MFDF
Trusted Insight for
Independent Oversight

SEPTEMBER 2024

MFDF Report

Board Oversight of Advisory Agreement Approvals

Part 1: Regulatory Requirements and Judicial Caselaw

MFDF
Trusted Insight for Independent Oversight

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 Challenges and Analysis
Part 4: Enforcement Action Takeaways

Contents

OVERVIEW I

FIDUCIARY DUTIES AND THE BUSINESS JUDGMENT RULE 1

1940 ACT REQUIREMENTS 2

Section 15 of the 1940 Act 2

Section 36 of the 1940 Act 2

SECTION 36(B) CASELAW AND THE *GARTENBERG* FACTORS 3

15(C) DISCLOSURE REQUIREMENTS 4

RECORDKEEPING REQUIREMENTS 5

UNIQUE FACT PATTERNS: SUB-ADVISERS, CHANGES OF CONTROL AND ASSIGNMENTS 5

Sub-Advisers 5

Section 15(f) Change of Control 6

Section 15(a)(4) Assignments 7

CONCLUSION 7

ENDNOTES 8

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.

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 1035 independent directors, representing 149 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.