No. 08-586

IN THE

Supreme Court of the United States

JERRY N. JONES, MARY F. JONES,
AND ARLINE WINERMAN,

Petitioners,

v.

HARRIS ASSOCIATES L.P.,

Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

BRIEF OF *AMICUS CURIAE* MUTUAL FUND DIRECTORS FORUM IN SUPPORT OF RESPONDENT

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INTEREST OF THE *AMICUS*[1]

The Mutual Fund Directors Forum (the "Forum") is an independent, non-profit membership organization for the independent directors of investment companies.[2] The Forum is dedi-

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[1] No counsel for any party has authored this brief in whole or in part, and no party or counsel for a party has made a monetary contribution to the preparation or submission of this brief. *See* Sup. Ct. R. 37.6. All parties have been timely notified of the undersigned's intent to file this brief; petitioners have filed a blanket consent with the Court to the filing of all *amicus* briefs; respondent has also consented to the filing of this brief. A copy of respondent's consent is filed herewith.

[2] The Forum grew out of the Mutual Fund Directors Education Council, a group convened in 1999 in response to a call for improved fund governance by then-SEC Chairman Arthur Levitt. *See* Press Release SEC, 99-130 (Oct. 13, 1999), *available at* http://www.sec.gov/news/press/press archive/1999/99-130.txt ("Securities and Exchange Commission Chairman Arthur Levitt today praised the creation of the Mutual Fund Directors Education Council. . . . The Council will foster and seek to encourage the development of programs to promote a culture of independence and accountability in fund boardrooms."). Each of the Forum's member groups selects a representative to serve on the Forum's Steering Committee, and the views expressed in this *amicus* brief have been reviewed by the Steering Committee and approved by the Forum's Board of Directors. The Forum's members are all independent directors. A member of the Oakmark Fund board is on the Board of the Forum, but has not participated in the drafting of this brief.

cated to improving mutual fund governance through continuing educational programs and the publication of "best practices" guides.[3] The Forum is financially independent from the advisory firms that sponsor and manage mutual funds.

Under the statutory scheme at issue in this case, the independent directors of a mutual fund are responsible in the first instance for evaluating and approving advisory fee agreements between the fund and its investment adviser. This role is especially relevant to the resolution of this case because, under the governing statutory scheme, Congress has directed that, in reviewing a claim challenging an adviser's compensation, a court is required to give appropriate consideration to a board's approval of the advisory agreement.

Drawing on the Forum's particular expertise, the purpose of this brief is to explain how and why the board's role is critical to Congress' statutory scheme. In particular, this brief focuses on how the relevant statutory and regulatory scheme has empowered independent directors to fulfill Congress' regulatory purpose, and

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[3] *See, e.g.,* Mutual Fund Directors Forum, *Best Practices and Practical Guidance for Mutual Fund Directors* (July 2004).

why, absent unusual circumstances, deference to the decision of a board to approve an advisory contract is a critical component of any judicial review of a claim challenging the adviser's fees.

PRELIMINARY STATEMENT

The issue before the Court is the proper construction of section 36(b) of the Investment Company Act of 1940 (the "ICA" or "Act"). As is relevant here, section 36(b) has three prominent features. First, it provides that an adviser to a mutual fund is "deemed to have a fiduciary duty with respect to the receipt of compensation for services" rendered to the fund. 15 U.S.C. § 80a-35(b) (2006). Second, it permits a shareholder of a fund to pursue a cause of action against the adviser on behalf of the fund for an adviser's "breach of fiduciary duty in respect of such compensation." *Id.* Third, it provides that, in any action brought under section 36(b), the decision of the fund's board of directors approving the contract governing the adviser's compensation "shall be given such consideration by the court as is deemed appropriate under all the circumstances." *Id.*

As the last of these three features makes plain, when a court reviews a claim under section 36(b), it is not enough for the court to consider by itself the scope of an adviser's fiduciary duty under the statute or whether the adviser has breached its duty in some way. Rather, the statute directs that the court must also take into account the board's decision to approve the contract setting the adviser's fee. This direction underscores a key element of the statutory scheme that petitioners largely ignore—namely, that Congress intended independent boards to serve in their own right as a critical means to assess whether an adviser's fee is appropriate. Moreover, it is evident from review of the legislative scheme and its history that Congress intended the board to have flexibility in its decision making: Congress chose not to dictate the factors boards must consider in approving an advisory contract, let alone the weight to be given any particular factor. Instead, Congress intended that each board would evaluate the appropriateness of an adviser's services and fees consistent with the particular needs and interests of the relevant fund.

In order to properly acknowledge the board's role in accordance with the statutory scheme Congress created, it cannot be true that, in an ordinary case, a board's decision to approve a contract may be ignored. On the contrary, absent unusual circumstances, a board's decision to approve a particular contract is entitled to deference. Otherwise, the statutory scheme that Congress designed cannot function as Congress intended.

The purpose of this *amicus* brief, rooted in the Forum's perspective and experience, is two-fold. First, it explains the central role that independent directors have always played in protecting shareholders under the ICA, how that role is reflected in section 36(b), and hence why, absent unusual circumstances, deference to a board's decision to approve an advisory contract is a critical component of Congress' statutory scheme. Second, it discusses how in recent years the Securities and Exchange Commission ("SEC") has strengthened the board's ability to negotiate advisory contracts as in an arms'-length manner, how the industry itself has taken steps to enhance the board's effectiveness in this regard, and why these measures further support the conclusion that, absent unusual circumstances, a board's consideration and approval of an advisory contract is entitled to deference.

In this case, there appears to be no demonstration that the board neglected its duties. The District Court observed that board members reviewed and evaluated information "regarding the funds' performance, the services [the adviser] provided to the funds, comparisons with fees charged to Harris's other clients, and comparisons with fees charged by other companies managing similar funds."[4] Likewise, the Court of Appeals determined that there appears to be no contention that the adviser deceived the board or "pulled the wool" over its eyes in fixing the adviser's compensation. In other words, this is not an unusual case, and under all the relevant circumstances, it appears that the board acted responsibly, in an informed and engaged way, in approving the adviser's compensation. Accordingly, under these circumstances, its decision should be accorded deference, and the judgment of the Court of Appeals should be affirmed.

SUMMARY OF THE ARGUMENT

As is relevant here, the history of section 36(b) reflects three predominant themes. First, rather than abandon board decision making in establishing appropriate adviser compensation, Congress has entrusted and empowered independent directors to have the primary role in this area. Second, the SEC and the industry have taken steps to strengthen the ability of boards to fulfill their assigned role. Third, courts reviewing claims under section 36(b) have prop-

[4] *Jones v. Harris Assocs. L.P.*, No. 04C8305, 2007 WL 627640, at *1 (N.D. Ill. Feb. 27, 2007); *see also* Mutual Fund Directors Forum, *Best Practices and Practical Guidance for Mutual Fund Directors* (July 2004) (discussing procedures boards should follow in reviewing advisory contracts).

erly recognized the importance of responsible director decision making. The seminal case in this regard is the Second Circuit's decision in *Gartenberg v. Merrill Lynch Asset Mgmt., Inc.*[5]—a decision that properly views the role of the board as central to the statutory scheme and the purposes underlying it.

As the history of section 36(b) reveals, Congress did not intend any single factor to control the question whether a board has behaved responsibly in approving an adviser's compensation. In particular, Congress consciously disapproved the notion that a comparison between the fees an adviser charges its mutual fund and non-mutual fund clients is entitled to any sort of special consideration or weight. Boards should properly tailor their decision making to the facts and circumstances before them, and Congress did not purport to dictate the details of how the board should fulfill its duties.

In this case, there is no demonstration that the board neglected its duties under the ICA, or was deceived in some material way. In other words, it appears that there are no unusual circumstances that would warrant disregarding the board's decision to approve the advisory contract.

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[5] 694 F.2d 923 (2d Cir. 1982).

Accordingly, the judgment of the Seventh Circuit affirming the District Court should be affirmed.

ARGUMENT

Review of the ICA reveals that its purpose is not to fix the amount of fees in an advisory contract. Nor is it to replace a fund's board with a court or administrative agency in the evaluation and approval of the amount of an adviser's compensation, or to dictate the factors that boards must consider in the evaluation and approval process. Rather, in key respects, the structure of the ICA and its implementing regulations entrust the board with responsibility for evaluating and approving advisory contracts, rely on the board to fulfill these functions, and seek to enhance these functions in several critical, interlocking ways, reserving judicial intervention for truly unusual circumstances.

Petitioners observe that advisers and their mutual fund clients often enjoy a close relationship, giving rise to the potential for a conflict of interest in the setting of the adviser's fees. Petitioners contend that advisory fees ought to resemble the product of arms'-length bargaining. While the Forum agrees with this contention, it disagrees with the mechanical means petitioners urge to test the appropriateness of the adviser's fees. As a talismanic benchmark for evaluating claims under section 36(b), petitioners urge a comparison between the fees the adviser charges its mutual fund client with the fees charged to non-mutual fund clients. Petitioners' focus on this factor as a litmus test is misplaced. During the legislative process, Congress consciously rejected a proposal that would have required a comparison of the kind petitioners advocate. Under Congress' scheme as enacted, although a comparison of the different fees advisers charge their various clients is something a board may consider in evaluating a particular contract, it is not controlling—far from it. Further, where the board considers a comparison of the different fees an adviser charges its various clients, it is up to the board to decide its relative weight in the overall analysis. This is particularly true given that the services the adviser provides to its various mutual fund and non-mutual fund clients may well be substantially dissimilar. More generally, what petitioners fail properly to acknowledge is that the provisions of the ICA itself, augmented by the SEC's regulations and evolving industry practices, are designed to create the functional equivalent of an arms'-length process.

First, the ICA confronts directly the conflict of interest problem that petitioners identify by assigning the central role in the advisory contract evaluation and approval process to a fund's *independent* directors—*i.e.*, those who are strictly unaffiliated with, and without an interest in, the adviser.[6] Among other things, section 15(c) of the Act requires that a majority of the independent directors approve the advisory contract, by vote cast in person at a meeting called for that specific purpose. 15 U.S.C. § 80a-15(c).[7]

Second, section 15(c) requires that the directors obtain and evaluate information reasonably necessary to consider and approve the advisory agreement, and for this purpose requires the adviser to supply information the board requests. *Id.* This information-gathering and approval function is necessarily flexible. Funds can feature vastly different investment strategies and call for distinctly different ser-

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[6] *See* 15 U.S.C. § 80a-2(a)(19) (2006) (defining "interested person").

[7] As the SEC has explained, the role of the fund's independent directors is to serve as "independent watchdogs" charged with furnishing a crucial check on fund management and providing a means for the representation of the interests of the shareholders of a fund. Interpretive Matters Concerning Independent Directors of Investment Companies, Investment Company Act Release No. 24,083, 64 Fed. Reg. 59,877 (Nov. 3, 1999); *see also Burks v. Lasker*, 441 U.S. 471, 484 (1979) (quoting *Tannenbaum v. Zeller*, 552 F.2d 402, 406 (2d Cir. 1977) and *Investment Trusts and Investment Companies: Hearings on H.R. 10065 Before a Subcomm. of the Comm. on Interstate and Foreign Commerce*, 76th Cong. 109 (1940) (statement of David Schenker, Chief Counsel, SEC Investment Trust Study)).

vices. Boards are intimately familiar with the particular operations of their funds, and boards are thus uniquely able to evaluate the appropriateness of advisers' services and fees. Moreover, after an initial two-year term for a new contract, this evaluation and approval process must take place every year in order for the advisory relationship to continue. No mechanically-applied benchmark analysis of the kind petitioners advocate can properly serve as a legitimate proxy for this tailor-made process.

Third, supplementing the Act's essential independence and disclosure structures, the SEC has, since 1970, adopted regulations that have effectively increased the influence and power of independent directors. Since its inception, the ICA has always required that at least 40% of a fund's directors be independent. Under more recent SEC regulations, that required percentage has effectively increased to greater than 50%. The SEC has also issued rules and regulatory guidelines that have helped structure the process of board consideration and approval of advisory contracts. Again, the mechanical benchmark analysis that petitioners advocate is at odds with this regulatory model.

Fourth, boards themselves have embraced their role and, with the assistance of the Forum, as well as industry organizations, have adopted practices that have enabled them to become steadily more proficient and proactive in evaluating and approving advisory contracts within the regulatory structure that Congress and the SEC have created.

Critically, the whole point of these various provisions, regulations, and practices is to establish a structured environment for responsible decision making over advisory fees in which a board conducts its evaluations informed by access to a broad range of information and with the advantage of critical expertise and practical experience. Given that Congress has gone to great lengths to create this regime after careful study and extensive deliberations, it cannot be presumed that Congress intended it to be ineffective or irrelevant in evaluating claims under section 36(b). On the contrary, the fact that Congress directed that courts "shall" consider the board's approval of a contract in evaluating a claim under the section demonstrates the opposite: absent unusual circumstances, a board's decision is properly entitled to deference.

A. The Centrality of the Role of Independent Directors under the ICA both Before and After Its Amendment in 1970

In drafting and passing the original provisions of the ICA in 1940, Congress understood that advisers typically sponsor the mutual funds they subsequently advise, and believed that fund shareholders would be adequately protected by a "few elementary safeguards" to protect against abuse.[8] In particular, as noted, the original legislation mandated that at least 40 percent of a fund's directors had to be unaffiliated with the fund's investment adviser-sponsor.[9] It also provided that advisory contracts would have to be approved initially by a majority of the outstanding voting shares of the fund. Thereafter,

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[8] *Investment Trusts and Investment Companies: Hearings on S. 3580 Before a Subcomm. of the Comm. on Banking and Currency*, 76th Cong. 252 (1940) (testimony of David Schenker, Chief Counsel, SEC Investment Trust Study).

[9] Investment Company Act of 1940, Pub. L. No. 768, ch. 686, § 10(a), 54 Stat. 789, 806 (1940) (amended 1970). The definition of an affiliated person, however, was not particularly rigorous. *Id.* § 2(a)(3). A new section was later added to the statute as part of the 1970 amendments, which tightened the independence requirements for directors by introducing the concept of "interested person" and substituting it for "affiliated person" in section 10(a). 15 U.S.C. § 80a-2(a)(19), 80a-10(a) (2006); *see also infra* notes 40-41 and accompanying text.

the contract was required to be approved annually, either by the shareholders or by the fund's board of directors, including a majority of unaffiliated directors.[10]

As the legislative history shows, it was not Congress' intention in 1940 to upset shareholder expectations that a fund's board would ordinarily retain the adviser shareholders had chosen.[11] In selecting a fund, investors are selecting a particular money manager, and Congress understood that retaining a particular adviser was frequently to the funds' advantage because an affiliation with a particular adviser could be a significant benefit in terms of attracting and retaining assets.[12]

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[10] 15 U.S.C. § 80a-10(a), 80a-15 (2006).

[11] *See Investment Trusts and Investment Companies: Hearings on H.R. 10065 Before a Subcomm. of the Comm. on Interstate and Foreign Commerce*, 76th Cong. 109-10 (1940) (testimony of David Schenker, Chief Counsel, SEC Investment Trust Study):

> If the stockholders want A's management, then A should have the right to impose his investment advice on that company. However we felt that there should be some check on the management and that is why the provision for 40 percent of independents was inserted.

[12] *See* Alfred Jaretzki, Jr., *The Investment Company Act of 1940*, 26 WASH. U. L.Q. 303, 319 (1941).

Congress' views, reflected in the legislation it adopted, facilitated remarkable growth in the industry. Investors flocked to mutual funds, which flourished and proliferated.[13] Eventually, however, a number of issues emerged, prompting Congress to revisit and amend, but not fundamentally restructure, its regulatory scheme. As is relevant here, rather than abandon reliance on boards, Congress chose to strengthen and enhance the role of independent directors to protect against excessive adviser fees, and required appropriate consideration of the directors' decision to approve an advisory contract in any suit challenging the adviser's compensation.

1. The Wharton Report

As the mutual fund industry grew, the compensation that advisers received based on a percentage of assets under management also grew, giving rise to concerns about the dollar amount of the fees. In 1958, the SEC enlisted the Wharton School of Finance and Commerce to produce a study on the mutual fund industry, and to analyze "the question of the effects of size on investment policies and comparative performance of [funds] and, to the extent possible, to the effects of size of [funds] on the securities

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[13] Wharton School of Finance and Commerce, *A Study of Mutual Funds*, H.R. REP. No. 87-2274, at 4 (1962).

markets and on the policies of portfolio companies."[14] The Wharton Report was delivered to Congress in 1962.[15]

The Wharton Report concluded, among other things, that "[a]dvisory fee rates charged by mutual funds tended to be substantially higher than those charged by the same advisers to the aggregate of their clients other than investment companies, for comparable asset levels."[16] Combined with later reports and testimony, the Wharton Report set the stage for subsequent amendment of the ICA in 1970, yielding the current section 36(b). Critically, although the Wharton Report clearly identified a disparity between the fees advisers charged their mutual fund clients and the fees that they charged to their non-mutual fund clients, Congress ultimately rejected a proposal that would have directed a comparison between these fees in reviewing claims under section 36(b). Instead, as discussed more fully below, Congress continued to rely on responsible director approval of advisory contracts as the primary means of ensuring appropriate levels of compensation.

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[14] *Id.* at 1 (internal quotation marks omitted).

[15] S. REP. No. 91-184, at 4 (1969), *as reprinted in* 1970 U.S.C.C.A.N. 4897, 4900.

[16] Wharton School of Finance and Commerce, *A Study of Mutual Funds*, H.R. REP. No. 87-2274, at 29 (1962).

2. The 1966 Report and Legislative Proposals Leading up to the 1970 Amendments

Following the Wharton Report in 1962, and the SEC's own report on the securities laws in 1963,[17] the SEC undertook and prepared a subsequent report (the "1966 Report") regarding the ICA, arguing that amendments to the statute were necessary to protect the interests of fund shareholders from excessive fees.[18] The report stated:

> Because the Act fails to articulate clearly the standard by which the propriety of managerial compensation should be measured, it makes for uncertainty and impairs rather than strengthens the fiduciary obligation of investment company managers to refrain from compensating themselves unfairly. If the Act is to be an effective force for fairness and equity in this area, the "few elementary safeguards," deemed adequate

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[17] SEC, *Report of the Special Study of the Securities Markets*, H.R. Doc. No. 88-95 (1963).

[18] SEC, *Public Policy Implications of Investment Company Growth*, H.R. Doc. No. 89-2337, at 143 (1966).

> for the industry of 1940 must now be supplemented.[19]

The SEC recommended in its report that Congress amend the ICA to add a section that would permit evaluation of advisory fees under a "Federal standard of reasonableness."[20] Fleshing out its standard, the SEC enumerated a list of considerations to be used in determining reasonableness.[21] Notably, the first factor appearing on the SEC's list was "the fees paid for comparable services by other financial institutions [engaged in administering] pools of investment capital of like size and purpose such as pension and profit sharing plans, insurance companies, trust accounts, and other investment companies."[22]

Following the 1966 Report, legislation to implement the SEC's recommendations was in-

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[19] *Id.*

[20] *Id*. at 146.

[21] *Id*. at 144.

[22] *Id*. The other factors included "the nature and quality of the services provided; all benefits directly or indirectly received by persons affiliated with an investment company and their affiliated persons by virtue of their relationship with an investment company; and such competitive or other factors as the Commission may by rule or regulation . . . determine are appropriate and material in the public interest." *Id.*

troduced in May 1967 in both Houses of Congress (S. 1659 and H.R. 9510).[23] The identical bills included a new Section 15(d) of the Act, which incorporated the SEC's suggested standard and proposed that advisory fees would be measured against a new yardstick of "reasonableness."[24] Like the 1966 Report, the bills listed factors to be employed in determining whether the fees that an adviser proposed to charge were reasonable.[25] With respect to com-

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[23] S. 1659, 90th Cong. (1967); H.R. 9510, H.R. 9511, 90th Cong. (1967).

[24] S. 1659, 90th Cong. § 8(d)(1) (1967), *reprinted in Mutual Fund Legislation of 1967: Hearings on S. 1659 Before the Senate Comm. on Banking and Currency*, 90th Cong. 915-16 (1967); *see also* SEC, *Public Policy Implications of Investment Company Growth*, H.R. Doc. No. 89-2337, at 144 (1966); H.R. 9510, H.R. 9511 90th Cong. § 8(d)(1) (1967), *reprinted in Investment Company Act Amendments of 1967: Hearings on H.R. 9510 and 9511 Before the Subcomm. on Commerce and Finance of the H. Comm. on Interstate and Foreign Commerce*, 90th Cong. 8 (1968).

[25] Section 8(d)(2)(A)-(E) of S. 1659 proposed five factors to be used to determine reasonableness:

> (A) The nature and extent of the services to be provided…; (B) The quality of the services theretofore rendered . . .; (C) The extent to which the compensation provided for in such contract takes into account economies attributable to the growth and size of such investment company . . .; (D) The value of all benefits, in addition to compensation provided for in

paring fees paid by a mutual fund and fees paid by other types of clients, the bills directed consideration of the following:

> The extent to which the compensation provided for in such contract takes into account economies attributable to the growth and size of such investment company and any such economies attributable to the operation of other investment companies under common management with such company, *giving due consideration to the extent to which such economies are reflected in the charges made or compensation received for investment advisory services and other services provided to investment companies having no investment adviser, other clients of*

> such contract . . .; [and] (E) Such other factors as are appropriate and material.

S. 1659, 90th Cong. § 8(d)(2)(A)-(E) (1967), *reprinted in Mutual Fund Legislation of 1967: Hearings on S. 1659 Before the Senate Comm. on Banking and Currency*, 90th Cong. 916-17 (1967); *see also* H.R. 9510, 90th Cong. § 8(d)(2)(A)-(E) (1967), *reprinted in Investment Company Act Amendments of 1967: Hearings on H.R. 9510 and 9511 Before the Subcomm. on Commerce and Finance of the H. Comm. on Interstate and Foreign Commerce*, 90th Cong. 8 (1968).

> *investment advisers and other financial institutions, but with due allowance for any relevant differences in the nature and extent of the services provided.*[26]

Thus, the bills would have required the comparison only as an adjunct to a broader inquiry into economies of scale.

During July and August 1967, the Senate Committee on Banking and Currency held extensive hearings on S. 1659. During October 1967, the House Subcommittee on Commerce and Finance of the Committee on Interstate and Foreign Commerce held hearings on H.R. 9510. Manuel F. Cohen, then chairman of the SEC, testified in the House Subcommittee proceeding, stating:

> Specifically, the Commission recommends that Section 15 of the Act be amended to provide that the compensation received for any service rendered directly or indirectly to a fund or its shareholders by an

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[26] H.R. 9510, 90th Cong. § 8(d)(2(C) (1967), *reprinted in Investment Company Act Amendments of 1967: Hearings on H.R. 9510 and 9511 Before the Subcomm. on Commerce and Finance of the H. Comm. on Interstate and Foreign Commerce*, 90th Cong. 8 (1968) (emphasis supplied).

> investment adviser . . . shall be *reasonable*. This would provide an explicit federal standard of fairness and reasonableness, as is normally applied in reviewing corporate transactions when a conflict of interest exists.[27]

Negotiations with representatives of the mutual fund industry resulted in a new bill, S. 3724, in July 1968. S. 3724 retained the reasonableness test for advisory fees and the approach of including a list of factors to be considered in determining reasonableness.[28] Significantly, however, the revised list of factors appearing in S. 3724 *omitted comparison with fees charged to other non-fund clients*.[29] According to the report

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[27] H.R. 9510, 90th Cong. (1967), *reprinted in Investment Company Act Amendments of 1967: Hearings on H.R. 9510 and 9511 Before the Subcomm. on Commerce and Finance of the H. Comm. on Interstate and Foreign Commerce*, 90th Cong. 44 (1968).

[28] S. 3724, 90th Cong. § 8(d)(1)(A)-(C) (1968), *reprinted in Mutual Fund Legislation of 1967: Hearings on S. 1659 Before the Senate Comm. on Banking and Currency*, 90th Cong. 24 (1967).

[29] S. 3724 instead listed:

> (A) all other compensation or payments paid to such person by such investment company and its security holders as a class; (B) the nature and extent of all services provided to such investment com-

accompanying S. 3724 explaining this deletion, the revised standard incorporated in the bill was "not designed to bring mutual fund management fees, which often cover services other than investment advice, down to the level of investment advisory fees charged in other noncomparable contexts."[30]

The Senate debated S. 3724 and, ultimately, passed the bill. The mutual fund industry, however, opposed the "reasonableness" standard on the grounds that it was tantamount to governmental ratemaking and would be antithetical to investor and industry interests. In September 1968, the bill died in the House when the Subcommittee on Commerce and Finance of the Committee on Interstate and Foreign Commerce voted not to give it further consideration.

> pany and its security holders as a class by such person in all capacities; and (C) such other factors as are relevant and material under all the circumstances.

Id.

[30] Investment Company Amendments Act of 1968, S. REP. No. 90-1351, at 13 (1968).

3. The 1970 Amendments

In January 1969, Senator Sparkman introduced S. 34 in the new Congress. S. 34 was the same bill—S. 3724—that the Senate had passed the previous year.[31] S. 34 retained the "reasonableness" test for advisory fees, as well as the approach of setting forth a list of factors to be considered in determining reasonableness. It again excluded any comparison with fees charged to other non-fund clients as a specific factor to be considered in determining reasonableness.[32]

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[31] *Investment Company Amendments Act of 1969: Hearings on S. 34 and S. 296 Before the Senate Comm. on Banking and Currency*, 91st Cong. 7 (1969) (Statement of Hugh F. Owens, Commissioner, SEC).

[32] Like S. 3724, S. 34 listed:

> (A) all other compensation or payments paid to such person by such investment company and its security holders as a class; (B) the nature and extent of all services provided to such investment company and its security holders as a class by such person in all capacities; and (C) such other factors as are relevant and material under all the circumstances.

S. 34, 91st Cong. § 8(d)(1)(A)-(C) (1968), *reprinted in Investment Company Amendments Act of 1969: Analysis of S. 34 Before the Senate Comm. on Banking and Currency*, 91st Cong. 78 (1969).

The mutual fund industry continued to object to the "reasonableness" standard. The industry pointed to the vague nature of the reasonableness test, the prospect of judicial ratemaking that it potentially invited, and inevitable inconsistencies in its application if it were implemented.[33]

While the Senate hearings were ongoing, industry representatives and the SEC conducted negotiations over the terms of the legislation. In April 1969, Senator McIntyre publicly raised the possibility of shifting the approach from a "reasonableness" standard to one imposing a fiduciary duty.[34] This suggestion met with the approval of the mutual fund industry and the SEC, both of which agreed to substitute a fiduciary duty approach for the reasonableness standard.[35]

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[33] *Investment Company Amendments Act of 1969: Hearings on S. 34 and S. 296 Before the Senate Comm. on Banking and Currency*, 91st Cong. 100 (1969) (statement of Robert L. Augenblick, President and General Counsel, Investment Company Institute).

[34] *Id.* at 193-94.

[35] S. 2224, 91st Cong. § 20 (1969), *reprinted in Mutual Fund Amendments: Hearings on H.R. 11995, S. 2224, H.R. 13754, and H.R. 14737 Before the Subcomm. on Commerce and Finance of the H. Comm. on Interstate and Foreign Commerce*, 91st Cong. 49-50 (1969). This bill, which was virtually identical to H.R. 11995, became the Investment Company Amendments Act of 1970. Pub. L.

As a result, proposed section 15(d) (containing the reasonableness test first proposed by the SEC in its 1966 Report) was deleted from the legislation. In its place, section 36(b) was inserted, providing that an investment adviser has a "fiduciary duty with respect to the receipt of compensation for services," and likewise providing that, in any action under section 36(b), a court "shall" consider the decision of a fund's board "as is deemed appropriate under all the circumstances."[36] In conjunction with deleting the reasonableness standard, the amended legislation also omitted any reference to any mandatory list of factors to be considered in reviewing advisory contracts.[37]

In May 1969, the amended bill was reported to the full Senate and passed as S. 2224.[38] A virtually identical bill passed the House,[39] and

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No. 91-547, 84 Stat. 1413 (1970) (codified as amended in scattered sections of 15 U.S.C.).

[36] S. 2224, 91st Cong. § 20 (1969), *reprinted in Mutual Fund Amendments: Hearings on H.R. 11995, S. 2224, H.R. 13754, and H.R. 14737 Before the Subcomm. on Commerce and Finance of the H. Comm. on Interstate and Foreign Commerce*, 91st Cong. 50-51 (1969).

[37] *Id.* at 44-48.

[38] *See* 116 CONG. REC. S39,124-25 (daily ed. Nov. 30, 1970).

[39] *See* 116 CONG. REC. H39,344-45 (daily ed. Dec. 1, 1970).

thereafter the 1970 Amendments to the ICA were signed into law.

In addition to creating section 36(b), the 1970 amendments also tightened the independence requirements for the "watchdog" members of the board responsible for evaluating and approving advisory contracts. Specifically, the new legislation included new section (2)(a)(19), first proposed in 1967,[40] which added the phrase "interested person" to the statute and defined it more broadly than the older phrase "affiliated person" defined in section 2(a)(3) of the original legislation. The new concept of "interested person" was then substituted for the phrase "affiliated person" in sections 10 and 15 of the Act. As amended, section 10(a) requires that at least 40 percent of a fund's board must consist of individuals who are not "interested persons," and section 15 requires that a majority of the directors who are not "interested persons" must approve the fund's advisory contract.[41]

As the 1969 Senate Report highlighted, "the function [of section 10] with respect to unaf-

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[40] H.R. 9510, 90th Cong. § 2(3) (1967), *reprinted in Investment Company Act Amendments of 1967: Hearings on H.R. 9510 and 9511 Before the Subcomm. on Commerce and Finance of the H. Comm. on Interstate and Foreign Commerce*, 90th Cong. 8 (1968).

[41] 15 U.S.C. §§ 80a-10(a), 80a-15 (2006).

filiated directors is to supply an independent check on management and to provide a means for the representation of shareholder interests in investment company affairs."[42] The report complained that "the definition of an 'affiliated person' in section 2(a)(3) of the [original] act does not adequately meet this purpose."[43] Thus, in order "to remedy the [ICA's] deficiencies in this regard," Congress defined the term "interested person" in section (2)(a)(19) and made use of it in sections 10 and 15.[44]

In order to enhance the board's ability to evaluate advisory contracts, the 1970 amendments also included new provisions in section 15(c) requiring directors to request and consider, and the adviser to provide, "such information as may reasonably be necessary to evaluate the terms of any [advisory] contract . . . ."[45] By mandating this information flow, Congress empowered a board to request and receive a broad

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[42] S. REP. No. 91-184, at 32 (1969), *as reprinted in* 1970 U.S.C.C.A.N. 4897, 4927.

[43] *Id.*

[44] For example, "interested person" was intended to include persons who were not reached by the term "affiliated person," including persons who have close family or substantial financial or professional relationships with investment companies, their investment advisers, principal underwriters, officers, and employees. *Id.* at 4928.

[45] 15 U.S.C. § 80a-15(c) (2006).

range of materials, including information that might not ordinarily be available in typical commercial negotiations.

Congress further enhanced the board's ability to negotiate advisory contracts by incorporating into new section 36(b) the possibility that a court could review the agreement between the fund and its adviser,[46] specifying that the court would give such consideration to the board's determinations as the court deems "appropriate under all the circumstances."[47] According to the 1969 Senate Report, far from supplanting the role of the board, section 36(b) was "designed to strengthen the ability of the unaffiliated directors to deal with [negotiating advisory fees]."[48]

In short, the 1970 Amendments recognize the critical role that boards, especially independent members, would continue to play in evaluating and approving advisory contracts. As the 1969 Senate Report concluded, "[a] responsible determination regarding the management fee by

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[46] *See* S. REP. No. 91-184, at 7 (1969), *as reprinted in* 1970 U.S.C.C.A.N. 4897, 4903.

[47] 15 U.S.C. § 80a-35(b)(2) (2006).

[48] S. REP. No. 91-184, at 7 (1969), *as reprinted in* 1970 U.S.C.C.A.N. 4897, 4903.

the directors including a majority of disinterested directors is not to be ignored."[49]

4. The Purpose and Effects of the 1970 Amendments

Review of the 1970 amendments reveals a constellation of relevant features. The amendments revised sections 10 and 15 to strengthen the independence requirements for boards, and enhanced the board's ability to obtain—indeed required them to obtain—information relevant to the process of reviewing and approving advisory contracts. They also created a special fiduciary duty for the adviser, and authorized a private cause of action incorporating an explicit feature directing consideration of a board's decision to approve the adviser's fees. While these features certainly constitute significant overlays on the original statutory structure, it is evident that, in enacting them, Congress desired to retain the basic premise of the original ICA that decision making over advisory fees is best left in the first instance to a fund's independent directors. Construed in context, these features represent Congress' efforts to enhance the board's ability to negotiate favorable advisory compensation agreements, as in an arms'-length manner, and not to

[49] *Id.*

prescribe a vehicle for routine second-guessing of a board's determinations.

First, Congress specifically declined to adopt a "reasonableness" standard. Instead, it deemed advisers to have a fiduciary duty with respect to their receipt of compensation. Congress' choice indicates that it did not intend to place in the hands of the courts an objective standard to assess directly the appropriateness of fees, but instead intended to rely on boards to fulfill their role. The function of the courts is therefore to serve as a backstop to board decision making.

Second, Congress declined to enumerate in the statute a list of factors that boards must consider in evaluating and approving advisory contracts. Congress' choice not to tie the board's hands indicates that it wanted boards to retain flexibility in exercising their decision making function to match the needs of their funds, and that there are no particular factors that directors must necessarily consider in approving an adviser's compensation, or that a court must consider in reviewing a board's decision.

Third, by directing courts to give appropriate consideration to a board's decision to approve a particular contract, Congress clearly rejected the idea that independent boards are ineffective in fulfilling their assigned function. Indeed, this

Court has rejected previously the idea that the independent directors of a fund are incapable of fulfilling their assigned role:

> While lack of impartiality may or may not be true as a matter of fact in individual cases, it is not a conclusion of law required by the ICA. Congress surely would not have entrusted such critical functions as approval of advisory contracts and selection of accountants to the statutorily disinterested directors had it shared the...view that such directors could never be 'disinterested' where their codirectors or investment advisers were concerned.[50]

As the Court has also observed, "when by 1970 it appeared that the 'affiliated person' provision of the 1940 Act might not be adequately restraining conflicts of interest, Congress turned not to direct controls, but rather to stiffening the requirement of [director] independence as the way to 'remedy the act's deficiencies.'"[51]

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[50] *Burks v. Lasker*, 441 U.S. 471, 485 n.15 (1979).

[51] *Id.* at 484 (quoting S. REP. No. 91-184, at 32-33 (1969), *as reprinted in* 1970 U.S.C.C.A.N. 4897, 4928).

On the issue of how section 36(b) should be applied, it is evident that Congress also did not require, and did not intend, that any single factor would be outcome determinative. Certainly it cannot be argued credibly that a factor proposed and eliminated early on by Congress—namely, the comparison of the fees charged under the advisory contract with the fees the adviser charged to other non-mutual fund clients—should be the central or dispositive factor in the board's or a court's determination.

Likewise, section 36(b) was "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."[52] As the 1969 Senate Report provides, section 36(b) "is not intended to shift the responsibility for managing an investment company in the best interest of its shareholders from the directors of such company to the judiciary,"[53] or to authorize the judiciary to set rates, or impose a "cost-plus" type of contract.[54]

Rather, just as the legislative scheme suggests, the relevant approach should be one

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[52] S. REP. No. 91-184, at 6 (1969), *as reprinted in* 1970 U.S.C.C.A.N. 4897, 4902.

[53] *Id.* at 4903.

[54] *Id.* at 4902.

whereby a court ordinarily will defer to the decision of a board to approve an advisory contract unless the court has a compelling reason not to defer. This approach is consistent with Congress' evident intent to rely on board approval in the first instance to determine the appropriateness of an adviser's fees, and likewise the elaborate safeguards that Congress put in place to ensure responsible decision making. Only in this way can the board's function receive the consideration that Congress intended it to have.

B. The Enhanced Independence of Mutual Fund Boards under SEC and Industry Guidance and Application of the Deference Principle

Following the enactment of section 36(b) in 1970, the history of the role of independent mutual fund directors in the evaluation and approval of advisory contracts has been one of expanding responsibility. Review of this history at the regulatory level lends further support to the conclusion that, absent unusual circumstances, a court reviewing a claim under section 36(b) should defer to directorial approval of an adviser's contractual compensation. Although the regulatory history extends across many years, the Forum highlights here developments most relevant to the issues presently before the Court.

In early 1999, the SEC held a "Roundtable" on the role of independent investment company directors.[55] As explained by Arthur Levitt, then Chairman of the SEC, the purpose of the Roundtable was to discuss "the increasingly important role that independent directors play in protecting fund investors, and precisely how their effectiveness may be enhanced."[56] The participants of the Roundtable included independent directors, investor advocates, executives of fund advisers, academics, and experienced legal counsel.

In October 1999, in response to the recommendations made at the Roundtable, and after its own review, the SEC issued a release entitled "Role of Independent Directors of Investment Companies"[57] along with a companion in-

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[55] *The Role of Independent Investment Co. Directors, Transcript of the Conference on the Role of Independent Investment Co. Directors*, SEC (Feb. 23-24, 1999), *available at* http://www.sec.gov//divisions/investment/round table/iicdtoc.shtml.

[56] *The Role of Independent Investment Co. Directors, Transcript of the Conference on the Role of Independent Investment Co. Directors*, SEC (Feb. 23, 1999), http:// www.sec.gov/divisions/investment/roundtable/iicdrndt1.ht m#valua (statement of Chairman Levitt).

[57] Role of Independent Directors of Investment Companies, Securities Act Release No. 7754, Exchange Act Release No. 42,007, Investment Company Act Release No. 24,082, 64 Fed. Reg. 59,826 (proposed Nov. 3, 1999).

terpretive release.[58] Together, these releases were designed "to reaffirm the important role that independent directors play in protecting fund investors, strengthen their hand in dealing with fund management, [and] reinforce their independence…"[59]

As a further result of the Roundtable, and in order to enhance the independence and effectiveness of independent directors, the SEC also proposed to amend and, on January 2, 2001 did amend,[60] ten exemptive rules under the ICA[61] to require investment companies that rely on those exemptive rules (which virtually all do) (1) to have at least a majority of their board consist of independent directors; (2) to have the independent directors select and nominate other inde-

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[58] Interpretive Matters Concerning Independent Directors of Investment Companies, Investment Company Act Release No. 24,083, 64 Fed. Reg. 59,877 (Nov. 3, 1999).

[59] Role of Independent Directors of Investment Companies, Securities Act Release No. 7754, Exchange Act Release No. 42,007, Investment Company Act Release No. 24,082, 64 Fed. Reg. 59,826, 59,827 (proposed Nov. 3, 1999).

[60] Role of Independent Directors of Investment Companies, Securities Act Release No. 7932, Exchange Act Release No. 43,786, Investment Company Act Release No. 24,816, 66 Fed. Reg. 3734 (Jan. 16, 2001).

[61] *See id.*; 17 C.F.R. §§ 270.10f-3, 270.12b-1, 270.15a-4(b)(2), 270.17a-7, 270.17a-8, 270.17d-1(d)(7), 270.17e-1, 270.17g-1(j), 270.18f-3, 270.23c-3 (2006).

pendent directors; and (3) to require that independent directors' counsel be independent.[62]

Regarding the first requirement, the SEC opined that "a fund board that has at least a majority of independent directors is better equipped to perform its responsibilities of monitoring potential conflicts of interests and protecting the fund and its shareholders."[63] As the Commission explained further, "[b]y virtue of its independence, and its ability to act without the approval of the investment adviser…such a board is better able to exert a strong and independent influence over fund management."[64]

With regard to the second requirement, the SEC stated that "[i]ndependent directors who are selected and nominated by other independent directors, rather than by the fund's adviser, are more likely to have their primary loyalty to shareholders rather than the adviser."[65] As the SEC added, "when independent directors are self-selecting and self-nominating, they are less

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[62] Role of Independent Directors of Investment Companies, Securities Act Release No. 7754, Exchange Act Release No. 42,007, Investment Company Act Release No. 24,082, 64 Fed. Reg. 59,826 (proposed Nov. 3, 1999).

[63] *Id.* at 59,830.

[64] *Id.*

[65] *Id.* at 59,832.

likely to feel beholden to the adviser."[66] As the Commission concluded, "[t]hus, they may be more willing to challenge the adviser's recommendations when the adviser's interests conflict with those of the shareholders."[67]

Explaining the third requirement, the SEC commented that "[b]ecause mutual funds are highly regulated and their boards frequently are called upon to protect fund shareholders from conflicts of interest, independent counsel can be particularly helpful to independent directors of funds."[68] As the SEC reasoned, "[e]xperienced counsel can help to identify potential conflicts of interest and other compliance issues."[69] The Commission observed further that courts have also recognized the importance of independent counsel to independent directors in determining how much weight to give a board's determination to approve an advisory contract.[70]

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[66] *Id.*

[67] *Id.*

[68] Role of Independent Directors of Investment Companies, Securities Act Release No. 7754, Exchange Act Release No. 42,007, Investment Company Act Release No. 24,082, 64 Fed. Reg. 59,826, 59,833 (proposed Nov. 3, 1999).

[69] *Id.*

[70] *Id.*; *see also, e.g., Tannenbaum v. Zeller*, 552 F.2d 402, 428 (2d Cir. 1977); *Fogel v. Chestnutt*, 533 F.2d 731, 750 (2d Cir. 1975).

Because virtually all funds rely on at least one of the exemptive rules, they are all effectively required to adopt each of these heightened independence features. In addition, the SEC has also required mutual funds to have a Chief Compliance Officer, who provides the board with an independent source of information and insight about the fund's and the adviser's operations.[71] As a result of these regulatory initiatives, the independence of boards has only increased over time, further facilitating Congress' scheme and reinforcing the principle that courts should ordinarily defer to directorial approval of advisory contracts.

Industry resources have also been used to support and educate independent directors. The Forum itself conducts educational workshops and conferences, and provides on-line news, information, and publications to assist independent directors in fulfilling their duties. The Forum's 2004 whitepaper on board "best practices," which includes an extensive discussion and analysis of advisory contract reviews, is a document widely consulted and relied upon within

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[71] *See* Compliance Programs of Investment Companies and Investment Advisers, Investment Advisers Act Release No. 2204, Investment Company Act Release No. 26,299, 68 Fed. Reg. 74,714, 74,721 (Dec. 24, 2003).

the industry.[72] The SEC and others have recognized the importance of the Forum's role. Speaking at the first Policy Conference held by the Forum after its formal organization, then SEC Chairman Harvey L. Pitt stated: "Mutual fund investors benefit from groups like the Forum that seek to improve and elevate fund governance, and promote the development of vigilant, dedicated and well-informed independent directors."[73]

Similarly, the industry itself has taken steps to "strongly support[] enhancement of the standards for, and the role of, independent directors."[74] Notably, for example, the industry's trade organization, the Investment Company In-

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[72] Mutual Fund Directors Forum, *Best Practices and Practical Guidance for Mutual Fund Directors* (July 2004); *see also* Letter from William H. Donaldson, Chairman, SEC, to David S. Ruder & Allan S. Mostoff, Mutual Fund Directors Forum (Nov. 17, 2003), *in* Mutual Fund Directors Forum, *Best Practices and Practical Guidance for Mutual Fund Directors* 40-41 (July 2004) (SEC Chairman Donaldson "call[ing] upon the [Forum] to develop guidance and best practices in areas where director oversight and decision-making is critical for the protection of fund shareholders").

[73] Harvey L. Pitt, Chairman, SEC, *Remarks at Mutual Fund Directors Forum* (Jan. 8, 2003), http://www.sec.gov/news/speech/spch010803hlp.htm.

[74] Richard M. Phillips, *Mutual Fund Independent Directors: A Model for Corporate America?*, 9 ICI PERSPECTIVE 1, 3 (Aug. 2003).

stitute, has recognized the importance of independent boards, establishing within its membership the Independent Directors Council, a subgroup dedicated to the needs of independent directors and the advancement of sound industry practices.

The SEC and the industry have taken substantial steps over the years to enhance the ability of a board's independent directors to engage in robust, effective evaluations of advisory contracts. This supports the principle that, absent unusual circumstances, the board's approval of an adviser's fees is entitled to deference under the provisions of section 36(b).

In determining whether a board's evaluation and approval of a particular advisory contract has in fact been conducted in an ordinary, responsible fashion (and is thus deserving of deference), or whether unusual circumstances exist warranting setting the board's decision aside, both the courts and the SEC have likewise provided essential guidance. For example, in the seminal case *Gartenberg v. Merrill Lynch Asset Mgmt., Inc.*,[75] the Court of Appeals for the Second Circuit highlighted the central role of a fund's board in approving advisory contracts, and adopted a standard that defers to and pro-

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[75] 694 F.2d 923 (2d Cir. 1982).

tects that function when exercised responsibly. The court held that, to be guilty of a violation of section 36(b), the 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."[76] The court also identified several factors that courts should consider in reviewing cases brought under section 36(b). Among these factors—and expressly singled out by the court of appeals as important—were "the expertise of the independent trustees of a fund, whether they are fully informed about all facts bearing on the adviser-manager's service and fee, and the extent of care and conscientiousness with which they perform their duties."[77]

The *Gartenberg* decision has the correct view of the role of the board. Not only is it consistent with the statutory text, it is faithful to the purposes behind it.

[76] *Id.* at 928.

[77] *Id.* at 930. *Gartenberg* further identified other factors as potentially relevant to whether a board properly evaluated an advisory contract, including: (1) the adviser's cost in providing its services to the fund; (2) the nature and quality of its services; and (3) the extent to which the adviser realizes economies of scale as the fund grows larger. *Id.* at 929-30.

Subsequently, in a 2004 Release the SEC recognized factors similar to those listed in *Gartenberg* that boards typically consider.[78] In its release, the SEC issued rules governing disclosure requirements in fund shareholder reports and proxy statements regarding board approval of advisory contracts. The SEC determined that the following "specific factors" were especially important for boards to consider when analyzing an advisory contract:

> The amendments will require a fund to include a discussion including, but not limited to, the following: (1) the nature, extent, and quality of the services to be provided by the investment adviser; (2) the investment performance of the fund and the investment adviser; (3) the costs of the services to be provided and profits to be realized by the investment adviser and its affiliates from the relationship with the fund; (4) the extent to which economies of scale would be realized as the fund grows; and (5)

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

> whether fee levels reflect these economies of scale for the benefit of fund investors.[79]

Regarding any comparison between the fees an adviser charges a mutual fund and the fees the adviser charges other non-mutual fund clients, the 2004 Release contained the following statement:

> *Comparison of Fees and Services Provided by Adviser.* The fund's discussion will be required to indicate *whether* the board relied upon comparisons of the services to be rendered and the amounts to be paid under the contract with those under other investment advisory contracts, such as contracts of the same and other investment advisers with other registered investment companies or other types of clients (*e.g.*, pension funds and other institutional investors). If the board relied upon such comparisons, the discussion will be required to describe the comparisons that were relied on and how they assisted the board in concluding

[79] *Id.* at 39,801.

> that the contract should be approved.[80]

Notably, the amended disclosure requirements implemented by the release do not *require* this kind of comparison. Rather, they merely provide that, if the board in its discretion conducts the comparison, that fact must be disclosed.

Where a board has actively sought and obtained the information directed by section 15(c), and has actively evaluated the merits of the advisory contract addressing the factors prescribed by the SEC, the board's decision to approve the contract is entitled to deference under section 36(b) absent a compelling demonstration that the adviser materially misled the board or that deference is unwarranted owing to other unusual circumstances. Absent such a compelling demonstration, the board's decision should be conclusive. In this case, the lower courts observed that there appears to be no contention that the board neglected its duties or was materially deceived. Accordingly, the board's decision to approve the advisory contract is entitled to deference.

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[80] *Id.* at 39,801-02 (emphasis supplied).

CONCLUSION

The judgment of the Seventh Circuit affirming the District Court should be affirmed.

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