Client Alert

June 19, 2015

SEC Sanctions Independent Trustees for Deficient Advisory Contract Review

In a cease-and-desist order entered on June 17, 2015, the SEC found that a fund adviser, two independent trustees, and an inside trustee willfully violated Section 15(c) of the Investment Company Act of 1940 (the "1940 Act") by failing to satisfy specific requirements for approving a fund's investment advisory agreement. The SEC also found that the funds' administrator caused one of the funds to violate Section 30(e) of the 1940 Act, and Rule 30e-1 thereunder, by omitting disclosure related to the trustees' evaluation of the advisory and sub-advisory agreements under Section 15(c).

Section 15(c) of the 1940 Act imposes a duty on the board members of a registered investment company to request and evaluate—and a duty on the adviser to furnish—such information as may reasonably be necessary for the directors to evaluate the terms of an advisory contract. Item 27(d)(6) of Form N-1A further requires that, if a fund's board approved any investment advisory contract during the fund's most recent fiscal half-year, the next shareholder report must contain a discussion, in reasonable detail, concerning "the material factors and the conclusions with respect thereto that formed the basis for the board's approval." The SEC said that the administrator violated Section 30(e) of the 1940 Act and Rule 30e-1 by failing to disclose the information required in Item 27(d)(6) of form N-1A.

THE FINDINGS

The SEC's charges were related to the approval of investment advisory contracts and sub-investment advisory contracts by the boards of two series mutual funds. The funds' investment adviser and administrator provided "turnkey" services to investment advisers that want to advise mutual funds.

The SEC's release chronicles how the investment adviser allegedly failed to provide information reasonably necessary for the trustees to approve the advisory and sub-advisory contracts, including: omitting information related to fees paid by comparable mutual funds; inadequately describing the nature and quality of the services provided by the investment adviser; and failing to provide adequate information about the adviser's profitability and cost-allocation methodology.

In the case of one of the funds, the release states that the fund's trustees did not follow up by obtaining missing information that they requested as being reasonably necessary to their evaluation of the contracts. Nonetheless, they approved the advisory and sub-advisory contracts.

The proceeding reveals the SEC's focus on the contract-renewal process. It is entering the boardroom and scrutinizing in great detail not only the information provided to fund trustees by advisers and other service providers, but also how the trustees evaluate that information. The order also provides an unusual peek into how two fund boards approached their contract-renewal process.

Without admitting or denying the SEC's findings, the trustees of one of the funds each agreed to pay a fine of $3,250. The chairman of the board, an "interested person" of the funds, jointly and severally with the adviser and the administrator agreed to pay civil penalties of $50,000.

THE BOARDS' PROCESS

The funds' independent trustees, through their independent legal counsel, requested that the adviser provide extensive information about the services provided to the funds. The SEC found that the adviser, in some cases, omitted the requested information and, in other cases, provided inaccurate information.

The order details the contract-renewal process, and describes why the SEC believes that the adviser and the trustees failed to meet the statutory standards for approval of advisory and sub-advisory contracts. Among other things, the SEC found the following facts:

- *Comparison of fees*: With respect to one of the funds, the SEC found that there was no documentary evidence that the adviser furnished information about fees paid by comparable funds. Nevertheless, the SEC said, the fund trustees approved the agreement because they believed the fees to be reasonable.
    - The SEC pointed out that one of the funds had a separate administrative fee, but the fund's advisory fee was compared to a fund with an advisory fee that included the administrative function, thereby creating a misleading comparison.
- *Nature and quality of services provided*: The SEC said that the adviser provided insufficient information about the services it provided. The advisory agreement description of the services provided to the fund was substantially similar to the description of services in the sub-advisory agreement, and the adviser's response to the independent counsel's Section 15(c) request for information included only limited disclosures that left unclear what services the adviser actually provided.
    - The SEC said that the adviser did not describe the compliance services that the adviser itself provided, and the trustees did not request additional information to clarify that point. Significantly, the SEC said that the trustees were obligated to evaluate the adviser's services in the context of the contractual fees, even though the adviser waived all its fees during the relevant time period.
- *Profitability*: The adviser did not disclose its cost allocation methodology, as requested in the counsel's letter request, but rather provided rough estimates.
    - Rather than provide two years' financial data, as requested in the independent counsel's letter, the adviser provided an income statement (but no balance sheet) for one year, plus estimated expenses.
- *Economies of scale*: The SEC noted that the breakpoints that the trustees thought had been approved were not included in the advisory contract.

- *Comparable-fund analysis*: The adviser provided comparative-fund information based on a standard industry database without editing the data to delete share classes of funds that were not directly comparable to one of the funds. Although the adviser did so to avoid claims of "cherry-picking" exemplar funds, the SEC noted that the chart contained numerous inapt comparisons.

DISCLOSURE

Following a board's approval or renewal of an advisory contract, a fund's next report to shareholders must discuss, in reasonable detail, the material factors and conclusions that formed the basis for the board's approval or renewal of that contract. In this case, the administrator, which was contractually responsible for preparing the shareholder reports on behalf of the funds, failed to include such information in one fund's 2010 shareholder report. Consequently, the SEC found that administrator caused the fund to violate Section 30(e) of the 1940 Act and Rule 30e-1.

OUR TAKE

This case is a clear reminder of the SEC's view that the annual review of a fund's advisory contract is one of the central responsibilities of a fund board, and demonstrates that the SEC will dive deep into the weeds to review the adequacy of that contract-review process. It appears that the SEC wants to send a strong message that independent trustees are fair game if the SEC believes trustees are asleep at the switch when carrying out their statutory responsibilities.

In addition, we note that this case may also confirm the adage that "no good deed goes unpunished." The SEC notes that, during the relevant time period, certain of the independent trustees waived their trustee fees and the adviser had waived its fees. The clear message is that fund trustees and investment advisers, as fiduciaries, must carry out their responsibilities whether or not they waive compensation to benefit fund shareholders.

For updates and future developments on this topic, and others, visit The BD/IA Regulator.

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