

FLOYD NORRIS

Loosening the reins on fund fees

NEW YORK

In 1970, the U.S. Congress decided that there was too little price competition in the mutual fund industry and amended the law to allow fund investors to file suits claiming that management fees were excessive.

Now a federal appeals court has decided that the law makes no sense, and has essentially repealed it.

The provision in question is not a model of legislative clarity, reflecting a compromise between some legislators who wanted to impose tough limits on compensation and others who favored a gentler approach.

It provides that fund managers have a "fiduciary duty with respect to compensation for services," and gives shareholders the right to go to court without being specific about what criteria judges should use in deciding such cases.

"A fiduciary must make full disclosure and play no tricks but is not subject to a cap on compensation," Frank Easterbrook, the chief judge of the U.S. Court of Appeals for the Seventh Circuit, wrote in a decision issued this week. "The trustees (and in the end investors, who vote with their feet and dollars), rather than a judge or jury, determine how much advisory services are worth."

One reason that decision surprised some lawyers was that such disclosures were required long before the 1970 amendments to the Investment Company Act were passed. If the new section added no new requirements, as Easterbrook concluded, then the section he was interpreting would appear to be superfluous.

Until now, the ruling precedent has been a 1982 decision by the U.S. Court of Appeals for the Second Circuit, in a case known by the name of the plaintiff, Irving Gartenberg. That ruling stated that a fee could be deemed excessive if it was "so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been the product of arms-length bargaining."

In the years that followed, there do not appear to have been any cases won by complaining investors. But securities lawyers says there have been some settlements, and the threat of action may have lowered some fees. Funds have set up elaborate processes in which the independent directors review information and then seek to negotiate lower fees with the manager.

Arthur Levitt, when he was chairman of the U.S. Securities and Exchange Commission, reflected the widespread view of the law when he said in 1998: "Directors don't have to guarantee that a fund pays the lowest rates. But they do have to make sure that fees fall within a reasonable band."

Levitt's remarks were cited by Harris Associates, which manages three funds for the Oakmark family, when it asked a U.S. District Court judge in Illinois to apply the "universally followed" Gartenberg rules and dismiss a challenge to the fund manager's compensation.

The judge agreed, and that might have been the end of the case. But the plaintiff appealed to the Seventh Circuit, based in Chicago. The plaintiff argued that the judge should have compared the fees charged to the fund with the much lower fees charged by Harris to institutional clients when it manages similar accounts.

That comparison has been widely cited as evidence that mutual funds are overcharged. Elliott Spitzer, when he was New York's attorney general, used it to conclude that investors in one fund family were overcharged by hundreds of millions of dollars each year.

At the heart of the dispute is the fact that the Investment Company Act seems to assume an industry structure that is very different from the actual one. It assumes that mutual funds are formed by groups of investors who come together and pool their money. They elect directors, sometimes called trustees, and the directors hire managers to run the fund. The directors negotiate to get the best possible deal from the best qualified managers.

In the real world, mutual funds are put together by sponsors, which have families of funds and try to come up with new ones that will attract investors. The fund directors are chosen by the sponsor and ratified by the few shareholders who bother to vote.

In the Gartenberg decision, Judge

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Join a discussion with Floyd Norris on his blog, High and Low Finance.



Air traffic controllers at Logan International Airport near Boston, where a system designed by Xsight that detects debris on runways is being tested. Photographs by Jodi Hilton for The New York Times

Striving to make airlines safe from objects on runways

By Matthew L. Wald

BOSTON: At the edge of Runway 15-right at Logan International Airport, Arik Fux watched a bright yellow sensor slowly scan back and forth across the pavement. He waited until it was pointed away from him and like a man dodging a lawn sprinkler, he rushed out towards the middle of the 150-foot-wide runway, tossed a blue plastic pen into the surface, and dashed back again.

It was not a lawn sprinkler, but a new instrument that the U.S. Federal Aviation Administration is testing at the airport that serves Boston to find "foreign object debris," known as FOD, which can damage airplane engines on takeoff or even lead to plane crashes. And on this occasion, it worked; in less than a minute, a computer in the control tower, 16 stories up and half a mile, or 800 meters, away, sounded an alarm in a mechanical voice.

"FOD Alert, FOD Alert," it said. The camera automatically zoomed in on the pen and the computer drew a red box around it, to focus human attention. A co-worker in the tower, Oded Hanson, announced over a radio, "I see a pen."

Then the two repeated the drill with an 18-inch, or 46-centimeter, long strip of metal like the one that fell off a Continental Airlines DC-10 at Roissy-Charles de Gaulle Airport outside Paris in July, 2000. An Air France Concorde, departing about four minutes later, ran over the strip and shredded a tire; rubber parts were then flung against the underside of the wing so hard that the fuel tanks ruptured, and a fire occurred. The plane crashed into a nearby hotel, killing all 109 people aboard, and four people on the ground.

A judge in Paris is supposed to decide this summer whether to proceed with involuntary homicide charges against two employees of Continental, one official of the company that built the Concorde and one French air safety regulator.

The U.S. Air Force has also lost several planes to runway debris. Some of them are more vulnerable than airliners, because they have a single engine, and a single wheel on each landing gear. More common than crashes, though, foreign objects sucked into engines can cause engine failure or expensive damage.

Jet engines are extremely reliable, one of the reasons that air travel is so safe, but they are vulnerable to foreign objects. And even in cases with little safety risk, the cost of the repairs and of lost time for the aircraft runs into the billions of dollars a year, according to estimates by Boeing and others.

The airlines' trade group and the aviation agency, known as the FAA, do not keep count,

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U.S. tests systems to detect the kind of debris that downed a Concorde in 2000



Alon Nitzan, front, the chief executive of Xsight, and a colleague, Arik Fux, left, on a runway at Logan. The company is one of four involved in tests of airport safety systems in the United States.

As price of oil leaps, big names in business feel the heat

By Michael M. Grynbaum and Jad Mouawad

NEW YORK: Oil prices leaped above \$135 a barrel Thursday, a record that underscored the growing pressures that runaway energy prices are placing on some of the biggest names in global industry.

The price of light sweet crude oil for July delivery shot as high as \$135.09 Thursday, then retreated to \$130.53 in afternoon trading in New York, down \$2.64, or 2 percent, from Wednesday's close. But in a week that has seen the price of oil rise by \$4 a barrel, the economic consequences of high fuel costs continued to mount.

Ford Motor, the U.S. automaker, said Thursday it would cut vehicle production for the rest of this year and fall short of reaching profitability in 2009, a long-held company goal. In a statement, a top Ford executive said rising gasoline prices "are having a tremendous impact on our sales, our manufacturing operations and our profitability."

Meanwhile, Europe's biggest airline, Air France-KLM, warned of a profound reshaping of the world airline industry

caused by what it called the "explosion" in the price of oil. And American Airlines said Wednesday that it would reduce flights and begin charging passengers to check bags, part of a company effort to cut costs in the face of skyrocketing fuel prices.

Gasoline prices are nearing \$4 a gallon, or \$1.06 a liter, in the United States, partially as a result of a 39 percent rise in the price of New York oil futures since the start of the year. Prices have more than quadrupled since 2003.

The gains early Thursday came after a series of unsettling reports that suggested world oil supplies might not be able to keep up with future demand, a situation that could potentially lead to even higher prices.

On Wednesday, weaker-than-expected weekly inventory data in the United States, the world's biggest economy, stoked fresh worries over oil supplies ahead of the busy summer driving season, sending oil prices up \$4.19 a barrel, or 3.2 percent, on the day.

Some investors reacted to a report on Thursday in The Wall Street Journal that the International Energy Agency, a policy advisory group in Paris for in-

dustrialized countries, was concerned about a reduction in the long-term world supply of crude oil.

But the agency's chief economist said during an interview that the study's results were still inconclusive.

"We are going to revise our oil supply prospects," said Fatih Birol, the economist. "We don't know the results yet."

And several oil analysts dismissed the importance of the current anxieties affecting the market.

"Concerns about future supply — that's nothing new, it's been there for four years," said Antoine Halff, an analyst at Fimat.

Some experts expressed frustration that investors were only focusing on alarmist reports about declining supplies in a few areas and failed to consider that higher prices would eventually reduce demand and attract new production from places like Brazil.

The International Energy Agency warned about such a disconnect three years ago. At the time, it said that if investments did not keep pace with the growth in consumption, the world might face a shortfall of as much as 15 million barrels a day by 2030. Instead of growing to reach 116 million barrels a day, global supplies would struggle to increase to 100 million barrels a day by then, up from today's average of 86 million barrels a day.

In recent years, a chorus of analysts and oil executives have raised concerns about possible shortfalls in supplies over the next years as new discoveries and production fail to keep up with rising demand. That, they warned, could lead to a supply crunch and spiking oil prices until demand eventually fell.

Part of the reason is that costs in the industry have more than doubled in the past five years, oil-rich countries are tightening access rules for foreign investors, and many developing countries are subsidizing their fuel costs, and thereby fueling energy consumption. Global demand is expected to grow by about one million barrels a day in the next decade.

Ford to cut production and lower profit goal

By Bill Vlasic

DETROIT: Higher gasoline prices and slowing vehicle sales prompted Ford Motor on Thursday to announce sweeping reductions in production and to retreat from its aim to become profitable by 2009.

The automaker, based in Dearborn, Michigan, said it would cut production by 15 percent in the current quarter from a year ago, and further reduce production by 15 percent to 20 percent in the third quarter and by 2 percent to 8 percent in the fourth quarter.

Ford's chief executive, Alan Mulally, said the cutbacks were the result of weak economic conditions and sharply lower demand for large trucks and sport utility vehicles.

"The challenge affecting the entire industry is the accelerating shift in consumer demand away from large trucks and SUVs to smaller cars and crossovers, combined with a steep rise in commodity prices and the weak U.S. economy," Mulally said.

Ford also backed off from its pledge to return to profitability in 2009, and said it hoped to break even by that time.

"Unless there is a fairly rapid turnaround in U.S. business conditions, which we are not anticipating, it now looks like it will take longer than expected to achieve our North American profitability goal," Mulally said.

Ford surprised the industry less than a month ago by posting a \$100 million profit in the first quarter, after losing a combined \$15.3 billion in 2006 and 2007. At the time, Ford said it remained committed to its goal of returning its auto business to profitability in 2009.

But the automaker and its domestic rivals, General Motors and Chrysler, have been hard hit by slumping demand for trucks and sport utility vehicles.

Ford sales have plunged almost 10 percent through the first four months of the year, and the U.S. automobile industry is headed toward its worst sales year in more than a decade.

The automaker said it was on track to achieve a goal of cutting overall costs by \$5 billion by the end of this year. Ford also said it was accelerating its investment in small cars and crossover vehicles.

In a related announcement, Ford's board said it would remain neutral on the billionaire investor Kirk Kerkorian's cash tender offer to acquire 20 million Ford shares at a price of \$8.50.

Kerkorian disclosed last month that he had built a 4.7 percent stake in Ford stock. Ford's shares were down more than 6 percent in afternoon trading.

Mulally said the dramatic shift by consumers from trucks and SUVs into smaller cars and crossovers appears to be "structural in nature," rather than a short-term reaction to gas prices.

"We needed to act now," he said. Over all, Ford cut its forecast for light-vehicle sales in the United States to between 14.7 million and 15.1 million this year. That would mark the lowest level in more than a decade.

Ford will be offering more buyouts to factory workers, as well as adjusting shifts in its plants. Cuts in white-collar jobs are also expected.

Mulally declined to rule out the possibility of closing more assembly plants. "What we're really trying to do is understand what the real demand is going to be going forward," he said.

Besides cutting truck and SUV production, Ford will increase its production of passenger cars like the Focus and Fusion and its crossover vehicles. With the changes, the company said it expected to maintain a 14 percent share of the U.S. market this year.

While Ford will miss its profit target for 2009, Mulally said the automaker had no additional plans to sell off assets, like its Volvo division.

"We continue to make progress on every element of our plan, and we are taking steps in the near term to ensure our long-term success," he said.

"We are concerned about the supply prospects," Birol said. "Investments is the main issue here. Each year we need \$400 billion a year in the oil and gas sector. But because of cost inflation, in real terms, we are far from the investments needed."

In recent months, the market's confusion over the long-term supplies, as well as a decline the dollar, and rising commodity investments, have accelerated the rally in oil prices. Since October, oil futures have surged by a whopping \$55 a barrel, jumping to \$135 a barrel from \$80.

And there are still considerable signs of speculative froth in the market.

David Jolly and Caroline Brothers contributed reporting from Paris. Graham Bowley contributed from New York.

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