GARTENBERG, JONES, BLACKROCK AND THE DEMISE OF § 36(B) LITIGATION

STEWART L. BROWN, PH.D., CFA*

Abstract

It has long been recognized that the forces of arm's length bargaining do not operate on mutual fund management fees. Beginning with the 1970 amendments to the Investment Company Act (ICA), Congress made mutual fund sponsors fiduciaries where management fees are concerned. This happened because, as the Securities and Exchange Commission (SEC) pointed out and Congress recognized, mutual funds are captives of the investment management firms that bring them into existence and manage their portfolios. As a result, fund boards must purchase investment management services from monopoly sellers who are able to charge excess management fees.

Early in this century, the plaintiffs' bar had some success in extracting settlements from fund sponsors by comparing management fees to fees actually determined by arm's length bargaining, e.g., pension and sub-advisory fees. The fiduciary standard established in Gartenberg v. Merrill Lynch was ambiguous about such comparisons.

This changed when the district court in Jones v. Harris Associates explicitly compared fees on the named fund with fees on other mutual funds. The implication was that fees on other mutual funds are determined by competitive forces and thus could not be excessive. This directly challenged the Second Circuit's decision in Gartenberg. Jones eventually made it to the U.S. Supreme Court.

Distilled to its essence, the issue in Jones and the issue that this paper analyzes is that there is disagreement about fee competition in mutual fund markets. If advisory fees respond to competitive pressures, then fee litigation is a costly and unnecessary indulgence. If competitive forces do not operate in mutual fund markets, then fund sponsors extract tens of billions of dollars annually in excess advisory fees. The competition argument has prevailed and there is, as of the time of publication, no § 36(b) litigation outstanding against mutual fund investment management firms.

*Professor of Finance, Emeritus, Florida State University. (prof brown@comcast.net).

Soon after Jones was filed, the Investment Company Institute (ICI) commissioned a study by two well-credentialled Ivy League academics purporting to demonstrate that competitive pressures are a strong force constraining investment management fees. This paper shows that their conclusions are based on misdirection and duplicity.

The Seventh Circuit in Jones gave great credence to the ICI commissioned paper and the US Supreme Court in Jones took the case to resolve differences between the Second and Seventh Circuits. Justice Alito wrote the decision in Jones that functionally embraced the competition argument, while appearing to embrace the Gartenberg status quo. Jones effectively removed the uncertainty over comparing mutual fund fees to pension and sub-advisory fees.

As a result, the industry has no incentive to settle fee cases. Subsequent case law almost universally favors the industry. The judicial system has successfully reduced its caseload and millions of mutual fund investors continue to be overcharged tens of billions of dollars annually in excess investment management fees.

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I. Introduction

Mutual fund management fee contracts, also known as advisory fee contracts, are no-bid contracts, the product of the annual contract renewal process that occurs between the fund sponsor and the fund's independent directors.[1] Mutual funds are effectively tied to their fund sponsors, who are monopoly sellers of investment management services.[2] It is well known that fund sponsors are rarely fired[3] and that contracts are almost always renewed. It is also well-known that pension plan investment management fees and mutual fund sub-advisory fees are substantially lower than mutual fund management fees.[4] Congress recognized these facts in 1970, when it amended § 36(b) of the Investment Company Act[5] to make fund sponsors fiduciaries with regard to their fees, after finding that "the forces of arm's length bargaining do not operate in the mutual fund industry in the same manner as they do in other sectors of the American economy."[6]

In making this change, Congress understood that there was a well-established, judicially-formulated fiduciary standard applicable to fund sponsors: "The essence of the [fiduciary] test is whether or not under all the circumstances the transaction carries the earmarks of an arm's length bargain."[7] In a mutual fund context, this *Pepper* standard would make it relatively easy for plaintiffs to prevail in litigation because, for the purposes of comparison, there are empirically observable fees determined by arm's length bargaining, *e.g.*, pension and sub-advisory fees.

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[1] *See* Lyman Johnson, *A Fresh Look at Director "Independence": Mutual Fund Fee Litigation and* Gartenberg *at Twenty-Five*, 61 VAND. L. REV. 497, 503 (2008).
[2] *See* Stewart L. Brown & Steven Pomerantz, *Some Clarity on Mutual Fund Fees*, 20 U. PA. J. BUS. L. 767, 776 (2018).
[3] *See* Johnson, *supra* note 1, at 519.
[4] *See* Brown & Pomerantz, *supra* note 2, at 770–71.
[5] Investment Company Amendments Act of 1970, Pub. L. No. 91-547, § 20, 84 Stat. 1413, 1429 (codified as amended at 15 U.S.C. § 80a-35 (2018)).
[6] S. REP. NO. 91-184 (1969), at 5; *see also* Walter P. North, *Investment Company Amendments Act of 1970*, 46 NOTRE DAME L. REV. 712 (1971) (arguing that added "fiduciary duties in connection with compensation and other payments to advisors" will be one "significant contribution to investor protection").
[7] Pepper v. Litton, 308 U.S. 295, 306–07 (1939).

For reasons explored below, the judicial system crafted a different and subjective fiduciary standard that made it far more difficult for plaintiffs to prevail in litigation. The Second Circuit ruled in *Gartenberg v. Merrill Lynch* that "[t]o be guilty of a violation of § 36(b), . . . the adviser-manager must charge a fee that is so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been the product of arm's-length bargaining."[8] Judicial application of the *Gartenberg* standard has proved to be an unsurmountable barrier as no plaintiff has ever won an award under the revised statute.[9] A wave of fee litigation early in this century threatened this record as plaintiffs filed cases comparing mutual fund advisory fees to fees actually determined by arm's length bargaining, *e.g.*, pension fees and mutual fund sub-advisory fees.[10] A study by John Coates and Glen Hubbard, two well-credentialed academics, significantly influenced the litigation landscape.[11] The study supposedly demonstrated that mutual fund advisory fees are the result of competitive forces.[12] A corollary to this proposition is that fee litigation is unnecessary and wasteful because competition in the mutual fund market generates fair prices.[13] The study was influential in *Jones v. Harris,* where Justice Alito functionally embraced the competition argument by significantly modifying application of the *Gartenberg* Standard while pretending to endorse the status quo.[14] The net effect is that, as of mid-2023, there are no § 36(b) cases outstanding against mutual fund investment management firms.

The wisdom of this ruling is an open question. If indeed competition adequately constrains mutual fund advisory fees, then fee litigation is unnecessary and should be curtailed. If not, then mutual fund investors have been and continue to be overcharged by tens of billions of dollars annually in excess advisory fees and the judiciary has systematically failed to protect them.

[8] Gartenberg v. Merrill Lynch Asset Mgmt., Inc., 694 F.2d 923, 928 (2d Cir. 1982).
[9] *See* Johnson, *supra* note 1, at 519 ("[T]he most remarkable statistic under section 36(b) is that, thirty-seven years after its enactment and twenty-five years after *Gartenberg*, no investor has obtained a verdict against an investment adviser".).
[10] *See* Section IV., *infra*.
[11] John C. Coates & R. Glenn Hubbard, *Competition in the Mutual Fund Industry: Evidence and Implications for Policy*, 33 J. CORP. L. 151 (2007).
[12] *Id.* at 184 ("[O]ur results are consistent with the claim that competition by funds and complexes for assets strongly constrains advisory fees.").
[13] *Id.* at 213–14.
[14] *See Jones v. Harris Assocs. L.P.*, 559 U.S. 335, 345–53 (2010).

The purpose of this paper is to bring clarity to these issues. It consists of three interrelated parts. First, the major propositions of the Coates and Hubbard article are analyzed in detail. This is contextualized with a brief overview of competitive markets and a short primer on the structure of mutual fund fees. The evolution of the *Gartenberg* fiduciary standard is traced from its origins in the 1970 Investment Company Act amendment to its final modification in *Jones*. Finally, an important post-*Jones* sub-advisory fee case, *Blackrock*,[15] illustrates why the plaintiffs' bar has rationally given up on § 36(b) litigation.

II. Competitive Markets and Mutual Fund Fees

The above introduction paints in a broad brush, elides some important issues, and omits twists and turns in case law. However, two facts stand out. First, the Coates and Hubbard article was influential in *Jones.* Second, there is currently no outstanding mutual fund fee litigation under section 36(b) of the Investment Company Act. The first fact is pivotal to understanding the second.

A superficial comparison of mutual fund markets and the theory underlying perfectly competitive markets suggests a strong resemblance. There are a large number of buyers and sellers, low barriers to entry and exit, and a reasonably homogeneous product.[16] However, a closer look suggests that caution should be exercised. The competitive markets theory assumes that market participants are rational and fully informed; however, there is evidence that these assumptions are systematically violated in mutual fund markets.

Studies have shown that fund investors are largely ignorant of the fees they are charged for mutual funds. An SEC survey found:

- *Only 18.9 percent of investors could give an estimate of expenses for their largest mutual fund;*[17]
- *Less than half (43 percent) claimed they knew of the expenses of their largest funds at purchase;*[18] *and*

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[15] In re BlackRock Mut. Funds Advisory Fee Litig., 327 F. Supp. 3d 690 (D.N.J. 2018), *aff'd*, 816 F. App'x 637 (3d Cir. 2020).

[16] *See* Coates & Hubbard, *supra* note 11, at 163–80.

[17] Gordon J. Alexander, et al., *Mutual Fund Shareholders: Characteristics, Investor Knowledge, and Sources of Information*, 7 FIN. SERVS. REV. 301, 309 (1998).

[18] *Id.* at 310.

- *Only 16 percent believed that higher expenses led to lower-than-average returns.*[19]

A second study, by Wallison and Litan, asked mutual fund investors to rate, on a scale of one to ten, how informed they were about their mutual fund investments.[20]

- *Only 21 percent of the surveyed investors rated their knowledge as high (8 or above);*[21]
- *Fewer than 10 percent of that sub-group "knew even approximately what they were paying as an advisory fee."*[22]

A third study found that 84 percent of investors believe that higher operating costs mean better performance.[23]

There is also evidence that behavioral biases influence mutual fund investor behavior.[24] Research shows that many individual investors hold significant positions in high-expense mutual funds.[25] Other research has found that fund flows tend to chase funds with high past returns.[26]

In addition to behavioral biases and the pervasive financial illiteracy of mutual fund investors, systemic frictions limit their ability to seek out lower fees. The tax code makes it difficult to switch to low-cost funds without incurring significant capital gains taxes and many funds are held in retirement accounts where choices are limited and there are tax penalties for withdrawal of funds.

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[19] *Id.*
[20] PETER J. WALLISON & ROBERT E. LITAN, COMPETITIVE EQUITY: A BETTER WAY TO ORGANIZE MUTUAL FUNDS 73 (2007).
[21] *Id.*
[22] *Id.*
[23] Brad M. Barber, et al., *Out of Sight, Out of Mind: The Effects of Expenses on Mutual Fund Flows*, 78 J. BUS. 2095, 2099 (2005).
[24] Warren Bailey, et al., *Behavioral Biases of Mutual Fund Investors*, 102 J. FIN. ECON. 1 (2011).
[25] Martin J. Gruber, *Another Puzzle: the Growth in Actively Managed Mutual Funds*, 51 J. FIN. 783-810 (1996); Barber et al., *supra* note 23, at 2095-2120.
[26] Daniel Bergstresser, et al., *Assessing the Costs and Benefits of Brokers in the Mutual Fund Industry*, 22 REV. FIN. STUDIES 4129, 4149-50 (2009); Travis Sapp & Ashish Tiwari, *Does Stock Return Momentum Explain the 'Smart Money' Effect?*, 59 J. FIN. 2605, 2607–08 (2004).

An understanding of the complexity of mutual fund fees is a prerequisite to understanding the challenges faced by mutual fund investors and courts in fee litigation. Those issues are addressed next.

A. A Short Primer on Mutual Fund Fees

Mutual fund fees are complicated. The same mutual fund may charge very different fees to different investors across various distribution channels and fund classes. Moreover, total fees can be disaggregated into their component parts, each of which responds individually to different forces.

The aggregate fee paid by each investor is the Total Expense Ratio (TER).[27] It is the overall annual fee rate paid by fund investors. When multiplied by the average annual level of assets invested in the fund, it yields the dollar level of fees paid annually. In general, the greater the TER, the lower the annual rate of return on invested funds accruing to fund investors. The TER is generally comprised of three major component parts.[28] To illustrate the breakdown of fees, it is useful to look at a specific fund, in this case, the BlackRock Equity Dividend Fund.[29] Consider Table 1:[30]

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[27] *See* Adam Hayes, *Total Expense Ratio (TER): Definition and How to Calculate*, INVESTOPEDIA, (Apr. 26, 2024), https://www.investopedia.com/terms/t/ter.asp [https://perma.cc/W68E-8576].

[28] *See id.*

[29] There is nothing exceptional or unusual about this fund. It is chosen as typical of thousands of other mutual funds available to investors. It also happens to be one of the named funds in the Blackrock sub-advisory fee case examined below. *See* Section V, *infra*. According to Morningstar, the Equity Dividend Fund is a large-cap value fund. Following the Morningstar convention, fee rates are presented in percentage form, *i.e.*, the TER on the Inv A fund is about .92 or point 92 percent. This corresponds to .0092 or 92 basis points.

[30] The information in Table 1-1 was obtained from Morningstar Direct, which aggregates it from various sources. Individual investors are likely to see only the information associated with their specific fund class. TER numbers are readily available as are distribution fees and total fund assets. More detail is available from various sources, including Fact Sheets, Summary Prospectuses, Prospectuses, Annual Reports and Statements of Additional Information.

Table 1

Blackrock Equity Dividend Fund

Fiscal Year: April 2023

Name	Annual Report Net Expense Ratio	Advisory Fee	12b-1 Fee	Fund Class Average Assets	Implied Admin Fee
BlackRock Equity Dividend Inv A	0.92	0.56	0.25	4,940,452,987	0.11
BlackRock Equity Dividend Inv C	1.69	0.56	1.00	326,384,128	0.13
BlackRock Equity Dividend Instl	0.69	0.56		10,501,241,516	0.13
BlackRock Equity Dividend K	0.58	0.56		2,966,870,076	0.02
BlackRock Equity Dividend R	1.27	0.56	0.50	432,473,054	0.21
BlackRock Equity Dividend Svc	0.99	0.56	0.25	52,943,596	0.18
Total Fund Average Assets				19,220,365,357	
Source: Morningstar Direct					

BlackRock is the investment management firm (fund sponsor) that brought this fund into existence and contracts to manage its investment portfolio.[31] The fund had average assets over the one-year period ending in April 2023 of about $19.2 billion.[32] Like many open-end funds, this fund is composed of share classes, in this case, six of them.[33] Different share classes are offered through different marketing channels. For instance, the A and C share classes carry sales charges and are principally sold through the brokerage channel.[34] The remaining share classes are sold through direct marketing channels.[35]

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[31] BLACKROCK, 2023 ANNUAL REPORT: BLACKROCK EQUITY DIVIDEND FUND (April 30, 2023), https://www.blackrock.com/us/individual/resources/regulatory-documents/stream-document?stream=reg&product=BR_EDF&shareClass=Class+Inst&documentId=920573%7E920847%7E920604%7E1807800%7E1852370&iframeUrlOverride=%2Fus%2Findividual%2Fliterature%2Fannual-report%2Far-equity-dividend-fund.pdf [hereinafter 2023 ANNUAL REPORT].

[32] *Id.* at 7–10.

[33] *Id.* at 20 ("Institutional, Service and Class K Shares are sold only to certain eligible investors. Service, Investor A, Investor C and Class R Shares bear certain expenses related to shareholder servicing of such shares, and Investor C and Class R Shares also bear certain expenses related to the distribution of such shares. Investor A and Investor C Shares are generally available through financial intermediaries. Class R Shares are sold only to certain employer-sponsored retirement plans.").

[34] *Id.* at 6.

[35] *See id.*

The TER for each share class is the sum of three components: advisory or management fees, distribution or 12b-1 fees, and administrative fees.[36] Average assets are different for each share class with the institutional class comprising more than half of total assets.[37]

Each share class carries a different TER.[38] Investors in different share classes experience different investment returns depending on the expense ratio paid. For instance, the expense ratio on the C fund, a level load fund, is 1.69 percent annually and the expense ratio on the K class is .58 percent.[39] The C fund expense ratio is thus about 3 times the K class ratio and the C class shares will underperform K class shares by 1.11 percent annually just because of the expenses involved.

Advisory fees are fees paid to the fund sponsor, in this case, BlackRock, to manage the fund's portfolio.[40] The advisory fee is the same for all fund classes, .56 percent, or 56 basis points.[41] Management fee contracts are at the total fund level. Fund sponsors generally do not charge different fee rates to different fund classes.[42]

Distribution or 12b-1 fees are marketing fees.[43] These are typically, although not universally, charged at either a 25 or 100-basis point level.[44] The 25-basis point 12b-1 fee, often referred to as a shareholder

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[36] *See id.* ("Shareholders of the Fund may incur the following charges: (a) transactional expenses, such as sales charges; and (b) operating expenses, including investment advisory fees, service and distribution fees, including 12b-1 fees, acquired fund fees and expenses, and other fund expenses.").
[37] *Id.* at 11.
[38] *See id.* at 6.
[39] *See* Table 1, *supra*.
[40] In this paper the terms advisory fees and management fees are used interchangeably.
[41] *See* Table 1, *supra*; 2023 ANNUAL REPORT, *supra* note 31, at 22.
[42] SUSAN A. JOHNSTON, TAXATION OF REGULATED INVESTMENT COMPANIES AND THEIR SHAREHOLDERS ¶ 3.02[2] (2022).
[43] LORI WALSH, THE COSTS AND BENEFITS TO FUND SHAREHOLDERS OF 12B-1 PLANS: AN EXAMINATION OF FUND FLOWS, EXPENSES AND RETURNS 2 (2005), https://www.sec.gov/rules/proposed/s70904/lwalsh042604.pdf; *see also* Bearing of Distribution Expenses by Mutual Funds, 45 Fed. Reg. 73,898 (Nov. 7, 1980) (to be codified at 17 C.F.R. pts. 239, 270, 274).
[44] *See* U.S. SEC. & EXCHANGE COMMISSION, DIV. OF INV. MGMT., REPORT ON MUTUAL FUND FEES AND EXPENSES § III(D)(I) (Dec. 2000), http://www.sec.gov/news/studies/feestudy.htm [hereinafter SEC Staff Study] ("After careful consideration, the NASD determined that funds should pay no more than 100 basis points in 12b-1 fees, 75 basis points of which could be for distribution expenses and 25 basis points for service fees annually. In

service fee, was sanctioned by the SEC in 1980.[45] It imposes marketing costs on existing shareholders in order to attract new shareholders. The theory at the time was that overall fees would eventually come down as a result of economies of scale.[46] This did not happen.[47]

Overall, distribution fees on funds that charge some form of sales load are capped at 100 basis points.[48] Fees at that level are composed of two components: shareholder service fees and fees used to compensate selling brokers.[49] For instance, in the Equity Dividend Fund, the C class shares carry a level load, and the selling broker is compensated with the 75 basis point distribution fee.[50]

Administrative fees are fees paid to various service providers to the fund.[51] These are not explicitly disclosed at the share class level and must be inferred as the difference between the TER and the sum of 12b-1 and management fees. These are calculated and presented in the right-hand column of Table 1. Administrative fee rates range from a high of twenty-one (21) basis points on the R shares to a low of two (2) basis points on the K shares. It is of note that administrative fees for the K class are unrealistically low. This is likely an example of what is known as revenue sharing, where costs such as recordkeeping are provided by

addition, the NASD determined that a fund with no sales load and a 12b-1 fee of 25 basis points or less could identify itself as a no-load fund.").

[45] Bearing of Distribution Expenses by Mutual Funds, 45 Fed. Reg. at 73,898.

[46] *See* SEC Staff Study, *supra* note 44, at § III(B)(2), n.64 ("Another rationale was that use of fund assets for distribution expenditures would result in a net flow of cash into funds, and in turn, economies of scale and more effective portfolio management."); John Freeman, *The Mutual Fund Distribution Fee Mess*, 32 J. CORP. L. 739, 768 (2007) ("A recurring claim made by the industry prior to Rule 12b-l's adoption was that by generating sales and thereby growing funds' assets, administrative and management costs would fall, allowing fund shareholders to, in essence, realize a net gain on their invested marketing dollars.").

[47] *See* SEC Staff Study, *supra* note 44, at § III(D)(I); WALSH, *supra* note 43, at 2.

[48] S*ee* Brown & Pomerantz, *supra* note 2, at 776.

[49] *See Fast Answers: Mutual Fund Fees and Expenses*, U.S. SEC. & EXCH. COMM'N, https://www.sec.gov/fast-answers/answersmffeeshtm.html#distribution [https://perma.cc/N5WX-94MW] ("'Distribution fees' include fees paid for marketing and selling fund shares, such as compensating brokers and others who sell fund shares, and paying for advertising, the printing and mailing of prospectuses to new investors, and the printing and mailing of sales literature.").]

[50] *See* Table 1, *supra*; 2023 ANNUAL REPORT, *supra* note 31, at 22.

[51] *See* Brown & Pomerantz, *supra* note 2, at 774.

third parties in 401(k) accounts.[52] Fund shareholders still pay for these services, but the costs are undisclosed in the BlackRock disclosure documents.

A principal insight to be gleaned from the above analysis is that investment management companies compete for mutual fund assets with variations of the TER in different marketing channels. These variations are the result of variations in distribution and administrative fees. Management fees are constant across fund classes. Fund distribution and some administrative services may be provided by subsidiaries of the fund sponsor, but the primary motivation of fund sponsors is to maximize assets managed in order to maximize investment management revenues.

Expenses in Table 1 are presented as percentages of the average assets involved. Every open-end fund publishes a "Statement of Operations" in the annual report showing the dollar level of expenses paid by the fund in different expense categories.[53] The dollar amounts are for the whole fund, not broken down by share class. The 2023 Statement of Operations for the Blackrock Equity Dividend Fund is presented in Table 2, *supra*.

For the purposes of comparison, the two right-hand columns have been added here to convert the dollar amounts in the Statement of Operations into percentages. Like Table 1, *supra*, there are three broad categories of expenses: investment management or advisory fees, distribution or 12b-1 fees, and administrative fees.[54] In Table 2, *infra*, total administrative fees are shown as well as the eight individual components involved.[55] Dividing the dollar amounts in each category by the average total assets of the funds yields a weighted average fee rate in each category. Thus, since each fund class has the same management fee, the weighted average management fee is the same, .56 percent or

[52] *See* Dana Muir, *Revenue Sharing in 401(k) Plans: Employers as Monitors?*, 20.2 CONN. INS. L.J. 485, 496 ("One survey shows that 83 percent of all fees associated with 401(k) plans are paid by plan participants. Most of those payments are made through revenue sharing. The survey also notes that some of the revenue sharing may pay for plan administration, including recordkeeping").

[53] *See* 2023 ANNUAL REPORT, *supra* note 31, at 12.

[54] *See id.* at 6.

[55] Administrative expense categories are not standardized. Most funds, like BlackRock, disclose transfer agent, custodial, audit and trustee fees. *See id.* at 12. Others disclose administrative fees in more or less detail. Morningstar standardizes administrative fee disclosure into thirteen expense categories.

56 basis points.[56] Because distribution fees are not charged in every fund class, overall Service and Distribution fees for the fund were 9.4 basis points.[57] Similarly, even though each fund class exhibited different administrative fees in Table 1, the overall or asset-weighted administrative fee was 11.3 basis points. The asset-weighted total expense ratio is .767 percent or 76.7 basis points. No single investor paid this exact fee rate as it is a composite of the six fund classes.

Table 2
Blackrock Equity Dividend Fund
Statement of Operations - Partial
Fiscal Year: April 2023

Expenses			Average Assets	Fee Rates
Investment Advisory		107,711,422	19,220,365,357	0.560%
Service and Distribution - class specific		17,988,435	19,220,365,357	0.094%
Administrative (Total)		21,742,942	19,220,365,357	0.113%
	Transfer Agent - class specific	18,891,350	19,220,365,357	0.098%
	Accounting Services	1,499,217	19,220,365,357	0.008%
	Registration	380,183	19,220,365,357	0.002%
	Custodian	340,449	19,220,365,357	0.002%
	Trustees and Officer	153,275	19,220,365,357	0.0008%
	Proifessional	150,673	19,220,365,357	0.0008%
	Printing and Postage	114,524	19,220,365,357	0.0006%
	Miscellaneous	213,271	19,220,365,357	0.0011%
Total Expenses		147,442,799	19,220,365,357	0.767%
	less			
	Fees waived and or reimbursec	(685,867)		
	by manager			
Total Expenses after fee waivers		146,756,932	19,220,365,357	0.764%

The single biggest component of fund expenses is investment advisory fees, with about $108 million in costs to fund shareholders.[58] Service and Distribution fees totaled about $18 million and administrative fees totaled about $22 million.[59] Overall, fund shareholders paid

[56] *See id.* at 22.
[57] *See id.* at 6.
[58] *Id.* at 12.
[59] *Id.*

about $147 million in costs on about $19.2 billion in assets for one year.[60]

Each of the different administrative expense categories represents payments on different contracts to different service providers. Transfer agent and custodial services are typically provided by firms independent of the fund sponsor.[61] SEC rules require that directors ensure that these fees are reasonable.[62]

B. Coates and Hubbard

The title of the Coates and Hubbard paper (hereinafter CH) is "Competition in the Mutual Fund Industry: Evidence and Implications for Policy."[63] Its principal thesis is: "From an economic perspective, competition is the best guardian against excessive fees. With price competition, fund advisers cannot set fees above the competitive level without driving themselves out of business."[64] CH summarize their findings as follows:

> Fund critics overlook the most salient characteristic of a mutual fund: redeemable shares. While boards rarely fire advisers, fund investors may "fire" advisers at any time by redeeming shares and switching into other investments.[65]
>
> [W]e review the structure, performance and dynamics of the mutual fund industry, and show they are consistent with competition. Concentration and barriers to entry are low, actual entry is common and continuous, pricing exhibits no dominant long-term trend, and market shares fluctuate significantly. We then present the

[60] *Id.*
[61] *See id.* at 34 (listing State Street Bank and Trust Company as custodian and BNY Mellon Investing Servicing Inc. as transfer agent for the Equity Dividend Fund).
[62] 17 C.F.R. § 240.14b-2 (2022) ("For the purposes of determining the fees which may be charged to registrants . . . , an amount no greater than that permitted to be charged by brokers or dealers for reimbursement of their reasonable expenses, both direct and indirect . . . shall be deemed to be reasonable.").
[63] Coates & Hubbard, *supra* note 11, at 151.
[64] *Id.* at 153.
[65] *Id.* at 151.

> results of our direct estimate of the effects of competition on fees, set out in more detail in the Appendix. Specifically, we find that enough investors are sensitive to advisory pricing that higher fees significantly reduce fund market shares.[66]

The CH paper is wide-ranging and includes a deconstruction of *Gartenberg* and subsequent cases, their interpretation of published research on mutual fund fees, as well as their analysis and presentation of data supporting their two principal propositions. Analysis below refutes the two propositions that directly support their overall conclusion that competition is a strong force constraining mutual fund fees. The first proposition addresses the indirect evidence that mutual fund markets are competitive. The salience of this proposition depends on a subsidiary hypothesis that competition for investor assets causes fees to be competitive. The initial proposition is clearly true, but the conclusion or inference is highly questionable. The second proposition examines CH's claim of direct statistical evidence that high advisory fees reduce fund market shares.

1. *Indirect Evidence of Impact of Competition of Fund Fees*

There is a disproportionate emphasis in the CH paper enumerating and discussing the factors in mutual funds markets that are "consistent with competition."[67] These include a large number of buyers and sellers, uninhibited entry and exit, numerous distribution channels, and other factors consistent with the model of perfectly competitive markets.[68] This analysis is impressively erudite but essentially amounts to misdirection.

It is unquestionably true that there is vigorous competition between investment management firms for investor's fund assets. For example, the numerous distribution channels associated with the BlackRock Equity Dividend Fund detailed above are a microcosm of

[66] *Id.* at 153.
[67] *See id.* at 153, 163–80.
[68] *Id.* at 180 ("New entry is common and, for decades, has been a constant feature of the industry. Barriers to entry are evidently low, and funds are distributed through multiple distribution channels that themselves reflect a second layer of competition for investor assets.").

this competition.[69] However, competition for investor assets is not the same as fee competition.

It is a simple immutable fact that mutual fund advisory fee contracts are no-bid contracts; the product of the annual fee review process that takes place between the fund sponsor and independent directors who face monopoly sellers of investment management services.[70] As CH note, fund sponsors are essentially never fired[71] and contracts are almost always approved. This is the central conflict of interest associated with the structure of mutual funds.[72] Fees don't change unless sponsors are incentivized and want them to change. The Second Circuit in *Gartenberg* clearly recognized this:

> 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).[73]

There is no market for mutual fund fees and none of the normal market functions like price discovery and liquidity are involved. Despite their obvious enthusiasm, the evidence CH present to the contrary is irrelevant. They depend instead on a core feature of mutual funds—share redeemability—to incentivize fund sponsors to lower fees.[74] This leads to the pivotal hypothesis of the paper.

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[69] *See* 2023 ANNUAL REPORT, *supra* note 31, at 6, 20.

[70] Coates & Hubbard, *supra* note 11, at 202 ("[M]utual funds are not required to put advisory contracts up for bid.").

[71] *Id.* at 151, 158–60.

[72] *Id.* at 158 ("[A]n adviser has—at least in the first instance—an incentive to maximize its profits by charging the highest possible fees for its services, and—again, at first pass—the fund's shareholders prefer the lowest possible fees so as to maximize the fund's returns.").

[73] Gartenberg v. Merrill Lynch Asset Mgmt., Inc., 694 F.2d 923, 929 (2d Cir. 1982).

[74] Coates & Hubbard, *supra* note 11, at 162 ("From an economic perspective, the protection of redeemable shares is arguably more important in supporting competition than any other aspect of the current legal framework.").

> Economic theory also tells us that competition will constrain prices even if *some* fund investors face significant switching costs. Not all, or even most, buyers have to switch from high- to low-cost products to affect price competition. . . . 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.[75]

The operational point is that "fund advisers must price competitively for their funds to retain price-sensitive customers." However, in order to do so, fees must be lowered for the whole fund. Fund sponsor profit incentives mitigate against this result.[76] It is well known that profit margins on investment management contracts are very high. Gross profit margin on the money fund in *Gartenberg* was 95 percent.[77] The operating profit margins on the seminal profit margin case was as high as 77 percent,[78] and margins in that range are commonly recognized in judicial decisions.[79] Given margins at that level, rational fund sponsors will let the fee-sensitive assets exit in order to maintain profits and profit margins on the remaining non-fee-sensitive assets.

There is evidence to support this proposition. Over the last twenty-five years, there has been a massive exodus of fee-sensitive investors to low-fee index funds and no commensurate decrease in the

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[75] *Id.* at 199.

[76] *See id.* at 159 ("Under competition, the initial desire of buyers . . . to decrease prices as low as possible will be constrained by the fact that sellers must earn enough to cover their costs, including a fair rate of return on their capital, and if they do not, they will exit the market.").

[77] Stewart L. Brown, Mutual Fund Advisory Fees: Forty Years of Failure, 16 BROOK. J. CORP. FIN. & COM. L. 1, 21 (2022) [hereinafter Brown, Forty Years of Failure].

[78] Schuyt v. Rowe Price Prime Reserve Fund, Inc., 663 F. Supp 962, 973 n.37 (S.D.N.Y. 1987) ("[T]he Court is willing for the purpose of argument to accept the profitability figures calculated by plaintiff's expert Mr. Silver, a 59.1% profit margin in 1979 and a 77.3% profit margin in 1981.").

[79] *Id*.

level of advisory fees on actively managed funds.[80] Consider Panel A of Table 3[81]:

	1996		2021		Percent Change
Table 3					
Panel A: Passively & Actively Managed Open-End Mutual Fund Assets 1996-2021					
	1996		**2021**		**Percent Change**
Actively Managed Assets ($billions)	$	1,237	$	13,936	1027%
Passively Managed Assets ($billions)	$	61	$	4,709	7587%
Total Assets (billions)	$	1,298	$	18,645	1336%
Percent Passive		4.7%		25.3%	435%
Panel B Weighted Average Fee Changes - Actively Managed Funds					
	1996		**2021**		**Percent Change**
Total Assets ($billions)	$	1,237	$	13,936	
Weighted Average Total Expenses (bps)		82.3		63.3	-23.1%
Weighted Average Advisory Fees (bps)		48.8		45.3	-7.1%
Weighted Average Distribution Fees (bps)		11.1		6.6	-40.5%
Weighted Average Administrative Fees (bps)		22.4		11.4	-49.1%

Over the twenty-five-year period between 1996 and 2021, total assets on all open-end mutual funds, excluding money market funds, increased from about $1.3 to about $18.6 trillion dollars. The passively managed share increased from about $61 billion, or 4.7 percent of the total, to about $4.7 trillion, or about 25 percent of total open-end mutual fund assets. Over the same period, the weighted average TER on passively managed funds decreased by about two-thirds from about 22 basis points to about 8 basis points. This is clear evidence that fee-sensitive investors have embraced passive index funds rather than actively managed funds with higher fees.

Consider Panel B of Table 3. Over the same twenty-five years, the assets of actively managed open-end funds increased from about $1.2 trillion to about $14 trillion, a 1000 percent increase.

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[80] *See* Coates & Hubbard, *supra* note 11, at 180 ("[H]olding other factors constant, investors shift substantial amounts of assets out of high-fee funds and into low-fee funds."); Stewart L. Brown & Steven Pomerantz, *Mutual Fund Advisory Fees: Sponsors Game the System as Watchdogs Slumber*, 15 OHIO ST. BUS. L.J. 29, 58–59 (2021) [hereinafter Brown & Pomerantz, *Mutual Fund Advisory Fees*] ("Although assets under management [for actively-managed funds] increased by approximately 670% [between 1995 and 2018], advisory fees declined by only 4.3 basis points or about 8 percent, from 53.6 basis points to 49.3 basis points.").

[81] This data is compiled and derived from the Morningstar Direct database.

Weighted average Total Expense Ratios decreased from about 82 basis points to about 63 basis points, a 23 percent decrease. The individual components of the TER decreased at widely different rates, with advisory fees down slightly at 7.1 percent, administrative fees down 49 percent and distribution fees decreased by about 40 percent. The overall decrease in TER was dominated by decreases in administrative and distribution fees; advisory fees were relatively flat.

Distribution fees are driven mainly by investor preferences. It is well-known that investors are most aware of what are known as load or sales fees.[82] Barber, Odean and Zheng find that "[i]nvestors are more sensitive to salient, in-your-face fees, like front-end loads and commissions, than operating expenses. . ."[83] It is therefore unsurprising that there has been a dramatic trend away from funds charging such fees, which is reflected in a decrease in assets of funds charging contingent deferred sales charges, a large component of distribution fees.[84]

The decrease in administrative fees was driven principally by competition and economies of scale.[85] The dramatic increase in mutual fund assets and the resultant economies of scale flowed through to fund investors in part because mutual fund boards are required to ensure that administrative fees are reasonable.[86] Fund directors and trustees compare these fees to fees available in the competitive market and this forces an overall decrease in administrative fees.

Unfortunately, there is no equivalent rule that directors ensure that advisory fees are reasonable. Rather, directors are charged as watchdogs to ensure that advisory fees do not violate fiduciary standards established by *Gartenberg* and *Jones*. As a result, section 36(b) litigation has focused on advisory fees, and it is in the advisory function that economies of scale are most likely to be realized.

As shown in Table 3, *supra*, advisory fee rates have decreased somewhat, although far less than distribution and administrative fee rates and also far less than fees on index funds where competition is

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[82] *See* Barber et al., *supra* note 23, at 2097 ("[W]e hypothesize that investors have learned to avoid front-end load funds by experience.").
[83] *Id.* at 2095.
[84] *See id.*
[85] Brown & Pomerantz, *supra* note 2, at 775 ("Administrative services are likely to be subject to economies of scale and there is robust and transparent competition to provide most of these services.").
[86] *See, e.g.*, John P. Freeman, *The Mutual Fund Distribution Expense Mess*, 32 J. CORP. L. 739, 815-27 (2007).

clearly present.[87] This small decrease has likely been caused by economies of scale in the advisory function which caused profit margins on some funds to increase to a level where they exceed the maximum margin of about 77 percent established in *Schuyt*[88] and usually adhered to by the industry.

The intuition, recognized by the industry itself, is that the mutual fund advisory function should exhibit scale economies.[89] It should cost little more to manage a $10 billion portfolio than a $1 billion portfolio and this should reduce fees because of the increased assets associated with the imposition of distribution fees. When advisory fees do not decrease as economies of scale are realized, it is the fund sponsors who capture the scale economies in the form of excess profits. Panel B in Table 3, *supra*, is consistent with a Wharton Report prepared for the Securities and Exchange Commission and with Malkiel's insights on this topic.[90] Between 1996 and 2021, the total assets of the universe of actively managed open-end fund increased about 1000 percent from

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[87] *See also* Brown & Pomerantz, *Mutual Fund Advisory Fees*, *supra* note 80, at 58–59.

[88] Schuyt v. Rowe Price Prime Rsrv. Fund, Inc., 663 F. Supp. 962, 989, n.77 (S.D.N.Y.), *aff'd*, 835 F.2d 45 (2d Cir. 1987). Economies of scale are one of the *Gartenberg* factors directors must consider when fulfilling the watchdog function; profit margins increase as economies of scale are realized. *See* Brown & Pomerantz, *Mutual Fund Advisory Fees*, *supra* note 80, at 31-32 (2021).

[89] *See* GENERAL ACCOUNTING OFFICE, GAO/GGD-00-126, MUTUAL FUND FEES ADDITIONAL DISCLOSURE COULD ENCOURAGE PRICE COMPETITION 34 (2000); Mutual Fund Industry Practices *and Their Effect on Individual Investors: Hearing Before the Subcomm. on Cap. Mkts., Ins., & Gov't. Sponsored Enters. of the H. Comm. on Fin. Servs.*, 108th Cong. 73 (2003) (testimony of John C. Bogle, President, Bogle Financial Markets Research Service and Founder and former Chief Executive, Vanguard Group) (highlighting that there are "staggering" economies of scale in the mutual fund business).

[90] *See* WHARTON SCH. OF FIN. & COMMERCE, 87TH CONG., A STUDY OF MUTUAL FUNDS (Comm. Print 1962) [hereinafter Wharton Report] (opining that mutual fund investment managers had captured the economies of scale because fees failed to respond to increases in assets); Burton G. Malkiel, *Asset Management Fees and the Growth of Finance*, 27 J. ECON. PERSPS. 97, 97-99 (2013) (noting that the financial services sector grew from 4.9 percent to 8.3 percent of GDP between 1980 and 2006 and attributing a large proportion of this growth to increases in the fees paid for asset management).

about $1.2 to about $14 trillion.[91] Over the same period, weighted average advisory fees did fall, but only slightly from 48.8 to 45.3 basis points.[92]

The CH insights into economies of scale are unhelpful, confusing, and mostly wrong:

> Why are economies of scale not more important than our data suggest they are? Advisory costs extend well beyond portfolio management, where economies of scale are most intuitive. Additional expenses include transfer agency, communication with investors (websites, telephone access, and fund reports), custodial service, reports to regulatory agencies, brokerage fees, and overhead expenses such as management, legal, regulatory, and accounting.[93]

It is unclear whether CH are themselves confused about the costs involved or are deliberately attempting to muddle the issue for the courts. They confuse fees and costs to the investment manager and fees and costs to fund shareholders. Economies of scale in the advisory function are about advisory fees and advisory costs, and do not extend beyond portfolio management. Further, as a perusal of Table 2, *supra*, should make clear, items such as transfer agency, communications with investors, accounting, and custodial services are paid for by investors under separate distribution and administrative contracts. Investors also pay commissions and trading costs. These are not additional expenses borne by the investment management firm. To suggest otherwise is wrong and highly misleading.

Overall, the fact that there is vigorous competition between investment management firms for investor assets is irrelevant to the actual fee-setting process that takes place annually during the fee review process. Mutual fund advisory fee contracts are no-bid contracts, period. Saying that fund sponsors compete for fund assets is irrelevant and amounts to misdirection.

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[91] *See* Table 3, *supra*.
[92] See *id.*
[93] Coates & Hubbard, *supra* note 11, at 192.

2. *Direct Evidence of Fee Competition*

Mutual fund § 36(b) litigation and its interpretation in *Gartenberg* and *Jones* is primarily concerned with advisory fees. CH directly state that they test the relationship between advisory fees and fund assets.[94] "Specifically, we find that enough investors are sensitive to advisory pricing that higher fees significantly reduce fund market shares."[95] This statement is untrue. CH present the results of econometric tests in an Appendix and state that: "The model is estimated at both the fund and complex level. Fees at the fund level are measured by the expense ratio, and fees at the complex level are measured by the net asset-weighted average expense ratio."[96] CH explicitly state that they test advisory fees while in fact, they tested TERs. The paper therefore contains a sleight of hand critical to their overall results.

It is unsurprising that CH should find a relationship between fund assets and TERs. As shown in Table 1, supra, the variability of TERs is dominated by variability of distribution and administrative fees. Regressions at the fund level relate fees at the fund class level to assets at the fund class level. It does not take a degree in statistics to note from Table 1 that advisory fees are constant across all fund classes, but distribution and administrative fees are highly variable. The two fund classes of the Equity Dividend Fund with the lowest TERs are the institutional class with a TER of 68 basis points and the K class with a TER of 57 basis points. The combined assets of these two classes are about $15 billion or 70 percent of total fund assets. Low fees are indeed associated with higher asset levels, but the relationship is driven by differential distribution and administrative fees and is unrelated to advisory fees.

The supposed direct results in the CH Appendix are pivotal and highly misleading. Advisory fee data are readily available from Morningstar and elsewhere.[97] Nowhere in the study do CH examine advisory fees directly. It is not unreasonable to suggest that if the authors had

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[94] *Id.* at 180, 183–84.
[95] *Id.* at 153.
[96] *Id.* at 216.
[97] *See* Bryan Armour & Zachary Evens, *2022 U.S. Fund Fee Study*, MORNINGSTAR MANAGER RSCH. (Aug. 2023) ("In 2018, Morningstar introduced our service-fee arrangement attribute in our U.S. funds database. This attribute classifies funds based on their service-fee arrangements between asset managers, distributors, advisors, and investors.").

been able to identify a relationship between advisory fees and assets they would have done so. It is telling that they did not.[98]

Advisory fee contracts are no-bid contracts and advisory fees are insulated from competitive pressures.[99] Professor Hubbard has admitted as much under oath:

> As Hubbard explained, from a shareholder's perspective, a mutual fund's total expense ratio is the most economically meaningful fee because the expense ratio, and not the advisory fee, is the fee that the shareholder *actually* pays; a shareholder cannot purchase portfolio management services from one adviser and then purchase transfer-agency, custodial, or other services from another adviser.[100]

To the extent that fund shareholders are aware of fees, it is indeed true that the fund's TER is the most meaningful fee.[101] Professor Hubbard's admission that there is a disconnect between TERs and advisory fees is an explicit repudiation of the highly misleading results pivotal to CH's overall conclusion that competition constrains advisory fees. It is a curious footnote that Judge Ramos in *Chill* attached such importance to a statement disconnecting competition from advisory fees when *Chill* was a § 36(b) case about advisory fees.

The CH research has gained traction at the highest levels of academic publishing.[102] Building on the implications of the redeemability feature of mutual funds, Roiter examines the implications for mutual

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[98] *See* Barber et al., *supra* note 23, at 2095 (analyzing mutual fund flows over a 30-year period and finding a negative relationship between flows and front-end load fees, but no relationship between operating expenses (advisory fees) and flows).

[99] *See* Coates & Hubbard, *supra* note 11, at 202; *see also* Stewart L. Brown, *Mutual Fund Advisory Fees: An Objective Fiduciary Standard*, 21:3 UNIV. OF PENNSYLVANIA J. OF BUS. L., 477, 490–91 (2019).

[100] Chill v. Calamos Advisors LLC, 417 F. Supp. 3d 208, 237–38 (S.D.N.Y. 2019).

[101] Research cited above, *see* fn. 17, 20, and 23, *supra,* suggest that most fund investors are unaware of fees being charged against their accounts.

[102] *See* John Morley & Quinn Curtis, *Taking Exit Rights Seriously: Why Governance and Fee Litigation Don't Work in Mutual Funds*, 120 YALE L. REV. 84 (2010).

fund governance.[103] Morley and Curtis look at the impotence of fund governance and fee litigation and frame the issues as follows:

> We argue that the problem with voting, boards, and fee liability in mutual funds is simply that investors will almost never use them. Investors will almost always prefer instead either to do nothing or to use a unique right of exit that is not available in ordinary companies. Mutual fund investors can be expected to behave this way *under any reasonable view of mutual fund market competition* and *regardless of whether investors are large and sophisticated or small and unsophisticated*.[104]

Morley and Curtis partially condition their argument on an acceptance of the CH results which they found compelling:

> The argument that *most* funds charge competitive fees has been made most persuasively by John Coates and Glenn Hubbard in an influential recent article. They present very compelling evidence to suggest that "[c]oncentration and barriers to entry are low, actual entry [by new funds] is common and continuous, pricing exhibits no dominant long-term trend, and market shares fluctuate significantly [among funds].[105]

They discuss some contrary evidence, but then identify the core arguments of this paper:

> The only skeptics who claim that the *entire* mutual fund market is uncompetitive are those who focus on a different kind of competition. These critics focus on competition among advisers for advisory contracts rather than on competition among funds for investors. Because boards always renew existing advisory contracts, there is said to be no competition among

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103 *See* Eric D. Roiter, *Disentangling Mutual Fund Governance from Corporate Governance*, 6 HARV. BUS. L. REV. 1 (2016).
104 Morley & Curtis, *supra* note 102, at 88 (emphasis added).
105 *Id.* at 110–11 (emphasis added; citations omitted).

> advisers for advisory contracts. The *Gartenberg* opinion made this argument, as have some law review articles.[106]

One of the law review articles Morley and Curtis cite[107] is Freeman and Brown.[108] As discussed there, above, and elsewhere, there is plainly no competition between advisors for fee contracts. Advisory contracts are no-bid contracts and mutual fund boards face monopoly sellers of portfolio management services. Those are incontrovertible facts that were true in 1970 and 1982 and true today. Morley and Curtis casually dismiss these inconvenient facts with a nonsensical counterfactual:

> Competition among advisers for advisory contracts, however, is not important independently of competition among funds for investors. A simple example will illustrate. Imagine that the competition among funds for investors was vigorously competitive and also that mutual funds did not have boards of directors at all. In this example, investors would receive less protection from boards than they would under even the most skeptical set of views about boards' passivity, since boards would not even exist. But even in this example, investors would be fine, because their fees, by assumption, would be set in a vigorously competitive market.[109]

Morley and Curtis assert that, "by assumption," fees would be set in a vigorously competitive market."[110] This assumption is conditioned on their embrace of the Coates and Hubbard article they find "persuasive" and "influential." However, as demonstrated above, the CH article was commissioned by the Investment Company Institute and its conclusions are thus tainted by self-interest and based on misdirection and duplicity. The Morley and Curtis counterfactual is therefore totally disconnected from reality and makes little sense.

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[106] *Id.* at 112 (emphasis added) (citations omitted).
[107] *Id.* at 112, n.11.
[108] John P. Freeman & Stewart L. Brown, *Mutual Fund Advisory Fees: The Cost of Conflicts of Interest*, 26 J. CORP. L. 609 (2001).
[109] Morley & Curtis, *supra* note 102, at 112.
[110] *Id.*

Morley and Curtis are undoubtedly correct that exit incentives lessen the importance of investor legal activism.[111] Fund governance and fee litigation could resolve these issues if there were a fiduciary standard with teeth, say, one that charged independent directors with ensuring that advisory fees were reasonable. The impact of this change would soon ripple through the investment management industry and fees would come into a reasonable congruence with fees determined by arm's length bargaining. Fee litigation would soon become unnecessary. This, however, is unlikely to happen.

III. Gartenberg – The § 36(b) Fiduciary Standard

The fiduciary standard that eventually emerged from the Second Circuit in *Gartenberg*[112] was an artifact of the ambiguities of the 1970 Amendments to the Investment Company Act[113] and the associated Senate Report.[114] Congress was caught in a pincer between the SEC, representing the public interest, and the Investment Management Industry, motivated to protect the profits of mutual fund sponsors.[115] Congress equivocated but sent the clear signal to the judiciary that what it really wanted was to maintain the status quo.[116] This is not a unique insight. Morley and Curtis expressed an essentially consistent view: "The strangely vague 'fiduciary duty' language of section 36(b) and the section's elaborate disguise as a form of shareholder litigation reflect an attempt by Congress to punt the issue to the courts and to create the illusion of action while essentially maintaining the status quo."[117] These issues were explored in a recent paper[118] and will be summarized here.

Reflecting the SEC position, Congress recognized that the forces of arm's length bargaining do not operate in mutual fund markets.[119] Making fund sponsors fiduciaries with respect to fees was

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[111] *See id.*
[112] Gartenberg v. Merrill Lynch Asset Mgmt., Inc., 694 F.2d 923 (2d Cir. 1982).
[113] Investment Company Amendments Act of 1970, Pub. L. No. 91-547, § 20, 84 Stat. 1413, 1429 (codified as amended at 15 U.S.C. § 80a-35 (2018)).
[114] S. REP. NO. 91-184 (1969).
[115] *See* Brown, *Forty Years of Failure*, *supra* note 77, at 6.
[116] *See id.* at 14.
[117] Morley & Curtis, *supra* note 102, at 142.
[118] Brown, *Forty Years of Failure*, *supra* note 77, at 1, 21.
[119] S. REP. NO. 91-184, at 5.

the ostensible fix to the problem of no-bid management fee contracts.[120] Congress also understood that a relevant fiduciary standard existed.[121] Given that, why would the judiciary choose to craft a unique standard for mutual fund fee litigation?

The judiciary recognized that Congress also said it wanted "adequate compensation for men of ability and integrity"[122] and that investment management profits were not to be limited as they are in public utility rate regulation.[123]

Congressional intent was ambiguous and consisted of two fundamentally incompatible goals: fair fees consistent with fees determined by arm's length bargaining and no limits on investment management profitability.[124] The public interest was and is consistent with the former. Politics favored the latter choice and ultimately the judicial system prioritized politics over the public interest.[125] The choice continues to reverberate forty years later.

Economic analysis in Gartenberg was not a model of clarity. The money fund in Gartenberg generated a 96 percent gross profit margin for Merrill Lynch. The appellate court ruled that this was unrealistically high because the profitability calculation failed to include the costs of processing customer orders.[126] Merrill Lynch produced three different estimates of processing costs which generated profitability estimates ranging from a negative 17 percent to a healthy positive 69 percent.[127] Thus, profitability was indeterminate. The Gartenberg courts also ignored the fact that there were several, much smaller funds with advisory fees a fraction of the Merrill Lynch fee.[128] *Gartenberg* also adopted the false narrative, set out as a desideratum in *Burks v.*

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[120] *See* Investment Company Amendment Amendments Act § 20.
[121] Pepper *v. Litton*, 308 U.S. 295, 307 (1939).
[122] S. REP. NO. 91-184 (1969), at 4.
[123] *Id.* at 6 ("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.").
[124] Brown, *Forty Years of Failure*, *supra* note 77, at 12.
[125] *Id.* at 47 ("Ultimately, the reasoning in [Jones v. Harris Assocs. L.P., 559 U.S. 335 (2010)] is transparently political.").
[126] Processing costs of customer orders are normally handled by the fund's transfer agent and are paid for separately by fund shareholders. Processing costs are anomalous and unique to a very few money funds at the time.
[127] *See* Brown, *Forty Years of Failure*, *supra* note 77.
[128] Gartenberg v. Merrill Lynch Asset Mgmt., Inc., 528 F. Supp. 1038 (S.D.N.Y. 1981), *aff'd*, 694 F.2d 923 (2d Cir. 1982).

Lasker,[129] that independent directors were dutiful watchdogs of investor interests.[130] Thirty years later in *Jones*, Justice Alito gratuitously volunteered that *Gartenberg* lacked "analytical clarity."[131] The facts favored the plaintiffs, and the politics favored the defendants. The defendants won.[132] The mutual fund industry would look much different today had the case gone the other way.

In granting Merrill Lynch summary judgment, Judge Pollack crafted his own "fairness standard":

> The standard of fiduciary duty under Section 36(b) "is concerned solely with fairness and equity." "The essence of the (fiduciary) test is whether or not under all the circumstances the transaction carries the earmarks of an arm's length bargain."[133] . . . The market price—freely available and competitively set—serves as a standard to test the fairness of the investment advisory fee under the facts shown in this record . . .[134] The issue of fair compensation becomes ultimately a social or philosophical—and hence a legislative question—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

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[129] 441 U.S. 471, 484 (1979) ("Congress' purpose in structuring the Act as it did was clear. It was 'designed to place the unaffiliated directors in the role of "independent watchdogs."'") (citing *Hearings on H.R. 10065 before a Subcomm. of the H. Comm. on Interstate & Foreign Commerce*, 76th Cong. 109 (1940)).
[130] Gartenberg, 694 F.2d at 930 ("As the district court recognized, 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 are important factors to be considered in deciding whether they and the adviser-manager are guilty of a breach of fiduciary duty in violation of § 36(b).").
[131] Jones v. Harris Assocs. L.P., 559 U.S. 335, 353 (2010).
[132] *Id.*
[133] *Gartenberg*, 528 F. Supp. at 1046–47 (citations omitted).
[134] *Id.* at 1067.

> disclosed and freely available elsewhere in the marketplace at comparable charges, without penalties or restraint.[135]

While bowing in the direction of *Pepper*, Judge Pollack directly contradicted Congress's clear and unambiguous statement that the forces of arm's length bargaining do not operate in mutual fund markets.[136] Essentially, the district court found that fees were the result of market forces and were thus "fair."[137]

The Second Circuit in *Gartenberg* was unwilling to countenance the district court's direct contradiction of Congress:

> 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 . . . . 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).[138]

Initially, the Second Circuit also nodded in the direction of the *Pepper* Standard:

> 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*

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[135] *Id.* at 1068.
[136] *See id.* at 1047 (citing Pepper v. Litton, 308 U.S. 295, 306–07 (1939)).
[137] *Id.* at 1068.
[138] *Gartenberg*, 694 F.2d at 929. The Second Circuit also said: "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," [it represents] "the best industry practice." *Id.* This statement is in reference to economies of scale and is clearly from comparisons in the management fee context.

> *been negotiated at arm's-length in the light of all of the surrounding circumstances*.[139]

The Wharton and PPI Reports underpinning the 1970 Amendment to § 36(b) highlighted the comparison of mutual fund advisory fees with pension fund and mutual fund sub-advisory fees that are actually determined by arm's length bargaining.[140] The Second Circuit dealt with the pension comparison peremptorily in a footnote:

> 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.[141]

The Second Circuit thus rejected the pension comparison in the narrow context of the named Merrill Lynch Money Market Fund. Subsequent courts, committing the fallacy of composition, have generalized this result to all mutual funds, even those not subject to the costs specific

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[139] *Id.* at 928 (emphasis added).

[140] *See* Wharton Report, *supra* note 91; *see also* Stewart L. Brown, *Mutual Fund Advisory Fee Litigation: Some Analytical Clarity*, 16 J. BUS. & SEC. L. 329, 338 (2016) ("[T]he Wharton report finds substantial fee differences, and attributes the differences principally to the lack of arm's length negotiation of fees.").

[141] *Gartenberg*, 694 F.2d at 930, n.3. As discussed in Brown, *supra* note 141, and Brown & Pomerantz, *supra* note 2, the money fund in *Gartenberg* exhibited certain unique characteristics that made it a poor choice upon which to establish the seminal fee case. The fund was integrated into the Merrill Lynch brokerage operations and the District Court in *Gartenberg* allowed anomalous processing costs to count as costs when estimating the profitability of the fund to Merrill Lynch. Gartenberg v. Merrill Lynch Asset Mgmt., Inc., 528 F. Supp. 1038, 1050 (S.D.N.Y. 1981). The Second Circuit did not recognize this anomaly, and this contributed to the fallacy of composition noted in the text.

to the money fund in *Gartenberg*.[142] As mentioned above, the vast majority of mutual funds employ transfer agents to handle purchases and redemptions and these costs are handled under separate contracts paid by investors, as illustrated in Table 2, *supra*.

After concluding that Congress had not adopted a specific fiduciary standard,[143] the Second Circuit articulated a new fiduciary standard: "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."[144] Since then, this fiduciary standard, as modified by the U.S. Supreme Court, has been applied consistently in mutual fund fee cases.[145]

The overriding feature of the *Gartenberg* Standard is its subjectivity and applicability to a broad range of facts, which allows courts wide latitude in applying the standard. The standard's high bar has led courts to decide every case in favor of the industry.[146]

The *Gartenberg* decision was ultimately a political decision favoring "men of ability and integrity" over the interests of the investing public.[147] The dispositive fact is that the Second Circuit chose to ignore the well-established *Pepper* standard and to substitute its own subjective standard that overwhelmingly favors defendants in § 36(b) litigation.[148] It is difficult to rationalize this as anything other than a cynical exercise in political accommodation.

IV. Jones v. Harris

The subjective *Gartenberg* "so disproportionately large" fiduciary standard dominated § 36(b) litigation until early in this century.

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[142] *See* Brown, *Mutual Fund Advisory Fee Litigation, supra* note 141, at 376–79, 387–89 (referencing Krinsk v. Fund Asset Management, Inc., 654 F. Supp. 472 (S.D.N.Y. 1988), *aff'd*, 875 F.2d 404 (2d Cir. 1989), cert. denied, 493 U.S. 919 (1989), and Kalish v. Franklin Advisers, Inc., 742 F. Supp. 1222 (S.D.N.Y. 1990)).
[143] *Gartenberg*, 694 F.2d at 928.
[144] *Id.*
[145] *See* Jones v. Harris Assocs. L.P., 559 U.S. 335, 353 (2010) ("The *Gartenberg* standard has been adopted by other federal courts . . . .").
[146] *See* Brown, *Mutual Fund Advisory Fee Litigation, supra* note 141, at 331 ("Since 1982, no plaintiff has received an award under the 1970 statute.").
[147] *See* S. REP. NO. 91-184, at 4.
[148] *Gartenberg*, 694 F.2d 923 at 928–30.

Courts essentially ignored the "range of arm's length bargaining" portion of the standard associated with *Pepper.* This resulted in a few scattered settlements and an uninterrupted series of litigation wins by the investment management industry.[149]

In 2001, Freeman and Brown published research showing that investment management fees on public pension fund portfolios were substantially lower than mutual fund fees on portfolios with similar investment objectives.[150] Fees on public pension portfolios, many managed by the same firms offering mutual funds to the public, are the results of arm's length bargaining.[151] This research called into question the efficacy of the 1970 Investment Company Act Amendment and the resulting § 36(b) litigation environment. The 2001 paper highlighted the traditional "range of arm's length bargaining" standard developed in *Pepper*, which gave rise to the possibility that a fee could be so disproportionately large that it bore no reasonable relationship to the services provided and could not have been the product of arm's length bargaining.[152]

Perhaps encouraged by the Freeman and Brown findings, the plaintiffs' bar instituted a wave of § 36(b) litigation. These cases documented mutual fund management fees greater than fees associated with arm's length bargaining, *e.g.*, pension and especially sub-advisory fees. *Jones v. Harris,*[153] one such case, was one of the first § 36(b) cases to come to trial after Freeman and Brown published their article and, after review by the Seventh Circuit, was accepted for review by the Supreme Court.[154]

The trial court in *Jones* explicitly included fees on other mutual funds in the range of arm's length bargaining, finding that Harris Associates fell between higher fees on other mutual funds and lower fees paid

[149] Brown, *Mutual Fund Advisory Fee Litigation*, *supra* note 141, at 331.
[150] Freeman & Brown, *supra* note 108, at 627–67.
[151] *Id.* at 634, 645.
[152] *Id.*; *see* Pepper v. Litton, 308 U.S. 295, 306–07 (1939).
[153] Jones v. Harris Assocs. L.P., 559 U.S. 335 (2010).
[154] Jones v. Harris Assocs. L.P, *cert. granted*, 556 U.S. 1104 (2009).

by institutional investors.[155] This was consistent with the fairness standard used by the trial court in *Gartenberg*,[156] which the Second Circuit had rejected.[157]

After the district court decision in *Jones*, CH published their article in the Journal of Corporation Law.[158] The principal thesis of the paper was that mutual fund fees are subject to competitive forces and therefore fee litigation is unnecessary.[159]

The article elicited strong expressions of support at the Seventh Circuit in *Jones*,[160] even though the authors had acknowledged having received financial support from ICI Mutual, an affiliate of ICI.[161]

Gartenberg, subsequently adopted by several other Courts of Appeal,[162] argued against including fees on other mutual funds as comparators in fee litigation, concluding that "[r]eliance on prevailing industry advisory fees will not satisfy § 36(b)."[163] The plaintiffs in *Jones* argued on appeal, as earlier articulated by Prof. Langevoort, "that this was a foolish test. If the industry remains dominated by conflicts of interest, then excessive fees will be the norm, and the norm should then not be made the benchmark for propriety."[164]

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[155] Jones v. Harris Assocs. L.P., No 04 C 8305, 2007 WL 627640, at *8 (N.D. Ill., Feb. 27, 2007).
[156] *See* Gartenberg v. Merrill Lynch Asset Mgmt., Inc., 528 F. Supp. 1038, 1046–47 (S.D.N.Y. 1981).
[157] Gartenberg v. Merrill Lynch Asset Mgmt., Inc., 694 F.2d 923, 929 (2d Cir. 1982) ("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 . . . .").
[158] Coates & Hubbard, *supra* note 11.
[159] *Id.* at 184, 213–14.
[160] Jones v. Harris Associates L.P., 527 F.3d 627, 634 (7th Cir. 2008) (citing Coates & Hubbard, *supra* note 11).
[161] Coates & Hubbard, *supra* note 11, at 151, n.**.
[162] *See* Migdal v. Rowe Price-Fleming Int'l, Inc., 248 F.3d 321, 327 (4th Cir. 2001); Gallus v. Ameriprise Fin., Inc., 561 F.3d 816 (8th Cir. 2009), *vacated,* 559 U.S. 1046 (2010); Jelinek v. Capital Research & Mgmt. Co., 448 Fed. App'x 716 (9th Cir. 2011).
[163] Gartenberg v. Merrill Lynch Asset Mgmt., Inc., 694 F.2d 923, 929 (2d Cir. 1982).
[164] 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, 1023–24 (2005).

At the Seventh Circuit, Judge Easterbrook, writing for the panel, affirmed the District Court ruling.[165] Based in large part on the CH research, the panel rejected the *Gartenberg* approach:

> 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.[166]

The Seventh Circuit ruled that as long as the fiduciary made full disclosure and played no tricks, then § 36(b) litigation is inappropriate.[167] In essence, competition sets fees and there is no need to second guess the market with fee litigation. The effect of this ruling, had it remained in place, would have been profound. If the metric to gauge the excessiveness of a litigated mutual fund fee is the level of mutual fund fees generally available to all investors, then it would have become essentially impossible for a plaintiff to ever prevail in a § 36(b) case. It would cement the notion that "regulating advisory fees through litigation" is no longer necessary.[168] Fee litigation would disappear.

Five judges dissented from the denial of rehearing *en banc*; Judge Posner wrote the dissent.[169] In response to the assertion that an adviser cannot make money from a captive fund if high fees drive investors away, Judge Posner cited the Freeman and Brown research:

> 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 arms-length bargaining occurs. As a rule, [mutual] fund shareholders neither benefit from

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[165] *Jones*, 527 F.3d at 627, 635.
[166] *Id.* at 634 (citing Coates & Hubbard, *supra* note 11).
[167] *Id.* at 632–35.
[168] *See id.* at 634 (citing Coates & Hubbard, *supra* note 11).
[169] Jones v. Harris Assocs. L.P., 537 F.3d 728, 729 (7th Cir. 2008) (Posner, J., dissenting from denial of rehearing en banc).

> arm's-length bargaining nor from prices that approximate those that arm's-length bargaining would yield were it the norm."[170]

A ruling in favor of Judge Posner's position would have had an equally profound and wide-reaching impact. It would result in a new and far larger outpouring of fee litigation with the probable result being a severe disruption in a multi-trillion-dollar industry.

After the Seventh Circuit rejected rehearing *en banc*, it was revealed in Forbes that CH had received $100,000 in funding from ICI Mutual.[171]

The Supreme Court accepted the case to resolve the conflict between the Second and Seventh Circuits.[172] The decision to grant review was made in the context of the filing of multiple fee litigation cases that threatened to seriously disrupt the multi-trillion-dollar investment management industry and increase the number of such cases in an already overstretched judicial system. Justice Alito, who wrote the decision,[173] had significant experience in mutual fund fee litigation.[174] He understood that a ruling upholding the Second Circuit would potentially unleash a barrage of new § 36(b) cases. Alternatively, if the Court sided with the Seventh Circuit and CH, it would effectively remove any

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170 *Id.* at 731–32 (quoting Freeman & Brown, supra note 108, at 634).

171 Asher Hawkins, *Well-funded Opinion*, FORBES (May 8, 2009, 10:00 AM), https://www.forbes.com/2009/05/07/mutual-funds-fidelity-columbia-business-school-personal-finance-hubbard.html?sh=1e2d30312bea ("But relying on the 2007 paper's authors for an opinion about whether small investors get a fair shake from fund firms is like asking a mechanic whether your car needs a tune-up. Their paper was apparently financed with at least $100,000 from an affiliate of the Investment Company Institute, the fund industry's lobbying group. The authors acknowledged this fact, minus the dollar amount, in a footnote.")

172 Jones v. Harris Assocs. L.P., 559 U.S. 335, 343 (2010) ("We granted certiorari to resolve a split among the Courts of Appeals over the proper standard under § 36(b).").

173 *Id.* at 337.

174 Justice Alito has considerable knowledge of the issues surrounding mutual fund fees. He was a named Solicitor General attorney in *Daily Income Fund*, another well-known money market mutual fund case, which held that no pre-suit demand on the board of directors of mutual funds is required, as the requirements of F.R.C.P. 23.1 do not apply to actions under § 36(b) of the ICA. Daily Income Fund v. Fox, 464 U.S. 523, 524 (1984).

protections given to investors by § 36(b) from excessive management fees. He ultimately chose the latter option,[175] with predictable results. At the time of publication there were no § 36(b) cases outstanding against mutual fund management companies.[176]

Justice Alito did not, however, simply affirm *Gartenberg*. Prior to *Jones*, courts had consistently emphasized the subjective "so disproportionately large" interpretation of *Gartenberg* and essentially ignored the "range of arm's length bargaining" interpretation consistent with the *Pepper* Standard.[177] Justice Alito reversed that. He noted that the parties disagreed about the interpretation of trust law and said:

> We find it unnecessary to take sides in this dispute. In *Pepper* v. *Litton*, 308 U.S. 295 (1939), [w]e . . . explained: *The essence of the test is whether or not under all the circumstances the transaction carries the earmarks of an arm's length bargain.* If it does not, equity will set it aside.[178]

Embracing the *Pepper* Standard allowed Justice Alito to rationalize the inclusion of mutual fund fees within the range of arm's length bargaining:

> The District Court assumed that it was relevant to compare the challenged fees with those that Harris Associates charged its other clients. But in light of those comparisons as well as comparisons with fees charged by other investment advisers to similar mutual

[175] Jones, 559 U.S at 354–53.

[176] In *Obeslo v. Great-West Capital Mgmt. LLC,* a § 36(b) case, after determining that plaintiffs' evidence was plainly insufficient, and that plaintiffs' counsel "recklessly proceeded to trial in violation of their duty to objectively analyze their case[,]" Obeslo v. Great-West Capital Mgmt., LLC, No. 16-cv-00230-CMA-SKC, 2022 WL 4098991, at *1 (Aug. 16, 2022) (citation omitted), the trial court awarded $1.5 million dollars in attorney's fees to Great-West, *id.* at *3. This has likely increased the reluctance of the plaintiffs' bar to litigate § 36(b) cases. However, the ruling was recently reversed by the Tenth Circuit. Obeslo v. Empower Cap. Mgmt., LLC, 85 F.4th 991, 1014 (10th Cir. 2023) ("[T]he district court abused its discretion by sanctioning Plaintiffs' counsel.").

[177] *See* Brown, *Mutual Fund Advisory Fee Litigation*, *supra* note 141, at 376–79, 387–89.

[178] Jones v. Harris Assocs. L.P., 559 U.S. 335, 346–47 (2010).

> funds, the Court held that it could not reasonably be found that the challenged fees were outside the range that could have been the product of arms-length bargaining.[179]

Having implicitly sanctioned the use of other mutual fund fees as comparators, Justice Alito downplayed the significance of the change:

> By the same token, courts should not rely too heavily on comparisons with fees charged to mutual funds by other advisers. These comparisons are problematic because these fees, like those challenged, may not be the product of negotiations conducted at arm's length. *See* . . . *Gartenberg, supra*, at 929 ("Competition between money market funds for shareholder business does not support an inference that competition must therefore also exist between [investment advisers] for fund business. The former may be vigorous even though the latter is virtually non-existent").[180]

With one hand, he therefore licensed courts to consider such fees, while with the other hand, he admonished courts to not rely *too* heavily on fees charged by other investment management firms. Finally, although Justice Alito claimed to endorse the status quo,[181] the opinion significantly modified the *Gartenberg* standard to the advantage of the investment management industry and the detriment of investors.

In oral argument, Justices Sotomayor and Scalia noted that there were disputed facts concerning the costs of providing sub-advisory investment management services as compared to mutual fund investment management services.[182] These disputed facts seemed to make

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[179] *Id.* at 341–42 (citation omitted).
[180] *Jones,* 559 U.S. at 350–51.
[181] *Id.* at 353. (The *Gartenberg* standard . . . 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 debate . . . regarding today's mutual fund market is a matter for Congress, not the courts.)
[182] *See* Brown, *Forty Years of Failure*, *supra* note 77, at 42 (citing Transcript of Oral Argument at 33-35, Jones v. Harris Assocs. L.P., 559 U.S. 335 (2010) (No. 08-586)).

summary judgment inappropriate.[183] Perhaps to mollify these concerns, Justice Alito included the following in the decision:

> [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. . . . [T]here 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 higher marketing costs.[184]

On the surface this appears to be a major concession to plaintiffs in fee cases, suggesting that courts may consider fees on institutional accounts but must "beware of inapt comparisons."[185] A footnote effectively nullifies this concession: "Only where plaintiffs have shown a large disparity in fees that cannot be explained by the different services in addition to other evidence that the fee is outside the arm's-length range will trial be appropriate."[186] The fee differences must not only be "large," they must be outside of the arm's length range which includes fees on mutual funds that the Supreme Court now allows but cautions against relying upon.

Further, the pension comparison by Justice Alito is a red herring. The fees in Jones were sub-advisory fees, not pension fees. Unlike pension funds, sub-advised mutual fund accounts are sub-advised for other mutual funds and thus subject to the same "myriad of daily purchases and redemptions throughout the nation" as the similar mutual funds Harris was advising for double the fees.[187] The upshot is that the

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[183] *See id.*
[184] Jones, 559 U.S. at 349–50 (citation omitted).
[185] *Id.* at 350.
[186] *Id.* at 350, n.8.
[187] *Id.* at 345 (internal quotation marks and citation omitted).

principal reason the court gave for rejecting the mutual fund/institutional comparison was irrelevant in the case against Harris.[188] It is difficult to see how permitting the comparison of no-bid contract fees to other no-bid contract fees is considered appropriate while comparison of mutual fund advisory fees with fees actually subject to arm's length bargaining is considered unreliable.

Courts soon recognized the implications of Justice Alito's ruling. The Seventh Circuit's interpretation on remand was extreme: "[T]he Supreme Court's approach does not allow a court to assess the fairness or reasonableness of advisers' fees; the goal is to identify the outer bounds of arm's length bargaining and not engage in rate regulation."[189] This was the same Seventh Circuit panel that ruled that market forces negated the necessity of any standard if the adviser played no tricks.[190] Under this interpretation it is no longer necessary—nor even allowed—for courts to assess the fairness or reasonableness of advisers' fees. The *Gartenberg* factors are irrelevant.

In a recent § 36(b) case, Judge Ramos of the United States District Court for the Southern District of New York interpreted *Jones* even more stringently than the Seventh Circuit did on remand:

> [N]or can Plaintiffs prevail by demonstrating *solely* that the Fees are higher, even much higher, than those charged by third parties to peer funds. It is neither the province nor the duty of federal courts to "assess the fairness or reasonableness of advisers' fees; the goal is to identify the outer bounds of arm's length bargaining and not engage in rate regulation."[191]

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[188] There may be more burdensome regulatory and legal obligations managing retail funds, but these costs are likely to be small, discoverable, and measurable at trial. Marketing costs on retail funds are separately compensated by distribution fees but must be absorbed by management fees on institutional accounts.

[189] Jones v. Harris Assocs. L.P., 611 Fed. App'x 359, 360 (7th Cir. 2015). Note that the Seventh Circuit did not bother to caution courts not to rely too heavily on fees charged to mutual funds by other advisors. It is also notable that the Seventh Circuit explicitly embraced the canard that restrictions on fees are tantamount to rate regulation.

[190] Jones v. Harris Assocs., 527 F.3d 627, 632–35 (7th Cir. 2008).

[191] Chill v. Calamos Advisors LLC, No. 15 Civ. 1004, 2018 WL 4778912, at *17 (S.D.N.Y. Oct. 3, 2018) (quoting *Jones*, 611 Fed. App'x. at 360) (emphasis added).

It is now common currency to refer to the "range of arm's length bargaining" standard. In *Gallus*, an Eighth Circuit case contemporaneous with *Jones,* directors approved an advisory fee contract on the basis that it was "in the middle of the pack" compared to fees on other mutual funds.[192]

Encouraged by the Supreme Court's suggestion that the judiciary might look favorably on the comparison of mutual fund fees to fees charged to different types of clients, the plaintiffs' bar filed a series of cases involving sub-advisory fees,[193] the latest decided in 2021.[194] The result was a clean sweep for the investment management industry. The results advocated by CH and Judge Easterbrook in *Jones* have thus come to pass.

It is instructive to examine the anatomy of sub-advisory fee cases after the *Jones* decision. These cases fall into two general categories: manager of manager cases and reverse manager of manager cases.[195] In manager of manager cases, mutual fund advisors hire sub-advisors to manage the portfolio and plaintiffs assert that sub-advisors are performing essentially all the management services but receive only a fraction of the fee paid to the manager.[196] In reverse manager of manager cases, mutual fund managers sub-advise portfolios for other mutual funds and plaintiffs assert that a management fee is excessive because the manager charges substantially lower fees to perform essentially identical services when sub-advising funds.[197] *Jones* was a reverse manager of manager case.[198]

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[192] Gallus v. Ameriprise Financial, Inc., 561 F.3d 816, 818 (8th Cir. 2009); *see also* In re Davis New York Venture Fund Fee Litigation, No. 14 CV 4318-LTS-HBP, 2019 WL 11272913, at *12 (S.D.N.Y. July 2, 2019); Goodman v. J.P. Morgan Inv. Mgmt., Inc., 954 F.3d 852, 860–61 (6th Cir. 2020).

[193] *See, e.g.,* In re BlackRock Mutual Funds Advisory Fee Litigation, No. 14-1165 (FLW) (TJB), 2019 WL 1387450, at *29 (D.N.J. Feb. 8, 2019), *aff'd* 816 Fed. App'x 637, 641 (3d Cir. 2020); Goodman v. J.P. Morgan Inv. Mgmt., Inc., 954 F.3d 852, 860-61 (6th Cir. 2020); Kennis v. Metro. West Asset Mgmt., LLC, 821 Fed. App'x 895, 896 (9th Cir. 2020).

[194] Obeslo v. Great-West Life & Annuity Ins. Co., 6 F.4th 1135 (10th Cir. 2021).

[195] *See* SEAN M. MURPHY, ET AL., DEVELOPMENTS IN LITIGATION UNDER SECTION 36(B) OF THE 1940 ACT 1, MILBANK, TWEED, HADLEY & MCCLOY LLP (2017).

[196] *Id.* at 1.

[197] *Id.*

[198] *See id.* at 5.

Kasilag[199] was a manager of managers case that concluded in 2017 and has been discussed in detail elsewhere.[200] The contract between Hartford Insurance and its sub-advisor Wellington Capital Management for six of its open-end mutual funds resulted in Hartford fees on the six funds of about $150 million and Wellington's sub-advisory fees of about $50 million.[201] Because Wellington provided all core investment management functions, Hartford profited by about $100 million for doing very little or nothing. Despite Hartford presenting no quantitative analysis of its risks, the *Kasilag* court approved Hartford's profits as just compensation for the risks involved, principally entrepreneurial risks.[202]

In *Kasilag*, there was a large disconnect between economic facts and the highly subjective interpretation of those facts by the court. *BlackRock*,[203] a reverse manager of managers case, exhibited a similar disconnect. Both cases illustrate the prejudice and bias endemic in *Gartenberg* as modified and ratified by *Jones*.

V. BlackRock

In *BlackRock*, BlackRock Advisors (BRA), a subsidiary of the parent company, BlackRock Inc. (BLK), managed two named open-end funds: the BlackRock Global Allocation Fund and the BlackRock Equity Dividend Fund.[204] BlackRock Investment Management (BRIM), another subsidiary of BLK, managed seven sub-advised funds that were 1940 Act funds in variable annuity wrappers offered by life insurance companies.[205] BRA's advisory fee rates on the two captive funds were

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[199] Kasilag v. Hartford Inv. Fin. Services, LLC, No. 11-1083 (RMB/KMW), 2016 WL 1394347, at *1 (D.N.J. Apr. 7, 2016), *aff'd*, 745 Fed. App'x 452 (3d Cir. 2018) (unpublished).
[200] Stewart L. Brown, *Mutual Fund Advisory Fees: An Objective Fiduciary Standard*, 21 U. PA. J. BUS. L. 477, 495 (2019); Brown, *Forty Years of Failure*, *supra* note 77, at 49–54.
[201] *Kasilag*, 2016 WL 1394347, at *4.
[202] *Id.* at *18–21 (refusing to grant plaintiffs summary judgment with regard to defendants' liability under §36(b)).
[203] In re BlackRock Mut. Funds Advisory Fee Litig., 327 F. Supp. 3d 690 (D.N.J. 2018), *aff'd,* 816 F. App'x 637 (3d Cir. 2020).
[204] In re Blackrock, 327 F. Supp. 3d at 694. The latter fund is discussed above. *See* Tables 1 & 2, *supra*.
[205] *Id.* at 706.

approximately double the rates charged to insurance companies to perform the same investment management services.[206] The BlackRock court teed up the major issues in summary judgment:

> The parties agree that BRIM performs substantially the same investment advisory (*i.e.*, portfolio management) services for the Subadvised Fund that BRA performs for the Funds, including using substantially the same investment strategies, research and analysis, and systems, technology, and other resources in providing investment advisory services. Outside of portfolio management services, however, the parties significantly dispute the scope and extent of the subadvisory services that BRIM renders to the Subadvised Funds.[207]

Judge Wolfson's summary tracks perfectly with Justice Alito's admonition to "beware inapt comparisons" in *Jones*.[208] *BlackRock* focused on and was decided on exactly those issues.[209]

A. Short Primer on Profit Margins

Contracts to manage mutual fund portfolios are assets of the investment management firms that create the funds. These contracts generate profits for fund sponsors. Because they are no-bid contracts, Congress made mutual fund sponsors fiduciaries with respect to fees.[210] Profitability is one of the *Gartenberg* factors courts examine in determining if the fee violates fiduciary standards.[211] The standard measure of profitability is the profit margin (PM).

The generic definition of PM is profits divided by sales or profit per dollar of sales.[212] In a mutual fund context, PMs are profits divided

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[206] *Id.* at 721.
[207] *Id.* at 706–07 (citations omitted).
[208] *See* Jones v. Harris Assocs. L.P., 559 U.S. 335, 353 (2010).
[209] *See In re Blackrock*, 327 F. Supp. 3d at 727 ("The crux of Plaintiffs' excessive fee claim rests on a theory of comparative fees.").
[210] 15 U.S.C. § 80a-35 (2018).
[211] *Jones*, 559 U.S. at 344, n.5 (listing *Gartenberg* factors).
[212] *See* Troy Segal, *Profit Margin: Definition, Types, Uses in Business and Investing*, INVESTOPEDIA (Jan. 22, 2024), https://www.investopedia.com

by revenues, and since revenues are dollar fees, this is calculated as profit per dollar of fees. In order to calculate PM, it is necessary to calculate dollar profits, labeled operating profits in a mutual fund context. Profits are the residual of revenues less costs to generate the revenues. The PM is thus revenues less costs, divided by revenues.

Gross profit margins include only direct costs in the numerator, *i.e.*, costs directly connected to the revenues in question.[213] Operating profit margins add corporate overhead costs.[214] Operating PM numbers are provided to directors annually in reports required by section 15(c) of the Investment Company Act (hereinafter 15(c) reports).[215] Mutual fund case law typically focuses on operating PM for comparison purposes.

Revenues are a product of fee rates and average annual assets. These are known with certainty, ex post. Profits are a residual of revenues over costs. It follows that the determination of costs allocated at the fund level is an important determinant of PM. These must be estimated using cost allocation models utilized by the fund sponsor.

Consider a hypothetical fund, Fund A in Table 4, *infra*. It is a captive of the fund sponsor, has $10 billion in assets and a 60 basis point advisory fee which generates $60 million annually in revenues. The cost allocation model allocates $25 million to this fund, which results in operating profits of $35 million (Revenues less costs, or $60 million, less $25 million). It follows that the profit margin ($35mm divided by $60mm) is 58.3 percent. Note that costs are 41.7 percent of revenues and .0025 (.25 percent or 25 bps) of assets under management.

/terms/p/profitmargin.asp#:~:text=Error%20Code%3A%20100013)-,What%20Is%20Profit%20Margin%3F,subtracting%20all%20of%20its%20costs, [https://perma.cc/UU3J-FR7X].

[213] *See* Andrew Bloomenthal, *Gross Profit Margin: Formula and What It Tells You*, INVESTOPEDIA (Jan. 28, 2024), https://www.investopedia.com/terms/g/gross_profit_margin.asp [https://perma.cc/9GTH-TER9].

[214] *See* Adam Hayes, *Operating Margin: What It Is and the Formula for Calculating It, With Examples*, INVESTOPEDIA (Apr. 28, 2024), https://www.investopedia.com/terms/o/operatingmargin.asp [https://perma.cc/U2WD-Q4HC].

[215] *See* 15 U.S.C. § 80a-15(c); *see also* H. Norman Knickle, *The Mutual Fund's Section 15(C) Process:* Jones v. Harris*, The SEC And Fiduciary Duties Of Directors*, 31 B.U. REV. BANKING & FIN. L. 265 (2012).

			Table 4				
			Hypothetical				
	Assets	Advisory Fee Rate	Annual Dollar Fees	Annual Dollar Costs	Percent Costs	Operating Profits	Profit Margin
Fund A Captive Fund	10,000,000,000	0.60%	60,000,000	25,000,000	0.25%	35,000,000	58.3%
Fund B Suv-Advised Fund	1,000,000,000	0.30%	3,000,000	2,500,000	0.25%	500,000	16.7%

Now consider Fund B in Table 4, a hypothetical fund sub-advised by the same fund sponsor. It is a $1 billion fund, and the sponsor has negotiated a 30-basis point advisory fee which generates annual revenue of $3 million. The sponsor's cost allocation model generates $2.5 million in costs. Operating profits are half a million and the profit margin to the investment manager is 16.7 percent.

The critical assumption is that both funds cost the investment management firm 25 basis points per dollar of assets annually: $25 million of costs for the ($10 billion) captive fund and $2.5 million for the ($1 billion) sub-advised funds. Given that it costs the same to manage both funds the lower fees on Fund B cause the profit margin ((Revenue-Costs)/Revenue) to be 16.7 percent, far lower than 58.3 percent for Fund A, the captive fund.

Given these facts, an objective court unhindered by precedent would rationally rule that the investment management firm was overcharging Fund A. The firm was willing to accept a far lower profit margin to provide its services in a competitive market than it was realizing on the captive fund. On the other hand, an inattentive, numerically challenged, myopic, or willfully blind court would rule that it costs far more in dollar terms to manage Fund A than Fund B, and therefore the services were different and the comparison inapt. It would rule that the fees on Fund A were not excessive. That is what happened in *BlackRock*.

B. BlackRock: The Big Picture

The relevant time period in *BlackRock* was February 2013 to November 2015.[216] Table 5, *infra*, is distilled from the case and is based on 2015 numbers. Panel A looks at the captive funds, *i.e.*, the BlackRock Equity Dividend Fund and the BlackRock Global Allocation Fund. Panel B looks at an average sub-advised fund for each captive fund.

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[216] In re BlackRock Mut. Funds Advisory Fee Litig., 327 F. Supp. 3d 690, 695 (D.N.J. 2018), *aff'd*, 816 F. App'x 637 (3d Cir. 2020).

In Panel A, advisory fees and advisory fee rates are taken from the final judgment in 2019.[217] Profit margins are also obtained from that opinion.[218] Given the level of advisory fees and the profit margins, it follows that operating profits were about $90 million for Equity Dividend and $240 million for Global Allocations. Operating costs are the difference between revenues (advisory fees) and operating profits of about $62 and $170 million respectively. Operating cost data were obtained from the § 15(c) reports relied upon by the directors and are based on the BlackRock cost allocation model. Given the BlackRock cost allocations, the Equity Dividend Fund cost about 22 basis points per dollar of assets to manage and the Global Allocation Fund about 28 basis points.

The seven sub-advised funds named in the case, three for Equity Dividend and Four for Global Allocation, were managed for insurance companies in Variable Annuity wrappers, and each carried the BlackRock imprimatur in the title.[219] These funds ranged in size from $400 million to $3 billion.[220] It is assumed in Panel B that the average level of assets under management for these seven funds was $1.7 billion, the mid-point of the range. This level of assets was inserted into each sub-advisory fee schedule and these numbers were averaged. These worked out to be about 31 basis points for Equity Dividend accounts and 40 basis points for Global Allocation.

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[217] In re BlackRock Mut. Funds Advisory Fee Litig., No. 14-1165, 2019 WL 1387450, at *2–*3 (D.N.J. Feb. 8, 2019). Average assets are calculated by dividing advisory fees by advisory fee rates.

[218] *Id.* at *16–*20. The case also presents "operating income" levels which, for unknown reasons, are slightly different from "operating profits" in Table 5, *infra*. These are inferred from profit margins. These numbers were used to maintain consistency with the fee and fee rate numbers obtained elsewhere in the case.

[219] *Id.* at *12.

[220] Trial Transcript Vol. I at 13, In re BlackRock Mut. Funds Advisory Fee Litig., No. 14-1165 (D.N.J. Aug. 20, 2018), ECF No. 185 (opening statement by Mr. Musoff).

		Table 5	
	Overview of Assets, Fees, Fee Rates and Profit margins, Equity Dividend, Global Allocation and Sub-Advised Funds		
Panel A Named Captive Funds, 2015			
		Blackrock Equity Dividend Fund	Blackrock Global Allocation Fund
	Average Assets	28,121,299,815	60,861,027,463
	Advisory Fees	151,855,019	407,768,884
	Advisory Fee Rates	0.54%	0.67%
	Profit Margin	58.8%	58.7%
	Operating Profits	89,290,751	239,360,335
	Operating Costs	62,564,268	168,408,549
	Costs/Assets (%)	0.222%	0.277%
Panel B	Comparison of Sub-Advisory Fees and Margins, 2015		
		Equity Dividend Sub-Advised Funds	Global Allocation Sub-Advised Funds
	Average Sub-Advised Fund Assets	1,700,000,000	1,700,000,000
	Advisory Fee rates	0.309%	0.398%
	Advisory Fees	5,254,167	6,765,000
	Costs/Assets (%)	0.222%	0.277%
	Operating Costs	3,782,160	4,704,070
	Operating Profits	1,472,007	2,060,930
	Profit Margin	28.0%	30.5%

Dr. Ian Ayres, the plaintiffs' expert, analyzed the § 15(c) reports provided by BlackRock to the directors of the sub-advised variable annuity funds.[221] These reports were based on the same BlackRock cost allocation model utilized in the § 15(c) report for the captive funds. Dr. Ayres found that, as a percentage of assets under management, it cost the same or slightly more to service the sub-advised funds than it cost

[221] *In re BlackRock*, 2019 WL 1387450, at *16–18. Dr. Ayres is a professor at Yale Law School and at Yale's School of Management who holds a Ph.D. in econometrics from M.I.T. and a law degree from Yale.

to service the captive funds.[222] Applying these cost rates to the sub-advised fund in Panel B reveals that, like the hypothetical, profit margins on the sub-advised accounts were far lower than those on the captive funds.[223]

It is worth noting that BlackRock was willing to perform essentially identical investment management services for an average of 35.5 basis points for the sub-advised funds while charging its captive funds an average of 60.5 basis points, about 70 percent higher. Inter alia, the case hinged on the idea that BlackRock was justified in charging greater fees because of the extra (non-investment management) services provided to the captive funds.[224] The case was decided using the *Gartenberg* factors as modified in *Jones*.[225] Judge Wolfson previously granted partial summary judgment to defendants on one of the *Gartenberg* factors, the independence and conscientiousness of the trustees, but also found:

> that genuine disputes of material fact exist regarding the comparative fees, economies of scale, and profitability factors of the *Gartenberg* test, and thus, as to whether the Advisory Fee falls outside the range of arm's-length bargaining, rendering summary judgment inappropriate. However, in light of this Court's finding that the Board's decision to approve BRA's Advisory

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[222] *Id.* at *16 ("Dr. Ayres' analysis determined that, as a percentage of AUM, BlackRock's reported costs for the Subadvised Funds for the period between years 2012 and 2014 were, in all cases, comparable to, if not greater than, BlackRock's reported costs for providing services to the [captive] Funds, excluding distribution-related expenses.").

[223] PMs on the sub-advised funds averaged about 29 basis points while they were about 59 basis points on the captive funds, roughly double. Dr. Ayers conducted a similar but not identical analysis in the case. *Id.* at *19–20.

[224] *Id.* at *27–29 ("[T]he Court finds that services that BRA provides to the Funds are much more extensive than the services that BRIM provides to the Subadvised Funds.").

[225] *Id.* at *21 ("In determining whether an investment adviser has breached its fiduciary duty by charging an excessive fee under § 36(b), *Jones* [*v. Harris Assocs. L.P.*, 559 U.S. 335, 353 (2010)] teaches that 'all relevant circumstances be taken into account,' including the factors set forth in Gartenberg v. Merrill Lynch Asset Management, Inc., 694 F.2d 923 (2d Cir. 1982).").

> Fee is entitled to substantial deference, the Court expects that trial will be limited to the other relevant *Gartenberg* factors.[226]

The analysis here will show that the *Blackrock* court erred in granting summary judgment on fund governance.

The court followed the standard *Gartenberg* playbook in which a court concludes that if a board "considers" information relative to the *Gartenberg* factors, examines voluminous amounts of material and approves the contract, it is entitled to substantial deference. The court found that:

> [p]rior to the Fee Approval Meetings, the Board received extensive information, spanning more than 25,000 pages of material potentially relevant to BRA's Advisory Fee, including comparative fee and performance data from Lipper, and information on each of the factors outlined in *Gartenberg* . . . . On at least two occasions during the Relevant Period, the Board negotiated to obtain fee concessions in favor of shareholders . . . .[227] [T]he undisputed facts demonstrate that the Board's process for reviewing BRA's Advisory Fee was robust.[228]

There is a large disconnect between case law precedent and the facts of the case. The *BlackRock* court's ruling is cartoonish but consistent with a false narrative created forty years ago in *Gartenberg*.[229] The actual process was far from robust, and plaintiffs disputed many facts offered by defendants and the court.

Examination of the 2015 Statement of Additional Information (SAI) for the BlackRock Global Allocation Fund is instructive in understanding the *BlackRock* decision.[230] There were 10 independent directors/trustees, all appointed by BlackRock and paid an average of about

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[226] In re BlackRock, 327 F. Supp. 3d at 742.
[227] *Id.* at 704.
[228] *Id.* at 713.
[229] *See* Brown, *Forty Years of Failure*, *supra* note 77, at 24–28 (2022).
[230] BLACKROCK GLOBAL ALLOCATION FUND, INC., REGISTRATION STATEMENT UNDER THE SECURITIES ACT OF 1933 I-1 (2016), https://www.sec.gov/Archives/edgar/data/834237/000089109216012767/e6

$335,000 to attend five meetings per year, including the one day "fee approval" meeting.[231] These ten directors had supervisory responsibility over 28 RIC's (Registered Investment Companies) and 98 portfolios (funds).[232] This was confirmed at trial by John Perlowski who testified that the board had oversight responsibilities over 90 funds.[233]

That BlackRock named a one-day meeting the "fee approval" day for 90 funds is impolitic but revealing. Each fund must be evaluated separately.[234] With that many funds on the agenda it is difficult to envision anything other than an empty check-the-boxes ritual where the outcome is pre-determined. In addition to the advisor's oversight responsibilities the boards must oversee all the fund's other service providers, the fund's compliance program, and the funds daily NAV calculation and must review, approve, and sign shareholder reports and SEC filings.[235] Moreover, these duties are undertaken without dedicated staff.[236]

The larger point is that there is an undeniable disconnect between the "robust" process found by Judge Wolfson in *BlackRock* and the true facts on the ground. Independent directors had vast responsibilities for 90 funds with no staff, operated on a part-time basis and met five times per year. The court knew this and chose to ignore the facts. This is not a subtle legal nuance.

Other evidence calls into question not only the court's ruling but the independence and conscientiousness of the trustees. It was revealed that directors did no numerical analysis of economies of scale.[237]

7586-485bpos.htm#e51352_toc3 [hereinafter BLACKROCK REGISTRATION STATEMENT]. The Blackrock Equity Dividend fund was served by the same board as the Global Allocation Fund. *See* In re BlackRock Mut. Funds Advisory Fee Litig., No. 14-1165, 2019 WL 1387450, at *2 (D. N.J. Feb. 8, 2019).

231 BLACKROCK REGISTRATION STATEMENT, *supra* note 231, at I-15–I-21.

232 *Id.*

233 Trial Transcript Vol. I, supra note 220, at 92 (direct examination of Mr. John Perlowski by Mr. Andrew Robertson, representing the plaintiffs).

234 *See* Brown, *Forty Years of Failure*, *supra* note 77, at 59–60.

235 *See* Emily D. Johnson, *The Fiduciary Duty in Mutual Fund Excessive Fee Cases: Ripe for Reexamination*, 59 DUKE L. J. 145, 152–53 (2009).

236 *Id.* at 152.

237 Trial Transcript Vol. II at 360–62, In re BlackRock Mut. Funds Advisory Fee Litig., No. 14-1165 (D.N.J. Aug. 21, 2018), ECF No. 186 (cross examination of Mr. Perlowski by Mr. Eben Colby, representing the defendants).

Rather, directors were presented with evidence of breakpoints in advisory fee schedules and assumed that, if there were economies of scale, they were being adequately shared with fund shareholders.[238] Similarly, there is no evidence in the case that directors looked at fees on sub-advised accounts as comparators. Rather, as Judge Wolfson noted, they concentrated on Lipper comparisons of fees on other open-end mutual funds.[239]

Judge Wolfson asserted without qualification that the board negotiated fee changes in favor of shareholders.[240] Yet, the plaintiffs argued:

> With respect to the ED Fund, Defendants rely on fee changes that were implemented after this litigation was filed and that had minimal impact on the fees charged to the Fund. Indeed, all of the new breakpoints implemented for that ED fund were at asset levels above the Fund's AUM (Assets Under Management), meaning none of those breakpoints have actually reduced the fees charged to the Fund. . . . Engaging in perfunctory "negotiations" that do nothing to remedy the underlying excessiveness of BlackRock's fees does not render a process "robust." The lack of meaningful negotiation, along with pricing funds solely commensurate with Lipper peer groups, confirms that the Board fee approval is entitled to no or minimal, at best, deference.[241]

C. BlackRock: Case Theory

The plaintiffs' theory of the case was straightforward. BlackRock charged higher fees on its captive funds than it charged for the same investment management services to funds it sub-advised for

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[238] *See id.*

[239] In re BlackRock Mut. Funds Advisory Fee Litig., 327 F. Supp. 3d 690, 728 (D.N.J. 2018), *aff'd*, 816 F. App'x 637 (3d Cir. 2020) ("[T]he Board received a presentation based on Lipper reports comparing BRA's Advisory Fee to the advisory fees paid by mutual funds identified by Lipper as comparable to the Funds").]

[240] *Id.* at 704 ("On at least two occasions during the Relevant Period, the Board negotiated to obtain fee concessions in favor of shareholders.").

[241] Plaintiff's Memorandum of Law in Opposition to Defendants' Motion for Summary Judgment at 33–34, In re BlackRock Mut. Funds Advisory Fee Litig., No. 14-1165 (D.N.J. May 4, 2018), ECF No. 135.

insurance companies.[242] Fees on sub-advised accounts are determined by competitive forces and fees on captive funds are not. Therefore, said the plaintiffs, fees on captive fund are excessive, *i.e.*, so disproportionately large that they could not have been the product of arm's length bargaining.[243]

The plaintiffs presented evidence derived from § 15c reports that BlackRock's costs to provide sub-advisory services were the same or greater than costs to manage captive funds.[244] This resulted in greater profit margins on captive funds, evidence that those fees were excessive. Moreover, the same § 15(c) reports supported economies of scale in the investment management function because, over time, costs as a percentage of assets declined as assets increased.[245]

The defendants' position was that BlackRock provided a vastly greater volume of services to captive funds and therefore higher fees and higher profit margins were justified.[246] The defendants also argued that reliance on § 15(c) reports was inappropriate because they are based on the internal BlackRock costs allocation model which yield unreliable cost estimates.[247] This argument was put forth despite Board reliance on § 15(c) reports in the annual contract approval process. Moreover, the Price Waterhouse Coopers (PwC) accounting firm "determined that the process, methodologies, and disclosure practices employed by BlackRock to estimate those profit margins were aligned with PwC's guiding principles and industry practice."[248]

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[242] In re BlackRock Mut. Funds Advisory Fee Litig., 816 F. App'x 637, 639 (3d Cir. 2020) ("The [plaintiffs] make a simple argument: BlackRock provides roughly the same management services to the Advisory and Subadvisory Funds, yet the Advisory Fees cost more.").

[243] *See* Consolidated Complaint at ¶ 4, In re BlackRock Mut. Funds Advisory Fee Litig., No. 14-1165 (D.N.J. May 27, 2014), ECF. No. 27.

[244] *See* In re BlackRock Mut. Funds Advisory Fee Litig., No. 14-1165, 2019 WL 1387450, at *16–20 (D.N.J. Feb. 8, 2019), *aff'd*, 816 F. App'x 637 (3d Cir. 2020).

[245] *See id.* at *18–19.

[246] *Id.* at *18 ("[Defendants' expert] echoed the testimony of Defendants' fact witnesses and opined that there were key differences between the functions performed by advisers and subadvisers generally, and BRA and BRIM here . . . .").

[247] *See* Trial Transcript Vol. VII at 1644–50, In re BlackRock Mut. Funds Advisory Fee Litig., No. 14-1165 (D.N.J. Aug. 28, 2018), ECF No. 191 (direct examination of Ms. Ashkenazy by Mr. Musoff).

[248] In re BlackRock Mut. Funds Advisory Fee Litig., 327 F. Supp. 3d 690, 715 (D.N.J. 2018).

Boiled to its essence the case turned on whether the court was persuaded by the plaintiffs' "comparative costs to manage funds" theory, or the defendant's "vastly greater volume of services provided to captive funds" theory.

D. BlackRock: The Decision

Judge Wolfson conducted an 8-day bench trial beginning in August of 2018. There were two expert witnesses called: Dr. Ian Ayres, for the plaintiffs, and Dr. Erik Sirri, for the defense.[249] All other witnesses were either current or past employees of BlackRock.[250]

1. Comparative Fees/Profitability

In its decision on summary judgment, the court cited "comparative fees" as one of the *Gartenberg* factors to be determined at trial.[251] A major part of the case involved the court's ruling relative to the higher level of services provided to the captive funds versus sub-advised funds as justification for the higher fees on captive funds.[252]

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[249] Dr. Sirri earned a PhD. In Finance from UCLA and served as Chief Economist and Director of the Division of Trading and Markets at the SEC. He is an independent director for the Natixis family of mutual funds and a member of the Board of Governors of the Investment Company Institute, the investment management industry trade association. He holds an academic appointment at Babson College. He was compensated in excess of half a million dollars for his efforts on behalf of BlackRock. *See* Trial Transcript Vol. VII, *supra* note 247, at 1443–65; Trial Transcript Vol. VIII, In re BlackRock Mut. Funds Advisory Fee Litig., No. 14-1165 (D.N.J. Oct. 8, 2018), ECF No. 192; In re BlackRock Mut. Funds Advisory Fee Litig., No. 14-1165, 2019 WL 1387450, at *25 (D.N.J. Feb. 8, 2019).

[250] In re BlackRock, 2019 WL 1387450, at *3, *14 (listing Blackrock witnesses).

[251] In re BlackRock, 327 F. Supp. 3d at 742 ("[T]he Court finds that genuine disputes of material fact exist regarding the comparative fees, economies of scale, and profitability factors of the *Gartenberg* test, and thus, as to whether the Advisory Fee falls outside the range of arm's-length bargaining, rendering summary judgment inappropriate.").]

[252] In re BlackRock, 2019 WL 1387450, at *26 (D.N.J. Feb. 8, 2019) ("Of the *Gartenberg* factors at issue in this case, Plaintiffs devoted the most time, both in their briefing and at trial, to arguing that the BRA offered substantially the same services to the Funds that BRIM provided to the Subadvised funds while charging substantially higher fees.").

The defendants relied on a strategy of misdirection. In more than two days of testimony Mr. Charles Perlowski enumerated in encyclopedic detail various services provided to the captive funds. In general, he characterized those services as consistent with BRA "responsibilities" regarding the funds.[253]

At various points these activities were referred to as: overseeing, coordinating, policy design and implementation, managing, facilitating, servicing, and supervising fund operations.[254] Each of these concepts is abstract and nebulous and, aside from a comprehensive description of the various activities, there were no explicit costs assigned to the activities.

Many pages of the post-trial decision were devoted to a detailed regurgitation of the testimony of Mr. Perlowski and other BlackRock employees.[255] These include numerous paragraphs examining compliance, board administration, regulatory and financial filings, NAV calculations and other services, the Administrative Services Agreement, transfer agency and Shareholder Agreement, custody, and the risks of BRA in assuming day to day operations of funds.[256]

Despite a huge volume of testimony and information detailing differences in services provided by BRA and BRIM, the defendants offered no analysis of the differential costs involved in providing the services. The situation is analogous to the hypothetical outlined in Table 4, *supra*. Fund A, with $10 billion in assets and $60 million (60bp) in fees realized a 58 percent profit margin. The adviser expended $25 million in costs, far more than the $2.5 million it expended in supporting Fund B, the sub-advised fund. Obviously, $25 million is greater than $2.5 million but the adviser's costs as a percentage of assets were identical at 25 bps which yielded a 17 percent profit margin. The advisers

[253] Trial Transcript Vol. I, supra note 220, at 135 ("Q. And where in this agreement might you find the responsibilities that you just referred to. A. I think the broad framework of that responsibility is in Section 1 where it describes the adviser is responsible for the investment of the fund's assets and supervise the day-to-day operations.") (cross-examination of Mr. Perlowski by Mr. Colby). Moreover, the court quoted Mr. Charles Park, who worked in the Financial Institutions Group servicing sub-advised accounts: "Indeed, as Park testified at trial, BRIM is 'simply managing the portfolio, we don't have the same breadth of responsibilities.'" In re BlackRock*,* 2019 WL 1387450, at *14.
[254] Trial Transcript Vol. I, supra note 220, at 36–113 (direct examination of Mr. Perlowski by Mr. Robertson).
[255] In re BlackRock, 2019 WL 1387450, at *2–20.
[256] *Id.*

were willing to accept a far lower profit margin on business where fees were determined competitively than they realized on the captive fund. The difference is that in *BlackRock*, the defendants offered no explicit estimate of the costs involved; they merely enumerated the relative services involved in great detail.

The court was effusive in its praise of defense expert Dr. Eric Sirri "based on his years of experience working in and around the mutual fund industry."[257] The court accepted Dr. Sirri's opinions in toto, even the superficial ones:

> In reviewing Dr. Ayres' work, Dr. Sirri opined that, regardless of the comparability of such costs, he "would not use cost data to assess comparability of services," because, among other things, "just[ ]'cause two things cost the same doesn't mean they are the same."[258]

The statement is inane on its surface, but the court apparently thought it sufficiently profound to include in the opinion. Similarly, the court uncritically accepted Dr. Sirri's opinion on cost allocation citing a hypothetical totally disconnected from the facts:

> Dr. Sirri reiterated why allocated costs, as a general matter, cannot be used to assess what services are provided to the funds. To do so, he created a hypothetical in which a single fund was allocated $100,000, but once a second fund was added, depending on the cost allocation methodology used, the first hypothetical fund received $90,000 in allocated costs, $50,000, or $70,000, even though nothing changed in the services provided to the first fund as its allocated costs changed.[259]

In 2015, the last year of the relevant period, Global Allocation and Equity Dividend funds were ranked number one and number three in AUM according to Morningstar. In Dr. Sirri's hypothetical, a new fund introduced into the cost allocation model would be one of at least

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[257] *Id.* at *7.
[258] *Id.* at *17.
[259] *Id.*

90 other funds and, of necessity, would be small and insignificant compared to the named funds.

In contrast to Dr. Sirri, the court was critical of Dr. Ayres's presentation, characterizing his testimony as "cursory,"[260] "superficial"[261] and "number crunching."[262] The court felt compelled to offer the gratuitous opinion that "I did not find Dr. Ayres, despite his academic credentials, to be particularly helpful, knowledgeable, or convincing in his opinions on the issues."[263] This is revealing. Dr. Ayres's analysis was focused on the core issues of the case. It was Dr. Sirri's analysis that was superficial.

> Dr. Ayres' analysis determined that, as a percentage of AUM, BlackRock's reported costs for the Subadvised Funds for the period between years 2012 and 2014 were, in all cases, comparable to, if not greater than, BlackRock's reported costs for providing services to the Funds. . . . For example, in 2014, BRIM's costs of providing services for the Subadvised GA Funds ranged from 0.201% to 0.553% of AUM, in all cases higher than BlackRock's reported costs . . . for Global Allocation of 0.176% of AUM.[264]

Dr. Ayres also presented an analysis of profit margins similar to the analysis in Table 5, *supra*.[265] He combined the sub-advisory fee schedules and the actual costs incurred by the captive funds to calculate profit margins and found that profit margins on the captive funds would have been far lower when the sub-advisory fee schedule was utilized rather than the actual fee schedule.[266] Overall:

> Dr. Ayres concluded that the Subadvised Funds were appropriate comparables. He concluded that "the description of the portfolio management objectives and strategies in the prospectuses," and "the description of

[260] *Id.* at *29.
[261] *Id.* at *28.
[262] *Id.* at *19.
[263] *Id.* at *25, n.28.
[264] *Id.* at *16.
[265] *See id.* at *20.
[266] *Id.*

> those services in BlackRock's response to RFPs [submitted to the sponsors of the Subadvised Funds]" showed that the portfolio services were substantially the same. [267]

In the end, the court ruled: "After trial, I am persuaded that the preponderance of the evidence demonstrates that the services offered by BRA and BRIM are not comparable."[268] This signaled game over for the plaintiffs. From this flowed the ruling on profitability:

> Plaintiffs have presented a "comparative theory of profitability," asserting that BRA's estimated profit margins on the Funds indicate that the Advisory Fees are excessive because BRA provides substantially the same services to the Subadvised Insurance Funds according to fee schedules that, if applied to the Funds, would still result in positive profit margins for BRA. . . . As trial revealed vast differences in the services that BRA and BRIM provide, Plaintiffs can no longer sustain their argument that BRA's profits are unjustified in light of any similarity in services.[269]

This statement is pivotal and illustrates the core confusion or willful blindness of the *BlackRock* court. To see this clearly, consider again the hypothetical outlined in Table 4, *supra*. The captive fund did indeed exhibit "vast differences" in annual dollar costs—$25 million, compared to $2.5 million for the sub-advised fund. This corresponds to the "vast differences in services" statement by the court in *BlackRock*.[270] The statement makes clear the court based its ruling on the absolute rather than the relative costs of managing the captive and sub-advised funds.

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[267] *Id.* at *17.

[268] *Id.* at *26. The court also characterized Dr. Ayres's testimony as "cursory." ("[B]ased upon the evidence introduced at trial, including the credible and knowledgeable fact witnesses who testified, and Dr. Ayres's cursory testimony, the Court finds that services that BRA provides to the Funds are much more extensive than the services that BRIM provides to the Subadvised Funds.").

[269] *Id.* at *35–36.

[270] *See id.* at *35.

Profits are the difference between revenues and costs. Costs are only part of the equation. The proper measure for mutual funds is comparative profitability of captive and sub-advised funds. As Table 5, *supra*, and Dr. Ayres's analysis make clear, using its own cost allocation model, BlackRock was willing to accept far lower profit margins on sub-advised funds where fees were negotiated than it realized on its captive funds where competition was absent.[271]

2. *Economies of Scale*

The *BlackRock* court cited the Black's Law Dictionary definition of economies of scale in a mutual fund context as a "'decline in a product's per-unit production cost resulting from increased output, [often] due to increased production facilities; savings resulting from the greater efficiency of large-scale processes.'"[272] Within the context of § 36(b), "[t]he concept of 'economies of scale' assumes that as a mutual fund increases in size, its operational costs decrease proportionally. If a fund realizes economies of scale, its willingness to let the shareholders participate in the resulting benefits becomes a factor in evaluating the reasonableness of the adviser-manager's fees."[273]

The plain English interpretation of this statement is: if costs don't increase as rapidly as Assets Under Management ($AUM), the fund is realizing economies of scale and profit margins increase as $AUM increase. Using cost allocation numbers distilled from the BlackRock § 15(c) reports, Dr. Ayres's analysis was consistent with the Black's Law Dictionary definition of economies of scale.[274] He demonstrated that between 2007 and 2015, $AUM for the Global Allocation Fund increased about 160 percent while operating costs increased only about 97 percent.[275] This caused operating profit margins to expand from 48.0 to 58.7 percent.[276] Similarly, over the same time period, the

[271] *See id.* at *29–30.
[272] *Id.* at *33 (quoting Hoffman v. UBS-AG, 591 F. Supp. 2d 522, 539, n.32 (quoting BLACK'S LAW DICTIONARY (8th ed. 2004))).
[273] *Id.* (*quoting* Kalish v. Franklin Advisers, Inc., 742 F. Supp. 1222, 1237 (S.D.N.Y. 1990), *aff'd*, 928 F.2d 590 (2d Cir. 1991)).
[274] *See id.* at *18, *36.
[275] *Id.* at *18.
[276] *Id.*

Equity Dividend Fund $AUM increased about 1500 percent while operating costs increased about 807 percent.[277] This caused operating margins to expand from 40 to 58.8 percent.[278] It is notable that the expansion in profit margins occurred despite the inclusion of some breakpoints in the advisory fee schedule.[279] Absent these breakpoints, profit margins would have expanded at a higher rate.

The BlackRock position was that the standard definition of economies of scale misses important factors and that (paraphrasing) the plaintiffs relied on our unreliable costs allocation numbers that the board relied on and anyhow, if there are economies of scale, we shared them adequately with fund shareholders.[280] The *BlackRock* court added another highly problematic issue into the mix when it insisted that the plaintiffs failed to deal with costs of processing customer orders.[281]

Moreover, Dr. Sirri introduced a red herring into the procedure when he testified that in order to prove the existence of economies of scale it was necessary for plaintiffs to demonstrate causation.[282] In approving this overreach, the court cited as authority a case involving processing costs, of which BlackRock had none:

> Economies of scale do not exist in a vacuum. The concept is meaningful only if increased size of a fund (more shareholders, more assets under management) *directly* reduces the manager's

[277] *Id.*
[278] *Id.*
[279] *See id.* at *3 ("The Advisory Fee is calculated as a percentage of the Funds' AUM, pursuant to a fee schedule containing 'breakpoints,' which reduce the percentage amount of BRA's Advisory Fee as the Funds' AUM increase.").
[280] *See id.* at *16–17.
[281] *See id.* at *33 ("[A]bsent the per unit transaction cost information, there is no way to determine whether any economy of scale even existed that could have been passed on to investors or whether there is another explanation by the statistics identified by the plaintiff.") (internal quotation marks and citation omitted).
[282] *See id.* at *34 ("Dr. Sirri concluded that Dr. Ayres' opinion on economies of scale is flawed because he observed an association between falling costs and a rising fund size. But he has not demonstrated a causal linkage.") (internal quotation marks and citation omitted)

> costs of processing each transaction and servicing each shareholder.[283]

The concept of "causation" is foreign in the economics and legal literature and by accepting this argument the *BlackRock* court added another new and impossible to overcome dimension to the Black's Law Dictionary definition of economies of scale.[284]

The Blackrock court resorted to unseemly contortions to obfuscate and ultimately reject the plaintiffs' inconvenient numerical analysis: "[I]f plaintiffs, as here, are unable to rule out other potential reasons for the observed effects, then its economies of scale analysis must fail. . . . Thus, plaintiffs have failed to demonstrate that the funds realized economies of scale." [285]

(a) The Exhibit 2124 Presentation

BlackRock produced a report to the Directors of about 240 mutual funds including the two named funds. We know of the existence of this report because Mr. Perlowski was examined about its contents.[286] The exact date of this report is unknown, but it is known that, consistent with the report, BlackRock instituted a standard breakpoint schedule in 2011 to be applied to all new funds.[287] There are several interesting observations to be gleaned from Mr. Perlowski's testimony related to this report:

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[283] *Id.* at *34–35 (quoting Kalish v. Fr*anklin Advisers, Inc.*, 742 F.Supp. 1222, 1239 (S.D.N.Y. 1990), *aff'd*, 928 F.2d 590 (2d Cir. 1991) (emphasis in original)).
[284] Specifically, Dr. Sirri testified about Dr. Ayres's opinion that: "he observed an association between falling costs and a rising fund size. But he has not demonstrated a causal linkage." In the Black's Law definition of economies of scale, as interpreted by the courts in *Hoffman and Kalish,* demonstrating an association is sufficient.
[285] *Id.* at *35.
[286] Trial Transcript Vol. III at 464–80, In re BlackRock Mut. Funds Advisory Fee Litig., No. 14-1165 (D.N.J. Aug. 22, 2018), ECF No. 187 (redirect examination of Mr. Perlowski by Mr. Robertson).
[287] *Id.* at 466.

> 1. "BlackRock experiences significant margin expansion" "between 1 and 5 billion."[288]
>
> 2. The standard fee schedule established breakpoints at $1, $3, $5 and $10 billion.[289]
>
> 3. The standard fee schedule reduced advisory fees by 15 percent when assets moved from $1 billion to $10 billion.[290]
>
> 4. One of the drivers of economies of scale is "[g]reater efficiency yields due to skills specialization, improved processes or enhanced organizational design."[291]

The *BlackRock* court therefore knew that in 2011 BlackRock's analysis of its cost structure confirmed that BlackRock experienced significant economies of scale between $1 and $5 billion in AUM and had so informed the directors of 240 of its mutual funds. The *BlackRock* court ignored this information and there is no reference to it in the decision. However, there is mention of a July 2015 analysis "prepared by BlackRock of potential economies of scale, that was shared with the Board explained that 'the imprecision of the allocation methodology, exposure to market beta, continuous reinvestment in the business, and a constantly changing regulatory landscape' all contributed to falling estimated costs even where AUM increases."[292] The court cites approvingly and without qualification a report produced during the litigation supporting the BlackRock litigation theory perfectly yet ignored an untainted document admitting to economies of scale that would support the plaintiffs' theory.

In 2011 (and during the relevant period), the first advisory fee breakpoint occurred at $8 billion for the Equity Dividend Fund and $10

[288] *Id.* at 468 ("Q. This discusses margin expansion? For example, in the third bullet point about the 24 funds that had average AUM between 1 billion and 5 billion, it says: 'BlackRock experiences significant margin expansion.' What does that mean? A. Margin expansion would represent the amount of operating income that you experience at different asset levels.").
[289] *Id.* at 480.
[290] *Id.* at 479.
[291] *Id.* at 467.
[292] In re BlackRock Mut. Funds Advisory Fee Litig., No. 14-1165, 2019 WL 1387450, at *19 (D.N.J. Feb. 8, 2019) (citation omitted).

billion for the Global Allocation Fund.[293] In 2011, the directors were on notice that BlackRock realized substantial economies of scale in the $5 to $10 billion range of assets, yet they did not negotiate a revised fee schedule for the named funds. This is further evidence that the supposed "robust" fund governance process was bogus.[294]

(b) Sub-Advisory Fee Breakpoints

Advisory fee breakpoint schedules for the named funds were and are readily available in annual reports and SAIs.[295] It is curious that the *BlackRock* court redacted these schedules in its summary judgment decision and did not disclose them in the decision despite disclosing detailed schedules for the sub-advised funds in both documents.[296]

Comparison of fee breakpoint schedules is highly relevant given that the court had ruled that the investment management processes were essentially identical.[297] There is no reason to believe that differential services in other areas would impact the economics of the underpinning investment management processes.

The contrast in fee breakpoint schedules is dramatic. In each of the three Equity Dividend sub-advised funds the final breakpoint occurred at $1 billion in AUM.[298] The average reduction in fees from the first to last breakpoint was in excess of 20 percent.[299] Two of the four Global Allocation sub-advised accounts scheduled the final breakpoint at $1.5 billion and the other two came in at $100 and $500 million in AUM.[300] The average reduction in fees from the first to the last breakpoint was also in excess of 20 percent.[301]

This contrast in fee breakpoints is reflected in Table 5, *supra*: In Panel A, the Equity Dividend Fund exhibited a 54 basis point advisory fee when AUM were about $28 billion. This is a 10 percent

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[293] *See* Consolidated Complaint, *supra* note 243, at ¶¶ 113, 118.
[294] *See* In re BlackRock Mut. Funds Advisory Fee Litig., 327 F. Supp. 3d 690, 716 (D.N.J. 2018), *aff'd*, 816 F. App'x 637 (3d Cir. 2020); *see also In re BlackRock*, 2019 WL 1387450, at *31.
[295] *See* BLACKROCK REGISTRATION STATEMENT, *supra* note 231, at 32.
[296] *See* BlackRock, 327 F. Supp. 3d at 697–99, 740.
[297] *Id.* at 724 ("[T]he record reflects that BRIM provides substantially the same portfolio management services for the Subadvised Funds that BRA provides to the Funds.").
[298] *Id.* at 707–08.
[299] *See id.*
[300] *Id.*
[301] *See id.*

decrease from the advisory fee of 60 basis points occurring at $8 billion in AUM. Similarly, the 67 basis point fee at $60 billion of AUM for the Global Allocation fund constituted a 10.7 decrease in fee rates of 75 basis points at the $10 billion AUM first breakpoint.

(c) Processing Costs

In a line of cases beginning with *Gartenberg*, courts considered order processing costs when testing for economies of scale.[302] These cases engendered substantial and unnecessary confusion in case law. As discussed elsewhere, *Gartenbeg* was the genesis of this confusion.[303] The money fund in *Gartenberg* was anomalous because the investment management function was integrated with the brokerage function and different processing cost estimates resulted in ambiguous profit margin and economies of scale calculations.[304] The gross profit margin in *Gartenberg* was 95 percent.[305] Similar confusion arose in *Krinsk*, which featured another Merrill Lynch money fund,[306] and in *American Funds*,[307] where the complaint combined distribution and investment management fees.

None of this had anything to do with *BlackRock*. BlackRock had no processing costs. All order processing was handled by the transfer agent and funds paid for these services in transfer agent fees. The plaintiffs argued that "Dr. Ayres looked at all of BlackRock's costs including whatever costs there are for supervising the transfer agent, for

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302 *See, e.g.,* Krinsk v. Fund Asset Mgmt., Inc., 875 F.2d 404, 411 (2d Cir. 1989) ("[T]o show economies of scale, plaintiff bore the burden of proving that the per unit cost of performing Fund transactions decreased as the number of transactions increased.") (citing Gartenberg v. Merrill Lynch Asset Mgmt., Inc., 528 F. Supp. 1038, 1055 (S.D.N.Y.1981)).
303 *See* Brown, *Mutual Fund Advisory Fee Litigation*, *supra* note 141, at 359; Brown & Pomerantz, *Mutual Fund Advisory Fees*, *supra* note 80, at 55–56; Brown, *Forty Years of Failure*, *supra* note 77, at 1.
304 *See* Brown, *Forty Years of Failure*, *supra* note 77, at 16 ("The Ready Assets Trust (RAT), the named fund, was a money market fund sponsored and managed by Merrill Lynch Asset Management (MLAM) but also integrated with Merrill Lynch Pierce, Fenner & Smith (MLPF&S) brokerage operations").
305 Brown, *Forty Years of Failure*, *supra* note 77, at 21.
306 *Krinsk*, 875 F.2d at 406.
307 In re American Mut. Funds Fee Litigation, 2009 WL 5215755, at *5–14 (C.D. Cal. Dec. 28, 2009).

supervising State Street."[308] None of this impressed Judge Wolfson, who noted that:

> When pressed on this issue at trial, Dr. Ayres verified that he did not perform the required per-unit transaction cost analysis, confirming that his "analysis on economies of scale was to crunch the numbers of finding what the assets under management were, seeing that they increased substantially over time, that during that same time period the expenses decreased."[309]

(d) Economies of Scale

The concept of economies of scale has a very long pedigree that begins with Adam Smith's Wealth of Nations and the famous example of the pin factory where division of labor caused dramatic decreases in average cost per unit.[310] Similarly, BlackRock listed one of the drivers of economies of scale as "[g]reater efficiency yields due to skills specialization, improved processes or enhanced organizational design."[311] The important and dispositive point is that scale efficiencies similar to those noted above would flow into and be accounted for in the operating expenses Dr. Ayres used in his economies of scale analysis.[312]

BlackRock's arguments on economies of scale hinged on two principal arguments, both fallacious. First, BlackRock argued that the decrease in costs could have been caused by the addition of new products causing fewer allocated costs to the named funds:

> Ms. Ashkenazy and Dr. Sirri also explained that BlackRock's cost allocation methodology could cause the trend that Dr. Ayres pointed out; namely, that the Funds' allocated costs decreased as AUM increased. As Ms. Ashkenazy and Dr. Sirri explained, this is because BlackRock's entire business grew and

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[308] In re BlackRock Mut. Funds Advisory Fee Litig., 327 F. Supp. 3d 690, 737 (D.N.J. 2018).
[309] In re BlackRock Mut. Funds Advisory Fee Litig., No. 14-1165, 2019 WL 1387450, at *34 (D.N.J. Feb. 8, 2019) (citation omitted).
[310] 1 ADAM SMITH, THE WEALTH OF NATIONS 10 (E.P. Dutton ed., 1910).
[311] Trial Transcript Vol. III, *supra* note 286, at 464–467 (redirect examination of Mr. Perlowski by Mr. Robertson regarding Exhibit 2124).
[312] *See* In re BlackRock, 2019 WL 1387450, at *18.

> changed over time, thereby resulting in fewer allocated costs to those Funds as additional products and additional AUM in other products "pooled costs from the at-issue [F]unds to the new funds . . . and those new products were allocated costs that had previously just been allocated to the at-issue funds.[313]

The obvious fallacy is that new expenses associated with the new products would be added into the cost allocation model along with the new assets. It is revealing that the *BlackRock* court did not recognize this obvious implication.

The second fallacious argument involves supposedly unaccounted-for costs. There was testimony at trial that numerous other factors could have caused estimated costs to fall as AUM increased over time: "For instance, Dr. Sirri opined that "technology," "recontracting," and obtaining lower prices from service providers could cause falling costs at a mutual fund complex as assets under management rise."[314]

These factors fall under the aegis of "Greater efficiency yields due to skills specialization, improved processes or enhanced organizational design."[315] As noted above, these costs would flow into and be accounted for in operating costs in the Black's Law Dictionary definition of economies of scale.[316] The *BlackRock* court's discovery of unaccounted-for costs would effectively contradict the standard definition of economies of scale used in case law. Ultimately, the court decided that "plaintiffs have failed to demonstrate that the funds realized economies of scale."[317]

In addition to the two fallacies put forward by the defendants, the Court added a fallacy of its own when it rejected the Ayres approach for failure to account for processing costs, of which there were none.[318]

E. Other Factors

The Blackrock court tidied up the decision by briefly addressing the issues of risk and the comparison of Blackrock's fees to fees on other mutual funds.

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[313] *Id.* at *19.
[314] *Id.* at *35.
[315] *See* Trial Transcript Vol. III, *supra* note 286, at 464.
[316] *See* BlackRock, 2019 WL 1387450, at *33.
[317] *Id.*
[318] *See id.* at *34–35.

1. *Risks*

At trial, the plaintiffs argued that the investment management agreements limited BRA's potential liability to losses "resulting from willful misfeasance, bad faith or gross negligence on its part in the performance of its duties or from reckless disregard . . . of its duties under [the IMA]."[319] The defendants argued, and the court ruled, that the risks facing BRA were all-encompassing and included different entrepreneurial, reputational, legal, and regulatory risks.[320] The defendants offered no numerical analysis or quantification of the different risks involved.

2. *Lipper Data*

The *Blackrock* court finessed Justice Alito's admonition in *Jones* to not rely too heavily on comparisons with fees charged to mutual funds by other advisers. The court found that "[t]he Lipper data, therefore, supports Defendants' argument that its fees are reasonable in light of industry standards" and concluded that "because the Subadvised Funds are not apt comparisons, and because independent data suggests that BRA's fees were reasonable, Plaintiff's comparative fee analysis fails."[321]

F. Discussion

It is uncontroverted that based upon its own cost allocation methodology, Blackrock's cost of managing sub-advised accounts was the same or higher than the cost of managing captive funds. As a result, Blackrock realized much higher profit margins on captive funds than it accepted on its sub-advised funds where competitive pressures caused lower advisory fees.

The Blackrock court embraced misdirection to arrive at a subjective and contrary conclusion. In the process, as noted earlier, it systematically denigrated Dr. Ayres's testimony as "cursory," "superficial," and a "number crunch" In contrast, Dr. Sirri's testimony was accepted wholesale despite his failure to note increased costs when new products are introduced and suggesting that the common Black's

[319] *Id.* at *31 (internal quotation marks and citation omitted).
[320] *Id.*
[321] *Id.* at *33.

Law Dictionary definition was incomplete because it omitted some costs.

A step back suggests some sympathy for Judge Wolfson. A finding for the plaintiffs in Blackrock would have required a profound understanding of mutual funds and the errors made by earlier courts. The willingness to discount Dr. Ayres's spot-on numerical analysis and the unbecoming embrace of Dr. Sirri's obfuscations demonstrate the lack of understanding that has permeated § 36(b) litigation since *Gartenberg*. On balance, *Blackrock* illustrates why § 36(b) litigation has disappeared and will likely not reappear unless Congress or the SEC unscramble the confusion.

VI. Summary and Conclusions

Mutual fund advisory fee contracts are no-bid contracts. That is as true today as it was in 1970 when Congress concluded that the forces of arm's length bargaining do not operate on mutual fund advisory fees. Yet, the Supreme Court in *Jones* functionally eviscerated what had been settled law since the Second Circuit endorsed the proposition in *Gartenberg*.

Two things happened to cause the change: first, the District Court ruling in *Jones* directly challenged the Second Circuit and, in response, the ICI commissioned CH to support the idea that advisory fees are influenced by competitive pressures.

Unsubtle recommendations relevant to the *Jones* District Court decision by CH are consistent with this notion:

> Economic analysis and continuing changes in the mutual fund industry suggest the importance of competitive market conditions as a factor to be considered under the *Gartenberg* legal framework. In particular, we argue, evidence of competition itself, and of fees paid by comparable funds, should be both admissible as evidence and a significant component of judicial analysis in cases under section 36(b).[322]

Despite the veneer of academic sophistication, the statement reveals the raw advocacy of an industry sponsored hit piece. The statement is consistent with the misdirection and duplicity revealed here.

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[322] Coates & Hubbard, *supra* note 11, at 154.

The Supreme Court took *Jones* to resolve the conflict between the Second and Seventh Circuits. Justice Alito faced a binary choice. Essentially, the Second Circuit position in *Gartenberg* was that fees on other mutual funds are inapt comparators in § 36(b) cases. Following CH, the Seventh Circuit took the opposite position. Favoring the Second Circuit would have unleashed a new wave of fee cases on the judiciary and cause major disruption in a multi-trillion-dollar industry. Favoring the Seventh Circuit would make it impossible for plaintiffs to ever prevail in § 36(b) cases and would allow the continued overcharging of mutual funds investors by tens of billions of dollars annually. On the surface, Justice Alito ratified *Gartenberg* while functionally doing the opposite.

> Consider the closing statement in *Jones*:
> The *Gartenberg* standard . . . 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 debate . . . . regarding today's mutual fund market is a matter for Congress, not the courts.[323]

Suggesting that Congress handle the problem is cynical in the extreme. In reality, *Jones* made it effectively impossible for plaintiffs to ever prevail in § 36(b) cases. The predictable result has been the disappearance of such cases—the reasoning in *BlackRock* being a primary example of why.

[323] Jones v. Harris Assocs. L.P., 559 U.S. 335 353 (2010).