DO YOU GET WHAT YOU PAY FOR? A LOOK AT THE HIGH FEES AND LOW PROTECTIONS OF MUTUAL FUNDS

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I. INTRODUCTION

Mutual funds have become a major part of the American securities market. As of 2004, mutual funds represented $8.1 trillion in assets and held nearly a quarter of all the outstanding stock of American corporations.[1] The value of the securities owned by mutual funds has increased almost 300% since 1995.[2] Mutual funds have also become a primary investment vehicle for individuals, and the industry has seen astounding growth among American households.[3] In 2004, individual shareholders held over 90% of mutual fund assets either directly or indirectly.[4] The tremendous growth in this field, combined with the high number of individual investors, many of whom are unsophisticated, creates a serious problem for shareholders seeking fair treatment by the funds. The excessive fees that mutual funds charge shareholders is a typical form of abuse.

The unique structure of mutual funds makes them particularly susceptible to agency problems that can result in higher fees. These agency problems prevent competitive forces from working properly in the mutual fund industry. Unfortunately, legislation in this arena generally has served only to increase the permissible types of fees that funds may charge, granting little in the way of increased shareholder protection.[5] The limited protection that shareholders do receive comes primarily from the fiduciary duties created by

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[1] INVESTMENT COMPANY INSTITUTE, 2005 INVESTMENT COMPANY FACTBOOK 4, 6-7 (45th ed. 2005), *available at* http://www.ici.org/pdf/2005_factbook.pdf [hereinafter ICI FACTBOOK].

[2] *See id.* at 3.

[3] *See id.* at 12 ("In 2004, individuals continued to use funds as one of their primary means to invest. . . . [H]ouseholds held nearly 20 percent of their $37 trillion in financial assets . . . through mutual funds.").

[4] *Id.*

[5] *Id.* at 24.

the Investment Company Act of 1940 (the "1940 Act").[6] This Note seeks to determine whether current law adequately protects shareholders from the agency problems inherent in mutual fund organization by analyzing the underpinnings of mutual fund fee calculations and the available avenues for shareholders to dispute such fees.

Section II discusses the organization of mutual funds and how their structure contributes to current problems with fees. Specifically, that Section argues that the agency problems created by the principal actors result in diminished competition and higher fees for investors. Section II also includes a description of the current types of fees used by mutual funds. Section III examines the leading cases concerning excessive fees to determine how and whether the so-called "*Gartenberg* factors" allow shareholders to bring successful claims against their mutual funds. As that Section demonstrates, the current judicial standards for measuring fees make it all but impossible for shareholders to prevail in court. Section IV looks at possible alternative methods for regulating mutual fund fees, including the development of new judicial standards, additional mandatory disclosures and procedural safeguards, implementation of fee caps, and policing by self-regulatory agencies or other soft regulations.

II. OVERVIEW OF MUTUAL FUNDS AND THEIR FEES

A. Organization of Mutual Funds

A mutual fund is comprised of four principal entities: the fund, an investment adviser, an underwriter of the fund's shares, and a custodian.[7] The fund is organized by the investment adviser, which is responsible for investing the

[6] 15 U.S.C. §§ 80a-1 to -64 (2000 & Supp. I 2001 & Supp. II 2002 & Supp. III 2003).

[7] William P. Rogers & James N. Benedict, *Money Market Fund Management Fees: How Much is Too Much?*, 57 N.Y.U. L. REV. 1059, 1063 (1982).

fund's assets and satisfying the fund's more banal business requirements, such as procuring staff and office space.[8] The investment adviser is typically an investment company that provides investment services to one or more mutual funds and is a key player in the mutual fund because its investments generate the investors' returns.[9] As compensation for its efforts, the adviser receives an advisory fee paid out of the assets of the fund.[10] Once the fund is organized, the investment adviser turns over the day-to-day supervision of the fund to a board of directors, which manages it and serve to protect the interests of the shareholders.[11] The investment adviser establishes the board and generally fills some of the director positions with its own employees and also oversees recruitment of the independent directors.[12] By law, at least forty percent of these directors must be independent;[13] nonetheless, this rule is flexible, and in certain circumstances, funds may be required only to have a single independent director.[14] The board of directors is responsible for setting the investment adviser's fee,[15] which must be renewed annually.[16] As guardians of shareholder interests, directors must ensure "that dealings between the fund and the adviser measure up to a fiduciary standard."[17]

Individuals or institutions invest in a mutual fund by purchasing shares that the fund issues.[18] The fund's

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[8] *Id.*

[9] 15 U.S.C. § 80a-2(a)(20) (2000).

[10] Rogers & Benedict, *supra* note 7, at 1063-64.

[11] *Id.* at 1064.

[12] ICI FACTBOOK, *supra* note 1, at 116, 119.

[13] 15 U.S.C. § 80a-10(a) (2000).

[14] 15 U.S.C. § 80a-10(d) (2000). This section describes eight criteria that, if satisfied, would permit a mutual fund to have "a board of directors all the members of which, except one, are interested persons of the investment adviser."

[15] Rogers & Benedict, *supra* note 7, at 1064.

[16] 15 U.S.C. § 80a-15(c) (2000).

[17] Kamen v. Kemper Fin. Serv., Inc., 500 U.S. 90, 90 (1991).

[18] ICI FACTBOOK, *supra* note 1, at 116.

principal underwriter handles the actual marketing of the mutual fund shares to investors,[19] and the fund then uses the asset pool generated by the sale of shares to purchase a portfolio of securities.[20] Mutual funds are typically created to invest in a specific type of security (e.g., high yield bonds), and investors select a particular fund as part of an overall portfolio crafted to meet their investment goals and objectives.[21]

The fund's custodian and transfer agent essentially serve as repositories for all securities purchased by the mutual fund.[22] To protect shareholders' interests, assets are not held by the mutual fund directly; instead the assets are placed with the custodian, which is generally a bank.[23] The transfer agent is responsible for maintaining the records of the mutual fund; it has information on all shareholder accounts, manages the payment and distribution of dividends and capital gains, and sends out shareholder account statements and tax information.[24] While these officers serve important functions for the mutual fund, this Note focuses primarily upon the roles of the investment adviser and the board of directors.

B. Types of Mutual Fund Fees

To fully appreciate the protections that exist for shareholders of mutual funds, one must understand how mutual fund fees work. Mutual funds are permitted to charge a variety of fees in a number of ways. Initially, mutual funds fees came in a single form: sales loads, which are still used today by many funds to compensate brokers for selling shares of the fund.[25] Load fees take two forms: front-

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[19] *Id.* at 120.

[20] *Id.* at 116.

[21] *See id.* at 113-18.

[22] *Id.* at 121.

[23] *Id.* at 122, 126.

[24] *Id.* at 121.

[25] SEC, MUTUAL FUND FEES AND EXPENSES (2006), http://www.sec.gov/answers/mffees.htm [hereinafter SEC REPORT ON MUTUAL FUND FEES].

end sales loads, which are deducted when investors first purchase the shares, and back-end or deferred sales loads, which are deducted when investors redeem or sell their shares. There is no specific limit set on load fees, although the National Association of Securities Dealers ("NASD") does not permit load fees to exceed 8.5% of the offering price.[26]

In the mid-1970s, a new type of mutual fund, the "no-load fund," took the market by storm.[27] This type of fund does not charge a sales load, but instead garners fees that are not considered loads (e.g., purchase fees, redemption fees, exchange fees, and account fees).[28] No-load funds became popular with investors because "the fund, rather than the investor, bore the burden of brokerage commissions."[29]

The SEC had long held that mutual funds could not distribute their own shares,[30] but the popularity of no-load funds, which placed the burden of distribution costs on the fund itself, forced the SEC to reconsider this position. In 1980, after consulting with members of the mutual fund industry, the SEC promulgated Rule 12b-1,[31] which permitted mutual funds to act as the distributor for their own shares under certain circumstances and to charge fees to the shareholders to help defray distribution costs.[32] Given the conflicts of interest that may arise when a fund decides

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[26] NASD, INC., MANUAL RULE 2830(d)(1)(A) (2001), *available at* http://nasd.complinet.com/nasd/display/index.html [hereinafter NASD MANUAL] ("Aggregate front-end and deferred sales charges . . . shall not exceed 8.5% of the offering price.").

[27] Craig A. Rubinstein, *Excessive Mutual Fund Fees: Give-ups in Rule 12b-1 Clothing?*, 14 ANN. REV. BANKING L. 385, 395 (1995).

[28] *See* SEC REPORT ON MUTUAL FUND FEES, *supra* note 25.

[29] Rubinstein, *supra* note 27, at 395.

[30] *See* 15 U.S.C. § 80a-12(b) (2000) ("It shall be unlawful for any registered open-end company . . . to act as a distributor of securities of which it is the issuer."); *see also* Rubinstein, *supra* note 27, at 396 (suggesting that the SEC prohibited a mutual fund from distributing its own shares out of a concern for "the dangers inherent in directors relying on the adviser for information and advice regarding distribution decisions").

[31] Rubinstein, *supra* note 27, at 396.

[32] *See* 17 C.F.R. § 270.12b-1(a)(1)-(2) (2005).

whether to pay the costs of distribution itself,[33] Rule 12b-1 requires approval of these fees at their inception by both the shareholders and a majority of the disinterested directors, as well as, through annual renewal by the disinterested directors.[34] As with sale loads, the SEC puts no specific limit on the amount that may be charged as 12b-1 fees, yet the NASD has imposed a cap of 0.75% of the fund's assets.[35]

C. Problems Created by Mutual Fund Structure

The relationship between the investment adviser and the board of directors can create a conflict of interest with a profound effect on shareholders. Agency problems of this type are common in the corporate world—the shareholders cannot efficiently deal with the investment adviser themselves, so the board acts as the shareholders' agent during negotiations. While the adviser wants fees to be as high as possible, the board seeks to negotiate the best deal possible on behalf of the shareholders. Agency problems arise because the board, which has been delegated power by the shareholders, may not always act in the shareholders' best interests.[36] The shareholders' main protection concerns the investment adviser's fiduciary duty with respect to any fees that it accepts,[37] and the board of directors is supposed to act as an additional and "independent chec[k] on excessive fees."[38] However, the board may not negotiate with complete fidelity on behalf of the shareholders' interests when faced

[33] Rubinstein, *supra* note 27, at 396.

[34] 17 C.F.R. § 270.12b-1(b)(1)-(2) (2005).

[35] NASD MANUAL, *supra* note 26, Rule 2830(d)(2)(E)(i) ("The amount of the asset-based sales charge [shall not exceed] .75 of 1% per annum of the average annual net assets of the investment company.").

[36] Walter Mattli & Tim Büthe, *Global Private Governance: Lessons from a National Model of Setting Standards in Accounting*, 68 J. LAW & CONTEMP. PROBS. 225, 229 (2005).

[37] *See* 15 U.S.C. § 80a-35(b) (2000) ("[T]he investment adviser of a registered investment company shall be deemed to have a fiduciary duty with respect to the receipt of compensation for services, or of payments of a material nature.").

[38] Daily Income Fund, Inc. v. Fox, 464 U.S. 523, 541 (1984).

with a tangible negotiating partner (namely, the investment adviser) and a nameless group of shareholders. In response to concerns that boards were not fulfilling their fiduciary duties to shareholders, Congress in 1970 amended the 1940 Act to create an "effective means for the courts to act where the mutual fund shareholders or the SEC believe there has been a breach of fiduciary duty."[39] These amendments mainly served to highlight the fiduciary duty of advisers with regard to advisory fees and "to provide a judicial remedy for breach of such fiduciary duty."[40]

Unfortunately, these amendments may not be enough to overcome the conflicts of interest between advisers and directors. In fact, the SEC conducted a study in 2000 that showed that mutual fund expense ratios have increased since the amendments to the 1940 Act (although they decreased in the three years immediately prior to the study).[41]

Although the board is obligated to negotiate the fee arrangement with the investment adviser at arm's length, the progressive increase in fees in recent years may reflect the fact that the board's negotiating power is so limited that the investment adviser essentially can dictate the terms of the agreement. The investment manager performs the majority of the management services for the fund; thus "a mutual fund cannot, as a practical matter, sever its relationship with the adviser."[42] The prohibitive expenses of terminating an investment adviser, and the potential difficulties in finding a new one, mean that boards effectively

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[39] S. REP. NO. 91-184, at 2 (1969), *reprinted in* 1970 U.S.C.C.A.N. 4897, 4898 (noting that the 1940 Act in its original form did not provide "any mechanism by which the fairness of management contracts could be tested in court").

[40] *Id.* at 13-14, *reprinted in* 1970 U.S.C.C.A.N. 4897, 4909-10.

[41] SEC REPORT ON MUTUAL FUND FEES, *supra* note 25.

[42] Gartenberg v. Merrill Lynch Asset Mgmt., Inc., 694 F.2d 923, 928 (2d Cir. 1982) (citing S. REP. NO. 91-184, at 5 (1969), *reprinted in* 1970 U.S.C.C.A.N. 4897, 4901).

negotiate with one hand tied behind their backs.[43] Thus, competitive forces may not reliably generate fair advisory fees in the mutual fund context.[44]

The multiple roles played by the investment adviser may also serve as an impediment to arm's length negotiations. In addition to providing investment services, the adviser often also serves as the mutual fund's administrator, keeping records and providing other services necessary to the operation of the fund.[45] While a director has a legal right to inspect these records at any time, "the adviser, as a practical matter, is in a position to seriously hamper any employment of that right which might interfere with or threaten the adviser's operation of or control over the fund."[46]

Courts appear to believe that the board, particularly the independent directors, speaks with the shareholders' voice. Once an advisory fee has been approved by a majority of disinterested directors, it therefore becomes very difficult to challenge.[47] This judicial deference to fee levels set by directors has prompted critics to claim that because "the men who need to be watched pick the watchdogs, no one should expect the disinterested directors of a fund to oppose its investment adviser or underwriter in matters in which the

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[43] *Id.* at 929 n.2 ("Thus, negotiations between the unaffiliated directors and fund advisers over advisory fees would lack an essential element of arm's-length bargaining—the freedom to terminate the negotiations and to bargain with other parties for the same services. In view of the fund's dependence on its existing adviser and the fact that many shareholders may have invested in the fund on the strength of the adviser's reputation, few unaffiliated directors would feel justified in replacing the adviser with a new and untested organization simply because of difficulty in obtaining a reduction in long-established fee rates which are customary in the industry." (quoting H.R. REP. NO. 89-2337, at 131 (1966)).

[44] *Id.* at 928.

[45] *Id.* at 929 n.2.

[46] *Id.*

[47] *See, e.g.,* Schuyt v. T. Rowe Price Prime Reserve Fund, Inc., 663 F. Supp. 962, 988 (S.D.N.Y. 1987) (stating that when "independent directors [are] qualified, fully informed, and extremely conscientious individuals, the directors' approval of the fee should be weighted heavily").

economic interests of the adviser or underwriter are at stake."[48]

Finally, the agency problem is exacerbated by the fact that, due to the relatively small amount that each investor pays, individual shareholders are unlikely to bring suit against their mutual fund. Without the threat of litigation, directors have little incentive to fight the investment adviser with respect to fees because "[c]ost reductions in the form of lower advisory fees do not figure significantly in the battle for investor favor."[49]

III. CURRENT PROTECTIONS FOR INVESTORS UNDER THE INVESTMENT COMPANIES ACT OF 1940

Congress passed the 1940 Act to protect mutual fund investors by combating the prevalence of managerial self-dealing and other investment company abuses that had existed during the Depression.[50] Prior to enacting the 1940 Act, the SEC had attempted to regain control of the investment industry through investigations and litigation, but eventually "[it] became apparent that nothing short of

[48] Nancy L. Conlin, *Mutual Fund Expenses: Caveat Investor?*, 13 ANN. REV. BANKING L. 365, 386 (1994) (citations omitted).

[49] SEC, REPORT OF THE SEC ON PUBLIC POLICY IMPLICATIONS OF INVESTMENT COMPANY GROWTH, H.R. REP. NO. 89-2337, at 126 (1966) [hereinafter 1966 SEC REPORT].

[50] Rogers & Benedict, *supra* note 7, at 1068-69 ("The precipitous drop in the size of investment company assets between 1929 and 1935, in part due to the Depression, also stemmed from mismanagement and fraud in the industry. The SEC estimated that mismanagement caused losses totaling more than $1 billion. Managerial self-dealing and 'get-rich schemes' were rampant. Witnesses at congressional hearings painted investment company directors and officers as persons bent on personal gain and oblivious to the interests of shareholders. In response to these abuses, Congress authorized the SEC to conduct a comprehensive review of the investment company industry. What the SEC found ranged from managerial breach of fiduciary duty to outright 'victimizing' of investment company shareholders. While the SEC investigation progressed, attempts to impose controls on investment companies were made, but met with limited success.") (citations omitted).

comprehensive federal regulation could remedy the industry's widespread problems."[51]

One of the main goals of the 1940 Act was to reduce self-dealing in investment companies.[52] In the 1940 Act, Congress first developed the idea of independent directors, who would serve as "the first line of defense against self-dealing by investment advisers."[53] Congress required that these independent directors be seated on mutual fund boards and imposed a series of special duties on them.[54]

Section 36 of the 1940 Act ultimately became even more important to the defense of mutual fund shareholders.[55] As originally drafted, it enabled the SEC to sue "in cases involving 'gross misconduct or gross abuse of trust' on the part of investment advisers, directors, officers, and principal underwriters."[56] However, the SEC proved surprisingly reluctant to file suit against mutual funds, claiming that such suits would "stigmatize advisers with charges of 'gross abuse of trust' solely because they had adhered to the traditional pattern of fee rates in the industry."[57] A few shareholders attempted to bring derivative suits under this

[51] *Id.* at 1069.

[52] *Id.*

[53] *Id.* at 1070.

[54] *See* 15 U.S.C. § 80a-10(a) (2000).

[55] Investment Company Act of 1940, Pub. L. No. 76-768, § 36, 54 Stat. 789, 841 (1940) (codified as amended at 15 U.S.C. § 80a-35(a) (2000)).

[56] *Id.* ("The Commission is authorized to bring an action . . . alleging that a person serving or acting in one or more of the following capacities has been guilty . . . of gross misconduct or gross abuse of trust in respect of any registered investment company for which such person so serves or acts: (1) as officer, director, member of an advisory board, investment adviser, or depositor; or (2) as principal underwriter, if such registered company is an open-end company, unit investment trust, or fact-amount certificate company. If the Commission's allegations of such gross misconduct or gross abuse of trust are established, the court shall enjoin such person from acting in such capacity or capacities either permanently or for such period of time as it in its discretion shall deem appropriate.").

[57] 1966 SEC REPORT, *supra* note 49, at 143.

section on an implied right of action theory, but only three of these cases went to trial and all of them were unsuccessful.[58]

Following critical reports by the SEC[59] and the Wharton School of Finance and Commerce at the University of Pennsylvania,[60] which argued that protections for investors against excessive mutual fund fees were insufficient, Congress proposed to amend the 1940 Act in 1970.[61] The final result was Section 36(b), which states, in relevant part:

> [The] investment adviser of a registered investment company shall be deemed to have a fiduciary duty with respect to the receipt of compensation for services, or of payments of a material nature, paid by such registered investment company, or by the security holders thereof, to such investment adviser or any affiliated person of such investment adviser. An action may be brought under this subsection by the Commission, *or by a security holder* of such registered investment company on behalf of such company, against such investment adviser, or any affiliated person of such investment adviser, or any other person enumerated in subsection (a) of this section who has a fiduciary duty concerning such compensation or payments, for breach of fiduciary duty in respect of such compensation or payments paid by such registered investment company or by the security holders thereof to such investment adviser or person.[62]

Section 36(b) thus gave individual investors a private right of action to bring suit against the mutual fund or investment adviser for fees that violated this newly created fiduciary duty.

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[58] *See* Acampora v. Birkland, 220 F. Supp. 527 (D. Colo. 1963); Saxe v. Brady, 184 A.2d 602 (Del. Ch. 1962); Meiselman v. Eberstadt, 170 A.2d 720 (Del. Ch. 1961).

[59] *See* 1966 SEC REPORT, *supra* note 49, at 11, 13.

[60] *See* WHARTON SCHOOL OF FINANCE AND COMMERCE, A STUDY OF MUTUAL FUNDS, H.R. Rep. No. 87-2274, at 28 (1962).

[61] Rogers & Benedict, *supra* note 7, at 1082.

[62] 15 U.S.C. § 80a-35(b) (2000) (emphasis added).

Prior to creating a fiduciary duty regarding fees, Congress considered requiring simply that fees be "reasonable."[63] However, mutual funds "express[ed] concern that the [reasonableness] standard would be read to prohibit investment advisers from profits," and so they lobbied hard against this wording of the statute.[64] Industry members also expressed concern that a judge-made reasonableness test would run contrary to the business judgment rule, which traditionally gave deference to board decisions on the reasonableness of fees.[65] Imposing a fiduciary duty on the board represented a compromise between the SEC and the mutual fund industry,[66] but the SEC and the mutual fund industry disagreed over the proper interpretation of "fiduciary duty" under Section 36(b). "The SEC contended that the shift from a reasonableness to a fiduciary duty standard was merely a change of form that did not affect the substance of the duty imposed. . . . The mutual fund industry, however, maintained that there were significant differences between the two standards."[67] Had courts followed the SEC's construction of "fiduciary duty," shareholders would likely have received much greater protection from excessive fees under Section 36(b).

A. Alleging a Prima Facie Case Under Section 36(b)

When bringing a claim for excessive fees, the shareholder bears quite a difficult burden of proof. In *Gartenberg v. Merrill Lynch Asset Management,* the court established the basic standard for determining whether adviser fees are excessive. The test is whether the "fee . . . is *so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been*

[63] S. 3724, 90th Cong. § 8(d) (1968); see 114 CONG. REC. 23, 546 (1968) for discussion of the reasonableness standard.

[64] Rogers & Benedict, *supra* note 7, at 1085.

[65] *Id.*

[66] *Id.* at 1084.

[67] *Id.* at 1084-85.

the product of arm's-length bargaining."[68] The Second Circuit later fine-tuned this test by identifying six factors to consider when evaluating fee reasonableness: "(a) the nature and quality of services provided to fund shareholders; (b) the profitability of the fund to the adviser-manager; (c) fall-out benefits; (d) economies of scale; (e) comparative fee structures; and (f) the independence and conscientiousness of the trustees."[69]

B. Shareholder Success in Section 36(b) Cases

The *Gartenberg* six-factor test imposes significant obstacles for litigants bringing a case for excessive mutual fund fees. In fact, no investor has *ever* been successful in bringing such a claim in federal court. As courts have applied this test, the *Gartenberg* factors offer mutual funds ample opportunities to demonstrate that their fees are reasonable, rather than working to protect investors.

1. Quality of Services Provided

The first prong of the *Gartenberg* test examines "the nature and quality of services provided to fund shareholders."[70] As part of this analysis, a court considers the basic services that an adviser is expected to provide—such as "devising an overall investment strategy, including analysis of current projected economic factors, the selection of securities, and the execution of trades"[71]—as well as the quality and speed with which these services are provided

[68] Gartenberg v. Merrill Lynch Asset Mgmt., Inc., 694 F.2d 923, 928 (2d Cir. 1982) (emphasis added).

[69] Krinsk v. Fund Asset Mgmt., 875 F.2d 404, 409 (2d Cir. 1989) (citing *Gartenberg*, 694 F.2d at 929-30). Despite the fact that the *Krinsk* court actually delineated these factors, courts generally refer to them as the "*Gartenberg* factors" or the "*Gartenberg* test." That custom is followed here.

[70] *Krinsk*, 875 F.2d at 409.

[71] Kalish v. Franklin Advisors, Inc., 742 F. Supp. 1222, 1228 (S.D.N.Y. 1990).

and any additional services offered by the adviser.[72] The qualitative nature of this prong gives mutual funds a significant opportunity to rationalize the value of the services that they offer.[73] Moreover, courts have interpreted SEC Rule 12b-1, promulgated under the authority of the 1940 Act, to permit mutual funds to spread their expenses over time, thereby allowing the fund to charge fees to cover earlier expenses.[74] In effect, the Rule gives investment advisers an additional means to justify the fees charged; even if the fees are excessive in light of the current service level of the fund, the board can claim that they are being used to cover expenses previously incurred by the fund.

Courts also tend to favor the mutual fund, whether intentionally or not, when considering the quality of its services. In cases where the performance of a mutual fund is above average, courts tend to count this factor in favor of the mutual fund.[75] The reverse, however, does not appear to hold true. In one case, for example, a shareholder argued that poor fund performance implied that the adviser had provided poor services, and therefore, that the fees were too high. The court disagreed, stating that "[while] performance may be marginally helpful in evaluating the services which a fund offers, allegations of underperformance alone are insufficient to prove that an investment adviser's fees are

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[72] *Id.* at 1229.

[73] *See, e.g.*, Yameen v. Eaton Vance Distrib., Inc., 394 F. Supp. 2d 350 (D. Mass. 2005) (allowing the fund to maintain its fees on the assumption that distribution and advertising costs had remained the same, even though the fund did not have any advertising costs because it was closed to new investors).

[74] *See* ING Principal Prot. Funds Derivative Litig., 369 F. Supp. 2d 163, 169 (D. Mass. 2005) ("A mutual fund may establish a fee structure that pays a large portion of these distribution and service charges up-front when investors purchase shares of the funds. Alternatively, a mutual fund may spread these charges over several years [through Rule 12b-1 fees]."). Accordingly, a shareholder who has recently purchased mutual fund shares may pay fees to cover expenses incurred before he or she was even a shareholder.

[75] Krinsk v. Fund Asset Mgmt., 875 F.2d 404, 409 (2d Cir. 1989).

excessive."[76] In general, this *Gartenberg* factor gives mutual funds and investment advisers wide latitude to justify their fees. The tendency of courts to consider every action of the adviser as "benefit[ting]" the fund and thus deserving of compensation causes "the actual bite of section 36(b) [to] collapse."[77]

2. Profitability to Adviser

The second *Gartenberg* factor examines "the profitability of the adviser-manager."[78] It is difficult to determine the practical effect of this factor as courts have rejected the contention that "excessive profitability alone should suffice to support a finding of unreasonableness."[79] Moreover, courts have not settled on a single method by which to measure profitability. Thus, within a single case, a court may face a wide disparity in the plaintiff's calculation of profits versus the figure offered by the defendant mutual fund.[80] The profitability factor, therefore, offers little protection to shareholders bringing suit.[81]

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[76] Migdal v. Rowe Price-Fleming Int'l, Inc., 248 F.3d 321, 327 (4th Cir. 2001).

[77] Rubenstein, *supra* note 27, at 404.

[78] *Krinsk*, 875 F.2d at 409.

[79] *Id.* at 410.

[80] *See, e.g.*, Gartenberg v. Merrill Lynch Asset Mgmt., Inc., 694 F.2d 923, 931 (2d Cir. 1982) (noting that the difference in cost accounting methods caused a profit calculation to range from a $7 million loss to a $15 million profit).

[81] This is unfortunate for shareholders, as some mutual funds have posted enormous profits in recent years. *See Daily Briefing*, ATLANTA J. CONST., Aug. 3, 2005, at 2C (listing profits of $68.1 million for Amvescap PLC's mutual funds during the second quarter of 2005); *Sun News Digest*, BALT. SUN, Apr. 27, 2005, at 2A (listing profits of $94 million for T.D. Rowe's mutual funds during first quarter of 2005); Bloomberg News, *Consumer Lending Helps Bank of America in Quarter*, N.Y. TIMES, July 15, 2004, at C5 (listing profits of $392 million for Bank of America's "wealth and investment management business, which includes its mutual funds").

3. Fall-out Benefits

The third *Gartenberg* factor, consideration of fall-out benefits, suffers from similar shortcomings. "Fall-out benefits" include commissions that an adviser obtains from the fund's shareholders' purchases of other securities, as well as, other indirect benefits that the adviser earns merely because of his or her affiliation with the fund.[82] It can be difficult to measure the impact of these fall-out benefits,[83] but, in general, courts have been unwilling to use this factor against mutual funds.

4. Economies of Scale

As the Fourth Circuit has recognized, "Section 36(b) was enacted in large part because Congress recognized that as mutual funds grew larger, it became less expensive for investment advisers to provide the additional services. Congress wanted to ensure that investment advisers passed on to fund investors the savings that they realized from these economies of scale."[84] Reflecting Congress's concern, the fourth *Gartenberg* factor[85] mandates that "investors share equitably . . . in the economies of scale available as a result of the growth and general acceptance of mutual funds."[86] To bring a claim under Section 36(b) for failure to incorporate economies of scale, a plaintiff "must first prove that in fact the fund realized economies of scale."[87] If the plaintiff satisfies this requirement, "then the question becomes whether the fund has permitted shareholders to

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[82] *See* Gartenberg v. Merrill Lynch Asset Mgmt., 573 F. Supp. 1293, 1313 (S.D.N.Y. 1983).

[83] *See* Ben L. Fernandez, *The Duties of Mutual Fund Trustees with Respect to the Investment Advisory Fee*, 41 B.B.J. 12, 14 (1997).

[84] Migdal v. Rowe Price-Fleming Int'l, Inc., 248 F.3d 321, 326-27 (4th Cir. 2001).

[85] Krinsk v. Fund Asset Mgmt., Inc., 875 F.2d 404, 409 (2d Cir. 1989).

[86] Gartenberg v. Merrill Lynch Asset Mgmt., Inc., 528 F. Supp. 1038, 1054 (S.D.N.Y. 1981), *aff'd*, 694 F.2d 923 (2d Cir. 1982) (citation omitted).

[87] Kalish v. Franklin Advisors, Inc., 742 F. Supp. 1222, 1238 (S.D.N.Y. 1990).

participate, at least in part, in the economies of scale it has realized."[88]

Most advisory fee schedules take into account these economies of scale by reducing the fees charged to the client as the asset base of the fund grows larger.[89] In the original *Gartenberg* decision, the trial court found that use of a sliding fee scale satisfied the adviser's obligation to share economies of scale with investors.[90] A sliding fee scale is widely used in the investment industry,[91] so it is very easy for the adviser to satisfy this prong of the *Gartenberg* test. As funds grow in size, however, the fee breakpoints may fail to consider further economies of scale, as most fee schedules max out at some high asset value.[92] It is unclear what impact this consideration may have when courts consider this factor in the future.

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[88] *Id.* at 1239.

[89] *Gartenberg*, 528 F. Supp. at 1054. A fee schedule typically incorporates a series of fee "breakpoints" and may appear as follows:

Amount of Assets	Fee
First $100 million	0.25%
Next $200 million	0.20%
Next $200 million	0.175%
Over $500 million	0.15%

[90] *Id.* at 1054-55 ("Defendants have raised doubts as to whether there are further economies of scale in the provision of the services. While the unit costs of portfolio management and general administrative services have almost certainly declined as the Fund has grown, the far greater costs of providing shareholder services appear to have remained relatively stable.").

[91] *See* Krasner v. Dreyfus Corp., 90 F.R.D. 665, 669 (S.D.N.Y. 1981).

[92] The SEC has noted that "most . . . funds . . . with management fee breakpoints [have] assets above the last breakpoint." *See* Paul Roye, The Investment Management Institute, Keynote Address: Mutual Funds and Investment Management (2001), *in* 1250 PLI/Corp 11, 17 (2001) [hereinafter *Roye Keynote Address*].

5. Comparative Fee Structures

Although the *Gartenberg* test considers comparative fee structures in evaluating excessive fees,[93] courts have limited substantially the application of this factor. Courts provide that "[reliance] on prevailing industry advisory fees will not satisfy § 36(b)" because inefficient competitive forces between mutual funds and their advisers make a comparison of fund fees untenable.[94] The limited importance of this prong was reaffirmed in *Krinsk v. Fund Asset Management*, in which the Second Circuit warned against placing too much emphasis on this comparison.[95] Unlike several of the other *Gartenberg* factors, however, a fee comparison is easy both to calculate and to verify as it simply involves comparing the expense ratio[96] and advisory fee of the fund to that of other mutual funds.[97] Thus, the relative disregard of this factor is detrimental to shareholder claims because it removes from a plaintiff's legal arsenal a concrete measuring stick for assessing the reasonableness of fees.

6. Independence and Conscientiousness of Trustees

The final factor in the *Gartenberg* test addresses the independence and conscientiousness of trustees.[98] In general, courts have placed substantial weight on a fee's approval by the fund's independent directors. In *Daily Income Fund, Inc. v. Fox*, the Supreme Court emphasized the importance of this factor in stating that, "[independent] directorial approval of the adviser's contract is entitled to

[93] Krinsk v. Fund Asset Mgmt., 875 F.2d 404, 409 (2d Cir. 1989).

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

[95] *Krinsk*, 875 F.2d at 412.

[96] Kalish v. Franklin Advisors, Inc., 742 F. Supp. 1222, 1226 (S.D.N.Y. 1990) (noting that expense ratio is obtained by "dividing expenses by [f]und assets").

[97] *See Krinsk*, 875 F.2d at 411-2.

[98] *Id.* at 409.

serious consideration by the court in a § 36(b) action."[99] Since then, courts have treated fees approved by the independent directors as virtually unassailable.[100] This unwillingness to interfere with the actions of independent directors has a significant impact on suits by shareholders because it is difficult to prove that directors are not acting independently. A shareholder cannot bring a Section 36(b) claim by merely alleging that the directors of the fund were not independent. "Section 36(b) is sharply focused on the question of whether the fees themselves were excessive, and not on the status of the directors who approved them,"[101] so a shareholder who doubts the independence of mutual fund directors may be left without a remedy.

When considering the conscientiousness of the directors, courts often look to:

> [whether] the independent directors took an active role in the fee negotiations by, for example, requiring information relating to costs and revenues, selecting an accounting firm to perform an analysis of those issues, requesting a reduction in the management fee charged to the fund, and articulating a basis for any decisions to compromise such requests.[102]

Courts have imposed an affirmative duty on directors to conduct substantive deliberations over advisory fees, rather than just rubber-stamping them each year.[103]

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[99] Daily Income Fund, Inc. v. Fox, 464 U.S. 523, 540 (1984).

[100] *See* Green v. Fund Asset Mgmt., 286 F.3d 682, 685 (3d Cir. 2002); Weiss v. Temp. Inv. Fund, Inc., 692 F.2d 928, 948 (3d Cir. 1982); *Kalish*, 742 F. Supp. at 1226; Batra v. Inv. Research Corp., No. 91-0190-CV-W-6, 1992 U.S. Dist. LEXIS 16148, at *4 (W.D. Mo. Apr. 2, 1992).

[101] Migdal v. Rowe Price-Fleming Int'l, Inc., 248 F.3d 321, 328 (4th Cir. 2001).

[102] Fernandez, *supra* note 83, at 13.

[103] *See* Gartenberg v. Merrill Lynch Asset Mgmt., Inc., 528 F. Supp. 1038, 1064 (S.D.N.Y. 1981), *aff'd*, 694 F.2d 923 (2d Cir. 1982) ("It was emphasized to the Trustees [in Section 36(b)] that '[i]n making their determination in this area, the independent trustees must be fully informed in an impartial manner of all relevant factors with respect to the advisory agreements and, after a thorough review of all relevant factors,

A director's disinterested status has been defined both by statute[104] and through regulations promulgated by the SEC. According to the SEC, when considering a director's independence, a court should examine:

> 1) selection or nomination of the director by the [adviser]; 2) existence of family ties; 3) social relations; 4) former business associations between the director and the [adviser]; 5) the amount of time spent by directors at meetings; 6) respective ages; 7) participation in recommending, evaluating and terminating policies; 8) independent knowledge of corporate affairs; 9) interlocking directors and officers, together with share ownership; and 10) actual domination and operation.[105]

In addition to the statutory and regulatory definitions, courts have created their own set of factors, which include compensation,[106] resistance to pressure from an incumbent adviser,[107] and "membership on multiple boards within a fund complex."[108] However, no court has held against the directors, despite several cases involving fairly egregious violations of those very criteria. In *Verkouteren v. Blackrock Financial Management, Inc.*, for example, a director that sat on *twenty-one* boards was still considered independent.[109] Similarly, in *In re Merrill Lynch Focus Twenty Fund Investment Co. Act Litigation*, the court rejected the

must reach agreement with the Fund's investment adviser on the basis of arm's length bargaining.'").

[104] *See* 15 U.S.C. § 80a-10(b) (2000) (stating that "interested" directors are the fund's regular broker, principal underwriter, and investment bank and "any director, officer, or employee" of those entities).

[105] Krantz v. Fidelity Mgmt. & Research, Co., 98 F. Supp. 2d 150, 156 (D. Mass. 2000) (citing First Austl. Fund, Inc., SEC No-Action Letter, Fed. Sec. L. Rep. P. 78,551 (Oct. 8, 1987)).

[106] *See In re* Merrill Lynch Focus Twenty Fund Inv. Co. Act Litig., 218 F.R.D. 377, 381 (E.D.N.Y. 2003).

[107] *See* Verkouteren v. Blackrock Fin. Mgmt., Inc., 37 F. Supp. 2d 256, 259 (S.D.N.Y. 1999).

[108] *Krantz*, 98 F. Supp. 2d at 155.

[109] *Verkouteren*, 37 F. Supp. 2d at 257.

plaintiff's contention that compensation for directors ranging from $160,000 to $260,000 a year was excessive.[110]

In general, although courts in several circuits have applied the *Gartenberg* test for over twenty years,[111] it appears to offer very little protection for shareholders. Although the six factors are intended to help shareholders demonstrate that a particular fee is excessive, the *Gartenberg* test suffers from a variety of problems, including quantification difficulties, low "safety" hurdles that offer little in the way of shareholder protection (such as the sliding fee schedule requirement), and essential immunization of fees approved by independent directors. To afford shareholders genuine protection, courts should amend the *Gartenberg* test to facilitate a more realistic assessment of mutual fund fees.

C. Do Courts Feel That Shareholders Do Not Need Protection?

Initially, courts may have been reluctant to find mutual fund fees excessive or to order reductions in fees due to a belief that, because investors could simply cash out of the fund, there was little need for judicial protection.[112]

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[110] *In re* Merrill Lynch Focus Twenty Fund Inv. Co. Act Litig., 218 F.R.D. at 380-81. *But see In re* eBay, Inc. Shareholders Litig., No. C.A. 19988-NC, 2004 Del. Ch. LEXIS 4, at *5 (Del. Ch. Jan. 23, 2004) (finding that because the value of a director's stock options could "potentially run into the millions of dollars" made it unlikely that a director could be considered independent).

[111] *See* Migdal v. Rowe Price-Fleming Int'l, Inc., 248 F.3d 321, 326 (4th Cir. 2001); Yameen v. Eaton Vance Distrib., Inc., 394 F. Supp. 2d 350, 355 (D. Mass. 2005); Strigliabotti v. Franklin Res., Inc., No. C. 04-00883, 2005 U.S. Dist. LEXIS 9625, at *9 (N.D. Cal. Mar. 7, 2005); Rohrbaugh v. Inv. Co. Inst., No. Civ.A. 00-1237, 2002 U.S. Dist. LEXIS 13401, at *32 n.20 (D.D.C. July 2, 2002).

[112] *See, e.g.*, Gartenberg v. Merrill Lynch Asset Mgmt., Inc., 528 F. Supp. 1038, 1067 (S.D.N.Y. 1981), *aff'd*, 694 F.2d 923 (2d Cir. 1982) ("Money market shareholders hold the key to the continuance of the Adviser in charge of their funds. They can terminate the relationship simply by writing a check and redeeming at once. This is the strongest kind of bargaining power against compensation that is improper.").

However, in light of the increased popularity of mutual funds among individual, unsophisticated investors,[113] the assumption that investors do not need protection may no longer be realistic. The SEC has recognized the potential for abuse of unwitting shareholders and has continually recommended increased education for investors and greater disclosure from mutual funds, particularly as an increasing number of Americans entrust portions of their retirement savings to mutual funds.[114] For example, in recent years, the SEC has considered requiring mutual funds to issue individualized statements to shareholders, detailing the "dollar amount of the fund's fees that each investor has indirectly paid."[115] But as it is difficult to determine the actual effect of SEC education, should individual shareholders not also enjoy the protection of excessive fee suits brought by other, more sophisticated investors?

Additionally, "[in] light of the prominence that the mutual fund industry has assumed for individual investment . . . it is deceiving to suggest that switching funds is an adequate remedy for investors. The [*Gartenberg*] court's reasoning ignores the substantial costs to the investor associated with switching funds."[116] The hidden costs of cashing out of a mutual fund investment include capital gains taxes and payment of a sales load on a new fund. These costs may overshadow any benefits that a shareholder may receive when moving to a fund with lower fees; consequently, investors may be locked into funds that charge excessively high fees.[117]

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[113] *See* ICI FACTBOOK, *supra* note 1, at 4.

[114] *See* SEC, DIV. OF INV. MGMT., REPORT ON MUTUAL FUND FEES AND EXPENSES I.B.2(a) (2000), *available at* http://www.sec.gov/news/studies/feestudy.htm [hereinafter SEC REPORT ON MUTUAL FUND FEES AND EXPENSES].

[115] *Id.*

[116] Conlin, *supra* note 48, at 387.

[117] *Id.*

IV. OTHER POSSIBLE TYPES OF PROTECTION

A. Disclosures and Procedural Safeguards

The SEC currently manages the main mode of investor protection through a regime of disclosure requirements and procedural safeguards. The current procedural safeguards place great stock in independent directors and require these directors to debate and to deliberate upon the merits of an advisory fee before giving their approval.[118] Beyond these procedural safeguards, the SEC, in an effort to provide greater substantive protection for shareholders, also imposes certain fiduciary duties on directors in approving fees.[119] In 2001, the SEC revamped its disclosure requirements to increase investor protection.[120] With this reform, the SEC sought to bolster shareholder awareness of mutual fund fees and the effects of these fees on investment returns.[121] Although mutual funds were already required to inform shareholders of fee rates, the new regulations also required them to disclose the actual dollar amounts of fees charged.[122]

A regime of disclosure tends to benefit investors who are sophisticated enough to understand both how mutual fund fees operate and how they can impact overall returns. Recognizing this fact, the SEC has made impressive efforts to increase the accessibility of information for less sophisticated investors. Continued efforts by the SEC to

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[118] *See* Gartenberg v. Merrill Lynch Asset Mgmt., Inc., 528 F. Supp. 1038, 1058, 1064 (S.D.N.Y. 1981), *aff'd*, 694 F.2d 923 (2d Cir. 1982).

[119] *See* 17 C.F.R. §§ 270.34b-1, 230.482 (requiring disclosure of the fund's expense ratio in all advertising materials).

[120] *See Roye Keynote Address*, *supra* note 92, at 16.

[121] SEC REPORT ON MUTUAL FUND FEES, *supra* note 25, at "A Word About Mutual Fund Fees and Expenses."

[122] SEÇ REPORT ON MUTUAL FUND FEES AND EXPENSES, *supra* note 114. The report suggested, for example, including in shareholder reports "a table showing the cost in dollars incurred by a shareholder who invested a standardized amount (*e.g.*, $10,000) in the fund, paid the fund's actual expenses, and earned the fund's actual return for the period." *Id.* at I.B.2(a).

enhance public understanding of fees represent an important way to combat excessive and abusive fees.

B. Fee Caps

Given the conflicts of interest inherent in the structure of mutual funds, it is perhaps surprising that Congress has not enacted a blanket fee cap for mutual funds.[123] The SEC, however, has consistently lobbied against implementing fee caps as it believes that "the current statutory framework's primary reliance on disclosure and procedural safeguards to determine mutual fund fees and expenses . . . is sound."[124] Based upon the regulatory experience of other countries, the SEC's argument may have some merit. Spain, the only country that currently uses a cap on mutual fund fees, permits mutual funds to charge no more than 2.25% of assets under management.[125] A recent study of one thousand mutual funds in Spain determined that even a statutorily imposed fee limit was not enough to protect investors from high fees caused by imperfect competition in the mutual fund market.[126]

Despite the lack of success of fee caps in Spain, fee caps could work *in conjunction* with the current disclosure and procedural safeguards touted by the SEC. In this context, a fee cap could operate as a safety valve to benefit investors in funds that charge egregiously high fees. In a perfect world, of course, these excessively high fees would be captured and lowered through shareholder litigation. Yet, given the lack of success in such suits, a fee cap may be necessary for the protection of investors.

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[123] *See* S. REP. NO. 91-184, at 4898 (1970) (stating that the "committee, rather than recommending that the Congress set a maximum statutory commission rate for mutual fund sales loads believes that industry self-regulation is a preferable approach").

[124] *Roye Keynote Address*, *supra* note 92, at 16.

[125] Javier Gil-Bazo & Miguel A. Martinez, The Black Box of Mutual Fund Fees 5 (unpublished work), *available at* http://xiforofinanzas.ua.es/programa/trabajos/1084.pdf.

[126] *Id.* at 18.

C. Other Regulatory Interventions

1. Policing by Self-Regulatory Agencies

Self-regulatory organizations ("SROs"), like the New York Stock Exchange ("NYSE") and the National Association of Securities Dealers ("NASD"), serve as important regulators in the financial industry because they allow "industry participants [to] bring to bear expertise and intimate knowledge of the complexities of the securities industry."[127] Traditionally, the NASD has been the most active of the SROs in regulating mutual funds and has placed some regulations and restrictions on mutual fund fees.[128] At present, the NASD's regulatory efforts primarily involve fee caps, yet because these caps are generally very high, they have had little to no effect on most mutual funds.

There are also potential problems with granting SROs the primary responsibility for regulating mutual funds. First, SROs are both regulators and market operators,[129] and thus, there is a risk that the inherent conflicts of interest between these two positions may lead SROs to enact regulations unfavorable to their competitors.[130] Additionally, in the case of for-profit SROs, the organization may be tempted to use its disciplinary function as a revenue generator, thereby overdeterring its regulated firms.[131] The greatest concern, however, is that SROs may create redundant or conflicting regulations and may employ regulatory staff and

[127] *Self-Regulatory Organizations: Exploring the Need for Reform: Hearing Before the Subcomm. on Capital Mkts., Ins., and Gov't Sponsored Enters. of the H. Comm. on Fin. Servs.*, 109th Cong. n.6 (2005), *available at* http://www.sia.com/testimony/html/lackritz11-17-05.html [hereinafter *Lackritz Testimony*].

[128] *See infra* Section II for a discussion of the different types of fees.

[129] U.S. GEN. ACCOUNTING OFFICE, SECURITIES MARKETS: COMPETITION AND MULTIPLE REGULATORS HEIGHTEN CONCERNS ABOUT SELF-REGULATION 2 (2005), *available at* http://www.gao.gov/new.items/d02362.pdf.

[130] *Id.*

[131] *Lackritz Testimony*, *supra* note 127.

infrastructure that is duplicative of SEC efforts.[132] Firms that are required to deal with two similar, yet not identical sets of regulations face higher costs of compliance and concerns over divergent standards of liability.[133] Therefore, while self-regulation can be beneficial, it should not be encouraged as the primary method of regulating the fee structure of mutual funds.

2. Soft Regulation

So-called "soft regulation" may represent another possible mechanism for protecting shareholder interests. "Soft regulation" describes regulations that are technically voluntary, but are conditions to enjoying some other benefit (i.e., the privilege of listing securities on a particular exchange). These regulations may "set standards that exceed statutory or common law legal minimums."[134] For example, the NYSE imposes approval rules upon listed corporations that are stricter than those provided by federal statute or the SEC.[135] Corporations may either comply with these soft regulations or list on a different exchange. Soft regulations can be beneficial because they tend to be market-driven, and thus, can adapt more quickly to changing investment norms.[136] Empirical evidence has also suggested that in some contexts, the psychological effects of soft regulation can cause even "regulated actors to go beyond the minimum required by the law."[137]

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[132] *Id.*

[133] *Id.*

[134] *Id.*

[135] *See, e.g.*, NYSE LISTED COMPANY MANUAL § 312.03 (listing corporate activities that may only be undertaken with shareholder approval).

[136] *See Lackritz Testimony*, *supra* note 127; Amir N. Licht, *The Maximands of Corporate Governance: A Theory of Values and Cognitive Style*, 29 DEL. J. CORP. L. 649, 741 (2004); Sophie Hsia, *Foreign Direct Investment and the Environment: Are Voluntary Codes of Conduct and Self-Imposed Standards Enough?*, 9 ENVTL. L. 673, 717 (2003).

[137] Jonathan M. Barnett, *The Rational Underenforcement of Vice Laws*, 54 RUTGERS L. REV. 423, 460 n.138 (2002) (citing BRUNO S. FREY,

As many of the same SROs promulgate these soft regulations, they tend to suffer from similar problems as those described above, such as unfair treatment of competitors, use of regulations for revenue generation, and overlap or possible conflict with SEC regulations. Thus, soft regulation is at best a fallback mechanism for investor protection.

D. Market Mechanisms

Market mechanisms, though reliable for regulation of prices in many other contexts, are not a reasonable alternative for the regulation of mutual fund fees because conflicts of interest between the board of directors and the investment adviser prevent true arm's length negotiations. Regulation of mutual fund fees arose to help compensate for this market failure; it is unlikely that market mechanisms alone would produce fair fees.

E. Alteration of Judiciary Protections

Given the problems with regulation, both from the SEC and SROs, litigation may provide the best protection for shareholders. Litigation allows sophisticated investors to bring class action suits on their own behalf and on behalf of less experienced investors who may be unaware that they pay excessive fees. However, litigation is not a viable alternative if it is impossible for shareholders to bring successful suits. Faced with a choice between an impossible lawsuit and changing funds, investors who feel that their fees are too high are much more likely simply to cash out their investments and to move to a different fund. This not only causes these investors to incur the significant costs associated with cashing out, but it also leaves unwitting investors to pay high fees all by themselves.

The *Gartenberg* test could be used legitimately to determine if mutual fund fees are appropriate. But as it

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NOT JUST FOR THE MONEY: AN ECONOMIC THEORY OF PERSONAL MOTIVATION 32 (Edward Elgar Publishing, Inc. 1997)).

stands currently, courts dealing with suits for excessive fees have rendered too many of the factors meaningless. There must be a reconsideration of the way the *Gartenberg* factors are applied before the prospect of litigation can grant any meaningful protection to investors.

V. CONCLUSION

The management structure of mutual funds creates problems for investors. The close relationship between the investment adviser and the board of directors can result in advisory fees that are unfair to the individual shareholders. The SEC has attempted to combat this problem by relying on independent directors to encourage greater freedom of negotiation and by imposing a fiduciary duty on all directors to establish fair fees. However, the SEC's regulatory scheme has been unable to overcome the inertia of the investment adviser's position with the fund—as a practical matter, it is impossible for the board of directors to threaten termination of the relationship no matter how high the fees become.[138] The failure of regulatory schemes to protect shareholder interests leaves litigation as the shareholder's most viable option for enforcing fair fees. Any protections that courts purport to offer, however, will be weak unless the current *Gartenberg* factors are revamped in a more shareholder-friendly fashion.

[138] The author was unable to find any instances of mutual funds successfully terminating their investment adviser and establishing a relationship with a new one.