Questions about fees land mutual funds before Supreme Court

By John Waggoner, USA TODAY

Every once in a while, someone you don't expect to see in court — a friend, a neighbor, your senator — winds up in front of a judge. Monday, you'll see the mutual fund industry hauled into court. And not just any court: the Supreme Court.

The case is *Jones v. Harris Associates*, and at issue is whether funds are treating their shareholders fairly when they set their fees. The plaintiffs argue that funds charge individual investors far more than they do institutional investors, such as pension plans. The fund industry points to fierce industry competition, longstanding practices and legal precedent to justify its fees.

BACKGROUND: Key arguments about the fund fee case

Few expect the Supreme Court to force mutual funds to revise the way they set their fees, which could lead to a raft of additional lawsuits and refunds to some of the industry's 93 million investors. But the fact that the case made it all the way to the nation's top court is significant: The court doesn't take cases lightly.

Despite frequent criticisms that fees in the $10.6 trillion industry are too high, funds routinely swat down shareholder lawsuits about high fees. But even if the Supreme Court rules for the fund industry, *Jones v. Harris Associates* is a landmark case.

"This could be a crack in the facade for the industry," says industry veteran Dan Calabria, a former executive and director at several fund groups.

Jones v. Harris Associates was brought by three shareholders against the Oakmark Funds, which are advised by Harris Associates, a Chicago fund adviser. At the heart of the case is how Harris — and most of the fund industry — sets its fees.

A mutual fund is owned by its shareholders; advisers like Harris Associates manage the assets. Technically, the fund's board of directors reviews the choice of management company each year and chooses the adviser. In reality, however, the directors rarely boot the management company. If a shareholder doesn't like how the fund is run, his best recourse — often his only one — is to vote with his feet and go to another fund.

The directors also decide how much the fund adviser gets paid. Mutual funds charge fees for their services, which are generally shown as a percentage of the fund's assets and called the expense ratio. For example, the American Funds' Growth Fund of America A has $63.9 billion in assets, according to Lipper, which tracks the funds. The fund's expense ratio is 0.621%, which means it takes roughly $397 million each year in fees. The money goes to mundane expenses, such as salaries and office space, as well as for servicing shareholder accounts, wooing big customers and, of course, to generating profit for Capital Research and Management, the fund's adviser.

As expense ratios go, the Growth Fund of America's is pretty low: The average stock mutual fund charges about 1.5% a year. But by all accounts, the fund industry is wildly profitable. T. Rowe Price, for example, has a profit margin of 17.5%, and Franklin Resources has a profit margin of 19.4%.

Jones v. Harris centers around the fact that fund companies typically charge institutions, such as pensions and 401(k) plans, far less than they do ordinary investors. The lawsuit alleges that, because Harris accepts much lower fees from big investors, its fees to its ordinary shareholders are excessive.

The arguments

So what makes a fee excessive? Since 1982, a two-part legal test has been used to determine if fund fees are excessive. It was created out of a lawsuit,***Gartenberg v. Merrill Lynch Asset Management.*** The test is whether the fund's fees are similar to what would be negotiated with a similar outside fund and whether the fees are not so large that they bear no resemblance to the services offered.

Shareholder advocates, such as John Bogle, founder of the Vanguard Group, say that funds are bound by their fiduciary duty to shareholders to keep fees as low as possible. And "fiduciary duty" has a special meaning in financial law. Fiduciaries must act in the best interest of their charges — in this case, the shareholders. Any fees must be fully and fairly disclosed, although there are no caps.

But low fees are in the best interest of shareholders. Over time, fees can wipe out big chunks of a fund's return. For example, consider two funds, each of which earn an average 8% a year for 20 years. One charges 0.5%; the other 1.5%. After 20 years, a $10,000 investment in the low-cost fund will be worth $42,480 vs. $35,240 for the other.

And here's where the problems start. Fund advisers owe it to their owners to make as much money as possible, which they do by collecting fees. But fund directors owe it to shareholders to keep fees. Making the problem more complicated: In most funds, some directors (but not a majority) work for the adviser.

The outcome

Both sides have amassed legal firepower as friends of the court.

On the funds' side: The Investment Company Institute, the Cato Institute (a conservative think tank), the Mutual Fund Directors Forum, Fidelity Management & Research, the Securities Industry and Financial Markets Association, the U.S. Chamber of Commerce and several law professors. Opposing them: The U.S. Justice Department, the North American Securities Administrators Association, AARP, the Consumer Federation of America, several law professors and John Bogle.

Guessing the outcome of any Supreme Court case is risky business, and the court won't publish its verdict for months. Should Harris Associates win, little will change. Should the plaintiffs win, the case is likely to be pushed back to the 7th Circuit Court, from which it was appealed.

"I don't think it will be a black-and-white decision where *Gartenberg* is thrown out," says Burt Greenwald, a Philadelphia-based fund consultant. It could be that the Supreme Court orders funds to disclose more about how they spend their fees.

Funds often say those costs are hard to break down, but Phillips is skeptical that they don't keep track of every penny. They just choose not to disclose all their expenses. "That would be fine if they owned the funds," Phillips says. "But they don't. You and I own the funds."