Supreme Court watch - Pay caps

An upcoming case will provide the first glimpse into how the justices feel about capping compensation.

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(Fortune Magazine) -- Even as the Obama administration is unveiling plans to impose unprecedented pay caps on top officials at the seven U.S. companies receiving the largest federal bailouts, the U.S. Supreme Court is preparing to hear a case that turns on whether to apply analogous pay caps on certain financial advisers.

Even more important, the court's ruling in the case known as *Jones v. Harris Associates* -- being argued November 2 -- will provide insight into how the current roster of justices view the economic question of our day: When should market forces be reined in by government?

Typically, when directors pay a CEO a suspiciously bloated salary, the action raises only state-law questions, not warranting the Supreme Court's attention.

The upcoming case, however, raises a closely analogous issue that does happen to be controlled by federal law: What happens when ostensibly independent directors of a mutual fund approve bloated fees for the fund's financial adviser -- the same adviser who most likely created the fund and, in most cases, still oversees it? (A 1970 amendment to the federal Investment Company Act imposes a fiduciary duty on fund advisers not to accept excessive compensation and empowers investors to enforce that duty in court.)

The facts of the case are these: In 2004 investors in three Oakmark mutual funds -- which had, ironically, each just completed three years of stellar performance -- sued the funds' adviser, Harris Associates, for allegedly accepting too much in fees during that time. (The investors' law firm also brought similar cases against 11 other leading fund advisers, including those for American Century, Fidelity, Janus (JNS), and Putnam.)

Citing the fact that Oakmark's fees had been fully disclosed and were well within industry standards -- roughly 1% of assets for the first $2 billion invested -- the district judge threw the case out before trial in 2007.

Last year the federal appeals court in Chicago affirmed that decision. U.S. Circuit Judge Frank Easterbrook, one of the most eminent jurists of the conservative Chicago School of Law and Economics, explained his ruling bluntly: "A fiduciary must make full disclosure and play no tricks but is not subject to a cap on compensation." Ho-hum.

Then things took a turn toward the extraordinary. In August 2008, when the full Seventh Circuit Court of Appeals declined to rehear the case, five judges signed a rare dissenting opinion. More remarkable still, the dissent was authored by Judge Richard Posner, another towering intellect of the free-market Chicago school.

Perhaps undergoing a mid-financial-crisis crisis, Posner urged that market forces could not be trusted in this situation. In his view Judge Easterbrook's analysis was "ripe for reexamination" because of the "feeble incentives of boards of directors to police compensation." He stressed that Harris charged mutual fund investors roughly twice what it charged independent institutional investors.

Seeing the deep rift within the Seventh Circuit and a conflict with other circuit court rulings, the Supreme Court snatched the case up in March.

Even aside from its implications for CEO pay, *Jones v. Harris Associates* directly affects the $10 trillion mutual fund industry in which 92 million investors participate. At least 14 outside groups have filed friend-of-the-court briefs.

Jones's supporters include Vanguard founder John C. Bogle, AARP, and the U.S. Securities and Exchange Commission. Rooting for Harris Associates, on the other hand, are various industry trade groups and the libertarian Cato Institute.

We're wagering that the court will reject Judge Easterbrook's view -- that virtually any fee, so long as it's disclosed, is okay -- but still won't find Oakmark's fees to have been illegally out of whack.

Of greater interest will be the straw poll of the Supreme Court's views on laissez-faire capitalism itself. Is it, too, "ripe for reexamination"? ■