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Trusted Insight for Independent Oversight

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MFDF Report

Board Oversight of Advisory Agreement Approvals

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Overview

Directors[1] of registered investment companies (funds) have a wide range of responsibilities, but a board's decision to approve an investment advisory agreement is arguably one of the most fundamental. Statutory requirements and judicial caselaw provide a basic construct for the advisory agreement approval, commonly known as the "15(c)" process, but the practices of fund boards in executing their 15(c) responsibilities vary widely based on the size of the complex and the type of fund(s) covered, among other factors.

This MFDF 15(c) White Paper[2] is intended to serve as a reference regarding the advisory agreement renewal process and relevant enforcement actions, as well as a resource of possible approaches to 15(c) board processes and avenues directors may consider when analyzing complex or challenging facts and circumstances in their review.

MFDF's 15(c) White Paper is divided into four distinct parts, also available as standalone pieces:

Part 1: Regulatory Requirements and Judicial Caselaw
Part 2: Board Processes
Part 3: *Gartenberg* Factor Analysis and Board Considerations
Part 4: Enforcement Action Takeaways

MFDF would like to thank Morgan Lewis for sharing their expertise and contributing to this White Paper.

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Part 1: Regulatory Requirements and Judicial Caselaw

INTRODUCTION

Fiduciary Duties and the Business Judgment Rule

The Investment Company Act of 1940 (1940 Act) and "excessive fee" case law prescribe the general requirements for directors to follow when evaluating an investment advisory agreement, but directors should also look to their fiduciary duties to provide the necessary lens through which to view these statutory requirements. As funds are organized under state laws, often as Maryland corporations, Massachusetts business trusts or Delaware statutory trusts, directors are generally subject to the fiduciary duties of loyalty and care to funds and their shareholders under the applicable state's laws.[3] The duty of loyalty means directors must put the best interests of the fund before their own interests or the interests of others. Directors must avoid self-dealing and be mindful of conflicts of interest that could negatively impact a fund in a potentially material manner. The duty of care requires directors to exercise the degree of skill, diligence and care that a reasonably prudent person would exercise in the same, or similar, circumstances. In exercising their duty of care, directors, in general, should regularly attend and engage during fund board meetings, educate and inform themselves to a reasonable degree regarding matters over which they have oversight, and monitor the fund's financial operations and performance and the quality and breadth of the fund's service providers, including the fund's investment adviser.

Courts view the actions of directors through the lens of reasonable business judgment and have deferred to the actions of directors unless egregious circumstances are present such as fraud, bad faith, or gross negligence. The courts' deference to the directors' business judgment can be best preserved by continually strengthening the diligence and discipline of directors. Directors can do so by staying informed about material aspects of a fund's business and the relationships with and between the adviser, the fund, and its key service providers. In addition, directors are well served to maintain an effective record demonstrating the rigor and ongoing process by which they inform themselves about specific issues over time. The business judgment rule provides a rebuttable presumption that, in reaching a determination, directors acted on an informed basis, in good faith, and in the honest belief that the action was taken in the best

interests of the fund. The business judgment rule incorporates the concept of fiduciary duty and has been supported in relevant case law.[4] In fulfilling their responsibilities to funds, directors should also keep in mind that their role includes a responsibility to monitor for potential conflicts of interest between a fund and its adviser and/or its service providers and to act in the best interests of the fund and its shareholders.[5]

1940 ACT REQUIREMENTS

Section 15 of the 1940 Act

The 1940 Act does not set forth specific factors that directors must consider in approving an advisory agreement and does not expressly impose a cap on the fees an adviser may charge for its services. Section 15(a) of the 1940 Act prohibits a firm from serving as an investment adviser to a fund except pursuant to a written contract that has been approved by the vote of a majority of the outstanding voting securities of the fund. Fund advisory agreements must be written agreements with a precise description of fees and services provided. After its initial term of up to two years, Section 15(a) of the 1940 Act provides that an advisory agreement must be approved at least annually by the fund's board or by the vote of a majority of the outstanding voting securities of the fund. Section 15(c) of the 1940 Act adds the requirement that an initial advisory agreement and any renewal of such agreement must be approved by the separate vote of a majority of the independent directors cast in person at a meeting specifically called to vote on the agreement (hence, such meetings are often called "15(c) meetings").[6]

Section 15(c) of the 1940 Act also provides that fund directors have a duty to request and evaluate, and the fund adviser has a corresponding and independent duty to provide, such information as may reasonably be necessary for the directors to evaluate the terms of any advisory agreement of a fund. Section 15 requirements apply to both investment advisory agreements with advisers and sub-advisers.

Many fund boards routinely acknowledge in their annual contract renewal processes that the "15(c) process" is in reality a process that is continuous and ongoing and not just occurring during the lead-up to the 15(c) meeting. In this manner, directors individually and the board as a whole accumulate knowledge of the relevant factors to analyze when considering whether to approve a particular advisory agreement each year and apply that accumulated knowledge, experience and understanding with each successive agreement consideration.

Section 36 of the 1940 Act

Section 36(a) of the 1940 Act authorizes the SEC to bring an action against an officer, director, adviser, and/or member of an advisory board for a breach of fiduciary duty involving personal misconduct.

Section 36(b) of the 1940 Act provides that the investment adviser of a fund has a fiduciary duty with respect to the receipt of compensation for its services from the fund. Accordingly, it provides a private right of action by a fund shareholder for breach of that fiduciary duty against an adviser or an affiliate. In addition, the SEC could elect to pursue an action against an adviser or an affiliate for breach of that fiduciary duty. Section 36(b) does not authorize actions against directors for a breach of fiduciary duty or otherwise.

Section 36(b) judicial decisions and Section 15 of the 1940 Act establish the framework for board analysis of advisory agreements.

SECTION 36(b) CASELAW AND THE *GARTENBERG* FACTORS

The ambiguity of the Section 36(b) fiduciary standard has resulted in the establishment of an industry standard for its interpretation through judicial decisions. This standard was initially set forth by the U.S. Court of Appeals for the Second Circuit in *Gartenberg v. Merrill Lynch Asset Management, Inc.* (*Gartenberg*).[7] In *Gartenberg*, the court stated that an adviser's receipt of an advisory fee will not constitute a breach of the adviser's fiduciary duty if "the fee is in range of what would have been negotiated at arm's length in the light of all of the surrounding circumstances."[8] The court observed that, to violate Section 36(b), an 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."[9] In making this determination with respect to the fee at issue in *Gartenberg*, the Second Circuit explained that "all pertinent facts must be weighed."[10]

In *Gartenberg*, the court established a non-exhaustive list of six factors for consideration in determining whether adviser fees are so "disproportionately large" that they would subject an adviser to Section 36(b) liability. The *Gartenberg* factors are:

1. the nature and quality of services provided to fund shareholders;
2. the profitability of the fund to the adviser;
3. fall-out benefits;
4. economies of scale;

5. comparative fee structures; and
6. the independence and conscientiousness of the trustees.[11]

In 2010, the U.S. Supreme Court unanimously affirmed the *Gartenberg* factors in *Jones v. Harris Associates, L.P.*[12] Directors should be mindful that the *Gartenberg* factors are non-exhaustive, and they should evaluate any other relevant factors when considering the approval or renewal of an advisory agreement. Directors may be required to explain or defend their process for analyzing the relevant factors in court at a later date should litigation arise. In addition, they could be called as witnesses and need to explain their analysis in the context of evaluating the justification for an adviser's compensation.

In essence, the *Gartenberg* factors, in conjunction with applicable court rulings and opinions in a large portion of concluded Section 36(b) matters,[13] help to provide guidance for directors. Counsel generally also provides a *Gartenberg* memo that provides a more detailed guide for directors. Diligently engaged and informed directors are expected to evaluate the terms, conditions and fees between a fund and its adviser as set forth in the fund's advisory agreement, considering all material facts and circumstances, both in the current period and generally over time. Directors are not charged with negotiating the lowest fee, but rather with evaluating an adviser's fee given all relevant facts and circumstances. In addition, it is important to acknowledge that a fund adviser is entitled to a profit. A fund adviser faces many risks in creating and operating investment management businesses which can differ dramatically depending upon many factors including, but not limited to: whether an entity is the fund's sponsoring adviser or a sub-adviser; the type of fund or product offered; the types of securities and investment strategies implemented; the scope of supporting requirements for systems, technologies, legal, compliance, marketing and regulatory specialists; and management and disclosure requirements, among others.

15(c) DISCLOSURE REQUIREMENTS

Funds are required to provide disclosure in Form N-CSRs, prospectuses and proxy statements about the board's evaluation and approval of advisory and sub-advisory agreements. In particular, funds are required[14] to:

- describe the material factors and conclusions that formed the basis for the board's approval of any new advisory agreement or renewal in the most recent fiscal half-year in the fund's Form N-CSRs;
- include disclosure in prospectuses regarding the disclosure in the Form N-CSRs;
- describe in any relevant proxy statements the basis for the board's proposal that shareholders approve an advisory agreement; and

- have the principal executive and financial officers certify the discussion based on their knowledge.

Largely tracking the *Gartenberg* factors, Form N-CSR disclosures generally include the following and must not contain material misstatements or omissions:

- the nature, extent, and quality of services to be provided by the adviser;
- the investment performance of the fund and the adviser;
- the costs of the services to be provided and profits to be realized by the adviser and its affiliates from the relationship with the fund;
- the extent to which economies of scale would be realized as the fund grows;
- whether fee levels reflect these economies of scale for the benefit of fund shareholders;
- whether the board relied upon comparisons of the services to be rendered and the amounts paid with those under other advisory agreements, including any comparisons used and how they assisted the board in concluding that the contract should be approved; and
- any benefits derived or to be derived by the adviser from the relationship with the fund such as soft dollar arrangements.[15]

Each required disclosure item must be addressed, even if it is just to note that the factor is not applicable. Other factors may be included if appropriate.

Directors should be mindful that they may have potential liability under the 1940 Act with respect to the 15(c) process and related disclosure. In particular, directors could have potential liability if they are found to be responsible for material misstatements or omissions in 15(c) disclosure[16] or are found to be responsible for a compliance program rule violation.[17]

RECORDKEEPING REQUIREMENTS

Funds should maintain the records of 15(c) materials provided, including documentation of the information requested by the directors and confirmation that they received the information requested. Boards should carefully consider the best way to oversee the recordkeeping obligations relating to sensitive 15(c) information, such as financial statements and profitability reports provided by advisers and sub-advisers. Records should also reflect that the advisory agreement of each fund was individually approved.

UNIQUE FACT PATTERNS: SUB-ADVISERS, CHANGES OF CONTROL AND ASSIGNMENTS

Fund directors may be presented with unique considerations in the event that they oversee one or more funds with a sub-adviser, or are faced with a change of control of the principal adviser

or an assignment of the advisory agreement. These facts and circumstances can be complex, and directors may seek to confer with counsel regarding the application of relevant legal requirements.

Sub-Advisers

Fund directors have the same responsibilities with respect to sub-advisory agreements as they do with respect to advisory agreements. Section 15 of the 1940 Act requires that a majority of a fund's independent directors and of the fund's shareholders initially approve all advisory agreements, which includes sub-advisory agreements—regardless of whether the fund is a party to the agreement.

Sub-advisory agreements can present unique considerations for fund directors, such as in the case of certain multi-manager funds that have received exemptive relief to hire new sub-advisers without obtaining shareholder approval for a new sub-advisory agreement. Sub-advisory relationships can also present additional oversight considerations for boards, such as in circumstances including, but not limited to, the following:

- the assessment of the allocation of fees and expenses among the adviser and sub-advisers;
- monitoring of sub-advisers, including compliance matters, codes of ethics, regulatory issues, litigation concerns and cybersecurity/data protection; and
- analyzing the profitability of sub-advisers with potentially less transparent financial information.

As the adviser is generally considered to be responsible for the performance of the fund and the continued selection and oversight of sub-advisers, one aspect of evaluating the performance of an adviser is understanding how the adviser continuously measures and monitors the performance of any sub-adviser. Directors may carefully consider the adequacy and stability of the financial condition of the adviser as well as the sub-adviser.

Section 15(f) Change of Control

Directors should note that advisory agreements terminate automatically if another entity acquires more than 25% of the adviser's voting securities. Advisers in this situation must tread carefully due to the potential application of the common law prohibition that a fiduciary cannot sell their office for compensation. Section 15(f) of the 1940 Act establishes a safe harbor from this prohibition if the following two requirements are met: 1) for a period of three years from the date of an assignment, at least 75% of the board members for a registered fund must be independent of either the prior or then current investment adviser, and 2) there must be no "unfair burden" imposed on a fund as a result of the assignment. Section 15(f) of the 1940 Act

specifies that "unfair burden" includes any arrangement during the two-year period after an assignment that results in the new or old investment adviser or interested person of either adviser receiving compensation other than bona fide underwriting or advisory fees.[18] This is often interpreted to mean that advisory fees for a fund should not increase for two years after an assignment occurs and that a fund should not bear the cost of proxies relating to adviser mergers or acquisitions.

Section 15(a)(4) Assignments

Section 15(a) also requires that an advisory agreement terminate automatically if it is assigned as such term is defined in the 1940 Act.[19] Rule 15a-4 was designed to deal with unforeseeable assignments of advisory agreements by permitting a board to act on an emergency basis to prevent the fund from being harmed by the absence of advisory services in circumstances such as a change of control. In particular, Rule 15a-4 provides a temporary exemption from the requirement that a fund's shareholders approve its advisory agreement and permits a fund to be advised under a short-term agreement until shareholders can vote on a new agreement. Rule 15a-4 under the 1940 Act permits an investment adviser to serve for up to 150 days under an interim agreement without the approval of shareholders when an advisory agreement is terminated under certain circumstances. Among other requirements, the board of directors, including a majority of the independent directors, must vote in-person to approve the interim agreement before the prior advisory agreement is terminated.[20] The application of Rule 15a-4 can be complex and the facts and circumstances under which it can be relied upon should be carefully analyzed.

CONCLUSION

The proper consideration and approval by a board of a fund's advisory agreement, including the advisory fee, is one of a fund director's core governance mandates under the 1940 Act. The 1940 Act and relevant judicial case law provide a well-established framework of elements for a board to formally review as part of a fund's 15(c) review, but directors are also continually receiving material information related to the services provided by an adviser and other *Gartenberg* factors throughout the year. Fund directors will find it helpful to keep their fiduciary duties in mind when evaluating these materials and executing their responsibilities relating to the advisory agreement approval process.

Part 2: Board Processes

INTRODUCTION

While Section 15(c) of the 1940 Act requires a designated annual "15(c) meeting" for independent directors[21] to vote to renew a fund's advisory agreement after its initial term of up to two years, it is important to note that the "15(c) process" usually occurs on an ongoing basis throughout the year. Directors receive information on a variety of matters, many of which may be related to their 15(c) responsibilities. Accordingly, the factors considered and the conclusions reached at the annual 15(c) review meeting will be based on information provided by the adviser and board discussions over the course of the year (perhaps even over several years) and will represent an overall assessment by the independent directors of the adviser's fees and services as part of their decision regarding annual renewal.

Independent directors have a fiduciary responsibility to protect the interests of fund shareholders, and their role in evaluating investment advisory agreements is one of their core board governance duties. Section 15 of the 1940 Act and relevant case law outline their responsibilities. In particular, the *Gartenberg* case and the many cases following *Gartenberg* provide guidance for independent directors in this area.[22] However, these statutory and judicial frameworks do not prescribe how independent directors should execute their responsibilities relating to advisory agreement approvals, and procedures vary widely across fund complexes. In considering the 15(c) process at their own complexes, boards should consider their particular funds.

Directors may find the following practical observations helpful. An abbreviated '15(c) Review Process Considerations At-a-Glance' section is attached as Appendix I to reference key takeaways that directors can refer back to in preparation for 15(c) meetings.

15(c) REVIEW CONSIDERATIONS FOR DIRECTORS

15(c) Questionnaire

The process for the annual 15(c) review can vary widely based on the complexity of the fund, the size of the fund complex, and other factors. The 15(c) meeting process often begins with the "15(c) questionnaire," which is a formal, written request from or on behalf of the board for information from any adviser or sub-adviser with an advisory agreement subject to review and approval at the annual 15(c) meeting. Counsel often assists the board in the preparation of the

15(c) questionnaire, which is designed to help satisfy the requirement of Section 15(c) of the 1940 Act that requires the board to request and evaluate, and the adviser or sub-adviser to provide, information reasonably necessary to evaluate the terms of the fund's advisory agreement. The 15(c) questionnaire generally contains information and material requests pertinent to each of the *Gartenberg* factors, as well as other information directors have found to be relevant.

While boards may request information relating to any factor that the board considers appropriate, boards generally find that the *Gartenberg* factors are sufficiently broad to cover most information necessary for the evaluation of any fund's advisory agreement. Counsel generally also provides a memo summarizing the board's legal obligations, relevant case law, and key factors to consider as the independent directors evaluate the approval or renewal of each advisory agreement. For series trusts or funds with one or more sub-advisers, each adviser or sub-adviser usually completes its own 15(c) questionnaire, although in some cases boards may wish to add certain questions to the adviser's questionnaire relating to its oversight role.

Directors are often involved in the review and modification of the 15(c) questionnaire from year to year, although counsel typically has primary responsibility for updating it on an annual basis. In some cases, after discussion about potential areas of inquiry, directors may elect to receive an updated 15(c) questionnaire, marked to show proposed changes from the prior year, and then have the opportunity to comment on the updated questionnaire. In addition to adding new areas for inquiry, questions may be reviewed to determine whether they continue to be relevant over time (for example, such as with respect to questions regarding COVID protocols). The 15(c) questionnaires may be modified each year to address any new areas in which the directors may be interested or remove questions that are no longer relevant. In addition, changes might be made to clarify the wording of certain questions, address changes in applicable laws, address regulatory or enforcement matters or priorities, or request information relating to rapid, unexpected or significant changes or other market conditions or other recent developments relating to the fund or adviser. To the extent that material edits have been made to the 15(c) questionnaire, the board may request to receive an updated draft of the questionnaire prior to its distribution to advisers.

A draft 15(c) questionnaire may be submitted to the adviser in advance to give the adviser an opportunity to seek clarification of questions or any potential ambiguities before the final 15(c) questionnaire is delivered. The content of the 15(c) questionnaire may be tailored to address the particular advisory agreement under review. For example, if an adviser provides investment advice to non-fund clients for similar strategies, the request will likely include information

concerning the fees charged and services provided to those other accounts, and if an adviser serves as a sub-adviser to other funds, the request may include fees earned by the adviser as sub-adviser for similar strategies. The questionnaire usually requests information regarding the services that the investment adviser has agreed to provide. The 15(c) questionnaire should include appropriate questions about any services other than investment advice included under the advisory agreement. Traditionally, other services may include items such as administrative, fund accounting or even compliance services. 15(c) questionnaires generally evolve over time as facts and circumstances change regarding services, fees, service provider relationships, and/or other relevant factors.

The 15(c) process may pose unique considerations for series trusts and multi-manager fund complexes. For example, using a standardized questionnaire and information gathering process can aid the independent directors' efficient consideration of multiple renewals for multiple advisers and sub-advisers over the course of the year. If a fund complex has a number of sub-advisers, boards may seek to request additional information or clarifying responses if answers from different sub-advisers conflict. For series trusts or funds with one or more sub-advisers, each adviser or sub-adviser usually completes its own 15(c) questionnaire. In evaluating sub-advisory agreements, independent directors may give significant weight to the primary adviser's oversight of the sub-adviser consistent with the primary adviser's role to select and monitor the sub-adviser. In a multi-manager fund complex, boards may wish to consider whether certain questions related to the sub-adviser should be added or moved to the primary adviser's questionnaire as part of the adviser's oversight of the sub-adviser. Each adviser and sub-adviser should clearly understand the information that the board is seeking.

15(c) Response Pre-Meetings and Review

After any updates have been incorporated, the formal 15(c) questionnaire is then distributed to each adviser and sub-adviser with ample time provided for each response. The advisers provide a written response to each question, and the completed questionnaire and supporting information is then distributed to the board for review. Boards may hold a single or series of meetings to analyze the information prior to a final vote. In many cases, representatives of the adviser may be asked to review the information for each fund with the board, either at the 15(c) meeting or during a pre-meeting. Pre-meetings may be held which provide an opportunity for open discussion between directors and adviser representatives in private sessions. Directors may also convene pre-meetings or pre-calls without the adviser representatives present to discuss any specific issues or areas of interest among the directors in order to assist in the preparation for the 15(c) meeting. In some cases, the advisory agreement, as well as the 15(c) responses provided for the 15(c) meeting and over time, may be reviewed and voted upon

during the single designated 15(c) meeting. In other cases, materials may be reviewed in one meeting while the formal vote regarding the approval of the advisory agreement may occur during a separate meeting.

After reviewing the written materials provided, independent directors may pose follow-up questions or requests to be addressed before the final vote is taken. Providing a reasonable amount of time for the adviser to respond to supplemental information requests is critical in order to obtain accurate and complete responses. Independent directors may request that advisers either provide supplemental information in written form prior to the 15(c) board meeting or be prepared to discuss their responses at the 15(c) board meeting. In-person responses may be appropriate, especially in circumstances in which the adviser has sensitivity about the extent of the audience for written materials. For example, the adviser may wish to restrict access to the adviser's financial statements only to the board. Oral discussions may also be appropriate when there is a late business development that may be material to the approval of the advisory agreement, such as a proposed proxy, investment strategy change recommendation or material portfolio management change.

With respect to the review of the 15(c) responses, there is no standard across boards, but it may be helpful to understand who, in addition to the board, might assist the board, including the fund CCO, fund counsel and/or independent director counsel. Completed 15(c) materials should be read carefully, and there should be follow-up for any incomplete or unclear responses. In most cases, corrected or additional information is requested and provided in writing or during a meeting so that the independent directors have the information they have determined is reasonably necessary in their evaluation of an advisory agreement. If any requested information is unavailable or determined to no longer be necessary, the facts and circumstances can be discussed with the board and documented appropriately. In some cases, the advisory agreement, as well as the 15(c) responses provided for the 15(c) meeting and over time, may be reviewed and voted upon during the single designated 15(c) meeting. In other cases, materials may be reviewed in one meeting while the formal vote regarding the approval of the advisory agreement may occur during a separate meeting.

15(c) Vendors and Fund Service Providers

Third party vendors can serve a critical role in aiding independent directors in their review of 15(c) materials. For example, boards may utilize third party vendors to help identify relevant peer groups as well as to provide independent fee and performance benchmarking data. These vendors offer both broad industry experience as well as an independent lens for relevant fund data. The identification of a relevant peer group to compare performance and expenses for each

fund is important. Boards may inquire about the methodology used by the vendor to select the peer groups. In addition, if there were any changes to the methodology or peer group selected, the board may inquire about why those changes were made, who requested the changes and the impact on the comparisons (i.e., does the fund's performance compare more or less favorably, and is the adviser's fee comparatively higher or lower). Boards may elect to re-evaluate the vendors utilized to prepare 15(c) reports and data on a periodic basis. There may be a wide range of levels of data available to boards, and boards may seek to periodically evaluate what resources are available to them from management or third-party vendors.

Fund boards may also hire unaffiliated third-party consultants, counsel or outside vendors to provide expert opinions, respond to board inquiries or offer an alternative point of view on topics such as investment models, profitability methodologies, comparing services or performance, operational issues, cybersecurity protocols, or the 15(c) process itself, among other areas. In some circumstances, consultants may be utilized in the development and review of the 15(c) questionnaire itself. Boards may also elect to engage consultants to provide 15(c) training on the 15(c) process and industry developments.

Use of Board Committees and Processes to Allocate Initial Review Responsibilities

Boards may elect to use committees, with varying levels of formality, to help with the 15(c) review process. For example, some boards may utilize contract committees, which focus on matters pertaining to fund agreements broadly, and others may utilize 15(c) committees, which are focused more specifically on the advisory agreement renewal process. Such committees may include all of the independent directors or a subset. These committees can be beneficial in order to divide initial review responsibilities or create a subset of independent directors. Board committees could be responsible for a preliminary review of counsel's *Gartenberg* memo, review and editing of the 15(c) questionnaire, the overall 15(c) process, and/or the evaluation of reports with information relevant to the assessment of each fund's advisory agreement, which may be amongst other committee duties. While boards generally adopt a charter outlining a committee's responsibilities, such charters may opt to describe the 15(c) processes undertaken by a committee at a high level rather than in a granular fashion.

Some boards may also opt to divide preliminary individual fund review responsibilities across types of funds (equity or fixed income, for example) in a 'divide and conquer' approach. Other boards might elect to divide preliminary review by groups of advisers or sub-advisers. In these circumstances, independent directors assigned to specific fund or adviser categories might be tasked with leading the discussions regarding their segment of the 15(c) review with the other

independent directors, voicing observations or identifying areas of focus or follow-up questions or requests.

Enhancing Effectiveness in the 15(c) Process

Capturing efficiencies in the 15(c) process can facilitate board review of advisory agreements, and boards have adopted various ways to do so. The adoption of common 15(c) questionnaires across a complex, the use of consistent investment performance results, fees and expenses, brokerage and portfolio management reporting mechanisms, and the use of "dashboards" or exception reporting are all options to consider in order to achieve a more efficient 15(c) review process. Dashboards may be utilized to aggregate, summarize and highlight key data and contain summaries of certain manager responses. Exception reporting can, based on pre-determined criteria, help highlight funds that independent directors may believe require additional scrutiny. Large complexes may also benefit from certain potential economies of scale and increased resources that can facilitate the review process, such as access to robust compliance and legal teams. Boards may wish to consider whether it is possible to produce information in light of resource or other constraints, and information requests can be tailored to information the independent directors need for their review.

In addition, boards may divide funds and/or advisers into risk levels (e.g., red, yellow or green) to determine which funds may require greater inquiry by the independent directors. When analyzing the nature and quality of services being provided, poor total return investment performance is often a factor cited in identifying funds for heightened review. Also, material compliance violations, advisory firm issues that could materially impact the services provided to a fund, merger and acquisition activity, advisory firm senior personnel changes or departures or portfolio manager departures/succession planning could also be deemed factors for heightened review. Boards may opt to use "watch lists" that could flag issues for further review and regular attention at subsequent board meetings until any identified issues are resolved and the subject funds are removed from the watch list. Watch lists may be formalized and operate pursuant to relevant compliance policies and procedures, or boards may elect to adopt a more informal means to monitor funds subject to heightened review.

15(c) Compliance Policies and Procedures

While not specifically required by Section 15(c), funds may elect to adopt 15(c) policies and procedures as part of their 38a-1 fund compliance manual. Although the 15(c) process itself is only prescribed to a limited degree under the 1940 Act, the SEC staff has shown interest in assessing industry approaches to managing the 15(c) process, e.g., directors' diligence, care, thoroughness, independence, etc. In 2023, the SEC staff focused its examinations on how fund

advisers respond to their board's 15(c) inquiries.[23] In addition, the SEC's November 2024 Risk Alert highlighted the fund investment advisory agreement approval process and the thoroughness of the board's review of fund fees for consistency with disclosures (e.g. whether fund boards compared the services to be rendered and amounts to be paid under the contract to those under other advisory contracts with the adviser or other fund advisers, such as peer groups, or other types of clients). In light of document requests made during exams, funds may want to consider if they want to adopt formal policies and procedures governing the 15(c) process. To provide appropriate flexibility to adapt to changing circumstances, funds may wish to consider adopting high-level, broad, and/or more philosophical, rather than prescriptive, 15(c) policies and procedures. Such policies could address the timing of key receivables from management and delivery of the 15(c) questionnaire and timing of meeting dates, etc. Funds may wish to avoid adopting 15(c) policies that are too granular in order to avoid inadvertent compliance violations related to actions not material to the overall 15(c) process. To the extent that there are material updates to roles or responsibilities in the 15(c) review process, timing and requested information, funds may elect to formalize procedures whereby modifications are communicated to all responsible parties, including the full board.

Documentation of 15(c) Review in Board Meeting Minutes

The documentation of the 15(c) review in the 15(c) board meeting minutes serves as a key primary record of each advisory and sub-advisory agreement review, discussion, and approval and also serves as a key supporting record for related disclosure. A goal in drafting minutes in this context is to evidence the robust discussion of the advisory and sub-advisory agreement deliberations of the independent directors. Counsel may assist in determining the appropriate level of detail to be included in the minutes to support the independent directors' conclusions. Any teleconferences or meetings among the independent directors to review the 15(c) materials prior to the 15(c) board meeting would generally be identified in the 15(c) board meeting minutes to memorialize such meetings in the 15(c) record. Board meeting minutes and board considerations disclosure filed with the SEC should not be boilerplate. Board meeting minutes or the board considerations disclosure should generally also address each relevant *Gartenberg* factor with respect to each advisory and sub-advisory agreement under consideration and its potential applicability to each fund. Directors should review minutes carefully in advance of their approval at subsequent board meetings to avoid material misstatements, omissions or untrue statements regarding the 15(c) process.

CONCLUSION

Consideration of the approval and renewal of fund advisory agreements is a fundamental responsibility of independent directors, but the 1940 Act does not precisely specify how this process should be executed. Pursuant to Section 15(c) of the 1940 Act, boards are responsible for requesting and evaluating, and advisers are responsible for providing, the information reasonably necessary to evaluate the terms of an advisory agreement. In order to limit the influence of interested directors, a majority of the independent directors must approve each advisory agreement initially and upon its renewal. Independent directors should consider how to develop a process that adequately addresses all material information and key areas relevant for their advisory agreement analysis and review. Approaches to the 15(c) process may justifiably vary considerably based on fund complexity, size and other factors. In addition, independent directors should be mindful to allocate sufficient time for a diligent, conscientious, and robust review process in order to prudently execute their responsibilities relating to 15(c) advisory agreement approvals. Directors may seek to allocate dedicated time during board meetings to discuss the 15(c) process with counsel, or attend educational sessions that capture regulatory and industry updates relating to the advisory agreement renewal process and provide the opportunity for directors of differing fund complexes to share best practices.

In general, it is extremely important to keep in mind that the 15(c) process is generally an "iterative process" over time. This process serves to provide a disciplined and rigorous review of material and relevant information regarding an adviser's operations and its acumen in managing funds for which it has contractual arrangements. In this way, independent directors can execute an effective 15(c) process which in good faith they believe will effectively fulfill their statutory duty in considering the various advisory agreements subject to their review.

Part 3: *Gartenberg* Factors Analysis and Board Considerations

INTRODUCTION

While the *Gartenberg* factors help to establish a framework for the evaluation of advisory agreements by independent directors, the 15(c) process is not intended to be formulaic or a "check the box" exercise. When independent directors have conducted an informed review process, "their decision to approve a particular fee agreement is entitled to considerable weight, even if a court might weigh the factors differently."[24] In addition to the *Gartenberg* factors, boards may identify and consider any other factors and information that they deem relevant to their evaluation, including information provided to the board throughout the year. No single factor is dispositive or controlling, and individual directors may vary in their weighting of each factor and may view some factors as more or less relevant than others.[25] Because independent directors may weigh the various factors differently, 15(c) reviews by fund boards may vary significantly across fund complexes. Similarly, independent directors make contract approval or renewal decisions on a fund-by-fund basis, and so they may view certain factors differently for different funds. Some of the important considerations that directors may wish to review regarding the *Gartenberg* factors are outlined herein.

NATURE AND QUALITY OF SERVICES PROVIDED TO FUND SHAREHOLDERS

When independent directors evaluate the nature and quality of services provided to a fund and its shareholders, they should be aware of the services covered in the advisory agreement. However, some of the services provided to shareholders may not be specifically enumerated in the language of the advisory agreement (or administrative agreement, if applicable), and directors may choose to consider all services provided for the benefit of the fund and its shareholders when evaluating the nature and quality of services provided to fund shareholders. Some common advisory services include the following:

- The provision of a continuous investment program and periodic determination of what investments or securities will be purchased, retained, sold or lent by the fund, and what portion of the assets will be invested or held uninvested as cash;
- Ongoing oversight of a fund's investment strategy to ensure alignment with the fund's investment limitations and registration statement disclosure; and

- Other services as necessary to carry out a fund's investment objective and strategy, such as selecting and monitoring brokers to execute fund trades and, if applicable, hiring and overseeing sub-advisers.

Advisers may also provide administrative and other services to a fund, which may include:

- Preparation of SEC filings for registration statements and other fund filings;
- Fund accounting services;
- Books and records maintenance;
- Support for the fund's board, including preparation of board materials;
- Provision of fund officers;
- Valuation services;
- Legal and compliance services;
- Shareholder support and communication services;
- Oversight of fund service providers;
- Administration and oversight of operational processes to monitor compliance with fund policies and guidelines and regulatory requirements;
- Cash management services, including the provision of credit lines (which might be drawn upon from time to time in order to facilitate redemptions without having to sell certain positions for short periods of time), determining where to invest idle cash held for potential redemptions, or for other purposes; and
- Other services necessary for the fund's operations or compliance program.

When boards review the quality of an adviser's services, boards may wish to consider the following in addition to the fund's performance:

- The adviser's compliance policies and procedures;
- If applicable, results of the adviser's regulatory, internal and/or external audits;
- Whether the adviser has a reputation that suggests to the board that the adviser is capable of providing advisory services of a nature and quality that are in the best interests of the fund and its shareholders;[26]
- The depth and breadth of fund offerings provided to shareholders;[27]
- The management team's experience, turnover, retention policies for senior staff and succession plans for senior management;
- The potential benefits provided to a fund by the adviser's risk and performance management programs, among others; and
- The complexity and type of a fund's investment strategies and the extent to which this may require more expensive or additional services.[28]

Boards that oversee funds with sub-advisers will have additional considerations to evaluate with respect to the nature and quality of services provided to a fund by each of the primary

adviser and the sub-adviser. Directors should understand the respective duties and responsibilities of the primary adviser and any sub-advisers to the fund, including the nature and extent of responsibilities retained and the risks assumed by the primary adviser that are not delegated to, or assumed by, the sub-adviser. In addition, directors should understand the source of the sub-advisory fee. In this regard, a primary adviser may pay a sub-advisory fee directly from the advisory fee it receives from a fund, or the fund may pay the sub-adviser its sub-advisory fee directly from fund assets.[29] The nature and quality of the services performed by a sub-adviser with respect to the fund should be considered in evaluating each sub-advisory agreement.

Review of the investment performance of a fund is a key component of the 15(c) process. Directors generally receive ongoing performance information for funds at meetings throughout the year and over time, which may include comparisons to the benchmarks included in each fund's registration statement as well as any other benchmarks the adviser considers relevant. Directors may compare fund returns prior to the deduction of fees and expenses to benchmark returns to assess fund performance without the impact of expenses.

Boards may also consider a fund's performance compared to that of peer funds as part of their analysis of the quality of an adviser's services.[30] Peer groups that reflect a group of comparable products available to investors may offer appropriate comparisons in addition to benchmarks, especially for funds with unique or alternative mandates, restrictions or parameters. However, in evaluating comparative performance data, boards may wish to consider the limitations of such data, including whether any notable differences exist between the fund and its peers. If a custom peer group is created, boards should understand the basis on which the custom peer group is being compiled and the criteria and methodologies used to determine the peer funds, including whether and to what extent the adviser is involved in identifying the custom peer group. The board should also understand the rationale behind any changes to peer group comparisons.

Boards should request that advisers address each fund's performance and provide assistance to the board in properly evaluating that performance, including by confirming whether the management of the portfolio has been consistent with the investment objective and strategies described in the fund's registration statement. If the fund has underperformed, boards may wish to focus on the adviser's reasons for such performance as well as any actions that the adviser has taken, or has agreed to take, to seek to enhance fund performance and the results of those actions. Underperformance can stem from numerous causes, including, but not limited to, fees and expenses that cause performance drag, poor security selection, unfavorable market conditions or timing, sector concentration in underperforming sectors, investments in higher

volatility asset classes, concentration issues or inconsistent or low fund flows that limit the adviser's ability to invest optimally.

Independent directors may also wish to review outperformance to understand whether it reflects appropriate investment decisions or excessive risk-taking by the adviser, deviation from a fund's investment strategy, frequent trading, larger than expected sector or geographic concentration, unexpected market conditions, inapt fund benchmark selections or style drift. On the other hand, consistent with the multi-factor *Gartenberg* analysis, outperformance that reflects strong portfolio management—i.e., a high quality of service—may be considered when evaluating whether to support a higher advisory fee relative to peers. Generally, fund performance should be closely monitored, and directors should be regularly updated as to the adviser's strategies for seeking to improve performance, as applicable. Directors may request risk-adjusted return information from the adviser in order to help evaluate returns per unit of risk to shareholders and may request that the adviser discuss performance attribution of individual funds.

In evaluating performance, boards should understand the adviser's process for determining when and what action the adviser should take or recommend if performance issues arise. The adviser is responsible for managing fund assets and taking steps to adjust the investment process, or possibly adding or changing committed resources, as needed to address performance issues. Independent directors oversee the adviser's process to address underperformance and, depending on the reason for the underperformance, as well as its persistence and severity, it may be appropriate for the board to consider actions to address it. Any action typically will reflect the result of dialogue between the board and the adviser (or sub-adviser) over a period of time. Although generally considered to be a last resort, boards have the authority to terminate the adviser or not approve the renewal of the advisory agreement if such action is believed to be in the best interest of the fund.

In evaluating any underperformance, boards should understand its cause and expected duration. Some fund investment strategies may be designed to perform differently than indexes and may be expected to underperform indexes or peers under certain market conditions. For funds that are not performing as expected, the board should understand any plans by the adviser to seek to address the underperformance. Potential solutions may include, for example, the adviser providing additional resources or making adjustments to a fund's portfolio management team. If these methods are not successful, an adviser may consider proposing changes relating to a fund's mandate, investment restrictions or applicable benchmarks or the adviser's staffing or execution of portfolio management responsibilities.

Board Considerations: Nature and Quality of Services

While each situation is unique, some actions directors may consider in their evaluation of fund performance include:

- Inquiring about an adviser's perspective on relative returns – (e.g., does the manager consider the performance lagging vs. their expectations? How does the adviser view the fund's 1, 3, 5 and 10-year performance results?);
- Discussing criteria for enhanced monitoring, data (such as attribution analysis, historical returns and risk measures) and expedited timelines for reporting to the board;
- Discussing the breadth and experience of the portfolio management team with the adviser and whether any changes may be appropriate;
- Evaluating the level of resources provided to the portfolio management team by the adviser;
- Requesting that the adviser present a remediation plan to the board for any significant or persistent underperformance;
- Requesting additional information from the adviser if fund performance reflects a deviation from a fund's investment objective, strategy, risk profile, holdings or trading methods;
- Considering a change to a sub-adviser engagement, if applicable;
- Considering any changes to a fund's investment objective, strategy, risk profile or trading methods; or
- Considering the possibility of merging or liquidating the fund.

Boards may wish to consider the following when considering other aspects of the nature and quality of services provided to a fund by the adviser:

- Are there any questions or concerns about the adviser's financial statements or Form ADV?
- Has the adviser experienced an elevated level of staff departures? What is the adviser's plan to ensure consistent service to the fund(s) in the event of personnel departures?
- What is the quality of the staff, legal support and other personnel that provide services to the fund?
- What is the adviser's structure for determining compensation/incentive pay for personnel?
- Are there any conflicts of interest with compliance staff and/or management and how are they mitigated?
- Have there been any material compliance violations? If so, have they been remedied in a timely manner and, if applicable, have appropriate changes to policies and procedures been adopted?
- Have there been any regulatory examinations and, if so, what are the results?
- Is there any existing or threatened litigation against the adviser?
- Have there been any internal audits performed on material aspects of the adviser's business relating to the funds, and if so, what have the conclusions indicated for important processes and management oversight, or otherwise?
- Have there been any engagements of external third parties to help evaluate certain aspects of the adviser's fund business, and if so, what conclusions and recommendations were provided?

PROFITABILITY TO THE ADVISER FROM MANAGING THE FUND

Courts have not held any particular profitability level to be either per se permissible or per se unreasonable. Instead, it is one factor to be considered in an overall assessment of a fund's advisory agreement. Assessing an adviser's profitability from managing an individual fund may be challenging for a variety of reasons. Profitability calculations require advisers to make various decisions regarding the appropriate methodology for determining an adviser's cost for providing advisory services to a fund. Industry participants may have different views on what might be considered an appropriate methodology or the types of expenses to include.[31] Independent directors cannot generally compare the profitability of a particular fund to similar funds in different fund complexes because this fund-level information is generally not publicly available. In addition, some advisers may not calculate their own profitability on a fund-by-fund basis in the course of running their advisory business.[32] There are no standard industry-wide allocation methodologies, and many consider allocation methodologies to be "more art than science" as there is no single correct way to perform allocations in the fund industry, or across advisers.

Methodologies for determining an adviser's profitability may vary for a number of reasons, including the complexity of the adviser and the types of expenses involved. Further complicating the analysis is the fact that certain expenses may need to be allocated between the adviser's funds and different lines of business or products. Once a methodology is adopted, an adviser should describe to the directors how the methodology operates, and directors may ask questions regarding the methodology that they consider to be material or relevant to their analysis. Boards should understand the allocation decisions and methodologies used by the adviser in determining fund-level profitability, including any changes that have been made to the allocation methods. Ultimately, independent directors can use their business judgment to determine if the methodologies used are reasonable.

Funds with sub-advisers may present unique considerations with respect to the assessment of the profitability of the adviser and any sub-advisers. Several courts have ruled that, when sub-advisory fees are paid from the advisory fee to an unaffiliated sub-adviser, the primary adviser's payment of sub-advisory fees should be treated as an expense item for purposes of calculating the primary adviser's profitability.[33] Under this treatment, the sub-advisory fee is a revenue item for the sub-adviser and an expense item for the primary adviser. When considering the approval of a sub-advisory agreement, the board may also request and consider information addressing whether the fee paid by the primary adviser to an unaffiliated

sub-adviser was based on an arm's-length bargaining. In addition, as with the primary adviser, directors can also consider the sub-adviser's performance relative to its fees and the expertise that the sub-adviser brings with respect to the management of fund assets.

Board Considerations: Profitability

Boards may wish to consider the following factors when evaluating the adviser's methodology for calculating profitability:

- What are the adviser's expense allocation methodologies? Are they reasonable and consistently applied?
- Have any changes been made to the adviser's methodology for calculating its profitability from prior years, and if so, why?
- Does the adviser have a robust process for computing, presenting and reporting its profitability analysis?
- Is the methodology employed in reporting profitability to the board consistent with that used by management in evaluating its fund business?
- On a periodic basis, has the adviser or the board engaged a consultant to review the adviser's expense allocation methodology to validate or assess its reasonableness and alignment with the adviser's business? If so, directors may opt to seek comment from the adviser, counsel or fund auditors on the consultant's findings.

FALL-OUT BENEFITS

"Fallout" or "ancillary" benefits are "collateral benefits that accrue to the adviser because of its relationship with the mutual fund."[34] In other words, fall-out benefits may be any direct or indirect benefit to the adviser (or its affiliates) that would not be realized without the existence of the fund. For example, fall-out benefits may include, but are not limited to:

- Use of soft dollars;
- Other business arrangements with the adviser or principal underwriter;
- Margin, sweep or "float" interest;
- Brand reinforcement and benefits;
- Advantageous banking relationships;
- Profits received from affiliates selling products or securities or providing services to the fund;
- Management fees earned through other accounts with the shareholder; or
- Profits earned from cross-selling.

Any fall-out benefit should be considered by the independent directors in their evaluation and approval of an adviser's management fee. There may be challenges in quantifying the exact amount of a fall-out benefit. However, the board should generally consider whether such

benefits, even if not specifically quantifiable, are so substantial that they impact the proportionality of the advisory fee to such an extent that the adviser has breached its fiduciary duty.

Many investment advisers offer other investment products and business lines, and directors may wish to consider any potential fall-out benefits associated with these relationships. Directors may consider requesting an analysis of such relationships and updates regarding management's criteria for identifying a fall-out benefit as well as a periodic inventory and assessment of such benefits. Advisers should clearly document any fall-out benefits that result from their relationship with a fund, and this information should generally be disclosed to the board as part of its evaluation of an advisory agreement approval or renewal. The board's consideration of such benefits will be disclosed in a report filed with the SEC regarding the factors considered by the board when approving advisory agreements. If an adviser does not believe that it receives any fall-out benefits from its relationship with a fund, the board may wish to request and review the adviser's analysis of that belief.

Board Considerations: Fall-Out Benefits

In order to assess fall-out benefits, boards may wish to consider the following:

- Has the adviser established a process for identifying any fall-out benefits?
- Has the adviser made reasonable efforts to quantify any fall-out benefits, if feasible, and how such benefits impact the adviser's overall profitability with respect to the fund?
- Has the board received information about any benefits to the adviser from any other business relationships the adviser or its affiliates have with the adviser or principal underwriter such as relationship pricing?
- Does the adviser provide the board with information regarding "soft dollar" research services received by the adviser on fund brokerage transactions, or information or written statements from the adviser about "soft dollar" usage and compliance?
- Does the adviser present or provide information periodically to the board regarding the fund's participation in the adviser's new or changed "soft dollar" arrangements, along with information about how these arrangements benefit the fund and its shareholders?
- Has the adviser identified any fall-out benefits that might accrue to its affiliates?

FEES

Under the *Gartenberg* analysis, an adviser violates Section 36(b) of the 1940 Act when it "charge[s] 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.[35] Accordingly, independent directors must find that the advisory fees paid by a fund are within

the range of what would have been negotiated at arm's-length in similar circumstances taking into account the services provided to the fund by the adviser. This does not mean, however, that the fund and adviser must arrive at the fee through bargaining at arm's length. The courts recognize that, because a fund is usually organized by its adviser, the bargaining is not between strangers. Independent directors may also compare the total annual operating expenses of a fund to those of its peer group when assessing the overall reasonableness of the fund's fees.

Independent directors should be mindful that the U.S. Supreme Court has cautioned against giving too much weight to comparative fee information, because fees charged by other advisers "may not be the product of negotiations conducted at arm's length."[36] In *Jones*, the U.S. Supreme Court noted that "the comparison of fees charged by other mutual funds, which plaintiffs urge as a decisive factor, is not sufficient by itself to establish that fees charged by the … funds are unreasonable."[37] Still, comparative fees may represent an additional source of data for the board and are widely used by boards as part of their considerations.

Independent directors may find that any comparisons of the fee structures of a registered fund with those of separate accounts or institutional accounts can be a complicated endeavor.[38] A comparison of fees between a registered fund and the adviser's separate or institutional accounts may not be appropriate because the services, risks and responsibilities of the adviser can be dramatically different across different account types even if the investment strategies are substantially similar. In this regard, the U.S. Supreme Court has stated that there can be no "categorical rule" regarding the utility of any such comparisons.[39]

To the extent that fees between sponsored registered funds and institutional separate accounts are compared, directors should give such comparisons the weight they merit in light of the similarities and differences between the services that the clients require. To this end, directors may wish to request that the adviser identify any material differences between these products and their associated services and risks. For example, most open-end mutual funds strike a daily NAV, offer daily redemptions and ensure cash availability for such redemptions. Institutional and separate accounts may not strike daily NAVs, and daily liquidity management may not be a substantial concern. Assumed risks by the adviser can also be vastly different between registered funds and separate accounts. For example, advisers may face greater risks from a NAV error impacting a registered fund as compared to an institutional separate account, because such an error for a registered fund could impact up to thousands of individual shareholders in the fund. In addition, an adviser's entrepreneurial and reputational risks are often much greater with respect to a registered fund than they are for separate accounts.

Independent directors may also make note of the considerable differences between services offered by an adviser in its capacity as primary adviser to a fund when compared to services offered by the adviser in its capacity as sub-adviser to a third-party fund. Unlike sub-advisers, primary advisers may be responsible for, among other things, a fund's registration statement and marketing materials, disclosures, daily NAV processes, SEC filings, overall fund compliance, oversight of service providers, general fund administration and securities pricing and valuations.

For funds with sub-advisers, directors also may review the sub-advisory fee and the fee split between the adviser and sub-adviser. If the sub-adviser is an affiliate of the primary adviser, the primary adviser may provide the board with combined profitability information that reflects the profitability of the fund with all affiliated entities of the adviser. Fees received by the sub-adviser may be compared to fees received by the sub-adviser for serving as sub-adviser to other funds with similar investment strategies. Directors should note that sub-advisory services typically do not involve the full range of services that would be performed by a primary adviser to a fund that does not have sub-advisers. When reviewing the fees of an unaffiliated sub-adviser, the board may wish to review information or representations addressing whether such fees were the product of an arm's-length negotiation between the adviser and the unaffiliated sub-adviser.

Board Considerations: Fees

Boards may wish to consider the following when evaluating the fees and expenses of a fund:

- Are the advisory fees being considered in relation to the costs of the adviser's services to the fund?
- Does the board understand how the fund's peer groups for fee and expense comparison purposes are determined?
- Are the services being provided to peer group funds comparable to the services being provided to the fund?
- How does the advisory fee compare to fees charged by other advisers that manage funds with similar investment strategies and provide similar services?
- If the adviser (or sub-adviser) provides advisory services for funds with similar investment strategies, how do the fees and services provided compare?
- Are there other drivers of comparably higher expense ratios (e.g., lower asset levels, out of favor asset classes, higher redemptions, etc.)?

ECONOMIES OF SCALE

The extent to which an adviser realizes any economies of scale in its costs to manage a fund as assets increase and the extent to which the adviser has shared any such benefits with the fund

is another *Gartenberg* factor that directors consider in their analysis of advisory agreements. One court has defined economies of scale as "decreasing costs on a per unit basis as the fund increases in size."[40] However, a fund's increase in size does not automatically mean that potential economies of scale exist.[41] For example, portfolio managers have to review each new potential fund investment individually, and a fund's 100th security selection could very well require the same amount of diligence as the first.

In considering economies of scale, boards may assess whether the adviser has experienced a direct reduction in its costs as a result of a growth in fund size. One way for a fund board to consider whether economies of scale exist for a fund is by scrutinizing the fund's profitability reports. The asset class of a fund can impact economies of scale due to different levels of required resources and complexity. When economies of scale may be found to be present, the board should assess whether an appropriate portion of the cost savings from any economies of scale is passed along to fund shareholders. This assessment is a facts and circumstances evaluation, and independent directors should consider if "the information that is available provides a reasonable basis for judgment that the benefits are in fact shared by the adviser with the fund."[42]

Advisory fee breakpoints, which are fee rate reductions that are imposed when a fund reaches designated asset thresholds, are one example of how economies of scale may be shared by the adviser for the benefit of shareholders. Breakpoints can show cost savings as assets grow, but asset growth independently may not always reflect benefits to shareholders. For example, costs may not decrease linearly with asset growth, exceeding optimal asset levels may be detrimental to a fund, or breakpoints may be minimal and have little impact.

Fee waivers, expense reimbursements and expense caps are other ways that economies of scale can be shared. Another possibility is seeking to price the fund as if it were at scale at launch in the adviser's estimation, resulting in the fund being priced lower than the level necessary for the adviser to recoup its cost of providing advisory services to the fund at launch.

Independent directors should also consider other ways in which potential economies of scale are shared other than through direct cost considerations. For example, the adviser may have made capital investments into the adviser's business that have resulted in additional or improved services to the fund, such as investments in technology and operational infrastructure and increases in portfolio manager compensation to stay competitive in the market. In addition, large fund complexes may benefit from potential economies of scale because the adviser can leverage greater internal resources for the preparation of 15(c) materials.

Board Considerations: Economies of Scale

Boards may wish to consider the following questions when analyzing the potential economies of scale in connection with the management of a fund:

- Are there any potential economies of scale that the adviser has received relating to the fund?
- Has the adviser shared any economies of scale with the fund and its shareholders through advisory fee breakpoints?
- Are there other ways in which economies have been shared with shareholders, such as through fee waivers, expense reimbursements, pricing the fund's advisory fees to scale at the fund's inception, and/or reinvestments back into the adviser's business to provide enhanced and/or additional services to the fund?

INDEPENDENCE AND CONSCIENTIOUSNESS OF THE DIRECTORS

Under the *Gartenberg* analysis, courts will consider "the expertise of the independent trustees of a fund" as well as "the extent of care and conscientiousness with which they perform their duties."[43] The *Gartenberg* court stated that this includes an assessment of whether directors are "fully informed about all facts bearing on the adviser-manager's service and fee."[44] The *Jones* court elaborated that "scrutiny of investment adviser compensation by a fully informed mutual fund board is the cornerstone of the … effort to control conflicts of interest within mutual funds."[45] The *Jones* court also stated that when "a board's process for negotiating and reviewing investment adviser compensation is robust, and the disinterested [trustees] considered the relevant factors, their decision to approve a particular fee agreement is entitled to considerable weight, even if a court might weigh the factors differently."[46] As a practical matter, this means that board decisions are less likely to be second-guessed by a court if the board has demonstrated it has a robust 15(c) process in which the directors are fully informed of factors relevant to their determinations. In contrast, courts may be more likely to scrutinize the results of a board's determinations if the process is deficient or if material information has been withheld.

Independent directors may consider factors impacting their independence (such as potential conflicts of interest, financial relationships or outside influences) or conscientiousness (such as diligence, level of participation and review of board materials). Annual director questionnaires are one tool that can be used to assist in identifying any potential conflicts or independence issues.

Consistent with their state law fiduciary duties, directors should focus on acting diligently and without conflicts of interest when reviewing and approving a fund's advisory agreement. A rigorous board process for reviewing and approving advisory agreements remains crucially important. The following are examples of practices that directors may wish to consider incorporating into their 15(c) process:

- Carefully reviewing materials that are specifically provided in connection with the advisory agreement approval or renewal as well as other relevant materials the board receives throughout the year;
- Ensuring that any requested materials are received by the board sufficiently in advance of the meeting at which the 15(c) votes will be taken;
- Becoming fully informed of all material facts bearing on the adviser's services and fees;
- Actively engaging in 15(c) discussions with the adviser, including asking probing questions;
- Ensuring there is an opportunity for the directors to request and receive additional information as they deem necessary;
- Assessing whether responses provided by the adviser are complete and responsive to the questions posed;[47]
- Holding one or more sessions or meetings without management or any interested directors present (e.g., prior to the meeting at which the 15(c) votes will be taken) and engaging in robust discussions among the independent directors regarding the 15(c) materials; and
- Seeking information from independent sources in addition to the adviser.

Counsel to the independent directors, if available, may also serve as an important source of guidance and the independent directors should avail themselves of the advice of counsel when evaluating the 15(c) materials.[48]

Board Considerations: Independence and Conscientiousness of the Directors

Boards may wish to consider the following when evaluating their independence and conscientiousness:

- Has the board received all relevant information it deems necessary for its analysis of any advisory or sub-advisory agreements subject to approval or renewal?
- Does the board consider the independence and level of conscientiousness of the independent directors and whether the directors, as a whole, are adequately equipped to discharge their fiduciary responsibilities to the fund?
- Does the board periodically review its 15(c) process, including any updates to reflect new funds, new services provided, new conflicts and market or regulatory developments?

- Do the meeting minutes adequately document the directors' material considerations of the advisory agreement?
- Has the board incorporated components of the 15(c) review process, such as quarterly performance or other fund management reporting, throughout the year and, therefore, engaged in a "yearlong" 15(c) evaluation of the Adviser?

Boards may also wish to consider the following:

- Has the board pursued educational resources relating to the 15(c) process or received guidance from fund counsel and/or independent director counsel on its duties and responsibilities when considering the approval of the advisory agreement?
- Has the board utilized any third-party consultants or other service providers relating to the 15(c) process or the development of certain 15(c) materials (e.g., performance and fee comparisons against peers)?
- Does the board represent a variety of background experiences and viewpoints?[49]

CONCLUSION

The *Jones v. Harris* case served not only to affirm the *Gartenberg* standard of review but also emphasized the importance of the process and substance of the board's review of each *Gartenberg* factor. Courts have shown significant deference to the decisions of directors when they are well informed and when the adviser has provided them with all material information pertinent to their review. When these criteria are met, a board's decision to approve an adviser's fees is unlikely to be second-guessed by the courts.

Part 4: Enforcement Action Takeaways

INTRODUCTION

The SEC has brought a number of notable enforcement proceedings against investment advisers, independent directors and others related to the advisory agreement renewal process and alleged failures and deficiencies in the 15(c) process. SEC enforcement actions can result in, among other things, penalties, disgorgement and the need to retain an independent (and often costly) compliance consultant to review and assess a firm's policies and procedures. Fund directors can benefit from staying apprised of key SEC enforcement actions relevant to the 15(c) process, as they offer real-world illustrations of regulatory expectations and the potential consequences of insufficient 15(c) processes. Such insights may, for example, assist boards in preparing 15(c) information requests and aligning their oversight practices to avoid ending up in the SEC's crosshairs.

This final section of the MFDF 15(c) White Paper highlights key takeaways from selected enforcement actions that directly involve Section 15(c).

SELECTED SEC ENFORCEMENT ACTIONS WITH SECTION 15(c) VIOLATIONS

Morgan Stanley Investment Management, Inc[50] (2011)

Fund: The Malaysia Fund, Inc.

Respondent: Morgan Stanley Investment Management, Inc. ("MSIM")

Case Overview: In December 2011, the SEC charged MSIM with a 15(c) violation for failure to provide the board of The Malaysia Fund, Inc., a registered closed-end fund, with information necessary to evaluate a sub-advisory agreement. MSIM, the primary investment adviser to The Malaysia Fund, Inc., had retained a Malaysian sub-adviser to provide certain services to MSIM, including research, statistical reports and local market intelligence and advice. MSIM repeatedly advised the board that the sub-adviser was actively providing such services. According to the SEC, however, the sub-adviser's actual services were limited to providing two monthly reports based on publicly available information, which MSIM neither requested nor

used. As a result, the SEC alleged that the fund's 15(c) disclosures regarding the services provided by the sub-adviser were materially false and misleading and that the fund paid approximately $1.8 million in advisory fees for services it did not actually receive.

Statutory Violations:

- 1940 Act Section 15(c): Failure to provide the board with information necessary to evaluate a sub-advisory agreement, including the nature and value of services provided.
- 1940 Act Section 34(b): Misstatements or omission in shareholder reports regarding the sub-adviser's role and contributions.
- Advisers Act Sections 206(2) and 206(4): Engagement in deceptive and fraudulent practices by misrepresentation of the extent of services provided by the sub-adviser.
- Advisers Act Rule 206(4)-7: Failure to maintain sub-adviser oversight policies and procedures designed to prevent misleading disclosures and proper board communication.

Penalties and Remedies:

- MSIM agreed to a censure and cease and desist order, repaid $1.845 million to the fund for improper sub-advisory fees, paid a $1.5 million civil penalty and consented to implement enhanced compliance policies relating to 15(c) review and sub-adviser oversight.

Key Takeaways for Fund Directors:

- Directors should request that advisers, including sub-advisers, provide detailed information regarding the specific services to be performed for the fund.
- In an adviser and sub-adviser arrangement, the directors should request that the adviser identify the separate services to be performed by the sub-adviser and confirm that the retention of the sub-adviser continues to be appropriate on an ongoing basis.
- Directors may want to confirm with the adviser that the adviser is reviewing for accuracy and completeness all information being provided to it by the sub-adviser for the Board regarding its services and operations.

Northern Lights Fund Trust[51] (2013)

Funds: Northern Lights Fund Trust ("NLFT"), Northern Lights Variable Trust ("NLVT")

Respondents: Northern Lights Compliance Services ("NLCS," provided compliance services), Gemini Fund Services, LLC ("GFS," provided administrative and shareholder report preparation services), interested and independent trustees of NFLT and NLVT

Case Overview: In 2013, the SEC brought an enforcement action against the trustees and service providers of NLFT and NLVT, each a series trust with multiple funds managed by unaffiliated investment advisers, focusing on systemic failures in board oversight of advisory agreement approvals. The SEC found that certain fund shareholder reports drafted by GFS

contained disclosures regarding the trustees' 15(c) evaluation process that were materially untrue or misleading in violation of Section 34(b) of the 1940 Act. Further, the SEC also faulted the trustees for approving board minutes containing boilerplate language and untrue or misleading statements concerning the trustees' Section 15(c) evaluation process, noting that the trustees were aware that board minutes were used to prepare corresponding disclosures to shareholders. The SEC also alleged that the administrator failed to maintain required records pertaining to the trustees' considerations. The SEC also found that NLCS and the trustees caused violations of Rule 38a-1 under the 1940 Act by approving compliance programs of service providers through reliance on brief written and oral statements by service provider representatives as to the sufficiency of the programs, rather than reviewing the advisers' compliance manuals or receiving a comprehensive summary highlighting key compliance risks, as required by the funds' procedures.

Statutory Violations:

- 1940 Act Section 15(c): Failure to properly request and evaluate information necessary to approve advisory agreements.
- 1940 Act Section 30(e) and Rule 30e-1: Failure to include accurate information in shareholder reports.
- 1940 Act Section 31(a) and Rule 31a-2(a)(6): Failure to maintain and preserve accurate records as board minutes were found to be misleading and not an accurate representation of what the board discussed or considered, as well as failures to maintain financial and other written materials considered by the board in approving the agreements.
- 1940 Act Section 34(b): Material misstatements in board minutes and shareholder reports.
- Rule 38a-1: Failure to adopt and implement effective compliance policies and procedures.

Penalties and Remedies:

- NLCS and GFS each subject to $50,000 fine and consent to cease and desist order.
- Independent compliance consultant required to review and enhance policies and procedures relating to advisory agreement approval, compliance program oversight and board reporting.

Key Takeaways for Fund Directors:

- Boards should understand the fund's process for preparing the disclosures regarding the directors' 15(c) evaluation process and work with counsel, as necessary, to ensure the accuracy of the disclosure.
- Boards should review meeting minutes closely and ask questions of counsel as necessary to ensure the minutes accurately reflect the meeting and the meeting materials.
- Boards should inquire of management regarding the processes of vendors or management for ensuring the written materials they consider in the 15(c) process are retained and maintained as required. Boards should inquire whether retention policies regarding board deliberations, follow-

ups and rationales are reflected in board meeting minutes or otherwise maintained consistent with regulatory requirements.
- Boards should ensure that the fund CCO and other service providers are providing the Board with the information necessary for the Board to approve service provider compliance programs.

Kornitzer Capital Management[52] (2015)

Funds: Ten series of the Buffalo Funds with a single board

Respondents: Kornitzer Capital Management, Inc. ("KCM") and Barry E. Koster

Case Overview: Between 2010 and 2013, the Buffalo Funds' board annually requested that KCM (as investment adviser to the funds) provide its profitability analysis and expense allocation methodology, including an explanation of how KCM allocated its expenses among the funds and other clients. Koster, KCM's chief financial officer and chief compliance officer, provided analysis stating that all employee compensation was allocated based solely on estimated labor hours. In reality, according to the SEC, Koster adjusted the allocation of the CEO's compensation to the funds each year using factors other than the estimated labor hours, in part to achieve consistent year-over-year profitability. These other factors and this adjustment, which were not disclosed to the board, resulted in reported pre-tax net profit margins that were nearly identical year-over-year. The SEC found that KCM failed to provide information reasonably necessary for the board to evaluate its advisory contracts, violating Section 15(c) of the 1940 Act.

Statutory Violations:

- 1940 Act Section 15(c): KCM failed to supply information reasonably necessary for the board to evaluate advisory contracts by providing incomplete and inaccurate profitability data. Koster was found to have caused KCM's violation.

Penalties and Remedies:

- KCM fined $50,000 and ordered to cease and desist from future 15(c) violations.
- Koster fined $25,000 and ordered to cease and desist from future 15(c) violations.

Key Takeaways for Fund Directors:

- Directors should request information to ensure that they understand the expense allocation methodology used to determine the adviser's profitability.
- If reported metrics have an unexpected uniformity year-over-year, directors may wish to ask the adviser about what assumptions are incorporated into their analysis or whether any adjustments have been made.

- Directors should make sure that detailed records are maintained regarding their information requests and what was received in response, as well as any additional follow-up questions, if applicable.

Commonwealth Capital Management, LLC[53] (2015)

Funds: World Funds Trust and World Funds, Inc.

Respondents: Commonwealth Capital Management, LLC ("CCM"), Commonwealth Shareholder Services, Inc. ("CSS"), John Pasco III (owner of CCM and CSS), and three trustees of World Funds Trust (WFT)

Case Overview: In 2015, the SEC sanctioned CCM, CSS, their owner John Pasco III, and three trustees of WFT for failing to meet their 15(c) obligations in connection with advisory agreement approvals for funds in the World Funds Trust and World Funds, Inc. Between 2009 and 2010, the trustees requested information from CCM regarding profitability, expense allocation, advisory fees paid by comparable funds, and fund subsidies. CCM either did not respond fully or provided what the SEC considered to be inaccurate fee charts and inappropriate industry fee comparisons. According to the SEC, CCM also falsely represented that breakpoints were included in the fund fee schedule of the advisory contracts, when the fund did not have breakpoints, and did not provide complete information on expense limitation agreements. According to the SEC, the trustees requested supplemental information from CCM to assist them in considering CCM's 15(c) materials but approved the advisory agreements without receiving the supplemental information requested or following up for additional clarity. The SEC found that CCM and the three trustees violated Section 15(c) and that Pasco caused CCM's violation. Additionally, the affiliated administrator Commonwealth Shareholder Services failed to include required disclosures about the 15(c) approval process in one shareholder report, violating Section 30(e) of the 1940 Act and Rule 30e-1 thereunder.

Statutory Violations:

- 1940 Act Section 15(c): Failure to provide fund directors with all information reasonably necessary to evaluate the advisory agreements (e.g., missing or inaccurate advisory fee comparisons, incomplete details about the nature and quality of services, omission of breakpoints, profitability, and expense limitation agreements). Trustees approved contracts without ensuring adequate information was provided.
- 1940 Act Section 30(e) and Rule 30e-1: Failure to include required disclosure of the board's advisory agreement approval rationale in shareholder reports.

Penalties and Remedies:

- Adviser and its president - $50,000 penalty and consent to cease and desist order.

- Each trustee - $3,250 penalty and consent to cease and desist order.

Key Takeaways for Fund Directors:

- Directors should raise questions if they believe that they have not received full, accurate and comparative fee data from advisers.
- If directors ask an investment adviser to include additional information or clarifications in the adviser's 15(c) response, the directors should ensure that adviser provides such information or clarification, or a satisfactory reason why such information or clarification is unnecessary or unavailable, before approving the advisory contract.
- Directors should be aware that advisers have a duty to provide all material information reasonably necessary for the board to evaluate the terms of the advisory agreement. Advisers must also ensure that the information that they provide is complete and not misleading.
- Directors should scrutinize areas of potential conflicts of interest and request additional information if there are red flags suggesting that the adviser is not being transparent with respect to any fee justifications.
- Independent counsel may be a valuable resource in identifying information gaps.
- Boards should document their advisory agreement review process to show thorough evaluation and independent judgment.

Van Eck Associates Corporation[54] (2024)

Fund: Van Eck ETF Trust (Van Eck Social Sentiment ETF (BUZZ))

Respondents: VanEck Associates Corporation ("VEAC")

Case Overview: VEAC, a registered investment adviser, created BUZZ to track an index based on "positive insights" from social media and other data. The index provider, which was unaffiliated with VEAC, partnered with a high-profile and controversial social media influencer to promote the ETF and participate in launch events. As an incentive for such promotion, the licensing agreement between VEAC and the index provider included a sliding-scale fee in which compensation to the index provider increased with the fund's asset growth. VEAC did not fully inform the board about the influencer's involvement or the sliding-scale fee arrangement during the advisory agreement review process. The board became aware of the influencer's involvement days before the launch, but it did not receive many details about the arrangement with the index provider. These disclosure failures limited the board's ability to evaluate the economic impact of the licensing arrangement and the influencer's role in the advisory contract approval process under Section 15(c). The SEC also faulted VEAC for not informing the board that the influencer's controversial views might be associated with the fund, despite having been warned about this risk by a public relations consultant shortly before launch.

Statutory Violations:

- 1940 Act Section 15(c): Willful failure to provide fund directors with material information necessary to evaluate the advisory agreement.
- Advisers Act Section 206(2): Engagement in deceptive practices by omitting material facts regarding influencer involvement and fee arrangements.
- Advisers Act Section 206(4) and Rule 206(4)-7: Lack of adequate compliance policies and procedures regarding disclosure obligations.

Penalties and Remedies:

- VEAC fined $1.75 million and consented to cease and desist order and formal censure.

Key Takeaways for Fund Directors:

- Board informational requests to the adviser should be designed to elicit information regarding adviser relationships with third parties where the compensation paid to the third party is derived from, or tied to, the fund's advisory fee.
- With unusual marketing arrangements, boards should be mindful of potential reputational and regulatory risks and should request information from the adviser regarding how such risks are being addressed.

CONCLUSION

While the SEC's Division of Enforcement may shift focus areas over time, it is expected to remain focused on fraudulent conduct generally across matters impacting retail investors. The sample enforcement actions discussed herein, as well as the attached overview chart, can provide independent directors with a helpful birds-eye view of regulatory expectations and an opportunity to compare and assess their own oversight practices. Fund boards can expect continued emphasis from the SEC's Division of Enforcement on substantive, independent oversight in the 15(c) processes and a low tolerance for formulaic approaches. Relevant enforcement actions underscore how critical rigorous inquiry and a clear connection between the information reviewed and the decisions made are, and just how vital the role of independent directors in the 15(c) process is.

Appendix I: 15(c) Review Process Considerations At-a-Glance

15(c) Questionnaire

The "15(c) questionnaire" generally serves as the basis of the 15(c) process. This formal, written request asks the adviser or sub-adviser for information relevant to the review and approval of the advisory contract. The 15(c) questionnaire generally contains information and material requests pertinent to each of the *Gartenberg* factors, as well as other information boards have found to be relevant[55]. In reviewing the 15(c) questionnaire, independent directors may consider the following:

- Providing input to 15(c) questionnaires or process[56];
- Adding new questions to reflect new areas of inquiry or regulatory developments; and
- Removing questions if some areas of inquiry are no longer relevant or are otherwise addressed in other materials or reports provided to the board.

Pre-Meetings and Review

The 15(c) process occurs throughout the year. Boards may find it helpful to develop a 15(c) calendar that sets a timetable for steps including document review, receipt of materials, board deliberations and submission to management of follow-up requests. Some independent directors have found the following approaches to review of 15(c) materials in advance of the designated 15(c) board meeting helpful:

- Holding pre-meetings or pre-calls with and/or without adviser representatives to facilitate discussion in advance of the 15(c) meeting;
- Reviewing 15(c) questionnaire responses in advance of the designated 15(c) meeting with counsel, as applicable;
- Assessing whether all independent director requests have been answered completely and requesting additional information when needed, as well as requesting whether the information should be provided verbally and/or in writing at the meeting;
- Involving the appropriate parties in the 15(c) process, such as the fund chief compliance officer, senior management of the adviser, fund counsel, and/or independent director counsel; and
- Incorporating enough time for advisers to provide complete responses and for independent directors to have sufficient time for comprehensive review.

Following each year's 15(c) review, boards may find it helpful to conduct a 'post-mortem' review to discuss how the process could be improved in the following year.

Vendors and Service Providers

Fund service providers and third-party vendors, such as independent providers of investment company data, can provide critical assistance in the 15(c) process. In their oversight of the entities relied upon in the 15(c) process, independent directors may wish to consider the following, as applicable:

- Whether the independent directors understand the methodology used to identify relevant peer groups and any limitations of the peer group data;
- Whether any changes to peer groups have been adequately explained, including who requested the change and the impact on the fund's comparative data;
- Periodically re-evaluating the vendors utilized to prepare 15(c) report and data;
- Inquiring about the level of data and resources available on an annual or other periodic basis; and
- Engaging unaffiliated third-party consultants, counsel or outside vendors to provide expert opinions or analysis, respond to inquiries or offer alternative or independent points of view on discrete matters (for example, with respect to complex investment strategies or new vendor reporting in response to emerging regulatory requirements).

Board Processes to Enhance Efficiencies and Effectiveness

Adopting a 'divide and conquer' approach to the initial 15(c) review can help to promote an effective and efficient process. Some boards may find that the following approaches can help allocate initial review responsibilities:

- Leveraging committees, such as contract or 15(c) committees, or less formal teams/working groups to conduct initial 15(c) reviews;
- Allocating 15(c) responsibilities, such as conducting an initial review of the 15(c) questionnaire and the annual *Gartenberg* memo, reviewing and proposing amendments to the 15(c) process, and evaluating 15(c) reports to designated committees;
- Assessing whether to modify committee charters to address any 15(c) responsibilities; and
- Dividing funds or groups of advisers or sub-advisers among independent directors for the purpose of leading reviews or discussions.

Boards generally review an enormous volume of material in connection with their 15(c) review process, and independent directors may find that the following approaches allow them to analyze materials more efficiently:

- Adopting the same 15(c) questionnaire across a fund complex;
- Using consistent investment performance results, fee/expense, brokerage and portfolio management reporting formats;
- Using dashboard or 'exception' reporting, dividing funds and/or advisers for different levels of review based on risk, and/or adopting 'watch lists' that flag issues for further review;
- Leveraging fund complex resources such as legal and compliance teams when available;
- Working with the adviser to give the board necessary information in a form that is reasonable for the adviser to produce; and
- In a 'manager of managers' fund complex, requesting that the adviser provide an assessment of its review of the sub-adviser's 15(c) questionnaire responses.

Compliance Policies and Procedures

Section 15(c) compliance policies are not required by Section 15(c) of the 1940 Act, but boards overseeing funds that do elect to have such policies may find it helpful to consider the following:

- Adopting high-level, broad and/or philosophical policies, rather than those that are prescriptive, to allow greater flexibility to adapt to changing circumstances;
- Addressing key responsibilities in the 15(c) process and/or designating key parties for execution of those responsibilities;
- Developing a 15(c) calendar; and
- Formalizing processes through which material updates to 15(c) roles, responsibilities, timing or requested information is communicated to all responsible parties, including the full board.

Board Meeting Minutes

Independent directors may wish to consider the following with respect to minutes of meetings relating to 15(c) reviews and approvals:

- Noting that minutes represent the primary record for the board discussion of advisory agreement approvals and the basis for N-CSR disclosure;
- Evidencing the robust analysis of the directors in their 15(c) review and working with counsel if available to determine the appropriate level of detail;
- Avoiding boilerplate language;
- Addressing each *Gartenberg* factor; and
- Reviewing minutes carefully in advance of their approval to avoid material misstatements, omissions or untrue statements.

Appendix II: Selected 15(c) Enforcement Actions Overview Chart

Case and Year	Parties Charged	Directors/Trustees Charged?	Core 15(c) Process Issues	Other Notable Issues	Statutory Violations	Director Oversight Takeaways
Morgan Stanley IM (2011)	Adviser	No	Misleading information to board about sub-adviser's role and fee split	Conflicts and undisclosed compensation implications	1940 Act Sections 15(c) and 34(b); Advisers Act Sections 206(2), 206(4) and Rule 206(4)-7	- Scrutinize sub-adviser roles and fees - Identify separate services being performed by any sub-advisers - Confirm that adviser is reviewing all sub-adviser information for accuracy and completeness
Northern Lights Fund Trust (2013)	- Fund administrator - CCO service provider - Five trustees	Yes	Boilerplate/minimal 15(c) minutes, no peer data, poor document retention	Compliance program deficiencies, missing shareholder disclosures	1940 Act Sections 15(c), 30(e), 31(a), 34(b) and Rules 31a-2, 30e-1 and 38a-1	- Review 15(c) disclosures to confirm they do not misrepresent or omit material information and are not boilerplate - Request information about fund's 15(c) process - Require substantive minutes and ensure minutes accurately reflect the meeting and board materials - Inquire about retention of all 15(c) records - Boards should assess whether the fund CCO and

						other service providers are providing the information necessary for approval of service provider compliance programs
Kornitzer Capital Management (2015)	Adviser and CFO/CCO	No	Adviser gave incomplete/misleading peer fee data; misstated services and affiliations	Misleading 15(c) disclosure	1940 Act Section 15(c)	- Request information necessary to understand the expense allocation methodology used to determine adviser's profitability - Scrutinize peer fee data and adviser reporting that reflects an unexpected uniformity on an ongoing basis - Confirm record retention of information requests and follow ups
Commonwealth Capital Management (2015)	- Adviser, affiliated administrator - Their owner - Three trustees	Yes	Adviser failed to provide information directors had requested and provided inaccurate information; trustees did not request additional clarifying information and approved the advisory agreements under review	Shareholder report omitted required 15(c) discussion	1940 Act Sections 15(c) and 30(e) and Rule 30e-1	- Raise questions if unsure whether complete and accurate comparative fee data has been provided - Follow up on all director requests for additional information - Note that advisers have a duty to provide all material information reasonably necessary for the board to

						evaluate the terms of the advisory agreement (must be complete and not misleading) - Evaluate conflicts and consider requesting additional information regarding fee justifications - Consider use of independent counsel to identify information gaps - Ensure 15(c) process reflects thorough and independent judgment of directors
Van Eck Associates Corp. (2024)	Adviser	No	Incomplete board materials regarding new strategy risks, fees and conflicts of interest	Misleading marketing vs. board materials; compliance failures	1940 Act Sections 15(c); Advisers Act Sections 206(2), 206(4) and Rule 206(4)-7	- Request information regarding adviser relationships with third parties if third party compensation is derived from or related to a fund's management fee - With unusual marketing arrangements, boards should be mindful of potential reputational and regulatory risks and request additional information from the adviser about how such risks are being addressed

Endnotes

[1] For ease of reference, 'Director' will be used universally herein rather than 'Trustee.' Funds have directors when their form of organization is a corporation, and trustees when their form of organization is a trust, but often the terms director and trustee are used interchangeably in the context of registered investment companies.

[2] This publication has been reviewed by MFDF's Steering Committee and approved by MFDF's Board of Directors, although it does not necessarily represent the views of all members in every respect. One representative from each member group serves on MFDF's Steering Committee. MFDF's current membership includes over 1044 independent directors, representing 159 mutual fund groups. Nothing contained in this report is intended to serve as legal advice. Each fund board should seek the advice of counsel for issues relating to its individual circumstances.

[3] Maryland, Massachusetts and Delaware courts have established frameworks for analyzing the application of the duties of loyalty and care in their respective states. The differences between court decisions in those states are outside the scope of this paper and accordingly this paper discusses the duties of loyalty and care as generally understood.

[4] *See Navellier v. Sletten*, 262 F.3d 923, 946 n.12 (9th Cir. 2001), in which the Ninth Circuit affirmed that the business judgment rule protects directors' conduct if they "acted on an informed basis, in good faith, and in the honest belief that the action taken was in the best interests of the company." The Ninth Circuit upheld a jury verdict that found directors did not breach their fiduciary duty when they did not renew an advisory agreement because the adviser would not provide requested financial information about the adviser and its affiliates.

[5] *See Jones v. Harris Assocs. L.P.*, 559 U.S. 335, 348 (2010).

[6] The SEC has indefinitely extended applicable exemptive relief in orders under the 1940 Act to allow fund boards to meet telephonically or by video conference to consider and vote on matters that would otherwise require an in-person vote. The relief applies whenever reliance upon it is necessary or appropriate due to circumstances related to current or potential effects of COVID-19. This exemptive relief will remain in effect until it is terminated by the SEC Division of Investment Management staff, and the termination date will be specified with at least two weeks advanced notice. For boards that rely on this relief, there are certain approvals that are required at the next in-person meeting. *See* SEC Public Statement: An Update on the Commission's Targeted Regulatory Relief to Assist Market Participants Affected by COVID-19 and Ensure the Orderly Function of Our Markets (June 26, 2020, updated January 5, 2021), available at https://www.sec.gov/news/public-statement/update-commissions-targeted-regulatory-relief-assist-market-participants.

[7] Gartenberg v. Merrill Lynch Asset Management, Inc., 694 F.2d 923 (2d Cir. 1982).

[8] *Id.* at 928. Notably, the profitability in the Gartenberg case was 70%.

[9] *Id.*

[10] *Id.* at 928-32.

[11] Krinsk v. Fund Asset Mgmt., Inc., 715 F. Supp. 472 (S.D.N.Y 1988), *aff'd* 875 F.2d 404, 409 (2d Cir. 1989) (citing *Gartenberg*, 694 F.2d at 929–30); accord *Jones*, 559 U.S. at 344 n.5.

[12] 559 U.S. 335 (2010). Litigation in the years post-*Harris* has affirmed and highlighted the importance of the integrity of the 15(c) review process and the Board's role therein. *See* Rodney T. Jelinek v. Capital Research and Management Co, No. 10-55221 (9th Cir. August 24, 2011), Gallus v. Ameriprise Financial, No. 11-1091 (8th Cir. March 31, 2012).

[13] *See, e.g.*, *Gartenberg*, *supra* n. 7, *Krinsk*, *supra* n.11, *Gallus*, supra n. 12, Gartenberg v. Merrill Lynch Asset Management, Inc., 573 F. Supp. 1293 (S.D.N.Y. 1983), *aff'd* 740 F.2d 190 (2d Cir. 1984) ("Gartenberg II"), Kalish v. Franklin Advisors, Inc., 742 F. Supp. 1222 (S.D.N.Y 1990), *aff'd* 928 F.2d 590 (2d Cir.), *cert denied*, 502 U.S. 818 (1991), Strougo v. BEA Associates, 188 F. Supp. 2d 373, 384 (S.D.N.Y 2002), Schuyt v. Rowe Price Prime Reserve Fund, 663 F. Supp. 962 (S.D.N.Y), *aff'd* 835 F.2d 45 (2d Cir. 1987), *cert denied* 485 U.S. 1034 (1988).

[14] *See* Form N-1A, Item 10, Form N-CSR, Item 11.

[15] *See* Form N-CSR, Item 11.

[16] *See* Section 34(b) of the 1940 Act.

[17] *See* Section 38(a) of the 1940 Act. In 2013, the SEC issued an order initiating and settling an administrative action against the board members of two funds, including four independent board members, as well as the trust's administrator and affiliated entity that provided chief compliance officer services. The SEC found that these entities caused the trusts to make untrue or misleading disclosures in public shareholder reports and in the minutes of board meetings relating to the factors considered and the conclusions reached by the board when approving or renewing investment advisory contracts. Disclosures found to be materially misleading included references to information the board claimed to have reviewed which they had not, and an omission of any reference to fees that were materially higher than a fund's peer group. *See* In the Matter of Northern Lights Compliance Services, et al., SEC Rel. No. IC-30502 (May 2, 2013).

[18] Section 15(f)(2)(B) defines "unfair burden" to include: any arrangement, during the two-year period after the date on which any [transaction described in Section 15(f)] occurs, whereby the investment adviser or [, its] predecessor or successor investment advisers […] or any interested person of any such adviser […] receives or is entitled to receive any compensation directly or indirectly (i) from any person in connection with the purchase or sale of securities or other property to, from, or on behalf of such company, other than bona fide ordinary compensation as principal underwriter for such company, or (ii) from such company or its security holders for other than bona fide investment advisory or other services (emphasis added).

[19] Section 2(a)(4) of the 1940 Act defines "assignment" to include the transfer of an advisory agreement to another investment adviser, as well as a transfer of a controlling block of the investment adviser's voting securities. 15 U.S.C. 80a-2(a)(4).

[20] However, *see supra* n. 5 regarding exemptive relief applicable to in person meeting requirements.

[21] Independent director means a director who is not an "interested person" within the meaning of Section 2(a)(19) of the 1940 Act. This means that independent directors are not permitted to own stock of a fund's investment adviser or certain affiliates, and are not permitted to have had a significant business relationship with the fund's adviser, distributor, or their affiliates at any time during the prior two years.

[22] *Gartenberg v. Merrill Lynch Asset Management, Inc.*, 694 F.2d 923 (2d Cir. 1982). The *Gartenberg* factors established by the court for boards to review in connection with their review of registered fund investment advisory agreements are: 1. The nature and quality of services provided to fund shareholders; 2. The profitability of the fund to the adviser; 3. Fall-out benefits 4. Economies of scale; 5. Comparative fee structures; and 6. The independence and conscientiousness of the directors. The *Gartenberg* factors are discussed in further detail in each of the other sections of this white paper.

[23] *See* Press Release, *SEC Division of Examinations Announces 2023 Priorities, Securities and Exchange Commission* (Feb. 7, 2023), available at https://www.sec.gov/newsroom/press-releases/2023-24.

[24] *Jones v. Harris Assocs. L.P.*, 527 F.3d 627 at 344 n.5 (citing *Gartenberg*, 694 F. 2d at 929-932) (7th Cir. 2008).

[25] Each independent director may view aspects of the *Gartenberg* factors through their own unique lenses of personal and professional backgrounds, judgment, and experience when considering whether to approve an advisory agreement, and therefore may weigh factors differently.

[26] *Jones v. Harris Assoc. L.P.*, 559 U.S. 335 (2010). The Supreme Court noted in *Jones v. Harris* that "directors may, of course, consider the adviser's reputation and experience in assessing the quality of the services provided."

[27] Directors may consider the breadth of an adviser's service offerings to the extent that this impacts the overall costs, benefits and service quality to the fund.

[28] For example, certain equity and international funds may be more expensive to manage due to applicable research costs.

[29] Whether the adviser or the fund pays a sub-adviser, the source of compensation is typically identified in the fund's registration statement and in the sub-advisory agreement.

[30] If a fund does not have any comparable funds for performance comparison purposes, this can be disclosed and explained to the directors.

[31] Directors may, but are not required to, engage an independent consultant or other third party (e.g., audit firms) on a periodic basis, generally subject to a separate engagement, to assess and/or interpret the adviser's cost allocation methodologies or the results of those methodologies.

[32] Directors may wish to note the potential impact of the structure of the adviser on the firm's view of its profitability – public companies vs. privately held companies and sole partnerships vs. partnerships have different expectations and drivers for firm-level profitability.

[33] *See Jones v. Harris*, supra n.1 at 344. *See also Kasilag v. Hartford Investment Financial Services, LLC*, Case No. 1:11-cv-01013 (D.N.J.), Feb. 28, 2017.

[34] *Jones v. Harris*, supra n.3 at 344 (citing *Gartenberg*, 694 F. 2d at 929-932) (7th Cir. 2008).

[35] *Id*.

[36] *Jones v. Harris*, supra n.5.

[37] *Id*.

[38] Note that some "investment products" are so different from registered fund management that comparative fees are often not provided, such as SMAs, wrap fee programs and model delivery programs.

[39] *Jones v. Harris*, supra n. 5.

[40] *Kalish v. Franklin Advisors, Inc.*, 742 F. Supp. at 1238 (S.D.N.Y 1990), *aff'd* 928 F.2d 590 (2d Cir.), *cert denied*, 502 U.S. 818 (1991).

[41] *Id*.

[42] *Id*. at 1239.

[43] *Gartenberg v. Merrill Lynch Asset Management, Inc.*, 694 F.2d 923, 930 (2d Cir. 1982). The focus on the process of directors was part of the Congressional intent in passing Section 36(b), in which the intent was to "rely largely upon independent director watchdogs to protect shareholders' interests. Courts consider the independence and conscientiousness of trustees when determining the degree of deference they might accord to a decision made by the directors. *See Jones v. Harris Associates, L.P.*, supra n.5

[44] *Id*.

[45] *Jones v. Harris*, supra n.5.

[46] *Id*.

[47] Note, however, that Section 36(b) does not require negotiation between a board and an adviser regarding advisory fees, and its absence is "insufficient to demonstrate that the board's process was deficient." *See In re Davis N.Y.Venture Fund Fee Litig.*, No. 14 CV 4318-LTS-HBP (S.D.N.Y May 30, 2019).

[48] In addition to third-party vendors, courts have recognized that independent counsel can greatly facilitate the board's review and provide critical expertise. *See Sivolella v. AXA Equitable Life Ins. Co.*, No. 11-CV-4194 (D.N.J. Aug. 25, 2016).

[49] *See* U.S. Securities and Exchange Commission, *Mutual Fund Governance and the Role of Independent Directors*, SEC Rule Release No. IC-26520, 2004, available at https://www.sec.gov/rules/final/ic-26520.htm, which states that "Mutual fund boards that encompass a variety of backgrounds, experiences and viewpoints are better positioned to demonstrate independence and conscientiousness in their oversight functions."

[50] *In the Matter of Morgan Stanley Investment Management, Inc.*, SEC Rel. Nos. IA-3315, IC-29862, (Nov. 16, 2011), https://www.sec.gov/litigation/admin/2011/ia-3315.pdf.

[51] *In the Matter of Northern Lights Compliance Services, et al.*, SEC Rel. No. IC-30502, (May 2, 2013), https://sec.gov/files/litigation/admin/2013/ic-30502.pdf.

[52] *In the Matter of Kornitzer Capital Management, et al.*, SEC Rel. No. IC-31560, (April 21, 2015). https://www.sec.gov/files/litigation/admin/2015/ic-31560.pdf.

[53] *In the Matter of Commonwealth Capital Management, LLC, et al.*, SEC Rel. No. IC-31678, (June 17, 2015), https://www.sec.gov/files/litigation/admin/2015/ic-31678.pdf.

[54] *In the Matter of VanEck Associates Corporation*, SEC Rel. Nos. IA-6560, IC-35132, (Feb. 16, 2024), https://www.sec.gov/files/litigation/admin/2024/ic-35132.pdf.

[55] Some boards that have independent director counsel may find them to be a helpful resource for guidance regarding other factors that may be relevant for the board's consideration.

[56] Note that not all boards review the 15(c) questionnaire annually in advance. Many boards rely on counsel to update the questionnaire, and boards may provide input during the process about supplemental requests or requests for the following year.