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FINANCIAL SERVICES
ALERT

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SEC Cracks Down on Directors' Section 15(c) Process

The SEC sanctioned an investment adviser, its principal and three mutual fund directors for failing to satisfy their statutory obligations with respect to evaluating and approving advisory agreements under Section 15(c). Without admitting or denying the allegations, the independent directors each agreed to pay a $3,250 penalty, and the adviser, the adviser's principal and the administrator agreed to pay in the aggregate $50,000 to settle the SEC's charges. All of the parties agreed to cease and desist. This case indicates that the SEC is continuing to focus on the details of directors' Section 15(c) obligations, and boards should be vigilant in performing and documenting their annual contract renewal decisions.

Deficient Section 15(c) Process

The adviser was part of a turnkey mutual fund platform and served as investment adviser to small and midsize mutual funds through two separate mutual fund entities. The SEC said that consistent with Section 15(c), the independent directors requested information "reasonably necessary" for them to evaluate the terms of the advisory contracts. The SEC said, however, that the adviser's written materials did not provide all of the requested information and, in certain instances, the information provided was inaccurate. As a result, the adviser and the directors violated Section 15(c).

Missing and Inaccurate Information

With respect to the first fund family, the SEC found that although the directors requested that the adviser provide comparative fee information, the requested information was not delivered. In spite of this, the directors approved the advisory contract anyway after concluding that the fees were "within an appropriate range" although there was no evidence that the information was provided by the adviser or evaluated by the directors.

The adviser may, however, have agreed to waive all fees during the initial contract period. The SEC acknowledged that during the period at issue, the funds paid no advisory fees and the adviser reimbursed the majority of the funds' operating expenses. The SEC said, however, that the directors still had a duty to evaluate the adviser's services as compared to the contractual fee level.

The SEC also found that the directors did not have the requisite information to provide a "sufficient evaluation" of the nature and quality of services provided by the adviser. According to the SEC, the adviser's written responses "left unclear" exactly what services the adviser would provide as compared to services to be provided by a sub-adviser. Furthermore, the SEC found that the adviser represented that it would provide due diligence reviews but did not adequately describe the services it would provide, as compared with services that others would provide.

According to the SEC, the directors acted wrongly by approving the contracts without receiving all the information they requested as "reasonably necessary" and without seeking to clarify the nature and quality of the adviser's services. The adviser and the directors, who were individually named, were found to have violated Section 15(c), and the turnkey platform owner was found to have caused the violation.

Inapt Fee and Expense Comparisons and Insufficient Responses

With respect to the other fund family, the SEC found that the adviser delivered "numerous inapt comparisons" in response to the directors' request, because the adviser did not exclude from its comparative fee analysis funds that had significantly different fee characteristics.

Specifically, the SEC said that the adviser's comparative fee and expense analysis included comparably sized share classes and funds using comparable strategies, but it also included information about funds and share classes that were not relevant to the fund being compared. Essentially, the SEC said the analysis contained extraneous information because it included:

- funds charging different distribution fees;
- assets at the share-class level instead of the total-fund level;
- exchange traded funds and index funds instead of only actively managed funds; and
- funds with combined advisory and administrative fees instead of separate fees.

While the SEC acknowledged that the adviser did not edit out unnecessary data to avoid claims of cherry-picking, the SEC also noted that the presentation was incomplete. The adviser presented other forms of comparative fee and expense analyses that also suffered from similar errors.

The SEC enumerated other defective responses to this fund board's Section 15(c) request:

- although directors requested "all reasonably available financial information" (including two years of financial statements) and a description of the basis and methodology of cost and expense allocations, the adviser provided only a one-year income statement and a one-year estimated profitability chart, and no written description of the allocation methodology;
- when asked to disclose the dollar amount of fees waived under an expense limitation agreement, the adviser erroneously reported that no fees were waived when in fact all fees were waived; and
- in addressing the adequacy of the fund's breakpoint schedule, the adviser informed the directors that the breakpoint schedule was appropriate; in fact, the schedule had been inadvertently omitted from the fund's advisory contract (although the assets of the fund apparently never exceeded the level that would cause fees to reach the first breakpoint).

The SEC also charged this fund's administrator with causing the fund to violate Section 30(e), because the administrator "omitted the text" describing the directors' Section 15(c) evaluation from the fund's annual report. Like all of the service providers to the turnkey platform, the administrator was owned by the principal of the adviser.

What Should Directors Do Now?

Although every case has unique facts, this case highlights the level of detail the SEC inspection and enforcement staff may apply in analyzing how directors fulfill their Section 15(c) obligations:

- Directors should focus on determining what information they believe "reasonably may be necessary" for contract renewal.
- Directors and their counsel should ensure that information requested is actually delivered and is complete and accurate.
- When further explanation is necessary, directors should ask additional questions, seek more information or ask for clarification.
- If requested information cannot be fully addressed,
    - either annual approval should be deferred (continuing the contract on an interim basis), or
    - documentation should be created reflecting that the additional requested information was determined not to be necessary for a reasonable evaluation by the board.
- Directors should ensure that they receive a clear and understandable presentation by the adviser addressing all *Gartenberg* factors.

The case also underscores the SEC's focus on the record supporting the directors' determinations:

- Specifically with respect to comparisons, directors should understand what information is being presented, and when there are few peers, directors should ask the adviser to document why particular data is presented.

The SEC is continuing to focus on the division of services provided by advisers and other service providers:

- Directors should ensure that they understand specifically what services the adviser is providing
    - when a sub-adviser provides portfolio management services, and
    - when the adviser or others oversee a sub-adviser.
- The adviser's response to directors should specifically describe the supervisory, compliance and other non-investment services provided by the adviser.
- Directors should seek some confirmation that services that the adviser represents in its Section 15(c) response that it delivered to the fund were actually delivered and performed by the adviser.

In the Matter of Commonwealth Capital Management, LLC, Commonwealth Shareholder Services, Inc., John Pasco, III, J. Gordon McKinley, III, Robert R. Burke and Franklin A. Trice, III, SEC Admin. Proc. File No. 3-16599, Inv. Co. Act Rel. No. 31678 (June 17, 2015).

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For public alternative fund filings and key terms, visit our site: www.PublicAlternativeFunds.com.

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If you have any questions, or would like to discuss these issues in further detail, please feel free to contact the authors below or any one of your Kramer Levin attorney contacts:

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