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FUND PROFITABILITY IN MUTUAL FUND FEE LITIGATION

In approving the Gartenberg *standard for appraising the reasonableness of investment advisory fees, the Supreme Court in* Jones *included in the list of factors "the profitability of the fund to the advisor." The authors nevertheless argue that neither the statute, nor the legislative history, nor case law compels the assessment of individual fund profitability in a fund complex, and that such calculations are of limited value because they depend on disputed cost allocations that require great effort and lead to widely differing results. They recommend calculations limited to complex-wide margins.*

By Sean M. Murphy and James G. Cavoli *

In *Jones v. Harris Associates L.P.*,[1] the Supreme Court endorsed the standard for liability under Section 36(b) of the Investment Company Act of 1940 first announced in 1982 by the Second Circuit Court of Appeals in *Gartenberg v. Merrill Lynch Asset Mgmt., Inc.*[2] The Court held:

> [W]e conclude that *Gartenberg* was correct in its basic formulation of what § 36(b) requires: to face liability under § 36(b), an investment adviser must charge a fee that is so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been the product of arm's length bargaining.[3]

By the time *Jones* was decided, the majority of courts that addressed Section 36(b) claims not only employed the *Gartenberg* standard, but also utilized several specified factors identified in the case law to aid in determining liability. Among the list of factors – which were cited in *Jones*, though not discussed in any detail – is "the profitability of the fund to the adviser."[4]

With respect to the so-called "profitability" factor, courts and litigants have for many years attempted to

[1] 130 S. Ct. 1418 (2010).

[2] 694 F.2d 923 (2d Cir. 1982).

[3] *Jones*, 130 S. Ct. at 1426.

[4] *Id* at 1425-26 & n.5. Other factors include: (1) the nature and quality of the services provided to the fund and shareholders; (2) the extent to which an adviser realizes economies of scale as a fund grows larger; (3) any "fall-out financial benefits," which are collateral benefits that accrue to the adviser because of its relationship with the mutual fund; (4) comparative fee structures; and (5) the independence, expertise, care, and conscientiousness of the board in evaluating adviser compensation. These factors are not exclusive, as "all pertinent facts must be weighed" in determining liability. *Id.*

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calculate and assess individual fund profitability in excessive-fee cases under Section 36(b). Likewise, outside of litigation, many mutual fund advisers and boards of trustees expend significant resources grappling with such data as part of the annual approval of mutual fund management contracts.

But, as discussed in more detail below, the value of fund-level profitability – either in the board room or the court room – is an oft-debated issue. Nearly without exception, determining the profitability of an individual mutual fund requires the allocation of numerous and substantial shared costs given the structure, product offerings, and nature of modern mutual fund complexes. Cost allocations typically can be performed using any number of different reasonable methodologies, but the methodology chosen may have a material impact on the resulting profit figures. Thus, such figures rarely establish the actual profitability of a given fund and arguably provide a questionable foundation on which to base decisions – whether business or legal.

In addition to the limited empirical value of profit figures based on cost allocations, there is no express requirement in Section 36(b) that fund-level profitability be analyzed, and the legislative history does not suggest otherwise. The practice of assessing fund-level profitability appears to have developed based on certain judicial opinions. Even among those courts that have analyzed and relied on fund-level profitability in assessing Section 36(b) claims, however, none have squarely held that such an undertaking is required. Indeed, many such courts have openly questioned the value of fund-level profit figures, and reliance thereon may have occurred simply because the litigants in those cases chose to present fund-specific profit figures and nothing else.

While the Court in *Jones* reiterated the frequently quoted profitability factor – *i.e.*, "the profitability of *the fund* to the adviser" (emphasis added) – it never addressed the factor in any detail. However, in various *amicus* briefs submitted in *Jones*, advocates for both the plaintiffs' and defense bar agreed that individual mutual fund profit data are of little value in assessing liability under Section 36(b). This rare accord might be an indicator that the use of fund-level profitability is ripe for reexamination. More aggregated profitability information that has fewer cost allocations – *e.g.*, margins derived from company-wide, complex-wide, or division-wide revenues and costs, or from other higher-level organizational viewpoints – appears to be a more reliable basis for assessing profitability.

THE ORIGIN OF THE PROFITABILITY FACTOR

The Legislative History

Nothing in the text of the statute[5] or its legislative history mandates that fund-level analysis of profitability be undertaken. Moreover, some of the most frequently quoted legislative history strongly suggests that Section 36(b) should not be used as a vehicle to regulate profitability.

In debating Section 36(b) before it was enacted, Congress explicitly recognized that "the investment adviser is entitled to make a profit. Nothing in the bill is intended to imply otherwise . . . ."[6] Congress rejected the notion that Section 36(b) should operate in the manner of a "cost plus" regulatory regime: "Nothing in the bill is intended to . . . suggest that a 'cost-plus' type of contract would be required. It is not intended to introduce general concepts of rate regulation as applied to public utilities."[7]

This is not to say that adviser profit levels were not a subject addressed by the Congress during its debate. In December 1966, the SEC issued its *Report on the Public Policy Implications of Investment Company Growth*. The "primary function" of this report, which was made

[5] Section 36(b) provides, in pertinent part, that "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." 15 U.S.C § 80a-35(b).

[6] S. Rep. No. 184, 91st Cong., 1st Sess., *reprinted in* U.S.C.C.A.N. 4897, 4902.

[7] *Id*.

part of the Congressional Record, was "to examine the present adequacy of the protections afforded by the Investment Company Act of 1940 . . . to those millions of Americans . . . who have chosen to entrust billions of dollars of their savings to the investment company industry."[8] The report spans nearly 350 pages and covers myriad topics, one of which is adviser profit margins.

Using data from the early 1960s, the Commission purported to have identified:

- pretax profit margins for 14 advisory organizations with at least $250 million under management. These figures reflected profits from *all* business operations of a given adviser and ranged from 68.5% to -14.3%, with a median of 42.6%;

- pretax profit margins for 10 large adviser-underwriters stemming solely from mutual fund distribution and advisory activities. These figures reflected profits from the operation of *all* mutual funds by a given adviser, and ranged from 4.3% to 71%, with a median of 45.6%.[9]

The Commission cited these figures, among other things, in support of its position that "the operating expenses of mutual fund advisory organizations do not require the maintenance of the present level of advisory fee rates."[10]

Thus, while profits were a topic of discussion during the congressional debates, there was no discussion of *fund-level* profits. Some of the figures reflected profits from overall business operations of a given adviser, which could include mutual fund and non-mutual fund advisory activities, and even operations unrelated to advisory work. To the extent that some of the profit data were limited to mutual fund activities, multiple funds were often aggregated. In short, nothing in the legislative history indicates that fund-level profitability was of particular import or that it should be an area of focus under Section 36(b). To the extent the legislative history supports looking at profitability, it is consistent with examining aggregated cost data, such as combined profitability of all business operations or all mutual fund operations.

Further, Congress apparently accepted the premise that mutual fund advisory companies, which often build mutual funds from the ground up and shoulder significant business risk in doing so, should be compensated for taking on such risk, beyond strict remuneration for providing services to a fund on a day-to-day basis, *e.g.*, advisory, trading, administrative, transfer agent, accounting, legal, and distribution services. As one House representative put it, "[w]e are accepting the fact that [advisers] should have some entrepreneurial profit, for those who have been successful in starting and building an investment vehicle. We recognize . . . that the creation and the building of a fund does involve certain risks, and that those who are successful are entitled to some reward."[11] This recognition seems to cast doubt on the propriety of assessing profitability at the individual fund level. The vast majority of advisory companies today manage multiple funds, sometimes hundreds, and the demise of some funds and introduction of others is not uncommon. Many advisory companies also offer non-mutual fund financial products and services within the broader financial services industry. In such cases, a narrow focus on the "profit" generated by a *single* fund simply because that fund is the target of a Section 36(b) claim arguably does not present a complete picture of the risks taken and rewards recognized by the adviser.[12]

The Case Law

Judicial opinions construing Section 36(b) fully endorse the principles that investment advisers are entitled to make a profit and that 36(b) is not a "cost-plus" statute. The trial court in *Gartenberg*, for example, held that an adviser "and its affiliates are entitled to recoup their costs and to make a fair profit without having to fear that they have violated Section

[8] Cover Letter to 1966 Report at VII.

[9] 1966 Report at 121-23.

[10] In addition, one Congressman introduced data comparing earnings as a percentage of stock holder equity for 14 mutual fund advisory companies against earnings as a percentage of equity for the 25 largest banks and 25 largest stock life insurance companies in 1966. H.R. Hearings, Committee on Interstate and Foreign Commerce, 90th Congress, 1st Sess., H.R. 9510, H.R. 9511 at 682-684 (Oct. 16-18, 23-24, 1967).

[11] *Id*. at 688.

[12] A fund's high profitability would not support a finding of excessive fees given that Section 36(b) was not intended to prohibit advisers from making a profit. Similarly, where a small fund has low profitability or suffered losses for a number of years, an adviser should not be attacked for charging purportedly "excessive" fees if the profit margin increases as the fund matures. At a minimum, the legislative history supports that the adviser be given credit for having shouldered the entrepreneurial risk and financial losses in the fund's earlier years.

36(b)."[13] Indeed, it is well established by now that "high" profitability cannot alone give rise to a violation of Section 36(b).[14]

Still, profitability is one of six factors – often called the *Gartenberg* factors – that courts have typically considered in evaluating whether mutual fund fees are excessive in violation of Section 36(b). Interestingly, the Second Circuit in *Gartenberg* described the investment adviser's "cost in providing the service[s]" to a fund as a factor pertinent in assessing the fairness of fees, but did not specifically speak in terms of a "profitability" factor; nor did it hold that any profitability assessment should be undertaken at the individual fund level.[15] Later, in *Krinsk*, the Second Circuit, citing *Gartenberg*, listed "the profitability of the fund to the adviser-manager" as one of the six factors to be considered.[16] On its face, this formulation seems to refer to individual fund profitability, but *Krinsk* contains no threshold discussion of the merits of using such a metric versus other viable profit measures, *e.g.*, company- or complex-wide profit levels.[17]

While neither the statute nor the legislative history appears to mandate the consideration of profits at an individual fund level, litigants and courts since *Krinsk* have often attempted – again, with no threshold discussion or explanation as to the merits of doing so – to drill down to that level, notwithstanding the near impossibility of achieving reliable results. But not all courts have taken such a tack. In *In re American Mutual Funds Fee Litig*., for example, the most recent Section 36(b) case to proceed to trial, plaintiffs challenged the fees for eight separate funds within the American Fund complex, a complex with 30 funds. In determining that "profitability [did] not weigh in favor of finding a violation of Section 36(b)," the court relied on company- and complex- wide profit data based on all business operations rather than attempting to decipher the "profit" generated by any one of the eight funds in question, or even the eight combined.[18] "In addition, as both parties' experts agreed, potential economies of scale are properly analyzed at the fund complex level and not at the fund level."[19]

THE PROBLEMS OF FUND-LEVEL PROFITABILITY CALCULATIONS

Investment advisers generally do not organize their operations around, or dedicate specific resources exclusively to, individual mutual funds. Rather, advisers typically draw upon many of the same personnel, systems, infrastructure, and other resources to manage and service all the mutual funds in the complex. In some cases, those same resources also support non-mutual fund products, such as institutional separate accounts, commingled pools, hedge funds, and exchange-traded funds ("ETFs"), as well as brokerage, banking, and other services beyond investment management. For example, the same staff of portfolio managers, research analysts, and traders may assist in the management of multiple

[13] 573 F. Supp. 1293, 1316 (S.D.N.Y. 1983); *see also In re American Mutual Funds Fee Litig*., No. 04-CV-5593, 2009 WL 5215755, at *50, ¶ 57 (C.D. Cal. Dec. 28, 2009); *Krinsk v. Fund Asset Mgmt., Inc.*, 715 F. Supp. 472, 485 (S.D.N.Y. 1988), *aff'd*, 875 F.2d 404 (2d Cir. 1989); *Schuyt v. Rowe Price Prime Reserve Fund, Inc.*, 663 F. Supp. 962, 972 (S.D.N.Y. 1987), *aff'd*, 835 F.2d 45 (2d Cir. 1987).

[14] *See Krisnk*, 875 F.2d at 410 ("excessive profitability" alone does not support a finding that an advisory fee was excessive); *Kalish v. Franklin Advisers, Inc.*, 742 F. Supp. 1222, 1237 (S.D.N.Y. 1990) (argument that adviser "just plain made too much money" is insufficient as a matter of law).

[15] *Gartenberg v. Merrill Lynch Asset Mgmt., Inc.*, 694 F.2d 923, 930 (2d Cir. 1982) ("important" factor under 36(b) is "the adviser-manager's cost in providing the service"); *Kalish*, 742 F. Supp. at 1231.

[16] *Krinsk*, 875 F.2d at 409.

[17] In *Jones*, as we previously noted, the Supreme Court cited the six *Gartenberg* factors, including "the profitability of the fund to the advisor." Here too, however, the Court never addressed the specific question of whether fund-level profitability is an appropriate metric for analysis where an advisory manages multiple funds as part of a larger fund complex and/or engages in other lines of business.

[18] No. 04-CV-5593, 2009 WL 5215755, at *50-51, ¶¶ 57-62 (C.D. Cal. Dec. 28, 2009).

[19] *Id*. at *28 ¶244. Consistent with the above-described expressions of Congress's intent, courts have avoided setting any absolute limits on profitability, whether assessed at the fund level or more broadly at the complex level. For example, the court in *Schuyt* found pre-tax profit margins of 77.3% and post-tax margins of 38.6%, but found no violation of Section 36(b). *Schuyt*, 663 F. Supp. at 989. Other courts have reached similar holdings. *See In re American Mutual Funds Fee Litig*, 2009 WL 5215755, at *50, ¶ 58 (pre-tax margins of up to 52% do not establish a violation); *Kalish*, 742 F. Supp. at 1250 (post-tax margin of up to 35% "neither requires nor supports a finding [of excessiveness]"); *Krinsk v. Fund Asset Mgmt., Inc.*, 715 F. Supp. 472, 502-03 & n.61 (S.D.N.Y. 1988) (margins as high as 33% were "well within the realm of reasonableness"); *Meyer v. Oppenheimer Mgmt. Corp.*, 715 F. Supp. 574, 577 (S.D.N.Y. 1989) (pre-tax margins ranging from 11.6% to 23.2% not indicative of a violation of Section 36(b)).

funds and non-fund products. The same website, telephone call centers, and investor centers may be used to provide customer service to shareholders of all the funds in the complex, as well as brokerage, banking, and other non-fund customers. The same executive office, human resources, legal, and compliance personnel, and the same information systems, technology, and physical infrastructure, may support all areas of the adviser's business, including fund and non-fund businesses. These shared resources can represent the vast majority of a typical investment adviser's costs.

The predominance of shared costs significantly complicates any analysis of an adviser's profitability (revenue less costs) from a particular fund. In order to determine its costs of managing and servicing the fund under consideration, the adviser first must determine how to allocate the costs of its shared resources to individual mutual funds, as well as to non-fund and non-advisory businesses. However, allocating shared costs is highly discretionary and does not lend itself to precise results.[20] There are no generally accepted standards, analogous to GAAP, to guide the adviser in how to allocate costs. Further, there is not one "right" way to allocate a particular cost; the same cost could reasonably be allocated using a number of different methods, each yielding different results. In short, and as one court aptly put it, "[c]alculation and allocation of costs against different product lines . . . is an art rather than a science."[21]

Nevertheless – in providing various information to mutual fund boards of trustees, and likely with Section 36(b) and various judicial opinions in mind – many advisers have implemented systems that attempt to allocate shared costs to individual mutual funds. These cost-allocation systems vary in their complexity and sophistication, but many require significant resource expenditure. Many advisers use high-level statistics – such as assets under management, revenue, or number of shareholders – to allocate costs. Some use the same statistic to allocate all costs, while others use different statistics for different categories of costs, such as assets under management for portfolio management expenses, and number of shareholders for servicing and administrative expenses. Still other advisers have developed so-called "activity-based" cost accounting systems that attempt to measure the level of use of certain resources by individual funds – for example, by tracking investor calls or website activity, or by requiring advisory personnel to complete time surveys or track their time in other ways.[22]

The choice of allocation methodologies can have a significant impact on the reported profitability for a particular fund. To illustrate this point, assume that a single adviser manages a fund complex consisting of four mutual funds, and all four funds are supported by a single research department. Any assessment of the adviser's profit from managing any one of the four in isolation would require allocation of the research expense across the four funds. There are arguably many reasonable methods for allocating research expenses. For example:

- *Flat or Even Methodology* – The adviser might conclude that, since all four funds draw upon the same research department, the research expenses should be allocated evenly to each fund.

- *Asset-Based Methodology* – The adviser also might conclude that funds with greater assets under management receive greater benefits from the research because they can take larger positions in securities and have more shareholders. In that case, the adviser could allocate the research expenses based on each fund's relative assets under management.

- *Revenue-Based Methodology* – Alternatively, the adviser could conclude that research expenses should be allocated based on the relative amount of advisory fees paid by each fund because that arguably reflects the benefit that the adviser receives from providing services to the funds.

- *Number of Securities Held* – The adviser also could use the number of securities held by each fund as a proxy for the fund's "use" of the adviser's research and allocate research expenses based on the relative number of securities held.

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[20] W.J. Baumol, *et al.*, *How Arbitrary Is "Arbitrary"? – or Toward the Deserved Demise of Full Cost Allocation*," Public Utilities Fortnightly (Sept. 3, 1987); PricewaterhouseCoopers, *The Mutual Fund Advisory Contract Review Process: Simplifying Complexity* (2009).

[21] *Krinsk*, 715 F. Supp. at 489.

[22] In assessing which cost-allocation methodology to employ, consideration also needs to be given to the time, burden, and expense of allocating a particular cost pool in relation to the amount of the expense. For example, it makes little sense to spend significant resources tracking activity levels to allocate some very small percentage of overall costs, particularly when it is generally accepted that the resulting profit margin is at best an estimate.

The choice among these four methodologies – any of which could be defended as reasonable – may have a significant impact on the amount of research expense allocated to each fund (and thus each fund's "profitability") depending on the characteristics of the fund. For example, assume the four funds have a range of assets under management from $1 billion to $20 billion, advisory fees of between .10% and 1.0%, and hold between 50 and 500 securities. *See* Appendix A for a chart with the specific characteristics of each of the four funds. If the research cost is allocated to each fund evenly, each of the four funds would be allocated 25% of the total research expense. *See* Appendix B for a chart with the percentage (and amount) of research costs allocated to each of the four funds using the different asset allocation methodologies. However, using a cost-allocation methodology based on assets would result in research cost of between 3% and 55% being assigned to a single fund. Using the number of securities held by each fund as a basis to allocate costs would lead to an even greater range, with between 7% and 72% of the research cost being assigned to a single fund. In sum, the research cost assigned to a fund in this hypothetical scenario can vary by as much as *20 times* depending on fund characteristics and the methodology chosen, resulting in huge profitability swings. A similar analysis could be performed for virtually any type of expense an adviser incurs in managing and servicing mutual funds.

Real life experience underscores the fact that very different margins will result if different, but equally reasonable, methodologies are used. For example, the court in *Krinsk* was presented with expert reports that employed different allocation methodologies (both of which the court found could be defended as reasonable) and reached very different conclusions as to the profitability of the fund at issue: plaintiffs' expert concluded that the annual profit margin was 40.4%, but defendants' expert concluded that it was *negative* 32.7%.[23]

Furthermore, regardless of the allocation methodologies employed, the resulting profit margins cannot be said to represent the adviser's "actual" profitability from managing the fund under consideration. At best, the results typically constitute a good faith estimate of where the adviser's profitability *might* fall. As the court observed in *Schuyt*, there is a "problem of uncertain profitability" because "full-cost accounting does not give an objectively accurate picture of the profitability of one product line in a multi-product firm."[24] In other words, "[l]ittle certainty exists in this field [of cost accounting] where different, albeit rational, methodologies lead to widely disparate results."[25]

IS THE EFFORT WORTH IT?

Given the inexactness of allocations, it seems reasonable to question the expenditure of considerable resources to design and implement a sophisticated cost accounting system for the sole purpose of determining fund level profitability. Indeed, even if the profitability results were reliable, fund complexes may make few, if any, business decisions based on the profitability of a single fund as opposed to a complex of funds. For example, a fund-level profitability analysis could reveal a fund to be unprofitable, but closing that fund might result in the overall complex being less profitable if, for example, the fund incurred very few fund-specific and avoidable costs, or the fund served an important place in the adviser's overall product offering.

Compounding the problem, cost accounting in the mutual fund context is a particularly daunting task in light of the myriad service offerings provided to mutual fund shareholders and the predominance of shared costs. The *Krinsk* case highlights both the enormous effort to determine fund profitability and the near futility of the exercise.[26] Following a bench trial, the bulk of the district court's lengthy written opinion dealt with profitability issues – almost twice as much text is devoted to profitability than on any other *Gartenberg* factor.

In *Krinsk,* the court was presented with three different profitability studies: an internal study done by the adviser, Merrill Lynch; a defense expert study prepared by Peat Marwick; and a plaintiff's expert study done by a Babson College professor. Not surprisingly, the court found that each of the three studies had its "own strengths and weaknesses." Among the many issues the court had to decide were: (1) whether Rule 12(b)(1) payments to Merrill Lynch financial consultants were revenue or an expense; (2) how much of the salaries, fringe benefits, overtime, communications, equipment rental, and other costs associated with Merrill Lynch's financial consultants' time were attributable to the fund;

[23] *Krinsk*, 715 F. Supp. at 494.

[24] *Schuyt*, 663 F. Supp. at 978.

[25] *Krinsk*, 715 F. Supp. at 489 (also recognizing "the impossibility of arriving at an exact profitability figure" and that "the Court must be satisfied with a common sense range of figures within which the Fund's profitability . . . most likely falls").

[26] *Id.* at 489-94.

(3) the proper allocation for new account processing, monthly statements, and marketing costs; (4) how to handle certain float costs and computer-based system costs related to excess capacity; (5) whether "fringe benefits" should be included in fund profitability; and (6) how to allocate overhead.[27]

To highlight the amount of time and effort that went into crafting possible allocations for these costs and revenues, consider the work done to allocate financial consultant costs. Peat Marwick conducted a "time study" by sending two representatives to 35 of the 480 Merrill Lynch branch offices for "two or three days at each of the 35 offices" in October 1986.[28] During these multi-day office visits, financial consultants were observed and questioned as to how much of their time was being spent on various activities. Despite the hundreds of a hours spent by a leading accounting firm, the court found Peat Marwick's allocation "to be of little probative value" and to have a "slender foundation" because the study may have wrongly assumed that the period observed (two weeks in October) was representative for the entire period at issue.[29] Having rejected the Peat Marwick study, the court had no basis to assign any of financial consultant costs to the fund, although the judge noted that it may be appropriate to include these costs under some circumstances.

Similarly, the court grappled with how to allocate corporate overhead costs, an issue which was "hotly disputed at trial."[30] The trial record contained two methodologies related to overhead costs: one from Peat Marwick and one from Merrill Lynch. The court found that both methodologies were reasonable even though they employed quite different approaches.[31] Indeed, each approach resulted in very different allocated cost amounts, with one producing $5 million in overhead costs, and the other as much as $34 million. In Solomonic fashion, the court concluded that the "true overhead" was somewhere in between the two estimates.[32]

The court's final conclusions on fund profitability underscore the futility of all of this effort. Despite enormous work by the parties and multiple accounting experts, and what the appeals court called "extensive analysis of factual data" by the district court,[33] the best the lower court was able to conclude was that pre-tax profitability was within the range "from a few percentage points greater than 0% and perhaps as much as 33% – a very broad range." And even this conclusion was not definite, as the court said profitability "would *probably* fall in [this] range."[34]

In light of the resources required to develop a cost accounting system and the limited value of the resulting profitability numbers, it is obvious why some have questioned the utility of the exercise. For example, some mutual fund boards have balked at relying too heavily, if at all, on such data in making findings in respect of contract renewals. In a recent annual report, the trustees of the Longleaf Partners Funds recognized that they "considered the profitability of [the adviser] as a whole, and . . . did not evaluate on a Fund-by-Fund basis [the adviser's] profitability and/or costs" because "no generally accepted cost-allocation methodology exists, and estimating the cost of providing services on a Fund-specific basis is difficult."[35] Similarly, the trustees of the Federated mutual funds "determined [individual fund profitability] to be of limited use" because "the inherent difficulties in allocating costs (and the unavoidable arbitrary aspects of that exercise) and the lack of consensus on how to allocate those costs may render such allocation reports unreliable."[36]

Even adverse litigants see eye-to-eye on this topic. In submissions to the Supreme Court in *Jones*, one adviser took the position (as *amicus curiae*) in support of defendants' arguments that "allocated cost and profit data . . . has very little economic meaning and should have no role in Section 36(b) litigation."[37]

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[27] *Id.* at 490-94.

[28] *Id.* at 491.

[29] *Id.* at 492.

[30] *Id.* at 493.

[31] *Id.* at 494-95 ("[b]oth . . . approaches to overhead allocation were rational, albeit wholly unrelated, methods").

[32] *Id.* at 495.

[33] *Krinsk*, 875 F.2d at 410-11.

[34] *Krinsk*, 715 F. Supp at 494 (emphasis added).

[35] Longleaf Partners Fund, Annual Report (Dec. 31, 2010) at 58.

[36] Federated Kaufmann Fund, Portfolio Manager Review and Annual Shareholder Report (Oct. 31, 2010) at 58.

[37] Brief for Fidelity Management & Research Company as *Amicus Curiae* in Support of Respondent, *Jones v. Harris Assocs. L.P.*, No. 08-586 (U.S. filed Sept. 3, 2009) at 17; *see also* Brief for the Investment Company Institute as *Amicus Curiae* Supporting Respondent (filed Sept. 3, 2009) at 11 n.4 ("Calculating the profitability of a single fund in a multiple-fund complex is enormously complicated and is especially difficult when, as is often the case, an adviser provides multiple services to a fund and the exact allocation of payments to each function is

Similarly, *amicus curiae* arguing in support of the plaintiffs in *Jones* quoted from an article by a frequent expert for plaintiffs in Section 36(b) litigation for the proposition that fund-level profitability, because it requires cost allocations, has little if any value in Section 36(b) litigation:

> [P]rofitability calculations involve cost-allocation issues that are subject to dispute, and there is no universally accepted methodology for making the analysis. This means that, in practice, profitability is bitterly contested . . . . Given that profitability data is hidden, subject to fierce dispute once found, and next to impossible for courts to analyze, it is unclear what is gained by making proof about the adviser's profitability a criterion for recovery in cases attacking advisory fees.[38]

Even among those that recognize that fund level profitability is difficult to analyze and subject to limitations, there are some that use fund level margins as a data point, believing them to be at least directionally informative. But the more cost allocations involved in calculating margins, the less precision and reliability in the resulting profit number. Examining the all-in revenues and all-in costs of an adviser would give you an accurate picture of the adviser's overall profitability, and audited numbers may be available at that level. The use of allocations increases, however, as one drills down closer to the fund level. For example, where the adviser manages money for non-mutual fund clients, such as institutional separate accounts, some allocations are needed to determine profitability of just the mutual fund business. Even within the mutual fund business, many allocations are required to determine the profitability of higher-level aspects of the business, such as different disciplines (*e.g.*, equity, fixed income, etc.) or distribution channels (*e.g.*, retail, retirement, etc.). While such analyses are generally more reliable than lower-level fund cost-allocation exercises because more and more allocations are required as you drill down closer to profitability of a single fund, they are less reliable than examining all-in costs and revenues.

CONCLUSION

Given the inherent limitations and lack of precision in any cost-allocation exercise, individual fund profitability data is a suspect foundation for assessing the reasonableness of an adviser's fees, and often requires massive resources to generate. Moreover, in the context of Section 36(b) litigation, almost any methodology used by an adviser to allocate costs will be second-guessed by plaintiffs and their cost accounting expert. Complex-wide profit figures or profit margins based on other types of higher-level organizational revenues and costs would appear to be a more accurate benchmark for assessing an adviser's profitability. Such figures are subject to far less debate given that they typically rely less on allocated cost data and thus provide a more meaningful assessment of the adviser's profitability. ■

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uncertain, or when advisory services to the fund are only one element of a larger financial product or package of financial services offered by an adviser or its affiliates."); Brief for Independent Directors Council as *Amicus Curiae* in Support of Respondent (filed Sept. 3, 2009) at 12 ("[W]ith respect to fund complexes that include several related funds, individual fund cost allocations and profitability analyses are generally less helpful than an aggregate cost or profitability analysis.").

[38] Brief of *Amicus Curiae* National Association of Shareholder and Consumer Attorneys in Support of Petitioners, *Jones v. Harris Assocs. L.P.*, No. 08-586 (filed June 17, 2009) at 14 (quoting John P. Freeman, et al., *Mutual Fund Advisory Fees: New Evidence and a Fair Fiduciary Duty Test*, 61 Okla. L. Rev. 83, 131-32 (2008)); *see also* Brief for John C. Bogle as *Amicus Curiae* in Support of Petitioners (filed June 17, 2009) at 23 (assessment of individual fund profitability relies on "highly contestable facts"); Brief for Petitioners (filed June 10, 2009) at 32 n.23 ("[U]ndue focus on factors such as 'the profitability of the fund to the adviser-manager,' . . . threatens to transform § 36(b) into the type of cost-based rate-making statute that Congress sought to avoid.") (internal citations omitted).

APPENDIX A

Fund Characteristics

	Fund A	**Fund B**	**Fund C**	**Fund D**
Assets under Management	$20 billion	$10 billion	$5 billion	$1 billion
Advisory Fee Rate	10 basis points	50 basis points	100 basis points	100 basis points
Annual Advisory Fees Paid	$20 million	$50 million	$50 million	$10 million
Number of Securities	500	100	50	50

APPENDIX B

Percentage of Research Expenses Allocated to Each Fund

	Fund A	**Fund B**	**Fund C**	**Fund D**
Flat or Even	25%	25%	25%	25%
Asset-Based	55%	28%	14%	3%
Revenue-Based	15%	38%	38%	8%
Securities Held	72%	14%	7%	7%