No. 08-586

IN THE
SUPREME COURT OF THE UNITED STATES

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

v.

HARRIS ASSOCIATES L.P.,
Respondent.

On Petition for Writ of
Certiorari to the United States
Court of Appeals for the Seventh Circuit

BRIEF *AMICI CURIAE* OF AARP AND CONSUMER FEDERATION OF AMERICA IN SUPPORT OF THE PETITION FOR WRIT OF CERTIORARI

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INTEREST OF *AMICI CURIAE*[1]

AARP is a non-partisan, non-profit organization with more than 40 million members, working and retired, dedicated to addressing the needs and interests of people aged 50 and older. Through education, advocacy, and service, and by promoting independence, dignity, and purpose, AARP seeks to enhance the quality of life for all. As one method of promoting independence, AARP attempts to foster the economic security of individuals as they age by seeking to increase the availability, security, equity, and adequacy of public and private retirement plans. In this regard, AARP has a longstanding interest in the operations of mutual fund and other investment vehicles because of the critical role they play in helping ensure financial security in retirement. A considerable amount of AARP's work in this area has focused on combating fraudulent practices in the nation's securities industry due to the fact that older people are frequent victims of such fraud. AARP has regularly commented on legislative and regulatory

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[1] Counsel for *amici curiae* complied with Sup. Ct. R. 37.2 by notifying counsel for the parties of the intent to file this brief more than ten days prior to the brief's due date. Counsel for Petitioner's letter granting blanket consent to the filing of *amicus curiae* briefs was docketed on November 6, 2008, and consent from counsel for Respondent has been filed with this brief. Pursuant to Rule 37.6 of the Court, *amici* state that no counsel for any party authored this brief in whole or in part, and no person or entity other than *amici* and their counsel contributed monetarily to this brief 's preparation or submission.

proposals that address investment fraud and opposed efforts to limit the remedies available to defrauded investors.

In addition to concerns about the effects of fraud on retirees' economic security, AARP also is dedicated to ensuring, to the greatest extent possible, that people seeking to augment the retirement income they expect from Social Security can make informed decisions among the myriad available choices. AARP's advocacy and consumer education activities in these areas are informed by the many studies it has undertaken over the years to understand investors' knowledge, behaviors, and concerns. Due to their affect on investment returns, much of this research has involved fees and other costs associated with various investment options. *See, e.g.*, Sandy Mackenzie, AARP Pub. Pol'y Inst., *Determining Whether 401(k) Plan Fees are Reasonable: Are Disclosure Requirements Adequate?* (Sept. 2008), *available at* http://assets.aarp.org/rgcenter/econ/i8_fees.pdf; AARP, *Comparison of 401(k) Participants' Understanding of Model Fee Disclosure Forms Developed by the Department of Labor and AARP* (Sept. 2008), *available at* http://assets.aarp.org/rgcenter/econ/fee_disclosure.pdf; AARP, *401(k) Participants' Awareness and Understanding of Fees* (July 2007), *available at* http://assets.aarp.org/rgcenter/econ/401k_fees.pdf; *AARP, Investor Perceptions and Preferences Toward Selected Stock Market Conditions and Practices: An AARP Survey of Stock Owners Ages 50 and Older* 21 (Mar. 2004), *available at* http://www.assets.aarp.org/rgcenter/econ/investor.pdf. These studies show that

investors often lack basic knowledge of how investment vehicles operate and are unaware of key important features of their own investments.

These findings are of particular concern given the entry of many first-time investors into the market and the responsibility they have had to assume for choosing the funds into which to invest due to the shift from traditional defined benefit pension plans (in which employers bear the risk of loss) to defined contribution retirement plans (under which plan participants bear the risk of loss). Integrity in the securities markets and adherence to fiduciary duties by various actors on whom investors rely are more important than ever. AARP thus has testified before congressional committees and filed comments in response to agency rulemaking proceedings on these critical issues. *See, e.g.*, Hearing on U.S. Dep't of Labor's Proposed Reg. Under Section 408(b)(2) of ERISA (2008) (statement of David Certner, AARP Legislative Counsel and Legislative Policy Dir.) (on file with AARP) (testifying concerning fee disclosures to retirement plan fiduciaries); Letter from David Certner, AARP Dir. of Fed. Affairs, to The Hon. John Boehner, Chairman, H. Comm. on Educ. and the Workforce (June 15, 2005) (on file with AARP) (expressing concerns about H.R. 2830, The Pension Protection Act, and H.R. 2831, The Pension Preservation and Portability Act of 2005).

Consumer Federation of America (CFA) is a non-profit association of 300 consumer groups, which in turn represent more than 50 million individuals.

CFA advances the consumer interest through research, education, and advocacy. As increasing numbers of people have come to rely on the nation's financial markets to fund their retirement and invest their savings, CFA has made enhancing investor protections a top legislative and regulatory priority. CFA's policies in this area are based on a fundamental belief that investors are entitled to a marketplace that provides them with a choice of appropriate investments and service providers, the information necessary to make informed choices, protection against fraud and abuse, and effective remedies when they are defrauded. For nearly two decades, CFA has been a leader in efforts to promote investor protection legislation and regulations, and to oppose efforts to weaken those protections, at the state and federal levels. One of CFA's particular areas of concern has been the ability of investors to seek legal redress for their losses. Toward these ends, CFA has conducted research, testified before Congress, participated in Securities and Exchange Commission (SEC) roundtables, and consulted with members of Congress, SEC Commissioners, and state securities regulators.

AARP and CFA have filed *amicus curiae* briefs in cases involving the construction and application of federal securities laws. *See, e.g.*, *Stoneridge Investment Partners, LLC v. Scientific-Atlanta*, 128 S. Ct. 761 (2008) (AARP & CFA); *Merrill Lynch, Pierce, Fenner & Smith v. Dabit*, 547 U.S. 71 (2006) (AARP); *Dura Pharmaceuticals, Inc. v. Broudo*, 544 U.S. 336 (2005) (AARP & CFA); *SEC v. Edwards*, 540 U.S. 389 (2004) (AARP); *SEC v. Zandford*, 535

U.S. 813 (2002) (AARP & CFA). AARP also has filed briefs in numerous cases involving the duties of various fiduciaries involved in pensions and other retirement plans. *See, e.g.*, *LaRue v. DeWolff, Boberg & Assocs.*, 128 S. Ct. 1020 (2008); *Varity Corp. v. Howe*, 516 U.S. 489 (1996).

AARP and CFA respectfully submit that the petition should be granted because the Seventh Circuit's analysis squarely contradicts the realities of the mutual fund market, particularly how the relationship between mutual funds and their investment advisers overrides traditional market forces that otherwise might ensure that advisers' compensation was consistent with their fiduciary duty. Mutual fund investors face significant risks if the Seventh Circuit's fiduciary standard is allowed to stand. The retirement security of millions of investors will be affected by the Court's decision, as more people than ever are investing in mutual funds, on their own and through employer-sponsored 401(k)s and similar plans, and expenses associated with inflated investment adviser fees get passed on to all of them. As discussed below, the U.S. Department of Labor has found that 401(k) fees would be substantially lower with more transparent disclosure to beneficiaries, showing that employers are picking funds that charge higher fees than efficient markets would produce, contrary to the Seventh Circuit's decision. The Court should resolve the Circuit conflict created by the ruling below so that the retirement security of millions of investors will not depend on the Circuit in which they happen to reside.

SUMMARY OF ARGUMENT

Congress passed the Investment Company Act of 1940, 15 U.S.C. § 80a-1 et seq., due to "its concern with 'the potential for abuse inherent in the structure of investment companies.'" *Daily Income Fund, Inc. v. Fox*, 464 U.S. 523, 536 (1984) (citing *Burks v. Lasker*, 441 U.S. 471, 480 (1979)). The Act was ineffective in accomplishing Congress' goal of minimizing conflicts of interest and, more than four decades later, the Court noted a report commissioned by the Securities and Exchange Commission (SEC) which "found that the structure of the [mutual fund] industry, even as regulated by the Act, had proven resistant to efforts to moderate adviser compensation." *Id.* at 537 (citation omitted). While Congress responded to ongoing conflicts of interest between funds and their advisers by imposing a fiduciary duty on advisers with respect to their compensation, Investment Company Amendments Act of 1970, 15 U.S.C. § 80a-35(b) ("§ 36(b)"), little has changed in the ensuing years.

Yet, the Seventh Circuit has crafted a standard to determine whether an investor has proved a breach of fiduciary duty that ignores the persistent conflicts of interest that fail to adequately monitor adviser compensation levels. The lower court also based its decision on its view of a market that simply does not exist. Rather, the mutual fund market does not benefit from the economies of scale or competition that otherwise would operate to regulate adviser compensation and benefit investors. As discussed below, the U.S. Department of Labor,

the SEC, the Government Accountability Office, and numerous scholars and industry analysts all have documented the factors that drive inflated compensation levels and how even slight increases harm the millions of investors relying on mutual fund investments for their retirement security.

Congress' creation of a fiduciary duty and a private right to enforce it has to mean more than that Congress intended to allow market forces to determine whether investment advisers had fulfilled their duty. The Seventh Circuit's decision, if allowed to stand, will do just that, and AARP and Consumer Federation of America thus urge the Court to grant the petition for *certiorari*.

ARGUMENT

I. THE SEVENTH CIRCUIT'S DECISION FLIES IN THE FACE OF THE REALITIES OF HOW MUTUAL FUNDS OPERATE.

A. The Mutual Fund Industry Has Inherent Conflicts of Interest That Drive Investment Adviser Compensation.

The Seventh Circuit discussed, but then ignored the implications of, a fundamental feature of mutual fund companies that differentiates them from other corporations and undermines the court's reasoning.

> A mutual fund is an investment company that buys a portfolio of securities selected by a professional investment adviser to meet a specified financial goal. . . . Mutual funds have officers and directors or trustees. In this way, mutual funds are like any other type of operating company . . . . Unlike other companies, however, a mutual fund is typically externally managed: it is not an operating company and it has no employees in the traditional sense. Instead, a fund relies upon third parties or service providers, either affiliated organizations or independent contractors, to invest fund assets and carry out other business activities.

Inv. Co. Inst., *2008 Investment Company Fact Book*, App. A: How Mutual Funds and Investment Companies Operate 162-64 (48th ed. 2008), *available at* http://www.icifactbook.org/pdf/2008_factbook.pdf [hereinafter *ICI Fact Book*].[2]

This Court, other federal courts, and Congress have recognized the unique nature of this structure and, most importantly, its potential dangers. As this

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[2] Founded in 1940, the Investment Company Institute (ICI) is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs).

Court stated:

> [m]utual funds, with rare exception, are not operated by their own employees. Most funds are formed, sold, and managed by external organizations, [called 'investment advisers,'] that are separately owned and operated. . . . The advisers select the funds' investments and operate their businesses. . . . Since a typical fund is organized by its investment adviser which provides it with almost all management services . . ., a mutual fund cannot, as a practical matter sever its relationship with the adviser. Therefore, the forces of arm's length bargaining do not work in the mutual fund industry in the same manner as they do in other sectors of the American economy."

Burks v. Lasker, 441 U.S. 471, 480-81 (1979) (citations omitted).

Like other corporations, a mutual fund is headed by a board of directors and, while the board is authorized to operate the fund, it primarily plays an oversight role and is not usually involved in the fund's day-to-day management. *ICI Fact Book*, *supra*, at 166. That role is typically played by the fund's investment adviser, which often was its initial sponsor and shareholder, as well. The investment adviser is a professional money manager that "also

provides a level of money management expertise beyond the scope of the average individual investor. The investment adviser has its own employees . . . who work on behalf of the fund's shareholders and determine which securities to buy and sell in the fund's portfolio." *Id.* The adviser works for and is paid by the fund and thus "may have interests other than maximizing the returns to shareholders in the fund." *Chamber of Commerce of the U.S. v. SEC*, 412 F.3d 133, 136 (D.C. Cir. 2005). The Second Circuit recognized that

> [t]he relationship between investment advisers and mutual funds is fraught with potential conflicts of interest. The typical fund ordinarily is only a shell, organized and controlled by a separately owned investment company adviser, which selects it portfolio and administers its daily business. Compensation for these services is determined under an advisory contract, the terms of which are all too often dictated to unwary or negligent fund directors and fund shareholders by the investment adviser.

Galfand v. Chestnutt Corp., 545 F.2d 807, 808 (2d Cir. 1976). *See also Role of Indep. Dirs. of Inv. Cos.*, Securities Act Release No. 33-7754 [1999-2000 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 86,212, at 82,451 (Oct. 14, 1999) (stating "Mutual funds are unique . . . in that they are 'organized and operated by people whose primary loyalty and pecuniary

interest lie outside the enterprise.'").

Congress passed the Investment Company Act of 1940, 15 U.S.C. § 80a-1 et seq., "because of its concern with the 'potential for abuse inherent in the structure of investment companies.'" *Daily Income Fund, Inc. v. Fox*, 464 U.S. 523, 536 (1984) (citing *Burks*, 441 U.S. at 480). In an effort to "minimize such conflicts of interest, Congress established a scheme that regulates most transactions between investment companies and their advisers." *Id.* Unfortunately, Congress' goals were not achieved.

> In the years following passage of the Act, investment companies enjoyed enormous growth, prompting a number of studies of the effectiveness of the Act in protecting investors. One such report, commissioned by the SEC, found that investment advisers often charged mutual funds higher fees than those charged the adviser's other clients and further determined that the structure of the industry, even as regulated by the Act, had proven resistant to efforts to moderate adviser compensation.

Id. at 537 (citation omitted).

The SEC later noted that investment advisers' compensation typically was based on a set percentage of the fund's assets, not on services performed or expenses incurred. As a result, "as a fund's assets grew, this form of payment could

produce unreasonable fees in light of the economies of scale realized in managing a larger portfolio." *Id.* (citation omitted). Moreover, the Commission found that investor lawsuits "challenging the reasonableness of adviser fees had been largely ineffective due to the standards employed by courts to judge the fees." *Id.* (citation omitted). In a further effort to remedy the innate conflicts at play, Congress passed the Investment Company Amendments Act of 1970 which, in part, imposed a fiduciary duty on investment advisers with respect to their compensation and created a private right of action. 15 U.S.C. § 80a-35(b) ("§ 36(b)").

Congress acted in response to the fact that decades after it passed the original Act those conflicts remained. Unfortunately, little has changed in the ensuing years. As Judge Posner stated in his dissent from the panel's denial of a petition for rehearing, the majority "bases its rejection of *Gartenberg* mainly on an economic analysis that is ripe for reexamination on the basis of growing indications that executive compensation in large publicly traded firms often is excessive because of the feeble incentives of boards of directors to police compensation." *Jones v. Harris Assocs. L.P.*, 537 F.3d 728, 730 (7th Cir. 2008) (Posner, J., dissenting). He also noted that connections between mutual fund industry agents "'foster favoritism, to the detriment of investors. Fund directors and advisory firms that manage funds hire each other preferentially based on past interactions. When directors and the management are more connected, advisors capture more rents and are monitored by

the board less intensively.'" *Id.* at 731 (citation omitted). *See also* John P. Freeman & Stewart L. Brown, *Mutual Fund Advisory Fees: The Cost of Conflicts of Interest*, 26 J. Corp. L. 609, 672 (2001) [hereinafter *The Cost of Conflicts of Interest*] (stating that "the gap between prices charged funds for advisory services versus prices fetched elsewhere in the economy for those same services represents the bill paid by fund shareholders for the advisory conflict of interest that is both the fund industry's hallmark and its stigma. That tab runs into billions of dollars per year.").[3]

The Seventh Circuit remains willing to maintain the status quo, leaving investors subject to these ongoing conflicts of interest and inefficient

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[3] *See also In re Banc One Inv. Advisors Corp.*, Assurance of Discontinuance Pursuant to Exec. Law § 63 (15) at 11-12, 15 (June 29, 2004), *available at* http://www.oag.state.ny.us/media_center/2004/jun/jun29d_04_attach.pdf (settlement of case alleging mutual fund adviser permitted unlawful excessive market timing activity in several of its mutual funds included, among other relief, $40 million in reduced management fees to be charged to investors over five-year period and commitment to hire full-time senior officer to ensure fees charged by funds are negotiated at arms' length and are reasonable); *In re AIM Advisors, Inc.*, Assurance of Discontinuance Pursuant to Exec. Law § 63 (15) at 6, 12, 14-16 (Oct. 7, 2004), *available at* http://www.oag.state.ny.us/media_center/2004/sep/sep7c_04_attach2.pdf (in settling case alleging two mutual fund management companies allowed illegal market timing, companies agreed to reduce advisor fees by $75 million over five years and to hire a full-time senior officer who will manage the process by which management fees are negotiated so that they are negotiated at arms' length and are reasonable).

market forces. *Amici* submit, however, that Congress' creation of a compensation-related fiduciary duty and an investor's right to enforce it has to mean something other than that Congress was content to allow market forces to determine whether investment advisers had breached their duty.

B. The Seventh Circuit Based Its Ruling on Faulty Premises About Market Forces in the Mutual Fund Industry.

The Seventh Circuit's standard for proving breach of an investment adviser's compensation-related fiduciary duty failed to recognize the inefficiencies endemic to the market and assumed a level of competition that simply does not exist.[4] In fact, the Seventh Circuit's assumptions conflict with Congress' findings when it enacted § 36(b) in 1970, and federal agency findings since then, that fees are not set in a perfectly competitive world. For example, in its recent rulemaking proceeding with respect to required fiduciary disclosures in participant-directed individual retirement accounts

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[4] The court also erred in basing its standard of proof on the notions that a "fiduciary must make full disclosure and play no tricks," and that "Plaintiffs do not contend that Harris Associates pulled the wool over the eyes of the disinterested trustees . . . ." *Jones v. Harris Assocs. L.P.*, 527 F.3d 627, 632, 635 (7th Cir. 2008). The court's emphasis on the absence of bad acts is misplaced, as § 36(b) specifically provides: "It shall not be necessary to allege or prove that any defendant engaged in personal misconduct . . . ." 15 U.S.C. § 80a-35(b)(1).

(e.g., 401(k)s)[5], the U.S. Department of Labor noted that "plan participants on average pay fees that are higher than necessary by 11.3 basis points per year." U.S. Dep't of Labor, Employee Benefits Sec. Admin., "Fiduciary Requirements for Disclosure in Participant-Directed Individual Account Plans," 73 Fed. Reg. 43014, 43020 & n.13 (proposed July 23, 2008) (to be codified at 29 C.F.R. pt. 86) [hereinafter "DOL Fiduciary Requirements"]. DOL believes that other research into the distribution of investor expense levels makes this estimate conservative, and notes that it "does not take into account less visible expenses such as mutual funds' internal transaction costs . . . which are sometimes larger than funds' expense ratios."[6] *Id.* at n.13. Moreover, in evaluating what underlies this variation, the Department found that "a significant proportion of the variation in plan fees is due to market inefficiencies." *Id.* at 43020.

The Seventh Circuit also failed to take into account another characteristic of the mutual fund

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[5] This rulemaking only applies to participant-directed plans but is significant to the Court's ruling because mutual fund ownership has grown sharply through workplace retirement plans; in 2007, 33 million households held mutual funds through such plans. Inv. Co. Inst., *Trends in Ownership of Mutual Funds in the United States, 2007*, Research Fundamentals 1 (Nov. 2007), *available at* http://www.ici.org/pdf/fm-v16n5.pdf [hereinafter *ICI Trends in Ownership*].

[6] The expense ratio is the cumulative total of fees and expenses charged to the fund for a particular period shown as a percentage of its net assets.

market, namely that investors do not benefit from reduced adviser compensation that would be expected to result from the economies of scale that exist in the market.

> The 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. Section 36(b) of the Act was specifically directed to economies of scale.

Kalish v. Franklin Advisers, Inc., 742 F. Supp. 1222, 1237 (S.D.N.Y. 1990). As the *Kalish* court noted, § 36(b) was addressed at a problem identified by the SEC, that """advisers' fees, generally stated as a percentage of the market value of the managed assets, which had been altogether reasonable when a fund was launched, may have become unreasonably high when the fund grew to enormous size.""" *Id.* at 1237-38 (quoting *Fogel v. Chestnutt*, 668 F.2d 100, 111 (2d Cir. 1981), *cert. denied*, 459 U.S. 828 (1982). *See also Migdal v. Rowe Price-Fleming Int'l, Inc.*, 248 F.3d 321, 326-27 (4th Cir. 2001) (stating "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 they realize from these economies of scale.").

As previously discussed concerning conflicts of interest, however, Congress' goals have not been realized with respect to investors' benefitting from the savings resulting from economies of scale. The General Accounting Office has noted that "[b]ecause mutual funds are expected to operate more efficiently as their assets grow, the significant asset growth in recent years has prompted concerns about fund fee levels." U.S. Gov't Accounting Office, *Mutual Fund Fees – Additional Disclosure Could Encourage Price Competition*, Report to the Chairman, Subcomm. on Fin. and Hazardous Materials and the Ranking Member, House Commerce Comm. 4 (June 2000) [hereinafter *GAO Mutual Fund Fees*]. Unfortunately, "GAO was unable to determine the extent to which the growth in mutual fund assets during the 1990s provided the opportunity for mutual fund advisers to reduce fees," due to the fact that "information on most fund advisers' costs is not collected by regulators or otherwise publicly disclosed." *Id.* at 5-6. GAO did conclude, however, that "the revenue fund advisers and other service providers collect as fees from the mutual funds they operate appears to have increased significantly. . . . As mutual fund assets have grown, the revenues that fund advisers and other service providers collect through the fees they deduct from these funds have also risen." *Id.* at 42.

Another analysis of adviser fees noted

"fiduciary-managers' seeming ability to reap large rewards by not sharing costs savings with shareholders," and found that while

> administrative expenses have dropped as fund size has grown, it is unclear whether there is robust price competition in the market for the most critical service offered by the fund to its shareholders: professional management. . . . Investment advice is essentially a commodity. Outside the fund industry, it is bought and sold in a much more competitive marketplace. Active portfolio management essentially is a mental process. It principally involves deciding which securities to buy and sell in order to maximize returns. The process is scalable, in that it is equally applicable to large and small portfolios. . . . [T]he fundamental management process is essentially the same for large and small portfolios, as well as for pension funds and mutual funds.

The Cost of Conflicts of Interest, *supra*, at 627-28. *See also* Robert Barker, *High Fund Fees Have Got to Go*, Bus. Wk., Aug. 16, 1999, at 122 (stating that "[v]ast economies of scale benefited mutual-fund companies, not investors."); Thomas Easton, *The fund industry's dirty secret: Big is not beautiful*, Forbes, Aug. 24, 1998, at 116, 117 (noting that while size is an advantage in most businesses, "[i]n mutual

funds it is an advantage only to the sponsor, not to the customer.").

Another fallacy of the Seventh Circuit's reasoning is its assumptions about competition in the mutual fund marketplace and its effect in regulating adviser compensation. In fact, the GAO found that the form and style of "competition in the mutual fund industry appear to resemble the type of market referred to by economists as 'monopolistic competition.' Although thousands of mutual funds appear to compete actively for investor dollars, this competition has not focused primarily on the price of the service -- i.e, fees charged to shareholders." *GAO Mutual Fund Fees*, *supra*, at 56.

II. THE SEVENTH CIRCUIT'S STANDARD FOR ESTABLISHING § 36(b) LIABILITY WILL HARM MILLIONS OF INVESTORS WHO DEPEND ON MUTUAL FUND EARNINGS FOR THEIR RETIREMENT SECURITY.

A. Individuals Are Investing in Mutual Funds in Record Numbers.

Demographic factors have led to considerable changes in participation in the nation's securities markets. Historically, wealthy individuals and corporations were the primary investors in the stock market. That is no longer true, due to the combined effect of the baby boom generation's entry into adulthood, changes in retirement regulations and strategies, and a stock market that, until recently,

produced high returns. We now live in an era in which Social Security provides proportionately less of needed retirement income, and traditional employer-sponsored defined benefit pension coverage has decreased significantly. In addition, during the last two decades more and more people have shifted their savings from bank accounts to money market mutual fund accounts.

A recent Investment Company Institute (ICI) survey of the mutual fund industry showed that the combined assets of the nation's mutual funds totaled $10.631 trillion in September 2008. Inv. Co. Inst., *Trends in Mutual Fund Investing*, Sept. 2008, *available at* http://www.ici.org/stats/mf/trends_09_08.html#TopOfPage. The ICI also reported that as of the end of last year, approximately 88.2 million individual investors, in an estimated 50.6 million households, or about 43.6% of all U.S. households, owned mutual funds. *ICI Trends in Ownership*, *supra*, at 2.

The increased number of individuals purchasing mutual funds is due, in large part, to the significant trend toward replacing defined benefit plans with defined contribution plans. Approximately 45 million U.S. households own mutual funds in tax-deferred accounts, such as 401(k)s and other defined contribution plans, more than own funds outside these accounts. *Id.* at 5. "About two-thirds of households that own mutual funds through tax-deferred accounts hold funds in employer-sponsored retirement plans. . . . . The growth of fund ownership through workplace

retirement plans has been largely fueled by the shift from traditional pensions to defined contribution plans, many of which offer mutual funds as investment options." *Id.* at 6. In 2007, 33 million households held mutual funds through such plans, up from 27 million in 1998. *Id.* at 6-7. This increased reliance on defined contribution plans places significant responsibility on individuals to make appropriate investment choices so they will have sufficient retirement income. With so many people relying on mutual funds to fund their retirement, they face a heightened risk not merely if the funds in which they invest perform poorly, but also if they pay unnecessary, or unnecessarily high, fees and other expenses.

B. Investment Advisers' Inflated Compensation Causes Significant Harm to Investors.

While individuals are investing in mutual funds in greater numbers than ever, many for the first time, they remain largely unaware of the various fees and other expenses that their funds charge, all of which reduce their earnings.[7] For

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[7] While much of this discussion focuses on 401(k) plan participants, it is highly relevant to the issue before the Court due to the high number of 401(k) participants who invest in mutual funds. *See ICI Fact Book*, *supra*, at 91 (noting that at the end of 2007, $1.7 trillion of 401(k) assets were invested in mutual funds, and mutual funds' share of the 401(k) market rose from 9% in 1990 to approximately 55 % at the end of 2007). In addition, for most plans, investment fees, such as those charged by mutual fund advisors, account for the largest

example, in a recent survey of 401(k) participants aged 25 and older, when asked whether they pay any fees for their 401(k) plan, nearly two in three (65%) participants reported that they pay no fees and only about one in six (17%) said they do pay fees. AARP, *401(k) Participants' Awareness and Understanding of Fees* 5 (July 2007), *available at* http://assets.aarp.org/rgcenter/econ/401k_fees.pdf. After being told that 401(k) plan providers often charge fees for administering their plans, the vast majority (83%) admitted not knowing how much they pay in fees and expenses associated with their own plans. *Id.* In addition, 54% said they do not feel knowledgeable about the long-term impact fees can have on their total retirement savings. *Id.* at 6. *See also* AARP, *Comparison of 401(k) Participants' Understanding of Model Fee Disclosure Forms Developed by the Department of Labor and AARP* 26 (Sept. 2008) *available at* http://assets.aarp.org/rgcenter/econ/fee_disclosure.pdf (stating that most plan participants do not know how much they are paying in fees and expenses for their 401(k) plans, and half are unable to perform the basic math necessary to convert basis points into dollars).

Despite this lack of knowledge of fees and

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portion of total fees. A "2005 industry survey estimated that investment fees made up about 80 to 99 percent of plan fees . . . ." *See* U.S. Gov't Accountability Office, *Private Pensions – Changes Needed to Provide 401(k) Plan Participants and the Department of Labor Better Information on Fees* 2, Report to the Ranking Minority Member, House Comm. on Educ. & the Workforce (Nov. 2006) [hereinafter *GAO Private Pensions Changes Needed*].

expenses, investors are trying to make smart decisions to ensure, to the greatest degree possible, that they will have invested sufficiently, and earned a high enough return, to achieve their retirement goals. Yet, the effect of inflated fees is more than merely academic.

> Whether the fees that 401(k) plans charge are fair or reasonable is a vital issue for working Americans and their families. . . . For the sake of their retirement security, participants in 401(k) plans . . . must also earn a respectable rate of return on their investments. Excessively high fees can eat into the accumulating balance of a plan participant, and cause the income that the balance can sustain in retirement to be much lower than it should be. . . . Excessive fees can jeopardize retirement security even when financial market performance is satisfactory.

Sandy Mackenzie, AARP Pub. Pol'y Inst., *Determining Whether 401(k) Plan Fees Are Reasonable: Are Disclosure Requirements Adequate*? 1 (Sept. 2008), *available at* http://assets.aarp.org/rgcenter/econ/i8_fees.pdf. The Government Accountability Office recently noted that fees are among the many factors 401(k) participants should consider when investing because fees can significantly decrease retirement savings over the course of an employee's career. Even "a 1-percentage

point difference in fees can significantly reduce the amount of money saved for retirement," had that amount remained in the account to be reinvested. *See GAO Private Pensions Changes Needed*, *supra*, at 7. *See also* U.S. Dep't of Labor, Employee Benefits Sec. Admin., *Understanding Retirement Plan Fees and Expenses* 2 (May 2004), *available at* http://www.dol.gov/ebsa/pdf/undrstndgrtrmnt.pdf (stating that the "cumulative effect of fees and expenses on retirement savings can be substantial."); *GAO Mutual Fund Fees*, *supra*, at 28 (same, and "studies have also documented the impact of fees on investors' returns by finding that funds with lower fees tended to be among the better performing funds."); "DOL Fiduciary Requirements," *supra*, at 43031 (noting that "[k]ey determinants of the return on an investment include the fees and expenses paid.").

CONCLUSION

The Seventh Circuit not only created a split in the Circuits, but in divorcing its decision from the realities of how the mutual fund industry operates, the appeals court created a standard for determining breach of fiduciary duty under § 36(b) that will potentially harm millions of individuals relying on such funds for their retirement security. AARP and

CFA respectfully urge the Court to grant the petition for *certiorari*.

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