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Trusted Insight for Independent Oversight

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MFDF Report

Board Oversight of Advisory Agreement Approvals

Part 4: Enforcement Action Takeaways

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

MFDF's 15(c) White Paper was issued successively in the following four parts:

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

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INTRODUCTION

The SEC has brought a number of notable enforcement proceedings against investment advisers, independent trustees 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[3] (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[4] (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 trustees' 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[5] (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[6] (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[7] (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 has shifted its focus to certain areas such as AI and ESG under the direction of new SEC Chairman Paul Atkins, 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: SELECTED 15(c) ENFORCEMENT ACTIONS OVERVIEW CHART

Case and Year	Parties Charged	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 boards. 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] *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.

[4] *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.

[5] *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.

[6] *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.

[7] *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.