Nudging Mutual Fund Fees Downward: Using Default Rules To Combat Excessive Advisory Fees

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I. INTRODUCTION

Mutual fund investments now constitute 19% of United States households' assets and an even more significant fraction of retirement savings.[1] The attempt by Congress and the Securities and Exchange Commission (SEC or Commission) to regulate mutual fund advisory fees under section 36(b) of the Investment Company Act of 1940[2] (Investment Company Act or Act) has resulted in a wealth of litigation, the vast majority of which has resulted in decisions upholding the challenged fees.[3] The ninety-three million United States mutual fund

1. INV. CO. INST., 2009 INVESTMENT COMPANY FACT BOOK: A REVIEW OF TRENDS AND ACTIVITY IN THE INVESTMENT COMPANY INDUSTRY 8–9 (2009). At year-end 2008, U.S.-registered investment companies managed $10.3 trillion in assets. *Id.* at 8. This figure represents a $2.6 trillion decline over year-end 2007, due largely to a 40% decline in major U.S. stock market indexes during the year. *Id.*

2. Section 36(b) of the Investment Company Act is codified at 15 U.S.C. § 80a-35(b) (2006). *See* Investment Company Amendments Act of 1970, Pub. L. No. 91-547, § 20, 84 Stat. 1413, 1428–29.

3. *See, e.g.*, James R. Carroll & David S. Clancy, *'Excessive Fee' Lawsuits*, NAT'L L.J., May 26, 2008, at 12 (noting that the most recent wave of excessive fee lawsuits has resulted in multiple rulings in the mutual fund industry's favor, while plaintiffs have neither prevailed in court nor garnered any public settlement requiring the return of advisory fees); John P. Freeman et al., *Mutual Fund Advisory Fees: New Evidence and a Fair Fiduciary Duty Test*, 61 OKLA. L. REV. 83, 86 (2008) ("[S]ection 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)."). *But see* JAMES D. COX ET AL., SECURITIES REGULATION: CASES AND MATERIALS 1211 (3d ed.

investors have a vested interest in advisory fee levels.[4] Small fee differences, cumulated over the life of an investment, can significantly impact total returns.[5] On the other hand, excessive fee litigation imposes costs on the mutual fund industry,[6] and mutual fund directors must consider the potential for litigation when setting advisory fee schedules.[7] In light of plaintiffs' nearly complete failure to prevail in excessive fee litigation and the prospect that the more restrictive standard the Seventh Circuit Court of Appeals recently proposed may render shareholder recovery even more difficult,[8] a growing body of evidence suggests that the fiduciary duty imposed by section 36(b) has not adequately protected mutual fund shareholders from excessive advisory fees.[9]

Section 36(b) expressly imposes a fiduciary duty on the investment adviser with respect to payments the adviser receives from the fund in exchange for advisory services.[10] Congress expressly granted investment

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2001) (noting that some investment advisers have agreed to prospectively reduce advisory fees as a condition of settling section 36(b) lawsuits).

4. INV. CO. INST., *supra* note 1, at 7. In exchange for providing a fund with facilities, administrative staff, portfolio management, and other services, an investment adviser charges the fund "an advisory fee based on a percentage of the average daily value of the [f]und's net assets." Gartenberg v. Merrill Lynch Asset Mgmt., Inc., 694 F.2d 923, 926 (2d Cir. 1982); *see also infra* notes 33–35 and accompanying text.

5. PETER J. WALLISON & ROBERT E. LITAN, COMPETITIVE EQUITY: A BETTER WAY TO ORGANIZE MUTUAL FUNDS 74 (2007) (citing JOHN C. BOGLE, THE BATTLE FOR THE SOUL OF CAPITALISM 161 (2005)) (noting that small advisory fee differences can reduce an investor's total gain by 75% over a ten-year period).

6. *See* Carroll & Clancy, *supra* note 3, at 12 ("[T]he recent wave of 'excessive fee' cases . . . has imposed significant litigation costs on the mutual fund industry, but it has not yielded judicial findings corroborating assertions that mutual fund fees are disproportionate to the services provided.").

7. *See* Lori A. Martin & Martin E. Lybecker, It's Too Early To Disregard the *Gartenberg* Factors During Advisory Fee Renewals (May 27, 2008), http://www.wilmerhale.com/publications/whPubsDetail.aspx?publication=8329 ("[B]oards of directors can clearly document that they have served as independent watchdogs on the management of investment companies by continuing to review the nature and quality of the services provided to the investment company and its shareholders.").

8. *See* Grace Carter & Katharine Chao, The Future of *Gartenberg*: A New Approach in Evaluating Investment Adviser Fees 3 (May 2008), http://paulhastings.com/assets/publications/919.pdf?wt.mc_ID=919.pdf ("If other courts do follow [*Harris Associates*], the Seventh Circuit's approach will create greater protection for advisers against excessive fees claims when their fees are in line with the market.").

9. *See infra* Part IV.C.

10. 15 U.S.C. § 80a-35(b) (2006) ("[T]he investment adviser of a registered investment company shall be deemed to have a fiduciary duty with respect to the receipt of compensation for services, or of payments of a material nature, paid by such registered investment company or by the security holders thereof, to such investment

company shareholders a private right of action as a means of enforcing this fiduciary duty.[11] However, under the *Gartenberg* standard employed by the majority of courts that have evaluated excessive fee claims under section 36(b),[12] no plaintiff has ever successfully demonstrated a breach of this duty.[13] Moreover, the replacement standard recently proposed by the Seventh Circuit Court of Appeals does not bode well for the prospect of plaintiff recovery because it relies on comparisons to other mutual fund fees prevailing in a market that many commentators condemn as lacking the level of competition necessary to fundamentally affect prices.[14]

Observers of the mutual fund market largely agree that the lack of competition for advisory services results from a governance structure riddled with conflicts of interest.[15] In short, the investment adviser establishes a fund, elects its initial board of directors, and provides the fund with advisory and administrative services.[16] The Investment

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adviser or any affiliated person of such investment adviser."). By incorporating the agency concept of fiduciary duty, section 36(b) obligates an investment adviser to act loyally for the mutual fund and its shareholders' benefit in matters related to compensation for services and other payments paid by the fund or its shareholders to the adviser. *See* RESTATEMENT (THIRD) OF AGENCY § 8.01 (2006) (explaining the fiduciary duty in general); *see also* S. REP. NO. 91-184, at 6 (1969), *as reprinted in* 1970 U.S.C.C.A.N. 4897, 4902 ("This bill states that the mutual fund investment adviser has a specific 'fiduciary duty' in respect to management fee compensation. . . . [It] is in accordance with the traditional function of the courts to enforce such fiduciary duties in similar type relationships.").

11. *See* 15 U.S.C. § 80a-35(b) ("An action may be brought under this subsection . . . by a security holder of such registered investment company . . . against such investment adviser . . . ."); S. REP. NO. 91-184, at 7, *as reprinted in* 1970 U.S.C.C.A.N. 4897, 4903 ("Under [section 36(b)] either the SEC or a shareholder may sue in court on a complaint that a mutual fund's management fees involve a breach of fiduciary duty.").

12. *See* Gartenberg v. Merrill Lynch Asset Mgmt., Inc., 694 F.2d 923 (2d Cir. 1982). Only the Seventh Circuit Court of Appeals has rejected the *Gartenberg* approach to mutual fund advisory fee litigation. *See infra* Part IV.C.3.

13. Freeman et al., *supra* note 3, at 86.

14. *See* Jones v. Harris Assocs. L.P., 527 F.3d 627, 632 (7th Cir. 2008) ("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."), *cert. granted*, 129 S. Ct. 1579 (2009). The Seventh Circuit Court of Appeals intimated that it would find that an investment adviser had breached its fiduciary duty only if it charged an advisory fee so unusual that the court might infer "deceit must have occurred." *Id.*

15. *See, e.g.*, Freeman et al., *supra* note 3, at 87–89 (discussing mutual funds' conflicted management structure).

16. S. REP. NO. 91-184, at 5, *as reprinted in* 1970 U.S.C.C.A.N. 4897, 4901 ("Mutual funds, with rare exception, are not operated by their own employees. Most funds are formed, sold, and managed by external organizations, that are separately owned and operated."). Following the adviser's election of a mutual fund's initial board of directors, the fund's shareholders may have the opportunity to replace the

Company Act imposes stringent regulations regarding the board members' qualifications, mandates that "disinterested"[17] directors comprise a fraction of the board, and governs the directors' conduct in approving the advisory services contract.[18] Notwithstanding these constraints, the conflicts of interest inherent in a mutual fund's governance structure generally prevent the fund's board of directors from firing the initial investment adviser-sponsor in favor of another adviser who might charge lower fees.[19]

Although section 36(b) indicates that shareholders may bring an action against the persons enumerated in section 36(a)[20]—including investment company directors[21]—section 36(b)(3) substantially qualifies that right by disallowing suits "against any person other than the recipient of such compensation."[22] A mutual fund's board of directors derives no

directors "at an annual or a special meeting duly called for that purpose." 15 U.S.C. § 80a-16(a) (2006). However, funds can—and do—dispense with shareholder meetings, meaning mutual fund directors often do not stand for periodic reelection. *See* LOUIS LOWENSTEIN, THE INVESTOR'S DILEMMA: HOW MUTUAL FUNDS ARE BETRAYING YOUR TRUST AND WHAT TO DO ABOUT IT 81, 169 (2008).

17. "The [Investment Company Act] requires that at least forty percent of an investment company's directors be 'disinterested,' and that every agreement with an investment adviser be approved by a majority of the disinterested directors." Migdal v. Rowe Price-Fleming Int'l, Inc., 248 F.3d 321, 329 (4th Cir. 2001) (citation omitted). For the various categories of relationships that render a director "interested" under 15 U.S.C. § 80a-2(19), see *infra* note 44.

18. 15 U.S.C. §§ 80a-2(a)(19), -10(a), -15(c) (2006).

19. *See Harris Assocs.*, 527 F.3d at 631 ("Few mutual funds ever change advisers, and plaintiffs conclude from this that the market for advisers is not competitive."); S. REP. NO. 91-184, at 5, *as reprinted in* 1970 U.S.C.C.A.N. 4897, 4901 ("[A] mutual fund cannot, as a practical matter[,] sever its relationship with the adviser."); WALLISON & LITAN, *supra* note 5, at 71 ("Unless the advisers themselves face competition from other advisers . . . the prices they offer to the funds they manage will never reflect the low costs to investors that competition could produce."); John C. Coates IV & R. Glenn Hubbard, *Competition in the Mutual Fund Industry: Evidence and Implications for Policy*, 33 J. CORP. L. 151, 159 (2007) ("It is thus a second aspect of the perceived conflict—one unique to the fund industry—that is crucial to the critics' belief that advisory fees are unconstrained by competition. This second aspect is based on the empirical fact that mutual fund boards of directors rarely 'fire' advisers and do not put advisory contracts up for bid among advisers—which we do not dispute.").

20. 15 U.S.C. § 80a-35(b) (2006).

21. *Id.* § 80a-35(a)(1).

22. *Id.* § 80a-35(b)(3); *see* Pfeiffer v. Integrated Fund Servs., 371 F. Supp. 2d 502, 509–10 (S.D.N.Y. 2005) (dismissing excessive fee complaint against fund officers when plaintiff failed to allege that fund officers received administrative or transfer agent fees); Tarlov v. Paine Webber Cashfund, Inc., 559 F. Supp. 429, 436 (D. Conn. 1983) ("Only the recipient of the allegedly excessive compensation can be sued.").

beneficial compensation from an excessive advisory fee.[23] Accordingly, shareholders have no cause of action under the Investment Company Act against mutual fund boards of directors that approve excessive advisory fee contracts.[24] Thus, one can reasonably argue that fund directors have little incentive to faithfully fulfill their fiduciary duties to fund shareholders by bargaining at arm's length with the investment adviser when the advisory contract comes up for approval.[25]

Two conclusions are especially relevant to the issue of investment adviser compensation. First, the insurmountable burden of proof that the *Gartenberg* test imposes has universally prevented plaintiff shareholder recovery in excessive fee actions brought under section 36(b).[26] Second, mutual funds' conflicted governance structure has stifled competition and allowed investment advisers to continue charging exorbitant advisory fees.[27] As a solution, this Comment proposes that Congress and the Commission implement a system of penalty default rules aimed at fostering more efficient arm's length negotiation between fund

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23. *See, e.g.*, *In re* Dreyfus Mut. Funds Fee Litig., 428 F. Supp. 2d 342, 351–52 (W.D. Pa. 2005) (dismissing section 36(b) claims when plaintiffs' only allegation regarding payments to directors consisted of claim that directors received excessively high salaries); Jerozal v. Cash Reserve Mgmt., Inc., No. 81 Civ. 1569, 1982 WL 1363, at *6 (S.D.N.Y. Aug. 10, 1982) ("[T]he numerous parties subject to liability under section 36(b) are only liable for receipt of compensation or payments for investment advisory services.").

24. Section 36(a) of the Act authorizes the SEC to bring civil actions against mutual fund board members who "engage in any act or practice constituting a breach of fiduciary duty involving personal misconduct." 15 U.S.C. § 80a-35(a) (2006). Although courts have historically recognized an implied right of action under section 36(a), modern courts have reversed course, holding that Congress did not intend to create a private cause of action in enacting section 36(a). *Compare* Strougo *ex rel.* Braz. Fund, Inc. v. Scudder, Stevens & Clark, Inc., 964 F. Supp. 783, 798 (S.D.N.Y. 1997) (recognizing a private right of action under section 36(a)), *with* Olmsted v. Pruco Life Ins. Co., 283 F.3d 429, 433 (2d Cir. 2002) ("Congress's explicit provision of a private right of action to enforce [section 36(b)] suggests that omission of an explicit private right to enforce other sections was intentional."). *See generally* Arthur S. Gabinet & George M. Gowen III, *The Past and Future of Implied Causes of Action Under the Investment Company Act of 1940*, 3 VILL. J.L. & INVESTMENT MGMT. 45 (2002). Moreover, some courts have held that section 36(b) provides an exclusive remedy with respect to excessive advisory fee claims, thereby preempting excessive advisory fee claims brought under other sections of the Act. *See* Merine *ex rel.* Prudential-Bache Util. Fund, Inc. v. Prudential-Bache Util. Fund, Inc., 859 F. Supp. 715, 723 (S.D.N.Y. 1994); *Tarlov*, 559 F. Supp. at 436 (declining to imply causes of action to recover excessive advisory fees under sections 1(b)(2), 15(a), 15(b), and 36(a) of the Act).

25. Often, mutual fund directors hold only nominal personal stakes in the funds they manage. *See* LOWENSTEIN, *supra* note 16, at 76. Accordingly, many mutual fund directors have little personal financial incentive to keep advisory fees in check.

26. *See* discussion *infra* Part IV.C.

27. *See* discussion *infra* Part IV.A–B.

directors and investment advisers, as well as encouraging investment advisers to effectively compete on price.[28]

Part II of this Comment provides a brief introduction to mutual funds, the fund-investment adviser relationship, and the regulation of this relationship under the Investment Company Act. Part III outlines the problem of excessive mutual fund advisory fees and provides some contemporary evidence suggesting that advisory fees remain excessive despite regulatory efforts. Part IV discusses mutual funds' conflicted governance structure, the lack of competition in the mutual fund market, and section 36(b)'s impotent shareholder remedy—all of which have served to perpetuate excessive advisory fees. Finally, Part V offers a proposal to implement a penalty default regime aimed at encouraging arm's length negotiation between investment advisers and mutual funds' independent directors. Part V concludes by suggesting a more reserved proposal intended to introduce the mutual fund market to default rules' efficacy.

II. A BRIEF INTRODUCTION TO MUTUAL FUNDS

An astonishing one-third of American families invest some portion of their savings in open-end investment companies—more commonly known as mutual funds.[29] Mutual funds give investors the option to purchase shares in pools of assets, generally including cash, securities, and securities options.[30] This unique structure provides smaller, individual investors with access to portfolio diversification and professional advisory

28. For a discussion of penalty default rules, see *infra* Part V.A.1. Default rules are a powerful component of libertarian paternalist regulation. *See* RICHARD H. THALER & CASS R. SUNSTEIN, NUDGE: IMPROVING DECISIONS ABOUT HEALTH, WEALTH, AND HAPPINESS 83, 85 (2008). The libertarian paternalist movement aims to allow entities to make their own choices, while simultaneously attempting to influence those entities' behavior in order to ensure that they make the most efficient, wealth-maximizing choices. *See id.* at 5.

29. MUTUAL FUND REGULATION § 1:1 (Clifford E. Kirsch ed., 2d ed. 2009); *see also* INV. CO. INST., *supra* note 1, at 7 (indicating that mutual funds have over ninety million investors in the United States).

30. THOMAS LEE HAZEN, THE LAW OF SECURITIES REGULATION § 20.1 (6th ed. 2009).

services.[31] By the end of 2008, mutual funds in the United States held combined assets of over ten trillion dollars.[32]

Mutual fund shareholders rely on the prudent advice of investment advisers, who recommend to a fund's board of directors where to invest the company's assets.[33] Additionally, a fund's adviser generally manages the fund's portfolio transactions and employs all of the staff assigned to a particular fund.[34] In exchange for its services, the investment adviser takes a fee calculated as a percentage of the fund's total assets.[35]

A. The Investment Company Act of 1940

This section outlines Congress's effort to regulate investment advisers' compensation through the Investment Company Act. As the discussion below will show, Congress has tried to regulate advisory fees indirectly—by setting the qualifications for mutual fund directors and specifying procedures for approving advisory services contracts—and directly through shareholder litigation under section 36(b).[36]

Originally, mutual funds—generally organized as corporations or business trusts[37]—were subject only to the laws of their state of

31. WALLISON & LITAN, *supra* note 5, at 1.

32. INV. CO. INST., *supra* note 1, at 9; *see also supra* note 1 (noting this figure represents a $2.6 trillion decline over year-end 2007).

33. HAZEN, *supra* note 30, § 20.2; Freeman et al., *supra* note 3, at 84 ("[The] portfolio management function is the single most important service performed for actively managed mutual funds.").

34. MUTUAL FUND REGULATION, *supra* note 29, § 1:2.2; *see also* S. REP. NO. 91-184, at 5 (1969), *as reprinted in* 1970 U.S.C.C.A.N. 4897, 4901 ("[A] typical [management] fund is organized by its investment adviser which provides it with almost all management services . . . .").

35. MUTUAL FUND REGULATION, *supra* note 29, § 1:2.2. Under a typical advisory fee schedule, the adviser charges a fee calculated as a percentage of net assets. *See id.* § 7:2.3. The adviser's fee typically decreases as the mutual fund's net asset value increases. *See id.* (noting that fee schedules use "breakpoints" as a means of passing on economies of scale generated as total assets increase). For example, a typical investment adviser might charge 0.60% of the first $1 billion in total assets, 0.575% of the next billion dollars in total assets, and so on, scaling down to 0.48% of total assets over $24 billion. Gallus v. Ameriprise Fin., Inc., 497 F. Supp. 2d 974, 977 (D. Minn. 2007) (describing the fee schedule of American Express Funds' Large Cap Equity Fund and New Dimensions Fund), *rev'd*, 561 F.3d 816 (8th Cir. 2009).

36. Direct regulation consists of ex post sanctions imposed when the regulated entity fails to comply with the law. *See* Lawrence Lessig, *The New Chicago School*, 27 J. LEGAL STUD. 661, 662 (1998). In contrast, indirect regulation "regulates . . . other regulators so that they regulate the individual differently." *Id.* at 666.

37. *See* MUTUAL FUND REGULATION, *supra* note 29, § 6:7.

incorporation.[38] After widespread abuses in the investment company industry came to light in the wake of the Great Depression, Congress and the SEC adopted the Investment Company Act to regulate the conduct of mutual fund operators.[39]

The Investment Company Act imposes a complex and comprehensive regulatory scheme on mutual funds.[40] Aside from the fiduciary duty contained in section 36(b), two categories of regulations bear substantially on the issue of adviser compensation: regulations governing mutual fund boards of directors and regulations governing the advisory contract.[41]

1. Regulation of Directors

Although investment advisers typically manage mutual funds' day-to-day operations, mutual funds, like all corporations, have boards of directors that oversee the investment adviser and otherwise represent shareholders' interests.[42] Recognizing that the close relationship between mutual funds and their investment advisers might produce unreasonable fee structures, in 1970, Congress adopted independent director requirements to limit the potential conflicts of interest that might arise in the advisory contract approval process.[43] Accordingly, under section 10(a) of the Investment Company Act, "interested persons"[44]

38. *See* Philip H. Newman, *Boards of Directors of Registered Investment Companies*, *in* INVESTMENT COMPANY REGULATION AND COMPLIANCE 373, 375 (Am. Law Inst.-Am. Bar Ass'n Comm. on Continuing Leadership in Prof'l Educ. ed., 2008) (indicating investment companies are "creature[s] of state law" also subject to the Investment Company Act).

39. *See* MUTUAL FUND REGULATION, *supra* note 29, § 1:1.

40. Investment Company Act of 1940, 15 U.S.C. §§ 80a-1 to -64 (2006).

41. For sections of the Investment Company Act regulating mutual fund boards of directors, see, for example, *id.* § 80a-2(a)(19) (defining "interested person"); *id.* § 80a-10 (regulating affiliations or interest of directors, officers, and employees); *id.* § 80a-16 (regulating boards of directors). 15 U.S.C. § 80a-15 governs contracts of investment advisers and underwriters.

42. AM. BAR ASS'N, FUND DIRECTOR'S GUIDEBOOK 5 (3d ed. 2006).

43. *See* Daily Income Fund, Inc. v. Fox, 464 U.S. 523, 537–38 (1984) ("In order to remedy . . . perceived inadequacies in the [1940] Act, the SEC submitted a series of legislative proposals to Congress that led to the 1970 Amendments to the Act." (explaining the additions of 15 U.S.C. §§ 80a-10(a), -15(c))).

44. Section 2(a)(19) defines "interested persons" to include: (1) persons affiliated with the fund; (2) persons with family members affiliated with the fund; (3) interested persons of the fund's investment adviser or principal underwriter; (4) persons employed by the fund within the preceding two fiscal years; (5) persons who, within the preceding

may comprise no more than 60% of a mutual fund's board of directors.[45] The Supreme Court has emphasized the "watchdog" role played by mutual funds' disinterested directors, noting that "Congress entrusted to the independent directors of investment companies . . . the primary responsibility for looking after the interests of the funds' shareholders."[46]

2. Regulation of the Advisory Contract

The independent directors' responsibility to mutual fund shareholders has marked relevance in the advisory contract approval context, as the approval or renewal of any advisory contract requires a majority vote of a fund's disinterested directors.[47] As a baseline, 15 U.S.C. § 80a-15(a) specifies that the advisory contract must be in writing and must precisely describe all compensation paid to the adviser under the contract.[48] Mutual fund boards of directors must request and evaluate any information necessary to assess the terms of the advisory contract, and the investment adviser has a duty to furnish such relevant information.[49] Subsequent judicial interpretation confirms the status of these provisions as more than mere formalities; shareholders may bring a federal claim alleging that a fund's board has failed to comply with statutory procedures governing the advisory contract approval process.[50]

3. Section 36(b)

In the mid-1960s, responding to concerns stemming from the significant growth within the mutual fund industry, the SEC concluded that disinterested directors, mandated disclosure, and other procedural requirements could not adequately protect mutual fund shareholders from excessive advisory fees.[51] Accordingly, Congress amended the

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two fiscal years, have had a "material business or professional relationship" with the fund, its principal executive officer, or other funds with the same investment adviser or principal executive officer. 15 U.S.C. § 80a-2(a)(19)(A).

45. *Id.* § 80a-10(a); *see also* LOWENSTEIN, *supra* note 16, at 81, 169 (noting mutual fund directors often do not stand for periodic reelection).

46. Burks v. Lasker, 441 U.S. 471, 484–85 (1979).

47. 15 U.S.C. § 80a-15(c) (2006). Although a mutual fund's shareholders may annually approve the adviser's contract, *see id.* § 80a-15(a)(2), "[i]n practice, the contract is renewed by the directors, not the shareholders (which is a costly and cumbersome alternative)," MUTUAL FUND REGULATION, *supra* note 29, § 6:2.2.

48. 15 U.S.C. § 80a-15(a) (2006).

49. *Id.* § 80a-15(c).

50. Brown v. Bullock, 294 F.2d 415, 420–21 (2d Cir. 1961).

51. SEC, PUBLIC POLICY IMPLICATIONS OF INVESTMENT COMPANY GROWTH, H.R. REP. NO. 89-2337, at 12 (1966) ("The disclosure requirements of the Federal securities

Investment Company Act in 1970 to add section 36(b),[52] which imposes a fiduciary duty on the investment advisers of SEC-registered investment companies to protect mutual fund shareholders from fee gouging.[53]

Put simply, section 36(b) forbids investment advisers from charging and collecting excessive investment advisory fees relative to the services provided.[54] As an enforcement mechanism, the statute grants fund shareholders an express private right of action against the investment adviser.[55] The plaintiff in a section 36(b) action bears the burden of proving a breach of fiduciary duty.[56] Although section 36(b) does not provide specific standards for evaluating the size of the adviser's fee, the statute directs courts to defer to the investment company's board's approval of the advisory contract to the extent that the circumstances warrant.[57] Although the Second Circuit Court of Appeals in *Gartenberg v. Merrill Lynch Asset Management* aptly described section 36(b)'s legislative history as "tortuous,"[58] one point is beyond dispute—Congress enacted the section out of concern regarding the conflicts of interest inherent in mutual funds' governance structure.[59]

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laws . . . [are] a less effective restraint on managerial compensation in this industry than . . . in other industries. . . . [A]dditional regulatory provisions for advisory fees . . . which mainly require approval of advisory contracts by shareholders and unaffiliated directors, have rarely operated to provide fund shareholders with an adequate share of the economies of size in many cases.").

52. Investment Company Amendments Act of 1970, Pub. L. No. 91-547, 84 Stat. 1413.

53. 15 U.S.C. § 80a-35(b) (2006).

54. HAZEN, *supra* note 30, § 20.9.

55. 15 U.S.C. § 80a-35(b); *see In re* Nuveen Fund Litig., No. 94 C 360, 1996 WL 328006, at *13 (N.D. Ill. June 11, 1996) ("[Section] 36(b) provided shareholders with an express cause of action against the investment adviser that by-passed demand on the directors." (citing Daily Income Ins. Fund, Inc. v. Fox, 446 U.S. 523, 535 (1984))).

56. 15 U.S.C. § 80a-35(b)(1).

57. *Id.* § 80a-35(b)(2).

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

59. *See* S. REP. NO. 91-184, at 2 (1969), *as reprinted in* 1970 U.S.C.C.A.N. 4897, 4898 ("[Y]our committee has adopted the basic principle that, in view of the potential conflicts of interest involved in the setting of [advisory] fees, there should be effective means for the courts to act where mutual fund shareholders or the SEC believe there has been a breach of fiduciary duty.").

III. EVIDENCE OF EXCESSIVE FEES

Nearly fifty years ago, Congress realized that investment advisers charged advisory fees disproportionate to the value of the services rendered.[60] This section provides an overview of the evidence that led Congress to grant a private right of action to mutual fund investors affected by excessive advisory fees. In addition, this section argues that mutual fund advisory fees remain excessive today, as evidenced by the disparity between mutual fund and pension fund advisory fees.

In the early 1960s, investment company industry observers recognized that mutual funds' conflicted management structure created an opportunity for investment advisers to overreach with respect to their fees.[61] In 1958, the SEC authorized the University of Pennsylvania's Wharton School of Finance (Wharton School) to conduct a study of the mutual fund market.[62] At the SEC's direction, the Wharton School produced the influential Wharton Report—the most thorough analysis of the relationships among institutional actors in the mutual fund market of its time.[63] Based on a questionnaire distributed to 163 investment advisers with mutual fund clients, the Wharton Report found that, in absolute terms, mutual fund investors paid higher advisory fees than the advisers' other clients.[64] The Wharton Report also observed that, despite the likely emergence of economies of scale and lower per shareholder costs as mutual fund assets increased, investment advisers failed to pass on any such savings to shareholders.[65] The Wharton Report posited that conflicts of interest inherent in mutual funds' governance structure—the close relationship between fund directors and investment advisers—distorted the normal operation of arm's length negotiation and prevented market forces from pressuring advisory fees down to the levels present in the non-mutual fund context.[66]

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60. *See* WHARTON SCH. OF FIN. & COMMERCE, A STUDY OF MUTUAL FUNDS, H.R. REP. NO. 87-2274 (1962).

61. *See id.*

62. SEC, PUBLIC POLICY IMPLICATIONS OF INVESTMENT COMPANY GROWTH, H.R. REP. NO. 89-2337, at 2–3 (1966).

63. H.R. REP. NO. 87-2274, at v; *see* Freeman et al., *supra* note 3, at 103 (describing the Wharton Report as "the first detailed and comprehensive study raising questions about the reasonableness of mutual fund fees").

64. H.R. REP. NO. 87-2274, at 430, 489. The advisers' other clients included all clients other than mutual funds, from small individual shareholder accounts to larger accounts. *See id.* at 481, 489. Nearly half of the advisers—twenty-four of fifty-four—with both mutual fund and non-mutual fund clients charged their mutual fund clients two or more times as much as they did their non-mutual fund clients. *Id.* at 489.

65. *Id.* at 28–29.

66. *See id.* at 493–94.

In 1966, the SEC largely adopted the Wharton Report's conclusions, recommended that Congress amend the Investment Company Act to impose a standard of reasonableness on fees received by investment advisers,[67] and suggested a number of factors that Congress should take into account in evaluating advisory fee structures.[68] In 1970, Congress responded by enacting the aforementioned section 36(b), which imposed a fiduciary duty on investment advisers as opposed to the reasonableness standard proposed by the SEC.[69] Despite this legislative attempt to regulate advisory fees, the conditions that persisted in the 1960s—significant disparities between mutual fund and non-mutual fund advisory fees—continue today.

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67. H.R. REP. NO. 89-2337, at 13. The SEC Report actually recommended that the Investment Company Act be amended to provide that "[a]ll compensation received by any person affiliated with a registered investment company . . . for services furnished to the investment company be reasonable." *Id.* The SEC would have applied this limitation not only to investment advisers' compensation, but to directors', trustees', and underwriters' compensation as well. *Id.* Ultimately, however, the 1970 amendments only imposed a fiduciary duty on investment advisers. *See* Investment Company Amendments Act of 1970, Pub. L. No. 91-547, § 36, 84 Stat. 1413, 1428–30.

68. H.R. REP. NO. 89-2337, at 13. The factors the SEC suggested included:

> [T]he fees paid for comparable services by other financial institutions engaged in administering pools of investment capital of like size and purpose . . . ; the nature and quality of the services provided; all benefits directly or indirectly received by persons affiliated with an investment company . . . by virtue of their relationship with the investment company; and such competitive or other factors as the Commission may . . . determine are appropriate and material in the public interest . . . .

Id.

69. *See* S. REP. NO. 91-184, at 6 (1969), *as reprinted in* 1970 U.S.C.C.A.N. 4897, 4902 ("[Y]our committee has decided that there is an adequate basis to delete the express statutory requirement of 'reasonableness,' and to substitute a different method of testing management compensation. This bill states that the mutual fund investment adviser has a specific 'fiduciary duty' in respect to management fee compensation."). This change in section 36(b)'s language came as a result of objections to the proposed reasonableness language on the part of the mutual fund industry. Gartenberg v. Merrill Lynch Asset Mgmt., Inc., 694 F.2d 923, 928 (2d Cir. 1982). Bills that would have amended the Investment Company Act to impose the SEC's proposed reasonableness standard failed to win passage. *See* S. 3724, 90th Cong. (1968); S. 1659, 90th Cong. (1967); H.R. 9511, 90th Cong. (1967); H.R. 9510, 90th Cong. (1967). Courts interpreting section 36(b)'s legislative history have read the rejection of these measures to imply that the version of section 36(b) that Congress eventually enacted entailed something other than a review for reasonableness. *See Gartenberg*, 694 F.2d at 928 ("[T]he legislative history of [section] 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.").

A. Modern Evidence of Excessive Fees: The Mutual Fund-Pension Fund Dichotomy

Legislative checks on advisory fees notwithstanding, mutual fund management fees and operating expenses grew 2400-fold in the period between 1950 and 2004, despite an only 1600-fold growth in mutual fund net assets.[70] Perhaps the most striking evidence that mutual fund advisory fees remain excessive is the substantial discrepancy between fees that investment advisers charge to pension fund clients[71] and fees that those same advisers charge to mutual fund clients.[72]

The advisory fees paid by the California Public Employees' Retirement System (Calpers), one of the few pension funds to fully disclose what it pays its investment advisers, provide a useful example of this inequality.[73] In 2002, Calpers paid three advisory firms an average of 0.08% of net assets to manage three portfolios of assets with an average size of $720 million.[74] During the same period, the same three advisory firms charged an average of 0.61% of net assets to manage three mutual funds with similar portfolios and an average of $12 billion in net assets.[75] Such disparities are commonplace,[76] despite the fact that one would expect the emergence of economies of scale to render larger mutual funds actually less expensive to manage than smaller pension funds.[77]

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70. BOGLE, *supra* note 5, at 154–55.

71. For ease of reference, this Comment generally refers to pension funds as an example of clients who pay lower advisory fees as a result of the ability to purchase advisory fees on the free market in arm's length transactions. The same claim also applies to other institutional investors, including "endowment funds, trusts, separate accounts, and even mutual funds that hire sub-advisers." Freeman et al., *supra* note 3, at 141.

72. *See, e.g.*, BOGLE, *supra* note 5, at 199–200; Freeman et al., *supra* note 3, at 106–17; John P. Freeman & Stewart L. Brown, *Mutual Fund Advisory Fees: The Cost of Conflicts of Interest*, 26 J. CORP. L. 609, 627–36 (2001).

73. BOGLE, *supra* note 5, at 199–200.

74. *Id.* at 199.

75. *Id.*

76. For example, in 2002, the Alliance Premier Growth Fund paid its adviser and sponsor Alliance Capital an advisory fee of $88 million—approximately 0.90% of the fund's net assets (90 basis points). Freeman et al., *supra* note 3, at 110–11. During the same period, Alliance managed pension funds and other noncaptive funds for between 10 and 24 basis points. *Id.* at 111. Alliance's public disclosures indicated that the same professionals managed both groups of funds according to similar investment strategies. *Id.* at 111–12.

77. *See, e.g.*, WHARTON SCH. OF FIN. & COMMERCE, A STUDY OF MUTUAL FUNDS, H.R. REP. NO. 87-2274, at 492 (1962) ("[S]hareholders of open-end companies do not require individual portfolio attention, as other clients usually do, so that a single quarterly compilation of portfolio holdings, for example, is all that is required for the aggregate of shareholders, whether they be a dozen or a million. This characteristic of investment

Courts and commentators advance a number of theories to explain the gap between mutual fund and pension fund advisory fees.[78] In section 36(b) actions, plaintiffs commonly point to the difference between a challenged mutual fund advisory fee and pension fund advisory fees charged by the same investment adviser as prima facie evidence of the mutual fund advisory fee's unreasonableness.[79] Perhaps the most common justification courts cite for summarily rejecting this comparison is the alleged "liquidity difference" between mutual funds and pension funds—the claim that mutual funds cost more to manage because their advisers must hold assets in more expensive, highly liquid investment vehicles to facilitate frequent redemptions.[80] However, this alleged liquidity difference is "something of a financial Loch Ness monster"—although it exists in theory, it has yet to be observed in practice.[81] In fact, the Investment Company Institute, a mutual fund industry group, has suggested that the true cost of providing management services to a mutual fund is comparable to the cost of providing management services

companies suggests the greater likelihood of the emergence of economies of scale and lower costs with increases in asset size than where clients must be catered to on a more individualized basis.").

78. *See, e.g.*, Coates & Hubbard, *supra* note 19, at 185 (citing services investment advisers must provide to mutual funds but not to pension funds).

79. *See, e.g.*, Jones v. Harris Assocs. L.P., No. 04 C 8305, 2007 WL 627640, at *8 (N.D. Ill. Feb. 27, 2007) ("[Plaintiffs] insist that we must compare Harris's fees not to those charged to funds run by managers other than Harris but rather to those charged to institutional clients."), *aff'd*, 527 F.3d 627 (7th Cir. 2008), *cert. granted*, 129 S. Ct. 1579 (2009); Hunt v. Invesco Funds Group, Inc., No. H-04-02555, 2006 WL 1581846, at *3 (S.D. Tex. June 5, 2006); Strigliabotti v. Franklin Res., Inc., No. C 04-00883 SI, 2005 WL 645529, at *34 (N.D. Cal. Mar. 7, 2005) (holding that plaintiff mutual fund shareholders stated a claim under section 36(b) by demonstrating, inter alia, that the defendant-adviser charged a lower fee for similar services provided to a state pension fund); Strougo v. BEA Assocs., 188 F. Supp. 2d 373, 384 (S.D.N.Y. 2002); Kalish v. Franklin Advisers, Inc., 742 F. Supp. 1222, 1237 (S.D.N.Y. 1990). *But see* Gallus v. Ameriprise Fin., Inc., 561 F.3d 816, 824 (8th Cir. 2009) ("Indeed, the argument for comparing mutual fund advisory fees with the fees charged to institutional accounts is particularly strong in this case because the investment advice may have been essentially the same for both accounts.").

80. *See, e.g.*, *Harris Assocs.*, 527 F.3d at 634 ("Harris Associates charges a lower percentage of assets to other clients, but this does not imply that it must be charging too much to the Oakmark funds. Different clients call for different commitments of time. Pension funds have low (and predictable) turnover of assets. Mutual funds may grow or shrink quickly and must hold some assets in high-liquidity instruments to facilitate redemptions. That complicates an adviser's task.").

81. Freeman et al., *supra* note 3, at 115; *see id.* at 113–14 ("[T]his liquidity factor tends not to be visible or quantifiable in the real world.").

to a pension fund.[82] Nevertheless, on average, mutual fund investors pay approximately twice as much for advisory services as do pension fund investors.[83]

IV. Causes of Excessive Mutual Fund Advisory Fees

The disparity between mutual fund and pension fund advisory fees, and the more general problem of excessive mutual fund advisory fees, cannot be solved by pointing to a single discrete issue; rather, a confluence of factors has allowed investment advisers to charge fees to their mutual fund clients representing several times what they charge to their pension fund clients for essentially the same services.[84] This Part discusses three aspects of the mutual fund industry and its regulation, and examines the adverse impact of these factors on mutual fund advisory fees. Specifically, this Part demonstrates that an industry-wide governance structure that impedes arm's length negotiation between advisers and directors, a lack of price competition in the mutual fund market, and section 36(b)'s impotent shareholder remedy for excessive fees allow investment advisers to charge advisory fees that a market free of these characteristics would not allow.

A. Mutual Funds' Conflicted Governance Structure: A Failure To Negotiate

Conflicts of interest inherent in most mutual funds' governance structures have served to perpetuate excessive advisory fees.[85] A typical mutual fund or mutual fund complex is established by an external

82. *See id.* at 113–15 (citing Sean Collins, *The Expenses of Defined Benefit Pension Plans and Mutual Funds*, INVESTMENT COMPANY INST. PERSP., Dec. 2003, at 8, http://www.ici.org/pdf/per09-06.pdf); *see also* Freeman & Brown, *supra* note 72, at 634 ("There is no evidence that managers of public pension fund equity portfolios are paid less than equity [mutual] fund managers because they do less work or perform at a lower level.").

83. *See* Freeman et al., *supra* note 3, at 106 (discussing a study that found that mutual fund managers received an advisory fee of 56 basis points, compared to pension fund managers' 28 basis points, to manage mutual funds that averaged three times the size of their pension fund counterparts).

84. *See, e.g.*, BOGLE, *supra* note 5, at 199–200 (citing several possible explanations for the disparity between mutual fund and pension fund advisory fees).

85. *See, e.g.*, S. REP. NO. 91-184, at 5 (1969), *as reprinted in* 1970 U.S.C.C.A.N. 4897, 4901 (noting that, because of the unique structure of the investment adviser-mutual fund relationship, the forces of arm's length bargaining do not operate in the mutual fund industry in the same manner as in other sectors of the economy); *see also* Caroline J. Dillon, *Do You Get What You Pay for? A Look at the High Fees and Low Protections of Mutual Funds*, 2006 COLUM. BUS. L. REV. 281, 308.

investment management firm, which incorporates the fund, registers the fund with the SEC, appoints the fund's initial board of directors, and serves as the fund's initial investment adviser.[86] The management firm unilaterally determines how it will be compensated for these tasks.[87] The manager also contracts to provide the fund with investment advisory, marketing, and administrative services.[88] Management firms tend not to relinquish their control of funds over time, and funds' directors rarely—if ever—fire a manager in favor of another firm that can provide comparable investment advisory services more cheaply.[89]

That this symbiotic investment adviser-mutual fund relationship redounds to the detriment of mutual fund shareholders in the form of increased advisory fees is an empirically demonstrable fact.[90] Close ties between mutual fund boards of directors and investment advisers correlate with higher advisory fees, induce boards to monitor advisers less closely than they otherwise might, and negatively affect fund performance—at least marginally.[91] Simply put, a mutual fund's

86. Freeman & Brown, *supra* note 72, at 614–15. More often than not, the nominally disinterested directors appointed by the management firm also serve as directors of other mutual funds administered by the management firm. *See, e.g.*, Krantz v. Fid. Mgmt. & Research, Co., 98 F. Supp. 2d 150, 152 (D. Mass. 2000) (noting that nine members of the twelve-member board of directors of Fidelity Management and Research Company's (Fidelity) mutual fund complex also served on the boards of all 237 mutual funds to which Fidelity provided investment advisory services).

87. BOGLE, *supra* note 5, at 172 ("The management company operates the fund, distributes its shares, and supervises and directs its investment portfolio. It unilaterally determines at the outset what fees it will charge.").

88. Freeman & Brown, *supra* note 72, at 615.

89. *Id.*; *see, e.g.*, S. REP. NO. 91-184, at 5, *as reprinted in* 1970 U.S.C.C.A.N. 4897, 4901.

90. *See* Camelia M. Kuhnen, *Business Networks, Corporate Governance and Contracting in the Mutual Fund Industry*, 64 J. FIN. 2185, 2219 (2009) (noting, however, that the overall economic effect of the adviser-board connections is small); Memorandum from Chester Spatt, Chief Economist, SEC, Office of Econ. Analysis (Dec. 29, 2006), *available at* http://www.sec.gov/rules/proposed/s70304/oeamemo 122906-litreview.pdf.

91. Kuhnen, *supra* note 90, at 2216.

This discussion of the investment adviser-mutual fund conflict leaves aside another negative consequence of the conflict—mutual fund directors' failure to monitor investment advisers. This breakdown produced the late trading and market timing scandals that came to light in 2003, along with other wrongdoing. *See* HAZEN, *supra* note 30, § 20.5 (discussing late trading and market timing scandals); *see also* BOGLE, *supra* note 5, at 145–47 (discussing examples of abusive mutual fund trading practices). These scandals had the immediate effect of transferring wealth out of the hands of ordinary investors to other investors favored by managers. *See id.* at 150.

independent directors do not negotiate with the investment adviser at arm's length on behalf of the fund, leading to high advisory fees—and high profit margins—for the investment adviser.[92] The disparity between mutual fund advisory fees and pension fund advisory fees provides ample evidence of this fact.[93] As discussed in greater detail above, investment advisers charge pension funds approximately half of what they charge mutual funds for comparable advisory services.[94] This discrepancy results, at least in part, from the simple fact that pension funds purchase advisory services in arm's length transactions on the free market, whereas mutual funds effectively have no choice but to contract with their adviser-manager.[95]

One of the most egregious examples of wrongdoing—which fund managers likely could have averted through judicious oversight—involved the purchase by Alfred Harrison, a mutual fund manager with Alliance Capital Management (Alliance), of almost 43 million shares of Enron stock, including greater than $120 million in purchases in the months leading up to firm's downfall. *See* Benak *ex rel.* Alliance Premier Growth Fund v. Alliance Capital Mgmt. L.P., 435 F.3d 396, 398–99 (3d Cir. 2005) ("[I]n October and November 2001, as the reports of Enron's worsening financial state increased, appellees continued to invest in the company."). In exchange for Harrison and Alliance's advice—which led to a $5 billion decrease in net assets for the fiscal year that ended November 30, 2001—the Alliance Premier Growth Fund paid a $135 million advisory fee. Alliance Premier Growth Fund, Inc., Annual Report (Form N-30D), at 13–14 (Nov. 30, 2001). Although the Alliance Premier Growth Fund was not the only mutual fund to feel the sting of Enron's collapse, it had the dubious distinction of being the only fund to share a common director—Frank Savage—with the failed energy conglomerate. Reed Abelson & Kenneth N. Gilpin, *2 Enron Roles Raise Questions of Allegiance*, N.Y. TIMES, Dec. 7, 2001, at C1. The Third Circuit ultimately dismissed a shareholder derivative suit against Alliance as untimely. *Benak*, 435 F.3d at 403. However, many shareholders and industry observers raised questions regarding the propriety of Savage's apparent conflict of interest. *See* Abelson & Gilpin, *supra*.

92. *See* BOGLE, *supra* note 5, at 172–73; Freeman & Brown, *supra* note 72, at 617–18.

93. *See* Freeman et al., *supra* note 3, at 141–42.

94. *See supra* notes 70–83 and accompanying text.

95. *See* Freeman et al., *supra* note 3, at 140–41 ("Because the [mutual] fund market features prices drawn from negotiation 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 individually or collectively, cannot reflect fair market value . . . ."). Thus, the investment adviser-mutual fund relationship is analogous to a bilateral monopoly—a market in which there exists only one buyer and one seller. Scott R. Peppet, *Contract Formation in Imperfect Markets: Should We Use Mediators in Deals?*, 19 OHIO ST. J. ON DISP. RESOL. 283, 302 (2004). Bilateral monopolies favor the party who possesses greater bargaining power, and the party who is most able to impose costs on the other side—while simultaneously absorbing costs imposed by the other side—captures a greater share of the available gains. *See id.* at 302 & n.65.

B. Competition in the Mutual Fund Market

Closely related to mutual funds' conflicted governance structure is the fact that ordinary forces of market competition have failed to protect mutual fund shareholders from excessive advisory fees.[96] Contrary to Judge Easterbrook's reasoning in *Harris Associates*, as well as the assertions of mutual fund trade groups, the mutual fund market simply does not exhibit the vigorous price competition necessary to drive down advisory fees to levels near their fair market value.[97] According to a recent study conducted by the American Enterprise Institute, the mutual fund industry exhibits a low degree of concentration and "should be one of the most competitive [industries] in the country."[98] Barriers to new firm entry are low, and mutual fund investors can—and do—move from fund to fund without incurring significant transactions costs.[99] Yet, a review of mutual fund advisory fees demonstrates that substantial price dispersion exists despite a general lack of differentiation among products and services.[100]

In a truly competitive market, absent significant differentiation among available products, one would expect prices for advisory services to group more tightly around the mean because advisers could not charge advisory fees markedly higher than the marginal cost of providing portfolio management services.[101] Commentators have suggested that advisory fees remain high despite other hallmarks of competition because the mutual fund market allows fund managers to compete aggressively for new sales while simultaneously sheltering extraordinarily

96. *See* Dillon, *supra* note 85, at 308 ("Market mechanisms, though reliable for regulation of prices in many other contexts, are not a reasonable alternative for the regulation of mutual fund fees because conflicts of interest between the board of directors and the investment adviser prevent true arm's length negotiations.").

97. *See* Jones v. Harris Assocs. L.P., 527 F.3d 627, 634 (7th Cir. 2008) (arguing that mutual funds compete on price and that the mutual fund market displays hallmarks of atomistic competition), *cert. granted*, 129 S. Ct. 1579 (2009); INV. CO. INST., *supra* note 1, at 61 ("[M]utual fund fees have been pushed down by . . . competition within the mutual fund industry.").

98. WALLISON & LITAN, *supra* note 5, at 48 (observing that the mutual fund industry's Herfindahl-Hirschman index—the measure of industry concentration favored by federal antitrust regulators—stands at 400, well within the "unconcentrated" category).

99. *Id.* at 48–49; Coates & Hubbard, *supra* note 19, at 167–70.

100. WALLISON & LITAN, *supra* note 5, at 62.

101. *Id.*

profitable advisory fee levels from price-cutting pressures.[102] Moreover, certain agency costs tend to hinder competition, belying the conclusion that low transactions costs allow investors to fire an investment adviser at will by moving their investment to a competing fund with a more attractive fee structure.[103]

C. The Current State of Section 36(b) Litigation

Recognizing that mutual funds' conflicted governance structure obstructed the forces of arm's length bargaining between mutual funds and their investment advisers,[104] in 1970, Congress amended the Investment Company Act to add section 36(b).[105] Before section 36(b)'s inclusion in the Act, a shareholder could challenge an investment adviser's fee only by alleging corporate waste.[106] The waste standard required plaintiffs to show that the adviser's services were of such inadequate value that no person of ordinary, sound business judgment would deem them worth what the mutual fund paid.[107] Congress

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102. *See* Freeman & Brown, *supra* note 72, at 655.

103. Memorandum from Chester Spatt, *supra* note 90, at 9–10. These agency costs include tax disadvantages inherent in the sale of appreciated mutual fund shares and the fact that shareholders' choices are often limited to those mutual funds included in their employers' retirement plans. *Id.* With regard to tax implications, "[i]t has generally been shown that investors are reluctant to sell securities that have appreciated significantly in the past. . . . As tax appreciation increases, along with the expected tax burden upon sale, investors are less likely to sell today even if they receive bad news about managers." *Id.* In essence, economically rational investors will not withdraw their investments from poorly managed funds with significant capital gains tax liabilities unless they expect the benefit from an alternative investment to outweigh the tax disadvantages inherent in the sale of appreciated securities. One might reasonably expect investors' lack of knowledge regarding the quality of fund management and the difficulty of predicting mutual fund returns to compound these agency costs because investors cannot accurately predict the value of alternative mutual fund investments. *See id.* at 9 ("[A]cademic studies find that Morningstar's rankings are poor predictors of future performance for all but the lowest rated funds. Investors' lack of knowledge about the quality of fund management may also make them less likely to withdraw assets from poorly managed funds.").

104. *See* S. REP. NO. 91-184, at 5 (1969), *as reprinted in* 1970 U.S.C.C.A.N. 4897, 4901.

105. Investment Company Amendments Act of 1970, Pub. L. No. 91-547, 84 Stat. 1413.

106. MUTUAL FUND REGULATION, *supra* note 29, § 7:2.1; *see* S. REP. NO. 91-184, at 5, *as reprinted in* 1970 U.S.C.C.A.N. 4897, 4901 ("[A]dvisory contracts which are ratified by the shareholders . . . may not be upset in the courts except upon a showing of 'corporate waste.'").

107. *See* Saxe v. Brady, 184 A.2d 602, 611 (Del. Ch. 1962) ("It is plaintiffs' contention that in each of the years after 1954, the dollar amount of the annual fee was so large that it bore no reasonable relation to the value of the advisory services then being rendered by [the adviser]; and thus, presumably, no person of ordinary, sound business

explicitly rejected this standard in enacting section 36(b), declaring it "unduly restrictive."[108] Ultimately, however, the judicial interpretations of section 36(b) improve little on the waste standard that Congress sought to supplant.[109]

Following the adoption of section 36(b), courts faced with excessive fee lawsuits consistently held that the statute incorporated the common law concept of fiduciary duty.[110] This standard implied rigorous scrutiny for fairness, limiting an adviser's fee to what could be considered fair under "traditional equitable standards."[111] To prevail, plaintiff shareholders bore the burden of demonstrating that the advisory contract was somehow unfair to the company and its shareholders.[112] Given the amorphous nature of this fairness review, the Second Circuit Court of Appeals saw fit to delineate a clear standard for evaluating section 36(b) claims.[113]

1. Gartenberg*: A Flawed Framework*

In 1980, individual shareholders Irving Gartenberg and Simone Andre brought suit against Merrill Lynch Asset Management (Merrill Lynch)—adviser to the money market fund Merrill Lynch Ready Assets Trust (the

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judgment would deem the services worth what Fund had paid for them."); *see also* MUTUAL FUND REGULATION, *supra* note 29, § 7:2.1 ("Under this standard, shareholders were required to show that the fee was 'unconscionable' or 'shocking.'" (citing Acampora v. Birkland, 220 F. Supp. 527 (D. Colo. 1963))). Conversely, "all the defendant needed to show was that 'any reasonable person might conclude that the deal made sense.'" Freeman et al., *supra* note 3, at 125 (quoting Steiner v. Meyerson, Civ. A. No. 13139, 1999 WL 441999, at *1 (Del. Ch. July 19, 1995)).

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

109. *See* Freeman et al., *supra* note 3, at 139 (2008) ("[T]he federal fiduciary standard applied in section 36(b) cases under *Gartenberg* is an infirm and warped legal standard . . . . It is not an improvement on the common law of waste standard.").

110. Angelo G. Savino, Note, *Mutual Fund Advisory Fees—Too Much for Too Little?*, 48 FORDHAM L. REV. 530, 543–44 & nn.115–16 (1980) (collecting cases).

111. Galfand v. Chestnutt Corp., 545 F.2d 807, 812 n.12 (2d Cir. 1976).

112. Gartenberg v. Merrill Lynch Asset Mgmt., Inc., 528 F. Supp. 1038, 1047 (S.D.N.Y. 1981) ("[T]he Court must consider the 'nature, quality and extent' of the services [provided] to the Fund in relation to the fee paid by the Fund."), *aff'd*, 694 F.2d 923 (2d. Cir. 1982). Mere demonstration that "a better bargain was possible" did not establish that the advisory contract was unfair. *Id.*

113. *See Gartenberg*, 694 F.2d at 928 (noting that the Congress that enacted section 36(b) had failed to set forth a definitive test for evaluating alleged breaches of fiduciary duty).

Fund)—under section 36(b).[114] The United States District Court for the Southern District of New York held that, although Merrill Lynch's advisory fee was irrefutably high in the abstract, the plaintiffs failed to show that it bore anything other than a reasonable relationship to the services Merrill Lynch had provided.[115] Noting that the Fund's trustees analyzed a substantial amount of documentary material and engaged in significant deliberations before approving the advisory contract, the court concluded that the totality of the circumstances compelled a finding in Merrill Lynch's favor.[116]

The Second Circuit Court of Appeals affirmed the district court's dismissal, enunciating the standard that courts applied in section 36(b) actions for the next twenty-five years.[117] Seizing upon language in section 36(b)'s legislative history, the court concluded that arm's length bargaining did not occur in the market for mutual fund advisory contracts.[118] Thus, the court held that the test of whether an adviser's fee violated his section 36(b) fiduciary duty "[was] essentially whether the fee schedule represent[ed] a charge within the range of what would have been negotiated at arm's-length in light of all of the surrounding circumstances."[119] The court listed six factors to consider in evaluating an allegedly excessive fee, including "[1] the nature and quality of services provided to fund shareholders; [2] the profitability of the fund to the adviser-manager; [3] fall-out benefits; [4] economies of scale;

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114. *Gartenberg*, 528 F. Supp. at 1040. At the time, the Fund's net assets exceeded $19 billion. *Gartenberg*, 694 F.2d at 927. For the fiscal year ending June 30, 1981, Merrill Lynch took an advisory fee of over $39 million, *id.* at 931, which constituted 0.288% of the Fund's average daily net assets, *Gartenberg*, 528 F. Supp. at 1040. Merrill Lynch's fee structure contained breakpoints, scaling the advisory fee downward as net assets increased. *Id.* at 1043. Accordingly, Merrill Lynch's fee ranged from 0.50% of assets not exceeding $500 million to 0.275% of assets exceeding $2.5 billion. *Id.* As noted by the court, 0.288% of the fund's net assets represents the "effective rate" of the fee when the scale is applied to the Fund's total average daily net assets. *Id.*

115. *Gartenberg*, 528 F. Supp. at 1068. The court noted that the Fund's explosive growth had required Merrill Lynch to provide costlier facilities and had increased the cost of processing redemption orders. *Id.*

The district court also gave significant weight to the structure of the fund, which allowed shareholders to "terminate the relationship simply by writing a check and redeeming at once." *Id.* at 1067. For an argument that low-cost redemption of mutual fund shares provides a check on advisory fees by facilitating competition in the mutual fund industry, see Coates & Hubbard, *supra* note 19, at 162.

116. *Gartenberg*, 528 F. Supp. at 1064, 1068.

117. *See, e.g.*, Migdal v. Rowe Price-Fleming Int'l, Inc., 248 F.3d 321 (4th Cir. 2001); Krinsk v. Fund Asset Mgmt., Inc., 875 F.2d 404 (2d Cir. 1989); Gallus v. Ameriprise Fin., Inc., 497 F. Supp. 2d 974 (D. Minn. 2007), *rev'd*, 561 F.3d 816 (8th Cir. 2009).

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

119. *Id.*

[5] comparative fee structures; and [6] the independence and conscientiousness of the trustees."[120] Upon considering these factors, the court concluded that the plaintiffs failed to carry their burden of establishing a breach of fiduciary duty.[121]

2. *Criticism of* Gartenberg

In recent years, commentators and courts alike have criticized the *Gartenberg* standard for excessive fee litigation. Commentators have argued that courts manipulate the *Gartenberg* factors in such a way as to effectively prevent recovery by plaintiff shareholders without ever creating liability on the part of the defendant advisers, thus establishing an insurmountable burden for section 36(b) plaintiffs.[122]

For example, one of the *Gartenberg* factors requires courts to examine the nature and quality of the services provided by the adviser in evaluating the size of the advisory fee.[123] Courts often equate above average yields with high quality advisory services, and if a fund has enjoyed above average yields, courts weigh the nature and quality of the services provided as a factor in upholding the challenged advisory fee.[124] The converse, however, does not hold true if a fund has suffered below average returns.[125]

120. *Krinsk*, 875 F.2d at 409 (citing *Gartenberg*, 694 F.2d at 929–30).

121. *Gartenberg*, 694 F.2d at 933. The court also summarily rejected the plaintiffs' argument that the court should consider the lower fees that Merrill Lynch had charged to administer pension funds as a criterion in evaluating mutual fund advisory fees. *Id.* at 930 n.3. Plaintiffs commonly make this argument in section 36(b) actions, to no avail. *See, e.g.*, sources cited *supra* note 79.

122. *See* Dillon, *supra* note 85, at 294–303 (discussing courts' manipulation of *Gartenberg* factors in investment advisers' favor); Freeman et al., *supra* note 3, at 139 ("[T]he 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.").

123. *Gartenberg*, 694 F.2d at 930; *accord Krinsk*, 875 F.2d at 409.

124. *See* Krinsk v. Fund Asset Mgmt., Inc., 715 F. Supp. 472, 488–89 (S.D.N.Y. 1988) (noting that fund enjoyed superior yields relative to other funds and suggesting that such yields resulted from adviser's research and trading strategies), *aff'd*, 875 F.2d 404 (2d Cir. 1989).

125. *See* Migdal v. Rowe Price-Fleming Int'l, Inc., 248 F.3d 321, 327–28 (4th Cir. 2001) (refusing to permit discovery in section 36(b) action when plaintiffs alleged that fund had underperformed).

In *Migdal v. Rowe Price-Fleming International*, plaintiffs in a section 36(b) action alleged that the investment adviser's fee was excessive in relation to the mutual fund's deficient performance.[126] Granting the investment adviser's motion to dismiss, the Fourth Circuit Court of Appeals refused to accept the plaintiffs' argument that investment advisory services resulting in below average yields necessarily had less value than similar services provided to a better performing fund.[127] Although the court did not hold that underperformance had no relevance in evaluating the size of the advisory fee, it noted that investors assumed some risk that their investments would not perform up to expectations.[128] Comparing the Fourth Circuit's treatment of the nature-and-quality-of-services factor in the context of an underperforming fund to other courts' treatment of the same factor in the context of a higher yielding fund, it becomes clear that the *Gartenberg* factors allow for significant judicial manipulation—a court can minimize the importance of those factors that would appear to weigh against the investment adviser in order to reach the court's desired result.[129]

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126. *Id.* at 327.
127. *Id.*
128. *Id.*
129. The Fourth Circuit Court of Appeals worried that allowing the plaintiffs to proceed to discovery upon a mere showing of underperformance would "make it possible for other plaintiffs to state a claim in limitless actions filed under Section 36(b)." *Id.* at 328. Although the court's concern was undeniably well founded in relation to actions in which the plaintiff only submitted evidence of a fund's deficient performance, a court could easily apply the same analysis to a case in which the plaintiff also submitted evidence on other *Gartenberg* factors.

Commentators have criticized other *Gartenberg* factors as incapable of reliable judicial measurement. *See* Dillon, *supra* note 85, at 296–97 (discussing the "profitability to adviser" and "fall-out benefits" factors); *see also* WALLISON & LITAN, *supra* note 5, at 77 ("[T]he only objectively quantifiable elements in [the *Gartenberg* analysis] are the adviser's cost and the volume of orders. Because order processing does not involve a significant cost, and the other elements of the test are either hard to evaluate or discover, or of little significance when discovered, the directors will naturally focus on the adviser's costs."). For example, in calculating the net profits to the Fund, the court in *Gartenberg* arrived at three estimates of after-tax profits ranging from $15,133,149 to –$7,739,391. Gartenberg v. Merrill Lynch Asset Mgmt., 694 F.2d 923, 931 n.4 (2d Cir. 1982). With a $22 million dollar disparity in its estimates, the court could not reasonably rely on profitability to hold that Merrill Lynch had charged the Fund excessive advisory fees. *Id.* at 931. Compounding the problem, mutual funds jealously guard data that would allow plaintiffs to accurately calculate profitability. Freeman et al., *supra* note 3, at 131 ("Profitability is difficult to calculate, for starters, because it is tough to obtain the raw data necessary to make the calculations. . . . To even start a profitability analysis, a plaintiff must marshal evidence the SEC itself does not have and says it cannot obtain.").

Similarly, courts have struggled to measure the fallout benefits—intrinsic benefits aside from advisory fees—accruing to the adviser as a result of its relationship with the

3. Jones v. Harris Associates*: Worse for Plaintiffs*

One court has rejected the *Gartenberg* approach, but its reasoning suggests that it did not do so out of concern that the *Gartenberg* standard placed an undue burden on plaintiffs. In August 2004, three individual plaintiffs filed a lawsuit against Harris Associates (Harris), investment adviser to the Oakmark family of mutual funds, alleging that Harris received an advisory fee so disproportionate to the value of the services it had provided as to constitute a breach of its section 36(b) fiduciary duty.[130] Ruling on cross motions for summary judgment, the United States District Court for the Northern District of Illinois considered the *Gartenberg* factors and concluded that Harris's advisory fee fell within an acceptable range.[131]

On appeal, the Seventh Circuit Court of Appeals affirmed the district court's ultimate conclusion, albeit on different grounds.[132] In an opinion written by notable law and economics scholar Judge Frank Easterbrook,[133] the court rejected the *Gartenberg* approach to section 36(b) litigation.[134] The court concluded—contrary to the plaintiffs' argument—that the *Gartenberg* standard relied too little on the role of markets in regulating

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mutual fund. *See* Gartenberg v. Merrill Lynch Asset Mgmt., Inc., 740 F.2d 190, 193 (2d Cir. 1984) ("Peat, Marwick Mitchell and Co. . . . concluded after a careful study that ['fall-out' commission] benefits could not be reliably quantified and that an attempt to do so would be prohibitively expensive."). *But see* Gallus v. Ameriprise Fin., Inc., 497 F. Supp. 2d 974, 981 (D. Minn. 2007) (noting that defendant investment adviser disclosed fallout benefits accruing to the adviser to the mutual fund's board of directors during the fee negotiation process), *rev'd*, 561 F.3d 816 (8th Cir. 2009).

130. Jones v. Harris Assocs. L.P., No. 04 C 8305, 2007 WL 627640, at *1–3 (N.D. Ill. Feb. 27, 2007), *aff'd*, 527 F.3d 627 (7th Cir. 2008), *cert. granted*, 129 S. Ct. 1579 (2009).

131. The district court noted that four factors compelled a finding in Harris's favor: (1) Harris charged funds comparable to those charged by similar funds managed by other companies; (2) Harris disclosed all relevant information to the Funds' trustees, who in turn approved Harris's fee; (3) the Funds' fee schedule contained breakpoints resulting from the trustees' negotiation efforts; and (4) the Funds performed well during the damages period. *Id.* at *8.

132. *Harris Assocs.*, 527 F.3d 627 (affirming district court's decision and disapproving *Gartenberg* approach to section 36(b) litigation).

133. *See, e.g.*, Stephen J. Choi & G. Mitu Gulati, *Choosing the Next Supreme Court Justice: An Empirical Ranking of Judge Performance*, 78 S. CAL. L. REV. 23, 40–61 (2004) (noting Judge Easterbrook's status as one of the most productive and widely cited circuit judges).

134. *Harris Assocs.*, 527 F.3d at 632 ("[W]e now disapprove the *Gartenberg* approach.").

advisory fees.[135] Noting that the mutual fund market has grown significantly since the 1970 Amendments,[136] Judge Easterbrook posited that the size and structure of the mutual fund market facilitate competition, thus driving down the price of investment advisory services.[137] Accordingly, the Seventh Circuit Court of Appeals declined to review Harris's advisory fee and held that the responsibility to regulate advisory fees belonged to "[t]he trustees (and in the end investors, who vote with their feet and dollars), rather than a judge or jury."[138]

The Seventh Circuit's *Harris Associates* decision promises to make shareholder recovery of excessive advisory fees under section 36(b) even less likely.[139] Although some commentators have argued that the Seventh Circuit Court of Appeals simply articulated the *Gartenberg* standard differently,[140] others contend that the *Harris Associates* approach will provide even greater protection to mutual fund advisers who charge fees comparable to those charged by other advisers in the market.[141] Judge Richard Posner, dissenting from the Seventh Circuit's

135. *Id.*

136. *Id.* at 633 ("Section 36(b) does not create a rate-regulation mechanism, and plaintiffs' proposal to create such a mechanism in 2008 cannot be justified by suppositions about the market conditions of 1970. A lot has happened in the last 38 years."). Between World War II and 2002, a market of less than 100 mutual funds holding just over $1 billion in assets became a market of over 8000 mutual funds holding $6 trillion in assets. *Id.* at 633–34 (citing Paul G. Mahoney, *Manager-Investor Conflicts in Mutual Funds*, 18 J. ECON. PERSP. 161, 161 (2004)). In fact, the assets of United States mutual funds have almost doubled since 2002. INV. CO. INST., *supra* note 1, at 7 ("[U.S.-registered investment companies] managed more than $10 trillion in assets at the end of 2008 for 93 million investors.").

137. Seizing on the argument that freely redeemable shares facilitate competition, Judge Easterbrook suggested that, even if sparse competition for mutual fund advisory contracts fails to regulate advisory fees, shareholders' ability to cheaply and easily move their money to another fund charging lower fees creates an incentive for investment advisors to keep their rates competitively low. *See Harris Assocs.*, 527 F.3d at 633–34 (citing Coates & Hubbard, *supra* note 19, at 151).

138. *Id.* at 632. However, the court did not rule out the possibility that the sheer size of an adviser's fee, relative to fees charged by competitors for similar services, might constitute prima facie evidence of a section 36(b) violation. *Id.* ("It is possible to imagine compensation so unusual that a court will infer that deceit must have occurred . . . for example, if a university's board of trustees decides to pay the president $50 million a year, when no other president of a comparable institution receives more than $2 million . . . .").

139. *See* Floyd Norris, *Fund Fees Revisited in Court*, N.Y. TIMES, May 23, 2008, at C1 ("Anyone who finds [fund] fees unreasonably high . . . now has a much smaller chance of getting the courts to intervene.").

140. *See* Lee Anne Copenhefer et al., Seventh Circuit "Disapproves" *Gartenberg*, but Is This New Approach Fundamentally Different? (May 27, 2008), http://www.bingham.com/media.aspx?mediaID=7004 ("At the end of the day, the *Harris Associates* decision articulates a standard that does not appear to be that different from the *Gartenberg* standard."); *see also* Martin & Lybecker, *supra* note 7.

141. Carter & Chao, *supra* note 8, at 3.

denial of the *Harris Associates* plaintiffs' petition for rehearing en banc, expressed concern that, given the conflicts of interest inherent in mutual funds' governance structure, a comparability approach to section 36(b) litigation might actually perpetuate inflated advisory fees.[142]

On March 9, 2009, the United States Supreme Court granted certiorari in *Harris Associates*.[143] The petitioners—plaintiffs below—presented the question as "[w]hether the [Seventh Circuit Court of Appeals] erroneously held . . . that a shareholder's claim that the fund's investment adviser charged an excessive fee . . . is not cognizable under [section] 36(b), unless the shareholder can show that the adviser misled the fund's director who approved the fee."[144] In opposition to certiorari, the respondent—Harris Associates—contended, inter alia, that the approach the Seventh Circuit Court of Appeals had adopted substantially mirrored the *Gartenberg* standard.[145] Although commentators expect the Supreme Court to provide mutual funds' boards of directors with guidance regarding how to negotiate fairer fees,[146] this Comment posits that a structural remedy would best serve to vitiate the conflicts inherent in mutual funds' governance structure and foster more efficient competition among mutual funds.[147]

V. A SOLUTION TO THE EXCESSIVE ADVISORY FEE PUZZLE: DEFAULT RULES

Market forces have largely failed to protect mutual fund shareholders from excessive advisory fees,[148] and Congress's attempt to remedy the

142. Jones v. Harris Assocs. L.P., 537 F.3d 728, 732 (7th Cir. 2008) (Posner, J., dissenting) ("The governance structure that enables mutual fund advisers to charge exorbitant fees is industry-wide, so the panel's comparability approach would if widely followed allow those fees to become the industry's floor."), *cert. granted*, 129 S. Ct. 1579 (2009); *see also* Freeman et al., *supra* note 3, at 128 ("Evaluating no-bid contract prices against other no-bid contract prices is futile.").

143. *Harris Assocs.*, 129 S. Ct. at 1580.

144. Petition for Writ of Certiorari at i, Jones v. Harris Assocs. L.P., No. 08-586 (U.S. Nov. 3, 2008).

145. *See* Brief in Opposition at 14–21, Jones v. Harris Assocs. L.P., No. 08-586 (U.S. Feb. 2, 2009).

146. *E.g.*, Jason Zweig, *Can the Supreme Court Undress High Fund Fees?*, WALL ST. J., Aug. 15, 2009, at B1.

147. *See supra* Part IV.A–C; *infra* Part V.

148. *See supra* Part IV.B.

problem through section 36(b) has proved ineffective.[149] Given that mutual funds' management structure lies at the root of these problems,[150] this Comment proposes that Congress and the Commission implement a system of default rules aimed at fostering more efficient negotiations between investment advisers and mutual funds' independent directors, as well as promoting price competition in the mutual fund industry.

A. Benchmarking Fees: A Penalty Default To Make Advisers Negotiate

In order to remedy the conflicts of interest inherent in mutual funds' governance structure, this Comment proposes that the SEC use its rulemaking authority to impose a default advisory fee level and to require investment advisers to reach a negotiated level of advisory fees with directors in order to opt out of the default.[151] By setting the default advisory fee level near the low end of the market, the Commission can successfully remedy the disparity in bargaining power that exists between the investment adviser and the mutual fund's board of directors and produce advisory fee structures more in line with the fair market value of advisory services.[152]

1. A General Theory of Penalty Defaults

In 1989, Professors Ian Ayres and Robert Gertner published a highly influential article on the role of default rules as they pertained to incomplete contracts.[153] Prior to Ayres and Gertner's article, commentators largely theorized that legislatures should fill gaps in incomplete contracts with "majoritarian" default terms approximating what the parties would have agreed upon given the opportunity to negotiate.[154] In

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149. *See supra* Part IV.C.

150. *See supra* Part IV.A.

151. The SEC has authority to "issue . . . rules and regulations and such orders as are necessary or appropriate to the exercise of the powers conferred upon the Commission" under the Investment Company Act. 15 U.S.C. § 80a-37(a) (2006). Congress granted the SEC broad authority to enforce the provisions of the Act. *See id.* § 80a-41; *see also id.* § 80a-35(b) (conferring authority on the Commission to enforce section 36(b)'s fiduciary duty).

152. *See* Freeman et al., *supra* note 3, at 140–41 (arguing that advisory fees negotiated between investment advisers and their captive mutual funds do not reflect the fair market value of advisory services).

153. Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 YALE L.J. 87 (1989).

154. *See id.* at 89–90, 93 ("Few academics have gone beyond one-sentence theories stipulating that default terms should be set at what the parties would have wanted. . . .

contrast, Ayres and Gertner proposed that efficient default rules might actually take the form of outcomes that the parties would not have agreed upon, thereby inducing the parties to affirmatively contract for the terms that they would prefer.[155]

Ayres and Gertner posited that penalty default rules could lead to more efficient contracting as a result of several mechanisms.[156] First and foremost, penalty default rules give at least one party an incentive to explicitly avoid the default outcome by contracting around the default rule—the party against whom a penalty default rule is set must reach an agreement with the party in whose favor the penalty default rule operates, or the default outcome prevails.[157] Second, by inducing parties to contract around the default, penalty default rules encourage the more informed contracting party to reveal information to the less informed party, especially if the incentive is on the more informed party to contract around the default.[158] Finally, by requiring parties to take affirmative procedural steps in order to opt out of the default outcome, legislatures can encourage the parties—especially the relatively uninformed party—to reflect on the consequences of entering into the contract before doing so.[159]

In recent years, commentators have adapted Ayres and Gertner's theory of penalty default rules to regulatory regimes, arguing that certain regulations act as "regulatory penalty defaults" by imposing undesirable outcomes on the regulated entity unless the default produces an

While this literature has vigorously examined what particular parties would have contracted for in particular contractual settings, it has failed to question whether the 'would have wanted' standard is conceptually sound.").

155. *Id.* at 91.

156. *See id.* at 97–100.

157. *Id.* at 97. By forcing ex ante bargaining, legislatures may prevent contracting parties from imposing costs on third parties by leaving the terms of a contract to ex post determination by a court. *Id.* at 93.

158. *Id.* at 97–98. By promoting the production of information that the relatively informed party might otherwise conceal, penalty default rules maximize the value created by the contract and minimize the opportunity for the relatively informed party to engage in rent-seeking behavior. *See id.* at 99–100. Although it would seem to defy rationality to suggest that a relatively informed party would withhold information that would increase the value created by the contract, this leaves aside the possibility that by revealing information the relatively informed party might simultaneously increase the value created by the contract and decrease the relatively informed party's share of that value. *See id.*

159. *See id.* at 123–25.

alternative outcome acceptable to the regulator.[160] Like penalty defaults in contract law, regulatory penalty defaults can force the regulated entity to produce privately held information, or information that the regulated entity is best situated to obtain, in order to propose an acceptable alternative outcome.[161] Moreover, regulatory penalty defaults that take effect at a future date force the regulated entity to propose an acceptable alternative outcome in order to avoid the effect of the undesirable default.[162] By opting for a regulatory penalty default, rather than a mandatory prescriptive rule, legislatures can encourage collaboration between the regulated entity and the regulator in order to achieve mutually desirable outcomes.[163]

2. Applying Penalty Defaults to Mutual Fund Advisory Contracts

This Comment posits that the rationale motivating the application of penalty default rules in both contract law and regulation apply equally strongly to the mutual fund-investment adviser relationship. First and foremost, a penalty default rule set against investment advisers will force advisers to actually negotiate with mutual funds' independent directors in order to avoid an undesirably low fee schedule.[164] Second, by requiring investment advisers to negotiate with mutual funds' independent directors, a penalty default rule will compel investment advisers to disclose fee-related information that, to this point, advisers have largely concealed.[165]

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160. Bradley C. Karkkainen, *Information-Forcing Environmental Regulation*, 33 FLA. ST. U. L. REV. 861, 869 (2006) ("Regulated entities have the option to avoid compliance with these rules by 'voluntarily' undertaking a self-initiated alternative course of action that under specified conditions may be a satisfactory substitute for the otherwise applicable rule."); *see also* IAN AYRES & JOHN BRAITHWAITE, RESPONSIVE REGULATION: TRANSCENDING THE DEREGULATION DEBATE 108–09 (1992).

161. Karkkainen, *supra* note 160, at 869.

162. *Id.* at 869–70.

163. *Id.* at 901–02. An example of a regulatory penalty default regime in the environmental law context is California's Proposition 65, which allows polluters to opt out of potential civil liability by producing information necessary to establish regulatory standards and cooperating with regulators to reduce toxic emissions. *Id.* at 871–75; *see* CAL. HEALTH & SAFETY CODE §§ 25249.5–.13 (West 2006).

164. *See* Ayres & Gertner, *supra* note 153, at 98 (arguing that, in the context of incomplete contracting, a penalty default price term set against the seller encourages the seller to negotiate to fill any price gaps).

165. *See* Freeman et al., *supra* note 3, at 131 (noting that investment advisory firms generally refuse to produce data regarding the cost of providing services to mutual funds, rendering judgment of advisers' profitability virtually impossible).

By forcing an investment adviser to reach a negotiated fee structure with a mutual fund's independent directors, a penalty default rule set against the investment adviser will result in the type of arm's length bargaining that has remained largely nonexistent in the majority of mutual fund boardrooms.[166] As discussed in greater detail above,[167] the significant disparity between mutual fund advisory fees and pension fund advisory fees stems in large part from the fact that pension funds have the ability to purchase advisory services in arm's length exchanges in the free market.[168] In contrast, mutual funds' conflicted governance structure has effectively allowed investment advisers to unilaterally set their own compensation.[169] By virtue of its sheer undesirability, a statutorily mandated or a rule-mandated low level of advisory fee approximating a penalty default rule will give the investment adviser no choice but to come to the bargaining table and negotiate with the mutual fund's independent directors in order to avoid the default outcome.[170] Moreover, by putting the investment adviser at an immediate disadvantage relative to the mutual fund's board of directors, a penalty default rule increases the likelihood that the adviser will offer

166. *See id.* at 140–41 (arguing that the disparity between mutual fund and pension fund advisory fees results from a general lack of arm's length bargaining); *cf.* Charles F. Sabel & William H. Simon, *Destabilization Rights: How Public Law Litigation Succeeds*, 117 HARV. L. REV. 1015, 1067 n.154 (2004) (arguing that destabilization rights, a concept based in part on Ayres and Gertner's theory of penalty defaults, can force negotiation between parties that might be otherwise reluctant to do so).

167. *See supra* note 95 and accompanying text.

168. *See* Freeman et al., *supra* note 3, at 141. The fact that many pension fund advisers are compensated according to incentive fee structures, through which they receive increased compensation only if the fund performs well, provides further evidence of the fact that pension fund advisory fees are negotiated at arm's length. *See* BOGLE, *supra* note 5, at 200. This type of fee structure is largely unheard of in mutual fund management arrangements. *Id.*

169. BOGLE, *supra* note 5, at 172–73.

170. Penalty defaults give the party or parties against whose interests the default is set an incentive to bargain around the default. Ayres & Gertner, *supra* note 153, at 97; *see also* Karkkainen, *supra* note 160, at 902.

In this same vein, a penalty default set against the investment adviser will also have an action-inducing character. *See* Karkkainen, *supra* note 160, at 869–70. A mutual fund's board of directors or shareholders must reapprove the investment adviser's contract yearly. 15 U.S.C. § 80a-15(a)(2) (2006). Thus, if the investment adviser fails to propose an alternative fee structure amenable to the mutual fund's board of directors by the time the directors must reapprove the contract, the potentially unprofitable default level of advisory fees controls.

concessions with regard to its fee structure in exchange for an escape from the unwanted default outcome.

As a consequence of its negotiation-inducing character, a penalty default rule set against the investment adviser will also trigger the production of fee-related information that the adviser might otherwise withhold.[171] Although the Investment Company Act requires investment advisers to furnish independent directors with whatever information they need to evaluate the terms of a proposed advisory contract,[172] advisers have historically been reluctant to share raw data pertaining to the costs of servicing mutual funds.[173] Without this data, it is nearly impossible for independent directors to determine a fee schedule that allows the investment adviser to realize a reasonable profit, while simultaneously reserving a fair share of gains to shareholders.[174] However, under a penalty default regime, investment advisers would have no choice but to reveal this data in order to avoid the undesirable outcome.[175] Like a regulatory penalty default, setting the advisory fee default at a level potentially unprofitable to the investment adviser would force the adviser to reveal profitability and other data to the mutual fund's independent directors in order to secure approval for its alternative fee schedule.[176] The Commission can further ensure that the adviser produces this information by delineating specific procedures for contracting around the default—the Commission might require the adviser or independent directors to explain to shareholders the basis for any departure from the default.[177] If the adviser refuses to produce this data, the unpalatable penalty default level of advisory fees will control, resulting in a windfall to the mutual fund at the adviser's expense.[178]

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171. *See* Ayres & Gertner, *supra* note 153, at 97 ("The very process of 'contracting around' [a penalty default] can reveal information to parties inside or outside the contract.").

172. 15 U.S.C. § 80a-15(c) (2006).

173. Freeman et al., *supra* note 3, at 131. Even the SEC has been unable to obtain this data. *Id.*

174. *See* BOGLE, *supra* note 5, at 159–60 ("[F]und managers have arrogated to themselves an excessive share of the financial markets' returns[] and left fund owners with a commensurately inferior share."); Freeman et al., *supra* note 3, at 131–32.

175. *See* Ayres & Gertner, *supra* note 153, at 99 ("By setting the default rule in favor of the uninformed party, the courts induce the informed party to reveal information, and, consequently, the efficient contract results.").

176. Karkkainen, *supra* note 160, at 869.

177. *See* Ayres & Gertner, *supra* note 153, at 124 ("[I]f a penalty default is chosen to encourage one party to reveal information to another, the court may want to regulate the process of contracting around the default so that meaningful information is conveyed."); *infra* Part V.A.3.b.

178. In this regard, a penalty default level of advisory fees can be likened to Professor Karkkainen's example of a regulatory penalty default—California's Proposition

3. Designing the Default

In order to accomplish these objectives, the Commission should structure the default in such a way as to maximize its negotiation-inducing and information-producing functions. Accordingly, this Comment proposes two potential benchmark models and suggests that the Commission adopt procedural rules around the default in order to ensure that investment advisers produce relevant information.

a. Benchmarking Fees

If the goal of the penalty default rule is to give a more informed contracting party an incentive to reveal information to a less informed party, the regulator should set the default against the more informed party.[179] Accordingly, and as the above discussion has already presupposed, the Commission should set the proposed default fee structure at a level unfavorable to investment advisers.[180] All evidence points to the fact that investment advisers systematically possess more information than mutual funds' independent directors.[181] Investment advisers frequently contract to provide portfolio management services to mutual funds,[182] whereas funds' independent directors may have no experience in the mutual fund industry beyond their service as board members.[183] Thus, the Commission must determine how—and by how much—to set the default against investment advisers.

The most obvious solution would set the penalty default at a uniform level tied to a particular market indicator, such as the average of the

65. Karkkainen, *supra* note 160, at 875. Under Proposition 65's regulatory scheme, a polluter who refuses to cooperate with regulators is exposed to potential civil liability. *Id.* Similarly, under the penalty default regime proposed in this Comment, an investment adviser who refuses to cooperate with a mutual fund's independent directors—the relevant regulators—will potentially receive an unprofitable level of advisory fees.

179. Ayres & Gertner, *supra* note 153, at 98.

180. *See supra* Part V.A.2.

181. *See* BOGLE, *supra* note 5, at 172–73 (suggesting that mutual funds' disinterested directors are "less-well-informed" than directors connected with management firms); Ayres & Gertner, *supra* note 153, at 98 ("If one side is repeatedly in the relevant contractual setting while the other side rarely is, it is a sensible presumption that the former is better informed than the latter.").

182. *See* BOGLE, *supra* note 5, at 172.

183. *See, e.g.*, Krantz v. Fid. Mgmt. & Research, Co., 98 F. Supp. 2d 150, 152 n.3 (D. Mass. 2000) (discussing the qualifications of the Fidelity fund complex's independent directors).

lowest decile or quintile of mutual fund advisory fees.[184] The Investment Company Institute annually publishes average mutual fund expense ratios, as well as data on expense ratios in the highest and lowest deciles.[185] However, these figures represent absolute expense ratios and do not isolate the expenses associated with the portfolio advisory function.[186] Because the SEC has allowed investment advisers to commingle administrative expense categories, a penalty default set according to the lowest decile of mutual fund advisory fees would likely require an accompanying rule requiring advisers to separate portfolio management expenses from other administrative expenses in order to function effectively.[187] Moreover, a uniform penalty default rule tied to such a variable indicator would likely entail significant monitoring costs, as the Commission would have to annually reset the default to keep pace with varying expense ratios.[188]

Alternatively, the Commission could place the onus on investment advisers, tying the default to data that advisers already possess. In 2001, Professors John P. Freeman and Stewart L. Brown conducted a careful study of the mutual fund industry, focusing on mutual fund advisory fees.[189] They concluded that investment advisers routinely overcharged mutual fund shareholders for portfolio advisory services, especially when compared to fees that advisers charged institutional investors for comparable services.[190] As part of a comprehensive solution, Freeman

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184. A decile is a division equal to one-tenth of a whole. *See* MERRIAM-WEBSTER'S COLLEGIATE DICTIONARY 298 (10th ed. 1993). A quintile is a division equal to one-fifth of a whole. *See id.* at 960.

185. *See* INV. CO. INST., *supra* note 1, at 64. The average expense ratio of all equity mutual funds is 1.46%, slightly less than twice the lowest decile's 0.79% average. *Id.* Similar information is available for free on the Internet. *See, e.g.*, Morningstar, http://www.morningstar.com (last visited Jan. 8, 2010).

186. *See* Freeman et al., *supra* note 3, at 112 ("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.").

187. *See id.*

188. *See* INV. CO. INST., *supra* note 1, at 62 (showing annually fluctuating mutual fund expense ratios).

189. *See* Freeman & Brown, *supra* note 72.

190. *See id.* at 672 ("The gap between prices charged funds for advisory services versus prices fetched elsewhere in the economy for those same services represents the bill paid by fund shareholders for the advisory conflict of interest that is both the fund industry's hallmark and its stigma. That tab runs into billions of dollars per year."); *see also* Tom Lauricella, *This Is News? Fund Fees Are Too High, Study Says*, WALL ST. J., Aug. 27, 2001, at C1 ("Using data on 1,343 domestic-stock funds from Morningstar Inc., the study found that mutual funds charged an average annual advisory fee equal to 0.56% of investor assets in 1999. By contrast, 1999 survey data from a third of the nation's 100 largest public-employee pension funds showed they paid an average of exactly half as much in advisory fees on 220 portfolios.").

and Brown proposed that the SEC use its rulemaking authority to grant mutual fund shareholders "most favored nations" treatment.[191] This proposal would have forbidden investment advisers from charging mutual funds more for portfolio advisory services than they charged pension funds and other institutional investors for comparable services.[192] However, the Commission has not adopted Freeman and Brown's proposal,[193] despite praise from regulators and industry insiders.[194]

This Comment proposes that the SEC convert Freeman and Brown's most-favored-nations pricing proposal into a penalty default rule. Under a most-favored-nations penalty default regime, each investment adviser would have its own unique default, determined by the amount the adviser charged institutional investors for portfolio advisory services.[195] Investment advisers would then bear the burden of justifying upward departures from the default by demonstrating to mutual funds' independent directors why they could not provide comparable investment advice for the same price charged to institutional investors.[196] This approach would likely capitalize on the penalty default's information-sharing character because investment advisers would need to produce management cost and profitability data in order to demonstrate why managing mutual fund portfolios merits higher advisory fees than managing pension fund portfolios.

Given that investment advisers already possess the information necessary to set their own default advisory fee levels, the most-favored-

191. Freeman & Brown, *supra* note 72, at 661.

192. *Id.*; *see also* Neil Weinberg, *Mutual Funds' Worst Nightmare*, FORBES.COM, Dec. 16, 2003, http://www.forbes.com/2003/12/16/cz_nw_1216mutualfunds.html.

193. *See* Freeman et al., *supra* note 3, at 150 ("The time has come for fund directors to demand that fund advisers give fund shareholders 'most favored nation' treatment on advisory fees.").

194. *See* Weinberg, *supra* note 192.

195. By way of example, in 2002, Alliance Capital charged approximately 0.90% of net assets to manage its captive Alliance Premier Growth Fund in 2002. Freeman et al., *supra* note 3, at 110–11. During the same period, Alliance Capital charged between 0.11% and 0.24% of net assets to manage portfolios of assets for pension funds and other institutional investors. *Id.* Thus, under the proposed regime, Alliance Capital's default level of mutual fund advisory fees would be approximately one-quarter of the fee that it had charged the Alliance Premier Growth Fund in 2002.

196. *See id.* at 110 (suggesting that the cost of providing investment advisory services to mutual funds does not exceed the cost of providing investment advisory services to pension funds).

nations penalty default approach has the benefit of being self-administering, obviating the need for an external regulator charged with setting default advisory fee levels.[197] However, with such a self-regulatory mechanism, there exists a possibility of abuse and manipulation. Because pension fund accounts generally represent a smaller fraction of investment advisers' revenue than mutual fund accounts, setting the default at pension fund advisory fee levels may actually lead to increased pension fund advisory fees.[198] Rational investment advisers could determine that the benefit of gaining additional ground in negotiations with mutual funds' independent directors outweighs the cost of lost pension fund clients, and increase pension fund advisory fees accordingly.

Given its likely propensity to force the production of relevant cost and profitability data and its self-administering character, a most-favored-nations methodology likely represents the most viable approach to setting the default level of advisory fees. Although investment advisers might abuse such a self-regulatory mechanism, this supposition ignores the competition and arm's length negotiation present in the pension fund advisory contract market.[199] In contrast to the mutual fund market, a pension fund manager can terminate its dealings with a particular investment adviser at any given time and take its business elsewhere.[200] Accordingly, competitive pressures will likely deter investment advisers from manipulating the default by raising pension fund advisory fees.

b. Setting the Ground Rules To Ensure Information Production

In addition to setting a penalty default against the investment adviser, this Comment proposes that the Commission capitalize on the default's

197. *See id.* (observing that investment advisers possess "apples-to-apples data" that allows them to compare the fees charged institutional investors to the fees charged mutual fund investors).

198. *See* BOGLE, *supra* note 5, at 199 (observing that the mutual funds managed by Calpers's investment advisers averaged seventeen times the size of the advisers' pension fund portfolios); Freeman & Brown, *supra* note 72, at 633 ("The average pension portfolio is $443 million and the average mutual fund portfolio is $1.3 billion, roughly three times greater. Moreover, in the largest deciles of portfolios/funds, the average mutual fund portfolio is about six times larger than the average pension portfolio.").

199. *See* Freeman & Brown, *supra* note 72, at 627–28 ("Investment advice is essentially a commodity. Outside the fund industry, it is bought and sold in a much more competitive marketplace.").

200. *Compare id.* at 628 ("Investment managers are regularly hired and fired and [institutional investors] doing the hiring enjoy the benefits of a competitive market."), *with* Freeman et al., *supra* note 3, at 140–41 (noting that mutual funds are generally compelled to purchase advisory services from their adviser-sponsor).

information-sharing character by regulating the process by which investment advisers may contract around the default. If the purpose of the penalty default is to encourage a more informed party to reveal information to a less informed party, the regulator may structure the process of contracting around the default in order to ensure the production of meaningful information.[201] By choosing a strong penalty default that requires explicit contractual language or affirmative procedural steps to opt out of the default outcome, legislatures can essentially require more informed contracting parties to apprise less informed parties of their legal rights.[202] Similarly, if the penalty default is regulatory in character, the supervisory body can require the production of specific information in order to escape from the default outcome.[203]

The Investment Company Act currently requires investment advisers to furnish to mutual funds' independent directors such information as is reasonably necessary to evaluate the terms of the adviser's contract.[204] By modifying this rule in conjunction with the proposed penalty default regime, the Commission can ensure that investment advisers come forward with relevant cost and profitability data that, to date, investment advisers have largely concealed.[205] Specifically, this Comment proposes that the SEC use its rulemaking authority to require that, in order to avoid the default level of advisory fees, an investment adviser produce detailed data to the mutual fund's independent directors demonstrating why the cost of servicing the mutual fund exceeds the cost of servicing the adviser's pension fund clients.[206] Additionally, in keeping with its objective of ensuring transparency in the advisory contract approval process, the Commission should also require mutual fund prospectuses to include a discussion of any decision to allow a departure from the

201. Ayres & Gertner, *supra* note 153, at 124.
202. *See id.*
203. *See* Karkkainen, *supra* note 160, at 875 ("Proposition 65['s regulatory penalty default mechanism] invites polluters to contract around the penalty provision by cooperating with regulators . . . by revealing (and if necessary by generating) information needed to establish health-protective numerical regulatory standards . . . .").
204. 15 U.S.C. § 80a-15(c) (2006).
205. *See supra* notes 172–76 and accompanying text.
206. In this regard, the proposed penalty default takes on a regulatory quality—it requires the investment adviser to produce information it asymmetrically holds in order to secure approval for an advisory fee structure in excess of the default. *See* Karkkainen, *supra* note 160, at 869.

default.[207] These measures should have the combined effect of ensuring that investment advisers produce relevant information and that mutual funds' independent directors faithfully reflect on this information in considering any proposed divergence from the penalty default.[208]

4. The Penalty Default's Advantage: Cooperation

In addition to its direct benefits of forcing negotiation and information production, the proposed default regime will have the collateral benefit of encouraging cooperation between mutual funds' independent directors and investment advisers.[209] Under the proposed regime, the Commission does not act as a direct rate regulator.[210] Instead, and as Congress envisioned in enacting the Investment Company Act, mutual funds' independent directors regulate the level of fees that advisers may charge.[211] The penalty default simply changes the starting point for

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207. Currently, mutual fund prospectuses must include a discussion of the material factors considered by the board of directors in approving the adviser's contract, including:

> (1) [T]he nature, extent, and quality of the services to be provided by the investment adviser; (2) the investment performance of the fund and the investment adviser; (3) the costs of the services to be provided and profits to be realized by the investment adviser and its affiliates from the relationship with the fund; (4) the extent to which economies of scale would be realized as the fund grows; and (5) whether fee levels reflect these economies of scale for the benefit of fund investors.

Disclosure Regarding Approval of Investment Advisory Contracts by Directors of Investment Companies, Investment Company Act Release No. 26,486 [2004 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 87,232, at 80,632 (June 23, 2004). These factors largely track the *Gartenberg* analysis. *See* Krinsk v. Fund Asset Mgmt., Inc., 875 F.2d 404, 409 (2d Cir. 1989) (citing Gartenberg v. Merrill Lynch Asset Mgmt., Inc., 694 F.2d 923, 929–30 (2d Cir. 1982)).

208. *See* 15 U.S.C. § 80a-15(c) ("It shall be the duty of the directors of a registered investment company to request and evaluate . . . such information as may reasonably be necessary to evaluate the terms of any contract whereby a person undertakes regularly to serve or act as investment adviser of such company.").

209. *See* Karkkainen, *supra* note 160, at 902 (arguing that regulatory penalty defaults may be superior to prescriptive regulation).

210. In enacting section 36(b), Congress indicated that it did not desire to directly regulate mutual fund advisory fees. *See* S. REP. NO. 91-184, at 6 (1969), *as reprinted in* 1970 U.S.C.C.A.N. 4897, 4902 ("[Section 36(b)] is not intended to introduce general concepts of rate regulation as applied to public utilities.").

211. *See* Burks v. Lasker, 441 U.S. 471, 484 (1979) ("Congress'[s] purpose in structuring the [Investment Company] Act as it did is clear. It was designed to place the unaffiliated directors in the role of independent watchdogs, who would furnish an independent check upon the management of investment companies." (citations and internal quotation marks omitted)); *see also* Alan R. Palmiter, *The Mutual Fund Board: A Failed Experiment in Regulatory Outsourcing*, 1 BROOK. J. CORP. FIN. & COM. L. 165, 165 (2006) (observing that Congress delegated the negotiation of advisory fees to mutual funds' boards of directors).

negotiations, giving the initial advantage to mutual funds' traditionally less informed independent directors.[212] So long as the parties comply with such regulations as the Commission may set for bargaining around the default, they are free to negotiate a mutually advantageous fee structure in excess of the default.[213] Accordingly, the proposed regime will likely foster genuine cooperation between investment advisers and mutual fund boards of directors, preventing advisers from dominating advisory contract negotiations to shareholders' detriment.[214]

B. An Alternative Default Proposal: Make Competition Happen

Recognizing that the Commission and the mutual fund industry might be resistant to such a sweeping reform proposal, this Comment also offers a more reserved proposal that Congress might implement in order to provide the parties with an introduction to the structure and efficacy of default rules. Specifically, this Comment proposes that Congress condition pension fund administrators' exemption from liability under section 404(c) of the Employee Retirement Income Security Act[215] (ERISA) on default enrollment in low-advisory-fee mutual funds.[216]

In 2008, 59% of mutual fund shareholders invested in funds through 401(k) and other defined contribution retirement plans.[217] The vast majority of plan administrators structure these defined contribution retirement plans so that individual contributors may direct all or part of

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212. *See* Karkkainen, *supra* note 160, at 902 ("Regulatory penalty defaults change the baseline for negotiation . . . .").

213. *See id.* at 901 ("[R]egulatory penalty default rules appear suitable for adaptation to a new role—creating incentives for parties to enter into collaborative new governance arrangements in good faith pursuit of . . . beneficial outcomes to avoid the harsher consequences that might follow from failure to do so.").

214. *See id.* at 902 ("Regulatory penalty defaults . . . make genuine cooperation more attractive than shirking or strategic bargaining."); Cristie L. Ford, *Toward a New Model for Securities Law Enforcement*, 57 ADMIN. L. REV. 757, 821–22 (2005) (arguing that cooperative new governance models of regulation can shift traditionally adversarial processes toward collaborative reform efforts).

215. 29 U.S.C. § 1104(c) (2006). For the operation of the exemption section 404(c) allows, see *infra* note 218 and accompanying text.

216. As with the penalty default regime proposed above, Congress could condition the section 404(c) exemption's availability on default enrollment in mutual funds that charge in the industry's lowest decile or quintile. *See supra* notes 185–88 and accompanying text.

217. INV. CO. INST., *supra* note 1, at 77. Mutual funds accounted for 47% of the 401(k) market at the end of 2008. *Id.* at 92.

their investments, allowing administrators to avoid potential fiduciary liability.[218] However, many individuals who participate in defined contribution retirement plans lack sufficient investing sophistication to adequately exercise control over their assets.[219] As a result, an overwhelming majority of individuals choose their plan's default investment fund.[220]

Individuals who save for retirement through defined contribution retirement plans are often limited to investing in those mutual funds offered by their retirement plans.[221] As a result, investors frequently do not withdraw from mutual fund investments even in the face of high advisory fees.[222] This "stickiness" increases the transactions costs associated with shifting assets to mutual funds charging lower advisory fees, hindering mutual fund investors' ability to discipline investment advisers who charge above market fees.[223]

In light of this conflict, Congress and the Department of Labor—responsible for administering ERISA—should require that defined contribution retirement plans' default investment funds only contain low-advisory-fee mutual funds.[224] Specifically, Congress should condition plan administrators' section 404(c) liability exemption on inclusion of only low-advisory-fee mutual funds in plans' default investment funds. This proposal would have two primary effects. First, by automatically enrolling individuals who choose their retirement plan's default investment fund, the rule would protect uninformed investors' retirement savings

218. *See* DELOITTE CONSULTING LLP, ANNUAL 401(K) BENCHMARKING SURVEY 21 (2006), http://www.deloitte.com/dtt/cda/doc/content/us_consulting_hc_401ksurveyresults_020806.pdf (indicating that 80% of responding 401(k) plan sponsors provided a statement that they intended to comply with ERISA section 404(c) protection). Section 404(a) of ERISA imposes a stringent standard of care on pension plan fiduciaries. *See* 29 U.S.C. § 1104(a) (2006). However, if the plan allows beneficiaries to exercise control over their own accounts, section 404(c) exempts from liability plan administrators who would otherwise be fiduciaries. *Id.* § 1104(c); *see also* 29 C.F.R. § 2550.404c-1 (2008). *See generally* Debra A. Davis, *Do-It-Yourself Retirement: Allowing Employees To Direct the Investment of Their Retirement Savings*, 8 U. PA. J. LAB. & EMP. L. 353, 356–60 (2006).

219. *See* Davis, *supra* note 218, at 367–68.

220. *Id.* (citing Julie Agnew & Lisa R. Szykman, *Asset Allocation and Information Overload: The Influence of Information Display, Asset Choice and Investor Experience* 3 (Ctr. for Ret. Research, Working Paper No. 2004-15), *available at* http://escholarship.bc.edu/cgi/viewcontent.cgi?article=1088&context=retirement_papers).

221. Memorandum from Chester Spatt, *supra* note 90, at 10.

222. *Id.*

223. *Id.* at 9.

224. Thus, if a defined contribution retirement plan only offered to its participants mutual funds from one fund family, this proposal would require the plan administrator to include in the default investment fund only those mutual funds with the lowest expense ratios.

from the detrimental effect of high mutual fund advisory fees.[225] Given that virtually no correlation exists between advisory fees and fund performance, there is minimal risk that default enrollment in low cost funds would adversely affect investment returns.[226] Second, and perhaps more importantly, requiring that defined contribution retirement plans' default investment funds only contain low-advisory-fee mutual funds will encourage price competition among mutual funds. Mutual funds and their investment advisers cannot ignore the relatively large segment of investors who invest through their retirement plans' default investment funds.[227] Rather, this default rule will likely force investment advisers to lower advisory fees to vie for inclusion in retirement plans' default investment funds, providing some palliative effect on the current lack of price competition in the mutual fund industry.[228]

VI. CONCLUSION

As a result of mutual funds' conflicted governance structure and the associated lack of price competition, excessive advisory fees have flourished. Moreover, a review of the case law and extant literature demonstrates that Congress's attempt to regulate advisory fees through litigation has not met with success. Courts have turned the proposed fiduciary duty standard into an onerous, insurmountable burden of proof. Although some commentators argue that the time has come to restructure mutual funds entirely, this Comment proposes to work within the existing framework to affect independent director behavior and foster the arm's length negotiation of portfolio management contracts that Congress sought in enacting section 36(b).[229] By enacting the proposed penalty default regime, Congress can give mutual funds' independent

225. *See* BOGLE, *supra* note 5, at 161 ("Investing on the basis of relative costs alone, then, fund investors would have improved their ten-year profit by 75 percent . . . ."); *see also* THALER & SUNSTEIN, *supra* note 28, at 129–30 (discussing default options' role in protecting investors).

226. *See* BOGLE, *supra* note 5, at 160.

227. *See supra* text accompanying notes 217–20.

228. *See supra* Part IV.B.

229. *See, e.g.*, WALLISON & LITAN, *supra* note 5, at 99–120 (proposing that mutual funds be structured as management investment trusts, in which investors contract directly with investment advisers); Palmiter, *supra* note 211, at 207–08 (suggesting that mutual funds be structured without boards such that investors purchase portfolio management services directly from the adviser).

directors the upper hand in negotiation, fostering the type of arm's length bargaining Congress and the Commission intended section 36(b) to accomplish. Given the importance of mutual funds to American investors, Congress and the SEC should attempt to overhaul the current Investment Company Act before they take any steps that might threaten investors' retirement security.