

No. 08-586

In The
Supreme Court of the United States

—————◆—————
JERRY N. JONES, et al.,

Petitioners,

v.

HARRIS ASSOCIATES L.P.,

Respondent.

—————◆—————

**On Writ Of Certiorari To The
United States Court Of Appeals
For The Seventh Circuit**

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**BRIEF AMICUS CURIAE OF CATO INSTITUTE
IN SUPPORT OF RESPONDENT**

—————◆—————

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QUESTION PRESENTED

Section 36(b) of the Investment Company Act imposes on investment advisors a “fiduciary duty with respect to the receipt of compensation for services.” Plaintiffs do not allege that investment advisor in this case misled the investment firm, or engaged in dishonest dealing in any respect. Is the advisor’s compensation nevertheless a violation of its fiduciary duty simply because plaintiffs consider that compensation “excessive”?

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Supreme Court Rule 37.3(a).....1

IDENTITY AND INTEREST OF AMICUS CURIAE

Pursuant to Supreme Court Rule 37.3(a), the Cato Institute respectfully submits this brief amicus curiae in support of the respondent.¹ Petitioners lodged consent to the filing of all amicus curiae briefs with the Clerk of this Court. Written consent for the filing of this brief was granted by counsel for respondent and lodged with the Clerk.

The Cato Institute was established in 1977 as a nonpartisan public policy research foundation dedicated to advancing the principles of individual liberty, free markets, and limited government. Cato's Center for Constitutional Studies was established in 1989 to help restore the principles of limited constitutional government that are the foundation of liberty. Toward those ends, Cato publishes books and studies, conducts conferences, publishes the annual *Cato Supreme Court Review*, and files amicus briefs with the courts. Cato Institute scholars have written a number of works discussing the importance of Constitutional protections for economic liberty against unreasonable government interference. *See, e.g.,* Kimberly C. Shankman and Roger Pilon, *Reviving the Privileges and Immunities Clause to Redress the Balance Among States, Individuals, and the Federal Government*, 3

¹ No counsel for any party authored this brief in whole or in part. No person or entity, other than amicus curiae, its members or its counsel made any monetary contribution specifically for the preparation or submission of this brief.

Tex. Rev. L. & Pol. 1 (1998). Cato has also participated as amicus curiae before this Court in cases involving economic freedom and property rights, including *Powers v. Harris*, 544 U.S. 920 (2005), *Empress Casino v. Giannoulis*, 129 S.Ct. 2764 (2009), and *Stop the Beach Renourishment v. Florida Dep't of Env'tl. Protection*, No. 08-1151 (2009). This case is of central concern to Cato because it addresses the scope of the freedom of contract and economic liberty that the Framers wrote into our Constitution – and threats to them that are felt most acutely during the current time of financial upheaval.



STATEMENT

This is a case about who gets to decide the compensation levels for investment professionals: regulators and judges, who base their decisions on their own conceptions of fairness, or consumers, whose decisions result from open and free bargaining in the competitive financial services marketplace. In a dynamic environment where thousands of mutual funds and mutual fund managers compete for individual, corporate, and institutional investors, should the government determine whether the fees charged by investment advisors are “reasonable”?

Harris Associates served as an investment advisor to three mutual funds. For these services, Harris received a fee according to a contract approved each year by the board of trustees that oversaw the three

mutual funds. *Jones v. Harris Associates, L.P.*, 2007 WL 627640 at *1 (N.D. Ill.). The board, comprising nine or ten members, delegated review of that contract to a committee that reviewed information about Harris's performance, the fees charged to Harris's other clients, and the fees charged by other advisors to their clients. *Id.* at **1-2. There is no allegation that Harris misled the board of trustees or any other person in negotiations over its compensation.

Three owners of shares in the above funds filed a derivative suit contending that Harris violated section 36(b) of the Investment Company Act in various ways; the relevant allegation here being that Harris's compensation was so disproportionate to the services rendered as to violate the "fiduciary duty with respect to the receipt of compensation for services." The court ruled for Harris, concluding that "the board as a whole was operating without any conflict that would prevent it from engaging in arm's-length negotiations with Harris," *id.* at *8, and that it was not evident that Harris received wildly disproportionate fees. On the contrary, the plaintiffs' evidence showed only that "others paid different amounts for similar [investment advisor] services." *Id.* at *9.

The Court of Appeals affirmed, observing that the fees charged by investment advisors are determined by private negotiations and kept in line by market competition. *Jones v. Harris Associates L.P.*, 527 F.3d 627, 631-32 (7th Cir. 2008). Disagreeing with the Second Circuit's decision in *Gartenberg v. Merrill*

Lynch Asset Mgt., Inc., 694 F.2d 923 (2d Cir. 1982), cert. denied sub nom. *Andre v. Merrill Lynch Ready Assets Trust*, 461 U.S. 906 (1983), the panel concluded that an advisor subject to section 36(b)'s fiduciary duty "must make full disclosure and play no tricks but is not subject to a cap on compensation. The trustees – and in the end investors, who vote with their feet and dollars – rather than a judge or jury, determine how much advisory services are worth." *Id.* at 632. The court denied rehearing en banc, over a dissent by five judges. *Jones v. Harris Associates, L.P.*, 537 F.3d 728 (7th Cir. 2008).

It is now up to this Court to determine whether the freely determined fees of investment advisers should be subject to review by the federal government.



SUMMARY OF ARGUMENT

All persons everywhere have a fundamental human right, recognized and protected by the Constitution, to earn a living and to keep the fruits of their labors. This means that as long as their dealings with others involve neither force nor fraud, each individual has the right to whatever compensation for his labor others agree to pay him. While the Investment Company Act rightly prevents fraud by imposing on investment advisers a fiduciary duty with respect to compensation, it imposes no limit on the amount of compensation an investment advisor may receive, so

long as the compensation agreement is freely and honestly adopted by both sides.

A “reasonableness” limit is not warranted by the plain text of section 36(b), which imposes only a “fiduciary duty”; that term has long been understood to require only honest dealing, not to require that “the terms of the contract . . . were ‘fair,’ whatever exactly that means.” *Maksym v. Loesch*, 937 F.2d 1237, 1241 (7th Cir. 1991). Nor is it warranted by the structure of the market for investment advising services – a market which is dynamic, in which consumers have a wide array of choices, and in which competitive pressures restrain the amount of fees charged. To create a “reasonableness” limit would involve the federal judiciary in determining what sort of compensation is fair for investment advisors, and possibly other professionals subject to fiduciary duties. This would stretch the judiciary’s role far beyond its constitutional boundaries and violate the right of honest individuals to choose what compensation they will receive from those with whom they make agreements. This Court should affirm the decision below and reject the Second Circuit’s approach in *Gartenberg*, which unduly expanded the judicial role and now threatens the security of the fundamental right to earn an honest living.



ARGUMENT

I. ALL PERSONS HAVE A FUNDAMENTAL HUMAN RIGHT TO WHATEVER COMPENSATION THEIR CONTRACTING PARTNERS FREELY AND HONESTLY CHOOSE TO PAY THEM

Everyone everywhere has the right to pursue happiness through economic trade and production. Declaration of Independence, 1 Stat. 1, 1 (1776) (“all men . . . are endowed . . . with [the] . . . unalienable right[] [to] . . . the pursuit of happiness.”); Thomas Jefferson, Letter to Joseph Milligan, April 6, 1816, *in* 14 *The Writings of Thomas Jefferson* 456, 466 (A.E. Bergh ed., 1907) (“the first principle of association” is “the guarantee to every one of a free exercise of his industry, and the fruits acquired by it.”). As Charles Fried has observed, the law of contracts

recognize[s] our rights as individuals in our persons, in our labor, and in some definite portion of the external world . . . [and] facilitates our disposing of these rights on terms that seem best to us. The regime of contract law, which respects the dispositions individuals make of their rights, carries to its natural conclusion the liberal premise that individuals have rights. And the will theory of contract, which sees contractual obligations as essentially self-imposed, is a fair implication of liberal individualism.

Contract As Promise 2 (1981).

The fundamental right to make contracts is guaranteed by the Constitution, which forbids the government from arbitrarily depriving persons of liberty, including the liberty to earn a living and keep the fruits of one's labor. *See, e.g., Lowe v. S.E.C.*, 472 U.S. 181, 228 (1985) (“[i]t is undoubtedly the right of every citizen of the United States to follow any lawful calling, business, or profession he may choose.” quoting *Dent v. West Virginia*, 129 U.S. 114, 121-22 (1889)); *Conn v. Gabbert*, 526 U.S. 286, 291 (1999) (“the liberty guaranteed by the Fourteenth Amendment denotes not merely freedom from bodily restraint but also the right of the individual to contract [and] to engage in any of the common occupations of life.”) (citations omitted). As Justice William O. Douglas wrote, the right to earn a living is “the most precious liberty that man possesses. Man has indeed as much right to work as he has to live, to be free, to own property. . . . To work means to eat. It also means to live. . . . The great values of freedom are in the opportunities afforded man to press to new horizons, to pit his strength against the forces of nature, to match skills with his fellow man.” *Barsky v. Board of Regents*, 347 U.S. 442, 472 (1954) (Douglas, J., dissenting).

The right to economic liberty – including the right to obtain and keep compensation for one's labors – is only part of the indefinite range of the liberty to which all are entitled. Because each person owns himself or herself, each person has such rights as the right to express his or her opinions, to travel without

unjustified obstruction, or to be free from assault or interference so long as he or she respects the equal right of others. So, too, each person has the right to employ his or her talents in the market and enjoy the fruits thereof. This realm of individual freedom was described by John Locke, who wrote that “every Man has a *Property* in his own *Person*. This no Body has any Right to but himself. The *Labour* of his Body and the *Work* of his Hands, we may say, are properly his.” John Locke, *Second Treatise of Civil Government* sec. 27 at 328-29 (Peter Laslett rev. ed., 1963) (1690). Each person has the right to use his or her labor – whether physical labor or intellectual labor – to earn a living through exchange, for whatever compensation another person chooses to give.

Following Locke, the authors of the Virginia Declaration of Rights (George Mason and James Madison) explained, in a phrase later revised by Jefferson, that “all men are by nature equally free and independent, and have certain inherent rights . . . [including] the means of acquiring and possessing property, and pursuing and obtaining happiness and safety.” Va. Decl. of Rights ¶ 1 (1776). The right to make money and acquire property with which to support oneself and one’s family is a central aspect of individual liberty. Alexander Hamilton observed that “[t]rue liberty” includes “protecting the exertions of talents and industry and securing to them their justly acquired fruits.” *In Defence of The Funding System* (1795) reprinted in 19 *The Papers of Alexander Hamilton* 1, 52 (Harold Syrett ed., 1973).

Likewise, James Madison explained that “the first object of government” is “the protection of different and unequal faculties of acquiring property.” *Federalist* No. 10 at 78 (Clinton Rossiter ed., 1961).

Before emancipation, opponents of slavery emphasized that among its chief evils was that slavery violated this fundamental right to earn a living and to enjoy the fruits of one’s labor. Senator Charles Sumner summed up the “ever-present motive power” of slavery as “*simply to compel the labor of fellow-men without wages!*” Cong. Globe 36th Cong. 1st Sess. 2592 (1860) (emphasis in original). Frederick Douglass likewise recalled the overwhelmingly liberating experience of earning his very first wages after escaping from slavery into freedom in Massachusetts. Douglass offered to help a neighborhood woman by moving some coal for her. “[T]he dear lady put into my hand *two silver half-dollars*. To understand the emotion which swelled my heart as I clasped this money, realizing that I had no master who could take it from me – *that it was mine – that my hands were my own*, and could earn more of the precious coin – one must have been in some sense himself a slave.” *The Life and Times of Frederick Douglass* (1893) reprinted in *Douglass: Autobiographies* 654 (Library of America 1994) (emphasis in the original).

It was largely to guarantee the economic freedom of those who had once been slaves that the first Civil Rights Act was enacted in 1866 and the Fourteenth Amendment adopted. See *Jones v. Alfred H. Mayer Co.*, 392 U.S. 409, 432 (1968) (a leading reason for the

Civil Rights Act was to secure “the right to acquire property . . . the right . . . to make contracts, and to inherit and dispose of property.”); Bernard Siegan, *Economic Liberties And The Constitution* 50 (1980) (“the [civil rights] act enumerates economic and not political concerns.”); Timothy Sandefur, *The Right to Earn A Living*, 6 Chap. L. Rev. 207, 228-30 (2003) (the Fourteenth Amendment was intended to protect economic freedom of former slaves and others). In the years following the Civil War, federal courts generally acknowledged that the right to earn a living as one saw fit was a central component of the liberty guaranteed to all individuals. *See, e.g., Cummings v. Missouri*, 71 U.S. (4 Wall.) 277, 321-22 (1866); *In re Parrott*, 1 F. 481, 506 (C.C.D. Cal. 1880); *Truax v. Raich*, 239 U.S. 33, 41 (1915).

Obviously no person has a right to obtain money through force or fraud; to do so violates the rights of others. Government’s proper role is to prevent force, fraud, and dangerous practices which might injure innocent persons. Justice Stephen Field, widely recognized as the leading defender of economic liberty in this Court’s history, and the father of so-called “economic substantive due process,” *see generally* Paul Kens, *Stephen J. Field: Shaping Liberty from The Gold Rush to The Gilded Age* (1999), nevertheless wrote the decision in *Dent*, 129 U.S. at 121-22, upholding an occupational licensing statute that required doctors to satisfy certain training requirements before practicing medicine. While reiterating that all persons have the right to earn a living

through free economic exchange, Field recognized that government could impose “conditions” on economic exchanges “for the protection of society.” *Id.* But where no persons are injured or endangered by the economic activity at issue, the government has no legitimate role dictating the terms of those exchanges.

In *Morta v. Korea Ins. Corp.*, 840 F.2d 1452, 1460 (9th Cir. 1988), the Ninth Circuit explained in more modern terms the importance of the freedom to make economic trades: “Despite recent cynicism, sanctity of contract remains an important civilizing concept.” *Id.* That right “embodies some very important ideas,” including “that people have the right, within the scope of what is lawful, to fix their legal relationships by private agreement.” *Id.* That right “includes the freedom to make a bad bargain,” the consequences of which the parties must shoulder. *Id.*

When an investment advisor, or any other person, agrees to perform a service for compensation, he has a right to that pay, no matter how large the amount may be, and regardless of whether others regard it as “excessive.” Whenever anyone chooses to exchange his or her labor for compensation – whatever that labor might be, and whatever that compensation might be – that decision is an exercise of freedom of choice which deserves respect. So long as it is the result of free and fair bargaining practices, that agreement represents an exchange of values with which no outsider may interfere.

II. COURTS HAVE NO POWER TO SECOND-GUESS THE “REASONABLENESS” OF ANY SALARY OR COMPENSATION AGREEMENT HONESTLY AND FREELY SIGNED BY BOTH CONTRACTING PARTIES

A. Any Honest Exchange Is By Definition Fair

There is no such thing as a “reasonable” rate of pay in the abstract. All prices, including the price of labor, are set by mutual bargaining and exchange between the parties. The price of a good or service represents only the priorities that the parties to the exchange set on their alternatives. *See, e.g.,* George Reisman, *Capitalism: A Treatise on Economics* 206-209 (1996). This insight, known in economics as the “marginal revolution,” banished forever the notion that there exists an abstract “value” to a good or services that prices must somehow “accurately” reflect. *See generally* Donald J. Boudreaux, et al., *Talk Is Cheap: The Existence Value Fallacy*, 29 *Envtl. L.* 765, 786-87 (1999). Salaries are set by the values placed on the product or service by consumers who compete to purchase the labor in question. There is no “correct” price or wage.

Where a person receives what appears to be a disproportionately large salary, this does not imply any wrongdoing by any party to the contract. It is the different and unequal talents of individuals who compete and interact in the economy, as well as the varying context of their needs and circumstances,

that account for the widely differing amounts of pay that employees receive.

Because the “reasonableness” of a particular rate of compensation cannot be compared to any universal standard, the reasonableness of compensation can be determined only by the parties to the contract itself. As Nobel laureate James Buchanan has said, “voluntary exchanges among persons, within a competitive constraints structure, generate efficient resource usage, *which is determined only as the exchanges are made.*” *Rights, Efficiency, And Exchange: The Irrelevance of Transaction Cost* (1984), reprinted in James M. Buchanan, *The Logical Foundations of Constitutional Liberty* 260, 273-74 (Indianapolis: Liberty Fund, 1999) (emphasis added). Consumers express their judgment as to that reasonableness by choosing whether to agree to the contract. In the absence of coercion or fraud, any economic exchange represents the judgment by the parties involved that the exchange is the best available determination of the parties’ respective needs, costs, and priorities. No other standard exists by which to judge the “reasonableness” of contractual exchanges.

B. Federal Courts Lack The Knowledge Necessary to Judge What Compensation Is “Reasonable”

All economic exchanges take place between parties who have limited access to information. For a central authority or bureaucracy to oversee or plan

the “proper” form of economic exchanges would require the accumulation and management of a vast amount of information that, as Nobel laureate Friedrich Hayek observed, “never exists in concentrated or integrated form but solely as the dispersed bits of incomplete and frequently contradictory knowledge which all the separate individuals possess.” *The Use of Knowledge in Society*, 35 Am. Econ. Rev. 519, 519 (1945).

The great informational benefit of free economic exchange is that it allows each individual to bring to bear on the problem of resource allocation his or her unique knowledge of “the particular circumstances of time and place.” *Id.* at 522. This is done by price competition. It is impossible for any individual agent to harness the information needed to put the “correct” price on a product or service. Rather, given the opportunity to exercise her own judgment and freely employ her own resources, “each individual can act as if she knew the myriad alternative uses for the products she uses as well as each one of their component resources, and to employ those products only if her use is one of the most efficient possible.” Christopher T. Wonnell, *Contract Law and the Austrian School of Economics*, 54 Fordham L. Rev. 507, 517 (1986). Bargaining and negotiation allows the resources to flow to those agents who value it most highly.

Rates of pay set by free competition reflect the myriad alternatives and priorities of the various actors in the market. If a firm overpays its executives,

investors will take their money elsewhere, requiring the firm to adjust its policies in the future; if the firm underpays, it will fail to attract talent, again creating an incentive for change in policy. The managers of the firms in question are in the best position to make judgments on such matters; no entity insulated from the incentives that the firms themselves face can hope to formulate a more accurate price for labor.

For example, imagine person X, who is offered a salary of \$100,000 from one firm, \$50,000 from another firm, and \$250,000 from a third. These employment offers represent a mixture of information held by the three firms, each of which balances its own estimate of person X's effectiveness, training, or prestige, against the other candidates available to fill the position. The firms also weigh these estimates against their respective economic circumstances, their needs and future expectations, and what their investors are willing and able to pay. The first firm may be more interested in hiring person Y instead; the second firm may be considering moving to another locale, and bids low, while the managers of the third firm believe person X to be uniquely suited to manage their company, and are willing to offer a high salary. It is not possible for any central authority to gather the relevant information about each of these firms, compare them, and determine which one "ought" to employ person X, or what pay rate is "reasonable" for person X's services. As Prof. Richard A. Epstein recently observed, every business firm in the market "operates in its own distinctive environment in which compensation formulas have to

interact with the patterns of shareholder control, the type of direct regulation in place and the rapid movement in product markets.” *Steering Clear of the Executive Compensation Bog*, Forbes Online, June 16, 2009.² Thus while the market salary for person X may not be an *a priori* “correct” price, it reflects the actual knowledge and needs of the participants in the market far better than could any price artificially set by a central authority. It is therefore a much more accurate valuation of X’s services than any constructed “reasonable” price could be.

Federal courts are particularly ill-suited to guess at the “reasonable” valuation of products or services. Legislatures are in a poor enough position to assemble the information necessary for setting “proper” rates of pay, but they are at least subject to the competing pressures of citizens and groups who can express their views, negotiate toward a mutually acceptable resolution, and vote out of office those who make irresponsible choices. But federal courts are overseen by life-appointed judges who are not subject to incentives set by consumers; moreover, courts are limited by the rules of evidence to the information provided by the parties in a particular case. That information may be inaccurate, biased, or spun in a way that the parties hope will influence the court, regardless of the actual economic circumstances. The

² Available at <http://www.forbes.com/2009/06/15/salary-bonus-ceo-opinions-columnists-executive-compensation.html> (visited August 24, 2009).

judiciary cannot apply the general standard of reasonableness to set the “correct” terms of an economic transaction.

In *Perkins v. Lukins Steel Co.*, 310 U.S. 113 (1940), this Court reviewed a suit in which the Secretary of Labor was statutorily authorized to set certain wages that the steel sellers must pay to workers if those sellers made contracts with the government. The Court found that courts could not intervene in the Secretary’s wage determinations because “the process of arriving at a wage determination contains no semblance of these elements which go to make up a litigable controversy as our law knows the concept.” *Id.* at 127. This is even more true of the process by which wages are determined in a free market, where private parties negotiate with each other on the basis of their knowledge to determine the rates of pay.

So, too, *Montana-Dakota Utilities Co. v. Northwestern Public*, 341 U.S. 246 (1951), held that courts could not intervene in an administrative determination as to what rate for utility services was “reasonable.” Reasonableness, the Court observed, “is an abstract quality represented by an area . . . between what is unreasonable because too low and what is unreasonable because too high.” *Id.* at 251. The judiciary could have no role in “reduc[ing] the abstract concept of reasonableness to concrete expression in dollars and cents.” *Id.* Administrative determinations are based on a variety of facts and circumstances of which courts could know nothing;

judges could not impose “the disembodied ‘reasonableness’” of their preferred price rates in the place of the agency with more facts at hand. *Id.* Courts have all the more reason to avoid imposing a disembodied concept of reasonableness on the compensation that mutual fund advisors receive as a consequence of honest and open negotiations to which sophisticated contracting parties bring their own knowledge and expertise.

In short, “[i]t is not within the power of a court to make a contract for the parties.” *Taminco NV v. Gulf Power Co.*, 322 Fed. App’x. 732, 734 (11th Cir. 2009) (citation omitted). This is not simply a matter of judicial restraint; it reflects the fact that courts lack the knowledge and expertise necessary to determine the terms of a contract between the private parties, and any attempt to do so is likely to lead to confusion, perverted incentives, and an interference with individual rights.

C. The Argument That Mutual Funds Are Not Subject to Supply and Demand Is Misleading

Petitioners and their amici argue that the market for mutual fund advisory services is different from all other markets and, indeed, has suffered “market failure.” *See, e.g.*, Brf. of AARP, sec. II. But as with most such claims, this argument overlooks some important basic principles. First, all markets are different from all other markets and have unique characteristics. The fact that one market does not

operate like another, or like an economist's hypothetical "perfect" model does not prove that it is non-competitive or that the forces of supply and demand do not work. Second, the presence of transaction costs and other factors that keep prices high does not prove that the market has "failed." Indeed, the market cannot be said to have "failed" simply because it fails to yield results that some people would prefer.

The AARP brief contends that mutual fund managers compete "on the basis of performance . . . rather than on the basis of the fees they charge." *Id.* at 15 (quoting U.S. Gov't Accountability Office, *Mutual Funds: Additional Disclosure Could Encourage Price Competition* 7 (2000)). But all economic competition consists of weighing costs and benefits. "Performance" in the market for investment advising services consists of obtaining for the client a high rate of return – one which will compensate the client for the fees charged to the client and return a profit to the client. John C. Coates IV and R. Glenn Hubbard, *Competition in The Mutual Fund Industry: Evidence And Implications for Policy*, 33 J. Corp. L. 151, 180 (2007) ("Mutual funds compete for investment funds by striving to outperform their rivals. Superior returns increase fund flows and market share.").

It is not meaningful, therefore, to say that advisors compete on the basis of performance rather than price – all product sellers or service providers compete for customers by offering a package of benefits, and it is the benefits of that package, when compared to its costs, that go by the name "performance." Nor can

the market be described as having “failed” simply because other investment options are less desirable, leading customers to remain with firms that pay advisors high rates. If a firm pays its advisors high rates but remains viable by comparison with other firms in free competition, this shows only that the firm is successful enough to afford high pay rates, not that the firm operates in a failed market.

The brief of amici curiae law professors, at 22, contends that “[i]f, as the evidence demonstrates, investors do not exit despite high fees – because of limited options in their 401(k) plans, adverse tax consequences, search costs, redemption fees, or other limitations – then advisors can make a great deal of money.” But this hardly proves that the market has failed; it cannot be argued that a market is failing when investors are free to weigh different options and choose to invest their money in a manner that reduces possible tax consequences, search costs, and redemption fees. All consumers in all markets have limited options. To point to these limits as evidence of market failure is to define all markets as failures.

Moreover, to contend that consumers choose to remain with high cost firms when confronted with less desirable alternatives merely proves that they have chosen the option they believe offers them the highest rate of return.³ Investors consider the cost of

³ Remarkably, the amici law professors, after acknowledging that investors presented with options regularly choose that
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exiting a fund when they first choose to invest their money: consumers are sensitive to the liquidity of their investments (or the lack thereof), and exit costs that limit liquidity factor into their assessment of a fund's performance. Exit fees are thus essentially part of the costs to entry into a particular investment. Consumers who choose to invest anyway have made a rational decision that the benefits outweigh those costs.

The market for investment advice is dynamic and competitive. *See* Coates and Hubbard, *supra* at 163 (“the mutual fund industry’s market structure is consistent with competition providing strong constraints on advisory fees.”). The number and variety of mutual funds is large and growing; barriers to entry for new firms are low; mutual fund fees have frequently decreased, and firms regularly gain and lose market share as is to be expected in a competitive market. *Id.*

option that brings them the highest return with the lowest costs, claims that investors “have demonstrated little behavioral capacity to invest rationally”! *Id.* at 23. This is incoherent; if parties choose the best – or the least bad – option, they are by definition behaving rationally. The law professors base their assertion on the claim that “many investors fail to enroll in retirement plans, leave their contributions uninvested, or allocate their savings too rarely, riskily, or rapidly.” *Id.* at 23-24. But many investors have good reasons for making these choices; many choose not to enroll in retirement plans or to invest their contributions because their circumstances are such that they prefer to keep money on hand for immediate needs. No individual or group can know these circumstances well enough to characterize all such choices as “irrational.”

Contrary to the claims of petitioners and their amici, mutual funds do compete in terms of price, and this has direct effects on the fees charged by investment advisors. During the 1990s, funds that performed poorly regularly waived their fees to improve their overall competitiveness in the eyes of consumers, and even successful funds waived their fees for the same reason. *Id.* at 173. If, as the petitioners and their amici suggest, adviser fees were the product of collusion or perverse markets rather than price competition, advisor fees would steadily grow; yet “[t]he evidence is to the contrary; fee declines are relatively common. Widespread common fee reductions and waivers by advisers can only be explained by price competition in both money market and equity mutual funds.” *Id.* at 174. And consumers do respond to costs: “investors shift substantial amounts of assets out of high-fee funds and into low-fee funds.” *Id.* at 180.

What’s more, competitiveness should not be assessed merely *within* the business model of mutual funds and their advisors; investors enjoy a variety of investment options other than mutual funds, and these alternatives create competitive pressure for mutual fund companies to lower costs or improve performance. Recent years have seen “the proliferation of new types of financial institutions, which is just what we would expect in a truly evolutionary system. . . . Not only have new forms of financial firm proliferated; so too have new forms of financial asset and service.” Niall Ferguson, *The Ascent of Money* 354 (2009). Indeed, Ferguson likens the enormous

growth of different varieties of investment options to “the Cambrian explosion, with existing species flourishing and new species increasing in number.” *Id.* at 355. Investors can choose to invest in any number of risky or safe strategies, with firms that pay top dollar to the best advisors they can find, or with firms that pay their investment advisors less.

In short, customers purchase a whole package of services when they invest their money – or when they purchase anything else. That package may contain certain anomalies, but if those anomalies do not make the value of the package as a whole unattractive to the customer, then the customer will still buy it, and will still be better off, even if others might consider the purchase unwise. For example, a restaurant that overpays the chef may still draw customers who believe the meals are good and the prices reasonable. Others may choose to patronize different restaurants. But it would be fallacious to describe the restaurant market as having “failed” because the chef is paid a disproportionate rate; the customers are satisfied with their choice among many options in a competitive market. This is true even if the market is characterized by “asymmetric information” – *i.e.*, if the customers do not know what the chef is paid. The market is working because customers have chosen (on the basis of “performance”) the alternative that comes closest to their desires.

As Coates and Hubbard, *supra* at 167, explain,

Firms have different business models and strategies. Some choose to compete for investors by offering extensive services, incurring higher costs with commensurately higher prices, while others choose to compete with less service, lower overhead, and lower prices. With hundreds of complexes seeking to gain a competitive advantage, “price” is an integral element of competition. The view that all fund complexes select not to compete on price, when price competition can gain new customers and increase adviser profits, is economically unfounded.

The evidence shows that “[b]oth advisers and fund directors are constrained by the effects of competition for fund investors.” *Id.* at 212. Although the judges who dissented from rehearing here expressed doubt that high fees will drive investors away, *Jones*, 537 F.3d at 731, the fact is that high fees will drive investors away *if those fees render the firm as a whole less desirable to investors than the available alternatives*. If investors choose to remain, then the market cannot be said to have failed, even if particular aspects of the firm’s operations seem anomalous to outsiders.

III. THE FIDUCIARY DUTY IN SECTION 36(b) REQUIRES ONLY FAIR DEALING, NOT ANY PARTICULAR OUTCOME

A. Fiduciary Duties Are Procedural, Not Substantive

The term “fiduciary duty” has long been understood to require fair dealing and honesty – not to require that a transaction have any particular outcome. It may be said by analogy to be a “procedural” rather than a “substantive” duty.

The fiduciary duty has been described as requiring good faith, candor, trustworthiness, or honesty. *See, e.g., Gresh v. Waste Services of America, Inc.*, 311 Fed. App'x. 766, 770-71 (6th Cir. 2009) (“fiduciary relationship turns ‘on trust or confidence reposed by one person in the integrity and fidelity of another’ that ‘necessarily involves an undertaking in which a duty is created in one person to act primarily for another’s benefit in matters connected with such undertaking’”) (citation omitted); *Employers Mut. Casualty Co. v. Collins & Aikman Floorcoverings, Inc.*, 422 F.3d 776, 779 (8th Cir. 2005) (“a duty to act for or to give advice for the benefit of another upon matters within the scope of the relation”) (citation omitted). It does not impose a substantive limitation on the fees that a fiduciary may charge her client, so long as those fees are freely and fairly negotiated.⁴ Fiduciaries cannot

⁴ This is not to suggest that individuals would have any private right of action under section 36(b) to enforce the full
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take advantage of clients or deprive them of relevant decision-making information. But where an informed client agrees to pay a fiduciary a high fee, that fee does not violate the fiduciary duty.

Informed consent is the cornerstone of the fiduciary relationship. Fiduciaries and clients often enter into dangerous, complicated, or costly agreements; for example, doctors are fiduciaries to their patients, but often enter into agreements to provide expensive and risky medical treatments. So long as the doctor fully discloses the risks, the client's decision to enter into that agreement does not violate the fiduciary duty even if the doctor receives high pay and even if the patient suffers a foreseen injury. *See, e.g., Hendricks v. Central Reserve Life Ins. Co.*, 39 F.3d 507, 510 (4th Cir. 1994). Attorneys are also in a fiduciary relationship with their clients, one that requires them to disclose information to a client and explain its import but allows the client to make potentially unwise choices so long as he or she is fully informed. *See, e.g., Kroblin Refrigerated Xpress, Inc. v. Pitterich*, 805 F.2d 96, 106 (3d Cir. 1986).

Fiduciaries have no obligation to work for below-market rates or to limit what they may charge for their services. In *Maksym*, 937 F.2d 1237, an attorney sued a former client to recover fees. The client claimed the fees were unrecoverable because the attorney breached his fiduciary duty by charging an exorbitant rate. The Court of Appeals, speaking through Judge

disclosure requirements of section 15(c); those requirements are enforced by the Securities and Exchange Commission.

Posner, rejected this argument on the grounds that attorneys, though fiduciaries, are nevertheless free to charge whatever compensation a client knowingly consents to pay. *Id.* at 1241. To contend that fiduciaries may never obtain a benefit for themselves in contracts with clients would be self-defeating: “As no one enters into a contract without hope of benefit, this argument if accepted would make all lawyers’ contracts presumptively unenforceable.” *Id.* As long as “the terms of the transaction were fully disclosed,” and the transaction supported by consideration, the transaction is enforceable between the fiduciary and the client. *Id.*

In words equally applicable to this case, Judge Posner and his colleagues concluded that most fiduciary contracts are entered into for purposes of profit, rather than from charitable motives, “yet the contracts establishing them are held valid without the court’s imposing on the . . . fiduciary the difficult burden of demonstrating that . . . the terms of the contract . . . were ‘fair,’ whatever exactly that means.” *Id.* The *Makysm* decision was correct: Courts are in no position to impose a “fairness” limitation on fiduciaries’ fees so long as fiduciaries act honestly and fairly in negotiating their terms of compensation.

B. The *Gartenberg* Approach Should Be Abandoned Because It Uses a Dubious Reading of Legislative History to Override Plain Statutory Language And Relies on Unconvincing Economic Propositions

The Second Circuit’s decision in *Gartenberg*, 694 F.2d 923, should be overruled. That decision relies on

legislative history to supersede the statute's explicit language, and involves courts in second-guessing the honest contractual agreements formed by private parties.

The *Gartenberg* court relied on “excerpts from the [Investment Company] Act’s tortuous legislative history,” *id.* at 928, to conclude that section 36(b)’s fiduciary duty provision imposes a reasonableness limit on advisor fees. Admitting that this legislative history “contains statements . . . pointing in both directions,” the court concluded that the term “fiduciary duty” was substituted for “reasonable” as “more a semantical than a substantive compromise.” *Id.* Yet the court simultaneously decided that the use of the former term was “possibly intended to modify the standard somewhat.” *Id.*

Such equivocal conclusions are precisely why courts are usually reluctant to rely on legislative history to override a statute’s plain language. As this Court observed in *Lamie v. U.S. Trustee*, 540 U.S. 526 (2004), when asked to base its interpretation of a statute on the intentions of legislators, “competing interpretations of the legislative history make it difficult to say with assurance . . . [which party] lays better historical claim to the congressional intent. . . . These uncertainties illustrate the difficulty of relying on legislative history here and the advantage of our determination to rest our holding on the statutory text.” *Id.* at 541-42. Congress may not have perfectly expressed its intent, but it alone is capable of comprehending that intent and putting it into statutory form, and “[i]f Congress enacted into law something

different from what it intended, then it should amend the statute to conform to its intent.” *Id.* at 542. *See also Ardestani v. INS*, 502 U.S. 129, 137 (1991) (“ambiguities in the legislative history are insufficient to undercut the ordinary understanding of the statutory language”); *Patterson v. Shumate*, 504 U.S. 753, 761 (1992) (“Although courts appropriately may refer to a statute’s legislative history to resolve statutory ambiguity, the clarity of the statutory language at issue in this case obviates the need for any such inquiry.”) (citation omitted).

The *Gartenberg* decision also relied on dubious assertions about the status of economic competition for investment advising services. 694 F.2d at 929. According to that decision, competitive forces do not work for investment advisors as they do for other service providers because the cost to each investor is relatively small and because advisors’ personal services are so crucial to the operation of an investment fund that a fund cannot easily change from one advisor to another. *Id.*

But as explained above, competition for investor dollars is robust; there are myriad financial instruments, investment mechanisms, and firms available to consumers. The fact that this specific method of investment involves paying high compensation rates to advisors with unique skills does not render the market for investment advice uncompetitive – any more than the gourmet restaurant business is rendered uncompetitive by the fact that particular chefs are highly paid for their special talents. As long as customers can choose the restaurant that provides the best quality food for a cost they are willing to pay,

competition will restrain the chef's pay to an amount that is profitable in light of consumer preferences.

Similarly, it may be true that "competition between money market funds for shareholder business" is "governed by different forces" than is competition "between advisor-managers for fund business," *id.*, but this is irrelevant: all markets are distinct and subject to unique forces. As long as consumers are free to choose between different packages of investment services and pick that package which gives them the best return for the lowest cost, that market is competitive, and concerns for the "reasonableness" of an advisor's salary are misplaced. *Cf. United States v. Syufy Enterprises*, 903 F.2d 659, 668 (9th Cir. 1990) ("[W]hen a producer . . . suppl[ies] a better product at a lower price, when he eschews monopoly profits, when he operates his business so as to meet consumer demand and increase consumer satisfaction, the goals of competition are served.").

Gartenberg held that courts could "evaluat[e] a fee's fairness" in part by comparing it to "the price charged by other similar advisers to [other] funds." 694 F.2d at 929. But there are many reasons why funds might charge different prices from investors: institutional investors might enjoy volume discounts, for example. Funds that engage in riskier investment strategies might seek more educated or experienced advisors, whom they must pay more, and therefore charge more to clients, while more conservative funds charge less. To compare the fees charged by various different funds, each of which has significantly different characteristics, is deeply misleading.

Nor should it matter that the advisor's compensation costs each investor a small amount. *Cf. id.* at 929. The same is true of most compensation for services in the market: a chef's salary is a small amount of each customer's dinner tab. Yet that does not mean, as the *Gartenberg* court claimed, that what a firm pays its employees is "competitively insignificant." *Id.* No cost is "competitively insignificant": All costs add up to a total that consumers compare to the benefits that they receive. Thus if an investor considers "\$2.88 a year for each \$1,000 invested," *id.* (emphasis in original), to be an insignificant cost compared to the benefit received, then that choice is a reasonable economic decision; it does not prove that the market for investment advisor services is uncompetitive and in need of court oversight.

In short, *Gartenberg* relied on an unconvincing interpretation of ambiguous legislative history to override the plain language of section 36(b) and transform a fiduciary duty – long understood as a procedural limitation requiring honest dealing and full disclosure – into a substantive "reasonableness" limitation. *Gartenberg* also relied on a flawed economic understanding that ignored the competitive characteristics of the market for investment advice. Contrary to that decision, "[c]ompetition among funds is strong, and competition constrains advisers in proposing fees, so that the general breakdown in arm's-length bargaining that has been assumed by the 1960s view is unconvincing." Coates and Hubbard, *supra* at 214. *Gartenberg* should be overruled.



CONCLUSION

Interpreting the fiduciary duty imposed by section 36(b) to impose a “reasonableness” limit on the amount of fees charged by an investment advisor would threaten the fundamental right of investment advisors to earn whatever compensation they freely negotiate with their clients; would force federal courts to make economic determinations for which they are unsuited; and would exceed all prior understanding of the meaning of the fiduciary duty. It would thus threaten the right of all professionals who exercise fiduciary duties to seek and obtain compensation for their services. This Court should follow the lower-court trend and hold that the fiduciary duty applicable to investment advisors requires only fair and honest negotiations. The decision of the Seventh Circuit Court of Appeals should be *affirmed*.

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Respectfully submitted,

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