

2016

Mutual Fund Advisory Fee Litigation: Some Analytical Clarity

Stewart L. Brown

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MUTUAL FUND ADVISORY FEE LITIGATION: SOME ANALYTICAL CLARITY

*Stewart L. Brown, Ph.D., CFA**

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ABSTRACT

*Households in the U.S. invest a large proportion of wealth in mutual funds. At the end of 2014, open-end mutual fund assets were \$16 trillion and annual fees exceeded \$100 billion. Mutual funds have a unique corporate structure that involves a conflict of interest with the investment management firm that creates and manages the fund. In 1970, Congress passed an amendment to the Investment Company Act of 1940 and made investment managers fiduciaries with respect to fees charged to captive mutual funds. In 1982, the Federal Court for the Southern District of New York, in *Gartenberg v. Merrill Lynch Asset Mgmt. Inc.*, established a fiduciary standard to determine if fund sponsors violated their fiduciary duty with respect to fees. Since 1982, no plaintiff has received an award under the 1970 statute. A recent U.S. Supreme Court case, *Jones v. Harris Assocs. L.P.*, confirmed the *Gartenberg* standard but noted that the *Gartenberg* case lacked “analytical clarity.” This paper examines the issues from a new and different perspective and uses micro economic analysis to clarify the ambiguities of the decision. The *Gartenberg* standard imposes a very high hurdle for plaintiffs in fee cases to overcome. However, in light of the evidence presented here, the ability to demonstrate that advisory fees are “so disproportionately large that they could not have been the product of arm’s length negotiation” is much enhanced.*

I. INTRODUCTION

Mutual funds are the repository of a very large proportion of household wealth in the United States. According to the Investment Company Fact Book,¹ at the end of 2014 open-end mutual fund assets

¹ INV. CO. INST., INVESTMENT COMPANY FACT BOOK: A REVIEW OF TRENDS AND ACTIVITIES IN THE U.S. INVESTMENT COMPANY INDUSTRY (55th ed. 2015), available at <https://perma.cc/9KWA-74JJ>.

totaled \$16 trillion. 46 percent of US households and 90 million individuals own mutual funds. In excess of \$7 trillion of Defined Contribution and IRA retirement accounts are invested in mutual funds. Investors paid somewhat more than \$100 billion in fees to mutual fund companies in 2014. Clearly, managing and providing services to mutual funds involve large sums of money.

Mutual funds are created and managed using a unique corporate form². The typical mutual fund has no employees and owns no physical assets or buildings. In essence, a mutual fund is a collection of contracts to provide services to the corporation. The chief service provider is the investment manager who manages the fund's portfolio of securities. The investment manager also creates the fund and the fund is captive of the manager. Investment managers that create and manage mutual funds are sometimes referred to as fund sponsors.

The U.S. Supreme Court has recognized that "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."³ Being a captive of the fund sponsor, the mutual fund Board of Directors faces a monopoly seller of investment advisory services. This fact colors the legitimacy of fees charged to mutual funds.

During the 1960's, studies conducted by the Wharton School⁴ and the Securities Exchange Commission⁵ found that the advisory fees charged to mutual funds were substantially higher than the fees charged to institutional customers for the same services. The SEC attributed the high fees to a lack of arm's length bargaining and recommended that Congress require that fees be "reasonable" and that the requirement be enforceable in court. The SEC recommendation presented congress with a very visible problem and beginning in 1967 it led to congressional hearings.

² Mutual funds are organized as either corporations or trusts and this paper utilizes the terms "directors" and "trustees" to represent the controlling power in each.

³ *Jones v. Harris Associates, L.P.*, 559 U.S. 335, 339 (2010) (quoting S. REP. NO. 91-184, at 5 (1969)).

⁴ WHARTON SCHOOL OF FINANCE AND COMMERCE, A STUDY OF MUTUAL FUNDS, H.R. DOC. NO. 2274, at XII (1962).

⁵ SEC, PUBLIC POLICY IMPLICATIONS OF INVESTMENT COMPANY GROWTH, H.R. REP. NO. 2337, at VIII (1966) [hereinafter, PPI STUDY].

After considerable pushback from the investment management industry, in 1970 Congress passed legislation amending the 1940 Investment Company Act (“ICA”).⁶ Rather than requiring that fees be reasonable, Congress made fund sponsors fiduciaries with respect to the fees charged to mutual funds, and it gave investors a private right of action⁷. Congress failed to define a standard to gauge violation of the new fiduciary requirement⁸. This failure combined with a brilliant and coordinated legal strategy on the part of the investment management industry effectively neutered §36 (b) as a private cause of action. No plaintiff has ever received an award under §36B of the ICA.⁹ This fact alone should cast doubt on the efficacy of investor protection against excessive mutual fund fees.

The legal strategy implemented by the investment management industry involved carefully selecting cases brought to trial in order to obfuscate the economic analysis of fee differences between mutual fund advisory fees and fees actually determined by arm’s length bargaining.

In *Gartenberg v. Merrill Lynch Asset Management, Inc.*,¹⁰ the basic liability formulation was established: in order “to face liability under Section §36(b), an investment adviser 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.” This has become known as the “Gartenberg standard”. The economic analysis in *Gartenberg* involved examination of six economic “factors” including economies of scale and the profitability of the fund to the fund sponsor. These factors were purposefully confused and corrupted by the anomalous nature of the money market fund that the investment management industry chose to bring to trial.

⁶ 15 U.S.C. § 80a-1 through 80a-64.

⁷ 15 U.S.C. § 80a-35(b) (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”).

⁸ The language of the ICA §36(b) has been called “a lesson in the art of studied ambiguity of drafting of statutes.” *Fogel v. Chestnutt*, 668 F.2d 100, 112 (2d Cir 1981) (quoting JENNINGS & MARSH, *SECURITIES REGULATION: CASES AND MATERIALS*, 1394, 1397 (4th ed. 1977)).

⁹ See JAMES D. COX et al., *SECURITIES REGULATION: CASES AND MATERIALS* (4th ed. 2004).

¹⁰ 694 F.2d 923, 928-29 (2d Cir. 1982).

Freeman and Brown (FB hereinafter)¹¹ updated the Wharton and PPI studies and showed that recently, mutual fund investment advisory fees continued to be roughly double the fees charged institutional clients for the same services. They hypothesized that the fee differential was caused by the lack of competition in the setting of mutual fund advisory fees. This led to a response from the mutual fund industry in the form of an article by Coates and Hubbard (CH hereinafter) purporting to show that mutual fund fees were effectively determined by market forces and thus could not be excessive.¹²

The FB and CH disagreement played itself out recently at the appellate court level in *Jones v Harris*¹³ where two judges took opposite positions on the issue of competition in the mutual fund market. This breach led to *Jones v Harris* being reviewed in the US Supreme Court. The Supreme Court essentially affirmed the *Gartenberg* standard but refused to weigh in on the issue of competition in mutual fund markets. Justice Alito, in a model of understatement, wrote the following concluding lines in the unanimous decision: ***“The Gartenberg standard, ...may lack sharp analytical clarity, but...it accurately reflects the compromise that is embodied in §36(b), and it has provided a workable standard for nearly three decades. The debate...regarding today’s mutual fund market is a matter for Congress, not the courts.”***¹⁴

Justice Alito’s reference to a “lack of analytical clarity” is consistent with the main thesis of this paper: mutual fund fee litigation is tilted in favor of the industry because of tainted and muddled economic analysis in the seminal *Gartenberg* case.

The purpose of this paper is to bring analytical clarity to the economic analysis associated with mutual fund advisory fee litigation via a micro-economic analysis of profits, costs and economies of scale in *Gartenberg* and subsequent cases which have established the analytical legal precedents. Two broad themes emerge from what follows. First, the genesis of analytical confusion in *Gartenberg* emanates from the unique nature of the mutual fund in that case. The anomalous processing costs associated with that fund have confused and corrupted the

¹¹ John P. Freeman & Stewart L. Brown, *Mutual Fund Advisory Fees: The Cost of Conflicts of Interest*, 26 J. CORP. L. 609, 614 (2001).

¹² John C. Coates IV & R. Glenn Hubbard, *Competition in the Mutual Fund Industry: Evidence and Implications for Policy*, 33 J. CORP. L. 151, 163 (2007).

¹³ 527 F.3d 627, 631 (7th Cir. 2008).

¹⁴ 559 U.S. at 336-37.

economic analysis of fee cases since 1982. Second, the issues of economies of scale and the profitability of fund sponsors will be analyzed and it is demonstrated that, contrary to industry assertions, mutual funds managers achieve extraordinary profits as the result of realizing very substantial economies of scale in the advisory function.

The paper is structured chronologically. In the next section, research by the Wharton School and the SEC is reviewed as is the Senate Report underpinning the 1970 amendment to the ICA. A discussion of the “Law of One Price” is included. Next, an analysis of economies of scale and the profitability measures applicable to fund sponsors are presented as analytical tools. The *Gartenberg* case and standard are examined in detail. Three cases subsequent to *Gartenberg* which refined the precedent are discussed and reinterpreted based on the analytical insights gained in this paper. The FB results are then summarized and the FB/CH disagreements highlighted. Then, recent cases, including *In Re American Funds*¹⁵ and *Jones v. Harris* are reviewed. The paper concludes that the analytical clarity associated with the removal of the processing cost canard causes the *Gartenberg* standard to be less formidable.

II. THE 1970 AMENDMENT TO THE INVESTMENT COMPANY ACT OF 1940

During the 1950’s, the mutual fund industry experienced explosive growth, leading the SEC to re-examine the industry for potential abuses. It commissioned the Wharton School of Finance to do a comprehensive study of the industry and in 1962 a report was issued to Congress.

A. The Wharton Study¹⁶

The issue of advisory fees was foremost in the Wharton report, which also dealt with abusive sales load and performance fees. The primary finding of the study as it relates to advisory fees is summarized in its Letter of Transmittal:

¹⁵ *Infra*.

¹⁶ *Supra* note 4, at II.

For *comparable asset levels*, advisory fee rates charged mutual funds tend to be **substantially** higher than those charged by the same advisors to the aggregate of their other investment companies. Nevertheless, it was found that the *expenses* involved in advising mutual funds were **less than** those incurred in advising other clients. Advisory fee rates of mutual funds also tend to exceed **substantially** the effective management costs of mutual funds which do not retain investment advisors. Advisory rates to mutual funds were found to be **less flexible** in relation to size of assets managed than rates charged other clients....

These findings suggest that the special structural characteristics of the mutual fund industry, with an external advisor closely affiliated with the management of the mutual fund, tend to weaken the bargaining position of the fund in the establishment of advisory fee rates. Other clients have effective alternatives, and the rates charged them are more clearly influenced by the force of competition. (Emphasis added).

The body of the report supports these findings with empirical data. A reasonable interpretation of the Wharton study suggests that in 1962 mutual funds sold to the public: (1) paid substantially higher advisory fees than institutional clients at the same asset level; and (2) had mutual fund management expenses lower than the expenses associated with institutional clients. In other words, mutual funds were more profitable to investment advisers than institutional clients where the fees charged were influenced by the forces of competition

Another inference is that the cost of managing mutual funds decreases as assets increase. However, those savings are not passed along to the funds. In other words, mutual funds are subject to economies of scale that are not being reflected in lower fees. Finally, note that the report references the industry *as a whole*. The implication is that excess fees are a systemic characteristic of the whole industry, not of just a few bad apples.

B. The Law of One Price

Underlying the Wharton and PPI studies is the assumption that mutual fund advisory fees should reflect competitive pricing if they are to be considered reasonable. Competitive markets, in theory, exist if prices satisfy the “Law of One Price,” which posits that in perfectly competitive markets, identical assets will sell at identical prices. In competitive markets, a divergence in prices of identical assets will give rise to forces that eliminate the price difference. Speculators will buy assets at the lower price, increasing demand, and simultaneously sell assets at the higher price, increasing supply, ultimately causing prices to converge. A failure of prices of identical assets to converge may indicate a lack of competition.

Rephrased, the Law of One Price suggests that in competitive markets, similar assets should sell for similar prices. Price differences are explained by qualitative and quantitative differences in the assets. For instance, in housing markets, one method of valuing properties is to examine the selling prices of other homes and adjusting for differences such as location, age and the number of bedrooms and baths to estimate the value of the property in question.

Although the Law of One Price is seldom achieved in reality, it is often useful to measure competitiveness in real world activity. Interchangeable commodities at different locations seldom differ in price by more than transaction costs (such as fees and transportation costs) between locations. For instance, gold of a given quality sells for the same price worldwide; its value at any particular location might be different than the world price because of transportation, transaction and storage costs. A barrel of crude oil at the well head in west Texas will sell at a similar price to North Sea crude oil, adjusted for quality differences (sulfur content, for example) and transportation costs.

The issue of price differences of similar assets or services boils down to considerations about the competitiveness, or lack thereof, of the markets involved and the similarities or differences in the good or service being priced. The Wharton and PPI studies conclude that differences in the services provided by mutual fund managers are insufficient to explain the differences in the fees charged to investors. Accordingly, the significantly higher fees charged to mutual fund investors result from an inability to negotiate the fees at arm’s-length. Why? Because the mutual fund is essentially captive of the fund sponsor

while institutional portfolio fees are determined competitively. Studies *do not* argue that the investment management services are *exactly identical* in each case, but the differences are too small to explain the large discrepancies in fees. Thus, the Wharton report finds *substantial* fee differences, and attributes the differences principally to the lack of arm's-length negotiation of fees.

C. The S.E.C. Report on the Public Policy Implications of Investment Company Growth

The PPI Study focused on the lack of arm's-length negotiation of investment advisory fees, and reached three main conclusions about externally managed fund fees:

1. Most of the advisory fee reduction since 1960 had occurred as a result of pressure generated by the Wharton report and the majority of reductions were the result of fee litigation settlements.
2. Fees on externally managed funds were far higher than fees on internally managed or bank managed funds.¹⁷
3. Fees on externally managed mutual funds were far less sensitive to assets levels than internally managed and bank managed funds.

The S.E.C.'s Letter of Transmittal to Congress recommended:

¹⁷ The Commission found that the median annual advisory fee rate of .48 percent of 57 externally managed funds was 4 times or more than that of the advisory fees of the internally managed complexes examined. The Commission also examined the fee schedules for pension and profit sharing plans for seven leading banks and found that the annual advisory fee for a \$100 million portfolio for five of the six banks was .06 percent (6 basis points), which was less than one eighth of the 50 basis points charged to mutual funds of that size. The fee on the seventh bank was 7 basis points.

The report concludes that mutual fund shareholders need protection against incurring excessive costs in ... management of their investments and that, given the structure and incentives prevailing in the industry, neither competition nor the few elementary safeguards against conflict of interest deemed sufficient in 1940 and contained in the Investment Company Act presently provide this protection in adequate measure.

It is recommended that the statute be amended to expressly require that the compensation received by persons affiliated with investment companies, including their management organizations, for services furnished to an investment company be reasonable, and that this standard be enforceable in the courts.

The S.E.C.'s recommendation that the courts establish a reasonableness standard for management fees was criticized by the industry as similar to public utility rate regulation. Rate regulation is imposed on natural monopolies such as electric and water utilities.

D. The 1970 Amendment to the ICA Act of 1940

Subsequent to the publication of the PPI Study, there was extensive pushback from trade groups, and in particular, the Investment Company Institute (ICI), the investment management trade association. The ICI and others argued for self-regulation and sought relief from a raft of litigation they believed was plaguing the industry.

The initial 1967 legislation failed and with it the "reasonableness" standard recommended for fees. After extensive hearings and debate, legislation was passed in 1970 and the final legislation, while acknowledging the conflict of interest problem and paying lip service to "reform," essentially ratified the status quo, which prevails even today.

The Senate Report accompanying the legislation gives a good flavor of the overall legislative intent and provides:

In reporting this bill, your committee recognizes the importance of permitting adequate compensation and incentives so that men of ability and integrity will continue to be attracted to the mutual fund industry. At the same time this bill recognizes that investors should *share equitably*, as they do in other areas, in the economies available as a result of the growth and general acceptance of mutual funds.

[Y]our committee has decided that there is an adequate basis to delete the express statutory requirement of ‘reasonableness,’ and to substitute a different method of testing management compensation. This bill states that the mutual fund investment advisor has a specific ‘fiduciary’ duty in respect to management fee compensation.¹⁸

This then is the “compromise” later suggested by Justice Alito in the *Jones* case. The industry did not get self-regulation, and the SEC did not get its reasonableness standard. It is clear that the overarching intent was to ratify the status quo, as made eminently clear by the last paragraph of the management fee section of the Report:

This provision does not represent a finding by the committee as to the level of fees of the industry. Your committee does not believe itself qualified to make such judgments. Nor is it contemplated that the Commission will seek a general reduction of fees on an industry wide basis.

Curiously, the committee did not feel qualified to make judgments concerning advisory fee levels - but was willing to ignore both the findings of the S.E.C., its own securities watchdog, and the Wharton Report, a prestigious Ivy League business school - in making its recommendations.

The overall message from the Senate is essentially a repudiation of the Wharton and PPI reports and nowhere is reference made to the finding of “substantial” industry wide differences between mutual fund

¹⁸ S. REP. NO. 91-184, 91st Cong., 1st Sess., at 4-6 (1969) (emphasis added).

and institutional advisory fees. The evidence was simply ignored. As the Senate opined in its Report, “Nor is it contemplated that the Commission will seek a general reduction of fees on an industry wide basis.” Thus, even though the Commission theoretically had standing to sue under the new law, its powers were essentially neutered from the start.

Aside from a fleeting reference to “share equitably” and other comments on economies of scale, the interests of the public and investors are essentially ignored, while other statements favored the industry:

1. The Investment advisor is entitled to make a profit. Nothing in the bill is intended to imply otherwise or to suggest that a cost-plus type of contract would be required.
2. This section should not be taken as reflecting any finding that the present level of management fees or that of any particular advisor is too high.
3. This section is not intended to authorize a court to substitute its business judgment for that of the mutual fund’s board of directors in the area of management fees.

Finally, the enacted legislation provides only a one year look-back damage period. This effectively limited monetary penalties, reduced any serious deterrent effect, and ignored the general principle that the damages period should conform to the period of wrongdoing. Thus, even if an investment manager violated fiduciary duties, their exposure to damages was curtailed.

Congress thus bypassed any real definition of fiduciary standards and instead handed the problem off to the judiciary. The problem with establishing standards, reasonable or otherwise, is that they must be ultimately tied to numbers and relationships existing in the real world. Congress essentially ignored persuasive evidence of substantial overcharging by investment managers. However numbers do not lie; honest accounting translates into inconvenient truths and the overcharging documented by the S.E.C. and Wharton Reports did not disappear. The judiciary was able to ignore those real-world facts with substantial complicity from the mutual fund industry, and the congressional desire to maintain the status quo was achieved. Much

later, the judicial solution to the numbers problem – which was, in fact, no solution at all - gave rise to the lack of analytical clarity noted by Justice Alito in *Jones*.

III. FUND PROFITABILITY AND ECONOMIES OF SCALE

The advisory fee is one component of the expense ratio; a percentage number charged against fund assets on an annual basis. The investment management contract is an asset of the fund sponsor and potentially produces dollar profits. Confusion and misinformation surrounds the concepts of the profitability of an individual fund to the fund sponsor and the associated economies of scale. This section attempts to explain the issues in a simple, clear and intuitive fashion, to serve as a basis for understanding these concepts in the case law.

A. The Expense Ratio

The expense ratio is typically comprised of three components: (1) the investment management or advisory fee; (2) the distribution fee; and (3) administrative fees. A typical expense ratio breakdown would be .5 (or half a percent) investment management fee, .25 (a quarter of one percent) distribution fee, and .25 (again, a quarter of one percent) administrative fee. The focus of this article is the first component, the advisory fee. However, the third component – administrative fees - is the sum of several other components, each typically representing a separate contract for services paid by the fund. Such contracts vary from fund to fund but typically include items such as transfer agent fees, custodial fees, board fees and audit fees.

Typically, the largest component of administrative fees is the transfer agent (“TA”) fee; it is the TA which “keeps the books” on the shareholders. It keeps track of purchases and sales, and it distributes dividends, among other functions. The TA contract is usually separate from the investment advisory contract, although the TA is often a subsidiary of the investment adviser. Importantly, the TA insulates the investment adviser from shareholders. The only real interaction between the two is that, at the end of each business day, the TA tallies net purchases and sales and then communicates this number to the investment adviser, who adjusts the portfolio accordingly.

The investment advisory fee is determined by a contract between the fund and the adviser, and it is approved by the trustees. The greater

the fee, the more profitable the contract is to the *owners of the advisory firm*, and since this fee is paid from fund assets, the higher the fee, the lower the investment return to fund shareholders. This is the essence of the conflict of interest: the fund is a captive of the investment adviser, which has an interest in maximizing fees charged to the fund, which are in turn paid by the fund shareholders.

The investment adviser incurs various costs which supposedly justify the advisory fee. These include salaries for portfolio managers, research costs, office expenses, computers, and other miscellaneous costs. A key to understanding whether the advisory fee is fair is the profitability of the contract (revenues less costs); profitability of the fund to the fund sponsor is intimately related to economies of scale. Intuitively, the investment advisory function should benefit from such economies: once the fund's basic infrastructure is in place, it does not cost substantially more to manage a \$1 billion fund than it would cost to manage a \$100 million fund. Scalability as used in this paper is synonymous with economies of scale.

B. Profit Margin – A Measure of Profitability

A generic formula for calculating a profit margin is: $(\text{sales} - \text{costs})/\text{sales}$, with the numerator as a measure of profits ($\text{sales} - \text{costs}$) and the denominator as sales. The profit margin is a percentage number that represents profit as a percent of sales.

There are different definitions of profit margin depending on the costs examined, so there are also differently labeled profit margins. Generically, the Gross Profit Margin ("GPM") is defined as $(\text{sales} - \text{cost of goods sold})/\text{sales}$. In this case, the numerator is Gross Profit, or profit after costs directly associated with the sales are deducted. This measure of profitability may be calculated on product line, division or whole firm basis.

In a mutual fund context, the GPM is a measure of the profitability of the fund to the fund sponsor and is calculated as $(\text{Revenues} - \text{Direct Fund Expenses})/\text{Revenues}$. Direct fund expenses are those costs that are directly attributed to the fund such as portfolio manager salaries, research costs and computers. GPM at the fund level excludes corporate overhead and other costs not directly attributable to the sponsor's cost of operating the fund.

The Pre-Tax, or Operating Profit Margin (OPM), is a more commonly used profit measure. Like the GPM, the OPM may be calculated at the product line, division or whole firm level, and it measures profitability, including all expenses (with the exception of taxes). The OPM at the individual fund level was discussed as the measure of profit in the seminal case of *Schuyt v. Rowe Price Prime Reserve Fund, Inc.*, which in a precedent setting opinion established a maximum profit margin of approximately 75 percent.¹⁹

Common usage in the industry is to label the individual fund OPM as the Advisory Margin. It is calculated as: $(\text{Revenue} - (\text{Direct Fund Expenses} + \text{Allocated Corporate Overhead})) / \text{Revenue}$. Revenue associated with the Advisory Margin is the average level of fund assets for the period in question, times the percentage investment management fee. Advisory Margin data is proprietary in nature and seldom available outside of the litigation process, where it is invariably subject to strict confidentiality agreements. However, some summary data, which cannot be attributed to individual firms or funds, is available and discussed below.

OPMs at the firm level are commonly available for publicly traded firms, and OPMs for fund sponsors at the firm level are on average lower than Advisory Margins. This occurs because fund sponsors typically have product lines other than just fund sponsorship. These often include subsidiaries or product lines that provide distribution and transfer agent services. Moreover, many fund sponsors are subsidiaries of large banks and insurance companies, and their fund sponsorship profits are aggregated into other product lines.

C. Economies of Scale

Economies of scale occur when the average cost of production decreases as the scale of production increases; when fixed costs are spread around more units of production. For instance, a factory that produces widgets and costs a million dollars in fixed costs to run a year has a per-widget cost of \$1 million, if the factory produces only one widget. On the other hand, if the factory produces a million widgets and costs \$1 million to run, the fixed cost per widget is one dollar. If the factory manages to produce over a million widgets, the cost per widget correspondingly decreases, reflecting an economy of scale. Of course,

¹⁹ 663 F. Supp. 962, 990 (S.D.N.Y. 1987).

there are other (variable) costs associated with increased production, but in general, the more efficient the production, the less cost per unit.

When investment management functions are analyzed under an economies of scale rationale, it becomes clear that costs should fall as the level of assets under management increases.

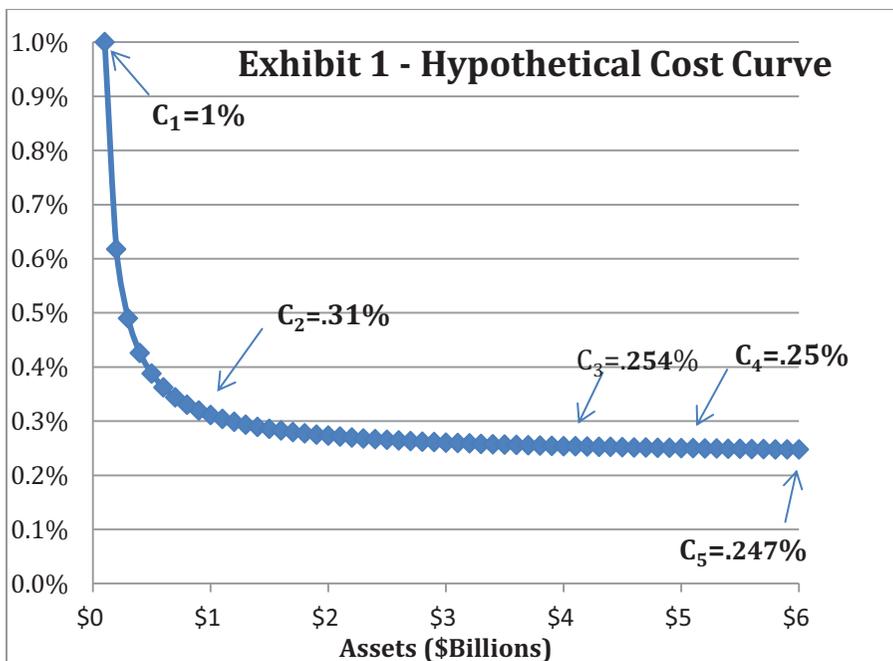
D. A Hypothetical Cost Curve

To gain insight into the nature of economies of scale in a mutual fund context, a hypothetical cost curve is here constructed. There is empirical evidence that the breakeven level of assets required for a standalone mutual fund is in the neighborhood of \$100 million.²⁰ Breakeven occurs when revenues and costs are equal; there are no profits but also no losses. Assuming the investment management fee is a flat 1 percent (or 100 basis points), a 1 percent fee on \$100 million would generate revenues of \$1 million, and assuming costs or expenses of \$1 million, there are no profits or losses.

As shown in the chart below as Exhibit 1, as the level of assets increase, assuming economies of scale, costs as a percentage of assets will decline. Here, the hypothetical cost curve is calibrated to generate a 75% profit margin at a \$5 billion level of assets under management²¹. In order to achieve this, it was assumed that variable costs increased by \$234,694 for every extra \$100 million under management. This generated total costs of \$12.5 million at an asset level of \$5 billion; this was comprised of \$1 million of fixed costs and a total of \$11.5 million of variable costs. So, with assets of \$5 billion and a fee of 1%, revenue would be \$50 million, costs \$12.5 million, and the Profit Margin would be $(50-12.5)/50 = 75\%$.

²⁰ MELINDA GERBER, *START A SUCCESSFUL MUTUAL FUND: THE STEP-BY-STEP REFERENCE GUIDE TO MAKE IT HAPPEN*, (JV Books, 2005); *see also* *MUTUAL FUND GOVERNANCE CONSULTING*, <https://perma.cc/7YB5-5WBM>.

²¹ The particulars of the hypothetical cost curve are unimportant. If breakeven is \$50 million or \$150 million or if a 75 percent profit margin is realized at \$3 billion or \$7 billion of assets, the fundamental analysis and insights remain unchanged.



The graph identifies costs as a percentage of assets at various points on the curve, C_1 to C_5 . As the level of assets increases from breakeven (\$100 million) to \$6 billion, the percentage costs decrease, but not in a linear (straight line) fashion. Costs decrease most dramatically from breakeven to about \$1 billion. After that, the cost curve flattens out so that high asset levels, the decrease in percentage cost is much less pronounced. Consider the section of the cost curve from \$100 million to \$1 billion (C_1 to C_2), reflecting substantial economies of scale. But economies of scale are modest when examining the decrease in costs for subsections of the curve at higher levels of assets.

Economists have developed a numerical measure to quantify economies of scale, called the “scale factor.” It is calculated by dividing the percentage change in dollar costs by the percentage change in output over a range of output. In the case of mutual funds, output is the level of assets under management. If dollar costs do not increase percentage wise as rapidly as assets, the scale factor will be less than one. Conversely, if dollar costs increase much more slowly than assets, the scale factor will

be well below one, and closer to zero. If there are minimal economies of scale, the factor will be less than (but close to) one²².

The Table below is a compilation of the scale factors over a range of assets for four sub-portions of the curve, as well as the whole curve. When examining sub-portions of the curve, economies of scale are labelled as “marginal” and when measuring economies of scale from breakeven, economies of scale are labeled as “realized.”

The smallest scale factors (the greatest realized economies of scale) are associated with the portions of the curve from breakeven forward²³ (realized economies of scale). Scale factors close to one are associated with the flat portions of the curve, labeled as marginal economies of scale.

The most important insight from this Table is that the measured level of economies of scale depends on the portion of the cost curve examined. Examination of the range of output from breakeven forward reveals large economies, while sub-portions of the curve suggest minimal economies.

²² Dollar costs that increase percentage-wise more than output are an indication of diseconomies of scale and generate a scale factor greater than one.

²³ The fact that scale factors from breakeven forward are constant in the table is an artifact of the assumptions used to construct the cost curve.

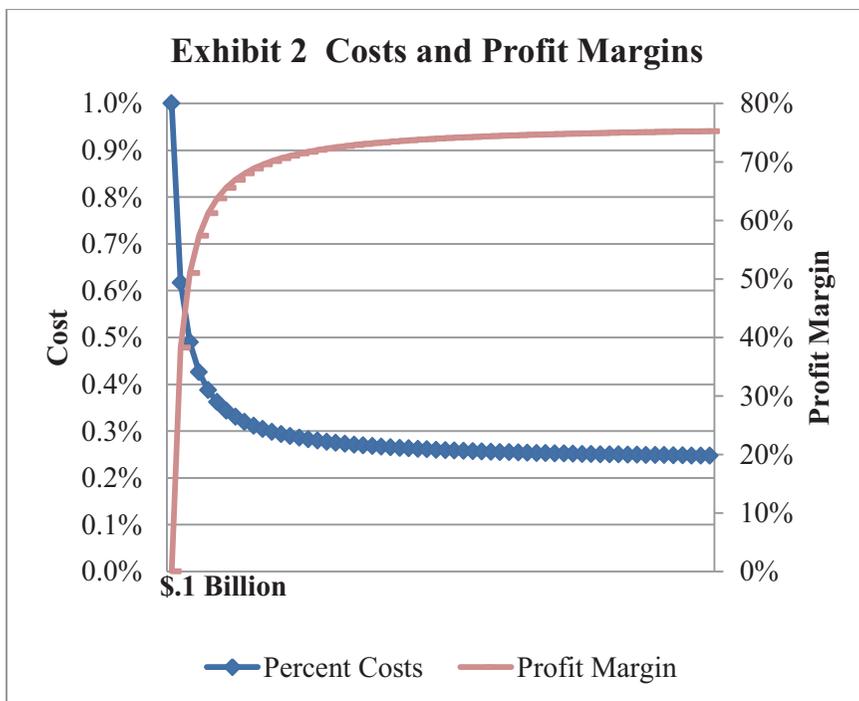
Scale Factors and Profit Margins for Hypothetical Cost Curve

	\$Costs_{beg}	\$Costs_{end}	\$Assets_{beg}	\$Assets_{end}	Scale Factor	Profit Margin
Marginal Economies of Scale*						
C₁ to C₂	\$1,000,000	\$3,112,245	\$100,000,000	\$1,000,000,000	0.235	68.9%
C₂ to C₃	\$3,112,245	\$10,153,061	\$1,000,000,000	\$4,000,000,000	0.754	
C₃ to C₄	\$10,153,061	\$12,500,000	\$4,000,000,000	\$5,000,000,000	0.925	
C₄ to C₅	\$12,500,000	\$14,846,939	\$5,000,000,000	\$6,000,000,000	0.939	
Realized Economies of Scale						
C₁ to C₃	\$1,000,000	\$10,153,061	\$100,000,000	\$4,000,000,000	0.235	74.6%
C₁ to C₄	\$1,000,000	\$12,500,000	\$100,000,000	\$5,000,000,000	0.235	75.0%
C₁ to C₅	\$1,000,000	\$14,846,939	\$100,000,000	\$6,000,000,000	0.235	75.3%

*Economies of Scale from Breakeven to \$1 Billion are both Marginal and Realized EOS.

E. The Relationship between Profit Margins and Economies of Scale

Advisory margins and economies of scale are related. As economies of scale are realized (costs decrease as a percent of assets), advisory margins increase. It is impossible to realize a positive advisory margin without simultaneously realizing a decrease in percentage costs, thus realizing economies of scale. The relationship may be demonstrated with the use of the following graph, Exhibit 2, which plots profit margins on the same charts as costs:



This graph and the underlying relationship show that advisory margins are intimately related to economies of scale and as scale economies are realized (i.e. costs as a percentage of assets decrease), profits as a percentage of assets (and revenues) also increase. The exact relationship illustrated above assumes that fees are a constant one percent of assets under management. The proposition holds in general but will not hold exactly if breakpoints are included in the fee schedule.²⁴

²⁴ The mathematically astute will note that the profit margin is one minus percentage costs and vice versa. Also, the scale factor is always less than percentage costs expressed as a decimal. This is true when fees are a constant percentage of assets. When breakpoints are present in the fee schedule, the scale factor will be less than the calculated scale factor.

F. Profit Margins - Empirical Evidence

Advisory margins on individual funds are proprietary in nature and are generally disclosed only subject to strict confidentiality agreements in litigation. However, a consulting firm named Mutual Fund Governance Consulting (“MFGC”), which provides services to fund trustees, publishes research reports that sometimes include summary advisory margin numbers (and other data) aggregated across several firms.²⁵ Three MFGC reports are of particular interest here:

“MFGC A”: *Profitability Benchmarks in Contract Renewal* – April 2008;²⁶

“MFGC B”: *Industry Profitability Returns as Average Assets Rise in 2010*;²⁷ and

“MFGC C”: *Advisory Fee Breakpoints: A new Look at the Data* – February 2012.²⁸

Several observations can be distilled from these three reports:

1. Average complex wide Advisory Margins were about 56% in 2008 (MFGC A) and ranged between about 50 and 60% between 2005 and 2010 (MFGC B).
2. Average operating margins at the firm level were around 31% and ranged from about 28 to 34% between 2005 and 2010 (MFGC B).

²⁵ MUTUAL FUND GOVERNANCE CONSULTING, <https://perma.cc/8NW5-328J>.

²⁶ C. Meyrick Payne & Sara Yerkey, *Profitability Benchmarks in Contract Renewal*, MUTUAL FUND GOVERNANCE CONSULTING (Apr. 2008), <https://perma.cc/2QRH-LM2B>.

²⁷ C. Meyrick Payne & Sara Yerkey, *Industry Profitability Returns as Average Assets Rise in 2010*, MUTUAL FUND GOVERNANCE CONSULTING (2010), <https://perma.cc/43GB-CUHH>.

²⁸ Sara Yerkey, *Advisory Fee Breakpoints: A New Look at the Data*, MUTUAL FUND GOVERNANCE CONSULTING (Feb. 2012), <https://perma.cc/DYL7-PNLB>.

3. Some types of funds are more profitable than others (MFGC A): Large Cap Equity and Money Market funds had average Advisory Margins of about 70%, while bond and small cap equity funds had margins from 40 to 50%.
4. Equity funds are the most likely to have breakpoints, and the bigger the fund, the lower the resulting percentage advisory fee (MFGC C).
5. MFGC A and MFGC B mention the 77% maximum permissible Advisory Margin established in the *Schuyt*, case, *supra*, although MFGC B mistakenly attributes it to the *Gartenberg* decision.

G. Three Propositions

Given the relationship between profit margins and economies of scale, and the empirical evidence on margins, some useful insights concerning margins and economies of scale emerge.

i. Proposition 1: There are Large Scale Economies in the Mutual Fund Investment Advisory Function

Economies of scale exist and are substantial in the portfolio management process. The above evidence shows that advisory margins are mathematically related to realized economies of scale, and empirically margins are between 50 and 60% on average.²⁹ Based on these facts it cannot be disputed that the investment advisory function of the fund sponsor business realizes substantial economies of scale. This evidence supports statements by industry pioneer John Bogle who has said that “there are staggering economies of scale in portfolio management and research.”³⁰

²⁹ Payne & Yerkey, *supra* note 25 (demonstrating that advisory margins of 60 percent would be associated with a realized scale factor of about .4 or smaller).

³⁰ JOHN C. BOGLE, *THE JOHN C. BOGLE READER: COMMON SENSE ON MUTUAL FUNDS* (John Wiley & Sons, Inc. 10th ed. 2010).

ii. Proposition 2: Case Law is Predicated on Misleading and Deceptive Economies of Scale Considerations

The United States Senate Report, as explained above, endorsed the concept that fund sponsors share equitably the fruits of economies of scale. The issues in case law revolve around how to measure economies of scale and what constitutes an equitable sharing of economies. In practice the two issues have been improperly conflated with a misleading measure of scale economies as an indication of an equitable sharing of economies. To illustrate these concepts, assume that a fund with a cost curve like that in Exhibit 1 currently has \$4 billion in assets under management. Its financial condition is identical to point C₃ above:

Assets	\$4 Billion
Revenues (1%)	\$40 Million
Costs	\$10.15 Million
Profits	\$29.85 Million
Profit Margin	74.6%

Now, consider a scenario where the fund sponsor expects assets to increase to \$5 billion in the future, and the Trustees are urging the fund sponsor to add breakpoints (which would serve to reduce fees) because of expected economies of scale. Assume that the fund sponsor argues that at \$4 billion in assets, economies of scale have been practically exhausted since economies of scale going forward (marginal EOS) are minimal because the cost curve is flat.³¹ Assume further that the fund sponsor prevails and no breakpoints are imposed on the fund. The financial condition of the fund when assets increase to \$5 billion (a situation identical to point C₄ above) would be:

³¹ The scale factor from C₃ to C₄ is .925 which is consistent with minimal economies of scale over that portion of the cost curve.

Assets	\$5 Billion
Revenues	\$50 Million
Costs	\$12.5 Million
Profits	\$37.5 Million
Profit Margin	75%

Even though the profit margin only increased slightly, from 74.6 to 75%, dollar profits increased by 25.6 % from \$29.85 million to \$37.5 million - an increase of \$7.65 million. The Trustees' acceptance of a misleading measure of scale economies led to a profit windfall to the fund sponsor. There was no equitable sharing of the increase in dollar profits resulting from economies of scale and in essence Trustees were duped by the fund sponsor.

The proper measure of economies of scale should be the realized, not marginal economies of scale. The Senate clearly intended that economies of scale should be shared, but utilization of marginal economies of scale leads to a contrary result. Unfortunately, the case law has evolved to support the use of marginal economies of scale in litigation rather than realized economies of scale, as illustrated below.

iii. Proposition 3: Profit Margin Ceilings and Flat Cost Curves Induce Only Modest Fee Reductions

Due to the flatness of the cost curve at high asset levels, only moderate fee rate reductions are necessary to keep profit margins under fiduciary standard ceilings. This proposition can be illustrated as follows.

Imagine an investment manager who faces the hypothetical cost curve illustrated above, with assets under management at \$5 billion, and a current profit margin of 75%. The manager's total revenues are \$50 million (.01 times \$5 billion) and the associated profits are \$37.5 million (at a 75% profit margin).

Now, assume that the manager is anticipating an increase in assets of \$1 billion to \$6 billion. On the hypothetical cost curve this is equivalent of movement from C_4 to C_5 . This will generate total revenues of \$60 million and a profit of \$45.15 million, an increase of \$7.65

million. However, because of economies of scale, the profit margin is now actually about 75.3% (rounded) 3 basis points above the statutory maximum of 75%. The profit margin increased only moderately because of the flatness of the cost curve.

If the investment manager institutes a 5 basis point fee break (to 95 basis points) on all assets above \$5 billion, then the revenues on the extra \$1 billion in assets would be \$9.5 million and the profit margin would then be $(59.5-14.85)/59.5$, or 75%. Customers would get a \$.5 million fee break and the investment manager would get to keep \$9.5 million of the revenues, which does not appear to be equitable.

IV. GARTENBERG³²

Professor Donald Langevoort³³ has pointed out that the late 60's and 70's were generally favorable to investors in litigation against fund sponsors. Gradually, however, the judicial landscape shifted, with the Supreme Court's pivotal 1979 decision in *Burks v. Lasker*.³⁴ Subsequent to *Burks*, courts used the supposedly "disinterested" directors as a pretext to reduce the level of judicial scrutiny afforded to allegations of breach of fiduciary duty. The scrutiny of independent directors was key in the *Gartenberg* decision and became one of what came to be known as the "*Gartenberg* factors."

Twelve years elapsed between the passage of the 1970 Amendment to the ICA and *Gartenberg*, but in the interim, the industry disposed of six fee-related cases filed under the ICA:

- *Boyko v. Reserve Fund, Inc.*, 1976 WL 775 (S.D. N.Y. 1976).
 - Settled out of court with stipulations, after litigation and appeals.
- *Halligan v. Standard & Poor's/Intercapital, Inc.*, 434 F.Supp. 1082 (E.D.N.Y. 1977).
 - Motion to dismiss was denied and no more proceedings on file: presumably settled.

³² *Gartenberg v. Merrill Lynch Asset Mgmt.*, 694 F.2d 923 (2d Cir. 1982).

³³ 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).

³⁴ 441 U.S. 471 (1979).

- *Untermeyer v. Fidelity Daily Income Trust*, 25 Fed.R.Serv.2d 1471 (D. Mass. 1978).
 - Case dismissal overturned by the appellate court and remanded; no further proceedings mentioned. Presumably settled following appeal.
- *Krasner v. Dreyfus Corporation*, 500 F.Supp. 36 (S.D.N.Y. 1980).
 - Settlement approved July, 1981.
- *Markowitz v. Brody*, 90 F.R.D. 542 (S.D.N.Y. 1981).
 - Initially complaints dismissed due to procedural issues and not reinstated or refiled; presumably settled or abandoned.
- *Lerner v. Reserve Management Co.*, 1981 WL 1641 (S.D. NY. 1981).
 - Dismissed on *res judicata* grounds, citing *Boyko, supra*.

Gartenberg, which came to trial in 1980, posed a problem because the fund at issue was not representative of mutual funds in general. This worked to the advantage of the industry, because the court did not have to confront difficult facts, such as a comparison of small fees charged to institutional clients, and the extraordinarily high profit margins of fund sponsors. The problems were compounded because of the District Court's interpretation of legislative intent, which has sown confusion and limited clarity in subsequent ICA fee cases. The net effect is that because of the unique nature of the fund at issue, the Second Circuit's distillation of the *Gartenberg* factors were badly corrupted and distorted. Moreover, given the limited facts the District Court did confront, it was unable to apply its own factors to properly analyze the fund in question. It was left to subsequent courts to refine the *Gartenberg* factors, and they did so in a way that was very unfavorable to investors.

*Gartenberg*³⁵ filed the case against Merrill Lynch, Merrill Lynch Asset Management and the Merrill Lynch Ready Assets Trust. The Ready Assets Trust was a money market mutual fund that was integrated with Merrill Lynch Brokerage operations.

³⁵ *Gartenberg*, 694 F.2d 923.

A. The Merrill Lynch Ready Assets Trust

The 1970's were a period of financial turmoil, leading to deregulation of the financial system. The Merrill Lynch Ready Assets Trust played a catalytic roll in these events. The Vietnam War led to deficit spending, high inflation, high interest rates and disintermediation out of the banking system. At the time, banks were prohibited from paying interest on checking accounts, and there were ceilings on rates paid on savings accounts. With interest rates high because of inflation, Merrill Lynch produced a striking financial innovation, and in 1977, married a money market fund, the Merrill Lynch Ready Assets Trust, with brokerage accounts. This allowed customers to write checks paid from their money market accounts.³⁶ Of course, the money market fund paid market interest rates which were well over ten percent at the time.

At a stroke, the fund was paying market rates of interest on what was functionally a checking account. Dividends and interest paid into the brokerage account from stocks and bonds were automatically swept into the Ready Assets Trust and immediately earned market rates of interest. Moreover, the proceeds from sales of stocks and bonds were also immediately swept into the fund. The Ready Assets Trust, the first money fund associated with a brokerage firm, experienced phenomenal growth and, as noted on page 6 of the *Gartenberg* opinion: "In June 1978 there was a total of about 6.8 billion of assets in money market funds; today (1981) their assets total more than \$185 billion - a 25 fold growth. The fund herein is by far the largest money market fund in existence."

These events pre-dated the computer revolution that swept the brokerage industry a few years later, and at the time, Merrill Lynch transactions were still largely paper based. If a customer wanted to buy a stock, the broker took the order over the phone and filled out a trade ticket. A clerk electronically entered the ticket and wired the transaction to the trading floor where it was executed. In cash management accounts ("CMAs"), each stock transaction generated an equal and opposite money fund transaction: when the broker filled out a stock trade ticket, he/she would automatically enter a trade ticket to correspondingly credit or debit (depending on the stock trade) the money fund.

Merrill Lynch, in its internal accounting procedures, allowed the brokerage operation to bill the money fund for the processing costs, and

³⁶ The "Cash Management Account", as it was known, also included a Visa Debit card and had a required minimum balance of \$20,000.

it conducted internal time and motion studies to estimate the incremental expenses involved.³⁷ Merrill Lynch was motivated to bill those costs to the money fund because without the processing costs, the gross profit margin on the fund would have been much higher - perhaps as high as 96% - and the fund's board would have undoubtedly pushed for more breakpoints and lower fees.³⁸ Thus, Merrill Lynch sought to attribute all processing costs to the Ready Assets Trust.

B. The District Court's Interpretation of Legislative Intent was Erroneous

The Court's interpretation of the statute's legislative intent closely mirrored the Senate Report, with a few notable but important exceptions, summarized below:

The Intention of the Legislation³⁹

1. What is intended:
 - (a) That the investment adviser is entitled to make a profit.
2. What is not intended:
 - (a) That a cost-plus type of contract is required.
 - (b) That general concepts of rate regulation as applies to public utilities are to be introduced.
 - (c) That the standard of "corporate

³⁷ See Gartenberg, 694 F.2d at 931 (referenced therein as the "Fitz-Gerald estimate").

³⁸ See *id.* at 931 n. 4. For the fiscal year of June of 1980 to June of 1981, the fund had average assets of \$13.52 billion and revenues of \$39,369,587. The schedule shows direct costs (exclusive of processing costs) of \$1,567,847. $((39,369,587 - 1,567,847) / 39,369,587)$ yields a gross profit margin of 96%.) The plaintiffs brought these figures to the attention of the Appellate Court, to no avail.

³⁹ Gartenberg v. Merrill Lynch Asset Mgmt., 528 F. Supp. 1038, 1046 (S.D.N.Y. 1981).

waste” is to be applied.

(d) That management fees should be tested on whether they are “reasonable”.

(e) That a congressional finding has been made that the present industry level or that the fee of any particular adviser is too high.

(f) That the Court is authorized to substitute its business judgment for that of the directors.

(g) That the responsibility for management is to be shifted from directors to the judiciary.

(h) That economies of scale are necessarily applicable at every stage of growth of the Fund.

3. The test of fairness is to be made by the Court, in part:

(a) By reference to industry practice.

(b) By reference to industry level of management fees.

4. The Court shall determine whether:

(c) The attention of directors was fixed on their responsibilities.

(d) The directors requested and obtained information reasonably necessary to evaluate the terms of the management contract.

(e) The directors having the primary responsibility for looking after the best interests of the Fund's shareholders, have evaluated such information accordingly.

While this recitation appears faithful to the legislation's intent, attention should be paid to 2(h), and 3(a) and (b). The Senate Report voiced concern about economies of scale being equitably shared with shareholders, yet, the *Gartenberg* court opined that the legislation was *not* intended to imply that “economies of scale are necessarily applicable to every stage of growth of the fund.” A search for any statement remotely related to this assertion through the Senate Report as well as

the related hearings, would be in vain. The *Gartenberg* court's language regarding economies of scale is very different from the actual language in the Senate Report, and has had a pernicious influence on the ability of plaintiffs to prevail in mutual fund fee cases. The industry has been able to argue that economies of scale measured from high levels of assets and "going forward" are minimal, even though profit margins and dollar profits are high once scale economies have been realized. The impact has been analytical confusion as it relates to economies of scale which has been invoked to benefit mutual fund defendants in fee cases.

Similarly, *Gartenberg* suggests that industry practice and fees as a fairness test is not supported by the facts. A search through all of the hearings and reports reveals no reference to industry practice as it relates to fee levels. There is no mention of the "industry level of management fees" with a sole exception, in the last paragraph of the Senate Report:

This provision does not represent a finding by the committee as to the level of fees in the industry. Your committee does not believe itself qualified to make such judgments. Nor is it contemplated that the Commission will seek a general reduction of fees on an industry wide basis.

Essentially, the *Gartenberg* court found that the proper gauge of fiduciary fairness of a no-bid fee contract was the industry level of other no-bid contracts. Judge Pollack wrote: "The compensation paid by the fund is high as a matter of numbers but the payment is lawful relative to the gargantuan size of the fund...The plaintiffs have not sustained their burden of proof...that the fees received should be characterized as a breach of fiduciary duty."⁴⁰ The court then made a whole series of judgments, including the comparison of management fees to management fees of other money funds, but was unable to reach a definitive conclusion on two of the six eventual "Gartenberg factors" set out by the Appellate Court. The undetermined factors were the profitability of the fund and economies of scale. In both instances, the District Court was confounded by processing costs. The District Court failed to establish any bright line test associated with these items, a burden was left to a subsequent court.

⁴⁰ *Id.* at 1068.

C. The Fee Paid

The District Court found that the average fee paid by Ready Assets Trust customers “compared favorably with others in the industry” as less than .29 percent, thus the ratio of expenses to average net assets was deemed “in line.” At least sixteen other funds had higher expense ratios while only five had lower ratios.”⁴¹ The District Court thus found the fee “in line” even though at the time of trial, the fund had “triple” the net assets of the next largest fund not sponsored by Merrill Lynch. The finding of those fees as “in line” - in spite of what the Court characterized as “gargantuan” assets - totally ignores the concept of economies of scale.

D. The Fund’s Profitability to the Adviser

The District Court chose to look at net earnings after taxes resulting from sponsoring and operating the Ready Assets Trust. Net earnings are dollar figures and thus, by their nature, preclude comparison with different sized funds. A more accurate analysis would consider percentage profits.

The Plaintiffs contended that only the direct costs associated with the fund should be considered in determining the fairness of the fee. The Court ruled that the associated processing costs were to be considered in determining net income. The Court considered three order processing costs, ranging from \$2 to \$7.5 per order. The Fitzgerald estimate of \$2 per order was a marginal cost estimated internally by Merrill Lynch prior to the litigation.⁴² The Deimer and PMM (Peat Marwick Mitchell) studies, conducted during the litigation, included branch office costs. The President of MLAM testified that the branch costs would still exist even if the fund did not, favoring the Fitzgerald cost estimates as the most accurate.⁴³

The following Table reproduces part of the District Court’s exhibit on profitability. It examines the latest period of analysis and adds

⁴¹ *Id.* at 1050.

⁴² *Id.* The Fitz-Gerald estimate was conducted in order to determine the level of reimbursement from the fund to brokerage operations.

⁴³ *Id.* at 1051.

a column for Profit Margin.⁴⁴ The Court concluded that, “[e]ven adopting the lowest estimate of processing costs (the reimbursement figure of the Fitzgerald estimate), the profitability of administering the Fund and the shareholder services amounted to four and a half ten thousandths (.00045) of the average net assets under supervision.”⁴⁵

Period		June 1980 to June 1981	Profit Margin
Average Net Assets		\$13,520,000,000	
Fees		\$39,369,587	
Direct Expenses		\$1,567,847	96.0%
Income Tax (55.774%)		\$21,083,543	
Net Earnings		\$16,718,197	
Order Volume		6,096,537	
Expenses	Fitzgerald	\$10,534,805	69.3%
	Diemer	\$30,848,477	17.7%
	PMM	\$45,541,130	-19.7%
Net Income	Fitzgerald	\$6,183,392	
	Diemer	(\$14,130,280)	
	PMM	(\$28,822,934)	

By this calculation, the Court implied that profits as a percent of assets under management were trivial and thus could be not excessive. The Court invented a metric that was tiny and appeared reasonable. The proper metric should consider profit as a percent of revenues. Revenues are a small percentage of assets and thus, the Court’s examination of

⁴⁴ *Id.* at 1053. In this table, the top line 96 percent number is best interpreted as a GPM. The Fitz-Gerald, Diemer and PMM numbers most closely resemble the Advisory Margin discussed above. The Advisory Margin numbers in the table ignore tax expenses included in the *Gartenberg* Court’s calculations and are thus consistent with subsequent case law.

⁴⁵ *Id.* at 1054.

profits as a percent of assets is misleading. Even taking into account the incremental processing cost, the Advisory Margin was almost 70 percent.

E. Economies of Scale

Here, an extended quote from the District Court is in order:

Defendants have raised doubts as to whether there are further economies of . . . scale in the provision of the services. While the unit costs of portfolio management and general administrative services have almost certainly declined as the Fund has grown, the far greater costs of providing shareholder services appear to have remained relatively stable.

As the trustees were informed in 1980, this was MLAM's reason for refusing to introduce any additional breakpoints. MLAM does not propose to introduce additional breakpoints at asset levels over \$2.5 billion because it believes the economies of scale applicable at lower asset levels tend to diminish when the fee rate reaches 0.275%...

(T)his “diminishing return” occurs largely because the costs of MLAM and Merrill Lynch associated with processing orders and administering shareholder accounts have not diminished as assets increase beyond the \$2.5 billion level.⁴⁶

This is the genesis of Judge Pollack’s “economies of scale (do not) necessarily apply to every stage of growth” insertion into the opinion’s legislative intent section. It is surely no coincidence that this is exactly the argument made by Merrill Lynch with respect to economies of scale. Again, the truly important economic issues are obscured by a misguided emphasis on processing costs.

The industry subterfuge - claiming that economies of scale are exhausted, and therefore no further fee reductions are necessary - is

⁴⁶ *Id.* at 1055.

exposed.⁴⁷ Exclusive of processing costs, Merrill Lynch would get to keep \$.96 of every revenue dollar going forward and the processing costs would not decrease further, allowing MLAM to claim that economies of scale are exhausted. If processing costs are included in allowed costs, then Merrill would get to keep about \$.70 of revenues going forward.

The Merrill Lynch fee schedule called for a fee of .275 percent on all revenues above \$2.5 billion. Since average assets in June of 1981 were about \$13.5 billion, Merrill got to keep .00275 times \$11 billion times .96, or about \$29 million of the incremental revenue above \$2.5 billion. Allowing for processing costs, the number is approximately \$21 million.

Ultimately, in the body of the Opinion, the District Court could reach no opinion about the existence of economies of scale but found that: "In any event, even if there do exist economies of scale, the present structure of MLAM's fee means that its effective fee has decreased as the size of the Fund has grown." However, in the conclusions section, the Court stated: "MLAM has shared with the Fund those economies of scale that it has realized from the Fund's growth in size."

F. Conclusion

Finally, the District Court's conclusion emphasizes the comparison of MLAM fees to industry fees in general, and offers its view of competition in the money fund business:

⁴⁷ *Id.* at 1064. The District Court in *Gartenberg* enthusiastically praised the deliberations of the Board of Trustees here, though the Board seems to have fallen for the same subterfuge as the Court. Apparently, MLAM misled the supposedly sophisticated Board of Trustees. Essentially, what MLAM was saying was that profit margins had flattened and therefore no further breakpoints were called for. However, a flat profit margin at a very high level meant the MLAM saw dollar profits grow exponentially with the exponential growth of assets. Fund sponsors get to spend dollar profits, not profit margins. This deliberate distortion of economic reality has led to great confusion in subsequent fee cases.

...when the fee is in harmony with the broad and prevailing market choice available to the investor...There would seem to be no sense to seek to limit by judicial fiat what is satisfactorily performed, sufficiently disclosed and freely available elsewhere in the market place at comparable charges, without penalty or restraint...Based on the rate of payment alone, that rate of compensation received by the adviser is neither extraordinary nor uncommon but is a commercially realistic rate.

The money market fund industry is a highly competitive business. There is no monopoly. There is no limited entry. There has been ample disclosure by the Adviser of the rate of fees to prospective customers, shareholders, the Fund and its trustees.⁴⁸

The decision may have been pre-ordained, given the legislative desire to maintain the status quo and the successful clouding of the issue because of processing costs. Unfortunately, the District Court appears to have bought, uncritically, the industry's talking points.

V. THE GARTENBERG SECOND CIRCUIT DECISION

The Second Circuit affirmed the District Court's opinion and established the "Gartenberg factors." Much of the decision reined in mistakes and excesses in the District Court opinion.

A. The Second Circuit Disagreed with the District Court's Reliance on Fees Charged by Similar Funds

The Appellate Court differed from the District Court regarding comparable fees:

We disagree with the district court's suggestions that the principal factor to be considered in evaluating a fee's fairness is the price charged by other similar advisers to funds managed by them, that the "price charged by

⁴⁸ *Id.* at 1067.

advisers to those funds establishes the free and open market level for fiduciary compensation," that the "market price ... serves as a standard to test the fairness of the investment advisory fee," and that a fee is fair if it "is in harmony with the broad and prevailing market choice available to the investor," 528 F.Supp. at 1049, 1067-68. Competition between money market funds for shareholder business does not support an inference that competition must therefore also exist between adviser-managers for fund business. The former may be vigorous even though the latter is virtually non-existent. Each is governed by different forces. Reliance on prevailing industry advisory fees will not satisfy §36(b).⁴⁹

B. The Second Circuit Cleaned Up the District Court's Profitability Analysis

The Appellate Court calculated the Net Income Margin using the Fitzgerald estimate of processing costs and found that it was 38.4 percent.⁵⁰ Using a similar methodology but ignoring processing costs, the Net Income Margin using direct costs only is 53.3 percent. The Second Circuit did not suggest a fiduciary maximum net income margin because the three cost estimates varied widely.

C. The Second Circuit Cast Doubt on the Competition Issue

The District Court opined that the money fund market is highly competitive and therefore the fee charged could not be unfair. The Appeals Court disagreed with this view and made the astute observation:

⁴⁹ Gartenberg, 694 F.2d at 929 (2d Cir. 1982).

⁵⁰ The Second Circuit used a 44.5 percent corporate tax rate to calculate the net income margin. *Id.* at 932.

One reason why fund competition for shareholder business does not lead to competition between adviser-managers for fund business is the relative insignificance of the adviser's fee to each shareholder. The fund customer's shares of the advisory fee is usually too small a factor to lead him to invest in one fund rather than in another or to monitor adviser-manager's fees. 'Cost reductions in the form of lower advisory fees ... do not figure significantly in the battle for investor favor.' *Id.* Hence money market funds do not generally advertise that their advisory fees may be lower than those charged by advisers to other funds. The disparity is competitively insignificant. In the present case, for instance, the alleged excessive Manager's fee amounts to \$2.88 *a year* for each \$1,000 invested. If rates charged by the many other advisers were an affirmative competitive criterion, there would be little purpose in §36(b).

D. The *Gartenberg* Factors

In determining whether fees charged are so excessive they could constitute a breach of fiduciary duty, the Second Circuit set forth six analytical factors:

1. The nature and quality of the services provided to the fund
2. The profitability of the fund to the adviser-manager
3. Fall out benefits
4. Economies of scale
5. Comparative fee structures
6. The independence and conscientiousness of the trustees

These factors, now enshrined in mutual fund fee case law, were misapplied under the unique facts in *Gartenberg*. Two (1 & 3 above) are inapplicable to mutual funds in general, and two (2 & 4 above) were misleadingly applied because of processing costs.

E. Nature and Quality of the Services Provided

The services provided in Merrill Lynch Ready Assets Trust involved the interaction of brokers with clients, an activity not normally

associated with the advisory contract. Advisory services typically involve portfolio construction and management and no interaction with fund investors.⁵¹ In normal mutual funds, these interactions are handled under the transfer agent or distribution contract and are charged separately from advisory fees. §36(b) cases should be limited to advisory fees only. But this factor confuses the issue, and subsequent courts have often felt compelled to examine shareholder services and expense ratios along with advisory services and fees, resulting in confusion.

F. Profitability of the Fund to the Adviser-Manager

Neither *Gartenberg* opinion could establish a statutory maximum profit margin due to the wide variability of the different cost estimates associated with the anomalous processing costs.

G. Fall-Out Benefits

The fall-out benefits in *Gartenberg* were the potential increase in brokerage commission income associated with the pairing of the money fund with a brokerage account, something unique to this type of fund, and irrelevant to the typical stand-alone equity/bond fund.

H. Economies of Scale

Similar to profit margins, economies of scale were indeterminate and confounded by the unique processing costs in *Gartenberg*, which became a misleading precedent for measuring economies of scale.

I. Comparative Fee Structures

The Second Circuit had reservations about the District Court's consideration of other funds' fees to justify the fees in *Gartenberg*. The

⁵¹ The advisory function, by its nature, is readily quantifiable and comparable to similar funds. Numerical comparisons include returns and fees. Non-advisory services, by their nature, are more qualitative and allow greater scope for subjective interpretation.

Appellate Court does reasonably assert that the “structure” (meaning the breakpoints) of other funds is relevant, given the Senate’s position.

We do not suggest that rates charged by other adviser-managers to other similar funds are not a factor to be taken into account. Indeed, to the extent that other managers have tended “to reduce their effective charges as the fund grows in size,” the Senate Committee noted that such a reduction represents “the best industry practice [which] will provide a guide.”⁵²

J. The Independence and Conscientiousness of the Trustees

Mutual fund trustees serve as watchdogs for the interests of fund shareholders. Subsequent to *Gartenberg*, their main function is to insure that fund management is in regulatory compliance with the rules.

K. The *Gartenberg* Standard(s)

The Second Circuit articulated not one, but two standards. However, the decision and subsequent courts have clearly favored the second standard. The first standard would seem to support the SEC position:

Standard 1: “the legislative history of §36(b) indicates that the substitution of the term ‘fiduciary duty’ for ‘reasonable,’ while possibly intended to modify the standard somewhat, was a more semantical than substantive compromise....As the district court and all parties seem to recognize, *the test is essentially whether the fee schedule represents a charge within the range of what would have been*

⁵² *Id.* at 929.

*negotiated at arm's-length in the light of all of the surrounding circumstances.”*⁵³

From an economic point of view, this “negotiated at arm’s-length” standard is appealing; the language is precise and the standard is amenable to statistical analysis with a reasonable degree of precision. The notion of a range of outcomes has clear mathematical meaning, and fees “negotiated at arm’s-length” can be observed empirically.

Standard 1 asserts that the proper test for fee comparison is to compare fund fees to fees actually determined in arm’s-length negotiations. This is called the “institutional comparison” and it refers to the comparison of fund fees to comparable institutional fees negotiated at arm’s-length, which is the comparison examined in the Wharton and PPI studies.

The problem in *Gartenberg* is that the comparison was corrupted by processing costs which were unique to that fund:

Appellants' argument that the lower fees charged by investment advisers to large pension funds should be used as a criterion for determining fair advisory fees for money market funds must also be rejected. The nature and extent of the services required by each type of fund differ sharply. As the district court recognized, the pension fund does not face the *myriad of daily purchases and redemptions throughout the nation* which must be handled by the Fund, in which a purchaser may invest for only a few days.⁵⁴

This language is important. The *myriad of daily purchases and redemptions throughout the nation* clearly refers to the Merrill Lynch brokerage operations and the concomitant processing costs. Merrill Lynch operated branch offices *throughout the nation* and the time brokers spent writing trade tickets was counted in *Gartenberg* as a

⁵³ *Id.* at 928 (emphasis added).

⁵⁴ *Id.* at 930 n. 3 (emphasis added).

legitimate cost of operating the fund.⁵⁵

After presenting Standard 1, the Second Circuit briefly discusses the notion that “as a practical matter the usual arm’s-length bargaining between strangers does not occur between an adviser and the fund....” The Court then presented Standard 2:

Standard 2: “To be guilty of a violation of §36(b), *therefore*, the adviser-manager must charge a fee that is *so* disproportionately large that it bears no reasonable relationship to the services rendered *and* could not have been the product of arm’s-length bargaining.”⁵⁶

The use of “therefore” suggests that the Court has, in some sense, refined and superseded its own Standard 1. Moreover, “therefore” seems to be a non-sequitur. There is nothing that justifies the more subjective and extreme Standard 2, which is extreme in the sense that it is far more difficult for plaintiffs to overcome than Standard 1. It is more subjective and less amenable to quantification.

Standard 2 involves a two-pronged test; the fee at issue must be “so disproportionately large” that it “could not have been the product of arm’s-length bargaining.” As Lyman Johnson⁵⁷ notes, “the court illogically framed the first prong in a way that deviates from ‘reasonableness’ and seemed to require extremeness—‘so disproportionately large,’ not just ‘disproportionately large,’ and ‘no reasonable relationship,’ not just ‘unreasonable.’”

Johnson goes on to discuss the corporate fiduciary doctrine and the relevance of the behavior of the fund’s trustees. He then suggests that the Second Circuit’s articulation of Standard 2 may have just been “clumsy”:

⁵⁵ There is a subtle but important distinction to be made here. A money fund not integrated with brokerage operations would also face a myriad of daily purchases and withdrawals of customers throughout the nation. However, that money fund or indeed the typical equity fund would not bear the costs of such operations which are handled under a separate transfer agent contract. *See, e.g., id.* at 926.

⁵⁶ *Id.* at 928 (emphasis added).

⁵⁷ Lyman Johnson, *A Fresh Look at Director “Independence”*: *Mutual Fund Fee Litigation and Gartenberg*, 61 VAND. L. REV. 497, 516 (2008), <https://perma.cc/DJ8N-CZS8>.

Furthermore, given the court's clear acknowledgement that a reasonableness standard is appropriate, its phrase 'so disproportionately large that it bears no reasonable relationship to the services rendered' is either a verbose way to express a reasonableness requirement or it wrongly introduces a stricter requirement that contradicts the very reasonableness standard that the court seemingly endorsed. The reading more consistent with legislative history and the rest of the opinion is that the court spoke clumsily.⁵⁸

A straightforward application of Occam's Razor suggests that the Second Circuit's articulation of the schizophrenic, subjective and extreme Standard 2 was a purposeful act consistent with the actual underlying legislative intent, which was to maintain the status quo of high fees in the mutual fund industry, and give deference to the advisors' fee-related decisions.⁵⁹ At any rate, Standard 2 is the *de facto* *Gartenberg* standard, which depends on the judgment of the fact-finder principally untethered from any real economic analysis.⁶⁰ Essentially it says that unless the fee is so outrageously high that it is unconscionable, then it is acceptable, which looks like a "corporate waste" standard⁶¹ in everything but name. It is not so much a standard as it is permission for courts to do what they want, or more specifically, what Congress wanted. The important point is

⁵⁸ *Id.* at 517-18.

⁵⁹ One hypothesis is that the dual standards illustrate an internal split in the Second Circuit.

⁶⁰ The explicit mention of "services rendered," by implication, includes the corrupting and confounding shareholder service costs.

⁶¹ The corporate waste standard is that the cost must "shock the conscience of the court." The test involves a determination of whether a stats agent's actions fall outside the standards of civilized decency. The U.S. Supreme Court established the "shock-the-conscience test" in *Rochin v. California*, 342 U.S. 165 (1952).

that Standard 2 has prevailed over Standard 1 and the *Gartenberg* opinion articulated contradictory standards, hence, the resultant schizophrenia. The resulting *Gartenberg* Standard is an unduly high hurdle for plaintiffs to overcome. The *Gartenberg* analytical factors are confused and corrupted by the presence of anomalous processing costs, which give rise to the lack of “analytical clarity” noted by the US Supreme Court in *Jones v. Harris*⁶².

VI. GARTENBERG’S PROGENY: SCHUYT, KRINSK, AND KALISH

None of the *Gartenberg* successor cases involved equity funds; rather, each involved funds that in one way or another were anomalous and unrepresentative of funds in general. This reinforced the confusion generated by the processing costs considered in *Gartenberg*. The industry was astute in allowing these particular funds to come to trial. *Schuyt* established a precedent for very high profit margins; *Kalish* established the precedent of disallowing fee comparisons with the Vanguard family of mutual funds.

A. Schuyt v. Rowe Price Prime Reserve Fund, Inc.

Schuyt was brought in 1980 and was pending while the *Gartenberg* court was deliberating. Like *Gartenberg*, the fund in *Schuyt* was a money market fund but unlike *Gartenberg*, the fund was not integrated into a brokerage firm and thus had no processing costs to confuse the issue. The costs of interactions with investors in *Schuyt* were handled by the fund’s transfer agent. The transfer agent contract was separate from the advisory contract.

Although there were no processing costs *per se*, the advisory contract was not exclusively for advisory services. It included compensation for administrative services, thus confusing the issues significantly. The administrative services provided fell into four categories: shareholder services, fund accounting, meeting legal and regulatory requirements, and marketing. The first and last of these are typically characterized as distribution costs.

Judge Ward, in *Schuyt*, made one peculiar ruling and one obvious error. Curiously, he chose to ignore expert economic testimony because the economic experts did not offer legal analysis of the behavior of the Trustees. The testimony of plaintiff’s expert Professor Bicksler,

⁶² *Jones v. Harris Associates L.P.*, 559 U.S. 335, 353 (2010).

was “not given much weight” because, among other things, he failed to investigate “whether the independent directors in this case bargained with care and in good faith.”⁶³ Plaintiff’s expert Silver, as with the Wharton and PPI studies, compared the profit margins on the money fund to the profit margins of private counsel (institutional) clients and concluded that the money fund profitability percentage (exclusive of marketing) was significantly higher than that of other product lines of the adviser. Judge Ward discounted Mr. Silver’s testimony for ignoring the *Gartenberg* factors, and not studying “the actual behavior of the directors in negotiating the fee.” It seems peculiar that an expert conducting an economic analysis that essentially followed the Wharton and PPI studies should not be given much weight.

Judge Ward significantly erred when he ruled that Mr. Silver’s analysis was flawed for comparing fee rates and profitability to rates and profitability of “companies that perform services that are unrelated to the advisory services at issue in this case.” Specifically, “fee rates of advisers to non-mutual fund clients should not be used as criterion for determining fairness of mutual fund fees because advisers to other types of entities perform services that *do not involve a myriad of daily purchases and redemptions.*”⁶⁴

The error is that the “myriad of daily purchases and withdrawals” was relevant in *Gartenberg* because of the processing costs of brokers writing trade tickets in Merrill Lynch’s branch office structure. In *Schuyt*, the money fund had a transfer agent to handle purchases and withdrawals; the portfolio manager would receive one number each day representing the net of purchase and withdrawal transactions. In money fund management it is normal to deal with such cash flows. There are no significant cost differences in managing an institutional and a mutual fund portfolio where cash flows are concerned.

Judge Ward rejected all expert testimony establishing any connection between the fee charges on the Rowe Price Prime Reserve Fund and fees set by actual arm’s-length negotiation. He determined that the actual fee on the Prime Reserve Fund was in the range of fees determined by arm’s-length negotiation by deferring to the good faith deliberations of the Board of Directors of the Prime Reserve Fund in

⁶³ *Schuyt v. Rowe Price Prime Reserve Fund, Inc.*, 663 F. Supp 962, 973 n.37 (S.D.N.Y. 1987).

⁶⁴ *Id.* at 973 n.38 (emphasis added).

spite of the fact that the Board did not consider the profitability of fees/funds actually established by arm's-length negotiation. The Court ruled:

Having found the testimony of the experts presented by both sides to be unavailing, in that all of the experts failed to address the relevant legal as opposed to economic implications of this case, the Court itself now must apply the analysis required in this Circuit. Although the Court considered all relevant facts in connection with the determination and receipt of the fees, the Court accorded the greatest weight to the testimony and documentary evidence which shed light on factors stressed by the Second Circuit: the nature and quality of the services rendered, the cost of these services, the sharing of economies of scale as the Fund increased in size, and the qualifications and performance of the independent directors⁶⁵.

i. The Profit Margin Standard

Judge Ward accepted the profit margin calculation of plaintiff's expert Silver: 59.1% in 1979, 66.8% in 1980 and 77.3% in 1981:

While it cannot be denied that the Adviser earned a significant profit from these services, it does not appear to the Court, in light of all of the facts, that the fees charged by the Adviser were so disproportionately large that they bore no reasonable relationship to the services rendered and could not have

⁶⁵ *Id.* at 974.

been the product of arms-length bargaining⁶⁶.

In the immediately following footnote 77 of the opinion, the Court observed:

The Court wishes to make clear that it is not holding that a profit margin of up to 77.3% can never be excessive. In fact, under other circumstances, such a profit margin could very well be excessive. For example, if advisory services being challenged were not of the highest quality and if the directors were not so obviously qualified, fully informed, and conscientious, a similar fee structure could violate section §36(b). This Court is simply holding that on the facts presented here, the fee schedules at issue represent charges within the range of what would have been negotiated at arms-length in the light of all of the surrounding circumstances.

The subjectivity of *Gartenberg* is in full view, and Judge Ward does not appear to be totally confident in his arguments; his opinion is hedged, defensive and apologetic. At any rate, 77% has been the fiduciary standard maximum profit margin for more than 25 years and the implication, consistent with Judge Ward's tone, is that this number is high.

ii. Economies of Scale in Schuyt

Schuyt looked at fees and fee breakpoints superficially and noted that the Board reduced them as assets increased. There was no analysis of costs or scale factors, or any attempt to quantify economies of scale: the presence of breakpoints was seemingly sufficient to convince the

⁶⁶ *Id.* at 989.

Court that economies of scale had been adequately addressed. Even with breakpoints, the Advisory Margin on the prime reserve fund was 77%, which the Court found acceptable.⁶⁷

B. *Krinsk v. Fund Asset Management, Inc.*⁶⁸

Krinsk followed *Gartenberg* in a suit against the Merrill Lynch money fund imbedded in the Cash Management Account (CMA). In the interim period, Merrill Lynch brokers were no longer writing trade tickets on money fund transactions. However, fund trustees had approved a distribution plan to encourage brokers to promote the fund. The distribution fee of 12.5 basis points was added to the advisory fee; brokers received 11 of the 12.5 basis points.

District Judge Walker ruled that the relevant fee was the advisory fee *plus* the distribution fee. Similar to *Gartenberg*, the inclusion of non-advisory activities on the firm's part corrupted the analysis of advisory fees and prevented a clear determination of profitability and economies of scale. Merrill Lynch argued that the distribution fee was inadequate to cover the time brokers spent dealing with money fund issues, and that overall, these activities generated losses to the firm.

Faced with a range of pre-tax profit margin numbers from the negative to about 40%, Judge Walker determined that a true figure for a three year weighted average margin would "probably fall in the range of a few percentage points greater than 0% to perhaps as much as 33%."⁶⁹

The Court's findings on economies of scale were confusing and contradictory. Judge Walker found that "merely because the ratio of fee based expenses to fee based revenue declined at a time when the Fund size grew, that fact does not establish that such a decline was necessarily due to economies of scale."⁷⁰ On the contrary, declining fee-based expenses relative to fee-based revenues, resulting from an increase in assets, is a clear indication of economies of scale in the *advisory* function. Judge Walker reached this conclusion because, "Although the

⁶⁷ As discussed above, an Advisory Margin of 77 percent is associated with a scale factor maximum of .23, an indication of substantial realized economies of scale.

⁶⁸ F. Supp. 472 (S.D.N.Y. 1988), *aff'd*, 875 F.2d 404 (2d Cir 1989), *cert. denied*, 493 U.S. 919 (1989).

⁶⁹ *Id.* at 496.

⁷⁰ *Id.* at 496.

per-unit cost of providing management services directly to the fund decreases as the fund grows, the per-unit cost of servicing fund shareholders does not.”⁷¹ Because non-advisory activities were lumped in with the advisory function, the failure to demonstrate economies of scale in *each* activity was considered evidence of an overall lack of economies of scale. Ultimately, the decision favored Merrill Lynch and the close integration of the fund with brokerage activities once again corrupted the analysis. Like *Gartenberg*, the fund in *Krinsk* was relatively unique and a poor candidate for a precedent-setting case.⁷²

C. Kalish v. Franklin Advisers, Inc.⁷³

Kalish is another case decided subsequent to *Gartenberg*. The fund at issue was a GNMA⁷⁴ fund. A distinguishing feature of the fund is that it paid for advisory and administrative services under a single unified contract. The contract included services for “underwriting, transfer agent, management and other” services. The fund had an expense ratio of .545% and an advisory fee over the period in question of .45%.

⁷¹ *Id.*

⁷² See *id.* at 497. See generally, *Gartenberg v. Merrill Lynch Asset Mgmt.*, 694 F.2d 923, 929 (2d Cir. 1982). The money fund in *Krinsk* was not totally unique; the case notes that in the winter of 1986, Lipper American Security Corporation reported 138 retail taxable money market funds of which 9 were central asset account funds, meaning 9 were *integrated* with the brokerage function. It is interesting that the *Krinsk* court acknowledged differences between stand-alone funds and funds that are part of central asset accounts stating: “Because stand-alone funds differ from central asset account funds in their services to shareholders and in their role as a vehicle for holding a customer’s assets, the prices charged for them are not entirely comparable.” *Krinsk*, 715 F. Supp. at 497. The *Krinsk* court thus ratified the central thesis of this paper that the fund in *Gartenberg*, the precedent setting case differed from mutual funds in general, the vast majority of which were stand-alone funds.

⁷³ 742 F.Supp. 1222 (S.D.N.Y. 1990).

⁷⁴ GNMA is an acronym for the Government National Mortgage Association and GNMA bonds are bundled packages of mortgages that are marketable securities. *Id.* at 1223-24.

The Court in *Kalish* analyzed the unified fee and made no attempt to analyze advisory services separate from administrative services. As a result, similar to the previous three cases, the analysis of profitability and economies of scale were corrupted and indeterminate.⁷⁵ Plaintiffs in *Kalish* argued that the Franklin GNMA fund fees were excessive relative to a comparable Vanguard GNMA fund. Defendants contended that the structure of the Vanguard family of funds is unique because the Vanguard family of funds owns the management company, and thus renders services to the funds at cost, whereas in the Franklin family, Franklin Advisers seeks to make a profit.

The contention was only partially correct. Administrative services were indeed provided to the Vanguard GNMA fund at cost. However, advisory services were provided by a sub-advisory contract with Wellington Management, a for-profit company. The expense ratio of the Vanguard fund was 35 basis points and the sub-advisory fee was 3 basis points. It bears repeating that Wellington Management was a for-profit company and was thus able to manage the portfolio for three 3 basis points and still make a profit.

So, Vanguard was providing all administrative services for 32 basis points (the 35 basis point expense ratio less the 3 basis point sub-advisory fee). The Franklin Expense ratio was 54.5 basis points including all administrative and advisory fees. This means that *if* the Franklin advisory fee was the same as the Vanguard sub-advisory fee, or 3 basis points, Franklin shareholders were paying 51.5 basis points for all non-advisory services, a 61 percent premium in excess of Vanguard. It is not clear how much more expensive it is to provide administrative services in a for-profit company than it is to provide them at cost, but common sense suggests that it is not 61 percent more expensive. If the Franklin advisory fee was double the Vanguard advisory fee, or 6 basis points, then the Franklin administrative premium would still be in excess of 50 percent. If Franklin charged three times as much for advisory services, or 9 basis points, then its administrative services would still be 42 percent higher than

⁷⁵ The Court in *Kalish* had to deal with the issue of whether underwriting expenses were properly charged as an expense in calculating profitability. In the process, management fees and management expenses for the firm and the fund were identified for three periods. Gross profit margins for Franklin as a whole were in the neighborhood of 92 percent. The GPM for the GNMA fund in question was in excess of 99 percent. *Id.* at 1228.

Vanguard's administrative services. It is not clear how much higher the Franklin fee would have to be relative to the Vanguard advisory fee in order for it to be so disproportionately large as to constitute a breach of fiduciary duty, but because the advisory fee was hidden or buried within the unified fee, the Court never made that determination.

Ultimately, the judge concluded that the Vanguard comparison was not persuasive:

The conclusion to be drawn is that the Vanguard GNMA fund furnishes some basis for a comparison of performance with the Franklin Fund, but there are also significant differences in structure, peculiar to the Vanguard family of funds, which lessen the value of the comparison for purposes of this litigation.⁷⁶

Vanguard advisory fees are a good proxy for institutional fees because they are competitively negotiated at arm's-length. The institutional comparison was disallowed in the *Gartenberg*, *Schuyt* and *Krinsk* cases, and the *Kalish* precedent effectively disallowed it for Vanguard.⁷⁷

D. Conclusion

Taken together, *Gartenberg*, *Schuyt*, *Krinsk* and *Kalish* are the precedents that have defined the fee litigation landscape for more than twenty-five years. As such, they have successfully fulfilled the Congressional intent of maintaining the status quo of mutual fund fees. Although three of the four funds were money market funds, and the

⁷⁶ *Id.* at 1231.

⁷⁷ *Kalish* also corroborates the notion that the fall-out benefit factor is an artifact of the unique nature of the fund in *Gartenberg*. Brokerage commission income accruing to Merrill Lynch was a factor in the case. "Another factor mentioned by the Second Circuit in *Krinsk*, 'fall-out benefits,' is not implicated by the facts of the case at bar." *Id.* at 1228 n.1.

fourth (*Kalish*) was also a fixed income fund, the precedent(s) applies to all kinds of mutual funds, equity, fixed income, international, life cycle, etc. The misguided notion that there are significantly higher costs associated with managing mutual fund portfolios because of the large customer base persists to this day.

VII. THE FREEMAN AND BROWN STUDY

FB updated the Wharton and PPI studies. They contacted the 100 largest public pension plans and asked for fee information on equity portfolios managed by external investment advisory firms. Information was presented on a total of 220 individual actively managed pension portfolios totaling about \$100 billion in assets. The assets and fees on the pension portfolios were compared to the assets and fees of similar mutual funds and the results confirmed and amplified the Wharton and PPI observation that mutual funds pay higher investment management fees than institutional investors. Like the Wharton and PPI studies, FB concluded that the differential is the result of a lack of arm's length negotiation of mutual fund advisory fees.

A. Overview of Freeman Brown Results

Pension and Mutual Fund Portfolios were ranked by assets under management and arranged in deciles.⁷⁸ Weighted average fees were then computed within each asset decile. Pension and Mutual Fund fees were then compared. Table 2 presents the results in tabular form and Exhibit 3 in graphical form. Mutual fund fees were the advisory fees exclusive of administrative and distribution fees. Overall, weighted average pension fees were 28 basis points while mutual fund fees were 56 basis points.

⁷⁸ Each decile contained 10 percent of the total number of funds examined.

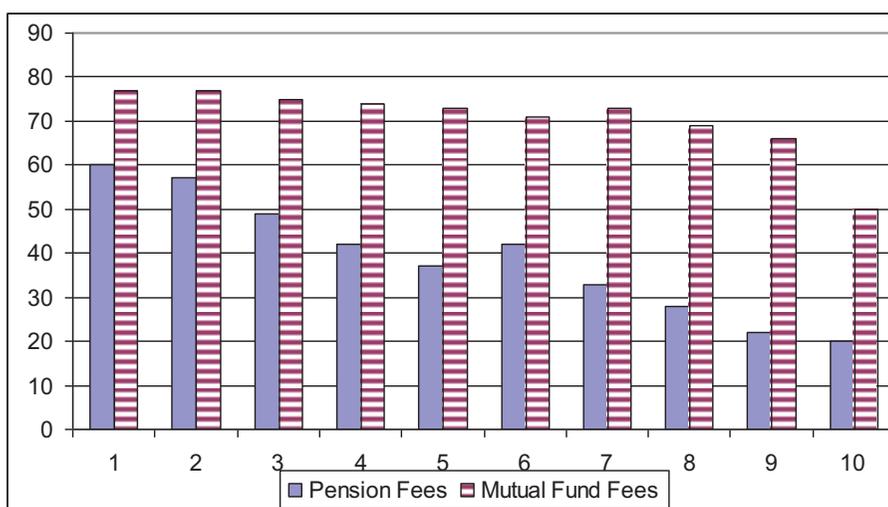
Table 2
**Comparison of Public Pension and Mutual Fund Investment
 Advisory Fees**

Decile	Public Pension Funds		Mutual Funds	
	Average Portfolio Size \$mm	Weighted Average Advisory Fee (Basis Pts)	Average Fund Size \$mm	Weighted Average Adv. Fee (Basis Pts)
1	36	60	24	77
2	79	57	47	77
3	130	49	76	75
4	194	42	121	74
5	257	37	185	73
6	327	42	284	71
7	437	33	454	73
8	579	28	759	69
9	842	22	1,527	66
10	1,550	20	9,666	50
Overall	443	28	1,318	56

In Exhibit 3, the height of the bars represents fees in basis points. The ten bars represent asset deciles with the smallest funds on the left and the largest on the right. Note that for both pension and mutual fund portfolios, fees tend to fall as portfolio size increases although this effect is much more pronounced for pension than mutual fund portfolios. The decrease is the result of economies of scale being passed along to

portfolio owners. The more pronounced decrease for pension fees is consistent with economies of scale and greater competitive pressures on pension managers. The fact that mutual fund fees do not decrease much is consistent with a lack of competitive pressures allowing mutual fund sponsors to capture the profits associated with economies of scale.⁷⁹

Exhibit 3



⁷⁹ The difference between average pension fees and average mutual fund fees is understated. The average pension portfolio held \$443 million in assets while the average mutual fund portfolio held about \$1.3 billion. If the largest mutual funds are excluded to calibrate similar sized portfolios, the weighted average mutual fund advisory fee is 68 basis points compared to a similar sized pension portfolio fee of 26 basis points. The difference is 42 basis points. Viewed another way, asset managers charged about \$1.15 million (26 bp on \$443 million) to manage a pension portfolio and about \$7.4 million (56 bp on \$1.3 billion) for similar services to mutual funds.

A notable feature of Table 2 is the pronounced negative skew in the distribution of fund assets⁸⁰. This is true for both pension and mutual fund portfolios but it much more pronounced for mutual funds than for pension portfolios. Pension assets almost double from the ninth to the tenth pension (\$1,550 from \$842 million) while mutual fund assets increase more than six fold (\$9,666 from \$1,527 million).

Pension fees decline quite smoothly over the range of assets, consistent with pension investment managers passing along economies of scale as they occur. By contrast, mutual fund advisory fees only drift downward slowly until the top decile when fees plummet from 66 to 50 basis points. This is consistent with the larger funds instituting breakpoints at higher assets levels, perhaps to keep profits below the 77 percent *Schuyt*⁸¹ ceiling.

B. The Industry Response to Freeman and Brown

The industry response to FB took two forms, both related to the Law of One Price. ICI Economist Collins argued that the services provided to mutual funds were substantially different and more expensive than the services provided to pension funds.⁸² His arguments are a continuation of the distortions produced by the processing costs in *Gartenberg*. The Investment Company Institute also sponsored⁸³ research by Coates and Hubbard⁸⁴, which argued that advisory fees are constrained by competitive forces.

⁸⁰ There are a large number of small funds and a small number of very large funds.

⁸¹ See *Schuyt v. Rowe Price Prime Reserve Fund*, 663 F. Supp. 962, 989 n.77 (S.D.N.Y. 1987).

⁸² Sean Collins, *The Expenses of Defined Benefit Pension Plans and Mutual Funds*, 9 INV. CO. INST. PERSPECTIVE No. 6 (Dec. 2003), available at <https://perma.cc/V574-7M5K>.

⁸³ The Coates & Hubbard study was at least partially sponsored by a subsidiary of the ICI. See Asher Hawkins, *Well-Funded Opinion*, FORBES (May 8, 2009), <https://perma.cc/R49K-EPRC> [hereinafter CH].

⁸⁴ *Id.*

C. Collins: The ICI Perspective

The Collins article is based largely in misdirection. He compares *operating expense ratios* on pension and mutual fund portfolios and finds them to be far different. Operating expense ratios are defined as advisory fees plus administrative fees and are naturally quite different because mutual funds must deal with far more customers. Collins *does* identify the differences in advisory costs and FB as well as Freeman, Brown and Pomerantz⁸⁵ cost out these differences in the neighborhood of three basis points, not enough to account for the 26 basis point difference in mutual and pension advisory fees.

D. Coates and Hubbard

Coates and Hubbard ("CH") postulate that conditions in the mutual fund "markets" approximate the theoretical model of perfect competition, i.e., a large number of rational and well-informed buyers and sellers dealing in a homogeneous product with no barriers to entry or exit. With perfect competition, market prices are in some sense correct and thus cannot be excessive.

One major problem with the CH argument is the evidence that many mutual fund investors are unsophisticated and make poor investment decisions.⁸⁶ CH handle these apparent problems in the core proposition of the paper:

⁸⁵ John Freeman et al., *Mutual Fund Advisory Fees: New Evidence and a Fair Fiduciary Duty Test*, 61 OKLA. L. REV. 83, 110 n.92 (2008).

⁸⁶ There is evidence that many investors do not understand the concept of an expense ratio. See Gordon Alexander et al., *Mutual Fund Shareholders: Characteristics, Investor Knowledge, & Sources of Information*, 7 FIN. SERVICES REV. 301, 302 (1998). The reported results of an SEC survey found that only nineteen percent of investors could give an estimate of expenses for their largest mutual fund. *Id.* at 302-05. A minority of respondents (forty-three percent) claimed to have known of the expenses of their largest funds at purchase and only sixteen percent of survey respondents believed that higher expenses led to lower-than average returns. *Id.* Moreover, another study found that eighty-four percent of investors believe higher operating expenses mean better performance, despite clear evidence to the contrary. See Brad M. Barber,

Given a sufficient number of buyers engaging in a price search for a given quality of product and service, willing and able to switch to competitors, fund advisers must price competitively for their funds to retain price-sensitive customers. Competitive prices benefit all funds investors, price-searching and non-price-searching, tax-constrained, or tax-free, alike.⁸⁷

CH find that larger mutual funds have lower expense ratios and hypothesize that lower fees (competition) are the *cause* of higher asset levels. A more persuasive hypothesis is that as funds grow in size, they realize economies of scale and increased profit margins. The larger funds may decrease fees in order to keep margins under the 77 percent ceiling mandated by case law.

Another problem with the CH proposition is that with profit margins perhaps as high as 77 percent, investment advisers are not incentivized to lower fees for all of their customers in order to retain price sensitive customers. Consider an abstract but reasonably realistic hypothetical: an actively managed large cap fund has \$10 billion in assets and a 50 basis point advisory fee. The fund sponsor's Advisory Margin is 70 percent, the typical large cap Advisory Margin according to MFGC A. The fund generates \$50 million in revenues (.005 times \$10 billion) and operating profits of \$35 million (.70 times \$50 million).

Assume that the fund sponsor is confronted with competition from Vanguard which offers an actively managed large cap fund with a 25 basis point advisory fee. A single large investor with \$1 billion invested in the fund will move to Vanguard unless the fee is lowered to match the 25 basis point Vanguard fee.

The fund sponsor can keep the whole \$10 billion in assets but must lower fees across the board so that revenues fall to \$25 million and

Terrance Odean, & Lu Zheng, *Out of Sight, Out of Mind: The Effects of Expenses on Mutual Fund Flows*, 78 JOURNAL OF BUS. 2095, 2099 (2005). Approximately thirty percent of all US employees who are eligible to participate in a 401(K) plan do not enroll. See RICHARD H. THALER & CASS R. SUNSTEIN, *NUDGE: IMPROVING DECISIONS ABOUT HEALTH, WEALTH, AND HAPPINESS* 107 (Yale University Press, 2008).

⁸⁷ *Id.* at 136.

profits fall to \$10 million.⁸⁸ Or, the fund sponsor can let the \$1 billion run off and maintain revenues of 50 basis points on \$9 billion, or \$45 million. This would allow the sponsor to earn operating profits of about 70 percent of \$45 million or \$30 million.⁸⁹ So his/her choice is to earn \$10 million and retain the fee sensitive assets, or \$30 million, and let the fee sensitive assets leave. This choice is clear.

The above example is stylized but realistic enough to illustrate the main point which is that when faced with the prospect of having assets leave the fund, or lowering the fees for all assets in the funds, investment advisors with profit margins as high as those documented here will rationally choose to maintain high levels of fees and profits and to let the assets exit the fund. It is unclear what percentage of total fund assets are fee-sensitive, but it seems obvious that it would have to be quite high in order for fund sponsors with 50 to 70 percent profit margins to lower fees for all fund participants, in order to retain the fee sensitive assets.

CH only “suggest” that mutual fund markets are competitive. They say that fund markets are “consistent with competition,” and the “mutual fund industry’s market structure is consistent with competition providing strong constraints on advisory fees.” The structure “implies effective price competition.”⁹⁰

The reason CH only suggest that mutual fund “markets” are competitive is that mutual fund expense ratios are not market prices; they are administered prices, the result of an annual approval process between the adviser and the mutual fund board. Investors, the ultimate buyers and the ultimate sellers (investment managers) do not directly interact to impact fees. Because buyers and sellers do not directly interact, expense ratios are not market prices. Finally, the fact that mutual funds are captive of fund sponsors is “consistent” with monopoly pricing. What is needed is some independent means of gauging the truth of the two

⁸⁸ A 70% profit margin at 50 basis points on \$10 billion means that costs would be 30 percent of \$50 million or \$15 million. If it is assumed that all of these costs are fixed, then the dollar profit would be revenue of \$25 million less costs of \$15 million or \$10 million.

⁸⁹ Using the same logic, if all costs are fixed, then the \$45 million in revenue, less \$15 million in costs, yields \$30 million in profit. In all likelihood, costs are not precisely constant but the main point of the illustration is clear.

⁹⁰ See Coates *supra* note 11 at 163, 170, 174, 180, 184, 197, 200.

competing propositions. Brown⁹¹ shows that the universe of publicly traded fund sponsors is extraordinarily profitable and that fund sponsors earn economic profits for their owners. Economic profits are a characteristic of firms with monopoly pricing power.

VIII. RECENT CASES: *IN RE AMERICAN MUTUAL FUNDS FEE LITIGATION* AND *JONES V. HARRIS ASSOCIATES L.P.*

The *American Mutual Funds Fee Litigation* decision was published in December, 2009, subsequent to the appellate court split in *Jones v. Harris* but prior to the U.S. Supreme Court decision.

A. In Re: American Mutual Funds Fee Litigation

The American Funds complex was/is the second largest by total assets in the U.S., behind Vanguard. The complex grew from \$338 billion at the end of 2002 to \$2.1 Trillion⁹² at the end of 2009. There were only 30 funds⁹³ in the complex but in 2009, four⁹⁴ of the ten largest funds in the Morningstar database were American Funds offerings. The named funds each had 14 fund classes but only three were available to the general public, the A,B and C fund classes which each carried some form of a sales load. American Funds pursued brokerage firms aggressively in order to gain shelf space and the strategy was successful.

With the application of breakpoints in the advisory contract, the Investment Advisor, Capital Research and Management Company (CRMC), aggressively reduced advisory fees as the funds grew in size. In addition to aggressive breakpoints on the investment advisory contract, CRMC also instituted fee waivers and instituted a profit sharing program for its employees which amounted to 35 percent of pre-tax operating income. The court characterized the level of profit sharing as

⁹¹ STEWART L. BROWN, *Gartenberg: Some Empirical Clarity* (June 9, 2015), available at <https://perma.cc/4RKQ-BJ3W>.

⁹² *Principia Pro*, MORNINGSTAR (December 2009).

⁹³ *In re American Mut. Funds Fee Litigation*, 2009 WL 5215755 at *5 (C.D. Cal. 2009).

⁹⁴ These four were American Funds Fundamental Investors, Washington Mutual, Investment Company of America and Growth Fund of America. The latter had \$156 billion in assets at the end of 2009.

“enormous and . . . at least some employees are compensated at levels that might be viewed as excessive.”⁹⁵ Aggressive breakpoints, fee waivers and an “enormous” profit sharing pool are *consistent with* CRMC realizing economies of scale on very large funds and reducing profitability at the individual fund level in order to not exceed the *Schuyt* 77 percent profit margin ceiling.

Fortunately for CRMC, the issue of profit margins and economies of scale at the individual fund level never came up in the case. Plaintiffs charged⁹⁶ that *overall* fees on the eight largest funds in the complex were excessive, including advisory, distribution, and transfer agent fees. As in previous cases, advisory fees were never examined in isolation. The plaintiff’s theory was that excessive distribution fees caused assets to grow to the advantage of the defendants but the detriment of fund owners who, because of the size of the funds, suffered low returns. They also alleged that the largest funds were essentially closet index funds and that the investment advisor failed to share economies of scale and the fall out benefits arising from a subsidiary providing transfer agency services. On balance the plaintiff’s theory of the case was confused, convoluted, and overly broad. Thus, once again the industry was astute in allowing this case to come to trial as there was no possibility of a clean measure of economies of scale or clean comparison to fees actually determined at arm’s length.

The court followed the *Gartenberg* precedent and found for the defendants, although apparently with some reluctance. The court found that the profit level of the various entities fell within the range of profit margins other courts have deemed acceptable under §36(b)⁹⁷. Profit margins were examined at the advisory firm level and not at the individual fund level. Even so, as discussed below there is reason to believe that, measured properly the margins of the investment advisor were very high.

Similar to margins, both sides agreed to examine economies of scale at the complex level. This led to unmitigated confusion of the issues as exemplified by the following:

⁹⁵ *Id.* at *34.

⁹⁶ Second Amended Complaint, *In re American Funds Fee Litig.*, No. CV-04-5593 (C.D. Cal. Feb. 17, 2006), *available at* <https://perma.cc/F8GG-F8QT>.

⁹⁷ *In re American Mut. Funds Fee Litigation*, *supra* note 93, at *47.

Economies of scale exist when “the per unit cost of performing Fund transactions decrease[s] as the number of transactions increase[s].” *Krinsk*, 875 F.2d at 411; *see also Kalish*, 742 F. Supp. at 1237 (“The concept of ‘economies of scale’ assumes that as a mutual fund increases in size, its operational costs decrease proportionally”). “The concept [of economies of scale] is meaningful only if increased size of a fund (more shareholders, more assets under management) directly reduces the manager’s costs of processing each transaction and servicing each shareholder.” *Kalish*, 742 F. Supp. at 1239.⁹⁸

Note the confusion caused by the anomalous processing costs in *Gartenberg* as it impacted on the notions of economies of scale in *Krinsk* and *Kalish*. The costs of processing transactions and servicing shareholders is irrelevant to economies of scale of the *advisory* function but in this case, as in other cases the advisory function is conflated with transfer agency and shareholder servicing which are provided under separate contracts.

The court chastised the investment manager for making conflicting argument in regards to economies of scale: “CRMC has consistently argued that economies of scale cannot be achieved or measured, but it has also argued that it has conferred the benefits of economies of scale on its clients. CRMC cannot have it both ways⁹⁹.”

The court found that advisory fees and expense ratios were lower¹⁰⁰ than comparable Lipper averages for peer funds and that performance¹⁰¹ was above average. However, the court was quite critical of the unaffiliated directors. It found them to be highly qualified but that

Although the record contains sufficient evidence to establish that the directors met their obligation under the *Gartenberg* standard, the record indicates that the Unaffiliated Directors’ did not diligently inquire into

⁹⁸ *Id.* at *51.

⁹⁹ *Id.* at *56 n.6.

¹⁰⁰ *Id.* at *25.

¹⁰¹ *Id.* at *21-22.

some issues of importance and failed to recognize the consequences of some of the information presented to them.¹⁰²

Ultimately, the court noted that the *Gartenberg* Standard was a very high hurdle for plaintiffs to meet and that in the present case it had not been met. Overall, the decision was viewed as a win by the industry, albeit with some trepidation. Mr. Daniel Pollack, a noted defense attorney,¹⁰³ commented in “Is American Funds Case the Calm Before the Storm?”:¹⁰⁴

The rumble of distant thunder can be heard in the American Funds fee case.... Although Judge Feess ultimately held . . . that the plaintiffs had not met their burden of proving a breach of fiduciary duty under the *Gartenberg* standard, he was clearly not pleased with defendants. [A]lthough the directors were represented by counsel and were provided with detailed materials to which they and Defendants can point to and say "see how thorough and careful we were" the entire process seems less a true negotiation and more an elaborate exercise in checking off boxes and preparing the file.

Reading these quite scathing lines, one might expect that defendants lost the case. However, that was not the case. The court ruled that the *Gartenberg* standard establishes a very high hurdle to overcome, and the plaintiffs failed in that effort. The American Funds case . . . is noteworthy [in] . . . that it expresses unhappiness with the state of the existing legal precedent, as did earlier courts. Another example of this unease is the 2000 decision in *Migdal v. Rowe Price-Fleming*, where

¹⁰² *Id.* at *55.

¹⁰³ See Daniel A. Pollack—Biography, MCCARTER & ENGLISH ATTORNEYS AT LAW, <https://perma.cc/6ZGH-PT9C>. It is interesting that Mr. Pollack is the son of District Court Judge Milton Pollack in the *Gartenberg* case. See *id.* Mr. Pollack was also the lead defense attorney in several mutual fund cases, including *Burks, Schuyt and Kalish*. *Id.*

¹⁰⁴ Daniel Pollack, *Is American Funds Case the Calm Before the Storm?*, <https://perma.cc/6JBG-DQHJ>.

District Judge Andre Davis (now a Fourth Circuit judge) wrote, "Investors in 'captive' mutual funds may well deserve, as some clearly desire, greater protection than the current legal regime against generous advisory and managerial fees. It may be that further legislative or regulatory study and action are overdue."

Even though the case was distorted by the inclusion of distribution and processing costs in the analysis, there are indications that the investment management company was generating very high levels of profitability and economies of scale. The case includes pre-tax operating margins for the management company alone for the period 2003 to 2008. The average pre-tax margin was 45.5 percent¹⁰⁵. The corresponding average pre-tax margin for the firms in the Mutual Fund Governance sample¹⁰⁶ was only 30 percent. Thus, as calculated CRMC pre-tax margins were 50 percent higher than a sample of publicly traded investment management companies. If it is assumed that expenses for the profit sharing plan characterized as "enormous" by the court are excluded, the firm's pre-tax margin is 60 percent, more than double the average for publicly traded investment management companies.

Similarly, there are indications of substantial economies of scale in the advisory function. The costs of investment professionals are a major component of advisory costs. The number of investment professionals grew from 137 in 2003 to 167 in 2006¹⁰⁷, a 22 percent increase. Over the corresponding period (2003-2006) total assets of the American Funds complex grew from \$422 billion to \$959 billion¹⁰⁸, an increase of 127 percent. Thus, a casual examination of costs uncorrupted by distribution and processing costs indicates that advisory function was subject to substantial economies of scale.¹⁰⁹

Finally, it is instructive to examine the break point structure of

¹⁰⁵ In re American Mut. Funds Fee Litigation, *supra* note 93, at *24.

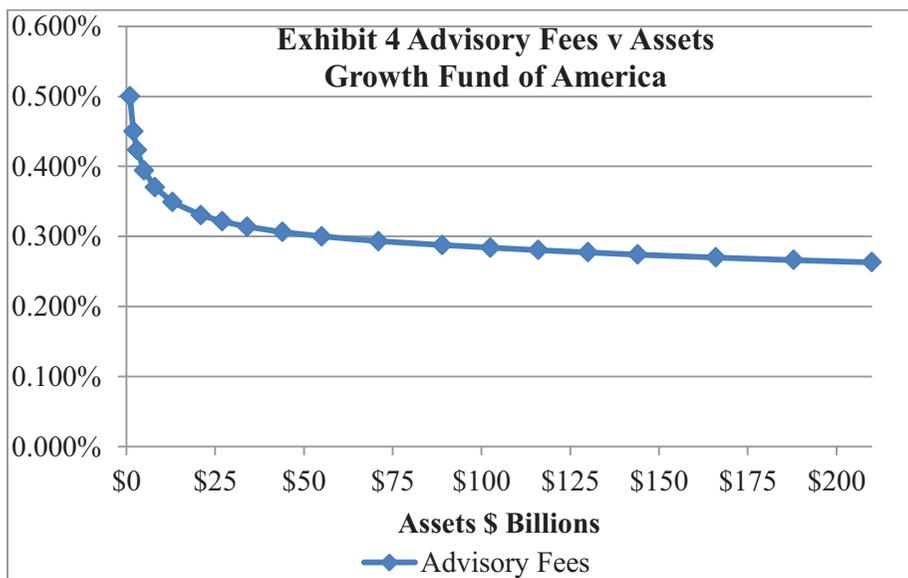
¹⁰⁶ See *supra* note 23.

¹⁰⁷ In re American Mut. Funds Fee Litigation, *supra* note 93, at *16.

¹⁰⁸ *Id.* at *6.

¹⁰⁹ The Growth Fund of America was the second largest fund in the Morningstar universe in December of 2014, second only to the Pimco Total Return bond fund with about \$202 billion in assets. *Principia Pro*, MORNINGSTAR (December 2009).

the Growth Fund of America (GFA), the largest American Funds mutual fund at the end of 2009. At that time, GFA had assets under management of \$153 billion and its advisory fee was 28 basis points¹¹⁰. The breakpoint schedule started at 50 basis points for the first \$1 billion under management and ended at 23.3 basis points for all assets over \$230 billion.¹¹¹ There were a total of 21 different advisory fee steps in the whole schedule. The cumulative effect of the breakpoint schedule at asset levels from \$0 to \$230 billion is shown in Exhibit 4.



The most striking feature of Exhibit 4 is that its shape is very similar to the hypothetical cost curve presented in Exhibit 1. This is no accident. Mutual fund sponsors are incentivized to maximize revenues and profits for their shareholders. This could be achieved above by just maintaining a flat 50 basis point advisory fee at all asset levels. The only brake on this behavior is the profit margin ceiling of about 75 percent set by the *Schuyt* precedent. The most likely cause of the shape of the advisory fee curve is that as assets increase and economies of scale are realized, CRMC was forced to lower fees at the margin in order to stay under the mandated ceiling.

¹¹⁰ *Id.*

¹¹¹ *In re American Mut. Funds Fee Litigation*, *supra* note 93, at *9.

The above interpretation is consistent with Propositions 1 and 3 in the theoretical section on economies of scale. The advisory function is subject to substantial economies of scale and, due to the shape of the cost curve, fund sponsors are incentivized to only reduce fees slightly at higher assets levels.

Give the breakpoint schedule, advisory fees fall from 50 basis points at \$1 billion in assets to 30 basis points at \$55 billion in assets, a forty percent decrease. However, fees fall from 30 basis points to 26.3 basis points at \$210 billion, a 12.3 percent drop. Given the flatness of the cost curve, fund sponsors lower fees at a slower rate at higher levels of assets and Exhibit 4 confirms this.

B. Jones v. Harris Assocs., L.P.

In *Jones v. Harris Assocs. L.P.*, an excessive fee case filed under §36(b), Harris Associates charged the Oakmark Fund greater advisory fees than it charged institutional clients for similar services.¹¹² However, the District Court gave great weight to the comparison of the Oakmark Fund advisory fees to advisory fees charged by similar mutual funds¹¹³

¹¹² See *Jones v. Harris Assocs. L.P.*, No. 04 C 8305, 2007 U.S. Dist. LEXIS 13352, at *1–3 (N.D. Ill. Feb. 27, 2007). “The Oakmark Fund paid Harris Associates 1% (per year) of the first \$2 billion of the fund's assets, 0.9% of the next \$1 billion, 0.8% of the next \$2 billion, and 0.75% of anything over \$5 billion.” *Jones v. Harris Assocs. L.P.*, 527 F.3d 627, 631 (7th Cir. 2008). “For a client with investment goals similar to Oakmark Fund, Harris Associates charges 0.75% of the first \$15 million under management and 0.35% of the amount over \$500 million, with intermediate break-points.” Note how initially the institutional fees were quite high but aggressive breakpoints soon had the fee down to 35 basis points above \$500 million.” *Id.*

¹¹³ *Jones v. Harris Assocs. L.P.*, No. 04 C 8305, 2007 U.S. Dist. LEXIS 13352, at *24 (N.D. Ill. Feb. 27, 2007). The Appellate Court in *Gartenberg* questioned the validity of comparing fees on a no-bid contract to fees on similar no-bid contracts and held: “Competition... for shareholder business does not support an inference that competition must therefore also exist between adviser-managers for fund business. The former may be vigorous even though the latter is virtually non-existent.

and granted summary judgment for the defendants.¹¹⁴

C. Jones v. Harris Assocs., L.P. – Seventh Circuit Decisions

The plaintiffs in *Jones* appealed to the Seventh Circuit and Judge Easterbrook, writing for the panel, issued a potentially game changing ruling. Based in large part on the CH research, the panel disapproved the *Gartenberg* approach:

[T]he fact “that mutual funds are ‘captives’ of investment advisers does not curtail... competition. An adviser can't make money from its captive fund if high fees drive investors away... Therefore, just as plaintiffs are skeptical of *Gartenberg* because it relies too heavily on markets, we are skeptical about *Gartenberg* because it relies too little on markets.”¹¹⁵

And, referencing Coates Hubbard:

A recent, careful study concludes that thousands of mutual funds are plenty, that investors can and do protect their interests by shopping, and that regulating advisory fees through litigation is unlikely to do more good than harm... 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.¹¹⁶

The Appellate Court ruled that as long as the fiduciary made full disclosure and played no tricks then a cap on compensation ala

Each is governed by different forces. Reliance on prevailing industry advisory fees will not satisfy §36(b).” *Gartenberg v. Merrill Lynch Asset Mgmt., Inc.*, 694 F.2d 923, 929 (1982).

¹¹⁴ *Jones v. Harris Assocs. L.P.*, No. 04 C 8305, 2007 U.S. Dist. LEXIS 13352, at *27-28 (N.D. Ill. Feb. 27, 2007).

¹¹⁵ *Jones v. Harris Assocs. L.P.*, 527 F.3d 627, 632 (7th Cir. 2008).

¹¹⁶ *Id.* at 634 (citing *Competition in the Mutual Fund Industry: Evidence and Implications for Policy*, 33 IOWA J. CORP. L. 151 (2007)).

Gartenberg is inappropriate. This represents a radical departure from the *Gartenberg* Standard.

A judge called for a vote on the suggestion for rehearing en banc and a majority did not favor rehearing. Five judges dissented from the denial of rehearing en banc and Judge Posner wrote the dissent in which he noted: "The panel bases its rejection of *Gartenberg* mainly on an economic analysis that 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."¹¹⁷

And, in response to the assertion that an adviser cannot make money from a captive fund if high fees drive investors away, Judge Posner cited Freeman Brown:

That's true; but will high fees drive investors away? "[T]he chief reason for substantial advisory fee level differences between equity pension fund portfolio managers and equity mutual fund portfolio managers is that advisory fees in the pension field are subject to a marketplace where arm's-length bargaining occurs. As a rule, [mutual] fund shareholders neither benefit from arm's-length bargaining nor from prices that approximate those that arm's-length bargaining would yield were it the norm."¹¹⁸

D. Jones v. Harris Assocs. L.P. – U.S. Supreme Court Decision

In March 2010, the U.S. Supreme Court unanimously overruled the District and Appellate Courts' rulings on summary judgment in *Jones* and remanded the case to the District Court for trial.

The Supreme Court reaffirmed *Gartenberg* as the proper standard for determining if a breach of fiduciary duty has occurred, noting that it may "lack sharp analytical clarity, but we believe that it accurately reflects the compromise that is embodied in §36(b), and it has provided a workable standard for nearly three decades." The Supreme

¹¹⁷ *Id.* at 730.

¹¹⁸ *Id.* at 731-32.

Court chose not to weigh in on the issue of competitiveness, reasoning that it was an issue to be handled by Congress. However, the Supreme Court did acknowledge that institutional fees *may* be a valid comparison:

[W]e do not think that there can be any categorical rule regarding the comparisons of the fees charged different types of clients... Instead, courts may give such comparisons the weight that they merit in light of the similarities and differences between the services that the clients in question require, but courts must be wary of inapt comparisons. . . there may be significant differences between the services provided by an investment adviser to a mutual fund and those it provides to a pension fund which are attributable to the greater frequency of shareholder redemptions in a mutual fund, the higher turnover of mutual fund assets, the more burdensome regulatory and legal obligations, and the higher marketing costs. If the services rendered are sufficiently different that a comparison is not probative, then courts must reject such a comparison. Even if the services provided and the fees charged to an independent fund are relevant, courts should be mindful that the Act does not necessarily ensure fee parity between mutual funds and institutional clients contrary to petitioners' [plaintiffs'] contentions.¹¹⁹

The statement encapsulates the confusion and lack of analytical clarity of the judicial system concerning the comparative costs of providing advisory services to institutional and mutual fund clients. The costs of providing all services (not just advisory services) are clearly different but the costs of providing advisory services are substantially the same. The confusion reflects the success of the industry in clouding the issues with processing costs, starting with *Gartenberg* and continuing to this day. It is useful to parse the Supreme Court language in regards to redemptions, turnover, regulatory obligations and marketing costs carefully.

It is true that there is a higher frequency of shareholder redemptions (and purchases) for mutual funds than for pension funds. This does not mean that it is more expensive to provide advisory services

¹¹⁹ Jones v. Harris Associates, L.P., 559 U.S. 335, 350 (2009).

to mutual funds. The costs of processing frequent shareholder purchases and redemptions are paid under a separate transfer agent contract and the advisor is insulated from these costs.

For mutual funds of any size the law of large numbers insures that purchases and redemptions will typically cancel or nearly cancel on a daily basis. In order to handle mismatches of purchases and redemptions the typical mutual fund portfolio will hold higher cash balances, on average than the typical institutional portfolio for the same type portfolio. The higher cash balances will impact the return of the mutual fund portfolio, vis-a-vie the institutional portfolio, but not the costs of providing portfolio management services. The management of cash flows including dividend reinvestment, trading and rebalancing is part in parcel of the portfolio management process and there are no significant cost differences between mutual fund and institutional portfolios.¹²⁰

It is true that shareholder purchases and redemptions may occasionally cause higher turnover vis-a-vie institutional portfolios. However, trading costs (commissions and market impact) influence portfolio costs and returns directly and do not impact on the costs of advisory services.

There are clearly more burdensome regulatory and legal obligations involved in managing mutual fund portfolios as compared to institutional portfolios. One incremental cost is the requirement that mutual fund portfolios mark to market on a daily basis. Another is the costs of reports to regulators not required of institutional money managers. However, such incremental costs are subject to economies of scale and are likely to be small. Freeman, Brown, and Pomerantz estimate these incremental costs as in the neighborhood of 3 basis points. Again, the Vanguard comparison provides a useful benchmark. If such cost were substantial they would be reflected in higher advisory fees for Vanguard funds as compared to institutional portfolios.

Finally, the Supreme Court's concerns about higher marketing costs for mutual funds may be exactly backward. Mutual fund marketing costs are covered under separate distribution fees and contracts while

¹²⁰ Freeman et al., *supra* note 85. The most telling argument against cost differences in providing liquidity is that Vanguard fees are comparable to institutional fees and Vanguard funds must cope with frequent shareholders purchases and redemptions.

marketing costs for institutional managers are not. Thus, it may cost more to market and manage institutional portfolios than is costs to manage mutual fund portfolios.

IX. CONCLUSION

The *Gartenberg* precedent continues to be the law of the land and the industry views the decision in *Jones* as a victory. Dan Pollack thinks so. In an article entitled, “Is the Supreme Court the ‘new best friend’ of the Fund Industry?”¹²¹ he says:

The mutual fund industry can now exhale: it has found a "new best friend" in Justice Samuel Alito and the Supreme Court. After months of uncertainty and anxiety in the industry over the possible outcome of *Jones v. Harris Associates*, the Supreme Court last week issued a 17-page Opinion, re-affirming 30 years of unbroken precedent on how courts are to judge whether advisory fees are excessive. *Gartenberg*, long the standard in this area, was solidly endorsed by Justice Alito, writing for a unanimous Court, with Justice Clarence Thomas concurring.

In its Opinion, the Supreme Court implicitly rejects (without naming them) the dueling theorists at the opposite ends of the spectrum: Freeman and Brown on the left; Hubbard and Coates on the right.

Freeman and Brown, in an obscure¹²² law review article, provided the "intellectual" underpinnings of the plaintiffs bar's attack on *Gartenberg* and on the several cases tried to judgment after *Gartenberg*... Hubbard and Coates contended, to the contrary, that in view of the industry's competitive nature, there cannot, as a matter of economic theory, be excessive fees since those charging

¹²¹ Daniel A. Pollack, *Is the Supreme Court the “new best friend” of the Fund Industry?*, <https://perma.cc/G9K4-QANL>.

¹²² Mr. Pollack describes the FB article as an “obscure” law review article although the CH article was published in the same law review, *The Journal of Corporation Law*. It seems that an article is not “obscure” when published by fellow Ivy Leaguers.

excessive fees would be driven out of business by those charging fair fees.

Both positions, each rooted in economic theory, were shunted aside by the Supreme Court. The justices stayed solidly within the bounds of *Gartenberg* and the case law post-*Gartenberg*.

Mr. Pollack's victory lap may be a bit premature. While affirming the *Gartenberg* Standard, the US Supreme Court did not categorically reject the comparison of mutual fund and institutional advisory fees. The fog of processing costs that clouded *Gartenberg* and succeeding cases was highlighted by the decision and this paper should clarify the matter. Absent the processing cost canard, the *Gartenberg* Standard is formidable but not insurmountable.

Consider, Freeman and Brown found that mutual fund advisory fees were, on average double institutional fees and that corresponding mutual fund portfolios were much larger. Absent the diversionary crutch of processing costs, on average mutual fund advisory fees *are* so disproportionately large that they bear no reasonable relationship to the services provided and could not have been the product of arm's length negotiation. Double *is* disproportionate. Double *is* unreasonable. Courts could and should recognize this and test fees relative to fees truly determined at arm's length, namely Vanguard and other fees determined by the interaction of market forces.

The most important contribution of this paper is the analytical clarity it brings in the realm of mutual fund advisory fees. The use of institutional fees as a proxy for those determined by arm-length negotiation is now unambiguously appropriate with suitable adjustments for differences in the services provided. Similarly, the notion that economies of scale and profits margins are intimately related offers a powerful insight into the economics of advisory fees. The canard that economies of scale are best viewed over a narrow range of assets has been here exposed.

In 1970, total mutual fund assets were less than \$48 billion; today they are about \$16 trillion. Based on the FB estimates, the overcharging of advisory fees currently amounts to about \$35 billion per

year.¹²³ This transfer of wealth from investors to mutual fund sponsors thus has serious public policy implications.

¹²³ This is based on \$16 trillion in mutual fund assets and the end of 2014 less \$2.5 trillion in Vanguard Fund assets multiplied times the FB estimate of 26 basis points of overcharging.