1980

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Recommended Citation
Available at: http://ir.lawnet.fordham.edu/flr/vol48/iss4/5

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MUTUAL FUND ADVISORY FEES—TOO MUCH FOR TOO LITTLE?

INTRODUCTION

During the first week in January, 1980, investors purchased a record $2.3 billion dollars worth of money market mutual fund shares.¹ Offering dividend yields in excess of 11%,² the seventy-eight money market funds have grown to nearly $50 billion in total net assets.³ Although the growth in money market funds may not be indicative of similar growth in the other forms of mutual funds, this rapid influx of investments has called into question the fees paid by mutual funds to their sponsors in return for advisory services. Consequently, two shareholders of the largest money market fund have sued that fund and its sponsor,⁴ alleging that the fund has become so large that the resulting advisory fee constitutes a breach of the fiduciary duty⁵ imposed on the fund’s adviser by section 36(b) of the Investment Company Act of 1940 (ICA).⁶ Although this fiduciary duty has been tested on the issues of recapture of brokerage commissions by a fund⁷ and modification of a fund’s advisory

1. N.Y. Times, Jan. 11, 1980, § D, at 9, col. 5.
2. Id., § D, at 6, col. 4.
3. Id., § D, at 9, col. 5.
4. Andre v. Merrill Lynch Ready Assets Trust, No. 79-5726 (S.D.N.Y., filed Oct. 23, 1979); Gartenberg v. Merrill Lynch Asset Management, Inc., No. 79-3123 (S.D.N.Y., filed June 14, 1979). Reference is made throughout this Note to several mutual funds sponsored by Merrill Lynch, Inc. or its subsidiaries and affiliates including Merrill Lynch Ready Assets Trust, which is a party to both of the cases cited supra. All references to any of these entities are intended to be purely illustrative of conditions or practices in the mutual fund industry. Neither the author nor the Fordham Law Review expresses any opinion, express or implied, as to the conduct of any of the Merrill Lynch companies or of any other mutual fund or adviser.
6. Section 36(b) provides in part: “For the purposes of this subsection, 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 [officer, director, member of any advisory board, deposito, or principal underwriter of an investment company] 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.” Investment Company Act § 36(b), 15 U.S.C. § 80a-35(b) (1976).
7. E.g., Tannenbaum v. Zeller, 552 F.2d 402 (2d Cir.), cert. denied, 434 U.S. 934 (1977); Fogel v. Chestnutt, 533 F.2d 731 (2d Cir. 1975), cert. denied, 429 U.S. 824 (1976); Moses v. Burgin, 445 F.2d 369 (1st Cir.), cert. denied, 404 U.S. 994 (1971). Brokerage commissions generated by investment companies are a large source of revenue to brokers who are members of national securities exchanges. Brokers can execute transactions for investment companies and other large customers at a cost that is only a fraction of their commissions. The managers of a substantial number of mutual funds own brokerage firms or are closely affiliated with them. In most cases, the commissions generated by fund transactions are wholly retained by the affiliated
contract, no court has determined whether the dollar amount of the advisory fee may become large enough to constitute, by itself, a breach of section 36(b).

This Note examines the rationale of the imposition of a fiduciary duty upon a fund's adviser with respect to its fees. Part I discusses the relevant history of the 1970 amendments to the ICA and the need for a fiduciary standard concerning the advisory fee. Part II addresses the issue of liability under section 36(b), and finally, Part III analyzes the effect of the fiduciary standard on whether a particular fee is excessive for the purposes of that section.

I. RELEVANT BACKGROUND OF SECTION 36(b)

A mutual fund is an investment company that purchases securities with the capital contributed by its shareholders. Participation in a fund provides relatively small investors with professional money management and the advantages of a diverse portfolio of securities. The most striking feature of mutual funds is their external management structure. Although some funds are "managed along conventional corporate lines by their own officers and directors," most are managed by the investment advisers that also develop and sponsor them. The adviser, which is typically a partnership or a corporation owned independently of the mutual fund it advises, "selects the fund's portfolio and operates or supervises most other aspects of its business," including the appointment of the fund's directors, several of whom are usually

broker and therefore increase the compensation of the fund managers. The practice of using these commissions to reduce fund advisory fees is known as recapture. SEC, Public Policy Implications of Investment Company Growth, H.R. Rep. No. 2337, 89th Cong., 2d Sess. 162-63 (1966) [hereinafter cited as PPI]. For example, one of the issues in Fogel v. Chestnutt, 533 F.2d 731 (2d Cir. 1975), cert. denied, 429 U.S. 824 (1976), was whether the adviser and affiliated directors of American Investors Fund, Inc. breached their fiduciary duties by not informing the independent directors of the fund that it might be possible to recapture brokerage commissions. Id. at 737.


9. See Tannenbaum v. Zeller, 552 F.2d 402, 405 (2d Cir.), cert. denied, 434 U.S. 934 (1977); PPI, supra note 7, at 33, 45. Investment companies are regulated by the SEC pursuant to the Investment Company Act of 1940, 15 U.S.C. §§ 80a-1 to -52 (1976). Generally, there are three types of investment companies: management companies, face-amount certificate companies, and unit investment trusts. Mutual funds are a form of management company. Face-amount certificate companies sell unsecured, nonvoting debentures on an installment plan. Unit investment trusts sell interests in a fixed group of securities held by a trustee. See PPI, supra note 7, at 37-39.

10. PPI, supra note 7, at 1. "Frequently cited reasons for the purchase of mutual fund shares are the availability of expert investment advice, diversification of portfolio risks, convenience of security management, and economy of bookkeeping activities, with the first two of particular importance. Mutual funds, unlike most other financial institutions, tend to specialize in common stock investment, and, as compared with the alternative of direct purchases of stock by people with surplus funds, they provide a relatively easy means of diversifying risk which may be particularly useful to small investors. From the standpoint of the economy as a whole, this diversification of risk and widespread acceptance of the associated indirect investment in common stock tends to lower the cost of equity capital and stimulate more risky undertakings, with a higher average rate of return than would probably otherwise be realized for a given total investment." Wharton School of Finance and Commerce, A Study of Mutual Funds, H.R. Rep. No. 2274, 87th Cong., 2d Sess. x (1962) [hereinafter cited as Wharton Report].

11. PPI, supra note 7, at 45.

12. Id. at 8.
officers or directors of the adviser.13 Control of a mutual fund, therefore, lies with an external entity whose primary interest is maximization of its own profits through the success of the fund.14 The adviser receives a fee for its services that is usually calculated as a percentage of the fund's total net assets.15 As a consequence, mutual fund advisers are able to collect large

13. Id. at 46; see Tannenbaum v. Zeller, 552 F.2d 402, 405 (2d Cir.), cert. denied, 434 U.S. 934 (1977). In most cases, the adviser forms the fund and appoints the fund's directors. PPI, supra note 7, at 46. The ICA defines two types of independent directors, unaffiliated and disinterested. A person is an affiliated director of a fund if, among other things, he is an officer, director, partner or employee of the fund's investment adviser, or if he owns five percent or more of the voting shares in the adviser. Investment Company Act § 2(3), 15 U.S.C. § 80a-2(3) (1976). A person qualifies as a disinterested director of a mutual fund if he is not affiliated with the fund's adviser or principal underwriter, and if he is not a member of the immediate family of a person affiliated with the adviser or principal underwriter. Id. § 2(19), 15 U.S.C. § 80a-2(19) (1976).

14. Tannenbaum v. Zeller, 552 F.2d 402, 403 (2d Cir.), cert. denied, 434 U.S. 934 (1977). "The mutual fund, unique [among] all corporations, is the creature and the captive—I don't use these as epithetical words, but as an objective description—is the creature and the captive of the manager, or the adviser, as we know him. The adviser gives birth to the fund. The adviser peoples the fund with its directors. The adviser's owners are the officers of the fund.

"That umbilical cord is never, never cut. That close, I might say incestuous relationship, is there for all time.

"In this relationship, . . . these men, and when I say 'these men,' I mean the advisers and managers, are both the givers and the receivers of astronomical amounts of money, moneys that run to $10 million a year and more by way of advisory fees, and lots more in the way of underwriting fees, et cetera.

"These advisers, wearing the cloak of their directorial responsibilities as directors of the fund, decide how much money to give themselves as investment advisers.

"There is nothing I have seen in my almost half century at the bar that even comes close to this arrant form of undisciplined self-help. I think it was Cardozo who once said in a similar context in his own inimitable prose, 'These men make themselves the beneficiaries of their own unrestricted munificence,' at the expense, I might add, of the fund." Mutual Fund Amendments: Hearings on H.R. 11995, S. 2224, H.R. 13754, and H.R. 14737 Before the Subcomm. on Commerce and Finance of the House Comm. on Interstate and Foreign Commerce, 91st Cong., 1st Sess. 768 (1969) [hereinafter cited as Fund Hearings] (statement of Abraham Pomerantz).

15. Tannenbaum v. Zeller, 552 F.2d 402, 405 (2d Cir.), cert. denied, 434 U.S. 934 (1977); PPI, supra note 7, at 46. Therefore, the advisory fee fluctuates with the value of the fund's net assets and provides some incentive for the adviser to work toward increases in fund value. Provision for a specific fee must be contained in the advisory contract. Investment Company Act § 15(a)(1), 15 U.S.C. § 80a-15(a)(1) (1976). It should be noted that a fund may receive a rebate on the adviser's fee if the fund's expenses exceed a specified amount. Such funds must be reimbursed by their advisers to the extent that the funds' ordinary operating expenses exceed a percentage of the funds' assets. For example, Merrill Lynch Special Value Fund, Inc. (Special Value) had total net assets of $53,265,205 as of March 31, 1979. Merrill Lynch Special Value Fund, Inc., Prospectus 30 (July 31, 1979) [hereinafter cited as Special Value Prospectus] (on file with Fordham Law Review). The fund's adviser was compensated at a rate of .75% of net assets which would have resulted in a fee of $399,489. By operation of its expense ratio limitation, however, the fund was only obligated to pay an advisory fee of $363,140. Id. at 31. Another fund, Merrill Lynch Ready Assets Trust (Ready Assets), had total net assets of $1,635,273,693 as of December 31, 1978. Merrill Lynch Ready Assets Trust, Prospectus 34 (May 29, 1979 (rev. Dec. 12, 1979)) [hereinafter cited as Ready Assets Prospectus] (on file with the Fordham Law Review). The Ready Assets advisory fee was calculated on a decreasing scale so that the fund paid the adviser at a rate of .50% on the first $500 million of net assets, .425% for net assets exceeding $500 million but less than $750 million,
advisory fees regardless of the cash value of the adviser's time and effort.\textsuperscript{16} Moreover, the mutual fund structure provides ample opportunities for self-dealing between the adviser and its affiliates. For example, the adviser negotiates the terms of the advisory contract, including its fee, with the same fund directors whom the adviser selected when it organized the fund.

In response to these problems, Congress enacted the ICA in 1940 to "mitigate and, so far as is feasible, to eliminate the conditions . . . which adversely affect the national public interest and the interest of investors."\textsuperscript{17} The objectionable conditions within the investment industry that Congress sought to rectify included: (1) the lack of adequate disclosure of information to purchasers and owners of investment company securities;\textsuperscript{18} (2) the organization and management of investment companies for the benefit of their managers rather than in the interests of the fund's shareholders;\textsuperscript{19} (3) the use of discriminatory practices in the issuance of securities to give preferential treatment to associates of the fund's adviser;\textsuperscript{20} (4) the use of unsound or misleading accounting principles by investment companies;\textsuperscript{21} (5) changes in fund investment policies and goals without consent of its security holders;\textsuperscript{22} (6) the use of excessive borrowing that unduly increased the "speculative character" of the fund's portfolio;\textsuperscript{23} and, (7) the operation of investment companies "without adequate assets or reserves."\textsuperscript{24}

In 1958, concerned with the rapid growth of the mutual fund sector of the investment industry,\textsuperscript{25} the Securities and Exchange Commission (SEC) au-
authorized the Wharton School of Finance and Commerce (Wharton) to study the effectiveness of the ICA in relation to the growth of mutual funds. \textsuperscript{26} Specifically, Wharton examined the effects of a fund's size on its investment policies and its performance. \textsuperscript{27} It concluded that "the more important current problems in the mutual fund industry appear to be those which involve potential conflicts of interest between fund management and shareholders, the possible absence of arm's length bargaining between fund management and investment advisers, and the impact of fund growth and stock purchases on stock prices." \textsuperscript{28} Moreover, investment advisers were not sharing with the fund shareholders the economies of size that resulted from fund growth. \textsuperscript{29} Most advisers tended to set fees at a constant .50\% of total net assets no matter how large the fund grew rather than on a sliding scale that reduced fees as fund size increased. \textsuperscript{30} At about the same time that Wharton prepared its report and shortly after it was issued in 1962, several mutual fund shareholders commenced lawsuits based on allegedly excessive advisory fees. Only three of these suits, however, were fully litigated. \textsuperscript{31}

In \textit{Meiselman v. Eberstadt}, \textsuperscript{32} the plaintiff, a shareholder of Chemical Fund, Inc., claimed that F. Eberstadt & Co., the fund's adviser, was entitled to be compensated only for time spent on Chemical's affairs and only at rates comparable to the compensation of salaried executives with similar responsibilities. \textsuperscript{33} The Delaware Chancery court rejected this view, however, and held that the advisory fees were not excessive. \textsuperscript{34} It noted that although most funds at that time

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\textsuperscript{26} Wharton Report, \textit{supra} note 10, at 1.
\textsuperscript{27} \textit{Id.} at 1.
\textsuperscript{28} \textit{Id.} at x.
\textsuperscript{29} "Individual mutual fund shareholders do not pay higher management fee rates than they would incur through other institutional investment channels (which, however, normally do not involve a substantial sales charge). Nevertheless, they do not generally benefit from the lower charges that the volume of their pooled resources might be expected to make possible. Mutual funds without advisers were found to have relatively lower and more flexible advisory costs—a situation which may be attributable, at least in part, to conventional limitations on salary incomes (as opposed to payments to external organizations)." \textit{Id.} at xiii.
\textsuperscript{30} \textit{Id.} at 28-29. "In an analysis of the relationships between investment advisers and mutual funds, it was found that the effective fee rates charged the funds tend to cluster heavily about the traditional rate of one-half of 1 percent per annum of average net assets, with approximately half of the investment advisers charging exactly this rate. This concentration around the one-half of 1 percent level occurs more or less irrespective of the size of a fund's assets managed by an investment adviser, although operating expenses of the adviser were found to be generally lower per dollar of income received, and also lower per dollar of assets managed, as the size of a fund's assets increased." \textit{Id.} at xii.
\textsuperscript{33} \textit{Id.} at 565-66, 170 A.2d at 722.
\textsuperscript{34} \textit{Id.} at 566-68, 170 A.2d at 722-23.
were charged a flat rate of .50% of total net assets, Chemical's fee included breakpoint reductions from the basic rate, and therefore, was lower than the average fee in the mutual fund industry. Moreover, the court emphasized that there could be no liability because Chemical's unaffiliated directors and shareholders had approved the compensation agreement.

One year after Meiselman, several shareholders of Fundamental Investors, Inc. contended that the advisory fee rate of .50% charged on that fund's assets of almost $600 million was excessive. In Saxe v. Brady, Chancellor Seitz ruled that because the shareholders ratified the advisory contract they had to prove that "no person of ordinary, sound business judgment would be expected to entertain the view that the consideration was a fair exchange for the value which was given." The plaintiffs argued that other comparable funds paid significantly lower advisory fees and that Fundamental's adviser was earning a profit of approximately two million dollars. In response to these arguments, the Chancellor observed that profits are certainly approaching the point where they are outstripping any reasonable relationship to expenses and effort even in a legal sense. And this is so even after making due allowance for incentive and benefit presumably conferred. This is not to say that no payment is justified after a fund reaches a particular size. It is only to say that the business community might reasonably expect that at some point those representing the fund would see that the management fee was adjusted to reflect the diminution in the cost factor.

Nevertheless, the court held that the fees were not excessive because the plaintiffs had failed to prove that the fees represented a waste of corporate assets. Corporate waste was the only legal standard upon which the court could base a conclusion that the fees were excessive.

In the third case, Acampora v. Birkland, the plaintiffs argued that the advisory fee of .50% of net assets charged to Financial Industrial Fund, Inc. was excessive because the fund received fewer services than other funds. The district court held, on the basis of Saxe and Meiselman, that the fee was not excessive because it was not "unconscionable and shocking." Although the

35. Id. at 567-68, 170 A.2d at 723.
36. See note 13 supra.
40. Id. at 486, 184 A.2d at 610. Chancellor Seitz stated: "Where waste of corporate assets is alleged, the court, notwithstanding independent stockholder ratification, must examine the facts of the situation. Its examination, however, is limited solely to discovering whether what the corporation has received is so inadequate in value that no person of ordinary, sound business judgment would deem it worth what the corporation has paid. If it can be said that ordinary businessmen might differ on the sufficiency of the terms, then the court must validate the transaction." Id.
41. Id. at 490, 184 A.2d at 612.
42. Id. at 492-93, 184 A.2d at 614.
43. Id. at 498, 184 A.2d at 616-17.
44. Id., 184 A.2d at 617.
46. Id. at 547-48.
47. Id. at 549.
court stated that a percent of net assets fee "leaves a great deal to be desired" it could not determine whether the amount paid pursuant to that formula was excessive because "it is impossible to evaluate the service rendered." 48

Despite the Wharton finding that fund advisers did not share existing economies of size with fund investors, 49 the refusal of the courts to proscribe these practices severely hampered mutual fund shareholders in their efforts to benefit from those savings. The criticism of the existing system rendered in Saxe 50 prompted many fund advisers to incorporate breakpoints in their fees as a means to settle the pending derivative lawsuits. 51 Fund shareholders were forced to accept modest settlements, however, because no plaintiffs succeeded in advisory fee litigation. 52

As a consequence of the Wharton findings, and the failure of any plaintiffs to prevail in advisory fee litigation, the SEC began a study of investment company growth in 1966. 53 The SEC concluded that the ICA worked well to remedy the conditions addressed by Congress in 1940. 54 Nevertheless, because of growth and changes in the industry the SEC was alarmed by the cost to investors of participation in mutual funds. 55

One of the major aspects of mutual funds that the SEC addressed was the cost of advisory services. In particular, the SEC determined that the external management structure of the mutual fund industry was an obstacle to any shareholder benefit from decreased management costs. 56 It found, for example, that investment advisers "seldom, if ever, compete[d] with each other for advisory contracts with mutual funds." 57 As a result, fund shareholders were effectively prevented from shopping around for another adviser charging a lower fee. 58

The SEC also noted that not only did the lack of free market competition among investment advisers serve to discourage lower advisory fees, but shareholder awareness of the possibility of obtaining savings from lower advisory fees was minimized by their interest in other factors such as sales charges. 59 invest-

48. Id. at 548-49. Moreover, the plaintiffs did not challenge the form of the calculation, merely that the fees charged were not an accurate representation of the services provided by the adviser. Id.

49. Wharton Report, supra note 10, at XII.

50. Saxe v. Brady, 40 Del. Ch. 474, 497-98, 184 A.2d 602, 616-17 (1962); see note 43 supra and accompanying text.

51. PPI, supra note 7, at 138.

52. Id. at 83.

53. Id.

54. Id. at 1; see Investment Company Act § 1, 15 U.S.C. § 80a-1 (1976).

55. PPI, supra note 7, at 1.

56. Id. "These findings suggest that the special structural characteristics of the mutual fund industry, with an external adviser closely affiliated with the management of the mutual fund, tend to weaken the bargaining position of the fund in the establishment of advisory fee rates. Other clients have effective alternatives, and the rates charged them are more clearly influenced by the force of competition." Wharton Report, supra note 10, at XIII.

57. PPI, supra note 7, at 126-27.

58. Id.

59. The sales load can be of greater significance than the advisory fee to a cost-conscious investor. A sales load is the sales charge exacted from mutual fund investors when they purchase fund shares. It is usually the difference between the net asset value of a fund share and its purchase price. Therefore, because the sales load is first deducted from the purchase price, an
ment performance,\textsuperscript{60} and selling efforts on behalf of the fund.\textsuperscript{61} The SEC observed that the prospect of paying another sales charge and, possibly, a capital gains tax is likely to deter someone who already is a mutual fund investor from switching to another fund with a lower advisory fee.\textsuperscript{62} Thus, the effect of the external management structure of mutual funds is such that even cost-conscious investors have few incentives to learn that fees are excessive or to pressure the fund's adviser for lower advisory fees.

Similarly, the SEC found that the disclosure requirements of the ICA did not provide sufficient protection for fund shareholders. It suggested that, despite an adviser's compliance with the statutory disclosure provisions,\textsuperscript{63} the reasonableness of charges for the "entire package" of services provided by the adviser, its affiliates, and other professional, administrative and clerical personnel to fund investors is perhaps too complex for an effective evaluation by them.\textsuperscript{64} The SEC also stated that "[t]o the extent that disclosure has served to develop and maintain conventional limitations on the level of advisory fees . . . , these limitations have served mainly to keep advisory fee rates from rising" above traditional industry levels rather than to force fees down when economies of size occur.\textsuperscript{65} It concluded, therefore, that the Wharton finding that advisory fees clustered around .50\% of total net assets in the late 1950's "was less true—but not uncommon" in 1965.\textsuperscript{66} Moreover, the SEC noted that although more funds investor does not obtain an interest in the fund equal in value to the amount he pays for his shares. \textit{Id.} at 52. Although some funds sell their shares at net asset value (no-load), the majority of mutual funds charge a sales load. \textit{Id.} at 204.

\textsuperscript{60} \textit{Id.} at 126.

\textsuperscript{61} \textit{Id.}

\textsuperscript{62} \textit{Id.}

\textsuperscript{63} The ICA requires advisers to disclose all information that may reasonably be necessary to evaluate the terms of an advisory contract. Investment Company Amendments Act § 15(c), 15 U.S.C. § 80a-15(c) (1976).

\textsuperscript{64} PPI, \textit{supra} note 7, at 128. "Appraisal of the fairness of the charges for the entire package of these services is far more complex than an appraisal of the reasonableness of individual executives' compensation. The Wharton Report suggested the lower management costs of the internally managed companies may reflect the restraining influence of conventional limitations on executives salaries. But even here the restraints may have been weakened by the industry pattern of fees paid by the externally managed companies." \textit{Id.} (footnote omitted). Furthermore, in Meiselman v. Eberstadt, 39 Del. Ch. 563, 170 A.2d 720 (1961), Chancellor Seitz observed that a comparison between mutual fund advisory fees and compensation of salaried executives for similar services will not conclusively establish that a fee is excessive. \textit{Id.} at 567-68, 170 A.2d at 722-23.

\textsuperscript{65} PPI, \textit{supra} note 7, at 128. "With respect to the information requirements of the Investment Company Act, shareholders receive considerable factual data in mutual fund prospectuses and reports, and in whatever information is provided them by mutual fund salesmen. Whether this provides them with an adequate basis for evaluating performance, management fees, and the disposition of brokerage business, in the absence of some framework for appraisal (including comparative information) is an open question. It is also possible that in spite of the information provided, mutual fund shareholders are led by the structure of formal relationships into supposing that their fund is a truly independent organization, whose officers and directors negotiate at arm's length on their behalf with the investment adviser in fixing fees, deciding on brokerage allocations, continuing his services based on an appraisal of the adequacy of performance, etc." Wharton Report, \textit{supra} note 10, at 33 (footnote omitted).

\textsuperscript{66} PPI, \textit{supra} note 7, at 97; see note 30 \textit{supra}.
obtained scaled down rates in 1965, fee reductions were not substantial because of concurrent increases in fund assets.

The SEC further determined that shareholder voting rights required by the ICA also proved to be an ineffective means by which investors could obtain savings on fees. The ICA requires shareholder approval of the advisory contract and its annual renewal by either the shareholders or the board of directors. Nevertheless, these ratification requirements do not give shareholders any practical control over the advisory fee. Shareholders can only ratify or reject advisory contracts already adopted by management. Because the fund derives its identity from the adviser, shareholders cannot ultimately reject the advisory contract. Moreover, shareholder rejection of a proposed contract pressures the adviser, directors and shareholders to reach agreement on a fee before the old contract expires, and potentially harms the fund because it might be left with no one to manage its investments. The ICA prohibits anyone from serving “as an investment adviser to a registered investment company except pursuant to a written contract.” Therefore, fund shareholders cannot, as a practical matter, use their voting rights to control directly the advisory fee rate because they may simultaneously jeopardize their own interests.

The ICA also provides for shareholder election of fund directors. This right, however, is also an inadequate means of controlling fees. Fund shares tend to be owned by more individuals and in smaller amounts than securities of other publicly held enterprises. Therefore, it is extremely difficult for fund share-

67. PPI, supra note 7, at 97-100.
68. Id. at 102.
69. Id. at 130. The SEC determined that “shareholder voting [rights] can serve as an important method of communication with management. Indications of shareholder dissatisfaction expressed in this way may play a significant role in influencing the actions of fund managers on many matters of policy. But shareholder voting rights cannot be used effectively to obtain departures from traditional fees that inadequately reflect the economies of size in the management of investment companies or with respect to other matters that affect so crucially the interests of the adviser and those who are affiliated with it.” Id.
74. PPI, supra note 7, at 129-30; Wharton Report, supra note 10, at 53-57. “The shares of stock of open-end companies are more widely distributed and less concentrated in ownership than those of most other types of financial and nonfinancial institutions of comparable size. In 1958 the median number of shareholders of open-end companies was almost 9,000; and in the case of only
holders to reach agreement or to collect sufficient votes to elect directors they choose as well as to adopt their own advisory fee proposals.

The role of independent directors of funds as a means of reducing advisory fees has also had questionable effect. The ICA required that at least forty percent of a fund’s board of directors not be directly or indirectly affiliated with the fund’s adviser. The provision for independent directors limited an adviser’s direct control over a fund by imposing adequate representation of shareholder interests on the fund’s board.

Typically, a fund’s independent directors are selected by the original organizers of the fund or its successive managements. As a result, independent directors are likely to feel obligated, or at least sympathetic, to the adviser, and therefore, they might be reluctant to challenge vigorously the adviser’s requests. Even if the independent directors are truly independent, however, they must rely on the adviser or persons employed by the adviser for the information.

3 of the 47 companies with assets exceeding $50 million was there a record owner holding as much as 5 percent of the outstanding shares. This wide distribution of mutual fund shares reflects the fact that they have been attractive to relatively small investors. Over two-thirds of the number of the largest shareholdings (those among the largest 20) of open-end companies were owned by individuals, for the most part directly, but also as beneficial owners of record holdings of trustees, nominees, and brokers.”

75. See note 13 supra.

76. The ICA requires that no more than 60% of the board of directors of a registered investment company be affiliated persons in the company. Investment Company Act § 10(a), 15 U.S.C. § 80a-10(a) (1976); see note 13 supra.

77. See note 13 supra.


81. The SEC general counsel has noted that “[t]he independent director is probably reluctant to exercise [his] power in a vigorous way, because, after all, it’s unpleasant to [reprimand] the people that he has worked with for years and likes and respects—and probably that’s the only reason that he’s on the board; he wouldn’t accept the job if he didn’t like and respect them.” Conference on Mutual Funds, 115 U. Pa. L. Rev. 663, 759 (1967) (statement of Philip Loomis); see Fund Hearings, supra note 14, at 768-69 (statement of Abraham Pomerantz).
about fund operations that is necessary for decisions that set fund policy. This dependence limits an independent director's ability to make informed decisions concerning the advisory fee. Furthermore, the independent directors do not have a realistic alternative to acceptance of the advisory contract sought by the adviser.

The possibility of disrupting the fund's operations, the prospect of a bitter and expensive proxy contest, and the risk and uncertainty involved in replacing the entire fund management organization with a new and untested one, make termination of the existing advisory relationship a wholly unrealistic alternative in negotiations over advisory fees. Without such an alternative, advisory fees negotiated between advisers and the unaffiliated directors lack the essential element of arm's-length transactions and provide inadequate assurance that the fees bear a reasonable relationship to the price at which similar services could be obtained in a genuinely competitive market.

Accordingly, the SEC proposed a standard designed to "measure the fairness" of adviser's fees. The SEC recommended that the ICA be amended to provide that compensation paid by the fund to any person affiliated with the investment adviser for advisory services be reasonable.

The conclusions and recommendations in the Wharton report and those of the SEC presented Congress with a comprehensive view of the inadequacies regarding mutual fund advisory fees inherent in the ICA. Beginning in 1967, Congress undertook a revision of the ICA to remedy the industry conditions that were adverse to fund and shareholder interests. Dissatisfied with the Saxe v. Brady standard of corporate waste or that of gross abuse of trust specified in the ICA, Congress considered a series of amendments that evolved into section 36(b). The amendment imposes a fiduciary duty on the adviser with respect to compensation received for its services. Congress intended this statutory duty

82. PPI, supra note 7, at 130-31. "They also have no staff of officers and employees who work for and are compensated by the fund. In most cases, even the fund's counsel is the adviser's counsel as well." Id. at 130.
83. Id. at 131.
84. Id. at 134.
85. Id. at 144. "Before arriving at its recommendations the Commission had considered carefully a number of other choices for providing such protections. These ranged from proposals for strengthening the existing safeguards of disclosure, shareholder voting rights and the role of unaffiliated directors to those for complete disaffiliation of the funds from their adviser-underwriters and the compulsory internalization of the management function. The former proposals were rejected as being wholly unrealistic, and, in the Commission's view, the latter appear too sweeping at this time." Id. at 147.
to provide an “effective means for the courts to act” when the SEC or investors allege that advisory fees are excessive.\(^8\) It remains to be seen, however, whether the amendment adequately satisfies the Congressional purpose.

\section*{II. Liability Under Section 36 of the ICA}

As enacted in 1940, section 36 of the ICA provided for SEC suits against officers, directors, members of any advisory board, investment advisers, depositors or principal underwriters who engaged in practices that constituted “gross abuse of trust.”\(^8\) Congress intended to remedy some of the instances of self dealing found to exist in the mutual fund industry, such as the organization and management of investment companies for the benefit of the adviser or the preferential treatment of associates of the fund’s adviser.\(^9\) In 1970, Congress designated the existing provisions of section 36 as subsection (a) and replaced the gross abuse of trust standard with a breach of “fiduciary duty involving personal misconduct.”\(^9\) Breach of this duty may result, among other things, in an injunction against the defendant that prohibits him from serving the mutual fund in whatever capacity he occupied.\(^9\) Moreover, Congress required that independent directors be disinterested regarding the adviser, rather than unaffiliated.\(^9\) The effect of this change was to “supply an independent check on management” by “stiffening the requirement of independence” when the “affiliated person” provision of the ICA appeared to be inadequate.\(^9\) The purpose of the amendment was to impose a stricter standard of care on the independent directors than had previously been required.\(^9\)

\begin{itemize}
  \item management fee amendments. Fund Hearings, supra note 14, at 188 (memorandum of Philip Loomis, Gen. Counsel, SEC). Although no one objected to the basic proposition that management fees should be reasonable and that the bill should change the standard of gross abuse of trust in § 36 to a more realistic standard, industry members felt that the fiduciary standard would adversely affect the quality of fund management by forcing advisers to lower their fees and remove their incentive to encourage fund growth. Id. at 531 (statement of Raymond Cocchi). They also feared that the standard would create too much litigation over fees. Id. After discussing the matter with investment industry representatives, the SEC drafted and submitted H.R. 1199s, S. 2224, 91st Cong., 1st Sess. (1969), reprinted in Fund Hearings, supra note 14, at 4-59, which contained the fiduciary duty standard rather than the requirement that compensation for advisory services be reasonable.
  \item 89. See note 17 supra and accompanying text.
  \item 91. Section 36(a) provides in pertinent part: “If such allegations are established, the court may enjoin such persons from acting in any or all such capacities either permanently or temporarily and award such injunctive or other relief against such person as may be reasonable and appropriate in the circumstances, having due regard to the protection of investors and to the effectuation of the policies . . . of this title.” Investment Company Act § 36(a), 15 U.S.C. § 80a-35(a) (1976).
  \item 92. See note 15 supra.
  \item 94. Independent Directors, supra note 80, at 574.
\end{itemize}
Congress also added section 36(b) to the ICA which specifies that the SEC or any shareholder may bring an action on the fund's behalf against the investment adviser as well as against any officer, director, member of any advisory board, depositor, or principal underwriter of the investment company who, under the circumstances, may also have a fiduciary duty in respect to the payments received by the adviser. When it reported the section to Congress, the Senate Committee on Banking and Currency noted that "[t]he fiduciary duty of the . . . adviser is extended not only to compensation paid to the investment adviser but also to payments made by the investment company or its shareholders to an affiliated person." Congress, therefore, intended to provide a "remedy if the investment adviser should try to evade liability by arranging for payments to be made not to the adviser itself but to an affiliated person of the adviser." Furthermore, an affiliated director of the fund who is also an officer of the adviser can be liable to the fund under section 36(b) because the salary he receives as an officer of the adviser can be traced to advisory fee payments by the fund. Nevertheless, although the scope of this duty is broad, Congress barred its application to actions maintained against anyone other than a recipient of compensation for advisory services.

In contrast to the broad application of section 36(b), damages recoverable for breach of that fiduciary duty are limited. The fund can only recover "actual damages resulting from the breach of fiduciary duty," and the damages may not exceed the amount of payments received by the defendant. The requirements serve the traditional remedial goals of restitution and restoration by returning to the investors any of the adviser's unjust enrichment caused by his breach of duty.

The fiduciary standard set forth in the 1970 amendments provides mutual fund shareholders with sufficient safeguards to protect their interests in advisory fee negotiations in three ways. First, the legislative history of section 36(b) makes it clear that an investment adviser must deal with fund shareholders as if they were at arm's length. The report of the hearings before the House Subcommittee on Commerce and Finance, which considered the proposed ICA amendments, stipulates that a fiduciary may not use his power to benefit himself at the expense of shareholders "no matter how meticulous he is to satisfy technical requirements." By imposing this responsibility on investment advisers and their

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97. Id.
98. Id.
101. Id.
103. Fund Hearings, supra note 14, at 190 (memorandum of Philip Loomis, Gen. Counsel, SEC (quoting Pepper v. Litton, 308 U.S. 295, 311 (1939))). See also Geddes v. Anaconda Copper Mining Co., 254 U.S. 590 (1921); Meinhard v. Salmon, 249 N.Y. 458, 164 N.E. 545 (1928). Significantly, both Congress and the SEC recognized that advisers owed a fiduciary obligation to
affiliates, Congress undoubtedly intended that advisers must deal fairly with shareholders. 104

Second, the language of section 36(b) shifts the focus of any fee litigation from the fund's directors to the amount of the fee received and the adviser's role as a fiduciary. This change in perspective, although not an insulation of the fund's directors from liability under section 36(b), 105 ensures that litigation will test the fairness of the advisory fee regardless of the directors' approval. 106 Moreover, this policy shift represents an affirmative attempt to depart from the unsatisfactory results of Saxe v. Brady, 107 Meiselman v. Eberstadt, 108 and Acampora v. Birkland. 109

Third, shareholders receive protection under the 1970 amendments because their ratification of the advisory contract is now only one of several factors to be considered by the court in adjudicating the fairness of an advisory fee. 110 This change precludes the result reached in Saxe v. Brady 111 and requires the court to examine all services rendered to the fund in exchange for the adviser's fee. 112 Therefore, when the "package" of services provided to the fund by an adviser and its affiliates is too complex for an effective evaluation by the shareholders, 113 the court may weigh their ratification of the advisory contract and can disregard it entirely to determine the fairness of the fee.

III. EFFECT OF THE FIDUCIARY STANDARD ON THE DETERMINATION OF WHETHER THE ADVISER'S FEE IS FAIR

Although the fiduciary concept is firmly established in the common law, the effect of this standard on the amount of an advisory fee is an open question. 114 The courts that have interpreted the amended statute have ruled that

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104 Fund Hearings, supra note 14, at 189 (memorandum of Philip Loomis, Gen. Counsel, SEC).
105 Id.
106 Id.
107 40 Del. Ch. 474, 184 A.2d 602 (1962).
110 Fund Hearings, supra note 14, at 188 (memorandum of Philip Loomis, Gen. Counsel, SEC).
111 40 Del. Ch. 474, 184 A.2d 602 (1962).
112 Fund Hearings, supra note 14, at 188 (memorandum of Philip Loomis, Gen. Counsel, SEC).
113 PPI, supra note 7, at 128.
the section 36(b) standard incorporates the common law standard for fiduciaries, and thus, the adviser owes his undivided loyalty to the fund he serves. Courts still must decide, however, when a fee is excessive, or whether a fee that was initially reasonable has become excessive, and therefore, breaches the fiduciary duty merely because the fund's assets have grown. A court can either examine the dollar amount of the fee alone and determine if it is reasonable for advisory services in the industry, or scrutinize the procedure by which the fee was determined.

When the analysis of a claim that the advisory fee is excessive is limited to a consideration of the dollar amount of the fee, Congress' intention to provide an effective test of the fee's fairness will not be satisfied. Such a limited analysis does not permit an evaluation of the advisory fee beyond questioning whether the fund's directors followed reasonable business judgment in approving the fee. To follow the business judgment standard for the examination of the dollar amount of the fee, a court must validate the advisory fee if "ordinary businessmen might differ on the sufficiency of the terms." This analysis does not delve as deeply as the fiduciary standard into whether a fee is excessive because fund directors sometimes breach their section 36(b) responsibility even though they reached a reasonable business judgment about the adviser's fee. For example, in Galfand v. Chestnutt, the district court reasoned that the interested directors were not "improperly motivated" in their desire to improve the adviser's profits by reducing the possibility of a rebate to the fund. Nevertheless, the court held that "to do so without full disclosure [to the unaffiliated directors] and discussion of [the adviser's] financial condition . . . was inappropriate."

Following the business judgment rule, the district court in Galfand would have been precluded from finding that the interested directors breached their section 36(b) duty because the court first concluded that their action was reason-
Furthermore, to review the directors' business judgment, the court must compare the contested rate or dollar amount to those of other mutual funds. If a court makes this comparison and holds that an adviser's fee is excessive, it must assume that all advisory fees for all funds are excessive at that amount or higher, regardless of the differences in the various funds' investment policies and service requirements. In enacting section 36(b), however, Congress recognized that advisory fee levels at which a breach of fiduciary duty occur cannot be defined specifically due to the variations among mutual funds. A comparison of the fees alone, therefore, does not determine the fairness of the challenged advisory fee.

Alternatively, a court might scrutinize all of the facts that relate to the determination and payment of the adviser's fee. This type of analysis, which was contemplated by Congress, avoids the shortcomings of the purely mathematical approach. As stated by the SEC General Counsel in 1969, the factors that should be considered under this preferred evaluation of the fee include: (1) "[t]he nature, quality and extent of the service to be rendered"; (2) "the extent to which economies of scale and common management [in the case of a fund complex] were shared with the fund"; (3) whether "comparable charges [were] made by the adviser" to other investors and whether those charges are prevalent within the fund industry; (4) "the value of all other benefits

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128. See id.
132. Fund complexes are groups of funds which have different types of investment policies and are under a common management. PPI, supra note 7, at 47. For example, Merrill Lynch, Pierce, Fenner & Smith, Inc. sponsors Merrill Lynch Ready Assets Trust, Merrill Lynch Municipal Bond Fund, Merrill Lynch Special Value Fund, Inc., and CMA Money Trust. Not only do these funds share the same Merrill Lynch advisers, see note 71 supra, but their investment objectives often overlap. For example, Ready Assets and CMA invest in short term U.S. Government securities, bank certificates of deposit, and short term corporate debt securities. Ready Assets Prospectus, supra note 15, at 2; CMA Prospectus, supra note 71, at 6. MBF invests in state, municipal and public authority bonds, MBF Prospectus, supra note 71, at 3, and Special Value invests in a diversified portfolio of securities of small and emerging growth companies in an effort to provide fund investors with long term growth of capital. Special Value Prospectus, supra note 15, at 2. "Fund complexes enable a mutual fund adviser to reach a broader cross section of potential investors and to offer each investor the opportunity to apportion his aggregate mutual fund investment among several funds with different investment objectives all managed by the same adviser." PPI, supra note 7, at 47. Although complexes may cause substantial economies of size to accrue to the fund managers due to overlapping portfolios and common investment advice for the various funds in the complex, advisory fees "seldom give express recognition to these economies on a complex-wide basis." Id. at 108.
133. Fund Hearings, supra note 14, at 188 (memorandum of Philip Loomis, Gen. Counsel, SEC).
134. Id. Wharton observed that "[a]dvisory fee rates charged mutual funds tended to be
received" by the fund;135 (5) whether the directors approved and the shareholders ratified the advisory fee agreement;136 (6) whether there was complete and effective disclosure of all pertinent information by the adviser;137 and, (7) whether the deliberations of the directors were a matter of substance or a mere formality.138 By examining these factors a court can determine the fairness of the adviser's fee in light of all the circumstances surrounding its incorporation into the advisory contract.

When a fund does succeed in achieving its investment objectives, the performance of the fund tends to support a finding that an advisory fee is fair. If the success and growth of the fund occur for reasons other than the advisory skills of the adviser, however, the fee should be subjected to closer inspection. Scrutiny is necessary because these factual situations give rise to economies of size139 that should, to some extent, be passed on to the shareholders.140 The existence of lower fees paid by investors in funds of a similar size or those paid by investors to

substantially higher than those charged by the same advisers to the aggregate of their clients other than investment companies, for comparable asset levels. In 45 percent of the cases examined of mutual fund advisers with other clients, the effective fee rate charged mutual funds was two or more times that of the aggregate of other clients. Advisory fee rates of mutual funds also tended to exceed substantially the effective management costs of open-end companies without advisers. Adviser rates to open-end companies were also found to be less flexible in relation to size of assets managed than rates charged other clients (as well as the effective management costs of companies without advisers)." Wharton Report, supra note 10, at 29 (footnotes omitted). Furthermore, Wharton noted that the higher rates charged fund clients did not "appear to be a consequence of extensive services rendered to, or expenses incurred on behalf of, mutual funds." Id. Wharton based this conclusion on "the fact that fee rates charged open-end companies were frequently relatively high even where the expenses absorbed by the adviser were small" and "the fact that, with comparable services provided to mutual funds without investment advisers, management costs tended to be lower." Id. (footnotes omitted). The most decisive factor, however, was that "[e]xpenditure ratios were found to be sharply higher for those advisory firms which received income from both investment company and other clients. . . . [X]pense ratios increased with increases in the proportion of total income received from noninvestment company clients for most size classes of assets managed." Id. (footnotes omitted).

139. PPI, supra note 14, at 188; Wharton Report, supra note 10, at 30.
140. Fund Hearings, supra note 14, at 188 (memorandum of Philip Loomis, Gen. Counsel, SEC); Wharton Report, supra note 10, at 30.
advisers for analogous services is some evidence that the contested fee is unfair. The court should also consider any other benefits and services that the adviser provides to the fund in exchange for the advisory fee. "These include brokerage services, safekeeping of . . . securities . . . , receipt and delivery of securities . . . , receipt of dividend and interest income, [and preparation of] proxy material . . . ." In addition, some funds provide benefits such as retirement plans and checking privileges. These services vary from fund to fund and their relative values should be reflected in the advisory fee.

The fiduciary duty imposed by section 36(b) provides a measure of fairness for plaintiffs and defendants in advisory fee litigation. Moreover, a comprehensive test for the breach of that duty allows shareholders to challenge the advisory fee despite prior shareholder ratification when other circumstances provide evidence of overreaching by the fiduciary. This test also recognizes, however, that the adviser has a right to make a profit from its contract with the fund. Even large profits for the adviser may be essential to the continued growth and wellbeing of a mutual fund because they serve as incentives for the adviser to maintain diligent management practices.

Conflict between these interests occurs, for example, when a potential investor who read the fund's prospectus to learn the rate of advisory compensation purchases fund shares. If the fund's net assets increase greatly during the year for which that rate is effective, the adviser will undoubtedly receive a much larger fee than he did in the previous year. In a derivative suit in which the shareholder alleges that the fee is excessive, the court must decide whether the fee has become so large that the initial shareholder approval is now insignificant. This problem can be resolved by examining the nature, quality and extent of the advisory services. When the fund grows large because the adviser carefully selected and managed the fund's portfolio, it seems inequitable to allow shareholders who originally approved of the rate of compensation and who have benefited from the fund's growth to later challenge its success. This is especially so if the adviser and the affiliated directors fully disclosed all

141. Wharton Report, supra note 10, at 29; PPI, supra note 7, at 97.
142. PPI, supra note 7, at 86.
143. See, e.g., Ready Assets Prospectus, supra note 15, at 21-23.
144. See, e.g., id. at 15-16.
148. Section 15(a)(2) provides that an advisory contract continuing in effect for more than two years from the date of its execution must be approved at least annually by the directors or by the shareholders. Investment Company Act § 15(a)(2), 15 U.S.C. § 80a-15(a)(2) (1976).
149. Such a phenomenon may occur with the Ready Assets Trust. As of December 31, 1978, Ready Assets had net assets of over $1.6 billion. Ready Assets Prospectus, supra note 15, at 34. On February 27, 1980, however, the fund's net assets totalled $10.66 billion. N.Y. Times, Feb. 29, 1980, § D, at 6, col. 6. Therefore, even though the fee breakpoints and the expense ratio limitation, see note 15 supra, may provide some abatement, the dollar amount of the advisory fee payable by the fund has increased significantly in the last year.
150. See note 126 supra.
material facts, and if the adviser did not exert any improper influence upon the independent directors during negotiations of the fee. The same is true when a fund shareholder votes in favor of the rate agreed upon by the directors and the adviser. On the other hand, the SEC observed in 1966 that many funds achieve substantial fund growth through the sale of fund shares rather than through a capital gain in the value of portfolio holdings. In some cases a fund's investments represent less than one hundred percent of the fund's net assets, and therefore, the adviser has a smaller portfolio to manage than most shareholders might believe. Thus, when the fund grows due to factors other than the quality of the advisory services, a court should be more inclined to conclude that a relatively larger fee is unfair despite shareholder ratification of the advisory contract.

It should also be noted that under the proposed analysis disclosure of the pertinent information required by the ICA is another factor that a court must consider. The criteria for adequate disclosure under section 36(b), have already been established by the courts. In Fogel v. Chestnutt, for example, the Second Circuit ruled that the adviser is required to disclose information to the unaffiliated directors whenever there is a possible conflict between the director's interests and those of the fund and its shareholders. The information disclosed must also be sufficient to enable the directors "to participate effectively in the management of the investment company." To satisfy this requirement the

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151. See PPI, supra note 7, at 95; Wharton Report, supra note 10, at 405-08. Wharton questioned "whether there may not be a conflict of interest between mutual fund shareholders and their investment adviser in respect of the effort that should be devoted to selling shares. The benefits to the adviser of more or less indefinite growth by intensive selling are fairly obvious. Without a scaled management fee rate the advantage of such growth to the shareholders in the form of cost reductions is sharply restricted. A priori it has been argued that shareholders benefit from increased diversification of risk and the ability of the adviser to afford more substantial facilities and able personnel; but it has been pointed out on the other side that small or moderate-sized portfolios contribute to flexibility of portfolio adjustments in the light of changing circumstances." Wharton Report, supra note 10, at 31 (footnote omitted).

152. Presumably, the shareholders expected at the time of ratification that the fee was to serve as consideration for the investment advice to be rendered. "With respect to the performance of mutual funds, it was found that on the average, it did not differ appreciably from what would have been achieved by an unmanaged portfolio consisting of the same proportions of common stocks, preferred stocks, corporate bonds, Government securities, and other assets as the composite portfolios of the funds. About half of the funds performed better, and half worse, than such an unmanaged portfolio. While it might be expected that investors would be willing to pay higher prices in the form of management fees or sales charges for those funds with the better performance records, no relationship was found between performance and the amount of the management fee or the amount of the sales charge. It follows, on the basis of this evidence, that investors cannot assume that the existence of a higher management fee or a higher sales charge implies superior performance by the fund." Id. at x-xi.


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adviser must disclose any matter "that could be thought to be of possible significance." Although disclosure might be considered the "keystone" of federal securities laws, it should not be overemphasized in relation to the other factors that make up an evaluation of advisory fees. As Chief Judge Kaufman stated for the Second Circuit in Galfand v. Chestnutt Corp.: "[E]ven where a fiduciary has made full disclosure, it is the duty of a federal court to subject the transaction to rigorous scrutiny for fairness."

An extension of the disclosure requirements for information contained in prospectuses and shareholder proxies also merits consideration. Specifically, investment advisers should be required to disclose the dollar amounts of the fund's advisory fees for at least three years prior to the date of the prospectus or proxy in addition to the current rate of the advisory fee. Shareholders will then be able to consider changes in the fee the fund pays from year to year and to assess the returns on their investments in light of those changes. Such information is especially valuable to investors when advisory fees increase progressively in dollar value due to fund growth, even if the board lowers the percentage rate to give the shareholders the impression that the fee is being decreased.

Under the suggested analysis, a court may also examine the fund directors' diligence during deliberations over the advisory fee submitted by the adviser for their approval. Judge Friendly stated the guideline with which to measure the directors' deliberations in Fogel v. Chestnutt:

The minimum requirement to enable the fund's independent directors to discharge their fiduciary duties . . . [is] a careful investigation of the possibilities performed with an eye eager to discern them rather than shut against them, and, if these possibilities were found to be real, a weighing of their legal difficulties and their economic pros and cons.

Assuming that the directors meet the Fogel test, they are further required to arrive at a reasonable business judgment.

CONCLUSION

In advisory fee litigation, the court should reject any contention that the fee is so excessive that it alone constitutes a breach of fiduciary duty. Instead, it should analyze the advisory contract in light of all the circumstances. Only in this way can the court provide both the fund and its adviser with a fair test, conducted in accordance with the Congressional intent behind the Investment Company Act.

Angelo G. Savino

158. PFI, supra note 7, at 127.
160. Id. at 811-12.
161. The reason for the fund's growth must also be considered. See notes 140-42 supra and accompanying text.
162. 533 F.2d 731 (2d Cir.), cert. denied, 429 U.S. 824 (1975).
163. Id. at 749-50.