

# INVESTMENT INDISCIPLINE: A BEHAVIORAL APPROACH TO MUTUAL FUND JURISPRUDENCE

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*This Term, in Jones v. Harris Associates L.P., the Supreme Court will have the opportunity to resolve doctrinal, econometric, and philosophical divergences over a profoundly important financial system: the investment industry through which almost one hundred million Americans attempt to save more than ten trillion dollars for their retirement. When this case was before the Seventh Circuit, two of the foremost theorists of law and economics, Chief Judge Frank Easterbrook and Judge Richard Posner, disagreed vociferously on competing analyses of this industry. The Supreme Court's opinion in this case should not only resolve the intricate doctrinal fiduciary issues of the dispute but also have important implications for several major theoretical debates in contemporary American jurisprudence: the permissible constraints—if any—upon determinations of executive compensation; the judicial capacity to evaluate increasingly sophisticated econometric analyses of financial systems; and the growing tension between neoclassical and behavioral economics.*

*Professor Birdthistle advances a positive account of the economic and legal context of this dispute and argues normatively for a behavioral approach to its resolution. Because of the unique structure and history of the personal investment industry in the United States, the architecture of this segment of the economy is singularly unprotected by beneficial market forces and exhibits significant competitive weaknesses such as broad price dispersion and a negative correlation between fees and performance. The ultimate judicial resolution of this*

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*dispute should take account of the behavioral constraints upon individual investors and their advisors to avoid nullifying congressional action and to impose discipline in a vital segment of the U.S. economy.*

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#### INTRODUCTION

Federal judges cannot—within the bounds of judicial etiquette—call upon the Supreme Court to overturn the ruling of a colleague. But they certainly can attract the Justices’ attention. And when Judge Richard Posner published a passionate critique of a fellow jurist’s opinion in which he emphasized “the creation of a circuit split, the importance of the issue . . . and the one-sided character of the panel’s analysis,”<sup>1</sup> he came as close to demanding reversal as one is ever likely to read in the *Federal Reporter*. Posner’s displeasure was particularly remarkable because the author whose “economic analysis” he found “ripe for reexamination”<sup>2</sup> was none other than Chief Judge Frank Easterbrook. So public a contretemps between two such renowned jurists may well explain why the Supreme Court answered Posner’s call by granting certiorari<sup>3</sup> in what has become a remarkably well-timed case whose central quarrel concerns

1. *Jones v. Harris Assocs. L.P.*, 537 F.3d 728, 732–33 (7th Cir. 2008) (Posner, J., dissenting from denial of rehearing en banc).

2. *Id.* at 730.

3. *See Jones v. Harris Assocs. L.P.*, 129 S. Ct. 1579, 1580 (2009).

the degree to which the judiciary may, or indeed must, defer to fallible market forces. With the involvement of the Supreme Court, what debuted as an important appellate case now appears destined for a permanent pedestal within the canon of corporate law.

For decades, Easterbrook and Posner have collaborated famously<sup>4</sup> on a likeminded exposition of the economic analysis of law in their roles both as brethren on the Seventh Circuit<sup>5</sup> and as fellow faculty members at the University of Chicago Law School.<sup>6</sup> Precisely because of this philosophical kinship, some of their most notable scholarly contributions have emerged from their public disagreements—such as their dueling opinions in *Jordan v. Duff & Phelps, Inc.*<sup>7</sup>—which now anchor the corporate law curriculum.<sup>8</sup>

So when, in *Jones v. Harris Associates L.P.*, Posner published a cutting dissent to the denial of rehearing Easterbrook's opinion en banc,<sup>9</sup> scholars, practitioners, and regulators inclined closely to attend to the dispute that estranged these erstwhile intellectual allies<sup>10</sup> and attracted the interest of the Supreme Court.<sup>11</sup> Indeed, academic authors have already excerpted the 2008 appellate decision in corporate and securities

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4. See Floyd Norris, *Judges in Dispute Over Mutual Funds*, N.Y. TIMES, Aug. 16, 2008, at C3 (“They are both known as conservatives and were pioneers in the economic analysis of the law. Each is a past president of the American Law and Economics Association. . . . A 2001 poll of Legal Affairs Magazine readers listed them among the 20 most influential legal thinkers in the country. Only one other circuit court judge made the list.”). Both have also been chosen to write the foreword to the Supreme Court issue of the *Harvard Law Review*. Frank H. Easterbrook, *The Supreme Court, 1983 Term—Foreword: The Court and the Economic System*, 98 HARV. L. REV. 4 (1984); Richard A. Posner, *The Supreme Court, 2004 Term—Foreword: A Political Court*, 119 HARV. L. REV. 31 (2005).

5. See Norris, *supra* note 4; see also Stephen J. Choi & G. Mitu Gulati, *Choosing the Next Supreme Court Justice: An Empirical Ranking of Judge Performance*, 78 S. CAL. L. REV. 23, 44–50 (2004) (presenting empirical data that rank Judges Posner and Easterbrook as the first and second, respectively, most prolific publishers and most cited authors of appellate judicial opinions published between 1998 and 2000).

6. See, e.g., FRANK H. EASTERBROOK & DANIEL R. FISCHEL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* (1991); RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* (7th ed. 2007); Frank H. Easterbrook, William M. Landes & Richard A. Posner, *Contribution Among Antitrust Defendants: A Legal and Economic Analysis*, 23 J.L. & ECON. 331 (1980).

7. 815 F.2d 429 (7th Cir. 1987).

8. See, e.g., WILLIAM A. KLEIN, J. MARK RAMSEYER & STEPHEN M. BAINBRIDGE, *BUSINESS ASSOCIATIONS* 628–39 (7th ed. 2009) (excerpting *Jordan v. Duff & Phelps, Inc.*).

9. 537 F.3d 728 (7th Cir. 2008).

10. See, e.g., Brief of Amici Curiae Law Professors in Support of the Issuance of a Writ of Certiorari, *Jones v. Harris Assocs. L.P.*, 129 S. Ct. 1579 (2009) (No. 08-586) [hereinafter Brief of Amici Curiae Law Professors] (setting forth the argument of fifteen legal scholars of federal securities regulation, business organizations, and the law of investment funds). In addition to law firms publishing several client alerts immediately following the publication of Posner's dissent, the Securities and Exchange Chairman, Mary L. Schapiro, recently stated that she “expect[s] that the SEC will voice its views [in this case] through the amicus process.” Mary L. Schapiro, Chairman, U.S. Sec. & Exch. Comm'n, Address to Mutual Fund Directors Forum Ninth Annual Policy Conference: Critical Issues for Investment Company Directors (May 4, 2009), available at <http://www.sec.gov/news/speech/2009/spch050409mls.htm>.

11. *Jones v. Harris Assocs. L.P.*, 527 F.3d 627 (7th Cir. 2008), cert. granted, 129 S. Ct. 1579 (2009).

law casebooks.<sup>12</sup> No doubt the Supreme Court opinion will command even greater attention, scrutiny, and textbook pages.

At the heart of the matter lies a philosophical divergence between Easterbrook and Posner over a profoundly important financial system: the investment industry through which almost one hundred million Americans attempt to save more than ten trillion dollars for their retirement.<sup>13</sup> The Supreme Court's ruling should not only resolve the intricate fiduciary and doctrinal issues of this dispute but also have profound implications for several major theoretical debates in contemporary American jurisprudence: the permissible constraints—if any—upon determinations of executive compensation; the judicial capacity to evaluate increasingly sophisticated econometric analyses of financial systems; and the growing tension between neoclassical and behavioral economics.

The specific issue in *Jones* is whether an investment advisor breached its congressionally imposed fiduciary duty to investors by charging excessive fees to manage those investors' savings.<sup>14</sup> With ninety-two million Americans investing more than ten trillion dollars in retirement and investment funds<sup>15</sup> and paying almost one hundred billion dollars a year in fees to do so,<sup>16</sup> the practical implications of this decision are going to be enormous and will reach directly into American households. The Supreme Court's ruling could save investors—or, alternatively, reward investment advisors—tens of billions of dollars a year in expenses and even greater amounts in future compounded returns. Few judicial disputes possess the potential for such a direct pecuniary impact upon such a massive swath of ordinary citizens. Fewer still demand the attention of the nation's highest court at a historic moment in the immediate aftermath of systemic financial crisis.

In this Article, I advance a positive account of the economic and legal context of this dispute and then argue normatively for a behavioral approach to its resolution. Because of the unique structure and history of the personal investment industry in the United States, the architecture of this segment of the economy is singularly unprotected by beneficial market forces and exhibits significant competitive weakness such as broad price dispersion<sup>17</sup> and a negative correlation between fees and per-

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12. See, e.g., KLEIN, RAMSEYER & BAINBRIDGE, *supra* note 8, at 392–95 (excerpting *Jones v. Harris Associates L.P.*).

13. See INV. CO. INST., 2008 FACT BOOK 7–8 (48th ed. 2008), [http://www.icifactbook.org/pdf/2008\\_factbook.pdf](http://www.icifactbook.org/pdf/2008_factbook.pdf); Schapiro, *supra* note 10.

14. 15 U.S.C. § 80a-35(b) (2006) (stating, in pertinent part, that an “investment adviser of a registered investment company shall be deemed to have a fiduciary duty with respect to the receipt of compensation for services”); *Jones*, 527 F.3d at 630.

15. See INV. CO. INST., *supra* note 13, at 7–8; Schapiro, *supra* note 10.

16. See, e.g., Paul G. Mahoney, *Manager-Investor Conflicts in Mutual Funds*, 18 J. ECON. PERSP. 161, 166–68 (2004) (computing the total cost that investors pay to invest through mutual funds).

17. See PETER J. WALLISON & ROBERT E. LITAN, *COMPETITIVE EQUITY: A BETTER WAY TO ORGANIZE MUTUAL FUNDS* 8–11 (2007).

formance.<sup>18</sup> The ultimate judicial resolution of this dispute must take full account of the behavioral constraints upon individual investors and their advisors to avoid nullifying congressional action with an unexamined embrace of deregulation from the bench.

As a liminal matter, the anatomy of the investment fund industry lacks several important mechanisms that ensure effective corporate governance.<sup>19</sup> Unlike typical operating companies, mutual funds enjoy no market for corporate control, no conflict-assuaging system of managerial compensation, and no capacity for discipline by short selling.<sup>20</sup> Indeed, a 1970 Senate report accompanying the implementation of the fiduciary duty designed to compensate for these structural voids expressly described the relationship between investment advisors and their mutual funds as uncompetitive.<sup>21</sup>

Uncritical assumptions about the efficacy of deregulatory fiduciary protections via a judicial ruling are particularly ill-timed in an industry that has recently been accused of widespread violations of trust.<sup>22</sup> In 2003, state and federal regulators unleashed scores of investigations of investment advisors whom they accused of mismanaging clients' funds. Those efforts, which continue to this day, recouped billions of dollars in settlement fees.<sup>23</sup> During the recent market decline, investors with perilously undiversified and poorly allocated investment portfolios lost more than \$2.5 trillion from their retirement funds.<sup>24</sup>

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18. See Javier Gil-Bazo & Pablo Ruiz-Verdú, *The Relation Between Price and Performance in the Mutual Fund Industry*, 64 J. FIN. 2153, 2178–79 (2009); see also Mark M. Carhart, *On Persistence in Mutual Fund Performance*, 52 J. FIN. 57, 80 (1997); Burton G. Malkiel, *Returns from Investing in Equity Mutual Funds 1971 to 1991*, 50 J. FIN. 549, 570–72 (1995).

19. See Donald C. Langevoort, *Private Litigation to Enforce Fiduciary Duties in Mutual Funds: Derivative Suits, Disinterested Directors and the Ideology of Investor Sovereignty*, 83 WASH. U. L.Q. 1017, 1030–32 (2005).

20. *Id.*

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

22. See generally William A. Birdthistle, *Compensating Power: An Analysis of Rents and Rewards in the Mutual Fund Industry*, 80 TUL. L. REV. 1401 (2006) [hereinafter Birdthistle, *Compensating Power*]; William A. Birdthistle, *The Fortunes and Foibles of Exchange-Traded Funds: A Positive Market Response to the Problems of Mutual Funds*, 33 DEL. J. CORP. L. 69 (2008) [hereinafter Birdthistle, *Fortunes and Foibles*]; Stephen Choi & Marcel Kahan, *The Market Penalty for Mutual Fund Scandals*, 87 B.U. L. REV. 1021 (2007); James D. Cox & John W. Payne, *Mutual Fund Expense Disclosures: A Behavioral Perspective*, 83 WASH. U. L.Q. 907 (2005); Tamar Frankel, *How Did We Get Into This Mess?*, 1 J. BUS. & TECH. L. 133 (2006); Tamar Frankel & Lawrence A. Cunningham, *The Mysterious Ways of Mutual Funds: Market Timing*, 25 ANN. REV. BANKING & FIN. L. 235 (2006).

23. Many of the best known investment advisors in the retirement savings industry have paid eight- and nine-figure settlements over the past five years, including Bank of America (\$675 million), Bear Stearns (\$250 million), Putnam Investments, Massachusetts Financial Services (\$225 million), Janus Capital Group (\$225 million), Alliance Capital Management (\$600 million), Pilgrim Baxter (\$100 million), and many others. See, e.g., Greg Farrell, *Bear Stearns to Pay \$250M*, USA TODAY, Mar. 17, 2006, at 2B; Josh Friedman, *FleetBoston, BofA to Pay \$675 Million*, L.A. TIMES, Mar. 16, 2004, at C1; Tom Lauricella, *Alliance Offers to Cut Fees 20%*, WALL ST. J., Dec. 16, 2003, at C1.

24. Investment Company Institute, *Trends in Mutual Fund Investing*, December 2008, [http://www.ici.org/pressroom/news/trends\\_12\\_08](http://www.ici.org/pressroom/news/trends_12_08) (last visited Dec. 1, 2009) (showing a one-year decline in mutual fund assets from approximately \$12 trillion to \$9.6 trillion); Schapiro, *supra* note 10.

To summarize, in portions of the U.S. retirement savings industry, the professionally incompetent appear to have overcharged the financially unsophisticated.

The Easterbrook-Posner debate encapsulated in *Jones* provides an excellent and timely opportunity to conduct a comprehensive theoretical and doctrinal evaluation of the judicial contours of the U.S. savings industry. The case brings into conflict two of the leading economic and legal theories of our day. Easterbrook's panel opinion represents a neo-classical law-and-economics analysis that presumes a well-functioning market for investment advice, discounts possibly irrational investor behavior, and concludes with a call for deregulation of the industry.<sup>25</sup> Posner responded in his dissent with a behavioralist approach that focuses on market weaknesses, calls attention to systemic distortions of incentives, and implicitly countenances a role for salutary intervention.<sup>26</sup>

During the few months between the publication of these two opinions, Americans witnessed the dramatic collapse of certain financial instruments<sup>27</sup> and developed a concomitant increase in skepticism of economic theories emphasizing deregulation.<sup>28</sup> The stress that recent market problems have placed upon such legal theories prompted certain scholars to inquire whether we are witnessing what Brian Tamanaha has called "the receding tide of law and economics."<sup>29</sup>

While such a requiem is surely premature, recent events have energized the field of behavioral economics, which attempts to take account of the "predictably irrational"<sup>30</sup> ways in which market participants often behave.<sup>31</sup> In *Jones*, the Supreme Court will enjoy the ideal judicial opportunity to opine upon these dueling strains of economic analysis by endorsing one or the other as a mode for deciding whether the market

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25. See *Jones v. Harris Assocs. L.P.*, 527 F.3d 627, 631–35 (7th Cir. 2008).

26. See *Jones v. Harris Assocs. L.P.*, 537 F.3d 728, 731–33 (7th Cir. 2008) (Posner, J., dissenting from denial of rehearing en banc).

27. See, e.g., Frank Partnoy & David A. Skeel, Jr., *The Promise and Perils of Credit Derivatives*, 75 U. CIN. L. REV. 1019, 1019 (2007) (initiating "an in-depth analysis" of credit default swaps and collateralized debt obligations); Paul M. Jona, Comment, *In Search of Market Discipline: The Case for Indirect Hedge Fund Regulation*, 45 SAN DIEGO L. REV. 989, 1001 (2008).

28. See, e.g., RICHARD A. POSNER, *A FAILURE OF CAPITALISM* xii–xiv (2009).

29. Posting of Brian Tamanaha to Balkinization, <http://balkin.blogspot.com/2008/12/are-we-witnessing-receding-tide-of-law.html> (Dec. 17, 2008, 10:22 EST) ("Recent events appear to have genuinely shaken Posner's faith in the self-correcting power of the market."); see also Scott A. Moss & Peter H. Huang, *How the New Economics Can Improve Employment Discrimination Law, and How Economics Can Survive the Demise of the "Rational Actor,"* 51 WM. & MARY L. REV. 183, 254–58 (2009).

30. See DAN ARIELY, *PREDICTABLY IRRATIONAL: THE HIDDEN FORCES THAT SHAPE OUR DECISIONS* xx (2008).

31. See generally David Hirshleifer, *The Blind Leading the Blind: Social Influence, Fads, and Informational Cascades*, in *THE NEW ECONOMICS OF HUMAN BEHAVIOR* 188 (Mariano Tommasi & Kathryn Ierulli eds., 1995); Christine Jolls & Cass R. Sunstein, *Debiasing Through Law*, 35 J. LEGAL STUD. 199 (2006); Dan M. Kahan & Donald Braman, *Cultural Cognition and Public Policy*, 24 YALE L. & POL'Y REV. 149 (2006); Amos Tversky & Daniel Kahneman, *Introduction to JUDGMENT UNDER UNCERTAINTY: HEURISTICS AND BIASES* 3 (Daniel Kahneman, Paul Slovic & Amos Tversky eds., 1982).

alone can satisfy the fiduciary obligations imposed upon financial advisors in their management of investors' monies. In light of the remarkable recent market events, the timing of this litigation could not be more fortuitous for examining the assumptions and bases of economic legal analysis.

As a preview, and perhaps a harbinger, for the Supreme Court, the Eighth Circuit recently handed down a notable opinion that grasped this timely opportunity.<sup>32</sup> In the first judicial ruling upon the question of excessive fees since the Supreme Court granted certiorari in *Jones*, the Eighth Circuit expressly disagreed with Easterbrook's reasoning, endorsed Posner's argument, and provided what I argue should serve as a template for the Supreme Court's ultimate decision in *Jones*.<sup>33</sup> In *Gallus v. Ameriprise Financial, Inc.*, a case with facts materially identical to those in *Jones*, the Eighth Circuit chose not to stay its decision pending *Jones* but instead decided to make itself heard in this debate by issuing the first-ever decision in favor of a plaintiff in an excessive fees case.<sup>34</sup> The *Gallus* opinion demonstrates that the judiciary has begun to balance unbounded deregulatory measures by adopting broader academic theories that call into doubt certain assumptions about the rationality of investors.<sup>35</sup>

One approach the courts have begun to consider follows the behavioral theory of Cass Sunstein, who has suggested that real-world obstacles to rational investment decisions may compel a departure from a strict laissez-faire notion in favor of mild "libertarian paternalism" to achieve socially beneficial outcomes.<sup>36</sup> Congress recently enacted a very modest example of such a "nudge" in investment policy when—by relaxing pension regulations—it changed the default in savings accounts from requiring uninvested retirement contributions to be held in cash to permitting those funds to be invested in broad-based, low-cost funds.<sup>37</sup> Such a behavioral approach may thus afford protection to real-world investors who have neither the time nor the expertise to make the prudent investment decisions assumed of them by the rational actor model of neoclassical law and economics. Courts, too, can improve the savings industry

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32. See *Gallus v. Ameriprise Fin., Inc.*, 561 F.3d 816, 822 (8th Cir. 2009).

33. See *id.* at 822–23.

34. See Sam Mamudi, *Ruling Over Fees Raises the Stakes*, WALL ST. J., Apr. 16, 2009, at C9 (citing Professor James Cox for the proposition that "the Eighth Circuit's ruling against Ameriprise is the first time a federal court has taken the side of investors in a fees case").

35. See, e.g., Franklin Foer & Noam Scheiber, *Nudge-ocracy: Barack Obama's New Theory of the State*, NEW REPUBLIC, May 6, 2009, at 22, 23–24; Ryan Lizza, *Money Talks*, NEW YORKER, May 4, 2009, at 51, 53 ("Orszag has turned the O.M.B. into something of a behavioral-economics think tank.").

36. See RICHARD H. THALER & CASS R. SUNSTEIN, *NUDGE: IMPROVING DECISIONS ABOUT HEALTH, WEALTH, AND HAPPINESS* 5–6, 104 (2008); see also Gregory Mitchell, *Libertarian Paternalism Is an Oxymoron*, 99 NW. U. L. REV. 1245, 1245–46 (2005); Cass R. Sunstein & Richard H. Thaler, *Libertarian Paternalism Is Not an Oxymoron*, 70 U. CHI. L. REV. 1159, 1159–62 (2003).

37. See Pension Protection Act of 2006, Pub. L. No. 109-280, § 624, 120 Stat. 780, 980 (codified at 29 U.S.C. § 1104(c) (2006)).

by adopting a jurisprudential regime that takes greater and more reasonable account of the actual constraints on rational investor behavior as well as the painfully learned lessons borne of an uncurious reverence for deregulation.

In Part I of this Article, I discuss structural limitations unique to the savings industry, the resulting disproportionate reliance upon exit in this context, and the ways in which foibles of both investment advisors and investors undermine the efficacy of exit as a solitary bulwark for effective governance in these investment funds.

In Part II, I examine the competing doctrinal approaches of the appellate opinions in *Jones* and *Gallus* as modes for explicating the dueling theories that currently dominate corporate and securities regulation broadly and the retirement savings field more specifically.

In Part III, I advance a new, behavioral approach for resolving the current controversy. I also explore the practical and theoretical implications that may flow from the Supreme Court's ruling in *Jones*, including the Court's possible contributions to debates concerning the appropriate legal constraints—if any—upon executive compensation decisions, the judicial capacity to evaluate increasingly sophisticated econometric analyses of financial systems, and the tension between neoclassical versus behavioral economic theories.

## I. THE STATE OF OUR SAVINGS

After the dramatic decline of large and sophisticated sectors of the U.S. and global economies, assumptions that the investment industry nevertheless remains healthy and competitive warrant reexamination.<sup>38</sup> For courts that must evaluate claims that investment advisors have violated congressionally imposed fiduciary duties—such as section 36(b) of the Investment Company Act<sup>39</sup>—such a reexamination reveals the complexity of the structure and governance of the investment industry.

Although Chief Judge Easterbrook pointed to the sheer number of investment funds<sup>40</sup> and the size of the industry as probative indicia of its

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38. See, e.g., Troy A. Paredes, Comm'r, U.S. Sec. & Exch. Comm'n, Remarks Before the Mutual Fund Directors Forum Ninth Annual Policy Conference (May 4, 2009), available at <http://www.sec.gov/news/speech/2009/spch050409tap.htm> ("It is hard to argue that the mutual fund industry, on the whole, has been anything but a success for investors and our capital markets more generally.").

39. Investment Company Act of 1940 § 36(b), 15 U.S.C. § 80a-35(b) (2006).

40. See, e.g., *Jones v. Harris Assocs. L.P.*, 527 F.3d 627, 633 (7th Cir. 2008) ("Today thousands of mutual funds compete. The pages of the *Wall Street Journal* teem with listings.").

health,<sup>41</sup> similar averments were recently made with respect to the residential lending industry and the market for credit derivatives.<sup>42</sup>

Such unexamined assumptions are unhelpful in today's economic climate, and they may be particularly inapposite to a retail investment industry that, first, is structurally different and far more vulnerable than business segments involving typical corporations and, second, has so recently demonstrated such manifestly deleterious behavior on the part of its two most important constituencies: advisors and investors.

#### A. *Structure and Governance*

The primary vehicles through which U.S. investors save for retirement are mutual funds, which as of 2009 hold more than ten trillion dollars in shareholder assets.<sup>43</sup> Any attempt to understand and assess the investment industry must begin with an appreciation for the substantial structural differences that exist between mutual funds and typical corporations.<sup>44</sup> These dissimilarities produce material differences between the governance regimes of mutual funds and those of the more widely studied and understood corporations.<sup>45</sup> These architectural idiosyncrasies also explain why market forces alone may often be insufficient to guarantee competitive advisory fees.<sup>46</sup> Indeed, they were what motivated Congress to revise the Investment Company Act in 1970 to impose a specific fiduciary duty on investment advisors as a means of safeguarding investors from artificially high fees.<sup>47</sup>

The central protagonists in this field, the investment advisors, determine the structure of mutual funds by the manner in which they organize their enterprise.<sup>48</sup> Investment advisors are firms of portfolio managers whose business model is to provide investment advice to pools of money—mutual funds—in exchange for a percentage of the assets of those pools.<sup>49</sup> Initially, the advisors themselves create and incubate these funds, forming them as distinct legal entities, drafting and adopting their founding articles and bylaws, and seeding the funds' initial investment

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41. See, e.g., *Hecker v. Deere & Co.*, 556 F.3d 575, 586 (7th Cir. 2009) (asserting that a set of mutual funds “were also offered to investors in the general public, and so the expense ratios necessarily were set against the backdrop of market competition” (emphasis added)), *reh'g denied*, 569 F.3d 708 (2009).

42. Robert Lenzer, *Lessons Learned a Year After Lehman's Demise*, FORBES.COM, Aug. 21, 2009, <http://www.forbes.com/2009/08/21/bernanke-bailout-paulson-personal-finance-investing-ideas-lehman-brothers.html>.

43. See INV. CO. INST., *supra* note 13, at 9.

44. See generally Birdthistle, *Compensating Power*, *supra* note 22.

45. *Id.* at 1429–30.

46. *Id.* at 1439–46.

47. See Brief of Amici Curiae Law Professors, *supra* note 10, at 4 (discussing Investment Company Amendments Act of 1970, Pub. L. No. 91-547, 84 Stat. 1413).

48. See, e.g., *id.* at 2–5; INV. CO. INST., *supra* note 13, at 164–65; Birdthistle, *Compensating Power*, *supra* note 22, at 1419–20.

49. See Birdthistle, *Compensating Power*, *supra* note 22, at 1403 n.2, 1409–10.

capital.<sup>50</sup> An important task at this nascent stage is the appointment of a fund's board of trustees. Because the investment advisor is the only investor and therefore the only shareholder in a fund at this time, it has complete authority to appoint whomever it wishes to the board.<sup>51</sup>

The advisor's fee—the percentage of assets that it will receive for its services as a fund's external management—is set forth by contract in an investment advisory agreement.<sup>52</sup> Obviously, the advisor represents its own interests in the negotiation of the advisory agreement; representing the fund's interests is the board of trustees, whom the advisor has just appointed. The Investment Company Act requires that the advisory agreement be entered into anew each year, so advisors and boards undergo an annual “contract renewal process.”<sup>53</sup> As an empirical matter, boards almost universally retain and renew advisory agreements with the investment advisors that founded their funds, and the termination of an advisor by a board is exceedingly rare.<sup>54</sup> Once retained, an advisor provides the operational life-support system for its funds, providing them with substantially all of their business infrastructure and management.<sup>55</sup> Individual shareholders may invest in a mutual fund only after the advisor has completed this construction process and opened the fund to public investment.<sup>56</sup>

This particularly intimate and dependent bond between a fund and its advisor, combined with a concern for abuses inherent in such a relationship, prompted Congress first to enact the Investment Company Act of 1940 and then to revise that law three decades later with the Investment Company Amendments Act of 1970.<sup>57</sup> The Senate report accompanying the 1970 amendments included these observations:

Because of the unique structure of this industry the relationship between mutual funds and their investment adviser is not the same as that usually existing between buyers and sellers or in conventional

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50. See Alan R. Palmiter & Ahmed E. Taha, *Star Creation: The Incubation of Mutual Funds*, 62 VAND. L. REV. 1485, 1487–88, 1497–98 (2009).

51. More specifically, “[t]he composition of the board must, however, comport with certain federal requirements.” Brief of Amici Curiae Law Professors, *supra* note 10, at 3 n.5; see also Birdthistle, *Compensating Power*, *supra* note 22, at 1422.

52. See Investment Advisers Act of 1940 § 205(a)(1), 15 U.S.C. § 80b-5(a)(1) (2006). Rule 205-3 of the Adviser's Act, however, permits performance fees only if the investment advisor is entering into an agreement with a “qualified client.” 17 C.F.R. § 275.205-3(a) (2009). For an excellent discussion of the regulatory limits and policy limitations of compensation in mutual funds, see Mahoney, *supra* note 16, at 177–81.

53. This process is also referred to as the “15(c) process” (because of the relevant provision requiring annual approval) or the “Gartenberg process” (because of the leading federal case relating to this procedure). See Investment Company Act of 1940 § 15(c), 15 U.S.C. § 80a-15(c). For a discussion of proposals for heightened enforcement of the duties of mutual fund directors, see Donna M. Nagy, *Regulating the Mutual Fund Industry*, 1 BROOK. J. CORP. FIN. & COM. L. 11, 41–43 (2006).

54. See Birdthistle, *Compensating Power*, *supra* note 22, at 1424.

55. See *id.* at 1423–24.

56. See Palmiter & Taha, *supra* note 50, at 1488–89.

57. Investment Company Amendments Act of 1970, Pub. L. No. 91-547, 84 Stat. 1413 (codified as amended at 15 U.S.C. §§ 80a-1 to -64).

corporate relationships. Since a typical fund is organized by its investment adviser which provides it with almost all management services and because its shares are bought by investors who rely on that service, a mutual fund cannot, as a practical matter sever its relationship with the adviser. Therefore, the forces of arm's-length bargaining do not work in the mutual fund industry in the same manner as they do in other sectors of the American economy.<sup>58</sup>

Congress accordingly attempted to moderate the control that an advisor has over the contract renewal process and the setting of advisory fees.<sup>59</sup> Specifically, the 1970 addition of section 36(b) to the Investment Company Act was an effort to counterbalance the asymmetries of the advisor-fund relationship.<sup>60</sup> In section 36(b), Congress provided that "the investment adviser of a registered investment company [a mutual fund] shall be deemed to have a fiduciary duty with respect to the receipt of compensation for services."<sup>61</sup> To enforce this fiduciary duty, Congress provided fund shareholders with a private right of action for violations of the duty.<sup>62</sup>

Standard accounts of effective governance in operating corporations typically describe and laud the cooperative efforts of a panoply of mutually reinforcing mechanisms.<sup>63</sup> That is to say, the combined force of efficient capital markets, stock options, markets for corporate control, short selling, and influential institutional investors, inter alia, is thought to impose a healthy discipline on agency costs by policing the way managers operate corporations to maximize shareholder wealth.<sup>64</sup> But, importantly, the presence of such mechanisms, and therefore the applicability of such theory, is vastly diminished in the world of mutual funds.

As Donald Langevoort has pointed out, many of the most important of these devices simply do not exist or do not operate effectively within the unusual structure of mutual funds:

Because mutual funds are not traded in an organized market, arbitrage opportunities cannot work to keep prices in line with rational expectations. Mutual fund prices are simply the product of net asset value at the time of purchase or redemption. Insider compensation is largely based on assets as well, which creates the conflict rather than aligns insider-shareholder interests, and directors are typically paid all or mostly in cash. Institutional shareholder voice does not exist in the fund area, and there is no external market for

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

59. John C. Coates IV, *Reforming the Taxation and Regulation of Mutual Funds: A Comparative Legal and Economic Analysis* 31 (Dec. 30, 2008), *available at* <http://ssrn.com/abstract=1311945>.

60. *See id.* at 31–32.

61. 15 U.S.C. § 80a-35(b).

62. *See id.*

63. *See, e.g.*, JONATHAN R. MACEY, *CORPORATE GOVERNANCE: PROMISES KEPT, PROMISES BROKEN* 50 tbl.3.1 (2008).

64. *See id.*

corporate control at all because shareholders can only sell their shares back to the fund.<sup>65</sup>

Langevoort concludes by objecting to judicial attempts to import and then to graft general corporate governance theory onto mutual funds without understanding the distinctive nature of funds.<sup>66</sup> “Thinking about mutual funds by imagining them simply as a species of ‘corporations’ in a way that is directly informed by contemporary corporate law theory is completely misguided,” he argues.<sup>67</sup>

Given the absence of the traditional array of corporate constraints, the solitary remaining governance mechanism with meaningful applicability in the mutual fund context is shareholder exit.<sup>68</sup> Theory would suggest that investment advisors will be constrained from mismanaging mutual funds (by, for instance, charging excessive advisory fees) through the disciplining effect of existing investors selling their shares or potential shareholders declining to invest when the advisor governs poorly (by, for instance, charging excessive advisory fees). But shareholder exit is not only the sole meaningful governance mechanism in the mutual fund context, it is also distinctly fragile in that setting.<sup>69</sup>

With devices such as the market for corporate control, price arbitrage, and institutional shareholder voice, the prime movers are sophisticated investors, whose actions provide collateral benefits to unsophisticated investors. The device of shareholder exit, on the other hand, does not allow unsophisticated investors to benefit indirectly from the actions of sophisticated institutional players unless both sophisticated and unsophisticated investors inhabit the same market segment.<sup>70</sup> If they did invest in the same products, then the actions of sufficient numbers of sophisticated investors working with sufficient amounts of investment capital could protect the interests of less sophisticated investors. Advi-

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65. Langevoort, *supra* note 19, at 1031–32 (footnote omitted).

66. *Id.* at 1032.

67. *Id.*

68. The array of effective mechanisms that Jonathan Macey catalogs also includes initial public offerings (IPOs) as a governance measure. See MACEY, *supra* note 63, at 127–29. In the corporate context, IPOs may indeed involve “rigorous monitoring by a cadre of lawyers, investment bankers, and financial analysts, all of whom face reputational and legal risks for failure to do an adequate job of protecting investors.” *Id.* at 127. In mutual funds, however, the public offering process is very different, as it is overseen primarily by the advisor and its affiliated distributor and is not shepherded by investment banks. See Jennifer S. Taub, *Able but Not Willing: The Failure of Mutual Fund Advisors to Advocate for Shareholders’ Rights*, 34 J. CORP. L. 843, 844–51 (2009). Nor are the funds rated by financial analysts in the same manner as equity offerings. See, e.g., John C. Coates IV & R. Glenn Hubbard, *Competition in the Mutual Fund Industry: Evidence and Implications for Policy*, 33 J. CORP. L. 151, 183 (2007).

69. See *supra* note 68 and accompanying text.

70. See Birdthistle, *Compensating Power*, *supra* note 22, at 1446; Langevoort, *supra* note 19, at 1034 (positing a “suspicion that the market for mutual funds is indeed segmented into more and less sophisticated consumer groups, with funds (or even classes within the same fund) with different quality attributes appealing to different segments”).

sors would have to govern funds well lest they drive away an excessive amount of sophisticated investment.<sup>71</sup>

But empirical studies and, indeed, overt industry marketing and products demonstrate that investment advisors intentionally segregate institutional and individual investors into separate mutual fund products.<sup>72</sup> Investment advisors commonly offer different funds or different classes of shares, with far more advantageous pricing, to institutional and sophisticated shareholders.<sup>73</sup> Exit for less sophisticated investors in this context therefore requires action directly on the part of the individual shareholder,<sup>74</sup> who in turn must rely on disclosure regarding fees and performance by the investment advisor. Evidence, however, demonstrates that neither party in this duet is particularly adroit in playing its role.

### B. No Exit

With an appreciation for the unique structure of mutual funds and their *sui generis* governance dynamics, we can devote our attention to assessing the effectiveness of the central mutual fund governance mechanism—shareholder exit. Doing so, however, leads us towards the blurred line that separates paradigms of corporate governance and “product markets.”<sup>75</sup>

Categorizing mutual fund investors as shareholders imbues them with all the rights, privileges, and rich theory appertaining thereto. But when we observe that mutual fund shareholders are, in fact, protected almost solely by their ability to buy and sell mutual fund shares, they begin to take on the appearance of mere participants in the comparatively unprotected arena of product markets. As we shall see in *Jones v. Harris Associates L.P.*, this process of reverse bootstrapping very quickly strips away the bulk of legislative protections specifically enacted to protect mutual fund shareholders.<sup>76</sup> Given such a dynamic, courts might become preoccupied with asking why an investor should be treated differently from any other widget buyer, rather than asking why an investment advisor should be treated differently from any other corporate fiduciary. The immediate and critical answer is because Congress has determined that mutual fund investors belong in the shareholder category.<sup>77</sup> Until Con-

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71. See Birdthistle, *Compensating Power*, *supra* note 22, at 1446; Langevoort, *supra* note 19, at 1033.

72. See Langevoort, *supra* note 19, at 1034.

73. See Birdthistle, *Compensating Power*, *supra* note 22, at 1446.

74. For a discussion of the weaknesses of informational intermediaries and conflicts of brokers in the mutual fund context, see *id.* at 1459; see also Jill E. Fisch, *Fiduciary Duties and the Analyst Scandals*, 58 ALA. L. REV. 1083, 1097–98 (2007) (discussing the conflicts of interests and questionable independence of mutual fund analysts).

75. See Langevoort, *supra* note 19, at 1036–40.

76. See *infra* notes 225–34 and accompanying text.

77. For a discussion of corporate governance in the mutual fund context, see A. Joseph Warburton, *Should Mutual Funds Be Corporations? A Legal and Econometric Analysis*, 33 J. CORP. L. 745, 746–50 (2008).

gress decides otherwise, commentators and courts must operate within the corporate governance paradigm, no matter how impoverished the mutual fund version may be in comparison to that of typical corporations.

Indeed, the mutual fund model of governance is notably weaker than that of typical corporations not simply because its array of protections is far more limited, but also because the efficacy of its lone remaining protection, exit, is seriously handicapped by the demonstrated vulnerabilities of both participants in this particular investment dyad.

Investment advisors have spent much of the past five years recovering from regulatory investigations and private lawsuits into malfeasant practices in the operation of mutual funds, such as market timing and late trading, for which they have paid billions of dollars in fines, settlement fees, and restitution funds.<sup>78</sup> Individual investors, encumbered with ever greater responsibility for their own retirement savings as the popularity of 401(k) plans has eclipsed that of pension funds, have demonstrated little expertise nor the ability to invest prudently.<sup>79</sup> Indeed, many investors fail even to enroll<sup>80</sup> in retirement plans, while large numbers of those who do simply leave their contributions uninvested in a default cash or money market position.<sup>81</sup> Those investors who do consciously allocate their contributions either do so too rarely, too riskily, or too rapidly.<sup>82</sup> Such behavior occurs even where there are no penalties for immediate withdrawal and when doing so forfeits free matching funds from employers, but largely disappears when investors are invested by default. One cannot argue that such behavior is contemplated by the rational actor model without defining away almost the entire concept of irrationality.

### 1. *The Failings of Advisors*

For many years, certain observers considered the operation of mutual funds a model of good corporate governance.<sup>83</sup> Their relatively unblemished performance record was conspicuous in an era of corporate accounting fraud perpetrated by executives at Enron and WorldCom.<sup>84</sup> But in September 2003, then New York Attorney General Eliot Spitzer

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78. See *supra* note 23. See generally Birdthistle, *Compensating Power*, *supra* note 22, at 1451–64 (explaining the participants and mechanisms involved in the mutual fund investment irregularities).

79. See discussion *infra* Part I.B.2.c.

80. See THALER & SUNSTEIN, *supra* note 36, at 104; see also James J. Choi et al., *For Better or For Worse: Default Effects and 401(k) Savings Behavior*, in PERSPECTIVES ON THE ECONOMICS OF AGING 81 (David A. Wise ed., 2004).

81. This may also be due to reluctance resulting from recent economic downturn. See Gail Marksjarvis, *Many Investors Too Scared to Take Wing*, CHI. TRIB., Aug. 26, 2009, <http://www.chicagotribune.com/business/yourmoney/chi-tc-biz-investors-gail-0825-0aug26,0,7183761.column>.

82. See *infra* Part I.B.2.

83. See Richard M. Phillips, *Mutual Fund Independent Directors: A Model for Corporate America?*, PERSPECTIVE, Aug. 2003, at 1, 12, <http://www.ici.org/pdf/per09-04.pdf>.

84. See *id.* at 1–2.

announced allegations of wrongdoing in the comparatively staid sector of retirement savings.<sup>85</sup> Spitzer accused the advisors of specific mutual funds of colluding with hedge funds and other sophisticated institutional investors in a scheme to siphon profits out of mutual funds at the expense of individual, long-term investors in those funds.<sup>86</sup> Spitzer's charge of "market timing" sparked a long procession of regulatory investigations by federal and state agencies into the operations of mutual funds.<sup>87</sup> The plaintiffs' bar quickly followed with a salvo of class-action lawsuits against mutual fund advisors, and in the years since Spitzer's announcement, dozens of advisors have disgorged billions of dollars in fines, settlements, and funds created to remunerate long-term investors.<sup>88</sup>

a. Recent Advisor Malfeasance

The scope of the allegations against investment advisors is remarkable and impugns a broad array of the ways in which they operated mutual funds in recent years.<sup>89</sup> The past demidecade of public and private investigations unearthed a host of remarkable improprieties by investment advisors, the first and most prominent of which was a practice known as market timing.<sup>90</sup>

Market timing, per se, is neither illegal nor very unusual in the investment world. In fact, the principle—which simply involves investors purchasing and redeeming investments rapidly and forcefully upon the strength of temporal market developments<sup>91</sup>—is close to the core behavior of what one might expect of institutional and sophisticated investors. If news breaks regarding the discovery of a fresh petroleum reserve in the South China Sea, then rapid purchases of a mutual fund specializing in energy producers or Southeast Asian economies make perfect sense. Similarly, reports of an earthquake in Japan would naturally trigger prompt liquidations in a mutual fund holding concentrations of stocks listed on the Tokyo Stock Exchange. These practices are neither surprising nor illicit.<sup>92</sup>

The rapid acquisition and redemption of large blocks of shares in a mutual fund can, however, dilute the returns to long-term investors who hold their positions throughout such volatility, to the benefit of the market timers. Investment advisors to mutual funds have long been aware of

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85. See Press Release, Office of the N.Y. Att'y Gen. Eliot Spitzer, State Investigation Reveals Mutual Fund Fraud (Sept. 3, 2003), [http://www.oag.state.ny.us/media\\_center/2003/sep/sep03a\\_03.html](http://www.oag.state.ny.us/media_center/2003/sep/sep03a_03.html).

86. See *id.*

87. Birdthistle, *Compensating Power*, *supra* note 22, at 1403.

88. See *supra* note 23 and accompanying text.

89. See Mercer E. Bullard, *The Mutual Fund as a Firm: Frequent Trading, Fund Arbitrage and the SEC's Response to the Mutual Fund Scandal*, 42 HOUS. L. REV. 1271, 1272–73 (2006).

90. See Birdthistle, *Compensating Power*, *supra* note 22, at 1453–56; see also Mahoney, *supra* note 16, at 173–75.

91. Mahoney, *supra* note 16, at 173–74.

92. See *id.* at 174.

this wealth transfer, and to assuage long-term investors, many advisors voluntarily enacted policies that prohibit such trading activity in the funds they advise.<sup>93</sup>

What is illegal is for an advisor to publish a mutual fund prospectus that declares that a fund's policy is to disallow market timing and then to abet market timing.<sup>94</sup> Evidently, several investment advisors—in contravention of their statements expressly prohibiting market timing in their own prospectuses—countenanced such trading by institutional investors.<sup>95</sup> Why would they do such a thing? Because as a quid pro quo for market timing one mutual fund,<sup>96</sup> the institutional investors would typically park “sticky assets” in a related but separate mutual fund. In such an arrangement, the investment advisor—who is compensated by receiving a percentage of all assets under management—will receive concrete dollars from the sticky assets that more than compensate for any administrative or other qualms about the market timing. The long-term investors in the timed fund, however, are not similarly compensated.<sup>97</sup>

A separate practice, known as late trading, is per se illegal.<sup>98</sup> Because the determination of the value of a share in a mutual fund requires a complex calculation of the total value of the fund's portfolio (including large blocks of shares of possibly hundreds of separate issuers, plus cash, minus amounts owed to the fund's vendors, such as brokerage houses and law firms) and then the division of that figure by the total number of outstanding shares in the fund, mutual funds have historically waited until the close of business (and the resulting cessation of movement in the prices of portfolio securities) to compute the price per share.<sup>99</sup> Although these calculations can be computed instantaneously today, regulations still require the industry to use this method of “forward pricing” mutual fund shares once a day, after the close of business.<sup>100</sup> So when an investor places a buy order for a mutual fund, he or she must wait until after 4:00 p.m. eastern time for the trade to be executed and to learn the price of the share.<sup>101</sup> Similarly, upon redemption, sell orders must be placed before 4:00 p.m. in order to receive that day's price.<sup>102</sup>

Because mutual fund advisors need some time to administer buy and sell orders for trades after the close of business, this rather ungainly

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93. *See id.*

94. *See* Disclosure Regarding Market Timing and Selective Disclosure of Portfolio Holdings, 69 Fed. Reg. 22,300, 22,301–05 (Apr. 23, 2004) (to be codified at 17 C.F.R. pts. 239, 274).

95. *Id.* at 22,300.

96. Mahoney, *supra* note 16, at 175.

97. *See* Birdthistle, *Compensating Power*, *supra* note 22, at 1455.

98. *See* Amendments to Rules Governing Pricing of Mutual Fund Shares, 68 Fed. Reg. 70,388, 70,390–91 (proposed Dec. 17, 2003) (to be codified at 17 C.F.R. pt. 270); *see also* Birdthistle, *Compensating Power*, *supra* note 22, at 1458.

99. *See* Amendments to Rules Governing Pricing of Mutual Fund Shares, 68 Fed. Reg. at 70,388; Birdthistle, *Compensating Power*, *supra* note 22, at 1453.

100. *See* Amendments to Rules Governing Pricing of Mutual Fund Shares, 68 Fed. Reg. at 70,388.

101. *See id.* at 70,388–90.

102. *See id.*

pricing system can be gamed by anyone who learns of market-moving information shortly after the close of business. Consider, for instance, a situation in which the market closes at 4:00 p.m. The advisor computes the price of a fund's shares at 4:05 p.m., and a major corporate issuer whose stock is held by the mutual fund announces excellent financial news at 4:10 p.m. If one could slip a buy order into the trading system at 4:15 p.m. (well after the trading deadline) and still receive the day's now-stale price, one would guarantee a gain in the fund, which could be realized by selling shares the very next day. As an industry adage has it, the investor would in essence be betting on a race that has already been run. Various entities associated with the mutual fund industry—typically brokerage houses responsible for accumulating clients' buy and sell orders—have settled accusations of facilitating this late trading.<sup>103</sup>

A third charge involves a practice known as “fair valuation” and its unfair use.<sup>104</sup> Because the investment advisor to a mutual fund receives its compensation purely as a function of the fund's total assets under management, the advisor has a powerful incentive to increase the assets under management in every way possible. One way is to choose wise and prudent investments that increase in value, thereby expanding the holdings of every investor in the fund. Another, less challenging, method is simply to attract more new investors to the fund. And a third, even less taxing, approach is simply to overstate the true or “fair” value of the fund's assets.

Of course, an advisor may have a difficult time suggesting that the ten shares of Google that it owns are worth \$1000 when anyone with access to a newspaper can calculate that they are worth only \$750. What is easier to manipulate, however, is the accurate value of a mutual fund's investment that is not regularly or publicly priced. If a fund owns real estate or stock in a private corporation for whose shares there is no public market, for example, then a fund's advisor may more easily distort the fund's overall value and, accordingly, inflate the advisor's fee. In deceptions of this sort, what typically occurs is that the advisor purchases shares in a privately held corporation for the fund; then an event that deleteriously impacts the value of that company's shares takes place, such as crippling litigation or product failures. Any reasonable appraiser would note that the value of the fund's holding had dropped, even without the benefit of regular market prices. But, should an advisor wish unlawfully to take advantage of these stale prices, it could retain on its books the stock's value as the price it originally paid for the investment.<sup>105</sup>

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103. See, e.g., *In re Charles Schwab & Co.*, Exchange Act Release No. 50,360, Investment Company Act Release No. 26,595, 83 SEC Docket 2252 (Sept. 14, 2004) (setting forth SEC allegations of late trading).

104. See Birdthistle, *Compensating Power*, *supra* note 22, at 1456–58.

105. See *id.*

How could a conscientious advisor determine a price in the absence of a market transaction? Scrupulous trustees and investors require advisors to retain the services of independent, third-party appraisers who specialize in determining fair values for fund holdings for which there are no readily available market prices.<sup>106</sup> Advisors who choose not to value their funds' holdings fairly and regularly can easily extract excessive fees from the funds and their investors.<sup>107</sup>

Over the past five years, a horde of public regulators and private litigators has extracted billions of dollars in settlements and fees from advisors arising out of these and yet more<sup>108</sup> allegations of malfeasance. Among many, for example, Bank of America paid \$675 million in settlement fees; Bear Stearns paid \$250 million; Massachusetts Financial Services paid \$225 million; Janus Capital Group paid \$225 million; Alliance Capital Management paid \$600 million; and Pilgrim Baxter paid \$100 million.<sup>109</sup> Mutual fund advisors have compiled a recent track record that complicates assumptions that market forces alone produce results that benefit investors who entrust their savings to advisors.<sup>110</sup>

#### b. Ongoing Practices

Some observers of the mutual fund industry believe that additional troubling practices exist but have yet to attract public attention.<sup>111</sup> One such example involves the widespread use of so-called "12b-1 fees."<sup>112</sup> These fees—eponymously named for the securities regulation that permits their use<sup>113</sup>—are paid out of the assets of mutual funds (thereby decreasing the returns to existing investors in those funds) to advisors or their affiliates or counterparties for the purpose of marketing the fund to new potential investors. Customarily, one might expect the advisors, as direct beneficiaries of marketing efforts that increase the amount of assets under management, to bear such marketing expenses.

Why should mutual fund investors agree to spend money advertising their investments to the general public? Because, in theory, if a mutual fund grows increasingly popular, greater amounts of assets will flow into the fund from new investors. With greater assets under management, the investment advisor should be able to realize economies of scale

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106. *See id.*

107. *See id.*

108. Investment advisors have also settled allegations of other illicit practices, including selective disclosure, revenue sharing, and others. *See id.* at 1450–60.

109. *See, e.g.,* Farrell, *supra* note 23; Friedman, *supra* note 23; Lauricella, *supra* note 23.

110. *See, e.g.,* Edmund L. Andrews, *World Bankers Suggest Rebound May Have Begun*, N.Y. TIMES, Aug. 21, 2009, <http://nytimes.com/2009/08/22/business/economy/22fed.html>.

111. *See, e.g.,* Chuck Jaffe, *Fee Reform? Better Luck Next Year: SEC's Decision to Delay New Rules on 12b-1 Fees Hurts Investors*, MARKETWATCH, Apr. 12, 2009, <http://www.marketwatch.com/story/sec-fumbles-mutual-fund-fee>.

112. 17 C.F.R. § 270.12b-1 (2009); *see also* U.S. Sec. & Exch. Comm'n, *Mutual Fund Fees and Expenses*, <http://www.sec.gov/answers/mffees.htm> (last visited Dec. 1, 2009).

113. 17 C.F.R. § 270.12b-1.

in the management of the fund and then to pass those savings through to shareholders in the form of price breaks in the fund's advisory fee. Those price breaks should, in turn, redound to the benefit of each existing investor in the form of lower expense ratios. Observers are skeptical, however, that advisors who do charge 12b-1 fees and thereby successfully increase the size of their funds do in fact pass on a commensurate amount of fee discounts.<sup>114</sup> In such circumstances, some advisors have used existing investors' money to attract new investors who, in turn, pay more management fees to the advisor without any corresponding material benefit to investors.<sup>115</sup> Although the Securities and Exchange Commission (SEC) has intimated future action on this topic, the impact of these practices has yet to be reported widely by the investment media.<sup>116</sup>

## 2. *The Frailty of Investors*

The recent performance of certain investment advisors in the retirement savings field is accompanied by the less-intentional foibles of their clients. Not only does shareholder exit require vigilance by individual mutual fund investors, but increasing proportions of investment assets are flowing into individual investment accounts.<sup>117</sup> The pressure on individual investors to manage their savings wisely has dramatically increased in recent years as a greater percentage of personal savings has migrated from pension funds to defined contribution accounts.

Unfortunately, individual investors have not performed well under this new burden, demonstrating poor records at two critical stages of the investment process: first, at the moment of enrolling in retirement plans; and, second, when making investment decisions with their savings.<sup>118</sup>

### a. The Growth of Individual Investing

In recent decades, the mechanism by which American employees save for their retirement has undergone a somewhat bureaucratic but nevertheless profound alteration. Retirement savings have moved steadily from institutionally managed pension funds to individually directed retirement accounts.<sup>119</sup> The responsibility for the safe and effective stewardship of retirement savings has, accordingly, shifted increasingly from

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114. See, e.g., Jaffe, *supra* note 111.

115. See U.S. Sec. & Exch. Comm'n, *supra* note 112.

116. See *id.* (providing link to calculators for investors to determine total fees and sales charges).

117. See generally Inv. Co. Inst., *The U.S. Retirement Market, Third Quarter 2008*, 17 RESEARCH FUNDAMENTALS, Feb. 2009, [http://www.ici.org/pdf/retmrkt\\_update.pdf](http://www.ici.org/pdf/retmrkt_update.pdf).

118. See COLLEEN E. MEDILL, INTRODUCTION TO EMPLOYEE BENEFITS LAW: POLICY AND PRACTICE 21–23, 470–73 (2d ed. 2007).

119. See Inv. Co. Inst., *supra* note 117, at 11 fig.A-1 (reporting a steady decline over the past twenty years of assets held in pension funds and a concomitant rise in the assets held in private accounts).

employers to employees.<sup>120</sup> At the same time, the sophistication of the investment management of those monies has steadily declined, thus greatly intensifying the danger of ineffective conservation of personal finances for retirement.<sup>121</sup>

Although some prominent sectors of the American workforce, such as state and federal government<sup>122</sup> and the automobile industry,<sup>123</sup> still provide for the retirement of employees through the use of collective pension funds, the pension has grown increasingly less popular as a mechanism for saving in the United States.<sup>124</sup> In 2007, private pension funds held \$2.4 trillion, state and local government pension funds held \$3.2 trillion, and federal pension funds held \$1.7 trillion; although those figures are substantial, they constituted less than forty percent of the \$17.6 trillion in total U.S. retirement assets.<sup>125</sup> Just two decades ago, pensions comprised well more than fifty percent of those assets.<sup>126</sup>

So today, increasing numbers of individual employees, rather than the professional managers of pension plans of yore, bear the responsibility for determining how much money to set aside each month, to which financial institutions these contributions should be entrusted, and to which securities the savings should be allocated to provide for a future retirement.<sup>127</sup> As Sunstein and Thaler have observed,

The standard economic theory of saving for retirement is both elegant and simple. People are assumed to calculate how much they are going to earn over the rest of their lifetime, figure out how much they will need when they retire, and then save up just enough to enjoy a comfortable retirement without sacrificing too much while they are still working.

As a guideline for how to think sensibly about saving, this theory is excellent, but as an approach to how people actually behave, the theory runs into . . . serious problems.<sup>128</sup>

#### b. Failure to Enroll

Notwithstanding theoretical postulates to the contrary, empirical evidence suggests that, by and large, the average employee is not particularly adept at making long-range financial forecasts, immediate economic

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120. *See id.*

121. *See, e.g.,* Mary Williams Walsh, *Pensions: Big Holes in the Net*, N.Y. TIMES, Apr. 12, 2005, at G1 (discussing poor investment performance in private savings accounts and corresponding deficits in amounts needed for retirement security).

122. *See, e.g.,* Mary Williams Walsh, *Public Pension Plans Face Billions in Shortages*, N.Y. TIMES, Aug. 8, 2006, at A1 (reporting major deficits in state and local government pension plans).

123. *See* Micheline Maynard, *Saab in Bankruptcy Filing; G.M. Seeks More Aid*, N.Y. TIMES, Feb. 21, 2009, at B3 (discussing pension difficulties for U.S. automobile manufacturers).

124. *See* Inv. Co. Inst., *supra* note 117, at 1–2.

125. INV. CO. INST., *supra* note 13, at 86–87.

126. *See* Inv. Co. Inst., *supra* note 117, at 11.

127. *See id.*

128. THALER & SUNSTEIN, *supra* note 36, at 104.

sacrifices, or the type of ongoing investment decisions necessary to ensure a healthy corpus on which to retire decades hence.<sup>129</sup> Indeed, data reveal that substantial numbers of employees fail even to enroll in defined-contribution plans in which their employers promise to contribute substantial amounts or when there is no penalty for early or immediate withdrawal from such accounts.<sup>130</sup> In effect, these employees are discarding winning lottery tickets or “not bothering to cash [their] paycheck.”<sup>131</sup>

Each future retiree has two basic choices when deciding how to save for supernumeracy. Either one can simply invest whatever money is left unspent from one’s paychecks, or one can enroll in a savings plan that, with the forbearance of the federal taxing authorities, allows funds to be directed towards investment without first being subject to personal income taxation.<sup>132</sup> Obviously, the latter approach, which uses pre-tax dollars, is the vastly superior method. Indeed, the very reason Congress permits the use of tax-advantaged accounts—such as Individual Retirement Accounts (IRAs), 401(k) and 403(b) plans, and so forth—is to encourage personal saving.<sup>133</sup> Many private employers further enhance the attractiveness of such tax-advantaged accounts by voluntarily agreeing to contribute certain sums into each employee’s defined-contribution account.<sup>134</sup> All that the employee needs to do to enjoy these substantial financial benefits is enroll. And yet many nevertheless fall at this first molehill.<sup>135</sup>

Certainly, there may be rational reasons for choosing not to participate in a tax-advantaged savings scheme. If, for instance, one desperately needs every penny one earns to meet current financial burdens, the project of saving for the future—in any format—is simply an unaffordable luxury. But many who fail to enroll in these accounts do not do so for this kind of reason. Approximately thirty percent of all U.S. employees who are eligible to participate in a 401(k) plan do not enroll.<sup>136</sup> Studies conducted in other countries where there are no penalties for withdrawing sums from these accounts before retirement reveal that as many as *half* of all employees entitled to receive matching sums from

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129. See *id.* at 103–07; Shlomo Benartzi & Richard H. Thaler, *Naive Diversification Strategies in Defined Contribution Savings Plans*, 91 AM. ECON. REV. 79, 79–80 (2001).

130. See INV. CO. INST., *supra* note 13, at 86.

131. See THALER & SUNSTEIN, *supra* note 36, at 108; see also Daniel Gross, *The Empty 401(k): If White House Press Secretary Tony Snow Won’t Save for Retirement, Why Should You?*, SLATE, Sept. 4, 2007, <http://www.slate.com/id/217288>.

132. See THALER & SUNSTEIN, *supra* note 36, at 107.

133. See Pension Protection Act of 2006, Pub. L. No. 109-280, 120 Stat. 780 (“An Act to provide economic security for all Americans . . .”).

134. See James J. Choi et al., *\$100 Bills on the Sidewalk: Suboptimal Investment in 401(k) Plans 3* (Yale Int’l Ctr. Fin., Working Paper No. 08-05, 2007), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1084442](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1084442).

135. *Id.*

136. See THALER & SUNSTEIN, *supra* note 36, at 107–10 (citing 2006 Investment Company Institute statistics); Choi et al., *supra* note 134, at 4.

employers still do not enroll.<sup>137</sup> In systems with no penalty for early withdrawal, there is no rational justification for failing to enroll, as one can simply withdraw the funds right away to pay for any current needs.<sup>138</sup> Any effective governance of this field must therefore accept that investors frequently behave in ways that are not rational and must take their actual behavior into account.

### c. Investment Indiscipline

For those employees who do successfully enroll in their defined-contribution plan, abjure the instant gratification of some portion of their present salary, and allocate their savings into a specific investment option, one selection above all others dominates their choice. As we have seen, the primary vehicle through which U.S. citizens invest their savings is the mutual fund: forty-four percent of all U.S. households now own these funds.<sup>139</sup> The decisive majority of U.S. savings—over ten trillion dollars of the total seventeen trillion dollars—eventually make their way, either directly or indirectly, into mutual funds.<sup>140</sup> In the five years from 2003 through 2007, U.S. households demonstrated their investing preference by selling almost three trillion dollars of directly held stock while investing over two trillion dollars in mutual funds.<sup>141</sup>

But even once investors successfully make it across the threshold and into tax-advantaged savings accounts, opportunities for making poor investment decisions in mutual funds abound. Many investors contribute too little to their plans over time, while others attempt to time market movements and trade too rapidly, which erodes principal through buying high and selling low and through transaction fees.<sup>142</sup> But the most critical investment errors can be divided into two broad categories: poor asset allocations and poor fund selections.

In recent months, news reports have recounted stories of investors who, just a few years or months away from retirement, have seen large chunks of their nest eggs evaporate in the market collapse.<sup>143</sup> While these accounts are distressing, they reveal a common investing mistake: the misallocation of portfolio assets. Modern portfolio theory suggests that, as investors approach retirement, the composition of their retirement

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137. See Sheena Sethi-Iyengar et al., *How Much Choice Is Too Much? Contributions to 401(k) Retirement Plans*, in PENSION DESIGN AND STRUCTURE: NEW LESSONS FROM BEHAVIORAL FINANCE 83, 83–95 (Olivia S. Mitchell & Stephen P. Utkus eds., 2004).

138. See Brigitte C. Madrian & Dennis F. Shea, *The Power of Suggestion: Inertia in 401(k) Participation and Savings Behavior*, 116 Q. J. ECON. 1149, 1176–79 (2001).

139. See INV. CO. INST., *supra* note 13, at 19–20.

140. See *id.* at 86, 99.

141. *Id.* at 10 fig.1.3.

142. See DAVID F. SWENSEN, UNCONVENTIONAL SUCCESS: A FUNDAMENTAL APPROACH TO PERSONAL INVESTMENT 151–52 (2005).

143. See, e.g., Tara Siegel Bernard, *Target-Date Funds: Seven Questions to Ask Before Jumping In*, N.Y. TIMES, June 28, 2009, <http://nytimes.com/2009/06/29/your-money/mutual-funds-and-etfs/29target.html>.

portfolios should grow ever more conservative.<sup>144</sup> In practice, this dictate would mean that the percentage of retirement assets allocated to stocks, which are comparatively risk-laden investments, should diminish relative to the percentage of assets allocated to cash, treasury bills, or other comparatively risk-free investments.<sup>145</sup> Any investors on the eve of retirement who lose fifty percent of their retirement portfolios in a stock market crash appear to have grossly misallocated their investments.

Even assuming that some investors may have prudently allocated their assets to create an age-appropriate blend of different classes of risk, they must still choose how to effectuate those allocations. That is, if an investor determines that the optimal allocation of her assets should be fifty percent in stocks and fifty percent in bonds, how should she then go about actually investing her money in stocks and bonds? A prudent investment approach would counsel in favor of a broad diversification within each asset class, which would suggest that our investor should purchase a mutual fund, an exchange-traded fund, or another diversified vehicle to hold the assets allocated to securities.<sup>146</sup> But the choice of a particular fund, and whether it is actively or passively managed, can make a critical difference.

Passively managed funds typically attempt to track a particular index, such as the Standard & Poor's 500 or the Dow Jones Industrial Average, and the task requires no imagination or judgment—the fund simply mimics the index.<sup>147</sup> Actively managed funds, on the other hand, attempt to beat the market through the use of formulae or strategies devised and deployed by human portfolio managers. Time and time again, studies demonstrate that passive funds consistently outperform active funds in the long run.<sup>148</sup>

Notwithstanding these robust findings, many investors nevertheless choose to invest in actively managed funds because of the renown of particular portfolio managers who have won outsized returns in recent years. Not only do managers eventually prove themselves to be very human, but actively managed funds carry much higher fees on average than passively managed funds.<sup>149</sup>

As Donald Langevoort and Paul Mahoney have shown, we now have “enough data on mutual fund investor behavior to gain some useful

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144. See generally Harry Markowitz, *Portfolio Selection*, 7 J. FIN. 77 (1952). Given increasing life expectancies and longer retirements, investors might want to maintain a degree of risk in their portfolios, even upon retirement, but not to the extent reported in these stories.

145. See *id.*

146. See SWENSEN, *supra* note 142, at 83–84.

147. See Birdthistle, *Fortunes and Foibles*, *supra* note 22, at 81.

148. See, e.g., Mark Hulbert, *The Index Funds Win Again*, N.Y. TIMES, Feb. 22, 2009, at BU5 (citing the recent study by Mark Kritzman of M.I.T.'s Sloan School of Management which found “that, after fees and taxes, it is the extremely rare actively managed fund or hedge fund that does better than a simple index fund”).

149. See *id.*

insight”;<sup>150</sup> unhappily, the insight those data reveal consists largely of “discomfiting results.”<sup>151</sup> An extensive catalog of studies examining the behavior of mutual fund investors reveals, for instance, that there is “a negative relationship between returns and both fees and trading expenses,” that “market-beating strategies are hard to find or sustain,” and that “those who pay for above-average performance are likely to be disappointed should they ever come to understand their results.”<sup>152</sup>

Whether an investor is particularly lethargic or vigorous, both extremes hold dangers for retirement accounts that are uninvested or over-invested. Thus, saving for retirement effectively requires a discipline and vigor beyond the behavioral capacity of many investors.

### 3. *The Weakness of Shareholder Exit*

Even assuming an ideal investment market in which advisors reliably disclosed all material information and investors were capable of acting rationally upon that information, the effectiveness of exit is still constrained by two external factors that are widespread across the mutual fund industry: taxes and market timing rules.<sup>153</sup>

Investors whose mutual fund holdings would be subject to particularly harsh tax consequences upon sale might reasonably choose not to exit a fund whose advisor has raised fees beyond an otherwise acceptable level.<sup>154</sup> Similarly, investors may be discouraged from selling by the cost of levies that many fund complexes impose to discourage market timing by investors who trade in and out of any given fund within a short period of time.<sup>155</sup> In both circumstances, an investor who is dissatisfied with an advisory fee may nevertheless decline to exit.

Finally but critically, consider the particularly acute impact of advisory fees upon investors who are constrained from freely exiting a mutual fund. Advisory fees are, in many ways, a species of executive compensation paid to external management,<sup>156</sup> but the mutual fund context is distinctive in that increases in advisory fees have a larger relative impact

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150. Langevoort, *supra* note 19, at 1033.

151. Mahoney, *supra* note 16, at 169.

152. Langevoort, *supra* note 19, at 1033 & nn.102 & 103 (citing an extensive array of financial studies demonstrating poor behavioral decisions by mutual fund investors) (emphasis omitted).

153. See, e.g., Tamar Frankel, *Advisory Fees—Who Decides How Much Is Too Much?*, BOARDIQ, Apr. 28, 2009, [http://www.boardiq.com/articles/20090428/opinion\\_advisory\\_fees\\_decides\\_much\\_much](http://www.boardiq.com/articles/20090428/opinion_advisory_fees_decides_much_much) (“Dissatisfied small investors may indeed sell their fund shares to express their dissatisfaction, but such sales are often constrained by adverse tax consequences and other problems.”). Of course, taxes would not be an issue for funds in tax-advantaged savings accounts.

154. For a discussion of the tax regime governing mutual fund investments generally, see Coates, *supra* note 59.

155. For a discussion of the rules governing market timing in mutual funds, see generally Mutual Fund Redemption Fees, 71 Fed. Reg. 11,351 (proposed Mar. 7, 2006) (to be codified at 17 C.F.R. pt. 270).

156. See Birdthistle, *Compensating Power*, *supra* note 22, at 1429–31; see also Randall S. Thomas & Kenneth J. Martin, *Litigating Challenges to Executive Pay: An Exercise in Futility?*, 79 WASH. U. L.Q. 569, 602 n.117 (2001).

upon investment performance. Whereas executive compensation typically has an indirect and relatively minor effect, if any, upon the price of a corporation's stock, the impact of advisory fees on a mutual fund investor's return is direct and immediate.<sup>157</sup> Imagine, for example, that the senior executive officer of Disney negotiates an enormous compensation package.<sup>158</sup> Even an admittedly vast sum is still almost sure to be insignificant in comparison to the overall revenues of the corporation and thus to the growth or income associated with the company's stock.<sup>159</sup> In contrast, every additional percentage point that an investment advisor charges for its services comes directly out of the returns of investors. Over time, the compounded effect of even minutely larger fees can gravely diminish an investor's net returns in mutual funds.<sup>160</sup>

These mundane yet plentiful illustrations demonstrate the perils of relying solely on a single governance measure to produce effective governance in mutual funds. At the same time that the efficacy of exit as an effective market force is dampened in several ways, the impact of comparatively small increases on advisory fees has a profoundly detrimental impact upon the returns of shareholders in mutual funds.

Most importantly, empirical studies demonstrate the very real limitations that these constraints impose upon the actual competitiveness of mutual funds: the industry features remarkably high price dispersion—as great as 300 percent in one large sector—and “thus does not appear to conform to the ‘law of one price’”<sup>161</sup> while at the same time, “expense ratios, portfolio turnover, and load fees are significantly and negatively related to performance.”<sup>162</sup> These studies, in effect, conclude that however promising shareholder exit may be in theory, in practice it does not function effectively—when a market abounds with funds that perform worse and yet charge more, that market is neither competitive nor healthy.

## II. JUDICIAL PRECEDENT & THE SECTION 36(B) FIDUCIARY DUTY

Against this background of theoretical and empirical limits on independent behavior by investment advisors and shareholders in the governance of mutual funds, *Jones v. Harris Associates L.P.* presents the consequent issue of whether the two types of parties nevertheless function effectively when working together.<sup>163</sup>

The single most important nexus of the relationship between an investor and an investment advisor is the price that the investor pays for

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157. See Birdthistle, *Compensating Power*, *supra* note 22, at 1424.

158. See *Brehm v. Eisner*, 746 A.2d 244, 250 (Del. 2000).

159. *Cf., e.g., id.* at 259–60.

160. See Hulbert, *supra* note 148 (“Fees and taxes can have a huge impact on funds’ net returns.”).

161. WALLISON & LITAN, *supra* note 17, at 8.

162. Carhart, *supra* note 18, at 80; *see also* Gil-Bazo & Ruiz-Verdú, *supra* note 18, at 2178.

163. 527 F.3d 627, 629–31 (7th Cir. 2008).

the advisor's services. In *Jones*, the Supreme Court must decide whether the judiciary may, or indeed must, defer to market forces when determining whether that price is consistent with the advisor's fiduciary duty set forth in section 36(b) of the Investment Company Act.<sup>164</sup> To reach that question, the Court must first ascertain the doctrinal role of market forces in this body of jurisprudence and then evaluate their efficacy in governing mutual funds.

What makes this case of greater consequence than simply a clarification of the fiduciary duty of an investment advisor is the contributions of Easterbrook and Posner, two of the country's foremost jurists and economic intellectuals.<sup>165</sup> Their sharp disagreement as to the nature of the market for investment advisory services encapsulates a timely and vital debate on the state of the two leading modes of the economic analysis of law: neoclassical law and economics versus behavioral law and economics.<sup>166</sup>

When considering the judicial resolution of these issues, a cynical observer might attempt to predict the case's outcome using crude heuristics such as whether one of those lower court positions is more "conservative" or less "judicially activist" and therefore more appealing to the majority of current Supreme Court Justices. Without endorsing or debating the definition of those terms this litigation nevertheless resists simplistic categorization because of the ideological and political similarities of the two dueling appellate jurists. One would be hard pressed to substantiate a meaningful difference between their judicial philosophies, either politically or economically.<sup>167</sup> And although Posner's dissent is clearly more favorable to the plaintiffs,<sup>168</sup> Easterbrook's opinion rests upon a notable lack of deference towards congressional decisionmaking.<sup>169</sup> To complicate the wagering further, the Supreme Court in its most recent Term twice sided with plaintiffs against corporate defendants, in *Wyeth v. Levine*<sup>170</sup> and *Altria Group, Inc. v. Good*,<sup>171</sup> despite warnings of increased litigation and arguments that congressional intent pointed in the opposite direction.<sup>172</sup> The relevant congressional action in *Jones v. Harris Associates L.P.*, meanwhile, supports the plaintiffs.<sup>173</sup> With these superficialities acknowledged and handicapped, we must now parse the actual statutory and judicial complexities of this dispute.

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164. *See id.*, cert. granted, 129 S. Ct. 1579 (2009).

165. *See supra* notes 4–5 and accompanying text.

166. *See supra* note 13 and accompanying text.

167. Choi & Gulati, *supra* note 5, at 44–50.

168. *Jones v. Harris Assocs. L.P.*, 537 F.3d 728, 732–33 (7th Cir. 2008) (Posner, J., dissenting from denial of rehearing en banc).

169. *Jones v. Harris Assocs. L.P.*, 527 F.3d 627, 633–34 (7th Cir. 2008).

170. 129 S. Ct. 1187, 1204 (2009).

171. 129 S. Ct. 538, 551 (2008).

172. *Wyeth*, 129 S. Ct. at 1199–1200; *Altria Group*, 129 S. Ct. at 561 (Thomas, J., dissenting).

173. Investment Company Act § 36(b), 15 U.S.C. § 80a-35(b) (2006).

### A. *The Background of Excessive Fees Litigation*

Previously, we noted the language and legislative history of the section 36(b) fiduciary duty, which Congress enacted in the Investment Company Amendments Act of 1970.<sup>174</sup> Congress has never provided a definition of that duty, instead appearing content to abdicate the development of the scope and effect of the duty to the judiciary, and the federal courts have since attempted to fill that void.<sup>175</sup>

A dozen years after the passage of section 36(b), the Second Circuit handed down a seminal, albeit imprecise, elucidation of the fiduciary duty in *Gartenberg v. Merrill Lynch Asset Management, Inc.*<sup>176</sup> Notwithstanding a certain degree of opaque reasoning set forth in *Gartenberg*, this case held almost universal sway over the industry's conception of the duty for more than a quarter century, until last year's Seventh Circuit ruling in *Jones*.<sup>177</sup>

Even though the SEC and the mutual fund industry have fully encoded and incorporated the guidance of *Gartenberg* into their contract renewal regulations and associated operations,<sup>178</sup> the case itself fails to explicate the fiduciary duty clearly. As Lyman Johnson points out, the ruling contains “two quite different” phrasings of the test that appear contradictory and confused.<sup>179</sup> In one, the court “adopt[ed] a two-prong approach,”<sup>180</sup> holding that to violate the section 36(b) duty, an investment advisor “must charge a fee that is so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been the product of arm's-length bargaining.”<sup>181</sup> In the other, the court stated that “the test is essentially whether the fee schedule represents a charge within the range of what would have been negotiated at arm's-length in the light of all the surrounding circumstances.”<sup>182</sup> As Johnson notes, the first test appears to be substantive, while the second is more procedural (though reliant on an arm's-length process that the Second

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174. See *supra* text accompanying notes 58–62.

175. See 15 U.S.C. § 80a-35(b) (providing a private right of action for violation of the fiduciary duty).

176. 694 F.2d 923 (2d Cir. 1982).

177. See, e.g., *Krantz v. Prudential Invs. Fund Mgmt. LLC*, 305 F.3d 140, 143 (3d Cir. 2002); *Green v. Fund Asset Mgmt., L.P.*, 286 F.3d 682, 685–86 (3d Cir. 2002); *Migdal v. Rowe Price-Fleming Int'l, Inc.*, 248 F.3d 321, 326 (4th Cir. 2001); *Krinsk v. Fund Asset Mgmt., Inc.*, 875 F.2d 404, 409 (2d Cir. 1989).

178. See, e.g., 17 C.F.R. §§ 239.15A, 274.11A (2009); Disclosure Regarding Approval of Investment Advisory Contracts by Directors of Investment Companies, 69 Fed. Reg. 7852, 7854 (proposed Feb. 19, 2004) (to be codified at 17 C.F.R. pts. 239, 240, 270) (noting, with approval, the *Gartenberg* approach in contract renewal); Form N1-A, Item 22, <http://www.sec.gov/about/forms/formn-1a.pdf> (requiring boards of trustees of mutual funds to disclose whether they discussed *Gartenberg* factors in renewing investment advisory contracts).

179. Lyman Johnson, *A Fresh Look at Director “Independence”: Mutual Fund Fee Litigation and Gartenberg at Twenty-Five*, 61 VAND. L. REV. 497, 516 (2008).

180. *Id.*

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

182. *Id.*

Circuit and the legislative history acknowledge is almost never present in the mutual fund industry).<sup>183</sup> The effect of these formulations is to obfuscate whether the appropriate standard equates to corporate law's established touchstones of waste, reasonableness, or fairness.

To complicate the *Gartenberg* ruling further, the Second Circuit then identified a set of several elements that it deemed "important" in the determination of whether an advisor has violated its fiduciary duty. These *Gartenberg* factors include (1) "rates charged by other adviser-managers to other similar funds," (2) "the adviser-manager's cost in providing the service," (3) "the nature and quality of the service," (4) "the extent to which the adviser-manager realizes economies of scale as the fund grows larger," and (5) "the volume of orders which must be processed by the manager."<sup>184</sup> Boards of trustees and courts have subsequently cataloged these factors in their deliberations, without precisely clarifying their relative weight, their interaction with one another, or exactly how an investment advisor might run afoul of them.<sup>185</sup> At the same time, boards and courts have practically ignored potentially the most probative factor, mentioned in footnote three of *Gartenberg*: the comparison of different rates charged to institutional and individual clients.<sup>186</sup>

In fact, from the time of the enactment of section 36(b) in 1970 until the grant of certiorari in *Jones* in 2009, no mutual fund shareholder ever managed to convince a court that an investment advisor had breached its fiduciary duty.<sup>187</sup> As Johnson has observed, this record means either that the investment advisory business is a model of perfection or that "something is amiss under section 36(b)."<sup>188</sup> From the foregoing analysis of the governance of the investment advisory business, evidence suggests that perfection is the unlikelier of these two alternatives.<sup>189</sup>

### B. *Easterbrook and Neoclassical Law and Economics*

After this four-decade succession of unbroken judicial victories by investment advisors, the remarkable decision by Easterbrook arrived in *Jones v. Harris Associates L.P.*<sup>190</sup> Easterbrook openly and enthusiastically broke with the *Gartenberg* precedent, not to reverse the ill fortunes of plaintiff shareholders but to compound them. In his Seventh Circuit panel opinion, Easterbrook offered an alternative formulation of the section 36(b) standard that effectively removes the fiduciary duty from the

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183. See Johnson, *supra* note 179, at 516.

184. *Gartenberg*, 694 F.2d at 929–30.

185. See, e.g., cases cited *infra* note 197.

186. *Gartenberg*, 694 F.2d at 930 n.3.

187. See JAMES D. COX ET AL., SECURITIES REGULATION: CASES AND MATERIALS 1211–14 (3d ed. 2001).

188. Johnson, *supra* note 179, at 519.

189. See *supra* text accompanying notes 43–74.

190. 527 F.3d 627 (7th Cir. 2008), *cert. granted*, 129 S. Ct. 1579 (2009).

regulatory edifice.<sup>191</sup> His new ruling thus replaced a *Gartenberg* doctrinal regime that was theoretically, if not practically, open to shareholders with one that is far more hostile, reducing success under section 36(b) to a virtual impossibility.<sup>192</sup>

In an opinion with a more legislative than judicial tenor, Easterbrook took notice of the state of competition in the industry and then interpreted the statute anew through the lens of neoclassical law and economics. He presumed a well-functioning market for investment advice, discounted possibly irrational investor behavior, and concluded with a call for greater deregulation of the industry. “[W]e are skeptical about *Gartenberg* because it relies too little on markets,” he announced.<sup>193</sup>

First, Easterbrook confronted the statute’s textual imposition of a fiduciary duty but found and applied a minimalist interpretation of that legal concept that is difficult to distinguish from the existing background regime of securities regulations.<sup>194</sup> Second, he updated and overruled congressional findings that the market for mutual funds was dysfunctional by substituting his own judicial observation of the market’s ostensible health today.<sup>195</sup>

But Easterbrook’s evaluation of the mutual fund market—upon which rests his entire argument—confuses concepts of governance and product markets. Critically, his approach fails to appreciate that the structure of mutual funds is materially distinct from that of ordinary corporations and that the behavior of mutual fund shareholders falls far short of the theoretical ideals of rationality.<sup>196</sup>

The facts of *Jones* are similar to those of most lawsuits in which an investor alleges that an investment advisor has charged excessive fees for the advisor’s services.<sup>197</sup> Put succinctly, three investors—Jerry Jones, Mary Jones, and Arline Winerman—who held shares in mutual funds managed by the investment advisor, Harris Associates L.P., filed suit against the advisor alleging a breach of the advisor’s fiduciary duty imposed by section 36(b) because of the advisor’s inordinately high fees.<sup>198</sup>

In constructing his economic reinterpretation of section 36(b), Easterbrook first faced the challenge posed by the fiduciary duty. Without more, the term “fiduciary duty” could describe a broad range of obligations, from the most minimal requirements of a bailee to the far more

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191. *Id.* at 632.

192. *See id.*

193. *Id.*

194. *See id.* at 632–33.

195. *See id.* at 633–35.

196. *See supra* notes 26, 46 and accompanying text.

197. *See, e.g.,* *Gallus v. Ameriprise Fin., Inc.*, 561 F.3d 816, 818 (8th Cir. 2009); *Green v. Fund Asset Mgmt. L.P.*, 286 F.3d 682, 683 (3d Cir. 2002); *Migdal v. Rowe Price-Fleming Int’l, Inc.*, 248 F.3d 321, 325 (4th Cir. 2001).

198. *See Jones v. Harris Assocs. L.P.*, No. 04-C-8305, 2007 WL 627640, at \*1–2 (N.D. Ill. Feb. 27, 2007).

onerous responsibilities of an executor.<sup>199</sup> Justice Frankfurter succinctly captured the concept's indeterminacy:

But to say that a man is a fiduciary only begins analysis; it gives direction to further inquiry. To whom is he a fiduciary? What obligations does he owe as a fiduciary? In what respect has he failed to discharge these obligations? And what are the consequences of his deviation from duty?<sup>200</sup>

A creative jurist unconstrained by precedent can, therefore, select any point along this spectrum to reach a preferred outcome. In this case, Easterbrook looked neither to mutual fund precedent nor to Delaware corporate law for guidance, but instead to the law of trusts.<sup>201</sup> There he found guidance for his new statement of the section 36(b) duty: "A fiduciary must make full disclosure and play no tricks but is not subject to a cap on compensation."<sup>202</sup>

If Easterbrook's interpretation of the duty is correct, then section 36(b) adds nothing to the background array of antifraud provisions that have long existed in this regulatory regime. Investment advisors were already obligated to "make full disclosure and play no tricks" by section 34(b) of the Investment Company Act of 1940 (proscribing untrue statements of material fact in a registration statement or other documents),<sup>203</sup> section 206 of the Investment Advisors Act of 1940 (proscribing any fraud upon clients or prospective clients);<sup>204</sup> sections 11, 12, and 17 of the Securities Act of 1933 (providing civil liability for false registration statements and for noncompliant prospectuses and proscribing fraudulent interstate transactions);<sup>205</sup> and section 10(b) of the Exchange Act<sup>206</sup> and Exchange Act Rule 10b-5<sup>207</sup> (proscribing the use of any manipulative or deceptive devices). Easterbrook would appear to be arguing that section 36(b) is pure surplusage to these existing proscriptions and that the duty's language "with respect to the receipt of compensation for services" is an otiose appendage with no relevant meaning.<sup>208</sup>

In that same sentence in which he reworked the *Gartenberg* duty, Easterbrook also eliminated *Gartenberg*'s substantive cap on compensation.<sup>209</sup> Later he temporized by acknowledging that a fee twenty-five times above the next highest might suggest deceit or negligence:

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199. See Lyman P.Q. Johnson & David Millon, *Recalling Why Corporate Officers Are Fiduciaries*, 46 WM. & MARY L. REV. 1597, 1601 (2005).

200. SEC v. Chenery Corp., 318 U.S. 80, 85–86 (1943).

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

202. *Id.*

203. 15 U.S.C. § 80a-33(b) (2006).

204. *Id.* § 80b-6.

205. *Id.* §§ 77k, 77l, 77q.

206. *Id.* § 78j(b).

207. 17 C.F.R. § 240.10b-5 (2009).

208. See Jones v. Harris Assocs. L.P., 527 F.3d 627, 630, 632 (7th Cir. 2008); see also 15 U.S.C. § 80a-35(b).

209. Jones, 527 F.3d at 632.

It is possible to imagine compensation so unusual that a court will infer that deceit must have occurred, or that the persons responsible for decision have abdicated—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 . . . .<sup>210</sup>

Applied to mutual funds, this standard would mean that investment advisors could charge a fee greater than fifty percent of assets without triggering judicial suspicion. Although this scenario may be “possible to imagine,”<sup>211</sup> it is not a serious substantive limit of any kind.

Easterbrook was unimpressed with arguments that relied on the motivations of Congress in enacting Section 36(b). Although legislative history, such as the Senate report accompanying the passage of the 1970 amendments to the 1940 Act, takes extensive note of the weaknesses of the structure and practice of the mutual fund industry in producing effective competition, Easterbrook dismissed such arguments because “Congress did not enact its members’ *beliefs*; it enacted a text.”<sup>212</sup> Besides, he added, “[a] lot has happened in the last 38 years”<sup>213</sup> and positions cannot be taken today merely on the strength of “suppositions about the market conditions of 1970.”<sup>214</sup>

If no meaningful fiduciary duty or substantive cap exist and congressional intent is irrelevant, what then will prevent advisors from overcharging shareholders? Competition, answered Easterbrook.<sup>215</sup> Other courts, commentators, and even Congress may have “expressed some skepticism of competition’s power to constrain investment advisers’ fees,”<sup>216</sup> but all of them are wrong.

The issue of market competition in mutual funds was not raised before the trial court or briefed by any party.<sup>217</sup> Easterbrook provided a defense of the market with his own assessment. “Today,” he noted, “thousands of mutual funds compete. The pages of the *Wall Street Journal* teem with listings.”<sup>218</sup> (Surely the number of advisors would be the more relevant datum.) Easterbrook proceeds by arguing that “[h]olding costs down is vital in competition,” and “[a]n adviser can’t make money from its captive fund if high fees drive investors away.”<sup>219</sup> This argument assumes that high fees do, in fact, drive investors away, a claim contra-

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210. *Id.*

211. *Id.*

212. *Id.* at 633.

213. *Id.*

214. *Id.*

215. *See id.* at 631–32.

216. *Id.* at 631.

217. *See Jones v. Harris Assocs. L.P.*, No. 04-C-8305, 2007 WL 627640 (N.D. Ill. Feb. 27, 2007).

218. *Jones*, 527 F.3d at 633 (emphasis omitted).

219. *Id.* at 631–32.

dicted by multiple studies.<sup>220</sup> Further, Easterbrook attempted to preempt a counterargument that most investors in mutual funds are simple innocents: “It won’t do to reply that most investors are unsophisticated and don’t compare prices. The sophisticated investors who do shop create a competitive pressure that protects the rest.”<sup>221</sup> This argument assumes that sophisticated and unsophisticated investors are, in fact, shopping within the same pool, which is not the case with mutual funds.

Within this set of arguments, Easterbrook committed two particularly large errors that negatively reinforced each other. First, he failed to take account of the substantial idiosyncrasies in the structure and governance of mutual funds, insisting instead that “[t]hings work the same way for business corporations.”<sup>222</sup> Second, he confused a governance system affecting shareholders with a products market involving buyers by, for instance, demanding to know why judges who “would not dream of regulating the price of automobiles,”<sup>223</sup> should wish to do so for mutual funds.

In this somewhat “living Constitution”<sup>224</sup> approach to interpreting the market, Easterbrook insisted that the market today is far different and more competitive than it was thirty-eight years ago, which is why we may disregard such an outdated congressional view.<sup>225</sup> Certainly his claims with respect to the numbers of funds, advisors, and dollars may be true, but congressional objections to the state of this market centered not on those numbers but on the *structure* of the industry.<sup>226</sup> As we have already seen, the broad spectrum of sentinels protecting corporations from poor governance are, in the context of mutual funds, dramatically reduced to the solitary and, in this context, enfeebled exit option.<sup>227</sup> Rather than shoring up this vulnerability, Easterbrook exploited it by engaging in reverse bootstrapping that erroneously treated investors as buyers, thereby overriding their congressionally imposed protections. If judges do not dream of regulating the price of automobiles it is because the buyers of automobiles, unlike the shareholders of mutual funds, are neither shareholders nor beneficiaries of a fiduciary duty. Congress has chosen to create such a distinction fully aware of its implications—it has considered and rejected the alternative approach of categorizing mutual fund investments as mere products.<sup>228</sup> Where investors entrust their as-

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220. See, e.g., Gil-Bazo & Ruiz-Verdú, *supra* note 18, at 2178–79; Langevoort, *supra* note 19, at 1033 & nn.102 & 103; Mahoney, *supra* note 16, at 176.

221. *Jones*, 527 F.3d at 634 (citing Alan Schwartz & Louis L. Wilde, *Imperfect Information in Markets for Contract Term: The Examples of Warranties and Security Interests*, 69 VA. L. REV. 1387 (1983)).

222. *Id.* at 632.

223. *Id.* at 634.

224. William H. Rehnquist, *The Notion of a Living Constitution*, 54 TEX. L. REV. 693, 694–96 (1976).

225. *Jones*, 527 F.3d at 633.

226. See Mahoney, *supra* note 16, at 162.

227. See *supra* Part I.

228. Langevoort, *supra* note 19, at 1019, 1039.

sets for retirement is, after all, ultimately of far greater import and risk than the purchase of a car or any other widget. Of course, the ultimate irony in any celebration of today's mutual fund market over its predecessors is that it requires one to ignore the very recent and large scale failures of advisors and investors in this market.<sup>229</sup>

In sum, Easterbrook's opinion is a tour-de-force of orthodox law and economics. He spends little time considering either the intent or content of Congress's enactment of the fiduciary duty in dispute, which was imposed upon investment advisors expressly "with respect to the receipt of compensation for services."<sup>230</sup> He concludes that the duty requires nothing more than that advisors refrain from defrauding their investors, notwithstanding that such prohibition was already imposed by the existing securities regulations. He justifies the diminution of this legislative protection—in contravention of the *Gartenberg* line of precedent—by pointing instead to the salutary and inoculating powers of market competition.<sup>231</sup> Without examining the unique structure of mutual funds, he concludes that such competition does exist in this industry because there are a profusion of investment products available and because one academic study—by John Coates and Glenn Hubbard<sup>232</sup>—reached the same conclusion. He does not discuss multiple academic studies that demonstrate the troubling breadth of price dispersion amongst mutual fund fees or that show a highly problematic negative relationship between fund fees and performance.<sup>233</sup> He disregards the suggestion that investors may behave irrationally by investing in funds with high fees or by failing to shop for low fees by invoking the standard economic point that sophisticated investors can act as sentinels for unsophisticated investors in the same pool.<sup>234</sup> Finally, he concludes that a less regulated model of this industry is the better approach.<sup>235</sup> Much of this opinion could be drawn from the early law-and-economic texts of a few decades ago.<sup>236</sup>

### C. *Posner and Behavioral Law and Economics*

In dissenting from the Seventh Circuit's decision to deny rehearing en banc, Posner vigorously rebutted Easterbrook's arguments, not by rejecting economic analysis, but by calling for a more nuanced, subtle, and

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229. See *supra* Part I.

230. 15 U.S.C. § 80a-35(b) (2006).

231. *Jones v. Harris Assocs. L.P.*, 527 F.3d 627, 632 (7th Cir. 2008).

232. Coates & Hubbard, *supra* note 68, at 180.

233. See, e.g., Gil-Bazo & Ruiz-Verdú, *supra* note 18, at 2179; see also WALLISON & LITAN, *supra* note 17, at 8–11; Carhart, *supra* note 18, at 80.

234. *Jones*, 527 F.3d at 634.

235. *Id.* at 634–35.

236. See EASTERBROOK & FISCHER, *supra* note 6.

sophisticated version of such an analysis.<sup>237</sup> Posner's dissent incorporates a more behavioralist approach that displays vigilance for market failures, calls attention to recurring and predictable distortions of the incentives of market participants, and countenances a role for regulatory or private interventions in poorly functioning economic systems.<sup>238</sup> And, for Posner, the investment industry is such a disordered market.<sup>239</sup>

Posner began his dissent by declaring that the panel's economic analysis "is ripe for reexamination on the basis of growing indications that executive compensation in large publicly traded firms often is excessive because of the feeble incentives of boards of directors to police compensation."<sup>240</sup> Easterbrook's faith in the disciplining effect of multiple markets is misplaced, he argues, because "[c]ompetition in product and capital markets can't be counted on to solve the problem because the same structure of incentives operates on all large corporations and similar entities, including mutual funds."<sup>241</sup> Posner is unwilling to give these entities the benefit of the assumption of a well-functioning market because "[m]utual funds are a component of the financial services industry, where abuses have been rampant, as is more evident now than it was when Coates and Hubbard wrote their article."<sup>242</sup>

Indeed, he cited a contrary academic study in which the researcher found

evidence that connections among agents in [the mutual fund industry] foster favoritism, to the detriment of investors. Fund directors and advisory firms that manage the funds hire each other preferentially based on past interactions. When directors and the management are more connected, advisors capture more rents and are monitored by the board less intensely.<sup>243</sup>

He also invoked a study by the SEC's Office of Economic Analysis, which similarly reached a conclusion opposite to that of the Coates-Hubbard paper.<sup>244</sup>

A judge who relies on a solitary source might be suspected of cherry-picking evidence, particularly in a field such as this, which features

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237. See *Jones v. Harris Assocs. L.P.*, 537 F.3d 728, 732–33 (7th Cir. 2008) (Posner, J., dissenting from denial of rehearing en banc).

238. See generally Jolls & Sunstein, *supra* note 31; Kahan & Braman, *supra* note 31.

239. See *Jones*, 537 F.3d at 730.

240. *Id.* at 730.

241. *Id.*

242. *Id.*

243. *Id.* at 730–31 (quoting Camelia M. Kuhnen, *Social Networks, Corporate Governance and Contracting in Mutual Fund Industry*, available at <http://ssrn.com/abstract=849705>) (alteration in original) (internal quotation marks omitted). For Kuhnen's published piece, see Camelia M. Kuhnen, *Business Networks, Corporate Governance, and Contracting in the Mutual Fund Industry*, 64 J. FIN. 2185 (2009).

244. See *Jones*, 537 F.3d at 731 (citing Memorandum from Chester Spatt, Chief Economist, Office of Econ. Analysis, on Literature Review on Independent Mutual Fund Chairs and Directors to Investment Company File s7-03-04 (Dec. 29, 2006), <http://www.sec.gov/rules/proposed/s70304/oeamemo122906-litreview.pdf>).

such a wealth of contradictory findings by legal and financial experts,<sup>245</sup> including a Nobel laureate.<sup>246</sup> The Coates-Hubbard paper is notable because its conclusion that the industry is competitive contradicts a great number of other studies of this subject.<sup>247</sup> Easterbrook ignored directly contradictory findings of numerous other academics and regulators.<sup>248</sup> On the strength of a shallow review of the relevant literature and a non-existent record on this issue, Easterbrook leapt to confirm an inclination that this market operated efficiently.

For Posner, as for the plaintiffs, the most troubling indicium of a lack of competitiveness in the industry generally, and in this case specifically, is the wide pricing disparity between the fees that advisors charge to retail investors in their mutual funds and the fees they charge to unaffiliated institutional investors.<sup>249</sup> And Posner was particularly distressed by Easterbrook's failure to consider this discrepancy seriously.<sup>250</sup> The panel's opinion focused primarily on comparing the fees that one advisor charges its funds to the fees charged by other, similarly situated advisors to their own funds. But, as Posner points out, such a comparison is valuable only if one has reason to believe that the market is competitive.<sup>251</sup> If that market is not competitive, then the fact that many advisors are charging similar fees may prove nothing more than the fact that investors in all the funds are being overcharged: "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."<sup>252</sup>

Posner concluded his opinion with a remarkable summation of dissatisfaction with the panel's decision: "[T]he creation of a circuit split, the importance of the issue to the mutual fund industry, and the one-sided character of the panel's analysis warrant our hearing the case en banc."<sup>253</sup>

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245. See, e.g., Gil-Bazo & Ruiz-Verdú, *supra* note 18; see also WALLISON & LITAN, *supra* note 17, at 8–11; Carhart, *supra* note 18, at 80; Malkiel, *supra* note 18.

246. See *infra* note 314 and accompanying text.

247. Cf., e.g., U.S. SEC. & EXCH. COMM'N, PUBLIC POLICY IMPLICATIONS OF INVESTMENT COMPANY GROWTH, H.R. REP. NO. 89-2337 (1966), available at <http://sechistorical.org/museum/papers/1960/>; WHARTON SCH. OF FIN. & COMMERCE, A STUDY OF MUTUAL FUNDS, H.R. REP. NO. 87-2274 (1962), available at <http://sechistorical.org/museum/papers/1960/>; U.S. GEN. ACCOUNTING OFFICE, MUTUAL FUND FEES: ADDITIONAL DISCLOSURE COULD ENCOURAGE PRICE COMPETITION 56 (2000); John P. Freeman, Stewart L. Brown & Steve Pomerantz, *Mutual Fund Advisory Fees: New Evidence and a Fair Fiduciary Duty Test*, 61 OKLA. L. REV. 83, 106–22 (2008) (critiquing the Coates-Hubbard study).

248. See, e.g., U.S. SEC. & EXCH. COMM'N, PUBLIC POLICY IMPLICATIONS OF INVESTMENT COMPANY GROWTH, H.R. REP. NO. 89-2337 (1966), available at <http://sechistorical.org/museum/papers/1960/>; WHARTON SCH. OF FIN. & COMMERCE, A STUDY OF MUTUAL FUNDS, H.R. REP. NO. 87-2274 (1962), available at <http://sechistorical.org/museum/papers/1960/>; U.S. GEN. ACCOUNTING OFFICE, *supra* note 247, at 56; John P. Freeman & Stewart L. Brown, *Mutual Fund Advisory Fees: The Cost of Conflicts of Interest*, 26 J. CORP. L. 609 (2001).

249. *Jones*, 537 F.3d at 731.

250. *Id.*

251. *Id.* at 732.

252. *Id.*

253. *Id.* at 732–33.

Because Posner knew at the time he wrote those words that such a rehearing was not going to happen for a lack of votes, one may reasonably suppose that he was directing his petition to a higher authority.

Posner's approach thus acknowledges the unique structure of mutual funds and attempts to appreciate why mutual fund shareholders are unlike product buyers. Indeed, his focus on the evidence of a problem in competition—the pricing disparity between institutional and retail investors—suggests a willingness to reject Easterbrook's approach even on its own terms that assume shareholders are little more than buyers.

#### D. *Gallus v. Ameriprise Financial, Inc.*

A few months after Posner's dissent and after the Supreme Court granted certiorari in *Jones v. Harris Associates L.P.*, the Eighth Circuit handed down a remarkable opinion that opened an entirely new line of precedent in section 36(b) litigation. In *Gallus v. Ameriprise Financial, Inc.*,<sup>254</sup> the Eighth Circuit expressly disagreed with Easterbrook's reasoning, endorsed Posner's argument, and provided one template for the Supreme Court's ultimate resolution of *Jones*. In *Gallus*, a case with facts substantially similar to those in *Jones*, the Eighth Circuit could easily have stayed its decision pending the Supreme Court's decision in *Jones*—instead, the appeals court concluded that its opinion was important and ought to be heard in this debate.<sup>255</sup> By handing down the first-ever decision in favor of a plaintiff in an excessive fees case,<sup>256</sup> the *Gallus* court demonstrates that the judiciary has begun to balance unbounded deregulatory measures by adopting academic theories that call into doubt certain assumptions about the rationality of investors.

The Eighth Circuit focused on the discrepancy noted by the plaintiffs in *Gallus* and Posner in *Jones* between the rates advisors charge institutional investors and the rates they charge ordinary investors.<sup>257</sup> An important footnote in the *Gartenberg* decision suggested that such a comparison is permissible when possible, but advisors have long objected to any comparisons on the grounds that the investments are not readily comparable or that any variances are justified by the greater costs associated with advising retail investors.<sup>258</sup> The court in *Gallus* overrode these objections by pointing out that the retail and institutional funds here “had identical investment objectives and very similar stock holdings”<sup>259</sup> and that the advisor admitted in an internal e-mail that it possessed no good justification for the difference: “we should have a reply,” wrote an Ameriprise employee, “though it may or may not be convinc-

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254. 561 F.3d 816 (8th Cir. 2009).

255. *Id.* at 822–23.

256. See Mamudi, *supra* note 34.

257. *Gallus*, 561 F.3d at 816–20.

258. *Gartenberg v. Merrill Lynch Asset Mgmt. Inc.*, 694 F.2d 923, 930 n.3 (2d Cir. 1982).

259. *Gallus*, 561 F.3d at 819.

ing.”<sup>260</sup> Although Ameriprise ultimately produced a reply in the form of a report, the court questioned its “veracity and completeness.”<sup>261</sup>

The investment advisor’s remaining defense, presumably adopted as a variant of the argument set forth by Easterbrook and soon to be reviewed by the Supreme Court, was “that an adviser cannot be liable for a breach of fiduciary duty as long as its fees are roughly in line with industry norms.”<sup>262</sup> The Eighth Circuit quickly dismissed that contention, noting that “[t]o apply *Gartenberg* in this fashion across the entire mutual fund market would be to eviscerate § 36(b).”<sup>263</sup>

In a compact but pointed opinion, the Eighth Circuit has left *Gartenberg* largely undisturbed simply by expanding upon the single new factor identified by Posner (and minimized to a footnote in *Gartenberg*): whether the advisor can justify any discrepancies that exist between similarly situated institutional and retail funds.<sup>264</sup> Such a simple addition has shed dramatic new light onto this long-observed field even though *Gartenberg* itself has always contemplated such comparisons.

### III. A NEW JUDICIAL APPROACH

In its present posture, the litigation regarding excessive fees presents an excellent opportunity both for regulators to consider appropriate new guidance for retirement investments and, more immediately, for the Supreme Court to resolve a dispute upon which turns the health of the nation’s investment industry.<sup>265</sup> The linchpin of the arguments by Easterbrook, Posner, and the Eighth Circuit—and thus the key to the resolution of these cases—is the question whether the mutual fund industry is indeed reasonably competitive. In 1970, Congress concluded that it was structurally deficient, but in *Jones*, Easterbrook insisted that times have changed.<sup>266</sup> With a more nuanced appreciation for the structure of the investment industry and the behavior of mutual fund shareholders, however, Posner’s dissent—which the *Gallus* court followed—offers the more illuminating guidance. Easterbrook may have had the misfortune to publish his opinion immediately before a historic market collapse, but the Supreme Court now has the opportunity to incorporate the lessons of the recent market difficulties to deploy a behavioral approach to understanding the market dynamics of mutual funds.

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260. *Id.*

261. *Id.*

262. *Id.* at 820.

263. *Id.* at 823.

264. *See id.* at 818–23.

265. *See Jones v. Harris Assocs. L.P.*, 527 F.3d 627 (7th Cir. 2008), *cert. granted*, 129 S. Ct. 1579 (2009).

266. *Id.* at 633.

Any thorough treatment of this doctrine must first address the congressionally imposed fiduciary duty of section 36(b) and then assess the role and the effectiveness of market forces in supporting that duty.

A. *A Fiduciary Duty with Force*

Any argument that market forces are and ought to be the only restraints on the fees that investment advisors charge fund shareholders—and that courts are ill-suited to this task<sup>267</sup>—must first acknowledge that Congress has already decided otherwise in its enactment of section 36(b).<sup>268</sup> In his opinion, Easterbrook attempted to minimize this duty, first by defining it down to a nullity and second by arguing that its meaning must travel in concert with current understandings of the market.<sup>269</sup> The former approach involved the judicial elision of an inconvenient obstacle; the latter is the retroactive substitution of a judge's intent for what Congress desired.<sup>270</sup> But if the duty is going to be read out of the statute in either manner, then it must be Congress who makes such a determination, preferably after seriously considering rigorous empirical and theoretical studies on both sides of the debate.<sup>271</sup>

In the meantime, however, it seems clear that the force of section 36(b)—which expressly applies “to the receipt of compensation for services”<sup>272</sup>—deprives courts of the authority to disregard a congressionally enacted system of shareholder protections. But even if the Supreme Court were to agree with Easterbrook and therefore minimize the current relevance of section 36(b), a candid assessment of the retirement savings industry will nevertheless compel much more profound skepticism of the presence and benefit of market forces.

In the line of precedent that Easterbrook disapproved, other courts of appeals have closely examined the legislative history behind Congress's decision to create section 36(b).<sup>273</sup> The Seventh Circuit, however, eschewed legislative history in favor of a solely textualist interpretation, albeit one in which Easterbrook disregarded an essential portion of the statute.<sup>274</sup>

In two previous examinations of the Investment Company Act, the Supreme Court has recognized the legislative reasoning animating the

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267. See, e.g., Paredes, *supra* note 38.

268. 15 U.S.C. § 80a-35(b) (2006).

269. See *supra* Part II.B.

270. For a criticism of Easterbrook's opinion as an unwarranted act of judicial “sunsetting,” see Emily D. Johnson, Note, *The Fiduciary Duty in Mutual Fund Excessive Fee Cases: Ripe for Reexamination*, 59 DUKE L.J. 145, 149, 167–68 (2009).

271. See Brief of Amici Curiae Law Professors, *supra* note 10, at 13.

272. 15 U.S.C. § 80a-35(b).

273. See cases cited *supra* note 177.

274. See *Jones v. Harris Assocs. L.P.*, 527 F.3d 627, 632–35 (7th Cir. 2008).

passage of section 36(b).<sup>275</sup> Setting aside the debate over whether legislative history is appropriate in statutory interpretation, the aims of a statute can at times be self-evident. The existence of the statute—such as section 36(b)—can, on its own, reveal the legislator’s desire to correct a problem.<sup>276</sup>

The specificity of the phrase “with respect to the receipt of compensation for services” strongly suggests that section 36(b) created a new kind of fiduciary duty beyond the simple avoidance of defrauding an investor, as Easterbrook suggested.<sup>277</sup> Indeed, in his opinion, he offered no explanation of what work this phrase might be doing in the statute. To reach the conclusion that Easterbrook did, that this provision means simply that “[a] fiduciary must make full disclosure and play no tricks,”<sup>278</sup> one must in essence eliminate all substance from the fiduciary duty.

Certainly, as Justice Frankfurter has noted, the phrase “fiduciary duty” is a broad one capable of many different interpretations.<sup>279</sup> But the presence of any duty whatsoever in section 36(b), imposed atop the preexisting regulatory scheme, suggests that this duty must be distinct and possess some, even if only modest, weight in cabining the advisory fees that investment fiduciaries may charge their investors.

#### B. *A More Rigorous Economic Analysis*

Even if one were to put aside the question of statutory interpretation, the most important issue in Easterbrook’s opinion is his interpretation of the competitive state of the mutual fund market. But the cursory economic analysis that he advances is distressingly simplistic and, as Posner observed, “one-sided.”<sup>280</sup>

As a procedural matter, appellate courts are not in the business of finding facts that exist outside of the record, so much of Easterbrook’s project of taking judicial notice of the state of the mutual fund market is superficial and unsubstantiated. Indeed, his opinion is an illustration of why such fact-finding is discouraged at the appellate level without a trial court record. Easterbrook simply does not sift the evidence. Instead, he cites a single academic study—by Coates and Hubbard—and from it deduces the remainder of his findings.<sup>281</sup>

In light of the complex idiosyncrasies of mutual funds, a court should be particularly cautious when evaluating this industry in the absence of a rigorous and balanced empirical data. Several warning signs

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275. See *Daily Income Fund, Inc. v. Fox*, 464 U.S. 523, 536 (1984); *Burks v. Lasker*, 441 U.S. 471, 480–82 (1979).

276. See Brief of Amici Curiae Law Professors, *supra* note 10, at 13.

277. *Jones*, 527 F.3d at 630; see also 15 U.S.C. § 80a-35(b).

278. *Jones*, 527 F.3d at 632.

279. *SEC v. Chenery Corp.*, 318 U.S. 80, 85–86 (1943).

280. *Jones v. Harris Assocs. L.P.*, 537 F.3d 728, 733 (7th Cir. 2008).

281. See *Jones*, 527 F.3d at 634.

should have given Easterbrook pause: the infamous regulatory investigations and massive settlements relating to market timing and late trading;<sup>282</sup> the burgeoning literature raising doubts about the optimality of executive compensation;<sup>283</sup> and the ongoing and dramatic collapse of other segments of the nation's financial industry where, as Posner observed, "abuses have been rampant."<sup>284</sup>

A central challenge to the Coates-Hubbard study and, indeed, all claims of competitiveness in this industry is the presence of widespread price dispersion. Wallison and Litan point out that different advisors charge widely disparate prices for similar services, across the breadth of actively managed funds and even across funds with identical investment strategies such as S&P 500 index funds.<sup>285</sup> These findings challenge the economic law of one price: "that is, the prices of the collective investment services that mutual funds provide are not converging toward a common level, although convergence would be expected in a competitive market."<sup>286</sup> Although a certain amount of dispersion is not necessarily inconsistent with competition, the numbers in the mutual fund industry are remarkable, inasmuch as prices for shares in 811 actively managed equity funds "range from approximately 60 basis points to 170 basis points, or a difference in cost of almost 300 percent."<sup>287</sup> Coates and Hubbard hypothesize that these differences in price may be attributable to investors receiving something more when they pay more (such as membership in fund families with other, lower-priced funds that bring down the investors' overall expenses)—but they do not offer any evidence of this phenomenon. Supporting evidence would need to explain the many billions of dollars invested in those higher-priced funds and demonstrate the highly improbable claim that those investors do not invest in funds from multiple different advisors.

Robert Litan, Joseph Mason, and Ian Ayres point out that price dispersion is not the only problem with the Coates-Hubbard study: numerous studies demonstrate that fees are "correlated with negative mutual fund performance."<sup>288</sup> And even in studies suggesting that certain superstar advisors may produce "superior performance at a few standout funds," the authors of those studies nevertheless "acknowledge that, for the vast majority of funds, fees are not set in accordance with performance."<sup>289</sup> Indeed, just weeks before the Supreme Court oral argument

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282. See, e.g., Birdthistle, *Compensating Power*, *supra* note 22, at 1405–07.

283. See, e.g., LUCIAN BEBCHUK & JESSE FRIED, *PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION* ix (2004).

284. *Jones*, 537 F.3d at 730.

285. See WALLISON & LITAN, *supra* note 17, at 8–11.

286. *Id.* at 8.

287. *Id.* at 9.

288. Brief of Robert Litan, Joseph Mason, and Ian Ayres as Amici Curiae Supporting Petitioners, at 17, *Jones v. Harris Associates L.P.*, 527 F.3d 627 (7th Cir. 2008), *cert. granted*, 129 S. Ct. 1579 (2009) (No. 08-586).

289. *Id.* at 18.

in *Jones*, Javier Gil-Bazo and Pablo Ruiz-Verdú published a powerful study in the *Journal of Finance* demonstrating, once again, that performance and price in mutual funds are inversely related—that is, as performance increases, fund fees decrease, and as fees climb, performance drops.<sup>290</sup> This finding, repeated many times over the past several decades, is profoundly incompatible with a competitive marketplace.

Beyond his citation of Coates and Hubbard, Easterbrook offers ostensibly soothing data regarding the number of advisors, funds, and investments, but a closer analysis is necessary to adjudicate its healthy operation. Even in such a marketplace, competitive forces may not function effectively. Contrary to Easterbrook's assumption that "high fees drive investors away,"<sup>291</sup> significant numbers of investors are not driven away. As it happens, "many investors are not arriving to the agora unfettered."<sup>292</sup> Their freedom to enter or to exit a particular fund is constrained subjectively by their inadequacies as investors and objectively by the limited array of choices available in many tax-advantaged accounts.<sup>293</sup> Again, contrary to Easterbrook's assertion, it will do to contend that many of these investors are unsophisticated and incapable of making informed decisions about how to invest their savings.<sup>294</sup> Many of the aforementioned studies show that the investment field is varied and uneven, with some funds competing on price vigorously while others operate largely without contest.<sup>295</sup>

Easterbrook claimed that such unsophisticated investors as these will have their interests protected by sophisticated investors "who do shop" and thereby "create a competitive pressure that protects the rest."<sup>296</sup> This claim is true only if first, the number and assets of such sophisticated investors are sufficient to influence the advisors, and second, the sophisticated and unsophisticated investors operate within the same market space. Easterbrook offers no support that the number and clout of the sophisticated investors is material. And evidence directly contradicts the assumption that the two species of investors are similarly situated.<sup>297</sup>

In fact, the largest and most sophisticated investors in mutual funds do not actually hold the same securities as retail investors and they do

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290. Gil-Bazo & Ruiz-Verdú, *supra* note 18, at 2178–79.

291. *Jones*, 527 F.3d at 632.

292. Birdthistle, *Compensating Power*, *supra* note 22, at 1442.

293. See *supra* Part I.B. Note, though, that certain retirement accounts provide investors with access to more than a narrow menu of choices, while plans that are not employer-sponsored (such as IRAs) also have greater numbers of investment options.

294. See Birdthistle, *Compensating Power*, *supra* note 22, at 1415–16.

295. See Cox & Payne, *supra* note 22, at 923 (explaining why, under current practices, investors cannot be expected to make rational choices among funds in the fashion described by the Seventh Circuit). See generally Langevoort, *supra* note 19; Mahoney, *supra* note 16.

296. *Jones*, 527 F.3d at 634.

297. See, e.g., Langevoort, *supra* note 19, at 1034; Mahoney, *supra* note 16, at 179–80; see also, e.g., DREYFUS EQUITY INCOME FUND, PROSPECTUS (Oct. 1, 2009), [http://www.dreyfus.com/compliance/pdf/prs/6144\\_prs.pdf](http://www.dreyfus.com/compliance/pdf/prs/6144_prs.pdf).

not pay the same fees.<sup>298</sup> These institutions receive specially created accounts or institutional shares, or Class I shares, that differ materially from the Class A, B, and C shares that average investors typically purchase.<sup>299</sup> Although institutional investors may be investing in separate accounts that are precise clones of the funds of average shareholders, they receive preferential and lower fees.<sup>300</sup>

When sophisticated investors do pay advisory fees that are higher, they do not do so for the kinds of investments that average investors can access; instead, they pay such fees for private equity or hedge funds with radically different risk profiles. While Easterbrook chose to compare unsophisticated and sophisticated investors when the fees were similar but the investment risks very different (by pointing out that institutions pay higher fees to invest in hedge funds than retail investors pay to invest in mutual funds), he refused to compare the two types of investors when the investment risks were identical but the fees very different (such as when institutional investors receive a deep discount over average shareholders when they are all investing in the very same mutual fund).<sup>301</sup> This contradiction hints at one solution that the Supreme Court could use to resolve *Jones v. Harris Associates L.P.*, and that might in turn help to mend the broader operation of the retirement savings market.

### C. *The Comparison of Retail and Institutional Fees*

In his dissent, Posner illuminated the proper path for the Supreme Court to take to produce an immediately beneficial effect on the savings industry. Artificial doctrinal limitations (based largely upon misreadings of *Gartenberg* that ignore its third footnote) prevent plaintiffs from pointing out that institutional investors pay far lower fees than ordinary investors for the same funds and therefore may permit, in Posner's words, the entire industry of "mutual fund advisers to charge exorbitant fees."<sup>302</sup> The Court should therefore allow and indeed encourage such comparisons.

Investment advisors are quick to point out that there may be very good reasons why an advisor charges a large institution lower rates to invest its money, such as economies of scale, lower administrative costs, and similar wholesale savings.<sup>303</sup> Boards and courts should require advisors to come forward with such evidence to justify broad discrepancies in the two sets of fees. Because that information is almost entirely within

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298. See, e.g., DREYFUS EQUITY INCOME FUND, *supra* note 297, at 11–15.

299. See, e.g., *id.*

300. See, e.g., *id.*

301. See Brief of Amici Curiae Law Professors, *supra* note 10, at 19.

302. *Jones v. Harris Assocs. L.P.*, 537 F.3d 728, 732 (7th Cir. 2008) (Posner J., dissenting from denial of rehearing en banc).

303. See generally David A. Latzko, *Economics of Scale in Mutual Fund Administration*, 22 J. FIN. RES. 331 (1999).

the control of advisors, they should carry the familiar common law burden of demonstrating that their financial treatment of their fiduciaries is equitable. Indeed, a rigorous regime of disclosing such data would allow investors, trustees, and courts to evaluate the quality and persuasiveness of such information. But if such disclosure proves unconvincing, then there may indeed be such a thing as an excessive fee capable of redress by litigation pursuant to section 36(b). To be sure, one wonders whether any or all of the *Gartenberg* factors provide as much probative weight as this single piece of information. Requiring this information would both improve the efficacy of exit as a governance mechanism for mutual fund shareholders and simultaneously enhance transparency for buyers of mutual fund investments in a product market. With this simple doctrinal extension, mutual fund jurisprudence could thus invigorate both of its competing theoretical paradigms.

The Supreme Court might also clarify the single point of agreement between Easterbrook and Posner in this matter, with respect to the observation that “[t]he Oakmark funds have grown more than the norm for comparable pools, which implies that Harris Associates has delivered value for money.”<sup>304</sup> Posner, implicitly agreeing with Easterbrook, conceded that this fact may mean that “[t]he *outcome* of this case may be correct.”<sup>305</sup> But such a conclusion is warranted only if the growth of a fund necessarily implies the high performance of an advisor. In fact, the advisors’ trade group notes that only forty percent of funds’ growth is accountable to performance.<sup>306</sup> The majority of remaining growth is due instead to sales—that is, new investors joining the fund. Harris Associates might be a poor portfolio manager but a wonderful marketer, which would generate significant fund growth but very little investment value.<sup>307</sup>

In this case, the Supreme Court has an outstanding opportunity to endorse the more nuanced and sophisticated economic approach of Posner, which takes far greater account of the behavioral biases and distortions of investors. And, at the same time, the Court can make great inroads at providing a far more rigorous analysis of an industry sorely in need of greater judicial and regulatory understanding.<sup>308</sup>

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304. *Jones v. Harris Assocs. L.P.*, 527 F.3d 627, 631 (7th Cir. 2008).

305. *Jones*, 537 F.3d at 732.

306. *INV. CO. INST.*, *supra* note 13, at 8.

307. See TAMAR FRANKEL & ANN TAYLOR SCHWING, *THE REGULATION OF MONEY MANAGERS: MUTUAL FUNDS AND ADVISERS* § 12.03[c] (2d ed. 2001 & Supp. 2009).

308. Of course, these issues raise the question whether the SEC might be best situated to bring lawsuits, inasmuch as the mutual funds with the most suspicious fees may be unattractive to the plaintiffs’ bar.

*D. Practical Implications of a New Judicial Standard*

The range of likely doctrinal outcomes in *Jones v. Harris Associates L.P.* is relatively narrow. The Supreme Court might adopt the Easterbrook position at one extreme or simply reaffirm *Gartenberg*, though the practical effect of both approaches would simply be to perpetuate several more decades of plaintiff futility. In effect, the Court would be endorsing an elaborate but toothless fiduciary analysis that has no independent force for checking advisors but that does impose compliance costs on shareholders. At the other end of the narrow spectrum, the Court could establish a new standard focused upon the comparison of institutional and retail fees, either standing alone or as an additional factor to the existing *Gartenberg* litany. The likely effect of such a “comparative” or “*Gartenberg-plus*” approach would be to discipline fees using a realistic judicial threat without undue costs.

If investment advisors knew that they would be legally responsible for justifying discrepancies in the fees they charge institutions and individuals for the same services, they would confront a few options. First, they could narrow the fee discrepancy, either by charging institutions more or charging individuals less. Raising the prices on sophisticated and influential clients is clearly the more challenging of those two options, so lowering retail rates is more likely if there is any room to do so.

Second, if there is no cushion in those retail rates, then advisors could alternatively publish the data that justify the additional costs they incur to service retail accounts. Again, this process would provide greater transparency and information to the market, without requiring new SEC regulations.

Third, advisors might cease to provide services to both institutional and retail clients or attempt a formalistic separation of its services into distinct legal advisors. Such a dramatic withdrawal is unlikely in such a highly profitable industry; moreover, securities regulations have long dealt with indirect attempts to avoid jurisdiction.<sup>309</sup>

Before one assumes that a new standard would automatically open the floodgates of litigation or lead to a slew of plaintiff victories,<sup>310</sup> one must consider how section 36(b) litigation is conducted today. To prove their compliance with the existing *Gartenberg* factors, defendant investment advisors have long deployed vast amounts of experts, data, and legal expertise—indeed, they have never lost in a trial court. The simple addition of one more factor—albeit a particularly probative and relevant one—does not necessarily mean that easy victories lie ahead.

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309. EDWARD F. GREENE ET AL., U.S. REGULATION OF THE INTERNATIONAL SECURITIES AND DERIVATIVES MARKETS § 8.03[8] (9th ed. 2006).

310. See Johnson, *supra* note 179, at 536 (pointing out that a new doctrinal approach would not necessarily increase litigation materially).

Rather, the tone and force of a Supreme Court opinion, perhaps more than its doctrinal formulation, might ensure both prompt downward pressure on artificially inflated fund fees and, consequently, evaporate the pool of advisors vulnerable to potential lawsuits. A decision with the rigor and skepticism of Posner's dissent, more than the superficiality of previous rulings, might be the cheapest and yet most potent discipline for this market. One might certainly debate whether courts are the ideal institutions to resolve these disputes, but with its enactment of section 36(b), Congress has already answered this question in the affirmative. Detractors might prefer something more akin to a business judgment rule in which courts abstain from hearing fee disputes, but, again, Congress has already distinguished investment companies from typical corporations. Inasmuch as the business judgment rule applies only when corporate decisions are free from conflicts,<sup>311</sup> Congress appears to have concluded that the entire structure of mutual funds imbues this field with so much inherent conflict that the participation of courts is a necessary source of discipline.

One important lesson from the recent financial debacle is that when private systems fail to work, the government faces an inexorable choice between allowing the systems to fail with unhappy results or intervening with taxpayer funds.<sup>312</sup> One can easily anticipate that if vast swaths of the American public enter retirement with profoundly inadequate financial reserves, the government will once again be called upon to decide whether huge numbers of Americans are to be allowed to suffer destitution or if taxpayer funds should be used in a very expensive bailout. Far better to intercede with a modest corrective measure now to help avert such unpleasant dilemmas in the future.<sup>313</sup>

#### *E. Theoretical Implications of a Supreme Court Ruling*

The debate between Easterbrook and Posner—now to be refereed by the highest court in the land—takes place at a fascinating moment in the broader theoretical debate over the influence of law and economics. The recent shocks to the global financial markets have prompted careful reconsiderations of deregulation. Brian Tamanaha has documented a series of recent statements from Posner, Nobel laureate Gary Becker, and other erstwhile advocates of neoclassical law and economics that demonstrate a reconsideration of their earlier positions.<sup>314</sup> Indeed, Posner has

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311. See, e.g., *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 371 (Del. 1993); *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984).

312. See, e.g., Phred Dvorak & Joann S. Lublin, *Pay Changes Ripple Beyond Bailouts*, WALL ST. J., Feb. 17, 2009, <http://online.wsj.com/article/SB123379295977649947.html>.

313. See M. Todd Henderson, *The Nanny Corporation and the Market for Paternalism* 7–8 (Univ. Chi. Law Sch. John M. Olin Law & Economics, Working Paper No. 456, 2009), available at <http://ssrn.com/abstract=1348235>.

314. Posting of Brian Tamanaha, *supra* note 29 (“Recent events appear to have genuinely shaken Posner’s faith in the self-correcting power of the market.”).

recently published a book discussing the recent market collapse in which he substantially revisits many of the central premises and implications of his earlier pronouncements on law and economics.<sup>315</sup> With its ruling in *Jones v. Harris Associates L.P.*, the Supreme Court will have an opportunity to contribute greatly to the richness of this debate and, if it chooses, to develop a behavioral economic framework that will shape economic and financial jurisprudence for decades to come.<sup>316</sup>

Perhaps the central claim of neoclassical law and economics is that, as Easterbrook repeats in his opinion,<sup>317</sup> no matter how poor or weak the results produced by the free market may be, alternatives—particularly those championed by governmental authorities—are sure to be worse.<sup>318</sup> Sunstein, Thaler, and now Posner, however, have pioneered a challenge to that orthodoxy and suggested, instead, that certain mild interventions may help the market find its way to a competitive equilibrium with more socially beneficial outcomes.<sup>319</sup> The behavioralist approach is particularly compelling when the market in question may be far from free or competitive, as the retirement savings industry appears to be.<sup>320</sup>

When one contemplates how such interventions might take shape in the investment industry, abstract speculation is not necessary. Indeed, much of the existing structure of tax-advantaged savings accounts was devised with clearly discernible paternalist goals in mind.<sup>321</sup> Consider, for instance, that regulations prevent the owners of these accounts from withdrawing their money without incurring a substantial tax penalty until they reach the age of 59.5 years old.<sup>322</sup> That structure is clearly intended to encourage participants to leave their funds invested and in place until the participants reach the age of retirement.

More recently, the Pension Reform Act of 2006 removed previous legislation that required funds in these accounts to be parked in cash unless the account holder otherwise directed.<sup>323</sup> Because the oversight of these accounts is so often neglected by employees who are busier work-

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315. See generally POSNER, *supra* note 28.

316. While Coates and Hubbard insist that those who disagree with them are “[s]tuck in the [s]ixties,” D. Bruce Johnsen (who also believes the industry is competitive) insists that behavioral economics has “no place in law courts,” “no place in legal proceedings,” and constitutes “*avante garde* economic theory whose analytical contours have yet to be worked out and for which scientific testing is years away and far from inevitable.” Coates & Hubbard, *supra* note 68, at 155; D. Bruce Johnsen, *Myths About Mutual Fund Fees: Economic Insights on Jones v. Harris* 66–67 (George Mason Univ. Law & Econ. Res. Paper Series, Working Paper No. 09-49, 2009), available at [http://ssrn.com/abstract\\_id=1483862](http://ssrn.com/abstract_id=1483862)).

317. See *Jones v. Harris Assocs. L.P.*, 527 F.3d 627, 629–32 (7th Cir. 2008).

318. See, e.g., EASTERBROOK & FISCHER, *supra* note 6; POSNER, *supra* note 6.

319. See Jolls & Sunstein, *supra* note 31, at 214–16. See generally POSNER, *supra* note 28; THALER & SUNSTEIN, *supra* note 36, at 72–76.

320. See *INV. CO. INST.*, *supra* note 13, at 2.

321. See, e.g., Choi et al., *supra* note 80.

322. I.R.C. § 72(t) (2006). Of course, owners may borrow certain amounts from these accounts in the meantime.

323. Pension Protection Act of 2006, Pub. L. No. 109-280, § 624, 120 Stat. 780, 980 (codified at 29 U.S.C. § 1104(c) (2006)).

ing for their retirement than managing their retirement assets, large amounts of assets previously sat uninvested for years on end, foregoing many of the proven benefits of long-term, compounded returns.<sup>324</sup> Thus, today, accounts can be structured to place assets into relatively safe and cheap index funds.<sup>325</sup> Here, then, are two existing instances of behavioral pragmatism already at work. But the industry's current state of confusion on the section 36(b) issue demands the development of a more robust economic theory.

A subsidiary but related economic issue concerns the theoretical debate regarding executive compensation. In many respects, the fees that an advisor receives for the services that it performs for managing a mutual fund are akin to the compensation that executives receive for managing a conventional company.<sup>326</sup> And, just as advisory fees are now a subject of scrutiny, academics and legislators have long directed their attention toward executive compensation.<sup>327</sup> If anything, *Jones v. Harris Associates L.P.* presents the issue even more starkly: whereas executive compensation typically has an indirect and relatively minor effect, if any, upon the performance of a corporation's stock, the impact of advisory fees upon an investor's return is direct and immediate.<sup>328</sup> Although claims of excessive executive compensation are typically debated only in Delaware courts,<sup>329</sup> *Jones* presents an opportunity for the Supreme Court to expound upon an issue with unusually widespread popular and academic interest.

Finally, this case presents an interesting opportunity for the Supreme Court to demonstrate its comfort and skill in evaluating dueling econometric analyses of market competitiveness. To the extent the Court elects to pore closely over the competing claims of the studies by Gil-Bazo and Ruiz-Verdú, Coates and Hubbard, Wilson and Litan, Carhart, Malkiel, Sharpe, and others, the Justices have an opportunity to provide illuminating guidance for lower courts on how to interpret these complex methodologies, as well as for scholars on how to construct these studies most effectively.

## CONCLUSION

During the troubling financial developments of the recent past, trillions of dollars spilled quickly out of private retirement savings accounts.

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324. Chris Silva, *Pension Bill Gives Big Boost to Auto-Enrollment*, EMPLOYEEBENEFIT NEWS, Oct. 2, 2006, <http://ebn.benefitnews.com/news/pension-bill-gives-big-boost-auto-enrollment-39611-1.html>.

325. *Id.*; see also Julie Connelly, *The Ease of Index Funds: No Ins and Outs to Know*, N.Y. TIMES, Oct. 23, 2007, at H2.

326. See Birdthistle, *Compensating Power*, *supra* note 22, at 1411.

327. See, e.g., BEBCHUK & FRIED, *supra* note 283, at 23–44.

328. See *Jones v. Harris Assocs. L.P.*, 527 F.3d 627, 633 (7th Cir. 2008).

329. See William J. Carney & George B. Shepherd, *The Mystery of Delaware Law's Continuing Success*, 2009 U. ILL. L. REV. 1, 1–4 (describing Delaware court's dominance of the corporate market).

The speed and magnitude of this collapse provides a painful but invaluable opportunity to pay greater attention to the structural vulnerabilities of our financial system in order to detect where the stress is greatest. In the investment industry, which had already shown cracks over the past few years, the most profound weaknesses lie in the relationship between the advisor and the investor.

While the neoclassical economic theory articulated by Chief Judge Easterbrook insists that the investment industry remains untroubled, the newfound behavioral approach of Judge Posner digs deeper to uncover and address these fundamental weaknesses. In *Jones v. Harris Associates L.P.*, the Supreme Court enjoys an exceptional opportunity to recalibrate the doctrinal and fiduciary standards of section 36(b). More importantly, the Court can enrich a broad swath of economic jurisprudence with vigorous new theory that takes greater and more reasonable account of the actual constraints on rational investor behavior and the painfully learned lessons born out of an uncurious reverence for deregulation.