominent of those cases, *Harris v. Jones,*[150] just happened to be filed in federal court in Illinois, the state Senator Fitzgerald represented.

D. Harris v. Jones

The plaintiffs in this action were shareholders in three different mutual funds managed by Harris Associates, LP, their investment adviser. They alleged that Harris was breaching its fiduciary duties by charging the funds that it organized and controlled (the so-called "captive-funds") much more than the ones it merely managed for non-affiliated entities. A panel of the U.S. Court of Appeals for the 7th Circuit dismissed the action, refusing to accept that the structure of the captive funds inherently suppressed competition and thus resulted in higher fees for investors. If that were so, held Judge Frank Easterbrook, a noted law-and-economics scholar, those high prices would drive investors away.[151]

The panel for which Judge Easterbrook wrote then extended that logic to reject the *Gartenberg* test altogether.[152] That precedent allowed courts to find breaches of fiduciary duties whenever fund fees were so "disproportionately large" that they were excessive. Instead, Easterbrook declared, the statute's touchstone of unreasonable compensation should be interpreted as only requiring full disclosure of all fee arrangements.

With that, competition in the market would supposedly make sure that all manager compensation was reasonable.[153] Judge Easterbrook therefore stated his new test succinctly. A

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

151. Jones v. Harris Assoc., 527 F.3d 627, 633 (7th Cir. 2008).

152. *Id.* at 632.

153. For an article written in support of Judge Easterbrook's position, *see* D. Bruce Johnsen, *Myths about Mutual Fun Fees: Economic Insights on Jones v. Harris,* 35 J. Corp. L. 561 (2010) (arguing, among other things, that fees are irrelevant to rational investors and that lower advisory fees will not increase investor returns). *See also* John C. Coates IV & R. Glenn Hubbard, *Competition in the Mutual Fund Industry: Evidence and Implications for Policy,* 33 J. Corp. L. 151 (2007) (finding competition in the mutual fund industry). One of the authors' reasons for that assertion is that shareholders have easy rights of exit because they are allowed to freely redeem their shares. *Id.*

fund must only "make full disclosure and play no tricks."[154] As an apparent afterthought, however, Easterbrook conceded that the amount of an adviser's compensation might be relevant if it is so high that it could only have been gotten by deceit.[155]

Judge Easterbrook's judicial colleague and fellow law-and-economics specialist Richard Posner, however, wrote a *per curiam* opinion arguing unsuccessfully that Easterbrook's views were wrong and that the case should therefore be reargued *en banc* before the full Court.[156] He began his critique with an apt analogy to the "feeble incentives" of corporate boards to rein in ever-larger executive compensation paid to their executives.[157] Drawing from that, Posner then pointed to numerous reports and studies showing that abuses in compensation had become "rampant" in the financial services industry.[158]

Thus competitive pressures, argued Posner, could not be relied upon to check excessive fees for mutual fund managers any more than they could when directors who are beholden to CEOs set their CEO's pay. Fund trustees are likewise compromised in that they are prone to favoring the investment advisers who have appointed them to their lucrative positions. While fees paid to managers by independent funds are likely to be the product of arm's-length negotiation, those from captive funds, Posner concluded, are not.[159]

Since other Appellate Circuits followed *Gartenberg,* the Easterbrook ruling from the 7th Circuit split from that consensus. The Supreme Court therefore took the case and reversed. While endorsing the *Gartenberg* standard, however, the Supreme Court's opinion seemed to indicate a more welcoming attitude toward Section 36(b) suits. It accepted *Gartenberg's* deference to directors' actions but also recognized shareholder suits as an "independent mechanism for controlling conflicts."[160] It drew two inferences from that: "First, a measure of deference to a board's judgment may be appropriate in some

154. Jones, 527 F.3d at 632.
155. *Id.*
156. Jones v. Harris Assocs., 537 F.3d 728 (7th Cir. 2008).
157. *Id.* at 730.
158. *Id.*
159. *Id.* at 731-32.
160. Jones v. Harris Assocs., 559 U.S. 335, 348 (2010).

instances. Second, the appropriate measure of deference varies depending on the circumstances."[161]

Much of the remainder of the Supreme Court's opinion was given over to the justifiable differences in the fees that an adviser might charge its captive and independent clients. The Court made no outright ruling on that, but instead said (with some vagueness) that it would give such distinctions the weight that they merit while avoiding "inapt comparison."[162] The Court concluded its analysis by discussing the importance that process and disclosure play in those decisions. In other words, the question of excessive fees cannot, in the Court's thinking, be divorced from an inquiry into the deliberative process that directors use to determine them.

E. *The* Janus *Case*

Yet just a year after the Supreme Court cracked the door open for excessive fees suits in *Harris*, the Court shut it on another action that investment company shareholders might bring to redress wrongdoing by those running their funds. The case, *Janus Capital Group, Inc. v. First Derivative Traders*[163] arose out of the market timing scandals discussed previously. The plaintiffs were shareholders of Janus Capital Group, a public company, which had set up a number of funds which it ran through a wholly-owned subsidiary, Janus Capital Management, which acted as the investment adviser of the funds. That firm drafted prospectuses for various funds in the family which all stated that they would not allow market timing.

An investigation by the Attorney General of New York, however, revealed that market timing had in fact occurred. When that became known, investors started withdrawing substantial amounts from the Janus funds. Because the fees of the adviser were based on the amount of assets it managed, its income fell. That negatively impacted its parent's revenue as well by causing its share price to decline. When the shareholders saw the value of their stock drop they sued both the parent and its subsidiary (the adviser), under Securities Exchange Act

161. *Id.* at 349.
162. *Id.* at 350.
163. *See* Janus Capital Group, Inc. v. First Derivative Traders, 564 U.S. 135 (2011).

Rule 10-b-5,[164] which provides an implied cause of action against those who "make" false statements in the purchase or sale of securities. The shareholders thus alleged that their losses were caused by the adviser because it made materially false statements in the prospectuses of the funds which it drafted.

Since the adviser concededly controlled the funds and actually wrote their prospectuses, it seemed only logical to attribute the misstatements to it. However, in a 5-4 decision written by Justice Clarence Thomas, the Supreme Court adopted a narrow meaning of the verb "make." It disregarded what the plaintiff called "the well-recognized and uniquely close relationship of an adviser to its funds"[165] and held that the only entities under that subsection that could "make" a false statement were the funds themselves, since they alone were ultimately responsible for the questionable pronouncements.[166]

The adviser and others who might have drafted the false prospectus, said the Court, were akin to "speech-writers" since they did not have formal control over the content of the statement and whether and how to communicate it.[167] Since that literalistic distinction was the basis of its opinion, it didn't matter to the Court that employees of the adviser drafted the false language about market timing and disseminated the prospectuses through the parent company's website.

Because the misstatements appeared in the prospectuses of the funds, reasoned Justice Thomas, only the funds had "made" them, and the suit against the adviser and its parent was therefore dismissed. One of the foremost linguistic philosophers of the 20th century, Ludwig Wittgenstein, famously stated, "Philosophy is a battle against the bewitchment of our

164. Exchange Act Rule 10b-5(b), 17 C.F.R. 240.10b-5(b) provides: "It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange, . . . (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading. . . ." *See* 17 C.F.R. 240.10b-5(b)

165. Janus Capital Group, Inc. v. First Derivative Traders, 564 U.S. 135, 145 (2011). As Justice Breyer noted in dissent, "The relationship between Janus Management and the Fund could hardly have been closer." *Id.* at 161 (Breyer, J., dissenting).

166. *See id.* at 142.

167. *See id* at 143.

intelligence by means of language."[168] Perhaps the same could be said of Justice Thomas's opinion in *Janus*.

F. Northstar

Fund investors charging wrongdoing by advisers have recently fared better under an alternative theory—one borrowed from common law contracts. The opinion, *Northstar Financial Advisors v. Schwab Investments*,[169] keyed in on a provision in the ICA that requires a mutual fund to recite all its investment policies in its registration statement, which can only be changed by a shareholder vote.[170]

Based on this requirement, the plaintiff, a financial planning firm that manages accounts on behalf of its clients, filed suit against a Schwab-sponsored mutual fund, alleging that it had deviated from its stated investment policies. The plaintiff claimed that by doing so, the fund's trustees breached both their contracts and their fiduciary duties to their shareholders, exposing these shareholders to tens of millions of dollars in losses.

Specifically, the fund's prospectus stated that it would offer a high amount of current income by tracking the performance of a certain index comprised of government, corporate, and other bonds and that such policy was "fundamental."[171] It also stated that it would not invest more than 25% of its assets in any one industry unless that was necessary to track the index. The Schwab fund nevertheless deviated from that policy, diverting its shareholders' funds into more speculative investments by increasing its holdings in mortgage-backed securities beyond the stated percentage (25%). The deviation ended up causing substantial losses for shareholders.

Northstar alleged that its cause of action arose under contract law. In particular, Northstar argued that promises by the Schwab fund regarding how it would invest its shareholders' money were breached when it did not follow through with those commitments. The shareholders supplied the necessary

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168. LUDWIG WITTGENSTEIN, PHILOSOPHICAL INVESTIGATIONS 47 (G.E.M. Anscombe trans., Basil Blackwell 3d ed. 1974).

169. *See* Northstar Fin. Advisors, Inc. v. Schwab Invs., 779 F.3d 1036 (9th Cir. 2015).

170. 15 U.S.C. § 80a-8(b)(2).

171. *Northstar*, 779 F.3d at 1041.

consideration to make those promises binding by investing and continuing to invest their money with the fund. The Court upheld Northstar's claim, finding that the fund indeed made those promises in both its registration statement and in the prospectus that it had filed with the SEC. The shareholders therefore had a cause of action in contract when the fund breached those commitments.

In addition to forming a contract between the fund and its shareholders, the Court held that the promises in the prospectus did the same between the trust that ran the fund and the Schwab-sponsored adviser. The trust entered into an agreement with the adviser that committed it to managing the fund with the fundamental investment policies spelled out in the fund's SEC filings. The shareholders of the fund were thus third-party beneficiaries of that contract. As such, the Court held, the shareholders could hold the adviser liable for their losses under that theory as well.

Defendants made arguments that all of the plaintiffs' causes of action, for breaches of both contract and of fiduciary duties, as well as the third-party beneficiary claims, were preempted by the Securities Litigation Uniform Standards Act of 1998 (SLUSA), a statute which bars securities class actions based on state law claims when they involve deceptive statements or conduct.[172] The breach of fiduciary duty claims, however, could survive such preclusion, said the Court, under an exemption for actions that are brought under the law of the state that had organized or chartered the entity issuing the securities. The Court of Appeals then found that the state in question, Massachusetts, did in fact permit such direct fiduciary duty claims.

However, the panel declined to rule on the issue of whether SLUSA preempted any of the claims. Those questions had not been directly addressed by the District Court because it had dismissed all of the Plaintiff's claims on the merits. Since the Court of Appeals was reversing the dismissal, it sent the matter back to the District Court to determine whether they would survive under SLUSA.[173]

Schwab, not unexpectedly, petitioned the Supreme Court for a writ of certiorari. It argued that the common law contract

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172. 15 U.S.C. § 78bb(f)(1).

173. *Northstar*, 779 F.3d at 1050.

and other state law causes of action upheld by the Court violated the carefully crafted federal disclosure regime set up by the Investment Company Act and the 1933 and 1934 Securities Acts. That comprehensive scheme, said Schwab, was not designed to create a contractual relationship between a fund and its shareholders, but rather only to apprise those investors of the details of their fund's operations.[174]

The Mutual Fund Directors Forum weighed in with its own amicus brief, which also urged the Supreme Court to take the case and reverse the *Northstar* decision.[175] The Mutual Fund Directors Forum is an organization made up of the self-styled independent members of investment company boards—such individuals would obviously have the most to lose if the standards for fair treatment of mutual fund investors were heightened. In its amicus brief, the Forum therefore made arguments, similar to Schwab's, that claims under state law were precluded by comprehensive federal regulation.

More significantly though, the Forum seemed upset that the Court of Appeals, in approving the common law causes of action, had impugned the status of its members as independent watchdogs for shareholders. What the Forum appeared to find most distressing was the Court's statement that "the definition of 'independent' is fairly loose when it comes to fund board members"[176] and directors could therefore be "puppets"[177] of the adviser. Those remarks by the Court of Appeals, argued the Forum, were in derogation of the self-regulatory scheme that Congress had approved for mutual funds.

Notwithstanding those arguments, the Supreme Court declined to review the Court of Appeal's opinion.[178] When the case came back down to the trial judge, however, she used the SLUSA pre-emption question in two separate rulings to dismiss all the plaintiffs' claims. In the first opinion,[179] the Dis-

174. Petition for Writ of Certiorari, *Northstar*, 779 F.3d 1036 (No. 15-134).

175. *See* Brief of Mutual Fund Directors Forum as Amici Curiae Supporting Petitioners, *Northstar*, 779 F.3d 1036 (No. 15-134).

176. *Northstar*, 779 F.3d at 1061 (quoting John Shipman, *So Who Owns Your Mutual Fund?*, WALL ST. J., May 5, 2003, at R1).

177. *Id.*

178. Northstar Fin. Advisors, Inc. v. Schwab Invs., 779 F.3d 1036 (9th Cir.), *cert. denied*, 136 S. Ct. 240 (2015) (mem).

179. Northstar Fin. Advisors v. Schwab Invs., 135 F. Supp. 3d 1059 (N.D. Cal. 2015).

trict Judge initially held that the Trust itself had no fiduciary duties to its shareholders. She then went on to find that the third-party beneficiary claim for deviation from the fund's objectives was not a "garden variety contract claim."[180] Rather, it involved misrepresentations of the sort that SLUSA precludes from being litigated under state causes of action.

Following that logic, the District Judge then went on to rule out the breach of contract claims themselves because they arose "from the same core allegations."[181] The fund's adviser had "stated [it] would do one thing, but ended up doing another."[182] Those claims, said the Court, constituted "a misrepresentation or omission of material fact."[183]

In the second opinion,[184] the Court used the same SLUSA logic to give the coup de grâce to the plaintiffs' breach of fiduciary duty claim. It distinguished a case, *Freeman Investments., L.P. v. Pacific Life Insurance Co.,*[185] where SLUSA pre-emption did not apply because it "involved a dispute over the meaning of a specific contractual term."[186] *Northstar,* the Court said, was different because it alleged that the adviser promised to manage the fund a certain way but neglected to do so—thus making a misrepresentation. The Court repeated this point a number of times throughout the opinion on the apparent theory that by saying it over and over again it somehow became true.

The case is once again on appeal, and the Court of Appeals will have the opportunity to correct the lower court's understanding that a breach of contract necessarily gives rise to a tort claim. In doing that it should find instructive a Supreme Court case entitled *The Wharf (Holdings) Limited v. United International Holdings, Inc.*[187] There the Supreme Court found that a party to a contract had committed securities fraud, actionable under Rule 10b-5, when it made a promise it never in-

180. *Id.* at 1083–84.
181. *Id.* at 1088.
182. *Id.*
183. *Id.* at 1089.
184. Northstar Fin. Advisors Inc. v. Schwab Invs., No. 08-CV-04119-LHK, 2016 WL 706018 (N.D. Cal. Feb 23, 2016).
185. Freeman Invs., L.P. v. Pac. Life Ins. Co., 704 F.3d. 1110 (9th Cir. 2013).
186. *Northstar*, 2016 WL 706018, at *9.
187. Wharf (Holdings) Ltd. v. United Int'l Holdings, Inc., 532 U.S. 588 (2001).

tended to keep. The court held that promissory fraud exists when a promisor makes a commitment knowing that she is never going to do what she has promised.

"Garden variety" breach of contract claims (to use the District's Court's own phraseology)[188] are different. There a promisor makes a commitment but then breaks it by acting contrary to what she promised to do. Such was the case in *Northstar*. There was no showing that Schwab intended from the start to deviate from the stated objectives of its fund. The *Northstar* case therefore does not involve deception that would cause its claims to be pre-empted under SLUSA. Rather, it alleges a simple breach of contract. Unless the Appellate Court reinstates the case, however, there will be no recourse for fund shareholders who suffer damages to their expectation interests when their adviser lays out a set of objectives and then fails to follow them.

IV. MUTUAL FUND FEES AND THE DIRECTORS WHO AUTHORIZE THEM

A. *Adviser Compensation*

The most astounding thing about mutual funds is their fees and costs, which amount, in the aggregate, to $100 billion annually.[189] What makes these fees and costs so troubling is that they are paid by investors. One writer described that situation with the following apt, if somewhat mixed, metaphor: "The economics of a mutual fund are not terribly different from a leaky bathtub . . . [because of] the way in which advisers and their sibling entities arrange their compensation . . . it is always bleeding money in the form of fees."[190] As Senator Peter G. Fitzgerald put it during his Senate hearings: "The mutual fund industry is the world's largest skimming operation."[191]

John C. Bogle, the renowned founder of the Vanguard family, substantiated this insight in an essay appropriately

188. *See supra* text accompanying note 179.
189. BIRDTHISTLE, *supra* note 20, at 50.
190. *Id.*
191. Fitzgerald, *supra* note 2.

called *The Relentless Rules of Humble Arithmetic*,[192] and made many of the same points in his testimony before the Fitzgerald committee. Bogle indicted the profession he helped create for moving from "stewardship to salesmanship"[193] and abandoning its traditional role as "trustees of other peoples' money."[194]

He also laid out this computational basis for his charge: "The overarching reality is simple. Gross returns in the financial market minus the costs of financial intermediation equal the net returns actually delivered to investors."[195] If a fund therefore makes a 5% annual return on its holdings but charges its shareholders 2% "for advisory fees, marketing expenditures, sales loads, brokerage commissions, legal and transaction costs, custody fees and security-processing expenses,"[196] the investor nets just 3%. Over a long period of time these "compounding costs"[197] drain a substantial amount from a worker's retirement savings. For instance, over their lifetimes a typical dual-income couple will pay more than $150,000 in fees on their 401(k) plans.[198]

Even more problematic, these high fees are often hidden away from ordinary investors.[199] To elaborate on Mr. Bogle's point, let us consider some aspects of the cost structure of a typical fund. Right up front, the adviser fee is calculated by applying a percentage rate to the total assets under management, between 1 to 200 or more basis points per year.[200] The adviser's basic compensation is thus a cut of the assets it manages. A few initial observations can be made about this arrangement.

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192. John C. Bogle, *The Relentless Rules of Humble Arithmetic,* FIN. ANALYSTS J., Nov.–Dec. 2005, at 22.
193. *Id.* at 24.
194. *Id.*
195. *Id.* at 22.
196. *Id.* at 23.
197. *Id.* at 25.
198. *See* Bogle, *supra* note 192 and accompanying text.
199. Jeff Sommer, *The High Fees You Don't See Can Hurt You,* N.Y. TIMES, Apr. 23, 2016.
200. Johnsen, *supra* note 153, at 567. A basis point is "One hundredth of one percent; this unit is often used in finance when prices involve fine margins." *Basis Point,* OXFORD DICTIONARY OF BUSINESS AND MANAGEMENT (6th ed. 2016). Thus 150 basis points would amount to 1.5% of the total assets of a fund.

First, while the calculation of the adviser fee sounds simple, there are several ways fund advisers can manipulate the calculation to enrich themselves at the expense of their shareholders. Two of the most prominent methods are an over-valuation of the fund's assets, done most easily for holdings that are not publicly traded,[201] and failure to promptly liquidate a shareholder's holdings upon her request. The latter not only deprives the investor of the prompt return of her capital but also keeps more assets in the fund, allowing the adviser to increase its compensation by applying its fee charges against a larger asset base for a longer period of time than is justified.[202]

Second, like many business and professional services, the adviser's compensation could be based on a flat fee and therefore not dependent on the assets under management.[203] This would provide a more stable situation for shareholders. As the system is currently set up, however, investors only benefit when the fund they have invested in appreciates in value, that is, when total assets under its management increase, regardless of how the increase happens. The adviser who wishes to enhance its revenue, therefore, has a couple of ways of doing that.

If an adviser wants more compensation, rather than adjusting its percentage fee upward (which might be unpopular if done publicly), it can simply increase the amount of assets it manages.[204] That will happen as a matter of course if the assets in the fund appreciate in value. However, this may be the result of a general rise in the market, and have nothing to do with the adviser's management skill.

Yet fund growth can also occur when more money is put into the fund. One could argue that the corresponding extra investments will require more work by the adviser and thus legitimize its greater compensation. Those extra costs, however, could largely be offset by economies of scale. Such savings,

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201. BIRDTHISTLE, *supra* note 20, at 101–06. See also remarks by SEC chair Mary Jo White discussing ICA Rule 38a-1 which covers the duties of boards to assure that fund assets are fairly valued. Mary Jo White, Chair, Sec. Exch. Comm'n, The Fund Director in 2016: Keynote Address at the Mutual Fund Directors Forum 2016 Policy Conference (Mar. 29, 2016).

202. BIRDTHISLE, *supra* note 20, at 99.

203. *Id.* at 54.

204. See *Id.*

however, are rarely passed back to the shareholders.[205] Another technique used by funds to create unjustified fees involves the hiring of sub-advisors who provide the real management services, with the adviser doing very little to justify its compensation.[206]

Concerns also arise when investors try to come to better understand the fees they are paying. Where can an investor find out exactly what the fees are in the aggregate? Digging out the total charges levied on investors is not an easy task.[207] The SEC requires that fees be disclosed, and they must therefore be stated somewhere in a firm's prospectus.[208] But how many pages of those voluminous documents are actually read by shareholders?

And even if investors *do* look at a prospectus, these documents typically cover a number of funds from a common sponsor —each one charging different fees. As one observer said about the "farcical" nature of those disclosures, "[the prospectuses run] a hundred pages in length, bloated with regurgitated boilerplate. They are often squirreled away on obscure websites visited by only a handful of investors and understood by fewer."[209]

As John Bogle noted, however, the management fees paid to advisers are just the start of investor costs.[210] In fact, they may be preceded by a sales load—up-front and back-end

205. As Bogle commented on the changes he had seen in his 56 years in the mutual fund industry, "We've imposed soaring coasts on our investors that belie the enormous economies of scale in money management." *See* Bogle, *supra* note 192, at 24; *see also,* Sommer, *supra* note 199. For a case finding the possibility of excessive fees because savings from economies of scale were not passed back to investors, *see In re* Federated Mut. Funds Excessive Fee Litig., 2009 WL 5821045 (W.D. 2009).

206. For a case with such allegations see Curran v. Principal Mgmt. Corp., 2010 WL 2889752 (S.D. Iowa June 8, 2010). *But see* Kasilag v. Hartford Inv. Fin. Servs., LLC, 2012 U.S. Dist. LEXIS 178234, *23 (2012) (finding an inference that defendant's fees were "so disproportionately large that they bear no reasonable relationship to the services rendered and could not have been the product of arm's length bargaining.").

207. Bogle calls these "opaque fees," *supra,* note 192, at 2.

208. Sec. Exch. Comm'n, *Information Available to Investment Company Shareholders,* www.sec.gov/answers/mfinfo.htm.

209. BIRDTHISTLE, *supra* note 20, at 215.

210. Bogle, *supra* note 192, at 22.

charges by brokers who sell them the shares.[211] Then come the operating expenses.[212] Funds buy and sell securities in transactions that typically executed by brokerage firms. These brokerage firms charge fees too. Legal and accounting fees are also added into operational costs, as are the sizeable compensation and expense payments that fund directors get for attending meetings.

In addition, there are distribution fees—the so-called Rule 12b-1 expenses, described that way because the SEC permits them under the regulation of the same name.[213] These cover all the advertising and promotional costs that funds pay to get more investors to purchase their shares.[214] Like every other fee, they must ultimately come out of the money owned by investors.[215]

Growing a fund's assets, as has been said, directly benefits the adviser by increasing one of the multiplicands used to calculate its compensation.[216] It is questionable, however, whether existing shareholders profit by such an enlargement of their fund's holdings, particularly if the economies of scale that may result are not passed along to them by a reduction in

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211. *See* Johnsen, *supra* note 153, at 566 (discussing they would normally be about 5% of the purchase price of the shares). *See also* BIRDTHISTLE, *supra* note 20, at 58. The author points out these extra, up-front costs are not as prevalent as they used to be. "Loads are sufficiently galling that many investors have rebelled against them, and most fund families now offer no-load share classes."

212. These must all be disclosed to investors but many of these costs are found only in the Statement of Additional Information (SAI). Funds must give these reports to investors on request, but they are not required to provide them. 17 C.F.R. § 230.430(b)(2) (2014).

213. ICA Rule 12b-1, 17 C.F.R. § 270.12b-1 (2013).

214. See BIRDSTHISTLE, *supra* note 20, at 81–88 for a lengthy discussion of these and whether they are justified as being in the best interests of investors.

215. Johnsen, *supra* note 153, at 567. See Curran v. Principal Mgmt. Corp., 2010 WL 2889752 (S.D. Iowa June 8, 2010), for a case sustaining a claim for excessive fees for distribution services; *see also* Chill v. Calamos Advisors LLC, 175 F.Supp.3d 126, 150–52 (S.D.N.Y. 2016).

216. *See* Bogle, *supra* note 192, at 5. The author comments about the results of this practice, ". . .managers focus on salesmanship, their agendas dominated by a desire to bring in assets under management."

the percentage rate that the adviser uses to calculate its aggregate payments.[217]

Even beyond that, there are also several types of what can euphemistically be called "soft dollar" compensation arrangements that benefit fund advisers when they enter into transactions using their shareholders' money.[218] For instance, major brokerage firms reward managers who execute their fund's lucrative trades through them with premiums that are similar to the benefits that can be purchased with mileage accumulated in frequent flyer programs.[219]

Even more egregious, perhaps, are various payments that advisers make to brokerage firms to entice the brokerage firms to recommend the advisers' funds as investments to their clients.[220] One thinks of the payola scandals involving radio disc jockeys and other kickback and "play to pay" schemes.[221] Under the federal securities laws, those too are legitimate as sales expenses under Rule 12b-1 if disclosed. Yet how can brokers who receive those payments not be influenced to recommend funds that may not be in their clients' best interests?[222]

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217. *See* Sommer, *supra* note 199 ("As an analyst put it: 'The cost of individual funds has dropped, but the assets have gotten so much bigger that the companies' revenues from fees have grown tremendously. . .They could be sharing more of those revenues with consumers, but they're not.'").

218. BIRDTHISTLE, *supra* note 20, at 89–98. See Gallus v. American Express Fin., 370 F.2d 862 (D. Minn. 2005), for a case with such allegations.

219. BIRDTHISTLE, *supra* note 20, at 89.

220. For a good discussion of this "revenue sharing" and the SEC's attempts to make it more transparent, *see* James D. Cox & John W. Payne, *Mutual Fund Expense Disclosures: A Behavioral Perspective,* 83 WASH. U. L. REV. 907 (2005).

221. BIRDTHISTLE, *supra* note 20, at 86.

222. An important advance for investors here was a new Labor Department rule promulgated in June, 2016 under the Employee Retirement Income Security Act of 1974 (ERISA), 29 U.S.C.A. § 1002. It imposes a fiduciary duty on brokers and investment advisers in recommending securities to people saving for retirement. 29 C.F.R. § 2510.3–21. That is stricter than the previous standard that only required that brokers recommend "suitable" investments for that purpose. Jonnelle Marte, *Labor Department Rule Sets New Standards for Retirement Advice*, WASH. POST (Apr. 6, 2016) https://www.washington post.com/news/get-there/wp/2016/04/06/labor-department-rule-sets-new-standards-for-retirement-advice/?utm_term=.704505770857.

President Trump however at the behest of Gary Cohn, his appointee as director of the National Economic Council, has signed an executive order asking for a review of that rule. According to Cohn, a former executive of Goldman Sachs, the rule interferes with the ability of future retirees to invest

On top of all of these concerns looms another major question: how and why do costs vary from fund to fund? Advisers typically charge more for funds they actively manage than those they just passively hold, such as an index of certain stocks.[223] But is that differential a good thing for investors? Are extra payments to advisers who actively manage their shareholders' funds really justified by the service they provide?

Numerous academic studies say "no," supported by the efficient market hypothesis, which is also known as the "random walk" theory of stock valuation.[224] In short, the theory holds that it is impossible for any individual to regularly outperform the market. Active, well-informed traders are constantly buying and selling stocks which result in their prices instantaneously reaching an equilibrium point, reflecting their value.[225] Only a consistently lucky trader then (unless she has inside information) can outperform the market over time.

For decades, investors seemed to put their faith in famous stock-pickers who were said to beat the market.[226] That made it possible for those active managers to charge their customers

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their savings as they chose. Ron Lieber, *Fiduciary Rule is Now in Question. What's Next for Investors,* N.Y. TIMES (Feb. 3, 2017), https://www.nytimes.com/2017/02/03/your-money/estate-planning/fiduciary-rule-is-now-in-question-whats-next-for-investors.html?mcubz=1.

On a related issue, ERISA requires that fiduciaries of a pension plan act prudently in managing the plan's assets. 29 U.S.C.A. § 1104. There has been substantial litigation on this issue in recent years with the Supreme Court weighing in with two important cases. *See* Tibble v. Edison Int'l, 135 S. Ct. 1823, 1828–29 (2015) (holding that fiduciaries who select investment options for a 401(k) have a continuing duty under ERISA to monitor holdings and remove imprudent investments); Fifth Third Bancorp v. Dudenhoeffer, 134 S. Ct. 2459, 2464 (2014) (holding that a decision by a fidiciary of an employee stock option plan (ESOP) is not entitled to a "presumption of prudence." Instead, such fiduciaries are subject to "the same duty of prudence that applies to ERISA fiduciaries in general, except that they need not diversify the fund's assets.").

223. Sommer, *supra* note 19.

224. The classic explanation of this can be found in BURTON G. MALKIEL, A RANDOM WALK DOWN WALL STREET (1973).

225. In discussing the theory with approval, the U.S. Supreme Court stated its effects this way, "The market price of shares traded on well-developed markets reflects all publicly available information. . . ." Basic Inc. v. Levinson, 485 U.S. 224, 246 (1988); *accord* Halliburton Co. v. Erica P. John Fund, Inc., 134 S.Ct. 2398, 2401–02 (2014).

226. Sarah Krouse & Ben Dummett, *Janus to Be Acquired by U.K. Fund Giant Henderson Group*, WALL ST. J., Oct. 4, 2016, at A1.

higher fees.[227] Of late, however, investors appear to be getting savvier, and have begun to shift their resources out of those funds and into cheaper, passively managed ones—those that buy and hold stocks across a broad market index.[228] According to one report, "[a]lthough 66% of mutual-fund and exchange-traded-fund assets are still actively invested, . . . those numbers are down from 84% 10 years ago and are shrinking fast."[229]

B. *Directors and What They Are Paid*

Who then is responsible for allowing these arrangements that appear to be gouging the retirement savings of so many Americans? Advisers run the funds, but they are supposed to be overseen by their trustees/directors who, in the end, set policy.[230] Yet how effective can that supervision be? At a fund's origination, the adviser/founder is its only shareholder and thus has the prerogative to name the trustees and directors.[231] How free can such officials possibly be from the adviser's con-

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227. As one commentator put the question, "If corporate stock itself is efficiently priced, how can fund managers possibly hope to pick stocks that outperform the S&P 500 Market Index after charging brokerage commissions and other transactions costs, the advisory fee, and various administrative expenses to the fund?" Johnsen, *supra* note 108, at 569–70.

228. Anne Tergesen & Jason Zweig, *The Dying Business of Picking Stocks,* WALL ST. J. (Oct. 17, 2016), https://www.wsj.com/articles/the-dying-business-of-picking-stocks-1476714749. As the article continues: "Hedge-fund managers, the quintessential active investors, are facing mounting withdrawals as they struggle to justify their fees. Hedge funds, which . . . generally have higher fees than mutual funds, haven't outperformed the U.S. stock market as a group since 2008." *Id.*

The push-back against high fees is also continuing with arguments that they should be based on performance—the so-called "fulcrum fee," allowed by SEC regulations but disfavored by advisers because they require a lowering of fees when a fund underperforms. Jason Zweig, *It's Time for Investor Fees to Go Even Lower,* WALL ST. J., Jan. 6, 2017, at B1. Section 205(b)(2) of the IAA permits this arrangement. 15 U.S.C.A. § 80b-5(b) (2011).

229. Tergesen & Zweig, *supra* note 226.

230. 15 U.S.C. § 80a-51(a)–(c).

As Mary Jo White, chair of the SEC put it in an address to the Mutual Fund Directors Forum, "A fund's board oversees the operations of the fund and provides an independent check on fund management, particularly where the interests of the adviser and other service providers may conflict with the interest of the fund." White, *supra* note 201.

231. BIRDTHISTLE, *supra* note 20, 36–37.

trol when the statute only requires that 40% of them be independent from the adviser?[232]

From the beginning, 60% of a fund's directors may be in a dependent relationship with its adviser, and might even be the adviser's employees. Even beyond that, however, the legal definition of independence covers only financial arrangements, not other ties that the directors/trustees may have with the adviser, such as friendship.[233] Virtually all those supposed guardians of shareholders' funds therefore owe their lucrative positions to the adviser whose performance they review and whose compensation they set.[234]

The directors'/trustees' most important task, which the 1970 amendments requires be done as a fiduciary for the funds' shareholders, is to annually review the contract of its adviser to see if it should be renewed.[235] That obligation also involves setting the adviser's fee. The statutory process that the trustees must follow appears stringent, requiring them to meet in person and review a number of documents.[236] Funds' directors are supposed to do what one observer called their "single job—insuring that investors get fair returns at a fair price from their adviser."[237] And directors/trustees are rewarded hand-

232. Section 10(a) of the ICA, 15 U.S.C. § 10(a), prohibits more than 60% of a fund's directors from being "interested persons" of the fund. Section 2(19) of the ICA defines that term. 15 U.S.C. § 2(a)(19).

233. Lyman Johnson, *A Fresh Look at Director "Independence": Mutual Fund Fee Litigation and Gartenberg at Twenty-Five*, 61 VAND. L. REV. 497, 501 (2008). There the author faults the ICA's "narrow definition of 'independence.'" In that connection he argues that courts should follow the trend in general corporate law which calls for demanding greater fiduciary duties from directors. *Id.* at 502 (citing Donald C. Langevoort, *Private Litigation to Enforce Fiduciary Duties in Mutual Funds: Derivative Suits, Disinterested Directors and the Ideology of Investor Sovereignty,* 83 WASH. U. L. REV. 1017 (2005)).

234. As one commentator put it, "While many directors are classified as "independent" they don't have a lot of incentive to active independently if their sole source of income is directors' fees." Chuck Jaffe, *What Investors Don't Know About Mutual Fund Directors*, MARKET WATCH: SMART MONEY (May 7, 2012), http://www.marketwatch.com/story/what-investors-dont-know-about-mutual-fund-directors-1336421572207.

235. 15 U.S.C. § 80a-51(a)–(c).

236. 15 U.S.C. § 80a-15(c).

237. James Sterngold, *On Board, at a Mutual Fund,* WALL ST. J. (Sept. 3, 2014).

For a more detailed description of that duty which includes monitoring the performance of the adviser and analyzing whether its fee is warranted, *see* Knickle, *supra* note 106, at 318–28.

somely for discharging that duty, with payments well into six figures. For instance, some on the board of Pacific Investment Management Co. (Pimco) pull in upwards of $300,000 annually[238] and the outside directors of some of Fidelity's funds make more than $400,000.[239] These fees, like every other charge to the fund, ultimately come out of the investors' pockets.

To earn these amounts, fund directors typically attend meetings (some quarterly, others more frequently). They also serve on committees, and some oversee a group of funds in a particular family.[240] Yet directors/trustees almost never fire underperforming advisers and replace them with new ones.[241] Yale Professor John Morely, who has written extensively in this area, summed that up with this comment: "Corporate boards fire CEOs all the time, or they change the company's direction, but with mutual funds it almost never happens."[242]

As another commentator put it, "Directors would show that they get it by pruning and harvesting funds that deserve to be closed when no one but the fund firm is benefitting or the strategy hasn't proven viable."[243] Yet, to the contrary, these theoretical watchdogs for investors nearly always approve a renewed contract for the advisers who just so happen to have appointed them to their highly lucrative positions.

Conclusion: Shareholder Litigation as the Effective Remedy

Since the great reforms of the 1930s (and perhaps before), there have been substantial concerns that mutual funds have not been treating their shareholders fairly, and that their operators and affiliates have been using them as a means of personal enrichment. Congress addressed these concerns directly in its 1970 amendments to the ICA—focusing on the obvious flash point in such charges—the fees that advisers

238. Sterngold, *supra* note 237.
239. Birdthistle, *supra* note 20, at 37.
240. Jaffe, *supra* note 234.
241. For cases upholding Section 36(a) charges that trustees renewed advisers' contracts despite records of poor performance, *see Curran v. Principal Mgmt. Corp.*, No. 4:09-cv-00433, 2010 WL 2889752 (S.D. Iowa June 8, 2010); *Chill v. Calamos Advisors LLC*, 175 F. Supp. 3d 126, 142–43 (S.D.N.Y. 2017).
242. Sterngold, *supra* note 237.
243. Jaffe, *supra* note 234, at 3.

receive. It therefore placed fiduciary duties directly on advisers with regard to fees, and imposed similar obligations on fund directors in their approval of adviser contracts that legitimize such compensation arrangements. To assure that those safeguards would be enforced, the amendments also gave both the SEC and private investors express causes of action against advisers and fund directors for excessive fees.

While Commission officials from time to time have talked about bringing cases for excessive fees,[244] their enforcement actions of late have only been for less serious charges involving deficiencies in the process that directors must employ when they renew adviser contracts.[245] Such cases typically involve issues of whether directors were supplied the information they needed to evaluate the performances of their advisers. While of some significance, such actions pose no direct challenge to excessive fees themselves.

In addition to being more aggressive in attacking those abuses, the Commission could use its rule-making ability to compel more conspicuous and meaningful disclosure about the total compensation paid by mutual fund shareholders and the negative impact those expenses have on the returns from their investments. Truth-in-Lending statutes present an obvious practice for the Commission to emulate. Under those, full information about the cost of loans, including their annual percentage rates, must be presented in a highly visible box that all borrowers can understand.[246]

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244. The SEC has created the "Fund Fee Initiative" in its Asset Management Unit. Its co-chief stated recently that its purpose is ". . . to develop analytics. . . for inquiries into the extent to which mutual fund advisers charge retail investors excessive fees." Julie M. Riewe, Co-Chief, Asset Management Unit, Division of Enforcement, U.S. Sec. and Exch. Comm'n, Conflicts, Conflicts Everywhere—Remarks to the IA Watch 17th Annual IA Compliance Conference: The Full 360 View (Feb. 26, 2015), https://www.sec.gov/news/speech/conflicts-everywhere-full-360view.html.

245. Mary P. Hansen & Daniel E. Brewer, *SEC Charges Mutual Fund Board Members and Investment Adviser with Violations of Section 15(c) for Deficient Advisory Contract Approval Process,* NAT'L L. REV., July 8, 2016, http://www.natlawreview.com/article/sec-charges-mutual-fund-board-members-and-investment-adviser-violations-section-15c-.

246. *See, e.g.*, 15 U.S.C. § 1604 (laying out the disclosure requirements for mortgage loans). As to the requirement that finance charges be "clear[ ] and conspicuous[ ]," *see* 12 C.F.R. § 1026.17 (2015). With the election of Donald Trump as president, however, there may be a major overhaul of the federal regulations covering consumer transactions which could deregulate

With the failure of the Commission's enforcement here, however, shareholders themselves must use the cause of action provided by the statute. The narrow ruling in *Janus* unfortunately restricts such shareholder suits under Rule 10b-5, but *Harris v. Jones* and the claims recognized in *Northstar* (which should be reinstated on appeal) will be helpful. *Harris* in particular showed a welcoming attitude toward such breach of fiduciary duty actions.[247]

In addition, as this Article has demonstrated, there is increasing public awareness of the unfairness of excessive fees charged by mutual funds.[248] Aided by skillful and aggressive counsel, shareholders should go after both the advisers who breach their fiduciary duties and the directors who condone their activity. Through such litigation, the mutual fund industry can then be made accountable and brought back to serve the real needs of the investing public.

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much of this. *See* Ryan Tracy, *The Trump Train Takeover*, WALL ST. J. (Nov. 11, 2016).

247. Some may characterize this case as pertaining just to situations where funds charge institutional and retail clients substantially different fees. The opinion however should be read more broadly as a general endorsement of Section 36(b) suits, particularly in light of Judge Posner's dissenting opinion in the lower court proceeding. *See supra* notes 155–58 and accompanying text.

Harris reflects a refreshing change from earlier interpretations of the *Gartenberg* standard which were not helpful to such actions. *See supra* notes 150–59 and accompanying text. *See also* Cox, *supra* note 218, at 924 which characterized the plaintiff's burden of persuasion in the *Gartenberg* tests as "enormous."

For a recent "*post-Jones*" case signaling a more open attitude by Courts to these claims, *see Chill*, 175 F. Supp. 3d at 149.

248. As Professors Curtis and Morley put it, " . . . we acknowledge that excessive fee litigation retains substantial political support . . . ." Curtis & Morley, *supra* note 5, at 4.

The authors also urge a reformulation of the *Gartenberg* liability standard more along the lines of reasonableness. They would replace *Gartenberg's* six factors with three: "1) how a fund's fees compare to those of its peers; 2) whether the fund is a persistent underperformer; and 3) whether the fund provides ancillary services to justify high fees." *Id.* at 41.