# MUTUAL FUND ADVISORY FEES: NEW EVIDENCE AND A FAIR FIDUCIARY DUTY TEST

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*Introduction*

Anyone looking for a truly good investment should not consider a mutual fund; instead, the choice should be stock in a mutual fund sponsor. Nobel Laureate Paul Samuelson realized this more than forty years ago: "I decided that there was only one place to make money in the mutual fund business—as there is only one place for a temperate man to be in a saloon, behind the bar and not in front of the bar. And I invested in . . . [a] management company."[1]

The mutual fund industry is a financial force in this country, managing assets for more than 90 million Americans, roughly half the nation's households.[2] This massive market penetration has resulted in enormous profits for the mutual fund industry's service providers—the fund sponsors. Profits the fund sponsors have banked while attracting surprisingly little attention, at least until recently.

In the mutual fund industry, fund sponsors are often called mutual fund "advisers" or mutual fund "managers." They are in the business of creating mutual funds to which they sell portfolio management services as well as

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1. *Mutual Fund Legislation of 1967: Hearing on S. 1659 Before the S. Comm. on Banking and Currency*, 90th Cong. 353 (1967) (testimony of Paul Samuelson). The investment paid off. *Id.*; *see also* Ruth Simon, *How Funds Get Rich at Your Expense*, MONEY, Feb. 1995, at 130, 131 ("It is far more lucrative to own a mutual fund company than to invest in the company's products.").

2. INV. CO. INST., 2006 INVESTMENT COMPANY FACT BOOK (46th ed. 2006), *available at* http://www.ici.org/pdf/2006_factbook.pdf. According to one industry insider, most of the money saved by Americans from 1999-2001 was used to purchase mutual fund shares. *See* John C. Bogle, Founder and Former CEO, The Vanguard Group, The End of Mutual Fund Dominance, Keynote Address Before the Financial Planning Association (Apr. 25, 2002), *transcript available at* http://www.vanguard.com/bogle_site/sp20020425.html (noting that $320 billion was used to purchase fund shares out of $385 billion in savings).

administrative and "distribution" or marketing services.[3] The adviser establishes the mutual fund and thereafter controls a number of seats on the fund's board. Though legal requirements mandate that mutual fund boards are also populated by independent directors, it is the adviser who dominates the board and controls the fund's activities. The Second Circuit, in the seminal mutual fund fee case, described the board's relationship with its fund as virtually "unseverable."[4] Because of this "unseverable" relationship, the fund is usually limited to buying advisory services from a single provider. Fees, which compensate advisers for portfolio management, are negotiated annually between the adviser and its captive fund's board.[5] But, because the adviser dominates the board, the fee negotiation cannot truly be arm's-length. Consequently, despite functioning in a tightly regulated environment,[6] advisers (and their affiliated companies) are able to extract outsized rewards, even when producing sub-par results, while facing virtually no risk of getting fired for poor performance.[7] In short, the set-up is perfectly crafted to allow mutual fund advisers and their affiliates to overpay themselves at fund shareholders' expense.

This article focuses on money paid by mutual funds for portfolio management—selecting and managing pooled investments. This portfolio management function is the single most important service performed for actively managed mutual funds. Shareholders purchase portfolio management when they invest in professionally managed mutual funds, and it is the most crucial service fund sponsors deliver. While fund advisers or their affiliates typically derive revenue from distributing the fund's shares or performing other administrative services (such as serving as the fund's transfer agent),

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3. A report on mutual fund distribution behavior and legal issues arising therefrom is presented in John P. Freeman, *The Mutual Fund Distribution Expense Mess*, 32 J. CORP. L. 739 (2007).

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

5. It is harsh, but accurate, to refer to mutual funds as "captives" of the advisers who set them up. The United States Supreme Court recognized this reality in *Burks v. Lasker*, 441 U.S. 471 (1979), observing that a fund "cannot, as a practical matter sever its relationship with the adviser." *Id.* at 481 (quoting S. REP. NO. 91-184, at 5 (1969), *as reprinted in* 1970 U.S.C.C.A.N. 4897, 4901).

6. In the words of former SEC Chairman Ray Garrett, Jr.: "No issuer of securities is subject to more detailed regulation than mutual fund." Letter from Ray Garrett, Jr., Chairman, Sec. Exch. Comm'n, to Sen. John Sparkman, at v (Nov. 4, 1974), *quoted in* John P. Freeman, *Marketing Mutual Funds and Individual Life Insurance*, 28 S.C. L. REV. 1, 77 (1976).

7. In an exception to this rule, in 2002, Japan Fund's directors and shareholders agreed to hire Fidelity Management & Research to manage the fund's portfolio, shunning a Deutsche Bank affiliate. *See* Ian McDonald, *Seven Questions*, WALL ST. J. ONLINE, Dec. 23, 2002 (on file with the authors).

advisory income from portfolio management is the fund adviser's profit center.[8]

Building on previous studies finding advisory fees wildly out of line with the fees received for similar investment advisory services in the free market, this article examines the legal environment that has enabled fund sponsors to charge above-market fees and earn abnormally high profits for their efforts. We begin by discussing the unique management structure of mutual funds at the heart of the excessive fee phenomenon. We then consider new data confirming the findings of past studies, which show that fund sponsors' compensation pay is excessive.[9] Our new data compares the advisory fees charged to Vanguard, which engages in true arm's-length bargaining with its outside fund advisers, with the advisory fees charged to other mutual funds. Because of the conflicts of interests described above, other mutual funds do not engage in arm's-length bargaining with fund advisers. This comparison demonstrates that advisory fees are set at rates that enable fund sponsors to earn "economic profits"—profits typically garnered by companies facing little or no competition in the marketplace.[10] We next analyze evidence by fund industry supporters, principally Professors John Coates and Glenn Hubbard, who contend fees charged for mutual fund advisory services are fair and reasonable.[11]

Reasons why mutual fund fees have soared are then evaluated, focusing on aspects of the regulatory and legal setting that have given us noncompetitive pricing for mutual fund advisory services. We analyze section 36(b) of the Investment Company Act,[12] the key weapon in shareholders' arsenal to attack

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8. This has long been so, even for mutual funds that charge sales loads to incoming investors. *See* Sec. Exch. Comm'n Historical Soc'y, Roundtable on Investment Company Regulation 94 (Dec. 4, 2002) (remarks of Joel Goldberg, former Director of Investment Management, Securities and Exchange Commission), *available at* http://www.sechistorical.org/collection/oralHistories/roundtables/investmentCoRegulation/INV1204Transcript.pdf.

9. *See* WHARTON SCH. OF FIN. & COMMERCE, A STUDY OF MUTUAL FUNDS, H.R. REP. NO. 87-2274 (1962) [hereinafter WHARTON REPORT]; *see also* SEC. EXCH. COMM'N, PUBLIC POLICY IMPLICATIONS OF INVESTMENT COMPANY GROWTH, H.R. REP. NO. 89-2337 (1966) [hereinafter PPI STUDY], *available at* http://sechistorical.org/collection/papers/1960/1966_InvestCoGrowth/; John P. Freeman & Stewart L. Brown, *Mutual Fund Advisory Fees: The Cost of Conflicts of Interest*, 26 J. CORP. L. 609 (2001). The Freeman & Brown article will be referred to textually as "Freeman-Brown."

10. The concept of "economic profits" is discussed *infra* note 26 and accompanying text.

11. *See* John C. Coates IV & R. Glenn Hubbard, *Competition in the Mutual Fund Industry: Evidence and Implications for Policy*, 33 J. CORP. L. 151 (2007). This article will be referred to textually as "Coates-Hubbard." Background concerning different versions of Coates-Hubbard is set forth *infra* note 79.

12. Investment Company Act of 1940 § 36(b), 15 U.S.C. § 80a-35(b) (2000).

fee gouging.[13] Though Congress enacted 36(b) because it recognized the potential for abuse and wanted to empower shareholders to police excessive fees, section 36(b) is impotent in practice. Because of the impractical proof standard for succeeding in a 36(b) lawsuit, no plaintiff has ever won a fee case brought under section 36(b). In large part, this is because the key case interpreting the provision, the Second Circuit's opinion in *Gartenberg v. Merrill Lynch Asset Management, Inc.*,[14] created an unworkable, unfair, scavenger hunt-style liability test. *Gartenberg* demands fund shareholders prove their case with evidence that is usually hidden and, once found, subject to bitter disputes between the parties' experts. Even worse, *Gartenberg* permits a mutual fund adviser to defend its excessive fees by using as benchmarks other excessive fees set by similarly conflict-ridden boards. To top it off, courts have read *Gartenberg* to *bar* use at trial of the best evidence of fair pricing for investment portfolio advisory services—prices charged by investment advisers managing investment portfolios in the free market.[15]

The current system for evaluating mutual fund advisory fees is a failure. *Gartenberg* and its progeny fail to account sufficiently for the structurally anti-competitive nature of the fund industry and have allowed fund fees to float ever higher, free from the competitive market's gravitational pull. This article calls for a re-orientation in the way fund advisory fees are evaluated. We demonstrate there is a free market in which investment advisory services are priced and sold, and we show that this free market pricing can, and should, guide pricing in the fund market. While we concede the data is sometimes less than pristine, the arm's-length pricing data drawn from free market transactions offers a necessary reality check usable by both courts, in judging

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13. *See infra* Part IV.A.

14. 694 F.2d 923 (2d Cir. 1982).

15. *See, e.g.*, Gallus v. Ameriprise Fin., Inc., 497 F. Supp. 2d 974, 982 (D. Minn. 2007) ("Since *Gartenberg*, courts have held that other mutual funds provide the relevant comparison for measuring fees—not non-mutual fund institutional clients."); Order Granting Defendants' Motion in Limine, Baker v. Am. Century Inv. Mgmt., Inc., No. 04-4039-CV-C-ODS (W.D. Mo. July 17, 2006) (barring introduction of evidence related to non-mutual fund accounts); Kalish v. Franklin Advisers, Inc., 742 F. Supp. 1222, 1237 (S.D.N.Y. 1990) ("[T]o the extent that comparisons are probative at all, a mutual fund adviser-manager must be compared with members of an appropriate universe: adviser-managers of similar funds."), *aff'd*, 928 F.2d 590 (2d Cir. 1991). In *Kalish*, the district court went so far as to suggest that even a fee pricing comparison to a similar Vanguard mutual fund managed by an outside adviser was "seriously flawed" because Vanguard furnished various administrative services to its funds on an at-cost basis. *Id.* at 1231, 1250. Assuming the comparison focused purely on fees for advisory services rendered by the Franklin fund and the similar Vanguard fund, the comparison would not be "seriously flawed." The comparison would be highly appropriate.

whether fees are too high, and by mutual fund boards when negotiating fee levels with their funds' advisers.

We conclude by setting forth a new analytical framework for evaluating mutual fund fees. Under our approach, evidence a fund adviser or one of its affiliates treats an outsider more favorably than the very party to whom the adviser owes statutorily-provided fiduciary duties needs to be recognized for what it is: prima facie evidence of a breach of fiduciary duty. Courts should replace the outdated, impractical, and cumbersome *Gartenberg* factors with a new framework, as provided by the Supreme Court in an analogous circumstance in *McDonnell Douglas Corp. v. Green*.[16] By the same token, fund boards should heed a call we made in back in 2001.[17] Fund boards should impose the "most favored nation" concept, demanding that mutual funds pay a price for portfolio management that is no higher than that charged by the fund's adviser or its affiliates when managing the investment portfolios of third-party customers (such as pension funds, endowment funds, and the Vanguard funds) who bargain at arm's-length.

Use of free market comparative data by directors when negotiating with fund advisers over fees, and by courts in evaluating those fees, can pave the ways for investors to save billions of dollars annually. The analytical starting point for courts called on to determine whether advisory fees charged captive mutual funds by their advisers bear the earmarks of arms-length bargaining needs to be a comparison of the prices paid by the captive funds with actual prices negotiated in free market transactions by independent (i.e., non-captive) purchasers of similar investment advisory services.

## *I. Mutual Funds' Conflicted Management Structure*

Any discussion of mutual fund fees must begin with a discussion of mutual fund's unique management structure. Mutual funds do not function like normal businesses. In a normal business, the firm's management is free to hire and fire outside service providers. In the mutual fund industry, as a rule, the set-up is different. Instead of firm management being in charge, outside managers actually have de facto control of the fund and its board. This industry-standard arrangement is sometimes referred to "external management" in recognition of the fact that the nearly all mutual funds are captives of outside manager-service providers. The practical economic consequence of this conflicted relationship was explained by one industry pioneer who noted that one almost always finds mutual funds

16. 411 U.S. 792 (1973).

17. *See generally* Freeman & Brown, *supra* note 9 (discussing the structure of mutual fund fees in relation to pension fund fees).

> operated by external . . . management companies which seek to earn high returns for fund investors, to be sure, but seek at the same time to earn the highest possible returns for themselves. Some of these companies are publicly-held, in which case their shares are held by investors who own their shares for the same reason that investors own Microsoft or General Motors: To make money for themselves.[18]

The adviser's grip on the fund management starts when the fund is formed and tends to be strong and enduring.[19]

Recognizing the inherent conflict of interest between the fund's investment adviser and the fund when bargaining over compensation, Congress decreed, when it enacted the Investment Company Act of 1940, that fund boards needed the presence of independent directors to perform a "watchdog"[20] function.[21]

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18. John C. Bogle, Honing the Competitive Edge in Mutual Funds, Remarks Before the Smithsonian Forum 5 (Mar. 23, 1999) (transcript on file with the authors).

19. Referring to testimony offered by fund industry executives, one former SEC Commissioner emphasized the adviser's dominant position vis-à-vis the controlled fund:

> They also made the point that the investment adviser creates the fund, and operates it in effect as a business. Many of them stated that "It is our fund, we run it, we manage it, we control it," and I don't think there is anything wrong [with] them saying it. They were just admitting what is a fact of life.
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> The investment adviser does control the fund.

*Investment Company Act Amendments of 1967: Hearings on H.R. 9510 and H.R. 9511 Before the Subcomm. on Commerce & Fin. of the H. Comm. on Interstate and Foreign Commerce*, 90th Cong. 674 (1967) (statement of Manuel F. Cohen, Comm'r, Securities Exchange Commission).

20. Burks v. Lasker, 441 U.S. 471, 484 (1979).

21. The number of independent directors varies. For any funds formed under the special provisions of section 10(d) of the Investment Company Act of 1940, 15 U.S.C. § 80a-10(d) (2000), only a single independent director is required. Normally, however, 40% of the board must be comprised of independent directors. *Id.* § 80a-10(a). Various SEC exemptive rules require as a condition of obtaining the exemption that funds have at least half of their board seats filled by independent directors. *See, e.g.*, 17 C.F.R. § 270.12b-1(b)(1) (2007). In 2004, the SEC proposed a rule requiring that funds that rely on certain exemptions, such as Rule 12b-1, have a supermajority (at least 75%) of independent directors and that an independent director chair the board. *See* Investment Company Governance, Investment Company Act Release No. 26,323, 69 Fed. Reg. 3472 (proposed Jan. 23, 2004) (to be codified at 17 C.F.R. pt. 270). The SEC subsequently adopted Rule 0-1(a)(7), 17 C.F.R. § 270.0-1(a)(7) (2007). *See* Investment Company Governance, Investment Company Act Release No. 26,520, 69 Fed. Reg. 46,378, 46,389 (Aug. 2, 2004). The original compliance date for the governance changes was January 16, 2006. *Id.* Before the Rule could take effect, however, the SEC's action was attacked in a suit filed by the Chamber of Commerce of the United States. The U.S. Court of Appeals for the D.C. Circuit subsequently ruled that, in promulgating the Rule, the SEC had failed to satisfy certain rulemaking requirements, remanding the matter to the SEC to address the deficiencies. Chamber of Commerce of the U.S. v. SEC, 412 F.3d 133, 144-45 (D.C. Cir. 2005). Following

In addition, the statutory scheme for mutual funds requires fund boards to approve a new portfolio management contract with the fund's adviser each year.[22] These protections, however, do little to cure the essential and underlying conflict affecting mutual fund governance. Because the adviser simultaneously functions as service seller while controlling the service-buying fund, the adviser straddles both sides of the transaction. As we show in the next part, that essential conflict and the resulting lack of arm's-length bargaining leads to excessive fees.

### *II. Mutual Fund Sponsors—Your Best Investment Choice*

Just how lucrative the mutual fund management industry business can be was recently shown by a study listing the best performing American stocks over the last twenty-five years. Two of the top three were mutual fund sponsors. Franklin Resources led the list with an overall return of 64,224%; Boston-based fund manager, Eaton Vance, was third, up 38,444%.[23] The two publicly-held mutual fund sponsors' market performance far outdistanced the overall return for the large-cap segment of the broad stock market as represented by the S&P 500 Index, which returned less than 2000% over the same period.[24] Both fund sponsors also handily beat the stock market performance turned in by software behemoth Microsoft, which placed eighth place in the stock performance rating with an investment return of 29,266%.[25]

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that defeat, the SEC promptly issued a release declaring that it had determined not to modify, or seek further public comment, on its heightened independence requirements. Investment Company Governance, Investment Company Act Release No. 26,985, 70 Fed. Reg. 39,390 (July 7, 2005). The Chamber of Commerce then filed a new petition for review with the D.C. Circuit. The court subsequently ruled that, in addressing the issues remanded to it, the SEC once again erred, this time by relying improperly on materials outside the rulemaking record. Chamber of Commerce of the U.S. v. SEC, 443 F.3d 890, 909 (D.C. Cir. 2006). Instead of striking down the SEC's rulemaking, however, the court has allowed the SEC to continue to study the issue. *Id.* This study presumably continues, as the SEC has not yet filed its definitive response.

22. *See* Investment Company Act of 1940 § 15(a), 15 U.S.C. § 80a-15(a). Under section 15(a) of the Investment Company Act of 1940, the fund's financial dealings with its investment adviser must be governed by a written advisory contract. Independent directors have special responsibilities regarding the advisory agreement. A majority of the independent directors must vote in person at a specially designated meeting to approve it and its renewals every year. The board can terminate the contract at any time, without penalty, on sixty-days notice. *Id.*

23. *If Only I Had Bought* . . . , USA TODAY, Apr. 16, 2007, at 8B, *available at* http://www.usatoday.com/money/top25-stocks.htm.

24. According to Morningstar's Principia database, the actual return for the S&P 500 index over the period was 1944%.

25. The top ten ranking stocks of the twenty-five covered by the *USA Today* study were:

Data drawn from publicly held mutual fund sponsors confirm that these management companies earn substantial "economic profits" (sometimes called "economic rents" or "rents") reflecting extraordinary profitability consistent with returns earned by firms in monopolistic, non-competitive industries.[26]

As Table 1 below makes clear,[27] the excellent market returns earned by Franklin Resources (a compound annual return of 32.9%) and Eaton Vance (a compound annual return of 27.9%) are consistent with the generally excellent stock market performance turned in by fund management companies as a whole over the twenty-five-year period ending in 2006.[28] Compound

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1. Franklin Resources, up 64,224%
2. Danaher, up 47,913%
3. Eaton Vance, up 38,444%
4. UnitedHealth, up 37,672%
5. Cisco Systems, up 33,632%
6. International Gaming Technology, up 33,436%
7. Biomet, up 30,531%
8. Microsoft, up 29,266%
9. Best Buy, up 28,703%
10. Oracle, up 28,535%

*If Only I Had Bought . . .* , *supra* note 23.

26. It is possible to calculate economic profits by looking at what is called "economic value added" (EVA), a term coined by a consulting firm, Stern Stewart & Co. For a discussion of the economic value added concept and its utility, see EVA Dimensions LLC, http://www.evadimensions.com/main.php (last visited Mar. 31, 2008). In order to calculate whether a firm is generating economic profits, one considers both its cost of capital as well as the returns generated by the business. A firm is generating economic profits when its revenue exceeds the total cost of inputs, including normal returns on capital. This difference is referred to as the economic value added. EVA thus captures not only the financial result reflected by the income statement, but also the opportunity cost of the capital invested to generate accounting profits. The authors' study of public financial data for four publicly held mutual fund sponsors—Eaton Vance, Federated Investors, Franklin Resources, and Waddell & Reed—shows each to have earned economic profits exceeding the firm's weighted average cost of capital from 2003-05. In percentage terms, for Eaton Vance, economic profits averaged 11.4% over and above the firm's weighted average cost of capital; for Federated Investors, the number was 18.9%; for Waddell & Reed, it was 7.6%; while for Franklin Resources it was a comparatively small 2%.

27. The beginning dates in Table 1 correspond to the availability of data from the Center for Research on Securities Prices database. The fund sponsors presented are the largest publicly traded firms with at least fifteen years of return data.

28. Computations made by Stewart Brown, one of this article's co-authors, demonstrate that the universe of publicly traded fund sponsors earned statistically significant risk adjusted excess returns over the twenty-five-year-period from 1982 to 2006. A capitalization weighted index of publicly traded fund sponsors had a compound average annual return of 27.8% versus 13.4% for the S&P 500 index over the same period. The ability of specific fund sponsors to earn returns in excess of those generated by other companies is demonstrated by the data in Table 1. As shown there, stock market returns generated by large publicly held fund sponsors tended to more than double those turned in by S&P 500 companies over the years in question.

average annual returns for the five largest publicly traded fund sponsors were more than double returns on the S&P 500 market index over corresponding periods. Moreover, the average level of market risk for these five firms was equal to the market as a whole (average beta coefficient equal to one) so the excess returns were not the result of a market risk premium.

TABLE 1
COMPOUND ANNUAL EQUITY RETURNS FOR LARGE FUND SPONSORS

| Fund Sponsor | Market Capitalization ($Billions) | Beg Dates | Ending Dates | Months | Sponsor Beta | Compound Annual Return Over Period | Compound Annual S&P 500 Return Over Period | Difference Compound Annual Return |
|---|---|---|---|---|---|---|---|---|
| Alliance Bernstein | $6.81 | May-88 | Dec-06 | 224 | 1.00 | 29.4% | 12.0% | 17.4% |
| Eaton Vance Corp | $4.18 | Jan-82 | Dec-06 | 300 | 1.08 | 27.9% | 13.4% | 14.5% |
| Franklin Resources | $27.93 | Oct-83 | Dec-06 | 279 | 0.13 | 32.9% | 12.5% | 20.4% |
| Legg Mason Inc | $15.34 | Sep-82 | Dec-06 | 280 | 1.34 | 19.1% | 12.5% | 6.6% |
| T Rowe Price | $11.54 | May-86 | Dec-06 | 248 | 1.55 | 21.0% | 11.7% | 9.3% |
| **Averages** | **$13.2** | | | | **1.02** | **26.1%** | **12.4%** | **13.6%** |

The fund business was not always so lucrative. In 1980, the total sum of expense money extracted annually by all sponsors from the entire mutual fund industry was around $1.5 billion.[29] In November 2006, the mutual fund industry's assets climbed past $10 trillion.[30] Given that the weighted average expense ratio (costs excluding brokerage commissions, sales loads and redemption charges) for all mutual funds is reportedly around 0.91%,[31] annual payments for fund managers and their affiliates and service providers totaled more than $90 billion.[32] This means that in less than three decades, annual payments to fund sponsors and service providers have increased by an astonishing factor of *sixty times*: from $1.5 billion to $90 billion per year. Far less clear is whether the skyrocketing fund expense pay-outs that fuel the

29. Freeman, *supra* note 3, at 773.

30. Daisy Maxey, *Mutual Funds Pass $10 Trillion Mark: Investors' Focus on Stocks Helped Lift October Assets to Level for the First Time*, WALL ST. J., Nov. 30, 2006, at C11.

31. Rebecca Knight, *Making a Success out of Simplicity—Mutual Funds: Hedge Funds and ETFs Have Their Admirers but Mutual Funds Keep Growing, Says Rebecca Knight*, FIN. TIMES, June 20, 2006, at 10.

32. For professionally managed equity mutual funds, the kind used by many fund shareholders to indirectly invest in the stock market, the weighted average expense ratio is 1.12%, significantly higher than the industry average. *See* JASON KARCESKI ET AL., PORTFOLIO TRANSACTIONS COSTS AT U.S. EQUITY MUTUAL FUNDS 16 tbl.2 (2004), http://www.zeroalphagroup.com/news/Execution_CostsPaper_Nov_15_2004.pdf.

growth in fund management companies' stock prices is driven by conduct that is lawful, much less competitive.

### *III. A Basic Premise: Fund Advisory Fees Are Too High*

An old adage warns, "If it ain't broke, don't fix it." Obviously, there would be no point in discussing what can be done about fund advisory payouts if they are not excessive in the first place. Naturally, fund sponsors do not concede that fees are excessive by any measure. Our starting point thus must be a review of the evidence demonstrating that price gouging over portfolio management fees is a way of life in the fund industry.

The principal product sold by the mutual fund industry is portfolio management services.[33] The funds agree to pay for those services based on yearly contracts negotiated by fund boards which, as a rule, are populated by at least some directors employed by the outside advisory firm.[34] These interested-director contracts are "related party transactions,"[35] carrying the ever-present risk of unfair dealing. Evaluating fee pricing in an industry where conflicts of interest are an ingrained business practice is challenging, since prices routinely contaminated by conflicts of interest are a poor substitute for prices established in a free and competitive marketplace.

A recent article in *The Economist* called attention to the fund industry's flagrantly non-competitive fee pricing structure:

> Imagine a business in which other people hand you their money to look after and pay you handsomely for doing so. Even better, your fees go up every year, even if you are hopeless at the job. It sounds perfect.
>
> That business exists. It is called fund management. . . .
>
> Under the normal rules of capitalism, any industry that can produce double-digit annual growth should soon be swamped by eager competitors until returns are driven down. But in fund management that does not seem to be happening. The average

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33. Some mutual funds are index funds which are constructed around unmanaged portfolios designed to replicate the holdings of various benchmarks such as the S&P 500 index. These index funds lack the professional management feature common to the rest of the fund industry. *See* Sec. Exch. Comm'n, Index Funds, http://www.sec.gov/answers/indexf.htm (last visited Mar. 31, 2008).

34. A key exception to this rule is the Vanguard Group of funds. *See infra* notes 40-42 and accompanying text.

35. Traditionally, due to the potential for over-reaching and self-dealing, these sorts of contracts have called for detailed disclosure under the securities laws. *See* 17 C.F.R. § 229.404 (2007) (describing disclosure requirements for "[t]ransactions with related persons" where the sum involved exceeds $120,000).

> profit margin of the fund managers that took part in a survey by Boston Consulting Group was a staggering 42%. In part, this is because most fund managers do not compete on price.[36]

Because fund sponsors as a rule chose not to (and do not have to) compete on price, trying to establish reasonableness by comparing one sponsor's prices to another's is a fool's game. Fair pricing connotes arm's-length bargains reached where neither side is under any compulsion to deal. In the conflicted fund industry, fair bargaining is impossible because captive funds are under compulsion to buy services from or through their controlling sponsor.

At present, when mutual fund fees are evaluated no effort is made to account for the fact that essentially all fees are negotiated by conflicted boards. Rather, mutual fund fees typically are set in fund boardrooms and judged in federal courtrooms based on prices charged by other mutual funds.[37] These comparisons are skewed.[38] The measurement system is akin to judging the

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36. *Money for Old Hope*, ECONOMIST, Mar. 1, 2008, at 3. For a further, carefully worded expression of concern over evidence of a lack of competition in setting fund fees, see Brian G. Cartwright, Gen. Counsel, Sec. Exch. Comm'n, Remarks Before the 2006 Securities Law Developments Conference Sponsored by the Investment Company Institute Educational Foundation (Dec. 4, 2006), *transcript available at* http://www.sec.gov/news/speech/2006/spch120406bgc.htm (recognizing "the possibility that many investors are paying more for the services provided by their mutual funds than they would if the price had been set in a satisfactorily competitive market").

37. *See infra* Part V.D and accompanying text; *see also infra* notes 170-71, 220, 223-29 and accompanying text.

38. Currently, the comparables commonly used in evaluating fund advisory fees are distorted for two reasons. First, conflicted boards compare fund fees to the prices negotiated by other conflicted boards, meaning that fees set by agreements where a party was under compulsion to deal are used. This is antithetical to the concept of arm's-length bargaining where, by definition, neither side is under any compulsion to deal. Second, the fee comparators themselves are tainted. In the authors' experience, fee comparator data tends to be supplied to fund boards by Lipper Analytical Services, which is the leading supplier of fund fee data. Lipper clients manage more than 95% of the United States' fund assets. *See* 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. 181 (2004) [hereinafter *Oversight Hearing on Mutual Funds*] (prepared statement of Jeffrey C. Keil, Vice-President, Lipper Inc.), *available at* http://www.access.gpo.gov/congress/senate/pdf/108hrg/92686.pdf

The authors believe Lipper-generated comparators are based on biased methodology. To understand the problem in Lipper's methods, one must first understand that in the fund industry there are a large number of small funds and a much smaller number of large funds. The bulk of mutual fund assets are concentrated in the largest funds where fees tend to be lower. The first problem arises because, when examining and reporting on comparative funds, Lipper looks at funds of all different sizes and compares the subject fund's fees to the median of the comparative funds. In a highly skewed distribution, with fees tending to decline as assets rise, reasonableness of a person's body fat ratio by reference only to samples drawn from new members in Overeaters Anonymous. Depending on what is held up as a comparison, that which might appear reasonable may not *actually* be reasonable at all.

In the fund industry's closed fee comparison system, at any point in time, a significant proportion of funds are charging below average fees. This means that the advisers receiving those below average fees appear under-compensated in relation to their peers. The supposedly underpaid advisers have grounds to argue they deserve a pay hike, which, if obtained, leads to some other fund sponsor falling below the norm. This pernicious leap-frog game, with payment decisions effectively based on and checked against no-bid, conflict-ridden contracts, has yielded a payment system that is out of control. Mutual fund advisory fees are subject to great dispersion.[39] Because of this, nearly any fund fee schedule can be presented as more moderate and fair than an array of others extant in the industry.

Fortunately, the fund marketplace provides an exception to the norm of conflicted decision-making in the form of the Vanguard Group of funds. Unlike the standard practice elsewhere in the fund industry, no Vanguard fund director is employed by any entity selling investment advice to Vanguard.[40] Thus, no Vanguard board or board member is under any compulsion to buy advisory services from any particular third-party portfolio manager. Each fund

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the median fee will be higher than the mean. By using the median rather than the mean, the fees of the largest funds appear relatively lower. In an attempt to correct for this problem, Lipper introduced the second data problem. The second problem arises because Lipper takes the comparative funds and calculates assumed fees for them based on their current fee schedules, but assuming they hold assets at the level of the subject fund. The problem here is that smaller funds typically have either a fixed fee schedule or a fee schedule that often stops far below the level of assets for the subject fund. Comparative fees at the higher asset levels are biased upward because smaller funds typically introduce breakpoints (i.e., tiered schedules with lower management fee percentages at higher asset levels) as assets grow. Extrapolating from an existing fee schedule for these small funds with truncated fee schedules can only overestimate what the fee will actually be at far higher asset levels. Thus, for large subject funds—those whose fees are most likely to be attacked as unfair—Lipper's evaluation system overstates what the subject fund's Lipper-picked peer group funds would be charging at the subject fund's asset level. By showing higher peer fee levels than actually exists in the marketplace, the methodology is skewed to make the subject funds' look low in comparison—thus benefitting the sponsor.

39. *See infra* Figure 4.

40. As Vanguard's founder, John C. Bogle, explained: "[A]t Vanguard, none of our external managers are represented . . . ." John C. Bogle, Address at the "Is There a Better Way to Regulate Mutual Funds?" Event Series of the American Enterprise Institute of Public Policy Research (May 9, 2006), *transcript available at* http://www.aei.org/events/filter.all,eventID.1317/transcript.asp.

therefore controls the advisory service provider, rather than vice versa. It is to the Vanguard pricing and business model that we now turn.

*A. Evidence Advisory Fees Are Too High: The Vanguard Experience*

Vanguard has been going to the free market since 1975 to hire outside advisers,[41] called "sub-advisers," to manage its professionally-advised mutual funds.[42] The Vanguard experience with buying portfolio management services in the free market thus offers a pristine control group—a long-running laboratory experiment useful in evaluating the effect of free market pricing for advisory services within the fund industry. Operating with no compulsion to buy portfolio management services from any particular investment adviser, Vanguard gives us a setting where advisory fee decision-making is uncontaminated by conflicts of interest.

As of 2004, twenty-one Vanguard equity and balanced funds were "actively managed," meaning they were not index funds.[43] Each of these twenty-one funds had their portfolios managed by sub-advisers hired in the free market by the funds' boards. These twenty-one actively managed Vanguard funds accounted for $155 billion in assets. The average total expense ratio (all expenses, including portfolio advisory costs, divided by average fund assets) for these Vanguard funds managed by sub-advisers was 40 basis points (or bps) on a market-weighted basis.[44] A basis point is one one-hundredth of a percent, meaning that Vanguard's expense ratio of .40%, or 40 bps, was less than one-half the industry average of 91 bps.[45] The Vanguard experience is illustrated by the fee schedules established by Vanguard and its sub-advisers

41. While Vanguard is "internally managed" in the sense that its managers operate purely in the interests of the funds and their shareholders, the assets in its particular funds are managed by third-party or "external" advisers, sometimes leading to confusing terminology. Here, we use the terms "outside advisers" or "outsiders" whenever possible when referring to the third-party advisers Vanguard hires to manage the assets of its funds.

42. In 1975, the Vanguard Group of funds emerged as a free-standing mutual fund complex outside any adviser's domination. What are known today as the Vanguard funds previously had been controlled by the Wellington Group of Investment Companies. *See* John C. Bogle, *Re-Mutualizing the Mutual Fund Industry—The Alpha and the Omega*, 45 B.C. L. REV. 391, 399-404 (2004) (discussing the key events in Vanguard funds' emergence as free-standing, independent entities previously dominated by their funding adviser, Wellington Management Company).

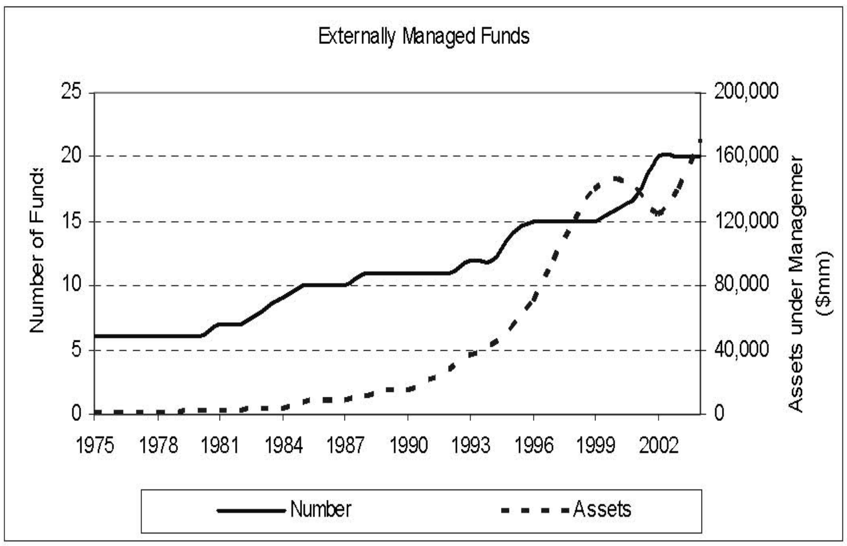
43. *See* Vanguard Investments, http://global.vanguard.com/international/hEurEN/research/portfolioEN.htm (last visited Mar. 31, 2008). The index funds do not require active management and are managed by Vanguard in-house.

44. Data for these funds has been provided to the authors by the Bogle Financial Markets Research Center, as well as annual reports for the individual funds. The data is on file with the authors.

45. *See supra* text accompanying note 31.

over the years.[46] Since 1975, there has been significant growth in the assets under management at the various Vanguard funds. Figure 1 below illustrates the number of funds and assets managed in millions from 1975 through 2004. A list of the funds in this program with their inception date is included in Appendix A.

FIGURE 1
ASSETS AND FUNDS MANAGED BY OUTSIDE ADVISERS FOR VANGUARD GROUP 1975-2004




According to a mutual fund sponsors' lobbying organization, the Investment Company Institute[47] ("ICI"): "The bedrock principle of the mutual fund industry is that the interests of investors always come first."[48] Within the

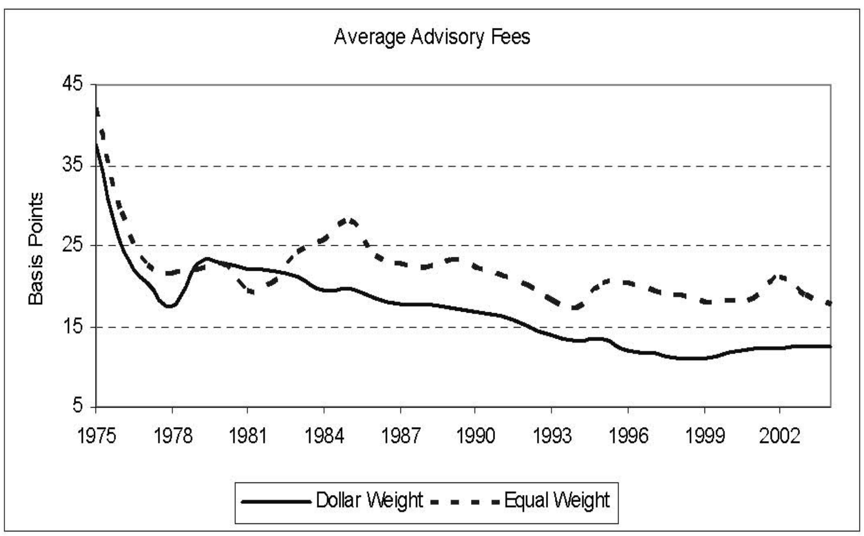
46. ROBERT SLATER, JOHN BOGLE AND THE VANGUARD EXPERIMENT (1997).

47. The ICI has done a splendid job of advancing the interests of fund sponsors, while drawing a major portion of its operating funds from mutual fund assets—and hence from mutual fund shareholders. *See* Kathleen Day, *So Sweet and Sour: Investor Fees Finance Interests of Lobbyists*, WASH. POST, Jan. 11, 2004, at F01; Paula Dwyer et al., *Breach of Trust: The Mutual-Fund Scandal Was a Disaster Waiting to Happen*, BUS. WK., Dec. 15, 2003, at 98, *available at* http://www.businessweek.com/magazine/content/03_50/b3862015.htm?chan=search. When the interests of fund shareholders diverge from fund sponsors' interests, the ICI regularly takes the side of the fund sponsors. *See* Paul B. Farrell, *A Mutual Fund Tale from Oz: Fund Lobbyists Twist Away from Shareholder Interests*, MARKETWATCH, Oct. 18, 2005, http://www.marketwatch.com/news/story/fund-lobbyists-put-wicked-twist/story.aspx?guid=%7BFF2B7205-45DA-47C7-9D5D-ED0DF09CA0A2%7D.

48. *Mutual Funds: Trading Practices and Abuses that Harm Investors: Hearing Before the Subcomm. on Fin. Mgmt., the Budget, and Int'l Sec. of the S. Comm. on Governmental Affairs*,

Vanguard Group, this bedrock principle is more than just "public relation" talk; it is a core value. As shown by the following two figures, with the growth of Vanguard funds' assets, the advisory fee for Vanguards' sub-advised funds has been declining. This decline demonstrates the presence of both arm's-length bargaining and "economies-of-scale" pricing.[49] In other words, as fund size grows, costs-per-dollar-managed decrease, with Vanguard fund boards passing on those cost savings to fund shareholders in the form of reduced fees. Figure 2 below shows that, between 1975 and 2002 the average advisory fee charged for Vanguard's sub-advised funds has been declining on both an equal-weighted and dollar-weighted basis.[50]

FIGURE 2
AVERAGE ADVISORY FEES PAID FOR VANGUARD FUNDS
MANAGED BY SUB-ADVISERS FOR 1975-2004



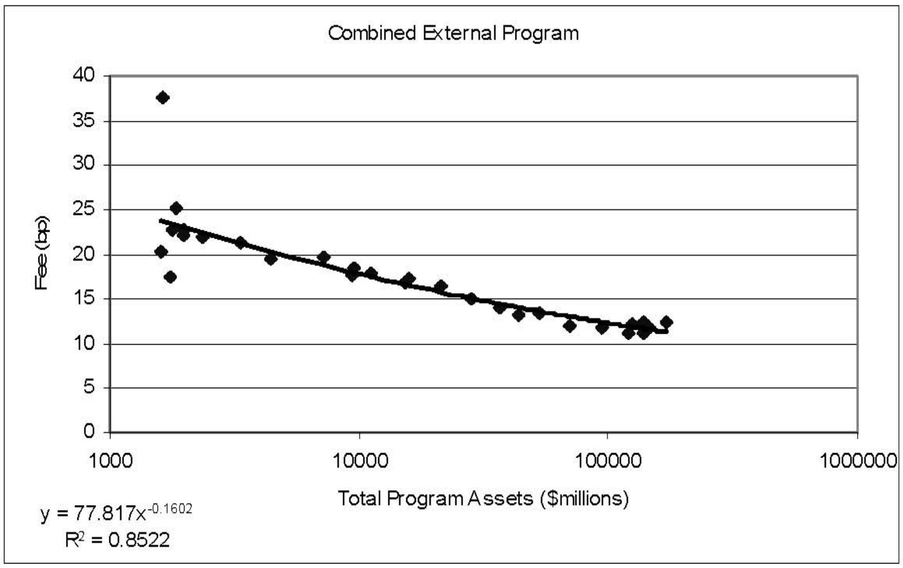

108th Cong. 187 (2003) [hereinafter *Trading Practices Hearing*] (prepared statement of Matthew Fink, President, Investment Company Institute), *available at* http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=108_senate_hearings&docid=f:91038.pdf.

49. As a theoretical matter, one would expect "economies-of-scale" pricing to mean that, as the fund gets bigger, prices come down because it is not ten times more difficult for a portfolio manager to decide to buy 100,000 shares of a company's stock rather than 10,000 shares. Nevertheless, some have questioned whether such savings exist within the fund industry. *See infra* note 209 and accompanying text. The Vanguard cost data in this article shows that economies of scale in the portfolio management business truly do exist and, at least at Vanguard, provide substantial savings to fund investors.

50. Fee data for these funds has been provided by the Bogle Financial Markets Research Center, as well as annual reports for the individual funds.

In Figure 3 below we illustrate the relationship between the total assets under management in the program versus the weighted average advisory fee, with the regression results also shown.[51]

FIGURE 3
REGRESSION ANALYSIS OF AVERAGE ADVISORY FEES PAID BY SUB-ADVISED VANGUARD FUNDS 1975-2004




The left-most points are the earliest years, and the fact that they are above the regression line is indicative of an earlier pricing schedule that was modified with the change in fund governance. For example, the top-left most point corresponds to 1975, when the average fee was 38 bps on $1.68 billion in assets. Since 1975, average fees for the sub-advised Vanguard funds have tended to decline as the amount of assets under management has grown. This shows two important things: the existence of economies of scale in the mutual fund portfolio management business and the capturing of those economies for the benefit of Vanguard's shareholders, by bringing fee levels down as assets increase.

51. The form of the regression is: ln (*Fee(bp)) = A + B * ln(Assets)*. The regression has as a dependent variable the natural logarithm of the fee in basis points, and has as an independent variable the natural logarithm of fund assets. The regression estimates an intercept coefficient (A) and a slope coefficient (B).

The sub-advised Vanguard funds have written fee arrangements with the outside managers who oversee the investments. A list of funds with their respective sub-advisers is set forth in Appendix B. Some of these funds have only one sub-adviser; some have as many as four. In total, as of 2004, there were thirty-six external managers represented by these twenty-one funds, each with their own fee schedule.[52] Taken collectively, as shown in Table 2 below, in 2004 the fee schedules had the following characteristics for various asset levels:

TABLE 2
VANGUARD FEES BASED ON FUND ASSET LEVELS – 2004

| Assets Managed ($ millions)[53] | 10 | 100 | 1000 | 10000 | 25000 |
|---|---|---|---|---|---|
| Minimum Fee (bps) | 10 | 10 | 10 | 5 | 4 |
| Maximum Fee (bps) | 50 | 50 | 37 | 26 | 25 |
| Mean Fee (bps) | 28 | 27 | 20 | 14 | 13 |

Economies of scale are evident in the pricing for these funds, where almost all of the sub-advisers charge substantially less for higher asset levels. The mean fee assessed against assets at the $25 billion level is less than half the mean fee assessed at the $100 million level.

The above figures and tables just compare fees paid by certain actively-managed Vanguard funds over a range of asset levels. Critically, Vanguard's pricing model provides a way to gauge the impact of conflicts of interest on pricing for advisory services. This is because nineteen of the thirty-six sub-advisers hired by Vanguard also manage their own mutual funds. When these same portfolio managers sell identical investment advisory services for their own captive funds, the captive funds' boards of directors often approve very different fee schedules, with prices significantly higher than those paid by the Vanguard funds. This pricing disparity works to the detriment of the captive funds' shareholders. Measuring the disparity is not difficult. For Vanguard's nineteen sub-advisers which simultaneously manage their own funds, we have compared the portfolio advisory fees they charge their own captive funds

52. Actual fee schedules and breakpoints are available through the SEC-filed Statement of Additional Information for each fund. These are available using the SEC's EDGAR database. *See* SEC Filings & Forms (EDGAR), http://www.sec.gov/edgar.shtml (last visited Mar. 31, 2008).

53. Breakpoint fee rates normally apply on an incremental basis. Thus, the first $100 million of a $1 billion fund would be charged at the higher rate, and the remaining $900 million would be charged at the lower rate. *See, e.g.*, *Oversight Hearing on Mutual Funds*, *supra* note 38, at 190 (prepared statement of Jeffrey C. Keil, Vice-President, Lipper Inc.).

(based on data filed by the funds with the Securities and Exchange Commission) ("SEC" or "Commission"),[54] with the portfolio advisory fees they charge Vanguard with whom they bargain at arm's-length. The results are set forth below.

TABLE 3
COMPARISON OF ADVISORY FEES CHARGED BY VANGUARD'S SUB-ADVISERS TO FEES THE SAME SUB-ADVISERS CHARGED THEIR OWN CAPTIVE FUNDS - 2004

| Assets Managed ($ millions) | 10 | 100 | 1000 | 10000 | 25000 |
|---|---|---|---|---|---|
| Captive Fund Mean (bps) | 70 | 69 | 66 | 64 | 63 |
| Vanguard Mean (bps) | 29 | 27 | 22 | 15 | 14 |

Table 3's first set of calculations ("Captive Fund Mean") reflects the advisory fee levels (as opposed to total expense ratios) charged by the Vanguard's sub-advisers when dealing with their own captive funds. The second set of numbers ("Vanguard Mean") represents the average of the Vanguard-negotiated fee schedules applicable to the Vanguard funds.[55] Table 3 shows that, at each asset management level, the captive funds paid at least double the level of advisory fees for identical services.

Table 3 also shows economies of scale. As funds increased in size from $10 million to $25 billion, the average fee charged Vanguard's shareholders declined from 29 bps to 14 bps—a reduction of more than 50%. Obviously, economies of scale exist, and Vanguard's boards capture those cost savings and pass that savings on to Vanguard's shareholders. When managing their own captive funds, however, Vanguard's sub-advisers reduced their fees from an average of 70 bps to only 63 bps, a decline of a meager 10%. Thus, for the captive funds, economies of scale are shared only very grudgingly, if at all.

Translating these schedules into dollar terms is enlightening. Vanguard has negotiated to limit the fees their funds pay to $35 million for the larger portfolio ($25 billion x 14 bps). The *same* external managers when dealing with their captive funds have been able to increase their compensation to $157 million ($25 billion x 63 bps). Vanguard's sub-advisers are thus able to

54. Through 2004, these sub-advisory fee schedules were published in each fund's SEC-filed Statement of Additional Information and are reflected in the SEC's EDGAR database. *See* SEC Filings & Forms (EDGAR), *supra* note 52.

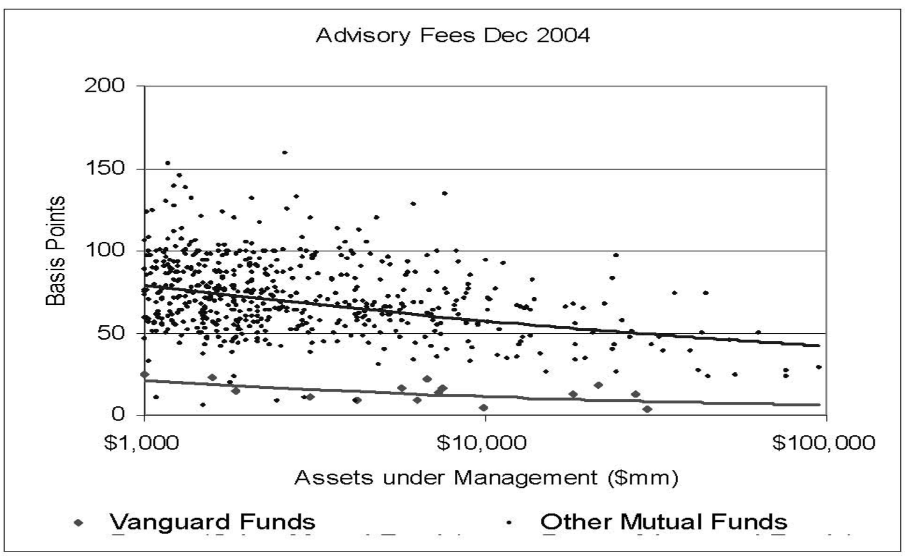
55. Even though this subset only contains nineteen of the thirty-six managers included above in Table 2, their combined Vanguard fee mean is within one basis point of the average for the entire sample.

extract far more money from their own captive funds than they charge Vanguard for the same work. The differential amounts to a potential windfall of more than $122 million in 2004 alone.

The Vanguard experience should stand as a model for the rest of the mutual fund industry to emulate. To put the fee savings in perspective, consider that the weighted average advisory fee paid by Vanguard to its funds' sub-advisers was 12.3 bps in 2004. For the fund industry's 500 largest equity funds, excluding Vanguard's, the advisory fee rate charged was 59 bps, nearly five times higher.[56] Figure 4, below, based on data obtained from Morningstar, compares the fees Vanguard pays its outside portfolio managers with advisory fees paid by the 500 largest actively managed equity mutual funds, excluding funds in the Vanguard Group.

FIGURE 4

ADVISORY FEES ON ACTIVELY MANAGED VANGUARD EQUITY FUNDS VERSUS ADVISORY FEES ON THE 500 LARGEST NON-VANGUARD EQUITY FUNDS - 2004




56. This fee rate is lower than the industry weighted average expense ratio of 91 bps mentioned earlier, *supra* text accompanying note 31, because for a great many funds it captures only charges for portfolio management services, and thus excludes administrative expense items such as transfer agency costs, printing and custodial services. Also excluded are marketing and distribution costs. See *infra* notes 95-96 for a typical itemization of different types of mutual fund expenses, including advisory fees and custodial charges. The industry's weighted average expense ratio of 91 bps is in turn lower than the 112 bps expense ratio for equity funds, *see infra* note 126 and accompanying text, since some funds, such as bond and money market funds, tend to have lower expense ratios than equity funds. For tables reflecting weighted average expense ratios for different categories of mutual funds from 1970 to 2004, see Todd Houge & Jay Wellman, *The Use and Abuse of Mutual Fund Expenses*, 70 J. BUS. ETHICS 23, 28 (2007).

Figure 4 illustrates the dramatic savings that Vanguard shareholders enjoy due to their boards' freedom to engage in true arm's-length negotiations. At the end of 2004, the 500 largest non-Vanguard equity funds held approximately $2.8 trillion in assets. With a mean weighted average advisory fee of 59 bps, these funds paid roughly $16.5 billion in gross advisory fees. If they had instead paid the 12.3 bps weighted average fee Vanguard pays outside portfolio advisers, shareholders of these 500 equity funds would have saved on the order of $13.1 billion. Even if the average portfolio advisory fees paid by the 500 non-Vanguard funds were *double* what Vanguard paid its own outside portfolio advisers, shareholders of these 500 funds would have saved more than $9.5 billion annually.

Supporters of the status quo in mutual fund pricing may argue that references to Vanguard are off-point because, unlike its peers, Vanguard functions as a "mutual" company, in the sense that the company is client-owned, and therefore the fund manager does not work to turn a profit for outside shareholders (as do the managers at Franklin Resources and Eaton Vance, for example). Rather, the Vanguard director works exclusively for the *fund's* shareholders. Vanguard furnishes distribution and administrative services (such as custodian and transfer agency, telephone access, internet services, printing, regulatory compliance, etc.) at cost. Thus, Vanguard shareholders enjoy savings because they do not pay the fund adviser or its affiliates cash reflecting a reasonable profit on those administrative charges. This expense mark-up is a cost item routinely charged by fund sponsors elsewhere in the fund industry. However, this expense item is not large.[57]

The Vanguard Group's business model can prove puzzling even to sophisticated industry observers. A study analyzing mutual fund fees recently published by the American Enterprise Institute[58] correctly found that the fund industry features "a unique system of price setting, one that does not include vigorous price competition."[59] The authors then tried to explain what it is

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57. For example, the total costs of all administrative expenses for equity mutual funds on a weighted average basis can be estimated at no more than 25 bps, which is the weighted average expense ratio for equity index funds. *See infra* notes 123-24 and accompanying text. This is in line with Freeman-Brown's calculation of equity fund administrative fees to be 21 bps on a weighted average basis. Freeman & Brown, *supra* note 9, at 624 tbl.2. For the equity index fund sample, profit to the advisers for the rendition of administrative services is included in the all-in charge of 25 bps. The only thing excluded is the cost of advisory services, and that is the expense item that accounts for the bulk of the costs showing up in actively managed funds' expense ratios. It also accounts for the bulk of fund sponsors' profitability.

58. PETER J. WALLISON & ROBERT E. LITAN, COMPETITIVE EQUITY: A BETTER WAY TO ORGANIZE MUTUAL FUNDS (2007).

59. *Id.* at 76.

about the Vanguard Group that causes its expense levels to be so much lower than industry averages. The authors contended Vanguard's organizational structure as a "mutual" company is what creates shareholder savings within the Vanguard Group.[60] This explanation is only partially correct. It holds water only insofar as it relates to Vanguard administrative and distribution services which, as noted above, are supplied to fund shareholders at cost. Though Vanguard is not in the business of profiting off the services it performs for its fund shareholders, the outside fund portfolio advisers it hires to manage its various actively managed funds certainly are. There is nothing non-profit about the work these advisory firms perform or the prices they charge the funds they manage. The portfolio managers for Vanguard's outsider-advised funds are simply independent contractors hired to render services, and those services are rendered on a *for-profit* basis. That Vanguard's funds pay low prices for advisory services simply reflect hard bargaining by the Vanguard funds' loyal and unconflicted board members.

Table 3 features a true "apples-to-apples" comparison of Vanguard's advisory fees with those charged by Vanguard's advisers when billing their captive funds for services. We see that captive shareholders are obligated to pay far more than Vanguard shareholders pay to the very same managers *for performing the very same work*. From a fiduciary duty standpoint, this is both disturbing and enlightening. This comparison demonstrates that advisory fees outside the Vanguard Group are grossly inflated.

The true extent of the fund market versus free market pricing disparity is driven home by Figure 4. Again, this is an apples-to-apples analysis, comparing what Vanguard funds pay with what shareholders of many other large funds pay for equivalent advisory services. That Vanguard's costs are far below fund industry averages should be an embarrassment to the rest of the fund industry. The Vanguard experience proves that the conflicts of interest influencing advisory contract negotiations in the great many sponsor-controlled funds causes those funds' shareholders to be substantially overcharged. As discussed below, this ultimate conclusion is nothing new.

### *B. Past Scholarly Studies Have Shown Mutual Fund Advisory Fees Are Inflated*

Academics at the Wharton School's Securities Research Unit performed the first detailed and comprehensive study raising questions about the reasonableness of mutual fund fees in 1962. Their study was commissioned by the SEC and is known as the *Wharton Report*.[61] Four years after the

60. *Id.* at 84.
61. WHARTON REPORT, *supra* note 9.

*Wharton Report*'s publication, the SEC published its own study of the mutual fund industry, entitled *Public Policy Implications of Investment Company Growth* (*PPI Study*).[62] The *Wharton Report* and the *PPI Study* each found evidence of unusually high fees in the mutual fund industry for advisory services.

Each also found that mutual fund advisers consistently charged significantly higher fees when selling portfolio management services to their captive funds, as compared to when the same advisers sold equivalent services on the open market.[63] They ascribed this disparity in fee structures to the same phenomenon discussed above: fund advisers' ability to capitalize on the conflict of interest inherent in most funds' management structures and convert it into the power to set non-competitive prices.[64] The *Wharton Report* identified fifty-four investment advisers with both mutual fund clients and other clients.[65] Of this sample, fee rates charged the mutual fund clients were at least 50% higher in thirty-nine out of the fifty-four cases.[66] Of this group of thirty-nine advisers, twenty-four charged their captive mutual funds fees that were 200% higher than they charged their institutional clients; nine charged their captive funds fees that were at least 500% higher.[67] Likewise, in its *PPI Study*, the SEC revisited the *Wharton Report*'s findings and determined that, "[t]he Wharton Report's conclusions correspond to those reached by the more intensive examination of selected mutual funds and mutual fund complexes made by the Commission's staff."[68] The Commission noted that advisory fee rates for pension and profit sharing plans (fees

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62. PPI STUDY, *supra* note 9.

63. Specifically, the *Wharton Report*'s authors found that where fund advisers had outside advisory clients, there was a "tendency for systematically higher advisory fee rates to be charged open-end [mutual fund] clients." WHARTON REPORT, *supra* note 9, at 493.

64. The price disparity was explained as follows:

> The principal reason for the differences in rates charged open-end companies and other clients appears to be that with the latter group "a normal procedure in negotiating a fee is to arrive at a fixed fee which is mutually acceptable." In the case of fees charged open-end companies, they are typically fixed by essentially the same persons who receive the fees, although in theory the fees are established by negotiations between independent representatives of separate legal entities, and approved by democratic vote of the shareholders. This suggests that competitive factors which tend to influence rates charged other clients have not been substantially operative in fixing the advisory fee rates paid by mutual funds.

*Id.* at 493-94 (footnote omitted).

65. *Id.* at 489.

66. *Id.*

67. *Id.*

68. PPI STUDY, *supra* note 9, at 120.

negotiated by parties dealing at arm's-length) were less than "one-eighth of the 0.50 percent rate commonly charged to mutual funds of that size."[69]

Following the *PPI Study*, a good deal of time passed without fee levels in the fund industry receiving much scrutiny, although from time-to-time, articles uncomplimentary toward mutual fund governance did appear in the financial press.[70] Similarly, over the decades, the findings of those scholarly reports about comparable fees were never challenged. In 2001, two of this article's authors, John Freeman and Stewart Brown, again scrutinized mutual fund fees.[71]

Freeman-Brown compared mutual fund portfolio management fees to portfolio management fees paid by government pension plans and found that the former were much higher than the latter.[72] Freeman-Brown relied on two main sources of data. The first was data collected from questionnaire responses received from public pension funds reporting on fee levels charged by the pension funds' external equity fund managers.[73] The other main source

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69. *Id.* at 115.

70. One of those articles noted the disparity between what fund investors pay for advice and what institutions pay, noting that fund shareholders "pay nearly twice as much as institutional investors for money management." Simon, *supra* note 1, at 131. Ms. Simon also noted that the "calculation doesn't even include any front- or back-end sales charges you may also pony up." *Id.*; *see also* Robert Barker, *Fund Fees Are Rising. Who's to Blame?*, BUS. WK., Oct. 26, 1998, at 162 ("If expenses are too high, it's the independent directors who have failed."); Robert Barker, *High Fund Fees Have Got to Go*, BUS. WK., Aug. 16, 1999, at 122 ("Since 1984, Morningstar reports, the average cost of actively run no-load U.S. stock funds fell less than 10%, even as their assets multiplied 32 times. Vast economies of scale benefited mutual-fund companies, not investors."); Thomas Easton, *The Fund Industry's Dirty Secret: Big Is Not Beautiful*, FORBES, Aug. 24, 1998, at 116, 117-18 ("The dirty secret of the business is that the more money you manage, the more profit you make—but the less able you are to serve your shareholders. . . . In most businesses size is an advantage. In mutual funds it is an advantage only to the sponsor, not to the customer."); Charles Gasparino, *Some Say More Could Be Done to Clarify Fees*, WALL ST. J., May 20, 1998, at C1 ("[I]s the industry really rising to the challenge? Is it doing all it can to clearly and simply explain how much investors are paying in fees and expenses?"); Tracey Longo, *Days of Reckoning: Congress Is Finally Starting to Look into Why Mutual Fund Fees Keep Rising*, FIN. PLAN., Nov. 1, 1998, at 171 ("Several leading mutual fund analysts and critics are also making the case that not only do higher fees not mean better performance, often the opposite is true."); Linda Stern, *Watch Those Fees*, NEWSWEEK, Mar. 23, 1998, at 73 ("Today's financial marketplace is a bizarre bazaar: in the flourishing fund industry, the law of supply and demand sometimes works backward, and heightened competition can mean higher prices.").

71. Freeman & Brown, *supra* note 9.

72. Key Freeman-Brown findings are discussed in DAVID F. SWENSEN, UNCONVENTIONAL SUCCESS: A FUNDAMENTAL APPROACH TO PERSONAL INVESTMENT 241 (2005).

73. The hundred largest public pension funds were surveyed. The cover letter asked for cooperation, mentioning that the request should be viewed as a Freedom of Information Act request by those disinclined to cooperate without compulsion. Fifty-three pension funds

was Morningstar's Principia Pro database. Fee breakdowns in that database are drawn from mutual funds registration statements.[74] Within the Morningstar data, Freeman-Brown's focus was on advisory fees only; costs designated by the funds as administrative (legal, transfer agency services, etc.), for distribution, or marketing were excluded from the comparisons.

Using this data, Freeman-Brown showed inter alia that the equity pension fund portfolio featured an average size of $443 million and an asset weighted average advisory fee of 28 bps. In comparison, the average equity mutual fund had an average asset size of $1.3 billion and an asset weighted average advisory fee level of 56 bps. Thus, despite the savings from economies of scale that one would expect, mutual fund managers were paid twice as much (56 bps rather than 28 bps) to manage funds that, on average, were almost three times as big (averaging $1.3 billion rather than $443 million). In dollar terms, the fee average for equity pension funds was $1.2 million; for the equity mutual funds, featuring a much higher fee level and a bigger asset base, it was roughly six times as much, around $7.28 million.

### *C. Fund Sponsors' Counterattack; The ICI Response and Coates-Hubbard*

The Freeman-Brown study made waves[75] and triggered calls for reform.[76]

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responded, of which thirty-six provided usable data. The thirty-six pension funds had average total assets of $21 billion. Freeman & Brown, *supra* note 9, at 630.

74. Financial data within those registration statements is trustworthy because material misrepresentations in registration statements filed under the Act are actionable civilly and criminally under the Securities Act of 1933. *See* Securities Act of 1933 §§ 11, 17, 15 U.S.C. §§ 77k, 77q (2000).

75. *See, e.g.*, Tom Lauricella, *This Is News?: Fund Fees Are Too High, Study Says*, WALL ST. J., Aug. 27, 2001, at C1. The article quotes Don Phillips, head of Morningstar, the mutual fund industry's leading performance and expense tracking company, saying: "[T]he [Freeman-Brown] study is dead-on in its methodology and findings. . . . This study is very damning . . . . It shows that retail mutual funds are not competitively priced." *Id.*

76. For instance, former SEC Chairman Arthur Levitt testified before a House Subcommittee and confirmed Freeman-Brown's findings and demanded radical reform. He testified: "The largest mutual funds pay money management advisory fees that are more than twice those paid by pension funds." Thus, he argued:

> It is essential that investment company boards be required to solicit competitive bids from those who wish to undertake the management function. Furthermore, boards should justify to their bosses, fund shareholders, why they chose a particular investment advisor and each year should demonstrate that they have aggressively and competitively negotiated management fees.

*Mutual Funds: Who's Looking out for Investors?: Hearing Before the Subcomm. on Capital Mkts., Ins. and Gov't Sponsored Enters. of the H. Comm. on Fin. Servs.*, 108th Cong. 48 (2003) (statement of Arthur Levitt, Chairman, Securities Exchange Commission), *available at* http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=108_house_hearings&docid=f:92982.pdf.

Then, as one would expect, defenders of the status quo sought to discredit the study. In 2003, the ICI published a report which purported to show that fund advisory fee levels were about the same as portfolio management fees paid by public pension plans.[77] The ICI's research eventually was embraced by two academics, Professors John C. Coates, IV of Harvard Law School and R. Glenn Hubbard, Dean of Columbia's School of Business. With funding by ICI Mutual, the insurance company affiliated with the ICI that insures mutual fund directors and advisers against liability claims,[78] Professors Coates and Hubbard have written an article appearing in the Fall 2007 edition of the *Journal of Corporation Law* entitled *Competition in the Mutual Fund Industry: Evidence and Implications for Policy*.[79]

Coates-Hubbard's thesis is that mutual funds operate in competitive markets, and excessive fees do not exist in competitive markets; therefore, mutual funds do not have excessive fees. In reaching this surprising conclusion,[80] Coates-Hubbard rejects the various, detailed studies that show

77. Sean Collins, *The Expenses of Defined Benefit Pension Plans and Mutual Funds*, ICI PERSPECTIVE, Dec. 2003, at 1, 8, *available at* http://www.ici.org/pdf/per09-06.pdf.

78. *See* Coates & Hubbard, *supra* note 11, at 151 n.aa1.

79. The paper was initially published in June 2006 under the auspices of the American Enterprise Institute. John C. Coates IV & R. Glenn Hubbard, *Competition and Shareholder Fees in the Mutual Fund Industry: Evidence and Implications for Policy*, (Am. Enter. Inst., Working Paper No. 127, 2006) [hereinafter *Coates-Hubbard Working Paper*], *available at* http://www.aei.org/publications/pubID.24577/pub_detail.asp. This article will be referred to textually as the "Coates-Hubbard Working Paper." Fidelity Investments then presented the Coates-Hubbard Working Paper to the SEC as an authoritative analysis of mutual fund fees by submitting it for inclusion in SEC File S7-03-04, a file relating to mutual fund governance issues pending before the Commission. *See* Letter from Eric D. Roiter, Sr. Vice Pres. & Gen. Counsel, Fidelity Inv., to Nancy M. Morris, Secretary, Sec. Exch. Comm'n (Mar. 2, 2007), *available at* http://www.sec.gov/rules/proposed/s70304/s70304-554.pdf. Fidelity used the Coates-Hubbard Working Paper research in support of their joint opposition to an SEC governance proposal calling for more independence in fund boardrooms. The Coates-Hubbard Working Paper is an attachment to the Fidelity submission, beginning on page 27. *Id.* at 27. The Chamber of Commerce of the United States adopted as authoritative the Coates-Hubbard Working Paper research as well. *See* Letter from David Chavern, Chief Operating Officer & Sr. Vice Pres., Chamber of Commerce of the U.S., to Nancy M. Morris, Secretary, Sec. Exch. Comm'n 5 (Mar. 2, 2007), *available at* http://www.sec.gov/rules/proposed/s70304/dcchavern8764.pdf. A subsequent version of the Coates-Hubbard Working Paper was published on the Social Science Research Network in August 2007. *See* John C. Coates & R. Glenn Hubbard, *Competition in the Mutual Fund Industry: Evidence and Implications for Policy* (Harvard Univ. John M. Olin Discussion Paper Series, Discussion Paper No. 592, 2007), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1005426.

80. As noted earlier, there is substantial evidence that fund advisory firms earn statistically significant risk-adjusted returns. *See supra* note 28 and accompanying text. Brown's study, covering the twenty-five-year period from 1982-2006, concludes that fund sponsors' profits and returns are accelerating rather than decelerating as increased competition would predict. The

excessive fees exist.[81] Coates-Hubbard dismisses the *Wharton Report*'s comparative fee analysis as superficial, which it was not,[82] and dismisses the *PPI Study* as simply "accepting without question" the *Wharton Report*'s findings,[83] which is a false characterization.[84] In essence, the *Wharton Report* and the SEC's *PPI Study* are rejected out of hand by Coates-Hubbard as irrelevant, old-school, meaningless 1960s research featuring "nonsensical" fee comparisons of different products with different services.[85]

As for Freeman-Brown, it is dismissed on the ground that pension fund advisory costs cannot be compared with mutual funds; Coates-Hubbard contends it amounts to a meaningless apples-to-oranges comparison.[86] Coates-Hubbard claims this is so for two reasons. First, "[m]utual funds report different costs in the same categories of expenses. Management fees sometimes include administrative and costs other than pure portfolio management."[87] The second ground they give is that differences in liquidity frustrate comparisons.[88] Each contention is explored below.

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study confirms the finding, noted earlier, that fund sponsors earn economic profits, contrary to the predictions of the model of perfect competition. *See supra* note 26 and accompanying text; *see also supra* note 36 and accompanying text.

81. Their view also collides with findings that the mutual fund industry features a distinct absence of price competition. *See, e.g.*, GEN. ACCOUNTING OFFICE, MUTUAL FUND FEES: ADDITIONAL DISCLOSURE COULD ENCOURAGE PRICE COMPETITION 62 (2000), *available at* http://www.gao.gov/archive/2000/gg00126.pdf (finding that mutual funds tend not to compete based on the operating expenses investors pay); WALLISON & LITAN, *supra* note 58, at 61-76 (concluding that, contrary to the Coates-Hubbard thesis, funds do not compete effectively on pricing of services).

82. Coates & Hubbard, *supra* note 11, at 156. The *Wharton Report* was also derided by Coates-Hubbard as "primitive and misleading." *Id.* at 153.

83. *Id.* at 156.

84. In truth, the *PPI Study* traveled well beyond the *Wharton Report*'s scope with fresh analysis supporting the same conclusion. The SEC confirmed, for example, that competition among advisers seeking to supply funds with services does not exist in the fund industry. It found instead that "[m]utual funds are formed by persons who hope to profit from providing management services to them," PPI STUDY, *supra* note 9, at 127, with the captive funds' managers seldom thereafter competing with each other for fund advisory contract business, *id.* at 126. Most importantly, based on its study of new and different data, the SEC determined mutual funds pay far more for advisory services than pension and profit-sharing plans. *See supra* notes 61-69 and accompanying text.

85. Coates & Hubbard, *supra* note 11, at 186.

86. *See id.* at 183.

87. Coates & Hubbard, *supra* note 11, at 186-87. Moreover, though Coates-Hubbard faults Freeman-Brown for not isolating the data, their article correctly admits: "Data are not readily available to accurately isolate the pure costs of portfolio management . . . ." *Id.* at 187-88.

88. *Id.* at 188.

### *1. The Commingling of Expenses in Management Fees*

As to the first concern dealing with occasional expense commingling, it is undoubtedly correct that a minor amount of commingling of expense items sometimes exists and—quite regrettably—frustrates perfect apples-to-apples comparisons on a universal basis.[89] But Coates-Hubbard overstates the problem's size,[90] exaggerates its impact, and ignores Freeman-Brown's efforts to adjust for expense commingling.[91]

Moreover, the authors are unaware of any competent data establishing that free market advisory costs cannot be compared with fund market advisory

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89. This problem could easily be eliminated if the SEC insisted that funds follow a uniform, clearly-defined system of expense reporting, an improvement called for by Freeman-Brown and reiterated here. As observed in Freeman-Brown:

> [T]o facilitate comparative cost disclosures, the SEC needs to require financial reporting on a standardized basis so that categories of expense are comparable on an industry-wide basis. Currently, some funds blend administrative costs into the advisory fee. This bundling frustrates cost comparisons and detailed analysis (most prominently by the SEC staff itself), and it needs to be stopped.

Freeman & Brown, *supra* note 9, at 669.

90. In making this argument, Coates-Hubbard essentially adopts the views expressed by the ICI. As discussed *infra* in notes 104 and 131, the ICI claims that various extraneous expenses are sometimes embedded in advisory fees, making it impossible to isolate true portfolio advisory costs. Specifically, Collins, *supra* note 77, at 7, lists certain expense categories that are sometimes included in advisory fees. We have considered each of these expense categories and averaged the closest expense categories for funds that report those expenses separately to Lipper Analytical Services. As explained *infra* in note 104, based on our analysis of this Lipper data, we conclude that when the spillover of non-advisory expenses into fund advisory expenses occurs, the amount of added costs approximates no more than 3 bps. Neither Coates-Hubbard nor any other source has attempted to quantify the amount of non-advisory costs included by some sponsors in their advisory fees. Of course, if the number was quantified by fund sponsors' defenders, it could be adjusted for, and the purported ground for fund fees being incapable of comparison would disappear.

91. Specifically, in framing the Freeman-Brown study, we determined that, on average, domestic equity mutual funds paid 21 bps for administrative services such as transfer agency, custodial, and legal fees. Freeman-Brown's operating expense (advisory and administrative fees) ratios were comparable to those found in the ICI's own cost study conducted in 1999. *See* John D. Rea et al., *Operating Expense Ratios, Assets, and Economies of Scale in Equity Mutual Funds*, ICI PERSPECTIVE, Dec. 1999, at 1, *available at* http://www.ici.org/pdf/per05-05.pdf. To hone our fund expense data down to advisory fee payments, we eliminated explicitly disclosed administrative fees together with the large amount of hidden administrative costs embedded in funds' 12b-1 expenses. At this point, after further investigation, we concluded that any residual administrative expenses embedded in fund advisory fees were de minimis. We then calibrated the mutual fund sample to closely resemble our pension fund sample. We found that the cost of advisory (stock picking) services for a large sample of domestic equity funds averaged 56 basis points. We found that public pension funds pay an average of 28 bps for the same services. This comparison led us to conclude that mutual funds pay around double what pension funds pay solely for stock picking services. *See generally* Freeman & Brown, *supra* note 9.

costs. A pool of stocks is not inherently harder to manage because the legal owner is a pension fund as opposed to being a mutual fund. Indeed, competing for advisory business in the free market necessitates a significant cost that fund advisers need not pay: the cost of finding business in a competitive marketplace. Fund managers escape paying that cost due to their unseverable tie with the fund.

Furthermore, Coates-Hubbard ignores the pure apples-to-apples data that does exist supporting Freeman-Brown's central thesis that fee gouging is rampant within the fund industry. One example of pure apples-to-apples data is the Vanguard data reviewed earlier in this article.[92] Another came to light in a 2004 Senate Subcommittee hearing. At that hearing examining excessive fees within the mutual fund industry, then-New York Attorney General Eliot Spitzer testified that, in the course of his investigation, he had asked for the "best apples to apples comparison for identical services" from Putnam Investments.[93] In response, Putnam gave him data showing Putnam's mutual fund investors were charged 40% more for advisory services than Putnam's institutional investors, meaning Putnam mutual fund investors paid $290 million more in advisory fees than they would have paid had they been charged the rate given to Putnam's institutional clients.[94]

Alliance Capital provides further apples-to-apples data. In 2002, according to its Certified Shareholder Report filed on Form N-CSR with the SEC,[95]

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92. *See supra* Part III.A. The Vanguard phenomenon was also explored (although to a lesser extent) in Freeman-Brown. *See* Freeman & Brown, *supra* note 9, at 637-40. Coates-Hubbard criticized Freeman-Brown for not explaining why Vanguard pays sub-advisors 13 basis points on a weighted average basis for providing advisory services, whereas the price paid by public pension plans holding the largest group of assets is more, 20 bps. Coates & Hubbard, *supra* note 11, at 187. But the answer is simple and apparent from Freeman-Brown's text. The weighted average size of the Vanguard outside-managed funds featured in Freeman-Brown was $11.6 billion. *See* Freeman & Brown, *supra* note 9, at 638 tbl.6. The weighted average asset size for the largest pension fund decile in the Freeman-Brown sample was much smaller: $1.55 billion, less than one-seventh the size of the average Vanguard portfolio. *Id.* at 632. The Vanguard fee rate is lower due to economies of scale being captured at Vanguard for the benefit of fund shareholders. Freeman-Brown's text showed that working for Vanguard is nonetheless lucrative. Applying the average fee rate to the average asset size yields an advisory fee to the sub-adviser of $15.1 million. The average numbers for pension managers yields far less, $3.10 million.

93. *Oversight Hearing on Mutual Funds*, *supra* note 38, at 23 (testimony of Eliot L. Spitzer, N.Y. Att'y Gen.).

94. *Id.* at 16.

95. A copy of the Alliance Fund's shareholder report is available on the SEC's EDGAR database. *See* AllianceBernstein Premier Growth Fund, Annual Report (Form N-CSR) (Oct. 14, 2003), *available at* http://www.sec.gov/Archives/edgar/data/889508/000093677203000412/0000936772-03-000412.txt.

Alliance Premier Growth Fund paid total advisory, distribution, and administrative expenses of $198 million.[96] Included in that sum was an advisory fee of $88 million paid by the fund to its sponsor, Alliance Capital.[97] Based on average assets of $9.1 billion, the advisory fee thus exceeded 90 bps.[98] At about the same time, Alliance was managing the Vanguard U.S. Growth Fund for 11 bps, a $672 million portfolio for the Kentucky Retirement System for 24 bps, a $1.7 billion portfolio for the Minnesota State Board of Investment for 20 bps, a $730 million equities portfolio for the Missouri Retirement System for 18.5 bps, and a $975 million equity portfolio for the Wyoming Retirement System for 10 bps.[99]

These price discrepancies cannot be justified on the basis of expense commingling. Alliance's certified shareholder report separately disclosed administrative, transfer agency, distribution, printing, custodian, registration, and audit and legal fees, among others; those items were not jumbled with the separately disclosed "Advisory fee."[100] Nor can they be justified on the basis of differences in service or personnel. Alliance Capital has publicly proclaimed that its mutual funds and institutional accounts are "managed by the same investment professionals."[101] According to the prospectus for the Alliance Stock Fund, the management company's institutional accounts and the Alliance Premier Growth Fund also shared "substantially the same

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96. *Id.* at 13. The expenses for the year ended November 30, 2002 were:

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|---|---|
| Advisory fee | $88,128,426 |
| Distribution fee--Class A | $8,300,777 |
| Distribution fee--Class B | $42,133,265 |
| Distribution fee--Class C | $15,548,417 |
| Transfer agency | $37,578,580 |
| Printing | $5,398,494 |
| Custodian | $652,328 |
| Audit and legal | $121,314 |
| Administrative | $150,000 |
| Registration fees | $145,000 |
| Directors' fees and expenses | $23,000 |
| Miscellaneous | $199,011 |
| Total expenses | $198,378,612 |

*Id.* Notice that, contrary to Coates-Hubbard's suggestion that fund fees customarily are jumbled, expense items usually are itemized separately with advisory fees easily broken out as an individual item.

97. *Id.* at 13, 17.

98. *Id.* at 25.

99. *See* Second Amended Class Action Complaint at 24-25, Miller v. Mitchell Hutchins Asset Mgmt., Inc., No. 01-CV-0192-DRH (S.D. Ill. Apr. 1, 2002).

100. *See supra* notes 95-96 and accompanying text.

101. Alliance Capital Mgmt. L.P., Annual Report (Form 10-K), at 8 (Mar. 28, 2000), *available at* http://www.sec.gov/Archives/edgar/data/1109448/0001104659-00-000074.txt.

investment objectives and policies" and were managed with "essentially the same investment strategies and techniques."[102] Moreover the different clients shared a "nearly identical composition of investment holdings and related percentage weightings."[103]

Obviously, free market competition has worked well for the institutional buyers of Alliance Capital's portfolio management services. For example, the managers of the Wyoming Retirement System's pension plan paid Alliance Capital less than $1 million per year for essentially the same advice, given by the same people, who were being compensated by Alliance Premier Fund's shareholders to the tune of $88 million yearly. But the price differential in dollar terms of *eighty-eight times* between advisory services sold in the free market versus the fund market for portfolio management by Alliance Capital tells us that price competition for advisory services in the fund market is not robust; it is on life-support, if it can be said to exist at all.

The point is this: Proof of price gouging in the fund portfolio management business is findable and has been found. We agree with Coates-Hubbard that the data are not always pristine. Because of the way the SEC has allowed mutual funds to blur expense definitions, it is not always easy to compare mutual fund portfolio management fees and portfolio management fees negotiated on the free market. It should be easier. And it would be if the SEC used its regulatory authority to bar mutual funds from commingling expense categories and demanded that the industry calculate expense items on a uniform basis. Nonetheless, expense overlaps are a minor problem,[104] and the

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102. Alliance Premier Growth Fund, Inc., Prospectus (Form 485BPOS), at 46 (Jan. 30, 2002), *available at* http://www.sec.gov/Archives/edgar/data/889508/000091957402000122/0000919574-02-000122.txt.

103. *Id.*

104. *See* Collins, *supra* note 77, at 6. Collins and the ICI contend that, in addition to portfolio management, the adviser's management fee

> typically also covers the costs of administrative and business services that the fund must have to operate. These include fund and portfolio accounting, valuation of portfolio securities, oversight of the fund's transfer agent and custodian, legal analysis to ensure compliance with federal and state laws and regulations, preparation and filing of regulatory and tax reports, and preparation and distribution of prospectuses and shareholder reports. The management fee also compensates the adviser for its expenses related to the salaries of fund officers and the costs of clerical staff, office space, equipment, and certain accounting and recordkeeping facilities. Finally, the management fee must offer the fund's adviser a competitive rate of return on capital.

*Id.* The authors have considered and analyzed each of these items. In many cases they are illusory. For example, in the case of Alliance Capital's handling of Alliance Premier Growth Fund, discussed above, the fund's transfer agency services were supplied by an Alliance affiliate, meaning that a monitoring charge to compensate Alliance for "oversight of the fund's apples-to-apples data that does exist powerfully confirms the Freeman-Brown thesis and debunks any claim that robust competition keeps prices for portfolio advisory services low in the mutual fund industry.

*2. Questions of Differences in Liquidity*

Another comparability-based argument made by Coates-Hubbard challenges Freeman-Brown's use of pension data. Coates-Hubbard contends pension funds and mutual funds cannot be credibly compared because of "differences in liquidity."[105] The point Coates-Hubbard seeks to make is that, because mutual funds are constantly selling and redeeming shares, mutual funds have a constant, unique liquidity challenge. This, Coates-Hubbard argues, makes mutual fund portfolio management unlike, and not comparable with, portfolio management for other institutional investors. According to Coates-Hubbard, "differences in liquidity" will always "prevent a one-to-one comparison of portfolio management costs."[106]

The Coates-Hubbard liquidity factor deserves special attention, for it lies at the heart of fund managers' strategy for disarming shareholder attacks and preserving the status quo. The strategy bars critics from evaluating fund fees based on free market comparables. To fund sponsors' defenders, "differences in liquidity" is the "X factor," a shield protecting mutual fund advisers from having their fees judged by comparison to free market benchmarks. This issue is a red herring.

Tellingly, though presented as an economic analysis, the Coates-Hubbard study never seeks to isolate and quantify the supposed "differences in liquidity" factor. Nor does it cite any authoritative source providing the liquidity factor any measurable weight at all. Moreover, this liquidity factor

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transfer agent" would basically amount to paying Alliance Capital to monitor itself. Other items mentioned in the Collins-ICI listing are typically covered in administrative expenses although they may not be labeled in precisely the same way. For instance, printing and distribution of prospectuses and shareholder reports would have been covered by the $5 million in printing costs in the Alliance Premier Growth Fund. *See supra* notes 95-96. Costs such as office space, equipment, and competitive rates of return on capital are also likely to be associated with institutional accounts and thus are included in both fees. About one-third of large cap funds in the Lipper database report fund accounting fees separately, and these had a weighted average cost of 1.1 bps for the 2006 fiscal year. We conclude that, in the aggregate, the various miscellaneous items do not account for more than 3 bps of the average mutual fund's advisory fee. We note further that study of cost allocations for one adviser who has both captive mutual funds and institutional clients shows that the institutional clients actually are more expensive to service than the mutual funds. *See infra* notes 227-29 and accompanying text. This suggests fund fee levels should be lower than institutional prices, rather than far higher, as they are.

105. Coates & Hubbard, *supra* note 11, at 188.

106. *Id.*

tends not to be visible or quantifiable in the real world. For example, it does not translate into differences in pricing for portfolio management services rendered to mutual funds and closed end funds (which do not issue redeemable securities and which do not constantly sell new shares to the public) by investment company sponsors who manage both.[107]

Interestingly, the ICI's own position is inconsistent with Coates-Hubbard's "liquidity" theory. In 2003, the ICI claimed that the true cost of managing a mutual fund portfolio on a weighted average basis is around 31 bps,[108] leading to the ICI's conclusion that "mutual fund and pension plans pay like fees for like portfolio management services."[109] Accepting this finding as true, which it is not,[110] the fee equivalence debunks the alleged "liquidity" factor featured by Coates-Hubbard, since the ICI's contention carries with it the implicit premise that pension fund and mutual fund portfolio advisory services are very similar, because, after all, the fees are "virtually identical."[111] Thus, the ICI's position on the comparability of fund and pension fees leads to the conclusion

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107. Investment company manager Mario Gabelli's advisory firm manages seventeen mutual funds that invest in stocks and/or bonds and nine closed-end funds. The management fee charged each of the twenty-six funds annually is set at 1%, with two exceptions. Gabelli's ABC Mutual Fund charges a fee of only .5%; the closed-end Global Deal Fund charges a performance fee that is a minimum of .5%, rising to 2% if the fund's total return exceeds the T-Bill index return by 6%. *See generally* Gabelli Home Page, http://www.gabelli.com/ (last visited Mar. 31, 2008). By definition, closed-end funds feature less liquidity pressure than mutual funds since their shares are not redeemable, and new shares are not constantly being sold. *See* Roger M. Klein, *Who Will Manage the Managers?: The Investment Company Act's Antipyramiding Provision and Its Effect on the Mutual Fund Industry*, 59 OHIO ST. L.J. 507 (1998) (describing characteristics of closed-end funds). If the "differences in liquidity" factor cited by Coates-Hubbard is real and had significant weight, it presumably would manifest itself in the need for substantially more work to be done by the mutual fund portfolio manager, who in turn presumably would charge higher fees to compensate for the greater effort being exerted. However, there is no drop off in fees for Gabelli's closed-end funds in comparison to the mutual funds. *See* Gabelli Home Page, *supra*. This indicates that the redeemability factor is either nonexistent, or is sufficiently insubstantial enough to not be worth building into the cost.

108. Collins, *supra* note 77, at 8.

109. *Id.* at 17. Indeed, the headline of the press release published by the ICI announcing its study attacking Freeman-Brown stated: "Mutual Fund and Pension Fund Fee Levels Are Similar, ICI Research Study Finds." Press Release, Inv. Co. Inst., Mutual Fund and Pension Fund Fee Levels Are Similar, ICI Research Study Finds (Jan. 6, 2004) [hereinafter ICI Press Release], *available at* http://ici.org/statements/nr/2004/04_news_dbplans.html.

110. The falsity arises due to fund advisers' practice of tacking on extra costs to the sub-advisers' fees, padding and thus inflating the overall advisory charges borne by the sub-advised fund and its shareholders. *See infra* Part III.D.

111. The ICI claims to have found: "Mutual fund subadvisors and pension plan investment managers charge 'investment advisory fees' that are virtually identical." *See* ICI Press Release, *supra* note 109. Coates-Hubbard adopted the ICI's flawed methodology and its unsupportable findings. *See* Coates & Hubbard, *supra* note 11.

that the unquantified "differences-in-liquidity" factor cited by Coates-Hubbard is something of a financial Loch Ness monster—a phenomenon talked about but never seen in real life.[112] Finally, to the extent "differences in liquidity" ever matter, they certainly cannot prevent comparisons of Vanguard's portfolio management costs with those charged elsewhere in the fund industry. After all, Vanguard's managers, just like other funds', must deal daily with the liquidity factor. The devastating Vanguard free market vs. fund market advisory fee comparison, as shown in Table 3 and Figure 4, *supra*, cannot be dismissed on this basis.

Another flaw with Coates-Hubbard's broader contention that free market comparators cannot be used in evaluating fund fees is that this "can't do" attitude goes against the grain of accepted financial evaluation practices. For example, business valuation experts and real estate appraisers typically study comparables and adjust them in reaching opinions about the value to be assigned to the property they are appraising. When it comes to business or real estate valuations, bond ratings, or innumerable other free market pricing calculations, nobody insists that the comparables' attributes be absolutely identical to the item being valued. All that is required is that the comparable be reasonably similar with appropriate adjustments being taken to make the comparisons persuasive.[113]

The Coates-Hubbard view that mutual fund fees can never be analyzed on a comparative basis[114] is unvarnished advocacy advanced on behalf of those who seek to preserve the status quo. Like other Coates-Hubbard claims,[115] it

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112. Indeed, the ICI has admitted as much. In the ICI's attempted defense of fund industry pricing, the ICI's lead researcher declared: "[I]t is possible to compare the portfolio management fees incurred by public pension plans with a comparable measure by examining the sub-advisory fees of mutual funds." Collins, *supra* note 77, at 8.

113. Another major problem with the industry's approach to fund fee comparisons is that too much reliance is placed on basis points, and too little attention is given to dollars. Translating basis points to dollars vividly underscores our conclusion that fees in the mutual fund industry are excessive. Freeman-Brown's data showed the top 10% largest pension funds hold on average $1.55 billion in assets, with a 20 bps management fee ratio. Freeman & Brown, *supra* note 9, at 631 tbl.3, 638 tbl.6. For mutual funds, the top 10% in size have assets of $9.7 billion and a 50 bps fee level. *Id.* Many mutual funds are much bigger than pension funds, and so even minor differences in basis points are amplified. Fund managers are paid roughly fifteen times as much for managing the largest mutual funds compared to managers of the largest public equity pension fund portfolios. Contrast this reality with the ICI's contention, adopted by Coates-Hubbard, that fees charged by pension fund portfolio managers and mutual fund managers are "virtually identical." *See infra* note 117 and accompanying text.

114. Coates & Hubbard, *supra* note 11, at 185-86.

115. For example, in support of their claim that the fund industry is highly competitive, Coates-Hubbard makes much of the entry into the industry of twenty new sponsors between 1994-2004. *See id.* at 167-68. They fail to mention that, at the end of 2004, these new sponsors

accounted for less than 1% of the industry's $8.1 trillion in assets. *Compare id.* at 168 tbl.4 (showing that the twenty new sponsors have $77.7 billion in combined assets), *with* INV. CO. INST., 2005 INVESTMENT COMPANY FACT BOOK 102 tbl.44 (45th ed. 2005), *available at* http://www.ici.org/pdf/2005_factbook.pdf (showing that mutual fund assets in the U.S. totaled over $8.1 trillion at the end of 2004). The total assets accumulated by all funds offered by the twenty new sponsors cited by Coates-Hubbard added up to less than *one half* of the total assets held by a *single* mutual fund, the Growth Fund of America, in early 2007. *See* GROWTH FUND OF AM., SEMI-ANNUAL REPORT FOR THE SIX MONTHS ENDED FEBRUARY 28, 2007, at 10 (2007), *available at* http://www.americanfunds.com/pdf/mfgesr-905_gfas.pdf (showing net assets of over $165 billion). Contrary to Coates-Hubbard's claim of increasing competition, the very evidence they cite shows the industry is becoming more concentrated and less competitive over time. Indeed, Coates-Hubbard cites Herfindahl-Hirschman Index ("HHI") numbers in an effort to establish the industry is not concentrated. Coates & Hubbard, *supra* note 11, at 165 tbl.1. However, the cited data shows increasing concentration at the complex level. *Id.* Data generated by the ICI similarly shows increasing concentration between 1995-2006. Over those years, the percentage of industry assets held by the largest five, ten and twenty-five complexes increased in each case. *See* INV. CO. INST., 2007 INVESTMENT COMPANY FACT BOOK 17 fig.2.2 (47th ed. 2007), *available at* http://www.ici.org/pdf/2007_factbook.pdf.

Moreover, Coates-Hubbard ignores that the mutual fund industry features a marketplace segmented between load funds and no-load funds. *See* RICHARD J. TEWELES & EDWARD S. BRADLEY, THE STOCK MARKET 416-17 (7th ed. 1998). In the load fund segment, more than one half of the Morningstar fund categories—twenty-seven out of fifty-one—feature an HHI number higher than 1800, reflecting concentrated markets. *See* Dep't of Justice, The Herfindahl-Hirschman Index, http://www.usdoj.gov/atr/public/testimony/hhi.htm (last visited Mar. 31, 2008). Our calculations show another fifteen of the fifty-one Morningstar load fund categories feature HHI numbers between 1000 and 1800, reflecting "moderately concentrated" markets. *Id.* Only nine of the fifty-one load fund Morningstar categories have index numbers lower than 1000.

Coates-Hubbard is also wrong in presenting the fund industry as a paragon of price competition, brimming with price-conscious investors benefiting from the free market's tendency to drive prices down. In fact, competition in the fund industry is most aggressively manifested by fund sponsors paying money to fund retailers to compensate them for offering a given sponsor's shares. For example, the industry pays more than $2 billion per year in "revenue sharing," a shady practice called the fund industry's "dirty little secret," in order to encourage retailer loyalty and selling effort. *See* Freeman, *supra* note 3, at 792-96. Predictably, this behavior functions to drive prices up, for it consists of advisers extracting outsized fees to pay high distribution costs to win favor among fund retailers.

Contradicting the Coates-Hubbard price competition thesis are data showing that from 1970 to 2000, the expense ratios for the funds that are the most expensive for fund shareholders to buy, the load funds, more than doubled, whereas expense ratios declined for no-load funds. *See* Houge & Wellman, *supra* note 56, at 28 tbl.I. In the index fund area, where products are most similar, prices have been rising with the most expensive funds receiving the greatest market acceptance. *See* Edwin J. Elton et al., Are Investors Rational?: Choices Among Index Funds (Oct. 2002) (unpublished manuscript), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=340482.

The fact that the most expensive form of an identical market offering receives the greatest market acceptance contradicts the position that there is strong price competition in the is unfounded. While we agree that data with which to compare mutual fund fees to fees charged in the free market is not always pristine, objective fee benchmarks are available and illuminating.

*D. The Sub-advisory Fee Argument Is a Sham*

Careful analysis of the fund industry's sub-advisory fee argument defending the status quo exposes the flaws in this rationale. Mutual fund advisers sometimes delegate the task of managing their funds' portfolios to third parties. These third parties, called "sub-advisers," manage less than 20% of the fund industry's assets.[116] The ICI relies on fund cost data involving sub-advisers to support its position that fund portfolio management fees are "virtually identical" to those charged by pension funds.[117] Coates-Hubbard adopts the ICI argument, also using sub-advisory management contracts as a proxy for fund advisory fees.[118] Rather than supporting the industry's position, however, close inspection of fund sub-advisory contract dealings reveals additional disturbing evidence of price gouging in the fund industry.

For one thing, as noted above, sub-advisory contracts are used to manage only a minor fraction of the fund business. Further, in focusing on sub-advisory fees, critics ignore that fund managers (save Vanguard, discussed above) routinely add a hefty "premium" or "monitoring fee" to the sub-advisers' charge. True, the sub-adviser may charge only 30 bps for its investment advice, but the manager will then typically pad the bill, adding an additional twenty to thirty basis point "premium" before passing along the

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marketplace. Under the Coates-Hubbard view, the most expensive funds ought to be redeemed out of existence, but this is not happening. In the fund industry, as between load funds and no-load funds, the load funds are the worst products at the point of sale because investors need to pay the load. Academic studies have shown that load funds are also proving to be the worst (i.e., most expensive) products for investors to own post-sale, because they tend to be cursed with the highest annual expense charges. *See, e.g.*, Daniel Bergstresser et al., *Assessing the Costs and Benefits of Brokers in the Mutual Fund Industry* 30 tbl.5 (Harvard Bus. Sch. Fin. Unit Research Paper Series, Working Paper No. 616981, 2007), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=616981 (noting the lack of evidence of buyer price-consciousness in the load fund marketplace where investors pay more to get the worst products). This phenomenon is not indicative of strong price competition.

116. *See* Matt Ackermann, *How Scandals May Change Playing Field for Subadvisers*, AM. BANKER, June 8, 2004, at 1, 9 ("Ten percent of the $5 trillion in long-term mutual fund assets . . . are subadvised, according to Financial Research."); *see also Oversight Hearing on Mutual Funds*, *supra* note 38, at 17 (testimony of Eliot L. Spitzer, N.Y. Att'y Gen.) (putting the number of sub-advised mutual funds at fewer than 20%). The ICI never quantified the extent to which sub-advisers are used in the mutual fund industry, noting only that "advisers of some mutual funds" use sub-advisers. *See* Collins, *supra* note 77, at 7.

117. Collins, *supra* note 77, at 7-8; ICI Press Release, *supra* note 109.

118. Coates & Hubbard, *supra* note 11, at 187.

advisory fee charge to fund shareholders.[119] In fact, overall fee levels for sub-advised funds are substantially higher than for funds managed in-house.[120] The effect of bill padding over sub-advisory services is huge. Table 4 below compares sub-advisory fees to the full, total amount of advisory fees actually charged by the advisers to their funds (sub-advisory fees plus the advisers' markups in the form of "monitoring" charges).[121]

TABLE 4
ADVISORY AND SUB-ADVISORY FEES FOR A SAMPLE OF SUB-ADVISED CAPTIVE EQUITY MUTUAL FUNDS – DECEMBER 2006

| Fund Name | Morningstar Category | Assets 12/31/06 ($millions) | Advisory Fees (bps) | Sub-Advisory Fees (bps) | Difference | Sub Adviser |
|---|---|---|---|---|---|---|
| AXA Ent Growth | Large Growth | $1,107 | 73 | 21 | 52 | Montag & Caldwell Inc. |
| Dreyfus Prem Alpha Gr | Large Growth | $1,313 | 75 | 25 | 50 | Bear Stearns Asset Mgt |
| FBR Small Cap | Mid-Cap Growth | $1,050 | 90 | 46 | 44 | Akre Capital Mgt, LLC |
| Hartford Div & Gr | Large Value | $3,596 | 64 | 14 | 50 | Wellington Mgt, LLC |
| Ivy Cundill Global Val | Foreign Large Val | $976 | 96 | 48 | 48 | Mackenzie Financial |
| Phoenix Mid-Cap Value | Mid-Cap Value | $541 | 75 | 48 | 27 | Sasco Capital Inc |
| Pioneer Cullen Value | Large Value | $2,428 | 70 | 35 | 35 | Cullen CapitaL Mgt LLC |
| RiverSource Value | Large Value | $403 | 67 | 29 | 38 | Lord, Abbet & Co, LLC |
| STI Classic Agg GrSt | Large Growth | $324 | 110 | 62 | 48 | Zevenbergen Cap Inv LLC |
| Touchstone Lg Cp Gr | Large Growth | $1,076 | 71 | 40 | 31 | Navellier & Assoc,Inc. |
| USAA Aggressive Gro | Large Growth | $1,182 | 50 | 29 | 21 | Marsico Capital Mgt,LLC |
| USAA Growth & Inc | Large Blend | $1,482 | 57 | 20 | 37 | Loomis, Sales, L.P. |
| USAA Income Stock | Large Value | $2,363 | 50 | 13 | 37 | GMO LLC |
| | Average | $1,372 | | | | |
| | Asset Weighted Averages | | 68 | 27 | 41 | |

119. *Oversight Hearing on Mutual Funds*, *supra* note 38, at 17 (testimony of Eliot L. Spitzer, N.Y. Att'y Gen.). As Spitzer noted:

> The [2003] ICI report used the amount charged by the sub-advisers without accounting for the premiums tacked on by the mutual funds and passed on to shareholders. The result is that even in mutual funds that are sub-advised, shareholders pay more for advisory services than the actual cost for that service incurred by the management company.

*Id.*

120. *See* Virginia Munger Kahn, *Investing: Mutual Fund Expertise, For Rent*, N.Y. TIMES, July 14, 2002, at B7 (reporting that actively managed funds with sub-advisers have an annual average expense ratio of 1.19 percent compared to 1.04 for funds managed directly by the fund's adviser).

121. The data is drawn from reports by Morningstar and Lipper Analytical.

Table 4 shows over $72 million annually in bill-padding by advisers of the listed sub-advised funds.[122] The sub-advisory fee data presented in Table 4 by no means exhausts the evidence reflecting inflation of overall advisory fees by fund managers who contract out the portfolio management function to sub-advisers.[123] Rather than support the industry's position that fund fees are fair, consideration of sub-advisory charges actually supports our thesis that mutual fund fees are grossly inflated and demonstrates how far conflicted fund managers have strayed from honest fiduciary principles.

There is another way to evaluate the industry's position that sub-advisory fees reflect the true cost of fund portfolio management. This way of testing the ICI/Coates-Hubbard thesis is to explore the ramifications of it being true as claimed that, on a weighted average basis, equity funds' portfolio investment management function actually costs only around 30 bps per year. The cost of all the rest of fund operations over and above the advisory function can readily be gauged. The weighted average expense ratio for the mutual fund industry's equity index funds is around 25 bps.[124] This is a telling figure, for it represents the true cost, on a weighted average basis, of performing all administrative and distribution services required to run a mutual fund with an

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122. Calculated by applying the 41 bps difference against the thirteen funds' $17.8 billion asset base.

123. For another example of advisory fee gouging despite the use of sub-advisers, consider this example involving sub-advisory services contracted out to Bernstein Investment Research and Management by Principal Management Corporation ("PMC"), the Principal Partners LargeCap Value Fund's investment manager:

| | | | | Other Fees | | |
|---|---|---|---|---|---|---|
| Assets | Management Fees | | | | Other | Total |
| *(Millions)* | *Bernstein* | *PMC* | *Total* | *12b-1 Fee* | Expenses | Expenses |
| 10 | 0.600 | 0.150 | 0.750 | 0.910 | 0.850 | 2.510 |
| 50 | 0.470 | 0.280 | 0.750 | 0.910 | 0.850 | 2.510 |
| 100 | 0.385 | 0.365 | 0.750 | 0.910 | 0.850 | 2.510 |
| 500 | 0.245 | 0.506 | 0.750 | 0.910 | 0.850 | 2.510 |
| 1,000 | 0.222 | 0.528 | 0.750 | 0.910 | 0.850 | 2.510 |
| 5,000 | 0.204 | 0.546 | 0.750 | 0.910 | 0.850 | 2.510 |

SWENSEN, *supra* note 72, at 240 tbl.8.7. Here, Bernstein is the sub-adviser, who bargained with PMC at arm's-length; PMC, the adviser, pads the bill. Note that Bernstein's management fees drop as the size of the fund increases, reflecting economies of scale. Note further that the savings realized by those economies of scale are diverted *completely* to PMC, which charges an escalated "management fee" to capture every last penny of savings.

124. *See* KARCESKI ET AL., *supra* note 32, at 16 tbl.2. Other data confirms a mutual fund can be organized and run on a total expense budget of less than 25 bps per year. The data from another source shows the weighted average annual expense ratio for no-load equity mutual funds during 1995-2004 to be a mere 19 bps. Houge & Wellman, *supra* note 56, at 28.

equity portfolio.[125] Stated differently, the only essential cost component missing for index funds, and present for actively managed funds, is portfolio management. If the average cost of advisory services approximates 30 bps, then the weighted average cost of the typical actively managed equity mutual fund ought to be around 55 bps (i.e., 30 bps for management plus 25 bps for everything else). Instead, for actively managed equity funds it is more than twice that—112 bps.[126]

The difference between the all-in cost of running an equity index mutual fund (25 bps) and the cost of running a typical managed equity fund (112 bps) thus is 87 bps. Adjusting that net number downward by 25 bps to account for so-called 12b-1 fees that many (but by no means all) actively-managed equity funds charge that index funds typically do not, still leaves a difference of 62 bps,[127] a number in line with the 59 bps average advisory fee for the industry's 500 largest actively managed equity funds noted earlier.[128]

The 62 bps number logically reflects the cost of portfolio advisory services, since advisory services are the only expenses (save 12b-1 fees, which we have already adjusted for in the preceding paragraph) that actively managed equity funds usually bear that equity index funds, as a rule, do not pay.[129] The 62 bps

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125. "Index funds, after all, actually are mutual funds." Freeman, *supra* note 3, at 773. Index funds lack advisory fees because they are not actively managed, but that is all they lack. Thus,

> [t]hey have shares, daily pricing, boards of directors, SEC regulatory requirements, prospectuses, 800 numbers, shareholder reports, etc. Fund sponsors set them up to make a profit for themselves, so profit to the sponsor is included, too, in the all-in cost of 25 [bps].

*Id.* at 773-74.

126. *See* KARCESKI ET AL., *supra* note 32, at 16 tbl.2. The difference between the 112 bps expense ratio noted here and the 91 bps expense ratios for mutual funds generally cited earlier, *supra* notes 31, 56 and accompanying text, is easily explained. Equity mutual funds tend to be more expensive to manage in comparison to other funds, such as bond funds and money market funds. *See* Chester S. Spatt, Chief Economist & Dir., Sec. Exch. Comm'n, Address to the Pennsylvania Association of Public Employee Retirement Systems (Apr. 12, 2007), *transcript available at* http://www.sec.gov/news/speech/2007/spch041207css.htm (noting that "equity portfolios often are more expensive to manage than fixed-rate accounts"). So an average of expense ratios in the fund industry as a whole will always be lower than the average expense ratio for the equity fund segment. Likewise easily explained is the difference between the 112 bps number and the results in Figure 4 suggesting lower expenses. Figure 4 reflects only advisory fee costs, not total expense ratios, which also include, *inter alia*, administrative and distribution costs.

127. Freeman-Brown found the weighted average advisory fee for equity funds was around 56 bps. *See* Freeman & Brown, *supra* note 9, at 631 tbl.3.

128. *See supra* text accompanying note 56.

129. No index fund pays any substantial portfolio advisory fee, since there is no active management. Most index funds do not charge 12b-1 fees, but some do. *See* Shauna Croome-

number is more than *double* the fee the ICI represents and Coates-Hubbard accepts[130] as the true cost of managing equity mutual fund portfolios, namely, around 30 bps. The roughly 30 bps gap between the typical advisory fee for managed equity mutual funds and the sub-advisors' typical fee of around 30 bps cannot be explained by the presence of hidden non-advisory expense items being imbedded in the advisory fee.[131] Rather, it confirms that mutual fund directors are grossly overpaying for fund advisory services, and gives some idea of the enormity of fund advisors' advisory profits.

*E. High Fees Drive Advisers' Profitability and Stock Market Performance*

A final problem with Coates-Hubbard's defense of the status quo for fund industry fee levels is that truly competitive pricing and fee levels ought to yield net financial returns for fund sponsors' traded stocks in line with the market generally. Instead, as one industry insider admitted on the record, fund sponsors preside over what is, for them, an "enormously profitable industry."[132] The fund management business is enormously profitable because of rampant fee gouging. To credibly advance the contrary position, Coates-Hubbard needs to demonstrate the cause for the outsized financial returns

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Carther, *You Can't Judge an Index Fund by Its Cover*, INVESTOPEDIA, June 11, 2003, http://www.investopedia.com/articles/mutualfund/03/061103.asp.

130. *See* Coates & Hubbard, *supra* note 11, at 187; Collins, *supra* note 77, at 8.

131. In so many words, this is the position taken by the ICI and adopted by Coates-Hubbard. *See supra* notes 90, 104 and accompanying text. The ICI contends, and Coates-Hubbard implies, that sub-advisory costs represent the true cost of providing portfolio management advice to mutual funds, with the difference between average fund sub-advisory costs (around 30 bps) and average advisory fees (around 60 bps) being explained by hidden non-advisory expenses buried in the advisory fee and not reported separately. *See generally* Coates & Hubbard, *supra* note 11; Collins, *supra* note 77. Keep in mind that major administrative expenses (custodial, transfer agent, printing, etc.), when separately itemized, total only 21 bps on average. Freeman & Brown, *supra* note 9, at 624 tbl.2. So, in order for the ICI and Coates-Hubbard to be correct in arguing that hidden expenses explain the difference between fund advisory fees on the one hand, and fund sub-advisory and pension advisory fees on the other, there would have to be about 30 bps of *additional* administrative costs in fund advisory fees, more than the average total level of identified and scheduled administrative fees reported by mutual funds to the SEC. This assumption simply is not credible. It is absurd to contend that, over and above a mutual fund's major scheduled administrative cost items, there are super-secret administrative costs that are too minor to mention separately yet systematically swamp those administrative costs that are itemized and disclosed. If this kind of financial misrepresentation were occurring, it would make funds' income statements materially misleading and the prospectuses presenting them actionable under section 11 of the Securities Act of 1933, 15 U.S.C. § 77k (2000).

132. Sec. Exch. Comm'n Historical Soc'y, *supra* note 8, at 33 (remarks of Joel Goldberg, former Director of Investment Management, Securities and Exchange Commission).

generated by sponsors' companies, other than extremely high revenue levels, consistent with a monopolistic industry.[133]

### *IV. The Regulatory Framework Is Broken*

Profitability at the levels encountered in the fund sponsor business is unheard of in regulated industries.[134] This makes the stock market performance of mutual fund managers all the more stunning for, in all of corporate finance, no securities issuers are subject to more intensive regulation than mutual funds.[135] Statutes, regulations, and decisions all have failed to rein in excessive fees. The question is, why?

The SEC surely deserves part of the blame. As the mutual fund marketplace's resident enforcement chief, the SEC talks a good game. For example, speaking of mutual funds costs, the Commission has proclaimed:

> While we can all applaud fair and reasonable fees, we think the best way to ensure them is a marketplace of vigorous, independent, and diligent mutual fund boards coupled with fully-informed investors who are armed with complete, easy-to-digest disclosure about the fees paid and the services rendered.[136]

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133. We showed earlier in Table 1, *supra*, that the market returns for five large publicly traded fund sponsors averaged 26.1% compared to an average return of 12.4% over matched periods for the S&P 500. As explained *supra* in note 28, a capitalization-weighted index of the universe of publicly traded fund sponsors (twenty-nine firms) had a compound average annual return of 27.8% from 1982-2006. A $100 investment in an index consisting of the universe of publicly traded fund sponsors starting in 1982 would have grown to over $46,000 by the end of 2006; the same money invested in the S&P 500 index over that period would have grown to $2300.

134. For example, public utilities, the paradigmatic regulated industry, have profit margins around 7.67%. *See* Utilities Sector - Yahoo! Finance Industry Browser, http://biz.yahoo.com/p/9qpmu.html (last visited Feb. 25, 2008). In contrast, profit margins for the asset management industry are over 17%. *See* Financial Sector - Yahoo! Finance Industry Browser, http://biz.yahoo.com/p/4qpmu.html (last visited Feb. 25, 2008). Some mutual fund sponsors boast profit margins that are far higher. Indeed, Bernstein lists a profit margin of 90%. *See* Yahoo! Finance Asset Management Industry Company List, http://biz.yahoo.com/p/422qpmd.html (last visited Feb. 25, 2008). That profit margin is more than eleven times higher than the typical profit margin for public utilities.

135. *See supra* note 6 and accompanying text.

136. Press Release, Sec. Exch. Comm'n, Alliance Capital Management Will Pay Record $250 Million and Make Significant Governance and Compliance Reforms to Settle SEC Charges (Dec. 18, 2003) [hereinafter SEC Press Release], *available at* http://www.sec.gov/news/press/2003-176.htm.

Even so, the SEC has failed to use its significant regulatory and enforcement power to make the "fair and reasonable fees" it talks about a reality.[137] As we have shown, "fair and reasonable" are not how an honest person would describe portfolio advisory fees charged, outside the Vanguard Group. Nor does one find compelling evidence that the fund marketplace is policed by "vigorous, independent, and diligent mutual fund boards."[138] Indeed, investor Warren Buffett has ridiculed directors for exhibiting "zombie-like" behavior "that makes a mockery of stewardship."[139] Yet, to date, the SEC has not brought a single action under Investment Company Act section 36(b) attacking fund portfolio management fees for being excessive.

The SEC has also failed mutual fund investors by not requiring mutual funds to supply investors with "complete, easy-to-digest disclosure" information, with clearly defined and segregated advisory costs.[140] This regulatory failure provides cover for those like Coates-Hubbard and the ICI who argue against the comparability of fund pricing data.[141] The agency's condonation of incomplete and inadequate expense disclosures subverts market forces and undermines fundamental purpose of ensuring full and fair disclosure.[142] By failing to insist on uniform expense categories and detailed disclosure of cost items, the SEC has played into the hands of fund sponsors who have no interest in seeing unfair pricing practices exposed or price competition flourishing.[143]

Congress, too, has not been solicitous of mutual fund investors, which is particularly noteworthy since members of Congress themselves are allowed to

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137. *Id.*

138. *Id.*

139. BERKSHIRE HATHAWAY INC., 2002 ANNUAL REPORT 17-18 (2003), *available at* http://www.berkshirehathaway.com/2002ar/2002ar.pdf.

140. *See supra* note 89.

141. Coates & Hubbard, *supra* note 11, at 185-86.

142. Henry T.C. Hu, *Faith and Magic: Investor Beliefs and Government Neutrality*, 78 TEX. L. REV. 777, 838 (2000) ("The specific philosophy governing the establishment of the SEC is . . . that the SEC should ensure that companies provide full and fair disclosure . . . .").

143. We agree with Coates-Hubbard that fee discrepancies can affect investors' purchasing patterns and can have a "material impact on advisers." Coates & Hubbard, *supra* note 11, at 212. But for the data to inform accurately, it needs to be uniform, complete, and clearly presented. This is not the case today. As one industry observer has complained, "Mutual funds have constructed a system where the costs are practically invisible." *Mutual Fund Industry Practices and Their Effect on Individual Investors: Hearing Before the Subcomm. on Capital Mkts., Ins., and Gov't Sponsored Enters. of the H. Comm. on Fin. Servs.*, 108th Cong. 157 (2003) (prepared statement of Gary Gensler, former Undersecretary for Domestic Finance, Dep't of the Treasury), *available at* http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname =108_house_hearings&docid=f:87798.pdf. An industry where costs are "practically invisible" is an industry where price competition is disadvantaged.

invest for their retirements in mutual fund-like entities operated for federal employees under the Thrift Savings Plan, similar to private 401(k) plans.[144] These index fund investments feature expense ratios of 11 bps or less, far less than the expense ratio's paid by virtually all mutual fund investors in the private sector.[145] When it comes to policing investment company expenses, Congress does a good job, so long as its members and their fellow federal employees are the purchasing investors. For the public at large, congressional indifference is palpable. Lacking sufficient protection from the SEC or from the halls of Congress, investors are left to obtain relief from excessive fees in federal courts. It is to these court actions to which we now turn.

*A. Introduction to the Federal Fiduciary Duty Scheme*

Analysis of fiduciary duty law applicable to mutual fund managers starts simply. The focus is on one statute, section 36(b) of the Investment Company Act ("ICA").[146] Section 36(b) was enacted in 1970. Between the ICA's 1940 enactment and 36(b)'s inclusion in 1970, the ICA lacked any "mechanism by which the fairness of management contracts could be tested in court."[147] Congress' decision to add section 36(b) was based on evidence generated by the SEC's PPI study that economies of scale stemming from booming growth in mutual fund assets in the 1950s and 1960s were not being fairly shared with fund shareholders.[148] The express civil liability provision was added as a tribute to the congressional finding that "the forces of arm's-length bargaining [did] not work in the mutual fund industry in the same manner as they [did] in other sectors of the American economy."[149] Section 36(b) provides, inter alia, that "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," and it empowers security holders to bring civil actions if investment advisers breach their fiduciary duties "in respect of such compensation or payments paid."[150]

Before the ICA was amended in 1970, mutual fund fees were evaluated pursuant to the "waste test" applied by state courts. The waste test is notoriously difficult to satisfy, requiring the plaintiff to show the challenged transaction was one that no reasonable person could view as representing "a

144. The federal retirement investment vehicle is discussed in *Oversight Hearing on Mutual Funds*, *supra* note 38, at 2 (opening statement of Sen. Peter G. Fitzgerald).

145. *Id.*

146. 15 U.S.C. § 80a-35(b) (2000).

147. S. REP. NO. 91-184, at 5 (1970), *as reprinted in* 1970 U.S.C.C.A.N. 4897, 4901.

148. PPI STUDY, *supra* note 9, at 10-12.

149. S. REP. NO. 91-184, at 5.

150. 15 U.S.C. § 80a-35(b).

fair exchange."[151] To win a state court waste case, moreover, all the defendant needed to show was that "any reasonable person might conclude that the deal made sense."[152] In enacting section 36(b), Congress recognized that the stiff burden imposed by the waste test was too demanding and, critically, sought to craft a "plaintiff-friendly" statute to lower the burden.[153] Specifically, Congress determined that, because "marketplace forces are not likely to operate as effectively," in the mutual fund industry, the corporate waste test was "unduly restrictive" and needed to be relaxed.[154] Yet, despite its promise, section 36(b), as interpreted and applied by the federal courts, has not served its intended purpose.

### *B. Fund Shareholders' Nemesis: The* Gartenberg *Standards*

#### *1. Introduction to the* Gartenberg *Ruling*

Congress was not alone in noting the pervasiveness of conflicts throughout mutual fund management and the need for a way to counterbalance those conflicts. The United States Supreme Court also has recognized the crucial flaw in the industry's peculiar governance structure.[155] While seeing and understanding a problem is one thing, fixing it is something else.

Just as one statute, ICA section 36(b), set the key fiduciary standard applicable to mutual fund compensation, one case has set the standard for how section 36(b) is interpreted and applied. *Gartenberg v. Merrill Lynch Asset*

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151. Steiner v. Meyerson, Civ. A. No. 13139, 1995 WL 441999, at *1 (Del. Ch. July 19, 1995).

152. *Id.*

153. Green v. Fund Asset Mgmt., L.P., 245 F.3d 214, 229 (3d Cir. 2001). In *Green*, the Third Circuit recognized the congressional intent for section 36(b) claims to be treated more leniently than excessive compensation claims would be treated under state law. *Id.* at 28-29.

154. S. REP. NO. 91-184, at 5.

155. In *Daily Income Fund, Inc. v. Fox*, 464 U.S. 523 (1984), the Supreme Court pointed out that within the fund industry, advisers typically do not compete by endeavoring to sell advisory services to existing funds. Rather, they create their own clients by forming mutual funds, setting up the funds' boards of directors, and then contracting with the boards to sell services to the captive client funds. The Supreme Court took notice that fund advisers typically established the mutual fund and frequently control the boards of directors with whom the advisers then sells services under annually approved advisory contracts. *See id.* at 536 ("Unlike most corporations, [a mutual fund] is typically created and managed by a pre-existing external organization known as an investment adviser . . . [that] often selects affiliated persons to serve on the [fund's] board of directors . . . ." (citation omitted)). Earlier, in *Burks v. Lasker*, the Court noted that, because self-dealing is ingrained in the adviser-fund relationship from its inception, "[t]he relationship between investment advisers and mutual funds is fraught with potential conflicts of interest." 441 U.S. 471, 480-81 (1979) (quoting Galfand v. Chestnutt Corp., 545 F.2d 807, 808 (2d Cir. 1976)) (alteration in original).

*Management, Inc.*,[156] decided on appeal in 1982, is still the leading section 36(b) case decided to date.[157]

*Gartenberg* was the first major fund industry fee case tried to a verdict. The trial judge, Milton Pollack, set a very high proof threshold,[158] and the Second Circuit's affirmance entrenched the "*Gartenberg* factors" as the principal yardstick for section 36(b) mutual fund fee litigation.[159] The *Gartenberg* factors have destroyed the promise held out by Congress in 1970 when it presented section 36(b) to fund shareholders as a fiduciary duty enforcement weapon. Despite stratospheric fees and resultant adviser profitability, to date, no complaining shareholder has ever won a lawsuit contesting mutual fund fee payouts under section 36(b).

A central point of this article is that the *Gartenberg* factors are passé. They were of limited use originally, but today they are of no use at all. Part of the reason why *Gartenberg* sets a failed standard for judging fiduciary duty breaches lies in the case's unique circumstances. Understanding *Gartenberg* requires an understanding of the economic times and the factual setting in which the case arose.

*Gartenberg* was a money market fund excessive fee case. The fund in question was Merrill Lynch's Ready Asset Trust. In late 1981 when the district court case was decided, the Merrill Lunch fund was "by far the largest

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156. 694 F.2d 923 (2d Cir. 1982). The U.S. District Court for the Southern District of New York decided the verdict in *Gartenberg* the year before. *See* Gartenberg v. Merrill Lynch Asset Mgmt., Inc., 528 F. Supp. 1038 (S.D.N.Y. 1981).

157. *See* Jeffrey S. Puretz, *Recent Developments for Mutual Funds and Fund Advisers*, *in* LIFE INS. CO. PRODS. 475, 532 (A.L.I.-A.B.A. Continuing Legal Educ. ed., 2006), *available at* Westlaw, SM039 ALI-ABA 475 (noting *Gartenberg* "was for many years followed by every court in reported decisions"). Numerous decisions endorsed *Gartneberg*. *See, e.g.*, *In re* Eaton Vance Mut. Funds Fee Litig., 380 F. Supp. 2d 222 (S.D.N.Y. 2005), *aff'd sub nom.* Bellikoff v. Eaton Vance Corp., 481 F.3d 110 (2d Cir. 2007); Kalish v. Franklin Advisers, Inc., 742 F. Supp. 1222 (S.D.N.Y. 1990), *aff'd*, 928 F.2d 590 (2d Cir. 1991); Meyer v. Oppenheimer Mgmt. Corp., 715 F. Supp. 574 (S.D.N.Y. 1989), *aff'd*, 895 F.2d 861 (2d Cir. 1990); Krinsk v. Fund Asset Mgmt., Inc., 715 F. Supp. 472, 493-94 (S.D.N.Y. 1988), *aff'd*, 875 F.2d 404 (2d Cir. 1989); Schuyt v. Rowe Price Prime Reserve Fund, Inc., 663 F. Supp. 962, 973-74 n.38 (S.D.N.Y. 1987), *aff'd*, 835 F.2d 45 (2d Cir. 1987). For a more complete listing of cases adopting *Gartneberg*, see James N. Benedict et al., *Recent Developments in Litigation Under the Investment Company Act of 1940*, *in* CORPORATE LAW AND PRACTICE COURSE HANDBOOK SERIES 571, 578 (Practising L. Inst. ed., 2003), *available at* Westlaw, 1373 PLI/Corp 571.

158. *See Gartenberg*, 528 F. Supp. 1038.

159. Very few fee cases have ever gone to trial on the merits. The first one that did post-*Gartenberg* was *Schuyt*, 663 F. Supp. 962. Like *Gartenberg*, *Schuyt* concerned a challenge to advisory fees charged for managing a money market fund. *Id.* And like *Gartenberg*, *Schuyt* was brought and decided in the Southern District of New York. *Id.* Other cases have also been won after trial by fund sponsors. *See Kalish*, 742 F. Supp. 1222; *Meyer*, 715 F. Supp. 574; *Krinsk*, 715 F. Supp. 472.

money market fund in existence,"[160] having exploded from $100 million in assets to over $19 billion "in just a few years."[161] Plaintiffs challenged as excessive the advisory fee paid to Merrill Lynch by its fast-growing money market fund.[162] Making the facts in *Gartenberg* distinctly different from those in modern fund fee cases was the fact that the Ready Asset fund was integrated into Merrill Lynch's sprawling branch office system. The fund had over 1.1 million shareholders,[163] and thousands of account executives were on hand at over 400 local offices to aid in processing and administering the 30,000-plus share orders received daily.[164] The orders were handled by the sales force "without any commission," leading to vexing cost accounting issues and considerable uncertainty over how much Merrill Lynch was paying for shareholder servicing and how much it was making as the fund's sponsor. Depending on how the numbers were crunched, and by whom, the fund's manager in 1980 either lost money or enjoyed an enviable profit margin exceeding 38%.[165]

### 2. *Evaluating Fiduciary Breaches Under* Gartenberg

The district court commenced its fiduciary duty analysis by acknowledging that under section 36(b), the adviser's conduct is to "be governed by the 'duty of uncompromising fidelity' and 'undivided loyalty.'"[166] The adviser must function "with an eye single to the best interests of the beneficiaries."[167] The

160. *Gartenberg*, 528 F. Supp. at 1042.

161. *Id.*

162. *Gartenberg*, 694 F.2d at 925.

163. *Gartenberg*, 528 F. Supp. at 1040.

164. *Id.* at 1041.

165. *Gartenberg*, 694 F.2d at 926. In 1980, the fund's assets exceeded $11 billion and generated a management fee of $33 million. *Id.* The defense's contention that managing the fund was unprofitable was premised on viewing the work of the Merrill Lynch brokers writing the ticket for the money market fund order as a loss item. The defense ignored the fact that the broker writing that ticket typically made a commission on the other side of that order, either purchasing stocks paid for out of the money market fund, or selling stocks generating cash to be deposited into the fund. Though the stock market side of Ready Assets transactions were enormously profitable to Merrill Lynch and its sales force, those benefits were ignored by the district court, which found: "[A]ny study of the benefits to Merrill Lynch as a result of the Fund's existence would be difficult, time-consuming and expensive, and probably entirely inconclusive, even if all of the logical problems could be resolved." *Gartenberg*, 528 F. Supp. at 1056. The court of appeals rejected the notion that estimating Merrill Lynch's fall-out benefits was impossible but found those benefits could not be considered because the plaintiffs never proved what they were. *Gartenberg*, 694 F.2d at 932.

166. *Gartenberg*, 528 F. Supp. at 1047 (citing Galfand v. Chestnutt, 545 F.2d 807, 809, 811 (2d Cir. 1976)).

167. *Id.* (citing Rosenfeld v. Black, 445 F.2d 1337, 1342 (2d Cir. 1971)).

court also found that candor and fair dealing are mandatory when the adviser deals with the fund over fees.[168] Distilled down, the district court held: "The essence of the [fiduciary duty] test is whether or not under all the circumstances the transaction carries the earmarks of an arm's length bargain."[169] The foregoing pronouncements are unexceptionable and consistent with section 36(b)'s plain language and legislative intent.

The trial court then held that section 36(b) requires proof of unfairness, giving due consideration to the "nature, quality and extent" of the services rendered to the fund in relation to the fee paid[170] plus "the money market fund industry practice and level of management fees."[171] This latter consideration was a problem. In suggesting that fund industry practices or fee levels provide useful standards for evaluating fees, the court did investors a massive disservice. Section 36(b) was created *precisely* because the fund industry's uniquely conflicted governance system could not be trusted to deliver fair pricing. Evaluating no-bid contract prices against other no-bid contract prices is futile. The lower court properly proclaimed: "The market price—freely available and competitively set—serves as a standard to test the fairness of the investment advisory fee . . . ."[172] Nonetheless, the lower court improperly permitted Merrill Lynch to defend its fees in reference to other similarly-tainted transactions, failing to recognize that, because of the conflicts described in Part I, mutual fund fees are not "competitively set" and thus are ineffective guideposts for use in judging arm's-length bargaining or pricing fairness.

On appeal, the plaintiffs in *Gartenberg* tried to convince the appellate court that the lower court's fairness standard tied to a "market price . . . freely available and competitively set"[173] sounded reasonable but bore no relationship to fund market reality.[174] The Second Circuit evidently recognized the no-bid nature of fund industry pricing, pointing to "the existence in most cases of an *unseverable relationship* between the adviser-manager and the fund it services."[175] But the appellate court nevertheless rejected the plaintiffs' contentions. The court held that, in a section 36(b) fee case, the plaintiff must

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168. Specifically, the court noted that "it is well settled that the investment adviser owes a duty of full disclosure to the trustees and shareholders of the Fund. And even when full disclosure has been made, the courts must subject the transaction to rigorous scrutiny for fairness." *Id.* (citations omitted) (internal quotation marks omitted).

169. *Id.* (quoting Pepper v. Litton, 308 U.S. 295, 306-07 (1939)).

170. *Id.*

171. Gartenberg v. Merrill Lynch Asset Mgmt., Inc., 694 F.2d 923, 927 (2d Cir. 1982).

172. *Gartenberg*, 528 F. Supp. at 1067.

173. *Id.*

174. *Gartenberg*, 694 F.2d at 929.

175. *Id.* (emphasis added).

demonstrate that "the adviser-manager [charges] 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."[176] Whether it did so deliberately, the appellate court imported into section 36(b) actions a de facto waste requirement, precisely the proof threshold Congress sought to eliminate by drafting section 36(b) in the first place.

This important substantive ruling was paired with an equally important and devastating evidentiary finding. The Second Circuit rejected the plaintiffs' contention that comparisons with fees charged pension plans were a worthy "criterion for determining fair advisory fees for money market funds."[177] According to the court, pension funds do not "face the myriad of daily purchases and redemptions throughout the nation which must be handled by the Fund, in which a purchaser may invest for only a few days."[178] As discussed below, the *Gartenberg* court's greatest failing was its refusal to accept that the pricing of investment advisory services offered in the free market provides a legitimate and helpful guidepost for evaluating such services in the fund market.

There are three reasons why the court's refusal to consider this comparative data made no sense. First, the cost of servicing accounts—of handling purchases and redemptions—is an administrative cost, not a cost associated with the portfolio management. The focus in fund fee cases belongs on the portfolio advisory function, not on administrative matters. Administrative costs need to be—and almost always are—broken out and accounted for separately. Second, if the defense's position was that the advisory function was made more expensive by having to adjust for inflows and outflows of cash, then the extra labor and the cost thereof should have been isolated and used as a variable to justify an increase (very likely slight)[179] in mutual fund portfolio management pricing. The key is that the extra cost item needed to be identified and quantified; it needed to be proved. The third reason why

176. *Id.* at 928.

177. *Id.* at 930 n.3.

178. *Id.*

179. The so-called liquidity factor was alluded to by the Second Circuit in *Gartenberg* when it referred to fund managers having to deal with "the myriad of daily purchases and redemptions" by fund shareholders. *Id.* As we have seen, the alleged liquidity factor is a bogus justification for differentiating fund advisory fees from those charged for managing pension assets. The factor has been talked about but has never been quantified, and there is some evidence it does not exist at all. *See supra* notes 105-12 and accompanying text. It is thus absurd to bar use of pension fee comparisons based on a supposedly special, distinctive mutual fund cost factor that has never been quantified. Moreover, if the elusive "liquidity factor" ever were identified and quantified, all anyone making fee comparisons using non-fund data would need to do is adjust for it.

*Gartenberg* erred in excluding comparative free market data has to do with a basic statistical concept. Missing from the court's analysis is recognition of the law of large numbers,[180] the statistical concept that guarantees a money fund manager's investment job is not made dramatically more difficult by constant inflows and outflows caused by individual trades.[181] Contrary to the court of appeals' analysis, a mutual fund portfolio manager, like the pension fund portfolio adviser, confronts each day a single net dollar inflow or outflow number calling for investment decision-making.[182] The *Gartenberg* court made a mistake in refusing to admit comparative free market data—a mistake that freed fund sponsors' advisory fees from the searching scrutiny Congress wanted.

### *3. The* Gartenberg *Factors, and Why They Stack the Deck Against Fund Shareholders*

Rather than permit the introduction of real free market data in the form of pension fund fee advisory fee evidence, the court enumerated the following six factors, today commonly known as "the *Gartenberg* factors,"[183] to be weighed in determining fee disproportionality: (1) the nature and quality of the services rendered; (2) the profitability of the funds to the adviser; (3) economies of scale; (4) comparative fee structures;[184] (5) fallout benefits (i.e., indirect profits

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180. In the investment context:

> [T]he law of large numbers suggests that institutional funds need to trade . . . far less often than individuals do. Institutions represent ever-changing pools of individual investors. So long as new investors buy in at roughly the same rate that old investors redeem their interests . . . the fund can meet individuals' liquidity needs without buying or selling assets. Liquidity buying and selling is only necessary for institutions when large numbers of individuals simultaneously either put money into, or draw money out of, the fund.

Lynn A. Stout, *Are Stock Markets Costly Casinos?: Disagreement, Market Failure, and Securities Regulation*, 81 VA. L. REV. 611, 665 n.171 (1995). To state the law of large numbers more precisely, the mean of a sample approaches the expected value of a sample size as the sample size tends toward infinity—the difference between the sample's mean and the expected value shrinks as the size of the sample gets larger. *See* Jeffrey D. Blume & Richard M. Royall, *Illustrating the Law of Large Numbers (and Confidence Intervals)*, AM. STATISTICIAN, Feb. 2003, at 51.

181. It is relatively certain that the court received no such information. Admissible evidence about pension fund advisory fees, and a full explanation why that evidence is probative, apparently was not submitted to the lower court for its consideration.

182. This is so for money market funds as well.

183. *See, e.g.*, Benedict et al., *supra* note 157, at 578 (discussing various 36(b) cases in light of holdings on the "*Gartenberg* factors").

184. Historically, this factor called for analysis of fees and expense ratios of other similar mutual funds. In light of SEC rulemaking, *see infra* notes 237-41 and accompanying text, today, mutual funds must reveal if the board considered the fees charged by the adviser to other

derived by the adviser as an outgrowth of its control position); and (6) the care and conscientiousness of the fund directors.[185] By relying on the above six factors to determine disproportionality, rather than real free market data (from Vanguard, pension funds, separate accounts, or the like), *Gartenberg* and its progeny demand that fund shareholders, bold enough to launch fiduciary duty attacks, build their cases largely out of data that is always skewed, often hidden, and, if found, invariably subject to ferocious disputes in subjective interpretation.

We begin with factor 2, the fund's profitability to the adviser. "Profitability is one of the most difficult factors to analyze in reviewing an advisory contract."[186] Profitability is difficult to calculate, for starters, because it is tough to obtain the raw data necessary to make the calculations. For instance, to calculate profits, one must first look to the adviser's cost of servicing the fund, data mutual funds jealously guard. Indeed, some years ago, the SEC's Chief Economist was asked about seeking to collect industry-wide data on fund advisory firms' revenue, costs, and profitability. He responded: "As to your suggestion that the SEC's Chief Economist do a revenue/cost/profit study, I know I'd be interested, but I don't think the industry would oblige us."[187] To even start a profitability analysis, a plaintiff must marshal evidence the SEC itself does not have and says it cannot obtain.[188] Exacerbating the difficulties, uniform expense categories and accounting methodologies do not exist, as the SEC staff's inability to analyze portfolio management costs, discussed further *infra*, shows.[189]

Next, even if the raw data is found, profitability calculations involve cost allocation issues that are subject to dispute, and there is no universally accepted methodology for making the analysis. This means that, in practice, profitability is bitterly contested. Recall that in *Gartenberg*, the experts' analysis of the advisers' profitability left the court in doubt whether the adviser had enjoyed a lush profit margin in 1980 of 38% or more or had suffered a

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non-mutual fund clients and if not, why not. The SEC rulemaking, we (and others) contend, brings comparative free market data into play under the *Gartenberg* test. *See* Laurin Blumenthal Kleiman & Carla G. Teodoro, *Forming, Organizing and Operating a Mutual Fund: Legal and Practical Considerations*, *in* THE ABCS OF MUTUAL FUNDS 2007, at 9, 31 & n.32 (Practising L. Inst. ed., 2007), *available at* Westlaw, 1612 PLI/Corp 9 (suggesting that comparative data cannot be ignored by boards in light of the SEC's rulemaking).

185. Gartenberg v. Merrill Lynch Asset Mgmt., Inc., 694 F.2d 923, 929-30 (2d Cir. 1982).

186. Am. Bar Ass'n, *Fund Director's Guidebook*, 52 BUS. LAW. 229, 250 (1996).

187. Letter from Erik Sirri, Chief Economist, Sec. Exch. Comm'n, to John C. Bogle, Chairman, The Vanguard Group (Mar. 23, 1999) (on file with the authors).

188. The SEC has also announced that it is unable to evaluate economies of scale in the fund industry because the data is lacking. *See infra* notes 205-07 and accompanying text.

189. *See infra* notes 205-07 and accompanying text.

loss.[190] In another Merrill Lynch-related fund case brought under section 36(b), the plaintiff's expert testified that, in a given year, Merrill Lynch's Cash Management Account generated pre-tax profits of $47.5 million and a pre-tax return on revenues of 28.5%.[191] For the same period, Merrill Lynch's chief expert reported a loss of $77 million and a *negative* profitability of 55.8%.[192] Over a three-year period, plaintiff's expert determined average annual profitability of the fee contract to the adviser was 40.4%; the defense expert's estimate was an annual return of *minus* 32.7%.[193] After disparaging both sides' presentations on profitability, the court concluded that a weighted average of pre-tax profitability over the three-year test period "would probably fall in a range from at least a few percentage points greater than 0% to perhaps as much as 33%."[194] In other words, all the parties' efforts, complete with expert reports and testimony, left the court clueless when gauging the adviser's profitability over the period in question. Likewise, in another fee case, the court found that calculating the adviser's cost of servicing the captive fund was a "virtually impossible task."[195] Given that profitability data is hidden, subject to fierce dispute once found, and next to impossible for courts to analyze, it is unclear what is gained by making proof about the adviser's profitability a criterion for recovery in cases attacking advisory fees.

Factor 3, economies of scale, is no less vexing. It is common knowledge that, as one fund industry pioneer has stated, "the economies of scale in fund operations are truly staggering."[196] The reason for this, according to one fund industry insider, is that "[t]he marginal costs of managing increasing dollars is minimal."[197]

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190. *Gartenberg*, 694 F.2d at 926.

191. Krinsk v. Fund Asset Mgmt., Inc., 715 F. Supp. 472, 489 (S.D.N.Y. 1988) (showing estimated profits and profitability percentages in a table comparing three studies), *aff'd*, 875 F.2d 404 (2d Cir. 1989)

192. *Id.* (showing a table containing data from Merrill Lynch's expert).

193. *Id.* at 494.

194. *Id.* According to the plaintiffs, Merrill Lynch's average annual profitability for 1984 to 1986 was 40.4%; the defendants' expert estimated average profitability for the same period to be -32.7%. *Id.*

195. Schuyt v. Rowe Price Prime Reserve Fund, Inc., 663 F. Supp. 962, 978 (S.D.N.Y. 1987), *aff'd*, 835 F.2d 45 (2d Cir. 1987). The same court held that the fund adviser's profit did not need to be disclosed to investors because profitability was not a material fact, *id.* at 990, even though the adviser's pretax profit margin was colossal, exceeding 77%. *Id.* at 977. If it is true that the adviser's profitability is not an important fact for plaintiffs to know about, then it follows shareholders should not be required to assemble and present profitability data in order to win fee cases.

196. Bogle, *supra* note 42, at 417.

197. Kahn, *supra* note 120, at B7 (quoting Jeffrey S. Molitor, Dir. of Portfolio Review, Vanguard Group).

There is no shortage of proof that economies of scale exist. In Part III, we show in Figure 3 and Tables 2 and 3 how Vanguard harnesses economies of scale to save its investors millions annually. Freeman-Brown found that advisory fees dropped sharply in the public pension marketplace as the pension funds' asset size increased.[198] Likewise, fund adviser Franklin Resource's tremendous success as a growth stock has been fueled by its ability to benefit from the economies of scale available as the size of fund assets under management grows. As Greg Johnson, CEO of Franklin Resources, explained: "We benefit from economies of scale. . . . As our asset base grows, the cost of servicing our shareholders does not grow proportionately."[199] Johnson's admission that economies of scale benefit the fund adviser tremendously comes as no surprise. Economies of scale obviously exist and are there to be realized.

And of course this makes sense. It is not that much harder to manage $1 billion than $100 million. Regardless of the size of the fund, one must evaluate and buy portfolio investments; the bigger the fund, the more shares you buy. Yet if one charged 2% to manage the $100 million fund, he would make $2 million annually, and to manage the $1 billion fund, he would make ten times as much. Recognizing this, pension managers insist that fees drop sharply as assets under management grow.[200] Vanguard's board does the same.[201] Outside the Vanguard Group, however, advisory fee levels fall little as funds' asset size skyrockets.[202]

Knowing that fund advisers exploit "staggering" economies of scale which are not being fairly shared with captive funds is one thing.[203] Proving it in a court of law is something different entirely. To prove factor 3—that economies of scale generated by fund asset growth have been converted into

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198. Freeman & Brown, *supra* note 9, at 632.

199. John Eckhouse, *Franklin Wins Again*, S.F. CHRON., Apr. 20, 1992, at D6.

200. Freeman & Brown, *supra* note 9, at 627-34.

201. *See supra* Table 2, Table 3 & Figure 3.

202. *See supra* Table 3 and accompanying text. Freeman-Brown found that, in mutual funds, the average fee charged was essentially flat through the fund sample's first seven deciles (covering the funds making up the first 70% of the sample, ranked according to size) and the fee charged was consistently greater than 70 bps. Freeman & Brown, *supra* note 9, at 632. Fees declined when fund size increased above about $750 million, but the decline was modest when compared to significant declines seen in pension funds. *Id.*

203. One experienced fund industry observer had this to say about economies of scale in the asset management side of the mutual fund industry and the extent to which the industry's advisers share them with fund shareholders:

> The staggering economies that I . . . know exist in the field of money management failed to materialize as total equity fund expenses rose [from 1980-2005] from $280 million a year to $37 billion a year, 129 times over.

Bogle, *supra* note 40.

unfairly high profits and improperly diverted by the fund's adviser—the plaintiff must have detailed cost[204] and profitability data. As explained above, data about the adviser's operations are viewed as proprietary and are not readily available even to the SEC,[205] much less to fund shareholders. A conclusion reached in a 2000 SEC report on mutual fund fees vividly illustrates the difficulty of obtaining this data.[206] In that study, the SEC staff explained that it was unable to "analyze directly the cost of providing portfolio management services to a mutual fund in order to determine whether economies exist (*because the data are unavailable*)."[207] This means that the SEC's own staff of lawyers and financial economists, specialized mutual fund experts all, have solemnly informed us they cannot locate cost data sufficient to permit them to analyze and opine upon whether economies of scale even exist in the fund industry because the staff lacks access to industry cost data regarding the portfolio management function. Given that the SEC has been left in the dark, it follows that mere fund shareholders, lacking the SEC's expertise, resources, and clout, also are apt to have a grave problem locating the cost and profitability data needed to make economies of scale calculations in litigation under *Gartenberg*.

Even assuming the cost and profitability data needed to generate economies-of-scale data can be obtained through discovery, the data still are subject to bitter arguments over accuracy and completeness.[208] Arguments are

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204. Cost data is especially difficult to isolate because even if the most easily calculated type of cost information—direct expenses for pure portfolio management—were available, costing out the advisory function (i.e., excluding administrative and distribution costs) would still necessitate allocating an appropriate share of the advisory firm's indirect costs, including overhead.

205. *See supra* notes 187-88 and accompanying text.

206. DIV. OF INV. MGMT., SEC. EXCH. COMM'N, REPORT ON MUTUAL FUND FEES AND EXPENSES (2000), *available at* http://www.sec.gov/news/studies/feestudy.htm.

207. *Id.* (emphasis added).

208. For example, consider the following complaints over deceptive accounting and misleading board disclosures advanced by investors in one fund fee case:

> Plaintiffs adduced an assortment of evidence that Harris provided the board with materially misleading and inaccurate information directly bearing on the reasonableness of Harris's fees. Among other things, Plaintiffs demonstrated that Harris grossly understated its profit margins to the board by accounting for huge profit-sharing payments to its partners as business expenses. Plaintiffs also demonstrated that Harris failed to supply the board with an economies-of-scale analysis and instead furnished it with misleading cost information that masked Harris's economies of scale. In addition, Harris provided the board with information regarding marketing and distribution payments that failed to disclose that Harris's accounting methodologies had caused the funds to bear an inappropriately large portion of these payments.

Reply Brief of Plaintiffs-Appellants at 18-19, Jones v. Harris Assocs. L.P., No. 2007-1624 (7th inevitable, in part, because there is no standard methodology to evaluate economies of scale within the mutual fund industry. Furthermore, in the authors' experience, fund companies have no problem finding and hiring well-credentialed experts to argue that the types of mutual funds most commonly involved in fee litigation (huge equity funds charging huge fees and generating enormous profits for the adviser) actually have no economies of scale at all.[209] Establishing that economies of scale both exist and have not been properly shared are crucial undertakings for plaintiffs in section 36(b) cases.[210] Because of the foregoing problems, to put it mildly, success is by no means guaranteed.

Likewise daunting for plaintiffs is the subject matter covered by items (5) and (6), fall-out benefits and directors' conscientiousness. Fall-out benefits are

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Cir. July 2, 2007) (citations omitted), *available at* http://www.ca7.uscourts.gov/briefs.htm (search for "07-1624"; then follow "07-1624 005.pdf" hyperlink).

209. The claim is that fund portfolio management offers no economies of scale on a marginal or forward-looking basis. The defense contention is that the only thing relevant to assessing economies is whether future operations will yield additional economies of scale that would justify a fee cut. The problem with this view is that in any given year, the fee contract being negotiated covers *all* assets under management, not just assets apt to be brought into the fund over the next yearly period covered by the advisory fee. The fee level set by the prevailing fee schedule is not the adviser's property. It is up for re-negotiation on an annual basis. No aspect of the fund's advisory fee payments are beyond questioning by fund boards. The Investment Company Act's governance scheme is intentionally slanted to give fund boards power over advisers who may believe they have a proprietary right to current fee levels. The statute requires annual approval of the fund's advisory contract covering all assets. *See* 15 U.S.C. § 80a-15(c) (2000). Congress deliberately gave fund boards annually-renewable power to fire the adviser and put the management contract covering all those assets up for bid. *See* Am. Bar Ass'n, *supra* note 186, at 249 ("The independent directors' ability, indeed their obligation, to consider the investment advisory agreement annually is the principal source of their leverage in dealing with the investment adviser."). Thus, it is simply wrong to say that economies of scale realized in the future are the only ones relevant in setting fund advisory fees.

210. The essence of an unfair fee case is that the adviser is profiting unfairly at the expense of fund shareholders. The simplest way to show this is to prove that the adviser captures a disproportionate share of the gains realized as revenues grow faster than expenses. This analysis calls for recognition that annual approval of the advisory contract places in issue, each year, the entire revenue stream for the advisory function, not just an incremental amount reflecting the amount to be spent based on expected fund asset growth over the next year. It is the board's job to monitor and control the advisory function. The fund's board controls fee setting. It has the power to replace the adviser each time the fee contract comes up for renewal. Thus, the fee approval undertaking addresses not a marginal cost, but every single dollar to be paid. In other words, there is not an ongoing fee contract with a layer of fee payments that is not eligible for inspection, analysis, or rejection. A guidebook written to educate fund directors about their fiduciary duties recognizes that review of the fund's growth over time is the crucial inquiry. *See* Am. Bar Ass'n, *supra* note 186, at 250 (calling on directors to analyze "the extent to which the adviser has realized economies of scale as a fund grows").

money-making tie-ins available to a fund's adviser by reason of its position.[211]

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211. A listing of various potential types of fall-out benefits that supposedly "are passed on to shareholders," was set forth by Professors Coates and Hubbard in an earlier version of their article published as a working paper by the American Enterprise Institute. *See Coates-Hubbard Working Paper*, *supra* note 79, at 57-58 n.123. It is by no means clear that, as the Coates-Hubbard Working Paper suggests, fund shareholders are on the receiving end of abundant fall-out benefits. Missing from their report is any data backing up these claims. Among other things, the Coates-Hubbard Working Paper contends shareholders profit through economies of scale when new investors are brought into the fund. *Id.* This economies argument was, of course, one of the major selling points when Rule 12b-1 was adopted. The idea that sales to new investors financed out of fund assets are beneficial to existing fund shareholders is dubious and not supported by the literature. *See, e.g.*, LORI WALSH, THE COSTS AND BENEFITS TO FUND SHAREHOLDERS OF 12B-1 PLANS 2 (2004) *available at* http://www.sec.gov/rules/proposed/s70904/lwalsh042604.pdf.

Other supposed fall-out benefits accruing to fund shareholders, according to the Coates-Hubbard Working Paper, are "[a]lleged rebates and soft dollar payments." *Coates-Hubbard Working Paper*, *supra* note 79, at 57-58 n.123. An "alleged" rebate has no recognized meaning and is thus hard to view as a benefit, if it exists at all. Actual rebates from service providers returning costs borne by the fund clearly are bad unless they are 100% paid into the fund, and in two cases rebates (akin to kickbacks) were demanded by the adviser from the funds' service providers, causing the funds to be overcharged and the adviser to be unjustly enriched. *See SEC v. Jones*, No. 05 Civ. 7044(RCC), 2006 WL 1084276 (S.D.N.Y. Apr. 25, 2006); *In re* BISYS Fund Servs., Inc., Investment Advisers Act Release No. 2554, Investment Company Act Release No. 27,500, SEC Admin. Proc. File No. 3-12432 (Sept. 26, 2006), *available at* http://www.sec.gov/litigation/admin/2006/ia-2554.pdf. As for soft dollars, they undercut price competition if undisclosed. The practice of padding brokerage costs (which, of course, are not reflected in funds' expense ratios) to generate money to pay for advisory services raises major policy issues. If the expenditures do not go to reduce the fund's advisory fees, the true amount being paid for advisory services is distorted, and fiduciary duty issues of fairness and full disclosure are implicated.

Additional supposed "fall-out" benefits singled out by the Coates-Hubbard Working Paper as beneficial to fund shareholders are particularly puzzling. One such category is "[r]eusing research and portfolio management." *Coates-Hubbard Working Paper*, *supra* note 79, at 57-58 n.123. Here is what the Coates-Hubbard Working Paper says in explaining how the fund benefits when the adviser resells the research know-how it developed at fund shareholders' expense:

> Using the research for additional portfolio management business, such as contracting to become a sub-advisor for another fund or an external portfolio manager for an institutional client, allows the fund to gain further incremental revenues toward covering total costs, benefiting all fund investors.

*Id.* This is a peculiar statement. It assumes that when, for example, Alliance Capital sold its services to the Wyoming Plan for 10 bps as discussed above, *see supra* note 99 and accompanying text, this transaction financially benefited Alliance Capital's Premier Growth Fund shareholders. But we are unaware of any tradition of fee sharing between advisers and funds in such cases. We are unaware of any instances—and the Coates-Hubbard Working Paper provides no examples—where "incremental revenues" collected by fund advisers are forwarded to the fund that paid for the original advisory work. What instead seems to be the norm is that

They were considered in *Gartenberg* because the fund in question, the Ready Asset Trust, was developed and flourished as an integral part of the Merrill Lynch brokerage operation.[212] Merrill Lynch enjoyed substantial fall-out benefits under the *Gartenberg* facts because cash inflows or outflows from the firm's money market fund often were tied to brokerage transactions creating commission income for the firm and its brokers. The same logic does not apply in a contemporary standard fund fee case challenging pure portfolio advisory fees. Unlike Merrill Lynch's situation in *Gartenberg*, today's typical fee case involves a free-standing mutual fund operation with no captive sales force. Typically the adviser and its affiliates operate under separate contracts covering the advisory, distribution, and administrative functions. In this different—and far more common—setting, there is no good reason why fall-out benefits must or should be analyzed as part of the advisory fee reasonableness calculus.[213]

This is especially true since weighing fall-out benefits is no easy task. Fall-out data is hard to find because, at present, public disclosures of advisers' business dealings with the fund tend to be summary "laundry lists," devoid of useful and necessary detail.[214] Information about fall-out benefits that would

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advisers take sensitive, proprietary research paid for by the fund and convert the asset to their personal benefit. The advisers thus use the funds' property—the information gleaned—to sub-advise other entities, keeping the profits for themselves, and raising fiduciary duty/corporate opportunity problems in the process. What is particularly odd, in the authors' experience, is that the sub-adviser's work tends to be done for others at a much lower price than was charged for the work performed for the originating fund.

212. Gartenberg v. Merrill Lynch Asset Mgmt., Inc., 528 F. Supp. 1038, 1055-56 (S.D.N.Y. 1981), *aff'd*, 694 F.2d 923 (2d Cir. 1982).

213. The presence or absence of fall-out benefits has next-to-nothing to do with the reasonableness of the adviser's pay for doing a specific task, namely running the fund's portfolio advisory operation. Each potential fall-out benefit is a separate, free-standing source of potential revenue for both the fund itself and the fund sponsor's organization. Sensible governance requires that these free-standing opportunities be the subject of separate negotiations and agreements between the fund's board and the adviser. Because each potential benefit relates to a discrete corporate opportunity that presumptively belongs to the fund, each needs to be disclosed, accounted for, quantified, and then approved by the fund's board upon terms that are fair to the fund and its shareholders.

214. *See, e.g.*, Fidelity Magellan Fund, Prospectus (Form 485BPOS) (May 29, 2005) [hereinafter Fidelity Prospectus], *available at* http://www.sec.gov/Archives/edgar/data/61397/000006139705000004/main.htm. The Fidelity Prospectus discusses the fund board's consideration of the adviser's fall-out benefits as follows:

> The Board of Trustees . . . also considered the character and amount of fees paid by the fund and the fund's shareholders for services provided by the Investment Advisers and their affiliates, including fees for services like transfer agency, fund accounting, and direct shareholder services. It also considered the allocation of fund brokerage to brokers affiliated with the Investment Advisers, the receipt of

be useful in fashioning a legal complaint is hidden from public view. Given that fall-out benefits are usually irrelevant and always burdensome, the scale should tip against courts requiring this fifth *Gartenberg* factor.

Data on the sixth *Gartenberg* factor, directors' diligence, likewise is hard to find and evaluate. Not until June 2004, twenty-two years after the lower court's ruling in *Gartenberg*, did the SEC begin to require that mutual fund boards disclose the material factors considered by fund boards in approving advisory contracts.[215] Even now, the required disclosure is generally made in vague terms. They are mere recitations of the many factors considered, and are devoid of details about how fees were determined or other specifics a shareholder would need to know in order to evaluate the director's level of care.[216] Moreover, directors' care and diligence is hard to evaluate. Neither

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> sales loads and payments under Rule 12b-1 plans in respect of certain of the Fidelity funds, and benefits to the Investment Advisers from the use of "soft" commission dollars to pay for research and brokerage services. [It] also considered the revenues and profitability of the Investment Advisers' businesses other than their mutual fund business, including the Investment Advisers' retail brokerage, correspondent brokerage, capital markets, trust, investment advisory, pension record keeping, insurance, publishing, real estate, international research and investment funds, and others. [It also] considered the intangible benefits that accrue to the Investment Advisers and their affiliates by virtue of their relationship with the fund.

*Id.* Note the lack of specific data. Without clear identification of the fall-out benefits being evaluated, their dollar values, and the extent to which they are shared by the adviser with the fund, a shareholder has no means of analyzing, based on publicly available information, whether the adviser's dealings with fall-out benefits was handled properly.

215. Disclosure Regarding Approval of Investment Advisory Contracts by Directors of Investment Companies, Securities Act Release No. 8433, Exchange Act Release No. 49,909, Investment Company Act Release No. 26,486, 69 Fed. Reg. 39,798 (June 30, 2004).

216. For example, consider this description of advisory fee decision-making presented in the Fidelity Prospectus:

> The Board of Trustees has established two Fund Contract Committees: the Equity Contract Committee (composed of Messrs. Stavropoulos (Chair), Gamper, and Lautenbach, Dr. Heilmeier, and Ms. Small) and the Fixed-Income Contract Committee (composed of Ms. Small (Chair), Mr. Dirks, and Ms. Knowles). . . . With respect to each fund under its purview, each committee: requests and receives information on the nature, extent, and quality of services provided to the shareholders of the Fidelity funds by the investment advisers and their respective affiliates, fund performance, the investment performance of the investment adviser, and such other information as the committee determines to be reasonably necessary to evaluate the terms of the investment advisory agreements; considers the cost of the services to be provided and the profitability and other benefits that the investment advisers and their respective affiliates derive or will derive from their contractual arrangements with each of the funds (including tangible and intangible "fall-out benefits"); considers the extent to which economies of scale

the SEC nor the fund industry have ever attempted to articulate a set of minimum standards directors must meet in order to fulfill their fiduciary obligations.[217]

In sum, the federal fiduciary standard applied in section 36(b) cases under *Gartenberg* is an infirm and warped legal standard requiring scrutiny of hidden or essentially undiscoverable data that, even if found, are subject to wildly different interpretations by well paid and highly-credentialed experts. It is not plaintiff-friendly, as Congress intended. It is not an improvement on the common law of waste standard. In truth, it is not a competent, legitimate fiduciary duty standard at all.

## *V. A Better Way to Evaluate Mutual Fund Fees*

Section 36(b), informed by *Gartenberg*, has thus proven to be the least useful express federal securities remedy for private litigants and has failed for thirty-seven years to yield a single trial verdict for plaintiffs. Meanwhile, fund shareholders pay fees generating astronomical profit margins[218] to their conflicted fiduciaries who typically provide investment returns lagging

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> would be realized as the funds grow and whether fee levels reflect those economies of scale for the benefit of fund investors; considers methodologies for determining the extent to which the funds benefit from economies of scale and refinements to these methodologies; considers information comparing the services to be rendered and the amount to be paid under the funds' contracts with those under other investment advisory contracts entered into with [Fidelity Management & Research Company] and its affiliates and other investment advisers, such as contracts with other registered investment companies or other types of clients; considers such other matters and information as may be necessary and appropriate to evaluate investment advisory agreements of the funds; and makes recommendations to the Board concerning the approval or renewal of investment advisory agreements. Each committee will consult with the other committees of the Board of Trustees, and in particular with the Audit Committee and the applicable Fund Oversight Committees, in carrying out its responsibilities. Each committee's responsibilities are guided by Sections 15(c) and 36(b) of the [Investment Company Act of 1940].

Fidelity Prospectus, *supra* note 214.

217. Mercer Bullard, *Rouge on a Corpse Won't Bring Mutual Fund Directors Back to Life*, JURIST ONLINE, Mar. 15, 2004, http://jurist.law.pitt.edu/forum/bullard1.php ("Neither the SEC nor the fund industry has set forth standards regarding the minimum steps that fund directors must take to fulfill their fiduciary duties to shareholders.").

218. In *Schuyt v. Rowe Price Prime Reserve Fund, Inc.*, the court approved, and thus gave the fund sponsors the green light to accept, an annual pre-tax profit margin of over 77%. 663 F. Supp. 962, 979 (S.D.N.Y. 1987), *aff'd*, 835 F.2d 45 (2d Cir. 1987). That pretax profit margin was no aberration; it was up from margins of 59.1% and 66.8% achieved the two previous years. *Id.* at 978-79.

benchmark standards. A knowledgeable observer in the United States Senate decried the fund industry as "the world's largest skimming operation,"[219] even though it operates in the most highly regulated money-management industry in the securities business and has a specially crafted federal "fiduciary duty" standard. There has got to be a better way to evaluate mutual fund fees. And, as will be shown, one does exist.

### *A. The Free Market Offers a Valuable, Needed Pricing Guide*

When it comes to enforcing standards of fiduciary behavior, the focus must be on honest accountability and fair dealing. While *Gartenberg* acknowledged that the standard for testing the reasonableness of a fiduciary's compensation in a self-dealing transaction is an arm's-length price,[220] the issue is from *which* marketplace the comparable market prices are to be extracted. The proof should come from free market transactions, not from the conflict-ridden, contaminated fund market. As it is, *Gartenberg* allows funds to defend their fees by referencing fees paid by other similarly conflicted funds and sends plaintiffs on a fruitless and frustrating quest for an empirical holy grail while simultaneously disallowing or down-playing the best evidence of fairness: true fair market prices, as negotiated by unconflicted boards.

Fair market value is defined as the cash price an item would sell for between a willing buyer and willing seller assuming they both have knowledge of the relevant facts and they have *no compulsion* to buy or sell.[221] Because the fund market features prices drawn from negotiations where one party (the fund) is under compulsion to buy from only one supplier (the adviser), mutual fund fees negotiated between captive funds and their adviser, whether considered

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219. *Trading Practices Hearing*, *supra* note 48, at 3 (opening statement of Sen. Peter G. Fitzgerald). According to Senator Fitzgerald, the fund industry represents a multi-trillion dollar "trough from which fund managers, brokers and other insiders are steadily siphoning off an excessive slice of the Nation's household, college and retirement savings." *Id.*

220. Gartenberg v. Merrill Lynch Asset Mgmt., Inc., 694 F.2d 923, 927-28 (2d Cir. 1982). Indeed, the lower court correctly observed that "[t]he market price—freely available and competitively set—serves as a standard to test the fairness of the investment advisory fee under the facts shown in this record." Gartenberg v. Merrill Lynch Asset Mgmt., Inc., 528 F. Supp. 1038, 1067 (S.D.N.Y. 1981).

221. *See* Newark Morning Ledger Co. v. United States, 507 U.S. 546, 570 (1993) (approving lower court's application of fair market value test as being "the price at which the asset would change hands between a hypothetical willing buyer and willing seller, neither being under any compulsion to buy or sell, both parties having reasonable knowledge of relevant facts"); *see also* Treas. Reg. § 20.2031-1(b) (as amended in 1965) (defining, for purposes of estate valuation, fair market value to be "the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts").

individually or collectively, cannot reflect fair market value and should not be used to judge whether a particular fee is fair.[222]

*B. Comparisons Can and Should Be Made*

Other available comparators are superior. After all, mutual funds are not the only institutional investors holding portfolios of securities needing professional management; almost all institutional investors have that need. Pension funds, endowment funds, trusts, separate accounts, and even mutual funds that hire sub-advisers, are all able to purchase investment advisory services in arm's-length transactions in the free market. Those separate institutional contracts are findable and easy to evaluate. They present an array of comparables eligible for use in evaluating pricing in the fund market when conflicted advisers deal with their captive funds.

These actual arm's-length transactions can and should be used as reliable benchmarks when judging the unfairness of prices set by a fund adviser for portfolio management services rendered to a captive fund. The validity of this data is especially obvious since many mutual fund sponsors or their affiliates simultaneously sell *their own* advisory services on the free market to other entities—such as pension plans, college endowment funds, separate accounts, or through sub-advisory contracts. Indeed, as shown in Part III, nineteen advisers hired by Vanguard simultaneously maintain their own captive mutual funds. In such cases, the advisory function provided to the institutional entities and the captive fund is equivalent, since portfolio management is approximately the same whether the shares in the portfolio belong to a pension fund, a mutual fund, a college endowment fund, or some other large institutional investor.[223] More accurately and objectively than expert

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222. Lawyers representing fund advisers in 36(b) litigation insist the *only* admissible pricing evidence usable at trial is that drawn from similar mutual funds. *See, e.g.*, American Century's Motion in Limine to Preclude Evidence Relating to Sub-Advised and Institutional Accounts and Suggestions in Support, Baker v. Am. Century Inv. Mgmt., Inc., No. 04-4039-CV-C-ODS (W.D. Mo. June 22, 2006), 2006 WL 2320405. In that filing American Century argued successfully for preclusion of evidence establishing pricing outside the fund business, citing and relying on *Gartenberg* and its progeny, *In re AllianceBernstein Mutual Fund Excessive Fee Litigation*, No. 4 Civ. 4885(SWK), 2006 WL 1520222, at *2 (S.D.N.Y. May 31, 2006); *Kalish v. Franklin Advisers, Inc.*, 742 F. Supp. 1222, 1237 (S.D.N.Y. 1990), *aff'd,* 928 F.2d 590 (2d Cir. 1991); *Krinsk v. Fund Asset Management, Inc.*, 715 F. Supp. 472, 486 (S.D.N.Y. 1988), *aff'd*, 875 F.2d 404 (2d Cir. 1989); *Schuyt v. Rowe Price Prime Reserve Fund, Inc.*, 663 F. Supp. 962 (S.D.N.Y. 1987), *aff'd*, 835 F.2d 45 (2d Cir. 1987); *Bromson v. Lehman Management Co.*, No. 84 Civ. 7795, 1986 WL 165 (S.D.N.Y. Mar. 13, 1986).

223. Recall that the fund managers' lobbying group and advocate, the ICI, agrees that mutual funds and other institutional investors are in fact comparable. *See supra* text accompanying notes 108-12.

testimony ever could, the institutional contracts, negotiated in the free market, prove what the adviser *actually* demands by way of price and profit when it sells portfolio management services in an arm's-length transaction.

Portfolio services are especially susceptible to comparison because they tend to be bundled with few if any other services in fund industry advisory contracts.[224] When the data is pristine, it is easy to show on an apples-to-apples basis whether an advisory fee is grossly excessive. Even if the adviser's charge for portfolio management services is bundled with some other minor administrative expenses, fund advisory fees can still be compared with fees charged for like services in the free market. Fact finders have no trouble adjusting prices when necessary.[225] As previously noted, nobody insists that the comparables' attributes be absolutely identical to the item being valued, just that it be reasonably similar, with appropriate adjustments to make the comparison useful.

In sum, courts must permit plaintiffs to introduce evidence of free market comparables.[226] Relegating plaintiff shareholders to comparing a given fund's no-bid pricing schedules to other similar funds' no-bid pricing schedules will never yield any fee relief for shareholders, as history has shown. An evidentiary standard based on evaluating tainted fees based on comparisons with other similarly tainted fees is no credible evidentiary standard at all.

### *C. Courts Must Recognize Comparables' Power*

Admitting evidence of free market comparables is a necessary but insufficient step. Courts must also recognize and harness the probative value of this evidence. Two recent cases have brought this point home. In these cases, courts have properly considered institutional pricing data but erred in the *manner* of consideration. In the first case, *Jones v. Harris Associates, L.P.*,[227] the court properly admitted into evidence proof that the adviser's institutional clients were charged fees that were less than half those charged

224. This is not always the case, though it should be. Because it is not uniformly the case, fund sponsor advocates like Coates and Hubbard are prone to contend that fund advisory fees are not subject to scrutiny because of data problems. *See supra* notes 86-87 and accompanying text.

225. *See supra* note 113 and accompanying text.

226. Without use of such comparators, section 36(b) plaintiffs are doomed. This was driven home recently when plaintiffs' counsel dropped a section 36(b) case on the eve of trial following the district court's ruling on a motion in limine to exclude institutional pricing evidence at trial. *See* Order Granting Defendants' Motion in Limine, *Baker*, No. 04-4039-CV-C-ODS.

227. Jones v. Harris Assocs. L.P., No. 1:04-cv-08305, 2007 WL 627640 (N.D. Ill. Feb. 27, 2007).

the captive funds,[228] but the court failed to grasp the evidence's importance.[229] In granting summary judgment for defendants, the court held that advisory fee pricing embraced a range of prices, with the far lower fees charged institutional clients simply on the low end of a spectrum, which was also populated by the tainted fees charged conflicted funds. Because the subject funds' fees fell within the spectrum, the fund's high fees were held proper as a matter of law.

Similarly, in a recent case involving the Ameriprise fund family,[230] the plaintiffs introduced evidence showing the adviser charged advisory fees to its captive mutual funds that were more than double what the fees that would have been charged had the adviser used the fee schedules it employed when selling portfolio management services in the free market.[231] Taking its lead from *Jones*, the court in the *Ameriprise* case held the adviser's far lower institutional advisory fee prices merely established the low end of a range of prices to be considered; the pricing array was, of course, dominated by tainted prices set by conflicted bargaining.

If the superficial *Jones* and *Ameriprise* mode of analysis stands, fund investors will never win a case challenging advisory fees under section 36(b). Institutional fees charged in the free market will always be lower than fees for like work charged in the fund market, but they fade into irrelevance once the

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228. For example, evidence in the record established that had the adviser charged Oakmark Fund according to its institutional fee schedule, the advisory fee would have dropped from 88 bps to under 36 bps, saving Oakmark Fund shareholders more than $33 million annually. *See* Expert Report of Edward S. O'Neal at 18, *Jones*, No. 1:04-cv-08305 (on file with the authors). For Oakmark Equity & Income Fund, the rate drop would have been from 73 bps to under 26 bps, and annual savings would have been over $37 million. *Id.* at 19. Thus, for these two funds alone, the difference between institutional pricing in the free market and conflicted pricing in the fund market amounted to $70 million in extra compensation for the adviser annually. In each case, the funds were paying more than double what the adviser was selling similar services for in the free market.

229. The court in *Jones* not only failed to focus on the importance of the pricing disparity, it also ignored a shocking fact supported with record evidence: It was more expensive for the adviser in Oakmark to service its institutional accounts than its mutual funds. In other words, the adviser in Oakmark was charging its mutual funds more than twice as much for advisory services even though those services were cheaper to deliver to the funds than to the institutional accounts. *See* Plaintiffs' Response to Defendant's Statement of Undisputed Facts and Plaintiff's Statement of Additional Facts ¶ 4, *Jones*, No. 1:04-cv-08305 (on file with the authors). From the data studied, it appears the adviser in Oakmark was charging its mutual funds more than twice as much for advisory services even though those services were cheaper to deliver to the funds than to the institutional accounts.

230. Gallus v. Ameriprise Fin., Inc., 497 F. Supp. 2d 974 (D. Minn. 2007).

231. Decl. of Edward S. O'Neal, Ph.D at 5, *Gallus*, 497 F. Supp. 2d 974 (No. 0:04-cv-04498-DWF-SRN).

court merely acknowledges them, with dispositive attention then turning to a pricing array of fund fees.[232]

Courts in section 36(b) cases must not only admit comparative price data into evidence; they also need to be carefully schooled on the probative value of free market pricing. Courts need to recognize that free market prices are more credible and hence ought to be far more illuminating than pricing examples taken from the conflicted fund market. Proof that a fund adviser treats a third-party outsider far more favorably than he treats the very party to whom he owes statutorily-provided fiduciary duties needs to be recognized for what it is: *prima facie evidence* of a breach of fiduciary duty. Consigning that powerful evidence to populate the low end of a range ships the damning proof of pricing unfairness off to oblivion. This outcome is particularly objectionable in cases where the issue being determined is whether fund pricing bears the hallmarks of an arm's-length bargain. In this context, evidence of actual arm's-length bargaining by the defendant or one of its affiliates is the best, most instructive evidence the finder of fact can study. In this light, a framework for processing crucial evidence extracted from the free market is presented in the following section.

### *D. The* McDonnell Douglas *Framework Should be Used When Evaluating Pricing Discrepancies*

Courts called on to evaluate free market vs. fund market pricing discrepancies need to abandon the disjointed, hit-and-miss, scavenger-hunt approach epitomized by *Gartenberg* and embrace a new, cleaner, and far more realistic approach to analyzing section 36(b) claims. In *McDonnell Douglas Corp. v. Green*,[233] the Supreme Court laid out a framework useful for analyzing disparate treatment cases relying upon circumstantial evidence of discrimination.[234] These cases are pertinent. Employment discrimination claims, like fund advisory fee claims, are rooted in a charge that a litigant (there the employee; here the captive fund) is being treated in a way that is unfair and unjustifiable.

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232. As shown by Figure 4 *supra*, fund advisory fees are subject to great dispersion. Because of this, many fund fee schedules can be presented as more moderate and fair than an array of others extant in the industry.

233. 411 U.S. 792 (1973).

234. *Id.* The *McDonnell Douglas* framework's distribution of the burden of proof and production was later refined by the Supreme Court in *Texas Department of Community Affairs v. Burdine*, 450 U.S. 248, 255 (1981). For a discussion of the *McDonnell Douglas* framework, see Leslie M. Kerns, Comment, Aka v. Washington Hospital Center*: Why the Debate over Pretext Ended with* Hicks, 60 OHIO ST. L.J. 1625, 1630-34 (1999).

Under *McDonnell Douglas*, the plaintiff is required to make a prima facie case of unfair treatment—employment discrimination. In the fund advisory fee context, this prima facie showing of a breach of fiduciary duty that the transaction—here the fee charged—lacks the "earmarks of an arm's-length bargain" would be satisfied by a showing that the adviser or one of its affiliates charged the captive fund significantly more than either the particular adviser—or a comparable competitor—charged an institutional client to perform roughly equivalent work.[235]

Under the *McDonnell Douglas* framework, once a prima facie case of disparate treatment is made, the defendant must produce evidence to rebut the presumption of discrimination. At this point it becomes incumbent on the defendant to articulate a legitimate non-discriminatory reason explaining why the disparity exists. In the fund fee context, the adviser would need to produce evidence showing that the captive fund was fairly treated—a task it could accomplish by identifying and quantifying the service differences between picking portfolio securities for third-party institutional clients versus the captive mutual fund.[236] Once the defendant has presented evidence to explain the fee disparity, it remains for the plaintiff to show the pricing disparity evidences a breach of fiduciary duty. The plaintiff would do this by proving, by a preponderance of the evidence, that the differences in services the defendant identified do not adequately explain or justify the fee disparity. Here, the plaintiff's ultimate burden will be to show that the captive fund was charged substantially more than free market clients for like work.

Had the *McDonnell Douglas* framework been used in the *Jones* and *Ameriprise* cases, the plaintiffs in each case could have survived summary judgment and had the opportunity to prove their cases. In each case, the plaintiff presented evidence of gross pricing disparity tending to show that the prices paid by the captive funds were grossly unfair, and in neither case did the adviser rebut that evidence.

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235. "The essence of the [fiduciary] test is whether or not under all the circumstances the transaction carries the earmarks of an arm's length bargain." Gartenberg v. Merrill Lynch Asset Mgmt., Inc., 528 F. Supp. 1038, 1047 (S.D.N.Y. 1981) (citing Pepper v. Litton, 308 U.S. 295, 306-07 (1939)) (alteration in original), *aff'd*, 694 F.2d 923 (2d Cir. 1982).

236. In *Burdine*, 450 U.S. at 250, the Court made clear the defendant shouldered only a burden of production, not a burden of proof, once the plaintiff had made a prima facie case. *See id.* at 254 ("The burden that shifts to the defendant . . . is to rebut the presumption of discrimination by producing evidence that the plaintiff was rejected, or someone else was preferred, for a legitimate, nondiscriminatory reason.").

### *E. Free Market Comparables Are Potent Negotiating Tools Directors Should Consider*

Free market pricing analogies, and the *McDonnell Douglas* analytical framework, offer great promise, not just as decision-making guides, but as tools a fund board may usefully employ in negotiating advisory fee contracts. In 2004, the SEC adopted rule and form amendments requiring that fund boards that take institutional fee comparisons into account in evaluating advisory contracts disclosures in proxy solicitations seeking approval of fund fee contracts—"the comparisons that were relied on and how they assisted the board in concluding that the contract should be approved."[237] The SEC said it adopted the disclosure requirement because it "believe[d] that information concerning whether and, if so, how the board relies on comparisons is important in understanding the board's decision."[238] This is a very powerful comment, for it evidences the SEC's belief that boards' decision to weigh or not weigh comparative pricing of advisory services is itself a material fact[239] investors ought to know in evaluating the board's actions.[240]

The SEC's decision to require disclosure about fund boards' processing of comparative cost information expressly recognized that the protocol used for evaluating advisory contracts had become detached from reality and outdated. Citing Freeman-Brown, the Commission explained:

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237. Disclosure Regarding Approval of Investment Advisory Contracts by Directors of Investment Companies, Securities Act Release No. 8433, Exchange Act Release No. 49,909, Investment Company Act Release No. 26,486, 69 Fed. Reg. 39,798, 39,802 (June 30, 2004).

238. *Id.*

239. In the context of the securities laws, a fact is material if there is "a substantial likelihood that a reasonable shareholder would consider it important." TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976).

240. The SEC's decision to revise and update disclosures concerning fund boards' consideration of advisory contracts shows just how far courts' rulings in fund advisory fee cases have strayed from reality. Some courts have taken the position that, under *Gartenberg* and its misguided progeny, comparative fees may not even be mentioned in court in a section 36(b) case. *See, e.g.*, Order Granting Defendants' Motion in Limine, Baker v. Am. Century Inv. Mgmt., Inc., No. 04-4039-CV-C-ODS (W.D. Mo. July 17, 2006) (finding that "Plaintiffs will be precluded from presenting any evidence relating to Defendants' management of non-mutual fund accounts, as such evidence is irrelevant to Plaintiffs' claims involving mutual fund fees under Section 36(b) of the Investment Company Act"); Kalish v. Franklin Advisers, Inc., 742 F. Supp. 1222, 1237 (S.D.N.Y. 1990) (suggesting evidence of "comparative fee structures" in section 36(b) cases should be limited exclusively to fees charged by other mutual funds), *aff'd*, 928 F.2d 590 (2d Cir. 1991). Yet the SEC considers comparative fee matters, such as fees charged by fund advisers to their pension plan clients, to be "important" in understanding how the fee approval decision was reached.

> Recently, concerns have been raised regarding the adequacy of review of advisory contracts and management fees by fund boards. In particular, the level of fees charged by investment advisers to mutual fund clients, especially in comparison to those charged by the same advisers to pension plans and other institutional clients, has become the subject of debate.[241]

Directors must thus disclose the comparables they consider. When considering comparables, directors' duty of care should require that they consider true free market transactions where fees were negotiated at arm's-length. Directors who consider fees determined only by tainted boards, are on the road to breaching their fiduciary duties by failing to fight for the best prices available for their funds' shareholders. In one case pertinent to the fund industry, the Delaware Supreme Court admonished independent directors to bargain hard in order to insure that the best possible bargain is struck on their corporation's behalf:

> The power to say no is a significant power. It is the duty of the directors serving on [an independent] committee to approve only a transaction that is in the best interests of the public shareholders, to say no to any transaction that is not fair to those shareholders and is not the best transaction available.[242]

Getting "the best transaction available" requires using the best negotiating ammunition available. When it comes to negotiating over fund portfolio management fees, that means using free market comparables aggressively.

In our experience, independent directors of mutual funds are ignorant about the value of comparative pricing and do not use it when negotiating over fund fees. In some cases, the directors simply are kept in the dark about the data's availability. In other cases, the pricing data is furnished, but the directors are advised, falsely, that using data extracted from free market transactions yields worthless "apples-to-oranges" comparisons. When asked why the comparison is "apples-to-oranges," directors are prone to be told that it just is.[243] Directors who accept or offer these flimsy explanations are guilty of failing to marshal

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241. Disclosure Regarding Approval of Investment Advisory Contracts by Directors of Investment Companies, Securities Act Release No. 8433, Exchange Act Release No. 49,909, Investment Company Act Release No. 26,486, 69 Fed. Reg. 39,798, 39,802 (June 30, 2004).

242. Kahn v. Lynch Commc'ns Sys., Inc., 638 A.2d 1110, 1119 (Del. 1994) (alteration in original) (quoting *In re* First Boston, Inc. S'holders Litig., Civ. A. No. 10338, 1990 WL 78836, at *7 (Del. Ch. June 7, 1990)).

243. This conclusion is based on confidential depositions the authors have read.

helpful facts[244] usable in negotiating advisory fees with their funds' advisers. When fund directors fail to wield the power they have to gather important data and make informed decisions, fund directors breach their duty of care owed to the funds they serve.

By the same token, advisers who hide or misrepresent comparative data are breaching their fiduciary duties. Those who simply supply comparative prices without more have furnished a necessary, but insufficient service. Full adherence to their fiduciary obligations requires that, if the comparative data supplied to directors is not self-evidently apples-to-apples, advisers must also supply information about the cost of each alleged service difference between the comparable contract and the specific fund's advisory contract so apples can be compared to apples post-adjustments.

Fund directors' discharge of their fiduciary duties demands they request, receive, and carefully review information about advisory services being sold by their funds' adviser to institutional clients. Data presented earlier in Table 3[245] and also in Freeman-Brown[246] show that fund managers sometimes sell their services on the open market and then grossly overcharge their own captive funds for those same services. Directors need to determine whether this is going on and, if it is, they need to consult with legal counsel about the practice's fiduciary-duty ramifications. Fund directors need a good answer to this question: Why should the adviser sell its services as an independent contractor in the free market at a price that is far lower than the same services are being sold to mutual funds to whom the adviser owed clear-cut fiduciary obligations? In Freeman-Brown, we coined the "most favored nation" concept for fund fee pricing. This concept demands that mutual funds should pay a price for investment advice that is no higher than that charged by the fund's adviser when it provides advice to third-party customers (such as pension funds, endowment funds, and others, like Vanguard) who bargained at arm's-length. Directors should impose the "most favored nation" concept within their funds. Advisers, who would argue that providing advisory services to institutional accounts entail service differences that explain pricing differentials, need to identify and quantify each separate point of difference. The advisers' fiduciary duties require no less.[247]

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244. The data is available as demonstrated by Eliot Spitzer's testimony cited earlier. *See supra* notes 93-94 and accompanying text.

245. *See supra* Table 3.

246. *See* Freeman & Brown, *supra* note 9, at 635-36.

247. *See* RESTATEMENT (SECOND) OF AGENCY § 381 (1958).

> Unless otherwise agreed, an agent is subject to a duty to use reasonable efforts to give his principal information which is relevant to affairs entrusted to him and

The advisers' fiduciary duty problems are exacerbated when strategies, policies, and processes developed by the adviser when working on behalf of the fund are then taken by the adviser and sold for discount prices to third-parties, with the adviser reaping the financial benefits. Directors who turn a blind eye to these asset diversion/corporate opportunity problems are asking to be sued. Full disclosure of accurate data paves the way for competent, honest evaluation of mutual fund portfolio management pricing.

## *Conclusion*

Over the past several years, there has been much discussion of whether fees for mutual fund portfolio advisory services are too high. In 2001, Freeman-Brown showed these fees were bloated by comparing mutual fund fees to fees charged pension funds for the same services. That comparison, which clearly touched a nerve within the fund industry, showed fund shareholders would save billions annually if fund portfolio management fees approximated those charged by managers of public pension funds' equity portfolios. In Part III, we revisit that inquiry and ultimately reach the same conclusion, this time by evaluating new data drawn from actual mutual fund advisory fee contracts entered into by the Vanguard Group and comparing that data to the fees the same fund advisers charge their own captive funds. This new data is powerful and robust, and it only confirms what has long been clear: Fee gouging is pervasive within the fund industry.

In 1970, Congress enacted Section 36(b) because it recognized the mutual fund industry's conflicted governance structure could stifle competition and lead to excessive fees flowing to fund sponsors and their affiliates. Section 36(b) exists because Congress wanted to reduce the burden on plaintiffs, as compared to the state court waste test. Yet, 36(b)—the weapon Congress specifically gave investors to fight excessive fees in the mutual fund industry—is singularly ineffective. Section 36(b), as systematically gutted by the courts—principally the Second Circuit's ruling in *Gartenberg*—requires the evaluation of data that is largely meaningless to investors. The required data is virtually impossible to find and, once found, is subject to bitter disputes between the parties and their experts. Furthermore, and even less logically, *Gartenberg* and its progeny permit funds to defend their excessive fees by reference to the bloated fees of their similarly-tainted compatriots while suppressing or paying lip service to evidence showing similar services cost far less in the free market. When it comes to evaluating fiduciaries' behavior, it

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> which, as the agent has notice, the principal would desire to have and which can be communicated without violating a superior duty to a third person.

*Id.*

is absurd to find federal courts in 36(b) cases barring free market data or downplaying its relevance. After all, the SEC now demands mutual fund prospectuses disclose whether comparative data drawn from the free market was relied on by the fund's board in approving the advisory contract and, if so, what the comparisons were and how they assisted the board in the approval process. Data deemed relevant and material in the board room deserves equal treatment in the court room.

Courts need to understand that in advisory fee cases, where the absence of arm's-length bargaining is the central issue, the focus belongs on free market comparators where arm's-length bargaining actually occurs and fair market values are honestly established. The focus needs to shift away from prices set by conflicted dealings in the captive fund market. In interpreting section 36(b), courts should replace *Gartenberg*'s misguided grab-bag of factors with the Supreme Court's specially-crafted test to determine when unfairly disparate treatment is compensable: the *McDonnell Douglas* test. In applying *McDonnell Douglas* in the mutual fund context, a plaintiff should be able to make out a prima facie case of a breach of fiduciary duty by showing that the fiduciary-adviser charged the captive fund significantly higher prices than the adviser (or an affiliate or similarly-situated adviser) charged institutional clients in the free market for similar work. Simply put, when major pricing discrepancies exist between free market and fund market pricing, these differences are prima facie proof that the fees charged the captive fund lack the "earmarks of an arm's-length bargain" and that fiduciary duties are being breached.

Just as courts must focus on free market comparators, so too must directors. Directors should not turn their eyes away from proof of gross pricing discrepancies for similar services. The fund's independent directors sit as watchdogs, tasked with policing the adviser's discharge of fiduciary duties. The time has come for fund directors to demand that fund advisers give fund shareholders "most favored nation" treatment on advisory fees. Fund directors, along with federal district court judges, need to learn that, in advisory fee cases, the focus belongs on fair market comparators, not conflicted dealings in the fund market. Embracing this simple, fair, and easily understood and applied concept would dramatically benefit fund shareholders, saving billions of dollars annually.

Applying most favored nation treatment to mutual fund advisory fee payments has been classified by *Forbes* magazine writer Neil Weinberg as the fund industry's "worst nightmare."[248] Weinberg's "worst nightmare"

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248. Neil Weinberg, *Mutual Funds' Worst Nightmare*, FORBES.COM, Dec. 16, 2003, http://www.forbes.com/2003/12/16/cz_nw_1216mutualfunds.html. Weinberg quoted one industry

description demonstrates that, when it comes to portfolio management services, knowledgeable Wall Street insiders themselves recognize that the gross disparity between free market prices and fund market prices is an accepted fact of life.[249]

That mutual fund sponsors' "worst nightmare" involves treating fund shareholders scrupulously fairly when pricing vital services shows how far the fund industry has strayed from sensible fiduciary standards. Section 36(b)'s promise has been squandered. Abandoning the confusing, vague, and unfair *Gartenberg* grab-bag and focusing directly on relevant free market pricing data will bring honesty and thoughtful analysis to fund advisory fee pricing decisions in the nation's boardrooms and courtrooms.

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observer who had this reaction to the idea: "It's a brilliant idea to bring most favored nation clauses to the mutual fund arena . . . ." *Id.* (quoting Edward Siedle, Investigator, Benchmark Financial Services).

249. In the same vein, when Freeman-Brown was first discussed in *The Wall Street Journal*, it was in a story with a title suggesting that proof of price gouging in mutual fund fees was old news. *See* Lauricella, *supra* note 75, at C1 (the headline stated: "This Is News?: Fund Fees Are Too High, Study Says").

## APPENDIX A

| *Fund* | *Yr. Entered Program* | *Average Assets 2004 ($ mm)* |
|---|---|---|
| Explorer | 1975 | 7,536 |
| Morgan Growth | 1975 | 4,174 |
| US Growth | 1975 | 5,698 |
| Windsor I | 1975 | 18,189 |
| Wellesley Income | 1975 | 9,906 |
| Wellington | 1975 | 29,940 |
| Intl Growth Fund | 1981 | 7,280 |
| International Value | 1983 | 1,864 |
| Primecap | 1984 | 21,336 |
| Windsor II | 1985 | 27,668 |
| Equity Income | 1988 | 3,042 |
| Growth & Income | 1993 | 6,278 |
| Capital Opportunity | 1995 | 6,747 |
| Global Equity Income | 1995 | 814 |
| Select Value | 1996 | 1,595 |
| US Value | 2000 | 631 |
| Growth Equity | 2001 | 745 |
| Capital Value | 2002 | 351 |
| MidCap Growth | 2002 | 345 |
| Int'l Explorer | 2002 | 999 |
| Dividend Growth | 2002 | 892 |

APPENDIX B

| *Vanguard Fund* | *External Manager* |
|---|---|
| Explorer | Wellington, Granahan, Chartwell, Grantham, |
| Morgan Growth | Wellington, Franklin Portfolio Assoc. |
| US Growth | Alliance, W. Blair |
| Windsor I | Wellington, Stanford C. Bernstein |
| Wellesley | Wellington |
| Wellington | Wellington |
| Int'l Growth Fund | Schroder, BG Overseas |
| Int'l Value | Hansberger, Sanford C. Bernstein |
| Primecap | Primecap |
| Windsor II | Barrow, Equinox, Hotchkis, Tukman |
| Equity Income | John Levin, Wellington |
| Growth & Income | Franklin Portfolio Assoc. |
| Capital Opportunity | Marathon, Arcadian |
| Global Equity Income | Marathon, Arcadian |
| Selected Value | Barrow |
| US Value | Grantham |
| Growth Equity | Turner |
| Capital Value | Wellington |
| Mid Cap Growth | Provident |
| Int'l Explorer | Schroder |
| Dividend Growth | M & G, Wellington |