Myths About Mutual Fund Fees: Economic Insights on Jones v. Harris

D. Bruce Johnsen*

“If mutual fund customers were charged the lower rate for advisory fees paid by institutional investors, they would save more than $10 billion a year.”
— Eliot Spitzer1

I. INTRODUCTION

In 1962, the Wharton School of Finance and Commerce at the University of Pennsylvania published the influential Wharton Report2, a study of the mutual fund advisory industry requested by the U.S. Securities and Exchange Commission (SEC). Among other things, the Wharton Report found that while assets under management and fund size in the industry had grown dramatically, fund advisers were doing little to reduce fees, in spite of what it asserted were obvious economies of scale in fund management.3 The Wharton Report concluded that fee competition in the industry was weak or

---

1. Paul Adams, Spitzer is Looking to Force Mutual Funds to Lower Fees: High Charges are Linked to Industry's Scandals, He Tells Senate Panel, BALTIMORE SUN, Jan. 28, 2004, at 1D.

2. WHARTON SCH. OF FIN. & COMMERCE, A STUDY OF MUTUAL FUNDS, H.R. REP. NO. 87-2274 (1962). Irwin Friend was the lead investigator.

altogether absent.\textsuperscript{4} The SEC followed in 1966 with a report to Congress drawing the same conclusion and recommending various statutory amendments to protect fund investors from excessive fees.\textsuperscript{5} Congress responded in 1979 by amending the Investment Company Act of 1940 (ICA) to add section 36(b), imposing on fund advisers a “fiduciary duty with respect to the receipt of compensation for services” and allowing private suits by fund shareholders for excessive fees.\textsuperscript{6}

One of the first private suits under section 36(b) was the 1981 case of \textit{Gartenberg v. Merrill Lynch Asset Management}.\textsuperscript{7} Over 80 private suits that have since been filed in federal court\textsuperscript{8} have relied on the Second Circuit’s \textit{Gartenberg} approach, under which a defendant’s liability depends on a multi-factor test aimed at “whether the fee schedule represents a charge within the range of what would have been negotiated at arm’s-length in the light of all of the surrounding circumstances.”\textsuperscript{9} Many of these cases have generated protracted and economically complex trials, but none have resulted in verdicts for plaintiffs.

Seventh Circuit Judge Frank Easterbrook recently rejected the \textit{Gartenberg} approach in \textit{Jones v. Harris Associates L.P.}, citing with approval a Third Circuit decision finding that “adherence to the statutory procedures, rather than the level of price, is the right way...
to understand the "fiduciary" obligation created by § 36(b)."10 Relying on the common law of trusts, Easterbrook observed that "a fiduciary duty differs from rate regulation. A fiduciary must make full disclosure and play no tricks but is not subject to a cap on compensation."11 Easterbrook reasoned that adherence to fiduciary procedures such as "candor in negotiation, and honesty in performance" is what the statute requires.12 In a competitive industry, which is surely an accurate characterization of the mutual fund industry by any structural standard, informed investors are free to take their money and invest it elsewhere if performance, net of fees, falls short of expectations. Although the competitive process is imperfect at weeding out investor errors, in his words it is "superior to a 'just price' system administered by the judiciary."13

Following the Seventh Circuit’s denial of the plaintiff’s petition for rehearing en banc, Judge Richard Posner, Easterbrook’s Seventh Circuit and University of Chicago Law School colleague, and fellow law and economics pioneer,14 wrote a pointed dissent, chiding Easterbrook for creating a circuit split where none had existed before without first giving advance notice to the entire court.15 In Posner’s view, there is substantial evidence that competition over advisory fees is insufficient to offset the structural conflict inherent in the board of director system for setting compensation.16 Although Easterbrook and Posner have lined up on the opposite sides of significant financial issues in the past,17 their disagreement in Jones v. Harris is notable as a point of economic and legal interest, as well as important to the commercial health of the $9.6 trillion mutual fund industry.18 On March 9, 2009, the U.S. Supreme Court announced that it had granted certiorari in Jones v. Harris, with oral argument set for its October 2009 term.19

The dramatic growth and innovative management of mutual funds over the past four decades is good reason to be skeptical of those who criticize fund fees as excessive and fund organization as mired in conflicts of interest. Indeed, in Gartenberg and other high-profile excessive fee cases the defendant advisory firms created, promoted, and managed funds that were tremendously popular and attracted investor dollars by the billions as a result. This essay argues that critics have failed to fully understand the economics of

10. Jones v. Harris Assocs., 527 F.3d 627, 632 (7th Cir. 2008).

11. Id.

12. Id.

13. Id.


16. Id. at 732.


mutual fund organization, and that this has led them mistakenly to rely on various myths about fund management that encourage frivolous private suits for excessive fees. Once these myths are fully revealed, Easterbrook’s procedural rule is the only economically sensible way to approach section 36(b)’s fiduciary duty without risking additional frivolous and protracted private suits.

Each myth consists of an incorrect positive statement of economic theory and any number of normative policy implications thought to follow from it. Myth 1, most essentially, is that fund shareholders own the fund’s investment returns. The normative implication is that they should share any returns accruing to their manager’s superior stock picking skill. In the language of economic theory, however, a mutual fund is an open access common pool subject to virtually free investor entry and exit.

For the universe of potential fund investors, the returns accruing due to a fund manager’s superior skill are a nonexclusive rent for which they must compete by buying shares at current net asset value and periodically paying the associated management fee and other expenses thereafter. Entry (or “crowding”) by rational shareholders will continue until all expected rents are either transferred to the manager in the form of fee payments or dissipated by added administrative expenses, transaction costs, and forgone investment opportunities. Fund shareholders own a pro rata share of existing net assets at any moment. Going forward, they can expect a normal competitive return on those assets, but, owing to fund flows, they have no exclusive claim to prospective investment returns resulting from superior manager skill.

Myth 2 is that a reduction in advisory fees will increase investor returns dollar for dollar. Regardless of the level of the advisory fee, in an open-access commons, any abnormal returns to a manager’s superior stock-picking skill will be competed away by investors chasing the prospect of capturing the associated rents. Based on their collective assessment of manager performance and share purchases or sales, rational investors determine fund returns net of fees, that is, fund flows endogenize investor returns. Holding manager stock-picking skill constant between two funds, the fund with the lower advisory fee will simply have larger total assets than the high-fee fund. No public investor can expect to capture a share of any fee reduction in the form of higher investment returns. As a first approximation, the level of advisory fees is irrelevant to fund investors. Eliot Spitzer and others who have suggested that lower advisory fees will increase investor returns dollar-for-dollar are simply mistaken.

Myth 3 is that fund management is subject to declining average cost, or scale

20. Some current fund shareholders are locked into their current funds because they must pay back-end loads to exit, or they have accrued tax liability that must be paid on exit. Of these investors, many have the ability to transfer between funds within their family at very low cost. Further, it is equally clear that many fund shareholders do not face load or tax impediments to switching. Finally, much of the investment dollars invested in funds in any given year is new to the industry. The weight of the empirical evidence discussed infra demonstrates that the flow of investment dollars is highly elastic with respect to fund performance. See Ippolito, infra note 29; Choi & Kahan, infra note 264; Sirri & Tuffano, infra note 110. Even for those shareholders who face tax liability on liquidation, this “cost” accrued at the time they experienced capital gains, so the true cost of the tax liability on liquidation is the cost of finding the cash to cover the tax liability. To the extent there is a capital gain, however, the shareholder should have the cash to more than cover the tax liability.

economies, owing to fixed costs that do not vary with total portfolio assets. The Wharton Report asserted this conclusion without careful analysis. The normative policy implication embraced by the SEC and Congress and embedded in section 36(b) is that scale economies should be passed on to fund shareholders in the form of lower advisory fees as total fund assets increase. That pre-1970 fees remained steady in the face of substantial industry growth in assets suggested to many that the competitive process had failed.

Scale economies exist when the average per-unit cost of producing an economic good consumers demand declines as output of that good rises. But assets-under-management is not an output investors demand, nor is it an accurate characterization of what fund advisors produce. Simply because the average cost of management declines as total fund assets rise is no reason to conclude asset-based advisory fees should decline as fund assets rise. Drawing such a conclusion requires an economic theory of contract choice defining the good being transacted, identifying the various parties’ incentives, and explaining how alternative adviser compensation affects the cost of transacting and the joint gains from trade. Such a theory has been largely, though not completely, absent from the financial economics literature and completely absent from SEC regulations and judicial opinions.

Myth 4 is that the much lower fees private money managers earn for managing institutional portfolios—those held by pension plans, insurance companies, and trust funds—are a proper metric for the fees fund advisers would charge if fee negotiations occurred at arm’s length. The normative policy implication is that the prospect of suits for fees in excess of what private institutions pay will benefit investors by driving fees down. But if fees are irrelevant to rational shareholders as a first approximation, the primary effect of excessive fee suits that do not require a demonstrable fiduciary breach is simply to tax advisory firms.

Implicit in much of the discussion critical of mutual fund fees is that fund management is a “commodity.” A number of commentators have rejected this conclusion because, with fund returns subject to noise, investors are unable to assess the quality of fund management at the moment they invest. Either they suffer cognitive biases that render them irrational and incapable of protecting themselves even in the face of

22. See supra note 3 and accompanying text.

23. See supra notes 3–5 and accompanying text.


26. Id. at 732.

27. Id.
intense competition between advisers,\textsuperscript{28} or, more plausibly, they face substantial information costs searching among the universe of funds and monitoring their manager’s performance once they invest.\textsuperscript{29} As in other settings where information is costly, mutual fund investors rationally choose some measure of ignorance. Why spend a dollar to save 50 cents?

Economics literature recognizes a number of models that show how market forces overcome the quality assurance problem. Many describe how producers use premium prices to assure consumers they will provide high quality. Application of these models to advisory fees is straightforward and compelling. It is part of a theory of contract choice that explains how advisers and imperfectly informed investors maximize the gains from trade rather than how advisers expropriate shareholder wealth. Those who suggest that the lower fees private money managers charge institutional clients are a valid metric for assessing mutual fund advisory fees fail to recognize that pension sponsors and insurance companies face far lower costs assessing manager quality than do dispersed public mutual fund investors. For institutional clients, quality assurance is unnecessary and lower fees are to be expected.

Reliance on these four myths has generated no end of muddled thinking in the scholarly literature, in the excessive fee case law, and in regulatory pronouncements from the SEC. This essay relies on standard economic theory—especially transaction cost economics of the kind familiar to antitrust scholars and courts—to dispel these myths and to provide key insights on \textit{Jones v. Harris} that support Judge Easterbrook’s opinion. Part II provides background by illustrating how mutual funds work, describing how they are regulated, reviewing the scholarly literature relevant to fund advisory fees, and summarizing the excessive fee case law, including the opinions by Easterbrook and Posner in \textit{Jones v. Harris}. Part III provides a careful economic analysis of mutual fund organization and traces the implications for excessive fee claims and fund regulation more generally. This Article provides testable implications where appropriate. Part IV summarizes and provides concluding remarks.

II. \textsc{Mutual Fund Organization, Regulation, Scholarship, and Case Law}

\textit{A. Fund Organization and Regulation}

Open-end mutual funds are investment pools organized as corporations or trusts under state law. They have their antecedents in the Massachusetts investment trust, a savings vehicle developed during the 1920s that offered investors diversification, active portfolio management, and tremendous liquidity. To raise capital, the fund issues shares to the investing public with the proceeds placed in a more or less diversified portfolio of risky assets (primarily corporate stocks and bonds, government debt, etc.) and cash to which shareholders have a pro rata claim. The unique feature of open-end funds, or simply mutual funds, is that they offer to issue and redeem shares publicly at the net asset


value of the portfolio when next calculated, normally at the close of trading on the
exchange where the portfolio securities are most actively traded. Net asset value (NAV) is
equal to the reported prices of the underlying portfolio securities less any transaction
costs, advisory fees, and administrative expenses charged to the fund since the last
calculation.30 Mutual fund shares are continuously bought from and sold back to the fund
that issues them; there is no secondary public market in which they are actively traded. In
contrast, shares in closed-end funds, once issued, must be bought and sold through
intermediaries in secondary public markets.

Mutual fund shares are normally marketed to the public by broker–dealers. Early on,
an underwriter affiliate of the fund adviser performed this distribution function through
its retail broker–dealer network. In exchange for marketing shares to the investing public,
broker–dealers received an up-front sales load,31 normally about five percent of the
purchase price of the shares. Over time the use of loads to compensate broker–dealers has
gradually declined with the ascent of so-called “no-load” funds. These funds began to
gain popularity even before the SEC’s 1980 passage of Rule 12b-1 that allowed advisers
to use general fund assets to pay broker–dealer sales charges for marketing shares, provided they complied with specific governance conditions.32 Rather than paying a one-
time up-front load, fund shareholders normally pay recurring 12b-1 fees out of the
common assets of the fund.33 Rule 12b-1 has had two important effects on the market for
mutual funds. First, it has dramatically reduced investor switching costs. Second, it has
allowed fund advisers to market shares through multiple unaffiliated broker–dealers by
way of so-called “fund supermarkets.” With broker–dealers offering shares in a large
number of funds sponsored and managed by many different advisers, the conflicts of
interests thought to plague the marketing of shares exclusively through affiliated
underwriters is avoided.

Most mutual funds are managed by an external advisory firm pursuant to a contract
approved by the fund’s outside directors.34 In exchange for advisory and other services,
the contract normally pays the adviser a periodic percentage fee based on total assets
under management, anywhere from 1 to 200 basis points or more per year.35 Many funds

30. See Amendments to Rules Governing Pricing of Mutual Fund Shares, Investment Company Act

31. “‘Sales load’ means the difference between the price of a security to the public and that portion of the
proceeds from its sale which is received and invested or held for investment by the issuer.” 15 U.S.C. § 80a-2(a)

(codified at 17 C.F.R. pts. 239, 270, 274).

33. Id.

34. Daniel N. Deli, Mutual Fund Advisory Contracts: An Empirical Investigation, 57 J. Fin. 109, 113
(2002) (noting that based on SEC filings in 1997 and 1998, 93% of fund advisers were compensated exclusively
with an asset-based fee).

35. Id. at 115.
are managed by a central adviser within a complex, or “family,” of funds, in which case the hands-on manager of each fund is an individual or team employed by the advisory firm or an external sub-adviser hired under contract.\(^{36}\)

Mutual funds can be either actively or passively managed. A unit investment trust is the most passive type of mutual fund.\(^{37}\) It places its investors’ money in a fixed portfolio of securities and other assets whose composition remains unchanged for the life of the fund. Shareholder redemptions are met by a pro rata liquidation of assets.\(^{38}\) So-called “index funds,” which place their assets in a portfolio of securities that mimics a published index such as the value-weighted S\&P 500,\(^{39}\) are also considered passively managed. Their portfolio composition changes only when the composition of the index changes, such as when General Motors recently dropped out of the list of the 500 most highly capitalized corporations based on the reduced value of its outstanding shares.\(^{40}\) As with unit investment trusts, shareholder redemptions in index funds are met by a pro rata liquidation of assets.

Fund advisory services include record keeping, custody of shares, and other ministerial functions, but in an actively-managed mutual fund they consist most importantly of portfolio management. As an agent for the fund, an active manager’s primary charge is to hold a well-diversified portfolio,\(^{41}\) to use his best efforts to perform or acquire research to identify mispriced securities, and to buy or sell those securities to make a profit for the fund before the market fully corrects the pricing error. Active fund managers are free to vary the composition of their portfolios as long as they meet certain statutory diversification and regulatory disclosure requirements based on their reported “style” (large cap, small cap, growth, income, etc.). Shareholder redemptions therefore need not be met by a pro rata liquidation of portfolio assets. To facilitate shareholder monitoring of the manager’s compliance with his stated style, the fund is required to report its portfolio holdings to the SEC quarterly with a 60-day lag.\(^{42}\)

Owing to alleged abuses by closed-end fund advisers and their affiliates surrounding

\(^{36}\) Id.

\(^{37}\) Id. at 117.

\(^{38}\) Id.

\(^{39}\) The S\&P 500 index is a hypothetical portfolio whose securities consist of the common stock issued by the 500 largest U.S. corporations by total market capitalization. The weight of each stock in the index is equal to the corporation’s equity capitalization relative to the total of all 500 firms.


\(^{41}\) There are many ways to diversify, but investors want efficient diversification, that is, the highest expected return for a given risk or the lowest risk for a given expected return based on the state of the art in portfolio management.

the stock market crash of 1929, in 1940 Congress passed the ICA and Investment Advisers Act (IAA), collectively known as the '40 Act. Given the collective action problem dispersed mutual fund shareholders face in gathering information to monitor their advisers, it is unsurprising that Congress expressed concern in the preamble to the Act that fund advisers might jeopardize Americans’ savings by operating managed funds in their own interest rather than in the interest of fund shareholders. Unlike the Securities Act in 1933 (SA) and the Securities Exchange Act in 1934 (SEA), the '40 Act goes well beyond merely requiring full disclosure of all material information as a modest prophylactic to prevent managerial misconduct. The '40 Act heavily regulates the substance of the adviser-fund relationship. Most importantly, it virtually mandates vertical separation of the advisory firm from its managed funds by requiring the fund to formally contract with the advisory firm for the provision of advisory services. Even though the adviser normally creates and promotes the fund from its inception, the ICA requires periodic renewal of the advisory contract by the outside members of the board or by shareholders, and also requires that the contract be terminable at will by outside board members or shareholders on 60 days written notice. Section 15(a) of the ICA requires that all advisory contracts provide for termination on assignment, although section 15(f) of the ICA allows advisory firm owners to profit from a sale of control in the advisory

43. 15 U.S.C. §§ 80a-1 to 80a-64.

44. §§ 80b-1 to 80b-21.

45. Section 1 of the ICA, titled “Findings and Declaration of Policy,” states in part that investment companies are affected with a national public interest in that . . . such companies are media for the investment in the national economy of a substantial part of the national savings and may have a vital effect upon the flow of such savings into the capital markets . . . . It is declared that the national public interest and the interest of investors are adversely affected . . . when investment companies are organized, operated, managed, or their portfolio securities are selected, in the interest of directors, officers, investment advisers, depositors, or other affiliated persons thereof, in the interest of underwriters, brokers, or dealers, in the interest of special classes of their security holders, or in the interest of other investment companies or persons engaged in other lines of business, rather than in the interest of all classes of such companies’ security holders.

§ 80a-1.


48. § 80a-15(a).

49. Id. By SEC exemption, there is a narrow opportunity for vertical integration where the managed fund or funds collectively own all the stock in the advisory firm. The Vanguard Group is one of the few prominent examples of “internally-managed” mutual funds, although it appears external vendors provide most of the associated services by contract.

50. Id.
firm that results in an indirect assignment if certain conditions are met. As already noted, section 36(b) of the ICA imposes on fund advisers a fiduciary duty with respect to the receipt of compensation for services.

Given that the adviser normally creates the fund and makes long-term relationship-specific investments in promoting it, it is unsurprising that in reality advisory contracts are almost invariably renewed. It is rare for the board to shop the contract around, and this in part accounts for widespread criticism that outside board members suffer from a structural conflict of interest. The de facto relationship between the adviser and the firm lies somewhere in an economic netherworld between vertical integration (an extended firm) and long-term contract (market exchange), with the standard principal–agent and trustee relationships lying somewhere between. Mandated vertical disintegration also applies to the function of marketing mutual fund shares, which must be managed by an underwriter that is legally separate from the adviser, though in most cases affiliated with it.

The mutual fund industry is highly competitive by any structural standard. There are literally thousands of mutual funds in the U.S. economy. Industrial concentration is low and declining over time, and both innovation and entry are prolific. The concentration of fund families is substantially higher than for mutual funds alone, but fund family concentration is nonetheless low and declining, and no single fund or fund complex enjoys a dominant market share. The question at issue is whether shareholder information costs are so high that they weaken or entirely negate the structural effect on competition of large numbers and low market shares.

B. The Scholarly Literature

An issue debated in the scholarly literature for decades is whether active fund management generates benefits for shareholders compared to investment in a well-diversified portfolio representing “the market.” If corporate stock itself is efficiently priced, how can fund managers possibly hope to pick stocks that outperform the S&P 500 Market Index after charging brokerage commissions and other transaction costs, the advisory fee, and various administrative expenses to the fund? Are the billions of dollars the industry spends on research to identify mispriced securities a colossal waste of social resources?

In 1968 Michael Jensen published a seminal empirical study of active fund manager

51. § 80a-15(f).
52. § 80a-35(b).
54. § 80a-12(b) (“It shall be unlawful for any registered open-end company . . . to act as a distributor of securities of which it is the issuer, except through an underwriter . . . ”).
55. See Coates & Hubbard, supra note 3, at 163–81 (describing the recent history of competition in the mutual fund industry).
56. Id.
performance suggesting it might be so.57 One of Jensen’s fundamental assumptions was that investors are able to, and do, choose between funds based solely on the information they have at hand about the funds’ expected risk and return.58 A question that concerned him was how to measure fund performance relative to the market of all equity securities.59 Any well-diversified portfolio will more or less track the market index driven by its nondiversifiable, or market, risk. Using a database of annual NAV returns to 115 equity mutual funds from 1945 to 1964,60 he ran the following linear regression for each fund based on the Capital Asset Pricing Model (CAPM) recently developed by Sharpe61 and others62:

\[ R_j - R_f = \alpha + \beta (R_m - R_f) + u \]

The variables \( R_j \) and \( R_m \) are the observed returns to fund \( j \) and to the S&P 500 Market Index after accounting for dividend distributions, and \( R_f \) is the risk-free rate of return on U.S. government bonds, with each variable being observed over each year in the sample.63 The differences \( R_j - R_f \) and \( R_m - R_f \) reflect the returns rational investors must earn to compensate them for investing in risky assets rather than the risk-free asset, so-called “risk premia.” The model recognizes that rational investors will sell (buy) assets whose expected returns are too low (high) until prices—NAV in this setting—fall (rise) to provide them with a normal expected return.

No doubt the risk premium on any portfolio of stocks is affected by a number of factors, but the one factor Jensen thought most important was the risk premium on the market portfolio. As shown in Figure 1, the regression equation above amounts to fitting a straight line to a scatter diagram of points indicating various concurrent observations of \( R_j - R_f \) and \( R_m - R_f \), with \( \alpha \) being the intercept of the line (that is, the value of \( R_j - R_f \) when \( R_m - R_f \) is zero) and \( \beta \) being its slope. The scatter diagram itself will rarely form a straight line, and \( u \) reflects the deviations of each observation from the fitted line under the condition that the fit of the line is constructed to minimize the sum of the squared deviations.


58. Id. at 390.

59. Id.

60. Annual net asset value returns are simply the percentage change in the funds’ net asset value over the year in question.


63. Jensen, supra note 57, at 401.
The portfolio’s $\beta$ indicates how the risk premium earned by the fund’s portfolio changes, on average, when the risk premium earned by the market portfolio changes. It is the standard measure of undiversifiable market risk. Having adjusted for market risk, $\alpha$ reveals the fund manager’s ability to pick stocks that outperform the market. If $\alpha$ is positive, fund investors have enjoyed positive abnormal risk-adjusted NAV returns, perhaps owing to manager skill; if $\alpha$ is negative, they have suffered negative abnormal NAV returns, perhaps owing to manager incompetence or indolence. Jensen found that

---

64. *Id.* at 396.
65. *Id.* at 400.
66. *Id.* at 399.
the average $\alpha$ across funds in his sample was a statistically significant negative 1.1% per year, suggesting that the returns to active management after netting out brokerage commissions and other transaction costs, advisory fees, and administrative expenses were less than the returns on the market portfolio. And although he found several funds whose $\alpha$s were persistently positive (though only slightly so), he was unable to rule out the possibility that these observations were due entirely to luck.

The question of how active management can possibly add value in an efficient market was answered theoretically by Grossman and Stiglitz. They made the important point that it is impossible for markets to be informationally efficient in the traditional sense. If markets are strong-form efficient and instantly impound all private information into prices, for example, market participants seeking to discover such information will be unable to cover their costs and will refuse to engage in arbitrage. The traditional notions of market efficiency—weak form, semi-strong form, and strong form—are simply empirically testable statements of a more fundamental version of market efficiency. According to this version, any given security can be mispriced at any given moment. It may pay market participants to do research to discover mispriced securities and to trade those securities to make money, but this process is costly. If markets are efficient in the Grossman–Stiglitz sense, these arbitragers can expect to earn only a normal competitive return on their investments in price discovery. It is therefore quite possible that active fund managers are able to identify mispriced securities from time to time, and perhaps even persistently, and to make a competitive wage for their time and effort.

C. Excessive Fee Case Law—Gartenberg and Jones

For many years preceding private litigation under section 36(b) of the ICA, the interest rate banks could pay on deposits was legally capped by federal regulation. Beginning in the 1970s, members of the fund advisory industry led by Merrill Lynch sought to provide fund investors with the liquidity of bank deposits while allowing them to earn substantially higher rates of return on the money they invested. This led to the

67. Id. at 405.

68. Jensen, supra note 57, at 406, 415.


70. Id. at 141.


73. Gartenberg, 528 F. Supp. at 1044.
creation of the first no-load money market mutual funds. Rather than quoting a NAV that fluctuated from day to day, money market funds sought to quote NAV at a constant one dollar per share. Any returns in excess of what was necessary to maintain NAV at one dollar would be reported as share dividends on the one-dollar principal, making them virtually identical to bank deposits. As with all mutual funds, they offered to issue and redeem shares at daily NAV plus accrued “interest,” but they made liquidation especially easy, allowing shareholders to redeem by writing checks to third parties. They also offered an increasing number of ancillary services, such as credit cards and retail brokerage to shareholders who opened accounts with their broker–dealer affiliates. By assuring the SEC that they would invest only in high-quality, short-term fixed income securities (primarily government T-bills) that were essentially inflation-proof, the advisory firm sponsors of money market funds succeeded in obtaining an SEC exemption from regulations that would otherwise have precluded them from operating.\textsuperscript{74}

Private litigation under section 36(b) of the ICA began in earnest with \textit{Gartenberg v. Merrill Lynch Asset Management, Inc.}\textsuperscript{75} Like many money market funds of the time, Merrill Lynch’s Ready Asset Trust (RAT) had proven wildly successful. From 1977 to 1981, Merrill’s RAT increased its assets under management from $428 million to over $19 billion,\textsuperscript{76} making it the largest in the industry.\textsuperscript{77} At the time the suit was filed it had over 1.1 million investors.\textsuperscript{78} In 1979 the adviser, Merrill Lynch Asset Management (MLAM), established a fee schedule that stepped down in increments from 50 basis points per year on total assets up to $500 million to 27.5 basis points per year on assets in excess of $2.5 billion.\textsuperscript{79} Despite stepped-down advisory fees, the total yearly fees

\textsuperscript{74. TAMAR FRANKEL & CLIFFORD E. KIRSCH, INVESTMENT MANAGEMENT REGULATION 465 (3d. ed. 2005).}

\textsuperscript{75. Gartenberg, 528 F. Supp. 1038.}

\textsuperscript{76. Gartenberg v. Merrill Lynch Asset Mgmt. Inc., 694 F.2d 923, 930 (2d Cir. 1982).}

\textsuperscript{77. Gartenberg, 528 F. Supp. at 1042.}

\textsuperscript{78. Id. at 1040.}

\textsuperscript{79. Id. at 1043. The following table, abbreviated here, appears in the court’s opinion:}

<table>
<thead>
<tr>
<th>Average Daily Value of Net Assets</th>
<th>Advisory Fee</th>
</tr>
</thead>
<tbody>
<tr>
<td>&lt; $500 million</td>
<td>0.50%</td>
</tr>
<tr>
<td>&gt; $500 million and &lt; $750 million</td>
<td>0.425%</td>
</tr>
<tr>
<td>&gt; $750 million and &lt; $1 billion</td>
<td>0.375%</td>
</tr>
<tr>
<td>&gt; $1 billion and &lt; $1.5 billion</td>
<td>0.35%</td>
</tr>
<tr>
<td>&gt; $1.5 billion and &lt; $2 billion</td>
<td>0.325%</td>
</tr>
<tr>
<td>&gt; $2 billion and &lt; $2.5 billion</td>
<td>0.30%</td>
</tr>
<tr>
<td>&gt; $2.5 billion</td>
<td>0.275%</td>
</tr>
</tbody>
</table>
MLAM collected increased over the 1977–1981 period from $1,578,476 to $39,369,587. The plaintiff’s main allegation was that owing to economies of scale this was just “too much money,” and that MLAM had therefore breached its fiduciary duty with respect to the receipt of compensation under section 36(b).

Reviewing the legislative history of section 36(b), District Court Judge Pollack noted that Congress had twice rejected imposing a “reasonableness” standard on fund advisory fees and had instead chosen to impose a fiduciary standard. Although he found no dispositive case law indicating how the fiduciary standard applies to adviser compensation, he quoted various cases that established the following general concepts:

The standard of fiduciary duty under section 36(b) “is concerned solely with fairness and equity.” . . . “The essence of the [fiduciary] test is whether or not under all the circumstances the transaction carries the earmarks of an arm’s length bargain.” . . . The conduct of the investment adviser must be governed by the “duty of uncompromising fidelity” and “undivided loyalty” to the Fund’s shareholders that is imposed by section 36(b).

According to the language of 36(b), however, the party bringing the action has the burden of proving a fiduciary breach.

Judge Pollack found that in enacting section 36(b), Congress had intended for courts to examine all the facts in connection with the determination of the adviser’s compensation. He reviewed the fees MLAM had earned, the quality and cost of the services it had provided, the potential for scale economies in management, the net earnings to MLAM, and the due diligence of the fund’s board of trustees. In rejecting the plaintiff’s claim, Judge Pollack pointed out that even if some functions of asset management are subject to scale economies others clearly are not, that MLAM’s fees were the lowest in the industry, that the yield it paid shareholders was above the industry average, that the package of services it provided—not the least of which was high-volume order processing—were without equal, and that the lower fees advisers charged pension funds and other institutional clients were irrelevant to assessing those charged by public fund advisers. He also found that the RAT trustees had exercised informed judgment in good faith and on a reasonable basis, leading him to weight heavily their approval of the advisory agreement.

What Judge Pollack found most persuasive in rejecting plaintiff’s claim was that Congress had intended section 36(b) to apply to equity funds that charged up-front

80. Id. at 1040.
81. Id. at 1046–47.
83. Gartenberg, 528 F. Supp. at 1039.
84. Id. at 1047–49.
85. Id. at 1045.
86. Id. at 1067.
These fixed one-time charges make it costly for investors to switch between funds, undermining the force of competition in the market for advisory services and fostering various abusive practices that Congress sought to prevent. He considered it clear from the record that Congress did not intend section 36(b) to apply to money market mutual funds, which charge no up-front load and did not even exist in 1970. Noting the tremendous growth of money market funds since that time, he concluded that competition between fund advisers was sufficient to prevent excessive fees. He concluded that the most important factor to be considered in evaluating the fairness of advisory fees is the price charged by similar advisers to funds managed by them.

[The] price charged by advisers to those funds establishes the free and open market level for fiduciary compensation [and] . . . serves as a standard to test the fairness of the investment advisory fee. . . . [A fee is fair if it] is in harmony with the broad and prevailing market choice available to the investor.

The Court of Appeals affirmed Judge Pollack’s judgment in favor of the defendant but substantially modified his reasoning. Writing for the court, Judge Mansfield rejected Judge Pollack’s finding that Congress had specifically declined to establish a reasonableness standard for fees under section 36(b). As he put it, “the legislative history of § 36(b) indicates that the substitution of the term ‘fiduciary duty’ for ‘reasonable,’ while possibly intended to modify the standard somewhat, was a more semantical than substantive compromise, shifting the focus slightly from the fund directors to the conduct of the investment adviser–manager.” The test of fiduciary breach under section 36(b), according to Judge Mansfield, is essentially whether the fee schedule represents a charge within the range of what would have been negotiated at arm’s-length in the light of all of the surrounding circumstances. . . . To be guilty of a violation of § 36(b) . . . the adviser-manager must charge a fee that is so disproportionately large that it bears no reasonable relationship to the services rendered and could not have

87.  Id. at 1044.
89.  Id. at 1047–48.
90.  Id. at 1067–68.
91.  Gartenberg v. Merrill Lynch Asset Mgmt., Inc., 694 F.2d 923 (2d Cir. 1982).
92.  Id. at 926–27.
93.  Id. at 928.
been the product of arm’s-length bargaining.\textsuperscript{94}

Judge Mansfield also rejected Judge Pollack’s reliance on market competition to assess advisory fees:

Competition between money market funds for shareholder business does not support an inference that competition must therefore also exist between adviser-managers for fund business. The former may be vigorous even though the latter is virtually non-existent. Each is governed by different forces. Reliance on prevailing industry advisory fees will not satisfy § 36(b).\textsuperscript{95}

Although evidence of market competition is relevant to the inquiry, it is merely a single factor to be considered, and not a particularly critical factor at that.\textsuperscript{96} Citing the SEC’s 1966 report to Congress, Judge Mansfield observed that “the existence in most cases of an unseverable relationship between the adviser–manager and the fund it services tends to weaken the weight to be given to rates charged by advisers of other similar funds.”\textsuperscript{97} Competition for investor money does not lead to fee competition by advisers because the fees each investor pays are insignificant. In his words:

The fund customer’s shares [sic] of the advisory fee is usually too small a factor to lead him to invest in one fund rather than in another or to monitor adviser-manager’s fees. . . . The disparity is competitively insignificant. In the present case, for instance, the alleged excessive Manager’s fee amounts to $2.88 \textit{a year} for each $1,000 invested. If rates charged by the many other advisers were an affirmative competitive criterion, there would be little purpose in § 36(b).\textsuperscript{98}

Judge Pollack’s distinction between load and no-load funds was therefore irrelevant, and his emphasis on competition between advisers for investor business was misplaced.

Judge Mansfield upheld Judge Pollack’s finding that the fees advisors charge institutional clients are irrelevant to an inquiry under section 36(b) because the nature and extent of the services advisers provide to each type of client differ substantially.\textsuperscript{99} Mutual funds must be prepared to process redemptions and sales daily, which requires them to hold substantial liquid assets and to incur the cost of processing orders throughout the

\textsuperscript{94} Id. If this statement leaves any doubt that Judge Mansfield intended to establish a standard for section 36(b) based on the reasonableness of fees, that doubt can be laid to rest by his statement in the appeal of Gartenberg II quoting, in part, the above statement, to wit: “The central issue in this case is the reasonableness of the advisory fee, which turns on whether it is so large that it ‘bears no reasonable relationship to the services rendered and could not have been the product of arms-length bargaining.’” Gartenberg v. Merrill Lynch Asset Mgmt., Inc., 740 F.2d 190, 192 (2d Cir. 1984).

\textsuperscript{95} Gartenberg, 694 F.2d at 929.

\textsuperscript{96} Id.

\textsuperscript{97} Id.

\textsuperscript{98} Id. at 929.

\textsuperscript{99} Id. at 930.
nation. Pension funds do not incur these or any other costs borne by fund advisers.

In upholding Pollack’s judgment, Mansfield stated that [the court’s] affirmance is not a holding that the fee contract between the Fund and the Manager is fair and reasonable. We merely conclude that on this record appellants failed to prove by a preponderance of the evidence a breach of fiduciary duty. Whether a violation of § 36(b) might be established through more probative evidence . . . must therefore remain a matter of speculation.\(^ {100} \)

Following on the heels of the “mutual fund scandals” initiated in 2003 by the now fallen New York State Attorney General Eliot Spitzer, Jones v. Harris\(^ {101} \) appeared to be an unremarkable case on its face. The District Court granted the defendant summary judgment,\(^ {102} \) and on appeal to the Seventh Circuit Judge Easterbrook could easily have affirmed and left it at that. Instead, he chose to reopen the issue of competition between fund advisers on which Judge Pollack had relied and that Judge Mansfield had rejected on appeal in Gartenberg I.\(^ {103} \) Citing a Third Circuit decision seemingly at odds with Gartenberg, as well as a favorable ruling from the Seventh Circuit, Easterbrook rejected Gartenberg’s “reasonableness” standard and adopted in its place the fiduciary standard for assessing compensation familiar in the common law of trusts.\(^ {104} \) In his words:

A fiduciary duty differs from rate regulation. A fiduciary must make full disclosure and play no tricks but is not subject to a cap on compensation. The trustees (and in the end investors, who vote with their feet and dollars), rather than a judge or jury, determine how much advisory services are worth.\(^ {105} \)

He found meritless Judge Mansfield’s conclusion that competition between advisers for investor business is insufficient to constrain advisory fees.\(^ {106} \) Citing a recent scholarly article by Coates and Hubbard,\(^ {107} \) he noted that there are literally thousands of mutual funds available to investors, and that the fund industry comes close to being a model of “atomistic” competition.\(^ {108} \) Even though fund boards rarely “fire” their advisers, investors can and do fire advisers cheaply and easily by moving their money elsewhere, not when the advisers’ fees are “too high” in the abstract, but when they are excessive in

\(^ {100} \) Gartenberg, 694 F.2d at 933.

\(^ {101} \) Jones v. Harris Assocs., 527 F.3d 627 (7th Cir. 2008).

\(^ {102} \) Id. at 629.

\(^ {103} \) Id. at 631.

\(^ {104} \) Id. at 632.

\(^ {105} \) Id.

\(^ {106} \) Jones, 527 F.3d at 634.

\(^ {107} \) Coates & Hubbard, supra note 3, at 156.

\(^ {108} \) Jones, 527 F.3d at 634.
relation to the results. He continued:

Holding costs down is vital in competition, when investors are seeking maximum return net of expenses—and as management fees are a substantial component of administrative costs, mutual funds have a powerful reason to keep them low unless higher fees are associated with higher return on investment. A difference of 0.1% per annum in total administrative expenses adds up by compounding over time and is enough to induce many investors to change mutual funds. That mutual funds are “captives” of investment advisers does not curtail this competition. An adviser can’t make money from its captive fund if high fees drive investors away.

Citing a well-known scholarly article by Schwartz and Wilde, he dismissed the common criticism that most investors are unsophisticated and do not, in fact, compare prices. Those investors who are sophisticated can be relied on to shop around and to exert competitive pressure that protects the rest. In affirming the judgment of the district court, he concluded that

[p]laintiffs do not contend that Harris Associates pulled the wool over the eyes of the disinterested trustees or otherwise hindered their ability to negotiate a favorable price for advisory services. The fees are not hidden from investors—and the Oakmark funds’ net return has attracted new investment rather than driving investors away.

The plaintiff petitioned the court of appeals for rehearing en banc, which a majority of the court denied. Writing in dissent from that denial, Judge Posner rebuked Judge Easterbrook for creating a circuit split where none had existed without first notifying the entire court. Judge Posner took the opportunity to note the growing body of evidence indicating that executive compensation in public corporations was excessive because board members had only “feeble incentives” to impose limitations owing to conflicts of interest, favoritism, and reciprocity. The same maligned incentives existed in all large entities and especially in the mutual fund industry where, he observed, recent “abuses

109. Id.
110. Id. at 631–32.
112. Jones, 527 F.3d at 634.
113. Id. at 634.
114. Id. at 635.
115. Jones v. Harris Assocs., 537 F.3d 728 (7th Cir. 2008).
116. Id. at 732.
117. Id. at 730 (Posner, J., dissenting).
have been rampant.”

As to the power of competition to constrain excessive advisory fees, Judge Posner noted Easterbrook’s claim that advisers cannot make money from their captive funds if high fees drive investors away, but he expressed doubt that high fees will, in fact, drive investors away. Quoting Freeman and Brown, he wrote that:

[T]he chief reason for substantial advisory fee level differences between equity pension fund portfolio managers and equity mutual fund portfolio managers is that advisory fees in the pension field are subject to a marketplace where arm’s-length bargaining occurs. As a rule, [mutual] fund shareholders neither benefit from arm’s-length bargaining nor from prices that approximate those that arm’s-length bargaining would yield were it the norm.

Posner conceded that “[t]he outcome of this case may be correct. . . . But the creation of a circuit split, the importance of the issue to the mutual fund industry, and the one-sided character of the panel’s analysis warrant our hearing the case en banc.”

Following the U.S. Supreme Court’s grant of the plaintiffs’ petition for certiorari in Jones v. Harris, 16 amicus curiae have filed briefs with the Court. Two of them from the scholarly community are worth reviewing. The first, by Litan, Mason, and Ayers, in support of the petitioners, makes two basic but related points. First, they argue that investors are unable to accurately assess the quality of the mutual funds in which they invest because “they do not behave rationally as predicted by economic models.” Second, they argue that even if mutual fund investors are purely rational, the fund industry exhibits “symptoms of market failure” owing to the cost investors must incur gathering information.

In support of their first point, Litan, Mason, and Ayers rely on literature from “behavioral economics,” which they assert “has come to be an enormously important

118. Id.
119. Id. at 732.
120. Jones, 537 F.3d at 731.
121. Freeman & Brown, supra note 25, at 634.
122. Jones, 537 F.3d at 732.
123. Id. at 733–34.
126. Id. at *5.
127. Id. at *5–6.
field of economic research.” 128 This literature documents a number of well-known “cognitive anomalies intrinsic in human behavior” that make it incredibly difficult for investors to determine “whether their money is being managed well.” 129 These include “misperceptions of chance,” “sample-size neglect,” “loss aversion,” and “mental accounting.” 130 In their view, investor irrationality impedes the forces of competition, and makes it extremely difficult for investors to simply “fire” their managers by redeeming their stock and investing it elsewhere, contrary to Easterbrook’s suggestion. 131 As a result, they state that the fee structure of the entire fund advisory industry is excessive and, therefore, evidence of what rival advisers charge similar funds is irrelevant. 132

In support of their second point they cite prior studies tending to show that few investors knew they paid advisory fees based on a percentage of assets under management, and that even fewer had any idea what that percentage actually was. 133 What is more, they assert, the economic literature confirms that mutual funds have been effective in “hiding their costs from investors.” 134 They also cite various studies of active fund performance, including several of those already discussed above such as Malkiel and Carhart, indicating that active fund managers generally underperform the market and that high advisory fees are systematically associated with poor fund performance. 135 Owing to the cost investors face in gathering accurate information, the market fails to protect them from excessive fees, which largely reflect wealth expropriation from fund shareholders to their advisers. 136

Litan, Mason, and Ayers conclude that the evidence on both points supports the inference that market forces cannot be relied on to constrain fund advisory fees to

128. Id. at *8.

129. Id. at *8–9.

130. Brief of Robert Litan et al., supra note 206, at *5.

131. Id.

132. Id. at *6.

133. Id. at *14.

134. Id.

135. Brief of Robert Litan et al., supra note 206, at *16.

competitive levels.\textsuperscript{137} But rather than price controls administered by regulatory agencies, they argue it is better to preserve Gartenberg’s “reasonableness” standard to expose the few bad actors in the profession to legal liability.\textsuperscript{138} The reasonable competitive benchmark rate, they advocate, should be set by the fees advisers charge institutional clients.\textsuperscript{139}

The second scholarly amicus curiae brief is authored by Coates and Hubbard and signed by various law and finance professors in support of respondent.\textsuperscript{140} The brief reiterates many of the points made by Coates and Hubbard regarding the effective working of competition in the fund industry.\textsuperscript{141} Their analysis closely tracks the standard type of industrial organization analysis of market competition familiar to courts and antitrust scholars and argues that those who criticize fund advisory fees as excessive mistakenly rely on outdated economic theory that is stuck in the 1960s.\textsuperscript{142} Their analysis strongly supports the conclusion that

investor mobility, combined with a number of other undisputed characteristics of the mutual fund industry, such as lack of concentration, a multitude of investor choices, low barriers to entry, common and continuous actual new entry, numerous distribution models, frequent and widespread advisory fee reductions, and, most importantly, strong and consistent correlation between lower advisory fees and higher returns, higher returns and investor flows, and lower fees and higher market share results in robust fee competition.\textsuperscript{143}

Especially compelling evidence that competitive forces constrain advisory fees is that 40% of equity funds from 1998 to 2004 waived fees annually.\textsuperscript{144} One 2001 study even showed that 55% of money market fund advisers waived at least two-thirds of their fees.\textsuperscript{145} It concluded that they did so owing to intense competitive pressure to report attractive returns that would generate fund inflows.\textsuperscript{146}

\begin{itemize}
\item \textsuperscript{137} Brief of Robert Litan et al., supra note 206, at *21.
\item \textsuperscript{138} Id. at *6.
\item \textsuperscript{139} Id.
\item \textsuperscript{140} Brief of Law and Finance Amici Curiae, as Amici Curiae Supporting Respondent, Jones v. Harris Assocs., 129 S. Ct. 1579 (2009) (No. 08-586), 2009 WL 2896315.
\item \textsuperscript{141} Coates & Hubbard, supra note 3, at 156.
\item \textsuperscript{142} Brief of Law and Finance Amici Curiae, supra note 221, at *12.
\item \textsuperscript{143} Brief of Robert Litan et al., as Amici Curiae Supporting Petitioners, Jones v. Harris Assocs., 129 S. Ct. 1579 (2009) (No. 08-586), 2009 WL 1759017.
\item \textsuperscript{144} Brief of Law and Finance Amici Curiae, supra note 221, at *30.
\item \textsuperscript{145} Id. at *31 (citing Susan E. K. Christoffersen, Why Do Money Fund Managers Voluntarily Waive Their Fees?, 56 J. Fin. 1117, 1121 (2001)).
\item \textsuperscript{146} Christoffersen, supra note 226, at 1138–39.
\end{itemize}
Despite what it argues is overwhelming evidence of fee competition in the fund advisory industry, the Coates and Hubbard brief supports Easterbrook’s judgment in Jones v. Harris, but rejects much of his reasoning, as well as his departure from the Gartenberg “reasonableness” standard. It merely asks the Court to find that in assessing excessive fees under section 36(b) trial courts should consider two sets of facts relating to the forces of competition. First, courts should consider evidence of competition for investors the adviser faces from rival advisers of similar funds, and, second, they should consider evidence of the extent to which competition constrains fee setting by the adviser and the fund’s board, as well as the extent to which “that competition is likely to be similar to arm’s-length bargaining.”

III. THE ECONOMICS OF MUTUAL FUND ORGANIZATION

IV. SUMMARY AND CONCLUDING REMARKS

Revelation of the four economic myths about fund advisory fees provides remarkable insight into the U.S. Supreme Court’s task in reviewing Jones v. Harris. I have shown that if investors are rational and fully informed, fund shareholders cannot expect to capture any abnormal return from their manager’s superior stock-picking ability and that the level of fund advisory fees can have no effect on shareholder returns. Whether fund management is subject to scale economies can be answered only once the output of fund management has been carefully specified. Assets under management is not the output. The primary effect of fees that decline as assets under management increase is simply to increase the size of existing funds and, secondarily, to create a conflict of interest between the adviser and fund shareholders that would not otherwise exist.

This essay suggests that a reasonable approximation of the output of fund management is state-of-the-art savings, including the adviser’s commitment to prospect for ways to generate unexpected abnormal returns, and state-of-the-art organizational arrangements to ensure investors their savings will be safe from indolent or self-dealing management—what I characterize as quality assurance. Any attempt to mandate that advisers reduce fees is likely to injure investors by forcing advisers to reduce quality.

These and other insights rely on economic theory that has been found admissible in numerous judicial proceedings, not the least of which includes the large body of antitrust case law that has emerged over the past few decades. This case law recently culminated in Leegin v. KSPS, where the U.S. Supreme Court reversed its near-100 year precedent condemning resale price maintenance (RPM). Citing Coase’s work on property rights and transaction costs, the Court found that manufacturer-imposed minimum resale prices might lead retailers to compete efficiently for customer sales in ways other than cutting

147. See generally Brief of Law and Finance Amici Curiae, supra note 221, at *30.
Because the manufacturer faces prohibitive monitoring costs, this can be the best way to ensure retailers provide customers with valuable but difficult-to-monitor special services. As a theory of contract choice, the quality-assurance explanation for why premium advisory fees benefit fund investors falls into the same general category as the Court’s theory of RPM.

The available empirical work in no way calls into question the proposition that investors are rational and collectively well-informed, in which case the level of fund advisory fees can have no effect on shareholder returns. More important, if investors are imperfectly informed owing to search and monitoring costs, widely accepted transaction cost economics suggests that premium advisory fees bond advisers’ implicit promise to provide high quality and thereby reduce investors’ search and monitoring costs. Given the quality-assuring performance bond high-quality advisers must post, it is hardly surprising that their advisory contracts are almost invariably renewed. The empirical evidence equally supports this proposition. As an intellectual matter, inventive theories based on cognitive biases and investor irrationality should be avoided where widely-accepted and well-tested economic theory will do. As a legal matter, theories based on “behavioral economics” have no place in law courts at this early time in their conception. Even if it were true, as Litan, Mason, and Ayers argue in their amicus brief, that “behavioral economics’ has come to be an enormously important field of economic research,” it has no place in legal proceedings. Law courts are an inappropriate forum to vet avant garde economic theory whose analytical contours have yet to be worked out and for which scientific testing is years away and far from inevitable.

Litan, Mason, and Ayers support the traditional Gartenberg approach as an appropriate way to punish the “few bad actors” in the industry. At the same time, they argue that the much lower fees private money managers charge institutional clients are the proper benchmark by which to assess advisory fees under section 36(b). Yet the use of this benchmark would punish virtually the entire industry of fund advisers, and if, as Litan, Mason, and Ayers acknowledge, investors have difficulty assessing fund quality, it would very likely punish investors as well. What is more, one need not

150. Id. at 903.


154. Id. at *7–*8.

155. Id. at *8.
scratch far below the surface of the section 36(b) case law to see that many cases have been brought against advisory firms that can by no plausible stretch of the imagination be seen as “bad actors.”

Merrill Lynch, for example, was a pioneer in the money market mutual fund industry. Its products were wildly successful. Immediately after defending itself in two Gartenberg cases, it found itself back in court defending a section 36(b) claim in Krinsk v. Fund Asset Management. That case involved MLAM’s Cash Management Asset Program (CMAP), which offered integrated services such as a securities margin account, a choice between one of three money market funds, and a Visa credit card and checking account. The CMAP included a patented sweep feature that cleared investors’ cash balances out of liquid but low-yielding accounts at the end of each day and into higher-yielding but less-liquid accounts overnight. This was one of the first business method patents ever issued, and surely cost Merrill dearly. As with MLAM’s earlier money market funds, the CMAP was wildly successful. The fund grew accordingly, as did its total yearly fees, in spite of a declining fee schedule. Had its fees been even lower it would simply have experienced larger fund inflows. Merrill has had to defend at least two additional section 36(b) claims since that time. In 2006, it finally pulled the plug, selling its asset management business to BlackRock, Inc., in exchange for a large minority stake in that firm.

In light of Merrill’s remarkable history of innovation and investor satisfaction, it would be difficult to argue with a straight face that it was a “bad actor” that deserved to routinely defend itself against excessive fee claims. It is ironic that what has landed advisers in court is their very success, as reflected by investors’ revealed preference. To my knowledge, no investor has ever brought a section 36(b) claim against a fund adviser.

156. Following the trial and appeal of Gartenberg I, Gartenberg v. Merrill Lynch Asset Mgmt, Inc., 528 F. Supp. 1038 (S.D.N.Y. 1981), Merrill Lynch Asset Management (MLAM) was forced to defend itself in Gartenberg II against a virtually identical set of claims, with the only difference being the time period over which MLAM earned the disputed fees. Gartenberg v. Merrill Lynch Asset Mgmt., Inc., 573 F. Supp. 1293 (S.D.N.Y. 1983). Judge Pollack dismissed many of the claims under the doctrines of res judicata or collateral estoppel. Gartenberg v. Merrill Lynch Asset Mgmt. Inc., 694 F.2d 923, 933 (2d Cir. 1982). The outcome on the remaining claims was identical to Gartenberg I, with the plaintiff appealing the District Court’s judgment and the Court of Appeals affirming. Id.


159. Id.

160. Green v. Fund Asset Mgmt., 147 F. Supp. 2d 318, 322–25 (D.N.J. 2001) (granting defendants’ motion to dismiss plaintiffs claim under section 36(b) of the ICA for breach of fiduciary duty and deceit), aff’d, 286 F. 3d 682 (3d Cir. 2002); In re Merrill Lynch Inv. Mgmt. Funds Sec. Litig., 434 F. Supp. 2d 233 (S.D.N.Y. 2006) (granting defendants’ motion to dismiss plaintiffs’ claim that the distributor and investment adviser defendants violated section 36(b) of the ICA by charging “inflated” and “excessive” marketing and management fees).

that negotiated an unusually high asset-based fee, say four percent, and then experienced substantial outflows owing to poor investment performance. To the contrary, it is the very success advisers have had in attracting investors that has driven up their total fees and subjected them to 36(b) claims. The underlying argument is not that the fee rate is too high, but that the contractual arrangement, according to which total fees depend on total assets, suffers from a crippling conflict of interest that inevitably leads to adviser self-dealing. As I have shown, this argument is completely inconsistent with standard economic theory and widely-accepted transaction costs analysis, both largely ignored in the scholarly literature, in regulatory pronouncements, and in judicial opinions under section 36(b). Writing in 1968, Oliver Williamson’s observations regarding the importance of transaction cost economics to antitrust enforcement is uncanny for its relevance to section 36(b). In his words, “if neither the courts nor the enforcement agencies are sensitive to [transaction cost] considerations, the system fails to meet a basic test of economic rationality. And without this the whole enforcement system lacks defensible standards and becomes suspect.”

I have argued here that basic economic theory provides novel and profound insights into the section 36(b) fiduciary duty standard. Owing to their open access nature, mutual funds cannot possibly provide fund investors with an expectation of systematically capturing the rents accruing to their adviser’s superior stock picking ability. The best they can expect is state-of-the-art savings on the efficient frontier, the chance to share in any unexpected superior returns while also suffering any unexpected inferior returns, and the assurance that their savings will be safe from expropriation and other forms of adviser misdealing. Indeed, Congress’s objective in passing the ’40 Act was to protect Americans’ savings. With any expected abnormal returns subject to a race to first possession, mandatory reductions in the level of fees cannot benefit fund shareholders. If one takes seriously the notion that investors face costly information about adviser quality, mandatory fee reductions are likely to injure fund shareholders by generating a reduction in management quality.

Given the open-access nature of mutual funds, Easterbrook’s approach in Jones v. Harris is the only economically sensible way to understand section 36(b)’s fiduciary standard if frivolous litigation that injures both advisers and fund shareholders is to be avoided. It is also the legally sensible approach. Once having imposed on fund advisers a fiduciary duty with respect to the receipt of compensation, there must be some way to constrain judges from indulging in hindsight bias when assessing claims for excessive fees, just as the business judgment rule does in most state corporation law. Once an adviser has created and promoted the fund, nurtured it through the public issuance of shares, negotiated the asset-based advisory fee, and experienced substantial fund inflows that dramatically increase total fees, it is all too easy for a judge to evaluate the adviser’s compensation as if the adviser knew at the moment of negotiation exactly what the future would bring. Absent some kind of demonstrable fiduciary breach such as failure to inform

---


or bad faith, the economically complex and protracted inquiry *Gartenberg*\(^{164}\) requires places far too much responsibility on judges ill-trained to assess the relevant issues. Only in the rare cases in which such “procedural” failures can be proved should courts make such detailed inquiries. This approach has the prudential benefit of focusing the court’s evidentiary proceedings on the causal relationship between the alleged breach and the excessive fees charged to the plaintiff. According to the quality assurance model, parsimonious ex post adviser liability will reduce the necessary quality assuring premium and the fees investors must pay for high quality management.

---

\(^{164}\) *Gartenberg v. Merrill Lynch Asset Mgmt.*, 694 F.2d 923 (2d Cir. 1982).