MFDF
Trusted Insight for Independent Oversight

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MFDF Report

Board Oversight of Advisory Agreement Approvals

Part 3: *Gartenberg* Factors Analysis and Board Considerations

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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 will be issued successively in the following four parts:

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

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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."[3] 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.[4] 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;[5]
- The depth and breadth of fund offerings provided to shareholders;[6]
- 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.[7]

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.[8] 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.[9] 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 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 of 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 provide oversight of 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 is 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.[10] 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.[11] 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.[12] 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."[13] 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.[14] 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."[15] 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."[16] 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.[17] 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.

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."[18] However, a fund's increase in size does not automatically mean that potential economies of scale exist.[19] 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."[20]

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."[21] 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."[22] 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."[23] 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."[24] 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 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 deemed necessary;
- Assessing whether responses provided by the adviser are complete and responsive to the questions posed;[25]
- 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.[26]

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 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?[27]

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.

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] *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).

[4] 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.

[5] *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."

[6] 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.

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

[8] 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.

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

[10] 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.

[11] 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.

[12] *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.

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

[14] *Id*.

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

[16] *Id*.

[17] 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.

[18] *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).

[19] *Id*.

[20] *Id*. at 1239.

[21] *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

[22] *Id*.

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

[24] *Id*.

[25] 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).

[26] 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).

[27] *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."