

THE MUTUAL FUND'S SECTION 15(C) PROCESS:
JONES V. HARRIS, THE SEC AND FIDUCIARY DUTIES OF DIRECTORS

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I. Introduction

The past decade has witnessed significant attention on mutual fund advisory fees and the importance of adequate corporate governance.¹ The fund board of directors' approval process of the

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¹ See *Oversight Hearing on Mutual Funds: Hidden Fees, Misgovernance and Other Practices That Harm Investors: Hearing Before the Subcomm. on Fin. Mgmt., Budget, & Int'l Sec. of the S. Comm. on Gov'tal Affairs*, 108th Cong. 2 (2004), available at <http://www.access.gpo.gov/congress/senate/pdf/108hr/92686.pdf> (statement of Sen. Peter G. Fitzgerald, Chairman, S. Subcomm. on Fin. Mgmt., the Budget and Int'l Sec.) (examining a "whole panoply of mutual fund fees"); *Testimony Concerning Regulatory Reforms To Protect Our Nation's Mutual Fund Investors: Hearing Before the S. Comm. on Banking, Hous. & Urban Affairs*, 108th Cong. (2003), available at <http://www.sec.gov/news/testimony/ts111803whd.htm> (statement of William H. Donaldson, Chairman, SEC) (outlining proposed mutual fund investors' rights including issues related to corporate governance); *Disclosure Regarding Approval of Investment Advisory Contracts by Directors of Investment Companies*, 69 Fed. Reg. 39798 (June 30, 2004) [hereinafter *2004 Disclosure Rule*] (to be codified at 17 C.F.R. pt. 239, 240, 274) (SEC rule on advisory fee disclosure); SEC, DIVISION OF INVESTMENT MANAGEMENT: REPORT ON MUTUAL FUND FEES AND EXPENSES (2000), <http://www.sec.gov/news/studies/feestudy.htm> (mentioning significant growth of mutual fund fees and ongoing debate over appropriate level of fees); Tom Lauricella, *This is News? Fund Fees Are Too High, Study Says*, WALL ST. J., Aug. 27, 2001, at C1 (analyzing the growing disparity between mutual

investment advisory fee and contract is the cornerstone of the fund governance mandate set forth in the Investment Company Act of 1940 (the “1940 Act”)². The 1940 Act creates both specific and general fiduciary duties for investment advisers and fund directors. These duties have recently received heightened scrutiny from both the Securities and Exchange Commission (the “SEC” or the “Commission”) and mutual fund shareholders.³ Recent activity reflecting such heightened scrutiny includes SEC rule-making, increased enforcement attention and the Supreme Court’s 2010

fund management fees and pension fund management fees); Press Release, Office of N.Y. State Att’y Gen., Statement by Attorney General Eliot Spitzer Regarding Mutual Fund Fee Reduction (Dec. 18, 2003), http://www.ag.ny.gov/media_center/2003/dec/dec18d_03.html (describing mutual fund fees as part of the “root cause” of harm to investors).

² See 15 U.S.C. § 80a-1 (1940); ROBERT ROBERTSON, FUND GOVERNANCE: LEGAL DUTIES OF INVESTMENT COMPANY DIRECTORS 6-3 (2011) (“One of the board’s most important duties is approving . . . the advisory agreement.”).

³ See, e.g., John P. Freeman & Stewart L. Brown, *Mutual Fund Advisory Fees: The Cost of Conflicts of Interest*, 26 J. CORP. L. 609, 611-13 (2000-2001) (discussing heightened scrutiny from the SEC, press, academics, and other interested parties over mutual funds’ fee and corporate governance structure); *Perils in the savings pool – Mutual funds*, ECONOMIST, Nov. 8, 2003, at 65 (arguing that fund boards tend to “rubber-stamp” their advisers’ contracts without question). See generally *Jones v. Harris Assoc. L.P.*, 130 S. Ct. 1418 (2010) (clarifying the standard to determine whether an investment advisor violated a fiduciary duty regarding fees paid by an investment fund); Value Line, Inc., Securities Act Release No. 9081, Exchange Act Release No. 60,936, Investment Company Act Release No. 28,989, 2009 WL 3652408 (Nov. 4, 2009), available at <http://www.sec.gov/litigation/admin/2009/33-9081.pdf> (instituting sanctions and cease and desist order in relation to undisclosed brokerage commission payments to a broker-dealer affiliated with investment adviser); N. Y. Life Inv. Mgmt. LLC, Investment Advisors Act Release No. 2883, Investment Company Act Release No. 28747, 2009 WL 1480831 (May 27, 2009), available at <http://www.sec.gov/litigation/admin/2009/ia-2883.pdf> (imposing sanctions and related cease and desist order related to advisory contracts); Jeffrey J. Haas & Steven R. Howard, *The Heartland Funds’ Receivership and Its Implications for Independent Mutual Fund Directors*, 51 EMORY L.J. 153 (2002) (examining the lessons learned from the collapse of the Heartland Mutual Fund); Alan R. Palmiter, *The Mutual Fund Board: A Failed Experiment in Regulatory Outsourcing*, 1 BROOK J. CORP. FIN. & COM. L. 165 (2006) (arguing that fund directors fail to adequately oversee fund advisors).

decision in *Jones v. Harris*⁴ to overturn the Seventh Circuit's challenge of the standard-bearing case, *Gartenberg v. Merrill Lynch*.⁵

This article explores significant issues pertaining to the investment advisory contract approval process, or the "15(c) process," named after the key operative section of the 1940 Act. This includes an examination of the fiduciary duties of fund directors and investment advisers, the so-called "*Gartenberg* factors" that drive the process, and recent attention by the SEC on mutual fund advisor fees.

The article begins with a summary of the 15(c) process as mandated by the 1970 amendments to the 1940 Act, as well as the *Gartenberg* and *Jones* cases.⁶ Next, the article provides a survey of important SEC and private actions that have brought a level of attention to the 15(c) process not seen since the congressional hearings leading up to the passage of the 1970 amendments. The article concludes with an in-depth analysis of the important obligations of fund directors during the 15(c) process.

II. Advisory Contract Approval Process

A. History—The 1970 Amendments

The contemporary statutory genesis of the 15(c) process began with the 1970 amendments to the 1940 Act, wherein Congress created a new Section 15(c), and divided Section 36 into two subsections: 36(a) on general fiduciary duties, and 36(b) on fiduciary duty with respect to fees paid by the fund.⁷

⁴ See *Jones*, 130 S. Ct. at 1426 ("[W]e conclude that *Gartenberg* was correct . . . to face liability under § 36(b), an investment 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.").

⁵ See *Gartenberg v. Merrill Lynch Asset Mgmt., Inc.*, 694 F.2d 923, 928 (2d Cir. 1982) ("To be guilty of a violation of §36(b) . . . the adviser-manger 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.").

⁶ Investment Company Amendments Act of 1970, Pub. L. No. 91-547, 84 Stat. 1413 (1970) [hereinafter *1970 Amendments*].

⁷ *Id.* §§ 8, 20, 84 Stat. at 1419-20, 1428-30 (amending Section 15(c) and Section 36 of the Investment Company Act of 1940).

The 1960s were a boom time for the mutual fund industry with assets under management increasing significantly.⁸ With this burst of success, however, elected officials and fund shareholders began questioning whether fund advisers had an obligation to share that success with shareholders through lower fees. The more intense scrutiny reflected the suspicion that investment advisers' control and influence over their sponsored funds was nearly total and reflected a relationship of "business incest."⁹ Thus, during the time leading up to the 1970 amendments, elected officials and fund shareholders raised concerns that mutual funds' management structure promoted excessive advisory fees that needed to be addressed.¹⁰

A key point in this movement happened in 1966, when the SEC issued a policy report citing three factors that contributed to the failure of competitive forces influencing the advisory contract and fee approval process: (1) dependence of independent directors upon affiliated directors for guidance on fund policy matters; (2) lack of time and pay attributed to director duties and lack of receipt of sufficient information from affiliated directors, especially on fundamental fund matters such as the advisory contract and fee; and (3) the practical inability to terminate or even to threaten to terminate the advisory contract.¹¹ In sum, at least up until 1970, the advisory contract approval process could not be characterized as "bid-and-ask."¹²

⁸ See generally H.R. REP. NO. 89-2337 (1966) [hereinafter *1966 SEC Report*] (discussing implications of mutual fund growth); H.R. REP. NO. 87-2274 (1962) [hereinafter *Wharton Report*] (analyzing significant growth of the mutual fund industry). For an elaborate discussion of the legislative events leading up to the 1970 Amendments, see William J. Nutt, *A Study of Mutual Fund Independent Directors*, 120 U. PA. L. REV. 179 (1971) (discussing the role of independent directors in fund management).

⁹ See Note, *The Mutual Fund and its Management Company: An Analysis of Business Incest*, 71 YALE L.J. 137 (1971) ("A recent wave of shareholder derivative actions against mutual fund directors and their management companies has challenged the independence and reasonableness of certain directors in granting fees to the funds' investment advisers . . .").

¹⁰ See *Wharton Report*, *supra* note 8, at 29-30 (stating that advisers charged their mutual fund clients more than their other clients, and that mutual funds, unlike those other clients, lacked the bargaining power to properly negotiate for fees).

¹¹ *1966 SEC Report*, *supra* note 8, at 148.

¹² Nutt, *supra* note 8, at 223 ("Contract renewal is not a bid-and-ask proposition.").

One commentator has suggested that *Saxe v. Brady*, a prominent case on the issue decided in 1962, “all but immunized” directors from liability for allowing the adviser to overcharge advisory fees.¹³ In other words, the case stood for the proposition that fees were not excessive if fully disclosed, ratified by shareholders and in line with industry averages.¹⁴ This case may have prompted both the SEC and Congress to push for a less stringent standard for proving fees were inappropriately excessive.

The SEC initially recommended that Congress draft a bill in 1967 that would have amended §15 of the 1940 Act to require that fees be “reasonable.”¹⁵ The Investment Company Institute (“ICI”) strongly opposed the bill claiming the reasonableness standard was stricter than a fiduciary standard and would allow the courts to engage in rate-making over fund fees.¹⁶

The proposed 1967 bill also enumerated standards similar to the factors that the Court eventually outlined in *Gartenberg*.¹⁷ The

¹³ Cynthia L. Kahn, *Direct not Derivative: Recovering Excessive Investment Advisor Fees in Mutual Funds*, 71 GEO. L.J. 1595, 1609 n.84 (1983) (“Under *Saxe* shareholder ratification of the advisory contract all but immunized advisory fees from judicial scrutiny . . .”). See generally *Saxe v. Brady*, 184 A.2d 602, 605 (Del. Ch. 1962) (discussing the effect of ratification on plaintiff’s claim); Comments, *Duties of the Independent Director in Open-End Mutual Funds*, 70 MICH. L. REV. 696, 704 (1972) (“This test effectively precluded a finding that fees were excessive . . .”).

¹⁴ See *Saxe*, 184 A.2d at 602 (finding fee not excessive when the contract was ratified by the shareholders, and the fee was “commercially realistic” and disclosed to shareholders); 1966 SEC Report, *supra* note 8, at 135-37 (discussing required showings for a claim of excessive management fees). The rationale of the *Saxe* Court appears ironically similar to that of the Seventh Circuit in *Jones*.

¹⁵ S. 1659, 90th Cong. § 8(d) (1st Sess. 1967) (requiring directors to establish that advisory contracts were reasonable); H.R. 9510, 90th Cong. §8 (d) (1st Sess. 1967) (requiring directors to establish that advisory fees were reasonable).

¹⁶ See Brief for the United States as Amicus Curiae Supporting Petitioners, *Jones v. Harris*, 130 S. Ct. 1418 (2009) (No. 08-586), 2009 WL 2564712; Nutt, *supra* note 8, at 187 (mentioning that the potential for judicial rate-making was one of the industry’s objections to a reasonableness standard).

¹⁷ S. 1659, *supra* note 15, at 20 (“[T]he factors considered shall include . . . nature and extent of services . . . quality of services . . .”); cf. *Gartenberg v. Merrill Lynch Asset Mgmt., Inc.*, 694 F.2d 923, 930 (2d Cir. 1982) (declaring the “nature and quality of services” as a factor in determining whether fees are excessive).

original draft of the bill focused on directors and fees, unlike the final bill, which focused on the adviser. Congress apparently removed the factors because they were intended to be non-exclusive, not because they were irrelevant.¹⁸ The eventual incorporation of the factors into the *Gartenberg* court's analysis of the 15(c) process supports that view.¹⁹

The argument over reasonableness versus fiduciary duty, as *Gartenberg* eventually noted, was primarily semantic.²⁰ That is, if the fees were not reasonable, then they would apparently constitute a breach of fiduciary duty. The original factors from the 1967 bill provided guidance for when the fees were unreasonable.²¹

By 1970, congressional focus was on mandating that the adviser furnish material information to the directors, requiring that directors evaluate the information provided, and creating a fiduciary duty on the adviser in connection with the fee charged.²² The

¹⁸ See Nutt, *supra* note 8, at 261 (“The broker affiliate’s cost of operation and the division of its profits are important, but not exclusive factors to be weighed by independent directors.”).

¹⁹ See *Gartenberg*, 694 F.2d at 929-30 (summarizing the relevant fund and industry specific factors weighed by the court to determine whether the fee was excessive).

²⁰ *Id.* at 928 (“[T]he legislative history of §36(b) indicates that the substitution of the term ‘fiduciary duty’ for ‘reasonable’ . . . was a more semantical than substantive compromise . . .”); see *Wharton Report*, *supra* note 8, at 144.

²¹ These factors included: (A) [t]he nature and extent of the service to be provided . . . ; (B) [t]he quality of the service theretofore rendered to such investment company . . . , or, if no such services have been theretofore rendered, the quality of the services rendered to other investment clients, if any . . . ; (C) [t]he extent to which the compensation . . . takes in account economies attributable to the growth and size of such investment company . . . given due consideration to the extent to which such economies are reflected in the charges made or compensation received for investment advisory services and other services provided to investment companies having no investment adviser . . . ; (D) [t]he value of all [non-compensatory] benefits . . . directly or indirectly received or receivable by the . . . investment adviser by reason of his relationship to such investment company; [and,] (E) [s]uch other factors as are appropriate and material. S. 1659, 90th Cong., 1st Sess. § 8(d) (1967).

²² Congress also concluded, “that the shareholders should not have to ‘rely solely on the fund’s directors to assure reasonable adviser fees, notwithstanding the increased disinterestedness of the board.’” *Kamen v. Kemper Fin. Servs., Inc.*, 500 U.S. 90, 108 (1991) (quoting *Daily Income Funds, Inc.*

amendments, which eventually became law, allowed Congress to address both the *Saxe* standard and the troublesome communication problems that existed between the independent directors and the affiliated ones. The 1969 congressional report states that the directors have fiduciary duties in all affairs of the fund, especially the management fee, thereby officially linking the 1970 amendments for purposes of Sections 15 and 36.²³ The final version of §15(c) provides, in pertinent part:

(c) [I]t shall be unlawful for any registered investment company having a board of directors to enter into, renew, or perform any contract or agreement, written or oral, whereby a person undertakes regularly to serve or act as investment adviser of or principal underwriter for such company, unless the terms of such contract or agreement and any renewal thereof have been approved by the vote of a majority of directors . . . *It shall be the duty of the directors of a registered investment company to request and evaluate, and the duty of an investment adviser to such company to furnish, such information as may reasonably be necessary to evaluate the terms of any contract whereby a person undertakes regularly to serve or act as investment adviser of such company.*²⁴

The final versions of §§36(a) and (b) provide, in relevant part:

v. Fox, 464 U.S. 523, 540 (1984)). Accordingly, amending the 1940 Act in 1970, Congress added Section 36(b).

²³ S. REP. NO. 91-184, at 5-7 (1969) (“Because of the unique structure of this industry the relationship between mutual funds and their investment adviser is not the same as that usually existing between buyers and sellers or in conventional corporate relationships . . . [The Senate] committee believes that the investment adviser should be a fiduciary of the fund in such matters as the handling of the fund’s assets and investments. Therefore, we have added a new section 36(b) . . . to specify that the adviser has a fiduciary duty with respect to compensation for services or other payments paid by the fund or its shareholders to the adviser or to affiliated persons of the adviser.”).

²⁴ Investment Company Act, 15 U.S.C. § 80a-15(c) (2006) (emphasis added).

(a) The Commission is authorized to bring an action . . . alleging that a person . . . serving or acting [as an officer, director, advisory board member, investment adviser, depositor, or principal underwriter] has engaged . . . or is about to engage in any act or practice constituting a breach of fiduciary duty involving personal misconduct in respect of any registered investment company

(b) For the purposes of this subsection, *the investment adviser of a registered investment company shall be deemed to have a fiduciary duty with respect to the receipt of compensation for services, or of payments of a material nature, paid by such registered investment company, or by the security holders thereof, to such investment adviser or any affiliated person of such investment adviser.*²⁵

Commentators at the time interpreted the changes as focusing investment advisers and fund directors more on the integrity of the process²⁶ by expanding the fiduciary duties under the 1940 Act.²⁷ Courts soon took the cue from Congress. The cases decided shortly after the 1970 Amendments emphasized the importance of the adviser in providing fund directors with sufficient information for them to properly act as fiduciaries.²⁸

²⁵ *Id.* §§ 80a-35(a)-(b) (2006) (emphasis added).

²⁶ See generally Clarke Randall, *Fiduciary Duties of Investment Company Directors and Management Companies Under the Investment Company Act of 1940*, 31 OKLA. L. REV. 635 (1978) (discussing fiduciary duties with the addition of the new amendments).

²⁷ See Brief for the United States, *supra* note 16 at *19 (quoting *Mutual Fund Amendments: Hearings on H.R. 11995, S. 2224, H.R. 13754, and H.R. 14737 Before the Subcomm. on Commerce and Fin. of the H. Comm. on Interstate & Foreign Commerce, 91st Cong., 190, 441 (1969)*) (discussing memorandum submitted to the committee by the SEC regarding the legal standard for a breach of fiduciary duty).

²⁸ See, e.g., *Fogel v. Chestnutt*, 668 F.2d 100, 116 (2d Cir. 1981) (“This was precisely the kind of information that could and should have been placed before the disinterested directors”); *Galfand v. Chestnutt Corp.*, 545 F.2d 807, 812 (2d Cir. 1976) (stating that duty includes “supplying information sufficient to enable the Fund’s Board to evaluate the new contract”); *Moses v. Burgin*, 445 F.2d 369, 377 (1st Cir. 1971) (asserting

B. The Contemporary 15(c) Process

1. Defined by *Gartenberg*

The primary legacy of the 1970 amendments was the creation of the 15(c) process and its influence on the fund board's approval of the advisory contract.²⁹ Since the 1970 amendments, the key judicial decision influencing the process has been *Gartenberg v. Merrill Lynch*, decided by the Second Circuit in 1982.³⁰ The plaintiff in *Gartenberg* alleged that his money market fund's adviser charged the fund excessive fees in violation of its fiduciary duties under Section 36(b) of the 1940 Act.³¹ The district court ruled against the plaintiff and the second circuit affirmed in the landmark decision.³²

The *Gartenberg* court first analyzed the legislative history of the 1970 Amendments and then concluded that it was appropriate to scrutinize the fee through a variety of factors.³³ The Court emphasized that the operative question is “whether the fee schedule represents a charge within the range of what would have been negotiated at arm's-length in the light of all the surrounding circumstances.”³⁴ In its now notorious elaboration, the Second Circuit said “[t]o be guilty of a violation of § 36(b) . . . the adviser-manager 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.”³⁵

that advisors' duties include “insur[ing] that unaffiliated directors are furnished with sufficient information . . .”).

²⁹ The creation of Section 36(b) provided for a private cause of action for excessive fees, but the private cases have primarily refined the information that needs to be evaluated by the directors rather than resulted in a successful weapon for shareholders to reduce fees on a case-by-case basis.

³⁰ See *Gartenberg v. Merrill Lynch Asset Mgmt., Inc.*, 694 F.2d 923, 1041-42 (2d Cir. 1982) (“To be guilty of a violation of §36(b) . . . the adviser-manager 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.”).

³¹ See *id.* at 925 (“The principal claim is that the fees paid by the Fund to the Manager for various services . . . were so disproportionately large as to constitute a breach of fiduciary duty in violation of § 36(b).”).

³² See *id.* at 925.

³³ See *id.* at 928.

³⁴ See *id.* at 928.

³⁵ *Id.*

The decision articulated six factors to review for purposes of determining whether there has been a breach of fiduciary duty on the part of the adviser with respect to fees paid by the fund.³⁶ These non-exclusive factors, now known prominently as the “*Gartenberg* factors,” have been articulated as follows: (1) the nature and quality of the services provided to the fund and shareholders; (2) the profitability of the fund to the adviser; (3) the adviser’s receipt of collateral benefits because of its relationship with the fund, *i.e.* “fall-out benefits”; (4) the extent to which the adviser realizes economies of scale as the fund grows; (5) comparative fee structure, *i.e.*, comparison of the fees with those paid by similar funds; and (6) the independence, expertise, care, and conscientiousness of the board in evaluating the adviser’s compensation.³⁷

The *Gartenberg* decision, along with the excessive fee cases that followed, created and refined the factors that need to be evaluated by fund boards prior to approving the advisory contract. Since Section 15(c) requires the directors to request and analyze information necessary to evaluate the terms of a proposed advisory contract, the “*Gartenberg* factors” encompass the information typically requested by the directors in a “15(c) Request.”

After receiving the 15(c) Request, the adviser provides a “15(c) Response.”³⁸ The adviser’s obligation to provide information

³⁶ See *id.* at 927-931 (articulating the “*Gartenberg* factors.”). Interestingly, the case and its progeny look at the process as that of whether the directors properly considered the “*Gartenberg* factors,” even though Section 36(b) creates a fiduciary duty for the adviser in the context of charging its fee to the fund, and not the directors in fulfilling their fiduciary duties to fund shareholders. The fiduciary duty of the directors overlaying the 15(c) and 36(b) process is actually found in 36(a), creating a general fiduciary duty upon the directors and the adviser in their dealings with fund shareholders.

³⁷ *Id.* at 927-31 (1982) (discussing the non-exclusive “*Gartenberg*” factors); see *2004 Disclosure Rule*, *supra* note 1, at 39,807 (listing in section 240.14A-101, Item 22(c)(11)(i) factors nearly identical to those found in *Gartenberg*); John C. Coates IV, *The Downside of Judicial Restraint: The (Non-) Effect of Jones v. Harris*, 6 DUKE J. CONST. L. & PUB. POL’Y 58, 58 (2010) (listing “*Gartenberg* factors”); Caroline J. Dillon, Note, *Do You Get What You Pay For? A Look at the High Fees and Low Protections of Mutual Funds*, 2006 COLUM. BUS. L. REV. 281, 294 (2006) (listing “*Gartenberg* factors”).

³⁸ While components of the 15(c) process appear programmed and predictable, the reality is that the directors may be receiving material information relating to the services provided by the adviser and other “*Gartenberg*

to the fund board is mandatory regardless of whether directors make a 15(c) Request and is not confined to information contemplated by the 15(c) Request. Section 15(c) imposes disjunctive obligations, with the adviser required to provide information to the directors that is reasonably necessary to evaluate the terms of the advisory contract, regardless of whether the information was specifically requested by the directors.³⁹

By requiring certain factors to be analyzed by fund directors, *Gartenberg* and its progeny link Section 15(c) directly to the fiduciary duties contained in Section 36(b). Section 15(c), however, is not limited in scope by the *Gartenberg* factors. While the scope of Section 15(c) includes all aspects of the advisory contract, not simply the advisory fee, the 15(c) Request is generally tailored to ensure fulfillment of the “*Gartenberg* factors,” so as to prevent the adviser from breaching its fiduciary duties in connection with charging

factors” throughout the year. According to the Independent Directors Council, “the process of preparing for [advisory contract approval] meeting is rigorous and takes several months, if not the entire year. Directors continuously assess the quality of the services provided by the adviser. Should any of those services need improvement, directors can and do require advisers to provide appropriate additional resources to resolve the issue.” Indep. Dir. Council, *Frequently Asked Questions About Mutual Fund Directors*, http://www.idc.org/idc/policy/governance/ci.faq_fund_gov_idc.idc (last visited May 10, 2011).

³⁹ See *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 190 (1963) (quoting testimony from the president of the Investment Counsel Association of America that an “[advisers’] remuneration for [their] work would consist solely of definite, professional fees fully disclosed in advance.”); see also Investment Advisers Act of 1940 § 206(2), 15 U.S.C. § 80b-6 (2006) (requiring advisers to provide information reasonably necessary to evaluate fees); *BISYS Fund Servs., Inc.*, Investment Advisers Act Release No. 2554, Investment Company Act Release No. 27500, 2006 WL 2787265 (Sept. 26, 2006), available at <http://www.sec.gov/litigation/admin/2006/ia-2554.pdf> (demonstrating an adviser can incur a penalty for violating § 206(1) of the Investment Advisers Act in connection with the improper use of fund assets for marketing and other expenses incurred by advisers); *Smith Barney Fund Mgmt. LLC*, Exchange Act Release No. 51761, 2005 WL 1278368, at *14 (May 31, 2005), available at <http://www.sec.gov/litigation/admin/34-51761.pdf> (finding the adviser “violated Section 206(1) [of the Investment Advisers Act] . . . by knowingly or recklessly failing to disclose to the Funds’ boards that [the transfer agent] had offered to do the same work for substantially less [to another fund].”); Robertson, *supra* note 2, at 6-1 – 6-89 (outlining procedures for fee approval).

fees.⁴⁰ Thus, an adviser may breach its duties by failing to properly respond to a 15(c) Request.

In addition, Section 15(c) creates a dynamic interplay with the Section 36(a) directors' fiduciary duty to approve the contract and the fee. Thus, while a failure of the directors to reasonably request or evaluate information about advisory fees can violate Section 15(c), the directors' duties under Section 36(a) overlay the process. Under Section 36(a), directors must fulfill fiduciary duties beyond the specific duties to request, furnish and evaluate the terms of the proposed advisory contract.⁴¹

A number of non-judicial sources discuss the 15(c) process, including, most prominently, a 2004 rule released by the SEC requiring that funds provide a discussion in their shareholder reports of those factors that fund directors considered in evaluating advisors' contracts.⁴² Notwithstanding the prominence of the 1970 Amendments, the SEC has brought only about a dozen enforcement actions under either Section 15(c) or 36(b), and private litigants have had very little success.⁴³

⁴⁰ See, e.g., MUTUAL FUND DIRECTORS FORUM, BEST PRACTICES AND PRACTICAL GUIDANCE FOR MUTUAL FUND DIRECTORS 44-47 (2004) [hereinafter "MDFD"], available at http://www.mfdf.org/images/uploads/resources_files/best_pra.pdf (suggesting information for independent directors to request of advisors regarding fees).

⁴¹ See *Tannenbaum v. Zeller*, 552 F.2d 402 (2d Cir. 1977) (elaborating fiduciary duties in relation to recapture); *Galfand v. Chestnutt Corp.*, 545 F.2d 807 (2d Cir. 1976) (discussing fiduciary duties generally); *SEC v. Treadway*, 430 F. Supp. 2d 293 (S.D.N.Y. 2006) (discussing generally director's fiduciary duties after *Gartenberg*).

⁴² See *2004 Disclosure Rule*, *supra* note 1, at 39,807 (listing in § 240.14a-101, Item 22(c)(11)(i) the information required to be disclosed in a proxy statement to shareholders). As discussed more fully in Part III.B.1 below, the *2004 Disclosure Rule* can be interpreted as essentially codifying the "*Gartenberg*" factors and may even have created a separate cause of action for material inaccuracies in setting forth a consideration of those factors.

⁴³ See, e.g., cases concerning 15(c) violations, yet unrelated to the 15(c) process: *Navellier v. Sletten*, 262 F.3d 923 (9th Cir. 2001) (rejecting plaintiff's claim that a third party was a "de facto" investment adviser and an interested person in violation of 15(c)); *Migdal v. Rowe Price-Fleming Int'l, Inc.*, 248 F.3d 321 (4th Cir. 2001) (involving independence of directors, dismissal affirmed); *Block v. SEC*, 50 F.3d 1078 (D.C. Cir. 1995) (involving a mutual fund shareholder challenging an SEC decision to not hold a hearing to determine whether directors were interested; accordingly, the shareholders urged that those directors "should not be permitted to meet the

requirement[]’ that a majority of non-interested directors approve any investment advisory contract” under § 15(c)); *Miller v. Mitchell Hutchins Asset Mgmt., Inc.*, 2002 U.S. Dist. LEXIS 27675 (S.D. Ill. 2002) (dismissed for failure to state a claim under the 1940 Act); *Krantz v. Fidelity Mgmt. & Research, Co.*, 98 F. Supp. 2d 150 (D. Mass. 2000) (finding approval by independent directors, dismissed); *Verkouteren v. Blackrock Fin. Mgmt., Inc.*, 37 F. Supp. 2d 256 (S.D.N.Y. 1999) (finding independence of directors, dismissed); *McLachlan v. Simon*, 31 F. Supp. 2d 731 (N.D. Cal. 1998) (dismissing plaintiffs’ contention that a third party was a “de facto” investment adviser); *Friedlob v. Tr. of the Alpine Mut. Fund Trust*, 905 F. Supp. 843 (D. Colo. 1995) (dismissing claims under the 1940 Act due to the statute of limitations expiration); *Korenstein v. Dreyfus Corp.*, 1980 U.S. Dist. LEXIS 9806 (S.D.N.Y. 1980) (approving settlement of a 15(c) claim).

See generally cases concerning private action related to the 15(c) process: *Galfand*, 545 F.2d at 807 (holding that failure to comply with the 15(c) process does not, standing alone, establish a *per se* violation of the 1940 Act); *Gartenberg v. Merrill Lynch Asset Mgmt., Inc.*, 573 F. Supp. 1293 (S.D.N.Y. 1983) (dismissing action on the merits unrelated to the 15(c) process); *Andre v. Merrill Lynch Ready Asset Trust*, 97 F.R.D. 699 (S.D.N.Y. 1983) (dismissing plaintiff’s 15(c) claim as “meritless” on the facts); *Krasner v. Dreyfus Corp.*, 90 F.R.D. 665 (S.D.N.Y. 1981) (discussing the 15(c) process, which the court found the directors have satisfied); *Cohen v. Fund Asset Mgmt., Inc.*, 1980 WL 1488 (S.D.N.Y. 1980) (finding cause of action “only against those persons who are recipients of the compensation or payments of material nature from the [f]und”); *Untermeyer v. Fidelity Daily Income Trust*, 79 F.R.D. 36 (D. Mass. 1978) (dismissing plaintiff’s 15(c) claim for failure to first make demand on the board as per 15(c) procedural requirements); *Halligan v. Standard & Poor’s/Intercapital, Inc.*, 434 F. Supp. 1082 (E.D.N.Y. 1977) (dismissing plaintiff’s 15(c) complaint for failing to state a 15(c) claim)

See generally cases concerning enforcement action related to the 15(c) process: Paul Buchbaum, Exchange Act Release No. 16622, 1980 WL 20779 (Mar. 4, 1980) (approving settlement of a 15(c) claim and finding that a fund’s director “did not adequately fulfill his obligation in overseeing the funds. He failed to make an adequate review of the investment policies pursued by [the adviser] and the disclosure documents disseminated to shareholders and filed with the [SEC]. Further, [he] approved an increased management fee paid to [the adviser by the fund] without requesting and evaluating such information as was necessary to evaluate the terms of the management contract.”).

See generally cases concerning enforcement action unrelated to the 15(c) process: Eric S. Emory, Securities Act Release No. 6905, Exchange Act Release No. 29467, Investment Company Act Release No. 18254, 1991 WL 284971 (July 22, 1991) (finding that a fund’s director and an adviser “willfully violated Section 15(a) of [the 1940 Act] by serving as investment

In sum, after *Gartenberg*, the 15(c) process requires that fund directors request—and an investment adviser furnish—such information as may reasonably be necessary to evaluate the terms of an advisory contract. Additionally, fund directors must evaluate material factors in deciding whether to approve an investment advisory contract, advisory fees, the terms of any advisory contract and any renewal thereof, by a vote of the majority of disinterested directors.⁴⁴

adviser to the [f]und without a written contract that had been approved by a vote of a majority of the outstanding voting securities of the [f]und.”); Sidney I. Shupack, Investment Advisers Act Release No. 1061, 1987 WL 757575 (Mar. 23, 1987) (denying an application for re-entry, citing a settled action involving an alleged 15(c) violation); Heart of America Inv. Servs., Inc., Investment Company Act Release No. 11975, 1981 WL 37845 (Oct. 6, 1981).

See generally other cases concerning the 15(c) enforcement action: SEC Sanctions Charles Dwyer, SEC News Digest 2001-155, 2001 WL 898676 (2001) (announcing a settlement of a charge brought against a fund director and an adviser based on the 15(c) violations, among others); Reserve Mgmt. Corp., Investment Company Act Release No. 9826, 1977 WL 173472 (June 27, 1977) (suspending advisers’ registration as part of settlement for 15(c) violation).

See also cases concerning 36(b) enforcement action: SEC v. American Birthright Trust Mgmt. Co., SEC Litigation Release No. 9266, 1980 WL 25434 (Dec. 30, 1980) (alleging excessive compensation to fund adviser); SEC v. Fundpack, Inc., 666 F.2d 612 (D.C. 1981); SEC v. Fundpack, Inc., 1979 WL 1195 (D.C. 1979) (plaintiff’s complaint alleging management “switching” scheme in violation of 15(c)).

⁴⁴ *See* Investment Company Act, 15 U.S.C. § 80a-15(c) (2006) (“[I]t shall be unlawful for any registered investment company having a board of directors to enter into, renew, or perform any contract or agreement, written or oral, whereby a person undertakes regularly to serve or act as investment adviser of or principal underwriter for such company, unless the terms of such contract or agreement and any renewal thereof have been approved by the vote of a [noninterested] majority of directors . . .”).

See, e.g., *Burks v. Lasker*, 441 U.S. 471, 483 (1979) (“Congress consciously chose to address the conflict-of-interest problem through the [Investment Company] Act’s independent-directors section . . .”); *Brown v. Bullock*, 194 F. Supp. 207, 235 (S.D.N.Y. 1961), *aff’d*, 294 F.2d 415 (2d Cir. 1961) (“By giving the directors the right to extend and to terminate the [investment advisory] contract, the [Investment Company] Act necessarily also imposes upon the directors the fiduciary duty to use these powers intelligently, diligently and solely for the interests of the company and its stockholders.”).

While the *Gartenberg* decision became the standard-bearer for the scope of the fiduciary duties pursuant to Section 36(b), some circuit court decisions raised questions. Three circuit court decisions criticized the holding in *Gartenberg*, including the 2008 Seventh Circuit decision in *Jones*, which rejected outright the *Gartenberg* interpretation of 36(b), and separate Seventh Circuit and Third Circuit decisions.⁴⁵ These decisions raised the question of whether *Gartenberg* overly confined the scope of 36(b) and instead should encompass undermining the 15(c) process as a violation of the standard of care of an adviser. The *Jones* decision appears to have answered this question.

2. *Jones v. Harris*

Jones involved a lawsuit filed by a shareholder of a mutual fund managed by Harris Associates. The shareholder alleged that Harris charged excessive fees in violation of the fiduciary duty owed to the shareholder by the manager, as set forth in Section 36(b).⁴⁶ The court in *Jones* stated that the fact that the adviser was charging other clients significantly less for similar services was probative of whether he was charged an excessive fee.⁴⁷ The district court dismissed the suit, finding *Gartenberg* as the controlling authority in the Seventh Circuit and, *inter alia*, the non-fund fees were incomparable.⁴⁸ The Seventh Circuit affirmed the decision but raised eyebrows by rejecting *Gartenberg* in favor of another standard.⁴⁹ Instead, the Seventh Circuit said the purpose of Section 36(b) was to

⁴⁵ *Jones v. Harris Assoc. L.P.*, 527 F.3d 627, 632 (7th Cir. 2008) (“[W]e now disapprove the *Gartenberg* approach); *see Green v. Nuveen Advisory Corp.*, 295 F.3d 738, 743 n.8 (7th Cir. 2002) (holding that § 36(b) allows for a broader range of actions than those under *Gartenberg*); *Green v. Fund Asset Mgmt., L.P.*, 286 F.3d 682, 685 (3d Cir. 2002) (finding that an advisor could breach a fiduciary duty under § 36(b) by failing to adequately disclose potential conflicts of interest).

⁴⁶ *Jones*, 527 F.3d at 629 (“Plaintiffs . . . contend that the fees are too high and thus violate § 36(b) of the Investment Company Act . . .”).

⁴⁷ *Id.* at 631 (“The [excessive fee] argument rests on the fact that the [adviser] . . . has institutional clients . . . that pay less [than the plaintiffs].”).

⁴⁸ *Jones v. Harris Assoc. L.P.*, 2007 WL 627640, at *7 (N.D. Ill. 2007) (accepting *Gartenberg* as the controlling framework in claims of fee-related breaches of fiduciary duties).

⁴⁹ *See Jones*, 527 F.3d at 632, 635 (disapproving the *Gartenberg* approach, but affirming the district court judgment).

address issues from the 1960s that essentially were no longer relevant.⁵⁰ This standard appeared to reject the legislative history of both the 1940 Act and its 1970 Amendments, which indicated that funds were effectively controlled by their advisers and captive to their fee decisions. Thus, the Seventh Circuit found that the only responsibility on the part of advisers pursuant to Section 36(b) was to provide full disclosure to fund boards.⁵¹ The court emphasized this by stating that it was the responsibility of the adviser to “make full disclosure and play no tricks.”⁵²

The plaintiff appealed the decision to the Supreme Court, and on March 30, 2010, the Court reversed the Seventh Circuit and held that *Gartenberg* was essentially the standard to determine whether an adviser has breached its fiduciary duty to shareholders under Section 36(b).⁵³ In so doing, the Court appeared to articulate three principles, two of which were left unclear after *Gartenberg*.

i. **Three Principles**

1. No Cause of Action for Process Violation

The *Gartenberg* Court left undecided whether an adviser could breach its fiduciary duties under Section 36(b) if it did not charge an “excessive fee.” That is, after *Gartenberg*, plaintiffs argued that the adviser could violate Section 36(b) in one of two additional ways: first, because the adviser did not cooperate with the fund board by disclosing material information necessary to determine a reasonable fee;⁵⁴ second, because the adviser created a structure of

⁵⁰ *Id.* at 633-34 (discussing the current state and features of the mutual fund industry).

⁵¹ *Id.* at 632 (“A fiduciary must make full disclosure and play no tricks but is not subject to a cap on compensation. The trustees . . . rather than a judge or jury, determine how much advisory services are worth.”).

⁵² *Id.* Interestingly, a literal reading of the Seventh Circuit was that a 15(c) process violation could trigger a cause of action under 36(b).

⁵³ *Jones v. Harris Assoc. L.P.*, 130 S. Ct. 1418, 1426 (2010) (“[W]e conclude that *Gartenberg* was correct in its basic formulation of what § 36(b) requires . . .”).

⁵⁴ *See, e.g.*, *Green v. Fund Asset Mgmt.*, 19 F. Supp. 2d 227, 234 (D.N.J. 1998) (plaintiffs contending that a claim of inadequate disclosure of the fee calculation method can give rise to a 36(b) cause of action); James N. Benedict et al., *Recent Developments in Litigation Under the Investment*

the fee that in and of itself was a breach of fiduciary duty, regardless of whether the fee itself was excessive.⁵⁵

The Third Circuit also appears to have interpreted the fiduciary duties owed by the adviser under Section 36(b) as broader than merely ensuring the fee was not excessive.⁵⁶ However, *Jones* seems to dismiss that possibility.

While not the precise holding of *Jones*, Justice Alito elaborated on the consequences of a fee approval process violation:

[W]here the board's process was deficient or the adviser withheld important information, the court must take a more rigorous look at the outcome. When an investment adviser fails to disclose material information to the board, greater scrutiny is justified because the withheld information might have hampered the board's ability to function as "an independent check upon the management."⁵⁷

Section 36(b) is sharply focused on the question of whether the fees themselves were excessive⁵⁸ But an adviser's compliance or noncompliance with its disclosure obligations is a factor that must be considered in calibrating the degree of deference that is due a board's decision to approve an adviser's fees.⁵⁹

Company Act of 1940, in INVESTMENT MANAGEMENT INSTITUTE, CORPORATE LAW AND PRACTICE COURSE HANDBOOK SERIES 729, 904 (2007) (citing allegations of material omissions where advisor arrangements were not disclosed).

⁵⁵ See *Green v. Nuveen Advisory Corp.*, 295 F.3d 738, 743 n.8 (7th Cir. 2002) (describing plaintiffs' contention that the structure of the fee arrangement in itself created a violation of 36(b)); *Benedict*, *supra* note 54, at 759 ("Plaintiffs also are attacking the structure of the fees themselves as per se violations of Section 36(b) . . .").

⁵⁶ See *id.* at 743 (adopting a broader reading of Section 36(b) and noting that the Third Circuit has also done so in *Fund Asset Mgmt.*).

⁵⁷ *Jones*, 130 S. Ct. at 1430 (citation omitted).

⁵⁸ *Id.* (quoting *Migdal v. Rowe Price-Fleming Int'l, Inc.*, 248 F.3d 321, 328 (4th Cir. 2001) (citation omitted)).

⁵⁹ *Id.*

Justice Alito, in a portion of the opinion that appears to deliberately recognize the unanswered question of whether a deficient process could lead to a violation of 36(b), specifically indicates that the consequence of such violation is merely a “factor” in determining whether there is a violation.⁶⁰ Thus, Justice Alito effectively limits deficient processes to a modified “6th *Gartenberg* factor”—the independence, expertise, care and conscientiousness of the board in evaluating the adviser’s compensation, *plus* whether the adviser fulfills its obligations in the 15(c) process.⁶¹

Notwithstanding Justice Alito’s statements, the Ninth Circuit, in a recent unpublished opinion, appears to disagree. Specifically, the Ninth Circuit opined that Section 36(b) “encompasses a claim that a fiduciary may breach its duty by *improperly using fees*.”⁶² This seemingly definitive opinion may cause the Supreme Court to address the issue more directly in the future.⁶³

2. Directors Must Inquire Regarding Fees to Other Clients

Jones also clarified a second issue: whether fees charged by advisers to non-fund clients, primarily pensions and institutional clients, could be considered in determining whether the fee is “excessive.” The *Gartenberg* court addressed the question in the context of money market funds and rejected the comparison.⁶⁴ But against the backdrop of numerous district courts forced to deal with

⁶⁰ *Id.* (explaining that a failure in disclosure should be a factor considered, but not a violation of 36(b) in itself).

⁶¹ *Gartenberg v. Merrill Lynch Asset Mgmt., Inc.*, 528 F. Supp. 1038, 1057-58 (S.D.N.Y. 1981), *aff’d*, 694 F.2d 923 (2d Cir. 1982) (considering the effect of a Board’s ratification of advisor fees).

⁶² *Jelinek v. Capital Research & Mgmt. Co.*, No. 10-55221, slip op. at 4 (9th Cir. Aug. 24, 2011) (emphasis added). As support for this ruling, the Ninth Circuit cites both *Forsythe v. Sun Life Fin., Inc.*, 417 F. Supp. 2d 100, 115-16 (D. Mass. 2006) and *Siemers v. Wells Fargo & Co.*, 2006 WL 2355411 (N.D. Cal. 2006).

⁶³ *Jones* was a unanimous opinion. However, there may not be unanimity on the question of whether Section 36(b) encompasses claims outside of the *Gartenberg* excessive fee realm.

⁶⁴ *See Gartenberg*, 528 F. Supp. at 1047 (explaining that when evaluating whether an advisory fee is so high as to constitute a breach of fiduciary duty, “[t]he Court must consider the ‘nature, quality and extent’ of the services to the [f]und . . .”).

empirical evidence that non-fund clients were paying significantly less in advisory fees than retail shareholders, *Jones* addressed the issue head-on by indicating that the fees, if relevant, should be part of the advisory contract approval process and considered by the fund board:

[W]e do not think that there can be any categorical rule regarding the comparisons of the fees charged different types of clients. . . . Instead, courts may give such comparisons the weight that they merit in light of the similarities and differences between the services that the clients in question require, but courts must be wary of inapt comparisons. . . . [T]here may be significant differences between the services provided by an investment adviser to a mutual fund and those it provides to a pension fund If the services rendered are sufficiently different that a comparison is not probative, then courts must reject such a comparison.⁶⁵

This holding departs significantly from previous cases. The decision impacts the 15(c) process in two ways. First, the non-fund fees must be encompassed. Second, fund directors must determine the relevancy of non-fund fees when comparing the fees charged by the adviser.⁶⁶

3. The Directors Will Receive More Focus and Deference

Jones presents a third issue with the Court's the emphasis on the robustness of the directors' review of the advisory contract. The Court discussed the importance of fund directors acting as independent watchdogs:

⁶⁵ *Jones*, 130 S. Ct. 1418 at 1428-29.

⁶⁶ *Id.* at 1430 (showcasing Alito explaining that directors should consider a number of elements in determining the relevancy of non-fund fees for comparison purposes, including frequency of redemptions, turnover rates, regulatory and legal obligations and marketing costs). See additional comments on this issue of relevance in Part IV.V.2. below.

In recognition of the role of the disinterested directors, the [Investment Company] Act instructs courts to give board approval of an adviser's compensation "such consideration . . . as is deemed appropriate under all the circumstances." From this formulation, two inferences may be drawn. First, a measure of deference to a board's judgment may be appropriate in some instances. Second, the appropriate measure of deference varies depending on the circumstances.

[A] court's evaluation of an investment adviser's fiduciary duty must take into account both procedure and substance. . . . Where a board's process for negotiating and reviewing investment-adviser compensation is robust, a reviewing court should afford commensurate deference to the outcome of the bargaining process. . . . Thus, if the disinterested directors 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. . . .

It is also important to note that the standard for fiduciary breach under § 36(b) does not call for judicial second-guessing of informed board decisions. . . . "[P]otential conflicts [of interests] may justify some restraints upon the unfettered discretion of even disinterested mutual fund directors, particularly in their transactions with the investment adviser," but they do not suggest that a court may supplant the judgment of disinterested directors apprised of all relevant information, without additional evidence that the fee exceeds the arm's-length range.⁶⁷

While the broader statement about the importance of the independence and conscientiousness of directors in the decision-making process raises nothing new, commentators consider the

⁶⁷ *Id.* at 1428-30.

Court's emphasis on it.⁶⁸ This emphasis suggests that courts will be expected to provide more scrutiny of the directors and their process in approving the fee, which shall include their consideration of non-fund fees charged by the adviser. In sum, the most meaningful legacy of *Jones* may be its impact on the 15(c) process.⁶⁹

As Justice Thomas admonishes in his concurrence, the *Jones* decision did not merely affirm *Gartenberg*.⁷⁰ Faced with the reality of scant plaintiff success under Section 36(b), however, the Supreme Court did nothing to alter the core statement of *Gartenberg* that has led to seemingly insurmountable odds against plaintiffs—the advisory fee must “be so disproportionately large that that it bears no reasonable relationship to the services rendered and could not have been the product of arm’s length bargaining.”⁷¹

⁶⁸ See Lori A. Martin & Matthew A. Chambers, *Supreme Court Endorses Gartenberg, But It's Not the Same Old Standard*, WILMERHALE LLP (Apr. 5, 2010), available at http://www.wilmerhale.com/supreme_court_endorses_gartenberg_04-05-2010/ (listing “the independence and conscientiousness of the boards” as a factor the Court considers in determining whether or not a fee is excessive); *Supreme Court Upholds Gartenberg Standard*, WILLKIE FARR & GALLAGHER LLP (Apr. 2, 2010) at 2, http://www.willkie.com/files/tbl_s29Publications%5CFileUpload5686%5C3289%5CSupreme%20Court%20Upholds%20Gartenberg%20Standard.pdf (“In short, the Court’s opinion is a significant pronouncement on the fundamental role that informed and conscientious fund directors play in the advisory fee approval process”); Cameron S. Avery et al., *Supreme Court Upholds Gartenberg Standard in Jones v. Harris*, K&L GATES LLP (Mar. 31, 2010), <http://www.klgates.com/newsstand/detail.aspx?publication=6321> (“The Court’s opinion appears to be a major affirmation of the crucial role of informed and diligent fund directors in overseeing fees and monitoring conflicts of interest.”).

⁶⁹ See *Supreme Court Decides Jones v. Harris Associates and Establishes Standard for Mutual Fund Excessive Fee Claims*, ROPES & GRAY LLP (Mar. 30, 2010), http://www.ropesgray.com/files/Publication/1dd7c077-c2fe-4029-80bb-ca7c78488351/Presentation/PublicationAttachment/02f6c85a-8e72-44e9-a1c8-1e9b43246c4e/RopesGray_Alert_jonesharrisdecision.pdf (stating that no meaningful change will happen with plaintiff suits).

⁷⁰ *Jones*, 130 S. Ct. 1418 at 1431 (concurring Justice Thomas stating that he would not shortchange the Court’s effort by describing it as affirmation of the “*Gartenberg* standard”).

⁷¹ *Gartenberg v. Merrill Lynch Asset Mgmt., Inc.*, 528 F. Supp. 1038, 1038 (S.D.N.Y. 1981).

III. SEC and Private Actions

A. SEC Enforcement Actions

Since the 15(c) process's creation in 1970, a handful of SEC enforcement matters have alleged violations of the process. These matters suggest what type of conduct will warrant an SEC charge. More importantly, they provide various principles for fund directors and advisers in connection with the 15(c) process. The following are seven matters in reverse chronological order, with three of the most recent actions coming in the past two years.

1. *In the Matter of Morgan Stanley Investment Management, Inc.*

On November 16, 2011 the SEC announced that it had charged registered investment adviser Morgan Stanley Investment Management ("MSIM") with, *inter alia*, violating Section 15(c) with respect to The Malaysia Fund, Inc. ("Fund").⁷² The SEC alleged, over a more than ten year time span, that MSIM failed to provide the Fund's board of directors with information reasonably necessary for the directors to evaluate the nature, quality and cost of a sub adviser's services.⁷³ According to the SEC, the sub-adviser misrepresented to the Fund's directors that it was providing advisory services for the benefit of the Fund, while in actuality it was not.⁷⁴

More specifically, the Fund entered into a "Research and Advisory Agreement" with the sub-adviser and MSIM, under which the sub-adviser undertook to provide "investment advice, research,

⁷² Press Release, Securities and Exchange Commission, SEC Charges Morgan Stanley Investment Management for Improper Fee Arrangement (Nov. 16, 2011), *available at* <http://www.sec.gov/news/press/2011/2011-244.htm>.

⁷³ *In the Matter of Morgan Stanley Inv. Mgmt., Inc.*, Investment Advisers Act of 1940 Release No. 3315 (Nov. 16, 2011), *available at* <http://www.sec.gov/litigation/admin/2011/ia-3315.pdf>.

⁷⁴ *Id.* It is noteworthy that the SEC's release characterized MSIM's violation of Section 15(c) as being a result of failing to provide information for the Fund's directors to properly evaluate the *sub-adviser*. It would seem that the failure of MSIM to disclose to the Fund's directors that it was not ensuring that the sub-adviser was providing meaningful services to MSIM, and correspondingly the Fund, would likewise be a violation of Section 15(c).

and assistance” to MSIM for the benefit of the Fund.⁷⁵ During the ten-year relationship between MSIM and the sub-adviser, MSIM falsely reported during the 15(c) process that it was receiving such advice, research and intelligence. In reality, the sub-adviser’s services were limited to preparing two minor monthly reports for MSIM, which MSIM’s portfolio management team neither requested nor used in its management of the Fund.

The settlement with the SEC provided for MSIM, without admitting to or denying the veracity of the allegations,⁷⁶ to reimburse the Fund the entire amount paid in so-called advisory fees to the sub-adviser (\$1.845 million) and pay a penalty of \$1.5 million.⁷⁷ The order also mandated that MSIM perform, *inter alia*, numerous compliance undertakings. Interestingly, the press release indicated that the investigation was “continuing.”⁷⁸

The press release acknowledged that the matter was part of the Division of Enforcement Asset Management Unit’s focus on “fee arrangements with registered funds.”⁷⁹ The order characterized the case as “improperly charged” advisory fees, although Section 36(b) was not charged.⁸⁰ This matter, along with American Birthright discussed below, raises the issue of proper oversight of sub-adviser in connection with the 15(c) process.

⁷⁵ *Id.*

⁷⁶ Brett Philbin & Jean Eaglesham, *First Shot Fired in Fee Fight*, WALL ST. J., Nov. 17, 2011, <http://online.wsj.com/article/SB100014205297020369940457704208248480306.html>.

⁷⁷ Kara Scannell, *Morgan Stanley settles SEC advisory fee claim*, FIN. TIMES, Nov. 16, 2011, <http://www.ft.com/intl/cms/s/0/0d61b482-107b-11e1-8010-00144feabdc0.html#axzz1eaRIJxEd>. The Settlement did allow for a reduction in the payment due by MSIM to reimburse the Fund for sub-advisory fees. This credit (\$543,000) represented monies that MSIM had already reimbursed to the Fund. Morgan Stanley *supra* note 73, at ¶ 24.

⁷⁸ The SEC press release also recognized the SEC’s examination team’s role by noting that the fund’s sub-adviser contract was terminated in 2008 as a result of the examination staff inquiring about the sub-adviser.

⁷⁹ Press Release, Securities and Exchange Commission, *supra* note 72.

⁸⁰ Morgan Stanley, *supra* note 73.

2. *In the Matter of Value Line, Inc.*⁸¹

On November 4, 2009, the SEC entered into an offer of settlement with a registered investment adviser Value Line, Inc., a registered broker-dealer Value Line Securities, Inc. (“VLS”), Chief Executive Officer Jean Bernhard Buttner and Chief Compliance Officer David Henigson.⁸² The SEC alleged that the parties violated several provisions, including anti-fraud sections of the federal securities laws, and the investment adviser was accused of violating Section 15(c).⁸³

The conduct that was the subject of the order took place from 1986 to 2004, when the investment adviser entered into arrangements with several unaffiliated brokerage firms to execute, clear and settle securities trades on behalf of the funds at a discounted commission rate that varied during the period from \$.02 per share to as low as \$.01 per share.⁸⁴ The adviser did not pass these savings onto the funds. Instead, the adviser’s affiliated broker-dealer, VLS, arranged for unaffiliated broker-dealers to charge \$.0488 per share and then to “rebate” between \$.0288 and \$.0388 per share to VLS.⁸⁵ In total, the adviser directed over \$24 million of fund brokerage, *i.e.*, fund assets, to its affiliated broker-dealer in what it called a “commission recapture” program.⁸⁶ According to the SEC, VLS did not provide any brokerage services to the fund and, in fact, did not have the ability to execute trades.⁸⁷

The investment adviser allegedly violated Section 15(c) by asserting that using VLS as a broker for the fund’s securities trades was in the best interests of the funds.⁸⁸ Additionally, the adviser

⁸¹ Value Line, Inc., *supra* note 3; *see also* Press Release, Securities and Exchange Commission, SEC Sues Value Line Inc. and Two Senior Officers for \$24 Million Fraudulent Scheme (Nov. 4, 2009), *available at* <http://www.sec.gov/news/press/2009/2009-234.htm>.

⁸² Value Line, Inc., *supra* note 3, at 2.

⁸³ *Id.* at 4, 7.

⁸⁴ *Id.* at 4 (“VLI sent the trades . . . on behalf of the Funds at a discounted commission rate as low as \$.01 per share. Although the Rebate Brokers charged at the outset \$.02 per share for their services, which rate was reduced over time to as little as \$.01 per share for their services . . .”).

⁸⁵ *Id.*

⁸⁶ *Id.*

⁸⁷ *Id.*

⁸⁸ *Id.* at 5.

failed to disclose to the fund's board of directors the specifics of the "commission recapture" program, especially the fact that the unaffiliated broker-dealers were executing the trades at a significant discount to the disclosed costs and sending the balance back to VLS.⁸⁹

This matter highlights the importance of the 15(c) process in the context of fund brokerage and an affiliated broker-dealer, specifically, the proposition that an investment adviser must fully inform fund directors regarding an affiliated broker-dealer's services, or lack thereof, for the fund. Further, when an adviser utilizes an affiliated broker-dealer to provide services to the fund, the adviser must disclose to the fund directors any "target percentage" that requires a certain amount of the fund's assets to be traded through the affiliated broker.⁹⁰

Most importantly from the standpoint of fund directors, this case alerts directors to a number of "red flag" issues. First, if there is an affiliated broker, then close scrutiny should be given to the costs of the trades. Second, if there is a recapture program or a "target percentage," the fund board should scrutinize the efficacy of such arrangements to ensure that the assets of the fund (fund brokerage) are used in the best interests of the fund, not others.

3. *New York Life Investment Management LLC*⁹¹

On May 27, 2009, the SEC entered into an offer of settlement with New York Life Investment Management LLC ("NYLIM"), a registered investment adviser.⁹² Among other things, NYLIM was charged with "willfully violating" Section 15(c) in 2002 and 2003.⁹³

The SEC alleged that NYLIM urged the fund board to consider a novel guarantee provision when it recommended the continuation of an advisory fee deemed by a third party as one of the "highest management fees in its peer-group."⁹⁴ The adviser did not provide information on the guarantee's cost or value, or whether a

⁸⁹ *Id.*

⁹⁰ *Id.*

⁹¹ *See* N. Y. Life Inv. Mgmt. LLC, *supra* note 3.

⁹² *Id.* at 1.

⁹³ *Id.* at 7.

⁹⁴ *Id.* at 5.

reserve for the guarantee had been established.⁹⁵ In fact, the adviser disclosed to shareholders that the guarantee was provided at “no charge.”⁹⁶ In 2000, the fund’s management fees were the highest in its peer group and its profit margin was at 91%, yet in 2003 an independent consultant concluded that high expenses were the main reason the fund ranked worst among its index fund peers for the one-, three-, and five-year periods.⁹⁷ An independent consultant concluded that the advisory fee was more than twice the average for its peer group.⁹⁸ Moreover, the independent consultant determined that the guarantee was of somewhat “limited value.”⁹⁹ During the 15(c) process, the adviser included the guarantee reserve as an expense to calculate profit margin, but did not report all assumptions used to calculate the guarantee reserve.¹⁰⁰

According to the SEC, the 15(c) process requires that the adviser explain “why [it] believed the reserve should be included in the analysis of the profitability.”¹⁰¹ In addition, the reserve amount increased, and the inclusion of the increase changed the profit margin calculation from positive to negative. The adviser did not explain, however, why it believed the full increase should be included as an expense in the calculation.¹⁰²

In sum, in light of all the facts, simply showing the increase in a reserve amount as a line item on the profitability analysis is not sufficient. While the SEC did not allege a violation of Section 36(b), it appears that the facts described in the SEC order could have provided a basis to allege that excessive fees were charged in violation of Section 36(b). If so alleged, it would have been the first excessive fee case brought by the SEC since *American Birthright*¹⁰³ almost thirty years ago.

⁹⁵ *See id.* at 7-8.

⁹⁶ *Id.* at 6.

⁹⁷ *Id.* at 4-5.

⁹⁸ *Id.* at 5.

⁹⁹ *Id.*

¹⁰⁰ *Id.* at 5-6.

¹⁰¹ *Id.* at 7.

¹⁰² *Id.* at 5.

¹⁰³ *S.E.C. v. American Birthright Trust Mgmt. Co., Inc.*, 1980 WL 25434 (S.E.C. Dec. 30, 1980) (exemplifying an excessive fee case brought by the SEC).

4. *In the Matter of OppenheimerFunds, Inc.*¹⁰⁴

On September 14, 2005, the SEC filed a settled administrative action against OppenheimerFunds, Inc. (“Funds”), a registered investment adviser, and OppenheimerFunds Distributor, Inc., a registered broker-dealer and distributor to the Oppenheimer Funds (“Distributor”).¹⁰⁵ The SEC alleged that the two parties used brokerage commissions on executed trades to reduce the distributor’s revenue-sharing obligations with certain broker-dealers.¹⁰⁶ In so doing, the Distributor used the fund assets, in the form of brokerage commissions, in order to defray its own expenses.¹⁰⁷ Among other things, neither the Funds’ adviser nor the Distributor informed the fund board that fund brokerage commissions were used to reduce the distributor’s revenue sharing obligations.¹⁰⁸

In sum, the adviser allegedly violated Section 15(c) by not disclosing to the fund board the details of how the brokerage commissions were being used to defray the costs of the Distributor.¹⁰⁹ This was another matter in which the fund directors were not informed in the 15(c) process as to how fund brokerage benefited either the adviser or an affiliated broker-dealer.

5. *In the Matter of PA Fund Management LLC*¹¹⁰

The SEC alleged that the investment adviser, sub-adviser and fund distributor failed to disclose to the Multi-Manager Series’s (“MMS Funds”) board of directors that the fund distributor entered into “shelf-space” arrangements with nine broker-dealers.¹¹¹ The funds’ distributor paid for the arrangements, at least in part, by

¹⁰⁴ OppenheimerFunds, Inc., Exchange Act Release No. 52,420, Investment Company Act Release No. 27,065 (ALJ Sept. 14, 2005), *available at* <http://www.sec.gov/litigation/admin/34-52420.pdf>.

¹⁰⁵ *Id.* at 1.

¹⁰⁶ *Id.* at 2.

¹⁰⁷ *Id.*

¹⁰⁸ *Id.*

¹⁰⁹ *Id.* at 6.

¹¹⁰ PA Fund Mgmt. LLC, Exchange Act Release No. 50,384, Investment Company Act Release No. 26598, (ALJ Sept. 15, 2004), *available at* <http://www.sec.gov/litigation/admin/34-50384.pdf>.

¹¹¹ *Id.* at 3.

having the sub-adviser direct fund brokerage to the nine broker-dealers.¹¹² The purpose of the arrangements was to promote the sale of all funds under the purview of the distributor, not just the MMS Funds.¹¹³

The undisclosed conflict of interest was the use of brokerage, a fund asset, to benefit the distributor and defray its expenses.¹¹⁴ More specifically, during the 15(c) process, the MMS Funds' board of directors was not informed by any of the parties that the MMS Funds' brokerage commissions were being used by the distributor to partially pay for shelf space arrangements.¹¹⁵ Additionally, the adviser did not report to the board that the distributor was reducing its payments to the broker-dealers for the shelf space arrangements by obtaining credit for the MMS Funds' brokerage.¹¹⁶

Thus, the Commission concluded that the investment adviser violated Section 15(c) by failing to disclose to the fund board shelf space arrangements and the fact that the distributor was using the direction of fund brokerage to pay for such arrangements.

6. *S.E.C. v. American Birthright Trust Management Co.*¹¹⁷

On December 30, 1980, the SEC filed a settled civil injunctive action in the federal district court of the District of Columbia against an investment adviser, American Birthright Trust Management Company, Inc. ("ABTM"), numerous officers of the adviser and directors of two mutual funds.¹¹⁸ The Commission alleged, in short, that compensation provided to ABTM was excessive in light of those services rendered to the funds.¹¹⁹ Indeed, most of these compensated advisory services were provided by a third-party "sub-adviser," which had been retained by ABTM.¹²⁰ Thus, while the aggregate fees disbursed to ABTM, exceeded \$2 million, ABTM

¹¹² *Id.*

¹¹³ *Id.*

¹¹⁴ *Id.*

¹¹⁵ *Id.*

¹¹⁶ *Id.*

¹¹⁷ *S.E.C. v. American Birthright Trust Mgmt. Co., Inc.*, 1980 WL 25434 (S.E.C. Dec. 30, 1980).

¹¹⁸ *Id.* at *1.

¹¹⁹ *Id.*

¹²⁰ *Id.*

only paid the “sub-adviser” approximately \$125,000 during the same period.¹²¹

The Commission further alleged that ABTM and two defendants, officers of the adviser, had failed to furnish information to fund directors that was “reasonably necessary to evaluate the advisory contracts.”¹²² Such information, which was neither disclosed nor sought, related to the services performed by ABTM, the advisory services provided by the “sub-adviser,” and the extent to which the “percentage of net assets paid by the funds for advisory fees and total expenses substantially exceeded that paid by most other funds without a justifiable basis therefore.”¹²³

In addition to the Section 15(c) violations mentioned above, the adviser was also permanently enjoined from engaging in acts or practices which would constitute violations of Sections 36(a) and (b), which impose fiduciary obligations on fund advisors.¹²⁴ This matter is one of only two cases brought by the SEC that alleged a violation of Section 36(b). The case does not set forth precisely what information the fund directors should have requested, but does show that directors did not request information to determine the amount of fees retained by ABTM and the amount paid to the sub-adviser.¹²⁵ One of the remedies in the settled action was that ABTM had to hire independent counsel.¹²⁶

7. *S.E.C. v. Fundpack, Inc.*¹²⁷

In March of 1979, the SEC filed a civil injunctive action against three mutual funds, their investment adviser, two broker-dealer subsidiaries of that adviser and three officers and employees of the same, among others.¹²⁸ The defendants were accused of instituting an arrangement called “switching,” intended to substantially

¹²¹ *Id.*

¹²² *Id.*

¹²³ *Id.*

¹²⁴ *Id.* at *2.

¹²⁵ *Id.*

¹²⁶ *Id.*

¹²⁷ *S.E.C. v. Fundpack, Inc.*, 666 F.2d 612 (D.C. 1981).

¹²⁸ *Id.*; *see also* Complaint for Injunction and Other Equitable Relief by Plaintiff, *S.E.C. v. Fundpack, Inc.*, 1979 WL 1195 (D.C. 1979) (No. 79-0859), 1979 WL 417709.

increase the revenues of the adviser but causing the fund to pay higher brokerage and interest costs and incur investment losses.¹²⁹

The so-called “switching program” permitted and encouraged shareholders to transfer their investments among funds by placing a telephone order.¹³⁰ It resulted in frequent fluctuations in the assets of Fundpack, including extremely high portfolio turnover in the funds and a significant increase in fund brokerage expenses, most of which were rebated to the investment adviser.¹³¹ One of the funds was forced to borrow extensively in order to make payments to the other two funds, when shareholders switched out of Fundpack, and to purchase portfolio securities in advance of receiving payment for switches into Fundpack.¹³²

The total operating costs and investment losses resulting from the switching program have occasionally been as high as 12% of Fundpack’s average net assets on an annualized basis.¹³³ The complaint also alleged, among other things, that the defendants engaged in other self-dealing practices that harmed fund shareholders.¹³⁴ In sum, the SEC alleged that Fundpack’s directors failed to conduct inquiries and failed to receive and consider information reasonably necessary for them to evaluate the switching program and the self-dealing transactions by the investment adviser.¹³⁵

B. SEC Rulemaking and Statements

1. 2004 Disclosure Rule

In 2004, the SEC promulgated a rule to increase disclosure in the 15(c) process. This new rule came on the heels of the market-timing scandals of 2003. Commentators stated that the release emphasized SEC concerns about fund directors’ “perfunctory” participation in the 15(c) process, and that fund fees were “higher than those charged by the same advisers to pension plans and other

¹²⁹ *Id.* at *9-10.

¹³⁰ *Id.* at *11.

¹³¹ *Id.* at *12.

¹³² *Id.* at *14-15.

¹³³ *Id.* at *12,

¹³⁴ *Id.* at *14.

¹³⁵ *Id.* at *10.

institutional clients.”¹³⁶ On their view, the SEC intended the disclosure requirements to “encourage” directors to provide “more independent oversight of advisory contracts” during the 15(c) process.¹³⁷

An SEC release announcing the proposal of the rule pointed out that it would require funds to provide a discussion of the factors that directors considered in evaluating the advisory contract.¹³⁸ The adopting release mandated that the following factors be discussed in the fund’s shareholder report:

- (1) [T]he nature, extent, and quality of the services to be provided by the investment adviser;
- (2) the investment performance of the fund and the investment adviser;
- (3) the costs of the services to be provided and profits to be realized by the investment adviser and its affiliates from the relationship with the fund;
- (4) the extent to which economies of scale would be realized as the fund grows; and
- (5) whether fee levels reflect these economies of scale for the benefit of fund investors.¹³⁹

These substantive disclosure requirements, while differing slightly from those articulated in *Gartenberg*, nonetheless capture *Gartenberg*’s essence and codify the factors into the 15(c) process. Regardless of an adviser’s potential liabilities under Section 36(b) for failure to adequately address those factors, the disclosure

¹³⁶ *Proposed SEC Rule: Disclosure Regarding Approval of Advisory Contracts by Directors of Investment Companies*, PAUL WEISS LLP, 3 (Feb. 19, 2004), <http://www.paulweiss.com/files/Publication/8116d2a4-3a5d-4370-8b95-25bdd320ff88/Presentation/PublicationAttachment/fe14ba8a-6cbe-4ce7-af2e-b58298c8fb9e/DiscAdvConAp.pdf> (citing to Freeman, *supra* note 3, and *Perils in the Savings Pool*, *supra* note 3).

¹³⁷ *Id.*

¹³⁸ Press Release, U.S. Securities and Exchange Commission, SEC Adopts Enhanced Mutual Fund Expense and Portfolio Disclosure; Proposes Improved Disclosure of Board Approval of Investment Advisory Contracts and Prohibition on the Use of Brokerage Commissions to Finance Distribution (Feb. 11, 2004), <http://www.sec.gov/news/press/2004-16.htm>; see also 2004 Disclosure Rule, *supra* note 1.

¹³⁹ See Press Release, U.S. Securities and Exchange Commission, *supra* note 138; see also 2004 Disclosure Rule, *supra* note 1, at § 240.14A-101, Item 22(c)(11)(i).

requirement appears to create a cause of action for both the SEC and private shareholders.¹⁴⁰ Effectively, however, the disclosure rule contains two obligations for the fund and its board: first, the fund and the board must affirmatively comply with the 15(c) process;¹⁴¹ and second, they must disclose their analysis of the “*Gartenberg* factors.”

The obligations stemming from the 2004 disclosure rule create at least two potential liabilities for violating its mandates. First, the SEC has often used Section 34(b) against investment advisers causing material misstatements in fund filings, especially registration statements and shareholder reports.¹⁴² If the SEC discovers material inaccuracies in the Section 15(c) disclosure, the SEC may charge a violation of Section 34(b).¹⁴³ Second, as discussed in Part III.C. below, if a private plaintiff can prove a material misstatement with scienter and comply with the litany of requirements of the Private Securities Litigation Reform Act of 1995 (“PSLRA”), then the plaintiff can file suit under Section 10(b) and Rule 10b-5 of the Exchange Act.¹⁴⁴

2. “Best Practices”

In November of 2003, then-Chairman of the SEC, William H. Donaldson,¹⁴⁵ asked the Mutual Fund Directors Forum (“MFDF”)

¹⁴⁰ See discussion *supra* Part III.B.1 and *infra* Part III.B.2.

¹⁴¹ At the same time, it will require each fund to address each of the enumerated factors, either substantively or by explaining why the factor is not relevant. *2004 Disclosure Rule*, *supra* note 1.

¹⁴² 15 U.S.C. § 80a-33(b) (2011) (prohibiting any person from making “any untrue statement of a material fact in any registration statement, application, report, account, record, or other document filed or transmitted . . .”).

¹⁴³ James G. Cavoli et al., *The SEC’s Mutual Fund Fee Initiative: What to Expect*, 16 WESTLAW J. SEC. REG. & LITIG. 1, 8 (2010), available at http://www.milbank.com/NR/rdonlyres/DD1AFBAB-D52A-4494-B1C3-38D5022D810D/0/111610_Westlaw_SCL1614_Commentary_Cavoli.pdf (citing 15 U.S.C. § 80a-33(b) (2011)).

¹⁴⁴ See Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737 (codified as amended in scattered sections of 15 U.S.C.).

¹⁴⁵ Letter from William H. Donaldson, Chairman, SEC, to David S. Ruder, Chairman, MFDF, in MUTUAL FUND DIRECTORS FORUM, *supra* note 40, at 40 (Nov. 17, 2003) (urging the MFDF to provide practical guidance to mutual fund directors regarding the 2004 SEC initiatives). Donaldson suggested that rules uniformly applicable to the entire industry are more desirable than fees set through enforcement actions. See William H.

to provide guidance to fund directors. The request came in the wake of uncovering late trading and market timing abuses. The Chairman first requested guidance on “board review of management contracts and management fees.”¹⁴⁶ The MFDF issued a report in July of 2004, just after the 2004 disclosure rule was promulgated, with thirty-two so-called “best practices,” including seven concerning the 15(c) process:

[1.] A fund’s board should designate a committee, consisting of some or all of the fund’s independent directors, to oversee the contract review process and the committee should have a written charter[;]

[2.] Independent directors and the contract review committee should consult with independent legal counsel as needed[;]

[3.] Independent directors and the contract review committee should consider retaining unaffiliated third party consultants[;]

[4.] The contract review committee should establish a structured process for the consideration of the advisory agreement[;]

[5.] A fund’s board should require the investment adviser to commit by contract to provide the independent directors with all relevant information and the contract review committee should prepare a

Donaldson, Chairman, SEC, Speech at the Mutual Fund Directors Forum: America’s Need for Vigilant Mutual Fund Directors (Jan. 7, 2004), *available at* <http://www.sec.gov/news/speech/spch010704whd.htm> (emphasizing the importance of fund directors’ addressing portfolio securities’ valuation, fund fees and fund performance and stating that fund directors are expected to address performance issues by asking advisers the following “tough questions”: “[A]re our funds too large to achieve optimum performance? Should we close our funds to new investors? What steps do we need to take to improve performance? Does management have the right team and expertise in place to manage the fund?”); *Testimony Concerning Regulatory Reforms*, *supra* note 1 (testifying to address problems in the mutual fund and brokerage industries).

¹⁴⁶ MFDF, *supra* note 40, at 1.

formal written 15(c) request to obtain that information[;]

[6.] Independent directors should ask counsel for a memorandum describing their legal obligations in reviewing an investment advisory agreement[; and,]

[7.] The contract review committee, and preferably all independent directors, should meet in person at least once, with no representatives of the adviser, including adviser affiliated directors, in attendance, to review the Section 15(c) report and to formulate a recommendation for the board regarding adoption or continuation of the advisory contract.¹⁴⁷

Since the MFDF issued the “best practices” recommendations, it also released a guide for fund directors on the 15(c) process.¹⁴⁸ This guide discusses several categories of circumstances that merit special attention by fund directors:¹⁴⁹ fund performance, selection of benchmarks and peer groups for appropriate comparisons and reviewing sub-advisers.¹⁵⁰

3. Recent SEC Statements Regarding 15(c) Process

In the fall of 2010, a statement by the SEC’s Director of Enforcement, Robert Khuzami, caught the attention of the mutual fund industry.¹⁵¹ Mr. Khuzami announced the creation of an asset management group to focus on investment adviser issues and informed Congress that the enforcement division would be

¹⁴⁷ *Id.* at 28-30.

¹⁴⁸ See MUT. FUND DIR. FORUM, MUTUAL FUND DIRECTORS HANDBOOK, at 10 (2010), available at http://www.stradley.com/library/files/mutual_fund_directors_handbook_2010.pdf. [Hereinafter “MFDF Handbook”].

¹⁴⁹ *Id.* at 4-8 (responding to six common questions).

¹⁵⁰ *Id.* at 5-8.

¹⁵¹ *Testimony Concerning Investigating and Prosecuting Fraud after the Fraud Enforcement and Recovery Act, Before the S. Comm. on the Judiciary*, 110th Cong. (2010) (statement of Robert Khuzami, Dir., Div. of Enforcement, SEC), available at <http://www.sec.gov/news/testimony/2010/ts092210rk.htm>.

conducting a “mutual fund fee initiative” and would be developing “analytics” for the purpose of inquiring into whether mutual fund advisers were charging “excessive fees.”¹⁵² These statements further heightened concerns over the integrity of the 15(c) process.

To the consternation of some, Mr. Khuzami did not provide any details behind the analytics that would be implemented by the enforcement division.¹⁵³ Nonetheless, he warned the industry to expect “examinations and investigations of investment advisers and their boards of directors concerning duties under the Investment Company Act” of 1940.¹⁵⁴

One mutual fund defense firm has since complained about the statements, arguing that the initiative “depart[s] from the SEC’s historical, relatively hands-off approach” to the determination of fund fees.¹⁵⁵ The firm also characterized the initiative as a “stark departure from [the SEC’s] past inactivity.”¹⁵⁶ And the firm correctly noted that the initiative raises questions about the future for investment advisers and fund directors in terms of possible SEC actions in the area of the 15(c) process.¹⁵⁷

Since Mr. Khuzami’s September 2010 statements, Co-Chiefs of the Division of Enforcement’s Asset Management Unit, Bruce Karpati and Robert B. Kaplan, have addressed the statement. Messrs.

¹⁵² *Id.*

¹⁵³ Beagan Wilcox Volz, *The SEC’s Plan Sets Lawyers Abuzz*, FIN. TIMES, Oct. 3, 2010, <http://cachef.ft.com/cms/s/0/c70d4e46-cd88-11df-9c82-00144feab49a.html#axzz1crBCpCnc>.

¹⁵⁴ Khuzami Testimony, *supra* note 152.

¹⁵⁵ Cavoli, *supra* note 143, at 1; Stephen J. Crimmins, *New SEC Enforcement Unit Focuses on Funds and Advisers*, K&L GATES (Dec. 9, 2010), <http://www.klgates.com/new-sec-enforcement-unit-focuses-on-funds-and-advisers-12-09-2010/> (stating the SEC’s “largely hands-off approach changed dramatically when the SEC’s new Enforcement Director Robert Khuzami announced that his restructuring efforts would include the creation of a new ‘Asset Management Unit’”).

¹⁵⁶ Cavoli, *supra* note 143, at 1.

¹⁵⁷ *Id.* at 8 (“One substantive provision that may be invoked in the context of the SEC’s mutual fund fee initiative is Section 15 of the ICA. This statute requires that there be a written contract between a fund and its investment adviser, approved annually by the fund’s board, and, among other things, imposes a duty on fund directors ‘to request and evaluate’ and on the investment adviser ‘to furnish’ ‘such information as may reasonably be necessary to evaluate the terms of any contract whereby a person undertakes regularly to serve or act as investment adviser of’ the fund.”).

Karpati and Kaplan explained that the initiative will focus on determining potential “candidates” for scrutiny by the enforcement division.¹⁵⁸

While some may interpret Mr. Khuzami’s statement as suggesting that the SEC could soon bring the first Section 36(b) case in thirty years, it has also been acknowledged that the SEC has other statutory tools in its enforcement chest, including Section 15(c).¹⁵⁹ Specifically citing the 15(c) process and the 2004 disclosure rule, the same firm warned:

The SEC may seek to evaluate the process the board followed in approving fees and/or agreements. For example, the agency may study fund proxy statements and shareholder reports, which, pursuant to SEC rules, must contain a discussion of the factors considered by a fund’s board in approving an investment advisory contract, including a discussion of the *Gartenberg* factors.¹⁶⁰

More recently, further comments from the industry, and at least one prominent law firm, indicate that the “initiative” affects fund directors and more specifically the 15(c) process.¹⁶¹ A recent publication warned directors that the SEC is “looking at [their] process” to scrutinize fund fees and other issues.¹⁶² One prominent law partner predicted that the new asset management group will be

¹⁵⁸ Stephen Crimmins, *supra* note 155 (citing Robert Kaplan and Bruce Karpati’s comments, reported in *Ignites*, Oct. 21, 2010); Cavoli, *supra* note 143, at 4 (citing Beagan Wilcox, *SEC Sheds New Light on Fund Fee Initiative*, *IGNITES*, Oct. 21, 2010, at 2).

¹⁵⁹ Cavoli, *supra* note 143, at 7 (highlighting that while the stated initiative centers on “excessive” fees, it may result in investigations and enforcement actions that do not involve Section 36(b) at all or involve the provision together with some other provision of the ICA or other relevant statute).

¹⁶⁰ *Id.* at 6.

¹⁶¹ *Brave New World: SEC Enforcement Initiative Leading to Added Board Scrutiny*, *FUND DIRECTIONS* (Inst. Investor Inc., New York, N.Y.), Jan. 2011, at 1, available at <http://www.funddirections.com/pdf/FD011011.pdf>. (“The Securities and Exchange Commission’s Division of Enforcement’s mutual fund fee initiative will result in increased scrutiny by mutual fund boards and will ultimately affect 15(c) reviews, according to Beth Kramer, partner at K&L Gates.”).

¹⁶² *Id.* at 8.

“asking sophisticated questioned [sic] as to . . . what the directors did with [the information], how they evaluated the information they received, what questions directors asked and then the articulated basis for the decisions they made.”¹⁶³ According to this partner, “it’s a new world for [fund] directors” under the current enforcement regime.¹⁶⁴

C. Private Actions

If the *Jones* decision eviscerated a private right of action under Section 36(b) for a deficient process, then few avenues remain for fund shareholders to enforce 15(c) process obligations. Unlike Section 36(b), Sections 15(c) and 36(a) do not provide explicitly for a private right of action. While implicit private rights of action thrived around the 1970 amendments, the initiation of such actions have come to a screeching halt since 2000.¹⁶⁵

¹⁶³ *Id.*

¹⁶⁴ *Id.*

¹⁶⁵ *Northstar Fin. Advisors, Inc. v. Schwab Inv.*, 615 F.3d 1106, 1114 (9th Cir. 2010) (summarizing the current state of the law on implicit private actions under the 1940 Act); see Arthur S. Gabinet & George M. Gowen III, *The Past and Future of Implied Causes of Action Under The Investment Company Act of 1940*, 3 VILL. J. L. & INV. MGMT. 45 (2002) (“[U]ntil recent years; the recognition of implied private rights of action even survived Congress’ addition of an express right of action under Section 36(b) of the Act in 1970. Recent years have witnessed a slightly more energetic debate over the issue, however, guided by a trend in the United States Supreme Court against judicial liberalist tendencies, including the inference and expansion of private rights under federal statutes.”); see also *Tannenbaum v. Zeller*, 552 F.2d 402, 417 (2d Cir. 1977) (“The remedial 1970 amendment of the section added a subsection (b) which explicitly granted a private right of action to recover unreasonable compensation paid by a fund to its investment adviser. Congress did not intend this modification to abrogate the private action already recognized under the Act for other types of breach of fiduciary duty.”); *Galfand v. Chestnut Corp.*, 545 F.2d 807, 811 (2d Cir. 1976) (“Congress, in imposing a fiduciary obligation on investment advisers, plainly intended that their conduct be governed by the traditional rule of undivided loyalty implicit in the fiduciary bond. It is axiomatic, therefore, that a self-dealing fiduciary owes a duty of full disclosure to the beneficiary of his trust.”); *SEC v. Treadway*, 430 F.Supp.2d 293, 341 (S.D.N.Y. 2006) (“As discussed in *PIMCO I*, the SEC need not allege fraud or self-dealing to prevail on this claim; instead, it must

Without a private right of action to enforce the 15(c) process obligations, fund shareholders have two other means to effectively enforce the 15(c) responsibilities of fund directors: Section 47(b) of the 1940 Act and Section 10(b) and Rule 10b-5 of the Exchange Act.¹⁶⁶

Section 47(b) provides, *inter alia*, “that a contract that is made, or whose performance involves, a violation” of the 1940 Act, or any rule or regulation thereunder, is unenforceable unless a court determines that enforcement would be more equitable than nonenforcement and such enforcement would not be inconsistent with the 1940 Act.¹⁶⁷ In 2001, the SEC authored an *amicus curiae* brief arguing to the Second Circuit that Section 47(b) provides a right of action for private plaintiffs for rescission and restitution when “a contract . . . is made, or whose performance involves, a violation of [the 1940 Act].”¹⁶⁸ While court decisions have been generally inconsistent, recently, judges circumscribe their interpretations of the section and consider whether it provides for private enforcement by fund shareholders.¹⁶⁹ In fact, a recent federal district court decision provided some positive guidance as to when the section could be enforced by fund shareholders even though the court dismissed the particular action:

Courts have determined that § 47(b) of the ICA contemplates a private right of action. *Lessler v. Little*, 857 F.2d 866, 874 (1st Cir. 1988); *Mothers Fund, Inc. v. Colwell Co.*, 564 F.2d 780, 783 (7th Cir. 1977); *Hamilton v. Allen*, 396 F.Supp.2d 545, 558-60 (E.D.Pa. 2005); *In re Mut. Funds Inv. Litig.*, 384 F.Supp.2d 873, 880-81 (D.Md.2005). Section 47(b) provides that any contract whose terms or

demonstrate an accepted breach of fiduciary duty via affirmative acts or “in appropriate cases, nonfeasance of duty or abdication of responsibility.”)

¹⁶⁶ Section 47(b) is codified at 15 U.S.C. §80a-46 (2010). Section 10(b) is codified at 15 U.S.C. §78j (2010). Rule 10b-5 is in the Private Securities Litigation Act of 1995, Pub. L. No. 104-67, 109 Stat. 737 (codified at 17 C.F.R. 240, 10b-5).

¹⁶⁷ 15 U.S.C. § 80a-46 (2010).

¹⁶⁸ Brief of the Sec. and Exch. Comm’n. at 13, *Olmsted v. Pruco Life Ins. Co. of N.J.*, 283 F.3d 429 (2d Cir. 2002).

¹⁶⁹ *Galfand v. Chestnutt*, 402 F. Supp. at 1318, 1326 (S.D.N.Y. 1976) (questioning whether 36(b) precludes utilizing 47(b) for 15(c) violations).

performance would involve violating any provision of the ICA is unenforceable. 15 U.S.C. § 80a-46 (b)(1). It gives “any party” to the contract the right to seek rescission. *Id.* (b)(2). Plaintiffs argue that the underlying contract is the underwriting agreement between the Funds and Morgan Keegan. (Pls.’ Resp. at 139.) Plaintiffs are not parties to the underwriting agreement and, therefore, may not assert a direct remedy under § 47(b). *Lessler*, 857 F.2d at 874; *Hamilton*, 396 F.Supp.2d at 558. A plaintiff may bring a § 47(b) claim derivatively on behalf of the Funds, but this suit is a direct suit against the defendants, not a derivative action. *Lessler*, 857 F.2d at 874; *Hamilton*, 396 F.Supp.2d at 558. Plaintiffs’ claim under § 47(b) of the ICA is prohibited and is DISMISSED.¹⁷⁰

Thus, the court left open the question of whether parties may use Section 47 to void the advisory contract if either the adviser or fund directors violate the 15(c) process, even if the advisory fee is reasonable and not violative of Section 36(b).¹⁷¹

¹⁷⁰ *In re Regions Morgan Keegan Sec., Derivative*, 743 F. Supp. 2d 744, 762 (W.D. Tenn. 2010); see generally *Marshel v. AFW Fabric Corp.*, 552 F.2d 471 (2d Cir. 1977) (remanding a case where the issue is “whether or not a ‘going-private’ transaction gives rise to a federal cause of action.”).

¹⁷¹ See H. Norman Knickle, *The Investment Company Act of 1940: SEC Enforcement and Private Actions*, 23 ANN. REV. BANKING & FIN. L. 777, 846 (2004) (“At nearly the same time that the Seventh Circuit decided *Mothers*, the Second Circuit addressed a plaintiffs suit in *Galfand v. Chestnut Corp.* alleging that section 47 should apply to rescind an amendment to an advisory contract that violated provisions of the 1940 Act. Unlike *Mothers*, however, the Second Circuit in *Galfand* concluded that section 47’s rescission provision was an appropriate remedy.”); *Smith v. Franklin/Templeton*, Fed. Sec. L. Rep. (CCH) P95, 775, 2010 U.S. Dist. LEXIS 56516 (N.D. Cal. June 8, 2010) (concluding section 47(b) provides a remedy for a violation of “any provision of [the ICA] or of any rule, regulation, or order thereunder”); *Davis v. Bailey*, Fed. Sec. L. Rep. (CCH) P93, 682, 2005 U.S. Dist. LEXIS 38204 (D. Colo. Dec. 22, 2005) (finding “the equitable remedy [of] section 47(b)(1) is only available upon showing of other violations of the ICA”); *Mutch v. Harris*, 373 F. Supp. 2d 1021, 1027 (C.D. Cal. 2005) (holding “plaintiff can seek relief under Section 47[(b)] only by showing a violation of some other section of the

Rule 10b-5 of the Exchange Act provides a much clearer path for fund shareholders to address 15(c) process deficiencies. Private plaintiffs may allege a fraudulent material misstatement of omission based on the affirmative obligations of the 2004 disclosure rule and the duty of fund directors to monitor the 15(c) process.¹⁷² In sum, failure to follow the 15(c) process may give rise to liability to the benefit of a private shareholder.¹⁷³

VI. *Special Issues for Directors—Red Flags and Principles in the 15(c) Process*

A. *Fiduciary Duties of Directors in the Context of the Advisory Contract Approval Process*

1. *State Law and the Business Judgment Rule*

Directors' general state and common law obligations impose the fiduciary duties of care and loyalty. Some courts have described the fiduciary duties of directors as a "triad" of duties, incorporating also the duty to act in good faith.¹⁷⁴ The American Law Institute has articulated a director's fiduciary duty of care as follows:

[ICA]" (citing *Tarlov v. Paine Webber Cashfund, Inc.*, 559 F.Supp. 429, 438 (D.Conn. 1983).

¹⁷² Haas & Howard, *supra* note 3, at 165-67 ("Nevertheless, the SEC has adeptly sidestepped these private litigant equitable requirements by arguing successfully that in many instances an injunction against violations of the federal securities laws cannot by itself ensure compliance." Subsequently, discussing the SEC will seek receivership when there is fraud under 10b-5); *see generally* Cavoli, *supra* note 143, at 10 ("Fund advisers and boards should continue to take the annual 15(c) process very seriously and do everything reasonably possible to ensure that it can stand up to scrutiny, by both the SEC and private litigants. Pursuing that course will serve the interests of not only fund shareholders, but also fund advisers and boards by making investigations and lawsuits less likely.").

¹⁷³ The liability for private plaintiffs, unlike the SEC, would need to be based on a material misstatement or omissions. In other words, the plaintiff would need to prove that the fund's disclosure materially misrepresented the fund board's 15(c) process, with scienter.

¹⁷⁴ Corinne Ball et al., *Advising the Board of Directors*, in *MERGERS & ACQUISITIONS 2008: TRENDS AND DEVELOPMENTS* 689, 701 (Practising Law Inst. ed., 2007) (describing "the duty to act in good faith . . . as 'part of a

A director . . . has a duty to the corporation to perform the director's . . . functions in good faith, in a manner that he or she reasonably believes to be in the best interests of the corporation, and with the care that an ordinarily prudent person would reasonably be expected to exercise in a like position and under similar circumstances.¹⁷⁵

Per ALI's "business judgment rule," when directors make business judgments, directors must be "informed with respect to the subject of the business judgment to the extent the director . . . reasonably believes to be appropriate under the circumstances," must not be interested in the subject matter and must rationally believe the decision advances the best interests of the corporation.¹⁷⁶¹⁷⁷

The business judgment rule is a state common law concept intended to articulate the standard of care owed by corporate directors when making business decisions. It also protects directors from personal liability for business decisions made on an informed basis and in good faith. That is, to be afforded the protection of the rule, directors must show that they complied with their fiduciary duties to inform themselves, demonstrate loyalty and act in good faith. In the mutual fund context, inside directors should not receive the protection of the business judgment rule.¹⁷⁸ In addition, the rule provides no protection for inattention.¹⁷⁹ Some states, such as

triad of fiduciary duties that includes the duties of care and loyalty.""); *see* *Stone v. Ritter*, 911 A.2d 362, 370 (Del. 2006) (citing *Guttman v. Huang*, 823 A.2d 492, 506 (Del. Ch. 2003) and *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 361 (Del. 1993)).

¹⁷⁵ PRINCIPLES OF CORP. GOVERNANCE: DUTY OF CARE OF DIR.; THE BUS. JUDGMENT RULE § 4.01(1992).

¹⁷⁶ *Id.* at § 4.01(c).

¹⁷⁷ *Id.*

¹⁷⁸ Likewise, no fund directors are protected if their actions violate their duty of loyalty. The Maryland business rule, for example, is only relevant to a director's duty of care, not his duty of loyalty. It provides help for neither directors nor non-directors whose dual affiliations present issues of loyalty. Byron G. Borgardt, Securities Act Release No. 167, 17 (ALJ June 1, 2000) (initial decision) (citing *Independent Distrib., Inc. v. Katz*, 637 A.2d 886, 895 (Md. 1994)).

¹⁷⁹ PRINCIPLES OF CORP. GOVERNANCE: DUTY OF CARE OF DIR.; THE BUS. JUDGMENT RULE § 4.01.

Maryland,¹⁸⁰ have codified their business judgment rule.¹⁸¹ A Commission release articulates the rule with language similar to ALI and Maryland.¹⁸²

How the rule applies to the 15(c) process remains unclear.¹⁸³ At least one decision indicated that the rule should also protect advisers in the context of their fiduciary duty under Section 36(b).¹⁸⁴ However, courts have criticized that decision.¹⁸⁵

Section 15(c) itself seems to codify a component of the business judgment rule by requiring directors to request and evaluate information reasonably necessary to evaluate an advisory contract. But Section 15(c) does not include the other elements of the rule: acting in good faith and rationally believing that they are acting in the best interests of the fund. In addition, the Supreme Court in *Jones* separates the Section 36(b) requirement that the adviser not charge an excessive fee from analysis of the issues surrounding the 15(c) process.¹⁸⁶ The Court also clarified that where the 15(c) process is

¹⁸⁰ Maryland, Delaware, and Massachusetts are the most important states for purposes of 1940 Act funds. See TAMAR FRANKEL & CLIFFORD E. KIRSCH, INVESTMENT MANAGEMENT REGULATION 281 (Fathom Publ'g Co. 3d ed. 2005).

¹⁸¹ The standard of care required of directors is as follows: “(a) A director shall perform his duties as a director . . . : (1) In good faith; (2) In a manner he reasonably believes to be in the best interests of the corporation; and (3) With the care that an ordinarily prudent person in a like position would use under similar circumstances.” MD. CODE ANN. CORPS. & ASS’NS §2-405.1 (West 2010).

¹⁸² SEC Interpretation: Matters Concerning Independent Directors of Investment Companies, Investment Co. Act Release No. IC-24083, STATEMENT OF STAFF POSITION ON 17 C.F.R. § 271 at n. 13 (Oct. 14, 1999), <http://www.sec.gov/rules/interp/ic-24083.htm> (“The business judgment rule generally protects fund directors from liability for their decisions so long as the directors acted in good faith, were reasonably informed, and rationally believed that the action taken was in the best interests of the fund.”).

¹⁸³ The Fund Director’s Guidebook states that courts have generally applied a type of business judgment rule to the fee approval process. TASK FORCE ON FUND DIR. GUIDEBOOK, FED. REGULATION OF SEC. COMM., FUND DIRECTOR’S GUIDEBOOK 99-100 (Am. Bar Ass’n, 3d ed. 2006).

¹⁸⁴ See *Reserve Mgmt. Corp. v. Anchor Daily Income Fund, Inc.*, 459 F. Supp. 597, 611 (S.D.N.Y. 1978).

¹⁸⁵ See *S.E.C. v. Treadway*, 430 F. Supp. 2d 293, 342-43 (S.D.N.Y. 2006).

¹⁸⁶ *Jones v. Harris Assocs.*, 130 S. Ct. 1418, 1430 (2010) (“[W]here the board’s process was deficient or the adviser withheld important information, the court must take a more rigorous look at the outcome.”).

“robust,” courts should “afford commensurate deference to the outcome of the bargaining process.”¹⁸⁷ Thus, if such robust review was undertaken by a fund board, “[it’s] decision to approve a particular fee agreement is entitled to considerable weight.”¹⁸⁸

However, the Court seemed to make clear that regardless of the robustness of the process, a fee may still be excessive and violative of Section 36(b) if the fee “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.”¹⁸⁹ Thus, the Court contemplated a situation in which directors fulfill their obligations under Sections 15(c) and 36(a), while advisers still violate Section 36(b) by charging an excessive fee.¹⁹⁰

It appears that after *Jones*, the decision making of fund directors in the 15(c) process will receive the protections of the business judgment rule for non-fee decisions. But decisions relating to the advisory fee will be afforded merely a “business judgment lite.”¹⁹¹ That is, if the elements of the traditional business judgment rule in the 15(c) context are met, it will be difficult, but not impossible, to prove that a fund adviser breached its duty to shareholders by charging an excessive fee.¹⁹²

¹⁸⁷ *Id.* at 1429.

¹⁸⁸ *Id.*

¹⁸⁹ *Id.* at 1429-30 (quoting *Gartenberg v. Merrill Lynch Asset Mgmt., Inc.*, 694 F.2d 923, 928 (2d Cir. 1982)).

¹⁹⁰ *Gartenberg*, 694 F.2d at 930 (“[E]ven if the trustees of a fund endeavored to act in a responsible fashion, an adviser-manager’s fee could be so disproportionately large as to amount to a breach of fiduciary duty in violation of § 36(b).”).

¹⁹¹ See S. REP. NO. 91-184, at 6 (1970), *reprinted in* 1970 U.S.C.C.A.N. 4897, 4902-03 (stating that Section 36(b) is “not intended to authorize a court to substitute its business judgment for that of the mutual fund’s board of directors[,]” nor is it meant “to shift the responsibility for managing an investment company . . . from the directors of such company to the judiciary.”). Directors of the fund have an important role in the management fee area and their approval of fees should by no means be ignored. Nonetheless, in light of the director’s duties under Section 15(c) and the adviser’s duties under Section 36(b), a pure application of the business judgment rule to 15(c) process is problematic.

¹⁹² For purposes of Section 36(b), directors are also held to the same fiduciary standards as advisers. 15 U.S.C. § 80a-35 (2006) (stating that the Securities and Exchange Commission may bring an action under subsection (b) against, *inter alia*, an adviser or director). Thus, this “business judgment lite” should apply to both directors and advisers. However, directors’

2. Federal Securities Laws

The federal securities laws effectively incorporate the triad of state fiduciary duties through certain provisions of the 1940 Act. The following sections have had a particularly strong influence on imposing fiduciary duties on fund directors: (1) Section 36(b), through *Gartenberg* and its progeny, requiring directors to perform a robust review of, among other things, the nature and quality of the services provided by the adviser; (2) Section 36(a), through its creation of a general fiduciary duty to, among other things, monitor the services provided by the adviser and conflicts of interest;¹⁹³ and (3) Section 15(c), through its requirement that directors properly inform themselves, properly be informed by advisers, and properly evaluate the terms of the advisory contract.¹⁹⁴

liability is remote since they hardly ever receive any of the objectionable fees subject to a Section 36(b) suit.

¹⁹³ SEC. EXCH. COMM'N, RELEASE NO. IC-24083, STATEMENT OF STAFF POSITION ON 17 C.F.R. § 271, n. 55 (Oct. 14, 1999), *available at* <http://www.sec.gov/rules/interp/ic-24083.htm> (“The [1940] Act places substantial responsibilities on the independent directors of investment companies to protect the interests of fund shareholders by policing potential conflicts of interest.”).

¹⁹⁴ 15 U.S.C. § 80a-35(a) (2006) (incorporating fiduciary duties into the ICA through Section 36(a), which allows actions against persons who have engaged in, or who are about to engage in “any act or practice constituting a breach of fiduciary duty involving personal misconduct in respect of any registered investment company . . .”); *see also* *Strougo v. BEA Assocs.*, 188 F. Supp 2d 373, 378-79 (S.D.N.Y. 2002) (discussing duties of directors under § 15(c)); *MFDF Handbook*, *supra* note 149, at ch.2 (providing a “practical guide to the 15(c) process,” including the standards governing a director’s duties); Sarah E. Cogan, Philip L. Kirstein, and Audrey C. Talley, *The Fund Board of Directors and the Fund’s Relationship with the Adviser*, in *ABCs OF MUTUAL FUNDS 2009*, at 38-40 (ALI Corp. Law & Practice, Course Handbook Ser. No. B-1744, 2009) (discussing statutory duties of directors during the advisory contract approval process); William K. Sjostrom, Jr., *Tapping the Reservoir: Mutual Fund Litigation Under Section 36(a) of the Investment Company Act of 1940*, 54 U. KAN. L. REV. 251, 262-71 (2005) (reviewing officers’, directors’, and investment advisers’ duties under Section 36(a)); Alan R. Palmiter, *The Mutual Fund Board: A Failed Experiment in Regulatory Outsourcing*, 1 BROOK. J. CORP. FIN. & COM. L. 165, 171-76 (2006) (detailing the “supervisory functions” of the mutual fund board); William J. Nutt, *A Study of Mutual Fund Independent*

Additionally, courts, commentators, and the SEC have highlighted the unique governance role of fund directors relative to their corporate cousins. Unlike corporate directors, fund directors must act as “watchdogs” for shareholders through constant oversight of the adviser.¹⁹⁵ The 1940 Act has been described as effectively establishing a system of “checks and balances” through its reliance on independent directors to provide oversight of the investment advisers that manage the funds.¹⁹⁶

One court succinctly stated the federal fiduciary responsibilities of directors exist in the 15(c) context: “[b]y giving the

Directors, 120 U. Pa. L. Rev. 179, 230-50 (1971) (summarizing the responsibilities of the mutual fund board in the context of the approval of the adviser fee).

¹⁹⁵ *Burks v. Lasker*, 441 U.S. 471, 484 (1979) (quoting *Tannenbaum v. Zeller*, 552 F.2d 402, 406 (2d Cir. 1977)).

¹⁹⁶ Securities and Exchange Commission, *Final Rule: Role of Independent Directors of Investment Companies*, in THE INVESTMENT MANAGEMENT INSTITUTE, at 203 n.6 (PLI Corp. Law & Practice, Course Handbook Ser. No. B-1250, 2001) (quoting JAMES M. STOREY & THOMAS M. CLYDE, THE UNEASY CHAPERONE 34 (2000); Chairman Harvey Pitt, Sec. & Exch. Comm’n, Remarks at Mutual Fund Directors Forum (Jan. 8, 2003), available at http://www.sec.gov/news/speech/spch010803hlp.htm#P55_7090 (stating that independent directors “must be leaders in setting the highest standards for [their] funds and investment advisers and making sure they meet them”); Hammes, Exchange Act Release No. 8,346A, Investment Company Act Release No. 26,290A, 81 SEC Docket 2,467 (Jan. 7, 2004) (dissent of Commissioner Roel C. Campos), available at <http://www.sec.gov/litigation/admin/33-8346a.htm> (“[I]ndependent directors are the final and ultimate guardians of shareholder assets.”). Campos argued that the Heartland Advisors’ independent directors should have been subject to harsher penalties, including a violation of 36(a) of the 1940 Act and a three year bar from serving as a director or officer. Fund directors are also viewed by the Supreme Court as the “watch dogs” for investors in the fund. *Burks v. Lasker*, 441 U.S. 471, 484 (1979) (quoting *Tannenbaum v. Zeller*, 552 F.2d 402, 406 (2d Cir. 1977)) (observing that the 1940 Act “was designed to place the unaffiliated directors in the role of ‘independent watchdogs’”); Stuart E. Fross, *US Investment Company Corporate Governance Outline*, WILMER CUTLER PICKERING HALE AND DORR, LLP, 3 http://www.wilmerhale.com/files/Publication/ba4dccd7-c869-4abe-91f0-53264bfeb519/Presentation/PublicationAttachment/7a85a131-258a-46c4-b50b-549d9483bd85/Fross_corporategovernanceoutline.pdf (last visited May 7, 2011) (“In short, fund directors are viewed by the Supreme Court as the “watch dogs” for investors in the fund.”).

directors the right to extend and terminate the [investment advisory] contract, the Act necessarily also imposes upon the directors the fiduciary duty to use these powers intelligently, diligently and solely for the interests of the company and its stockholders.”¹⁹⁷ This suggests that fund directors, as fiduciaries of the fund and independent watchdogs for shareholders pursuant to the 1940 Act, bear the greatest burden to see that the 15(c) process has integrity.¹⁹⁸

Recently, *SEC v. Treadway*¹⁹⁹ discussed the fiduciary duties of directors pursuant to Section 36(a):

[Section 36(a)] . . . imposes liability on officers, directors, members of advisory boards, investment advisers, depositors, or principal underwriters of a registered investment company for “any act or practice constituting breach of fiduciary duty involving personal misconduct” with respect to that investment company As discussed in PIMCO I, the SEC need not allege fraud or self-dealing to prevail on this claim; instead, it must demonstrate an accepted breach of fiduciary duty via affirmative acts or “in

¹⁹⁷ *Brown v. Bullock*, 194 F. Supp. 207, 235 (S.D.N.Y. 1961), *aff’d*, 294 F.2d 415 (2d Cir. 1961). Although it decided *Brown* before Congress enacted Section 15(c), the court scrutinized the advisory contract approval process in its opinion.

¹⁹⁸ In addition to the aforementioned fiduciary duties based primarily on state common law, the 1940 Act codifies numerous obligations of fund directors. Where the directors have a statutory or self-imposed affirmative duty, they have a fiduciary duty to see that there is compliance with that duty. For summaries of the directors’ duties, see generally Cogan, *supra* note 197 (reviewing the director’s duties during the advisory contract approval process and comparing the obligations of fund and corporate directors); Interpretive Matters Concerning Independent Directors of Investment Companies, Investment Company Act Release No. 24,083, 70 SEC Docket 2017 (Oct. 14, 1999) (highlighting staff’s position on director duties); *Transcript of the Conference on the Role of Independent Investment Company Directors*, U.S. SEC. & EXCH. COMM’N (Feb. 23-24, 1999), available at <http://www.sec.gov/divisions/investment/roundtable/iicdrndt1.htm> (providing discussion among directors and others on directors’ duties and other “key issues”); Fross, *supra* note 199, at 17 (describing the sources of directors’ duties).

¹⁹⁹ 430 F. Supp. 2d 293 (S.D.N.Y. 2006).

appropriate cases, nonfeasance of duty or abdication of responsibility.”²⁰⁰

More generally, in proposed guidance the SEC has discussed a fund director’s fiduciary duty to be informed prior to making a decision like the advisory contract approval:

As such, a director’s duty of care incorporates a duty to be informed, requiring that a director be reasonably informed about an issue before making a decision relating to that issue. To be reasonably informed about an issue, a director must inform him or herself of all material information regarding that issue reasonably available to him or her. In fulfilling these obligations, a fund director may rely on written and oral reports provided by management, auditors, fund counsel, the fund’s chief compliance officer (“CCO”), and other experts and committees of the board when making decisions, so long as the director reasonably believes that the reports are reliable and competent with respect to the relevant matters . . . In addition, to fulfill the duty of care, a director needs a well-informed decision-making process. This process may include, among other things, asking for and reviewing regular financial and other reports, questioning managers and outside experts about the meaning and implications of reports, and making inquiries when there are specific causes for concern.²⁰¹

The so-called “duty to be informed,” cited above by the SEC, has also been characterized as the duty to undertake a reasonable investigation or to obtain “advice” regarding the subject of

²⁰⁰ *Id.* at 340-41.

²⁰¹ Commission Guidance Regarding the Duties and Responsibilities of Investment Company Boards of Directors with Respect to Investment Advisor Portfolio Trading Practices, Exchange Act Release No. 58,264, Investment Company Act Release No. 28,345, Investment Adviser Act Release No. 2763, 93 SEC Docket 2469 (July 30, 2008).

deliberations.²⁰² More specifically, the duty has been articulated as requiring directors to review all material information necessary to evaluate the matter before them.²⁰³ This duty is enhanced if there are suspicious circumstances, or “red flags.”²⁰⁴ The duty to be informed and the related duty to monitor are important subsets of the fund directors’ duty of care.²⁰⁵

Notwithstanding the fact that there are numerous sources articulating the duty of care owed by directors, determining the actual standard of care in particular circumstances remains difficult for several reasons. Courts rarely hold directors liable for breaching the duty of care, and the relevant statutes and court decisions frequently state the standard in such general terms that they have been characterized as “vacuous.”²⁰⁶

²⁰² Robert Roy, J.D., *Duty of Corporate Directors to Exercise “Informed” Judgment in Recommending Responses to Merger or Tender Offers*, 46 A.L.R. 4th 887, § 2[a], at 80 (1986).

²⁰³ *Id.*

²⁰⁴ Generally speaking, directors have no obligation to look behind the information on which they are relying to make a business decision “unless suspicious circumstances or other unusual facts” warrant further inquiry. PRINCIPLES OF CORP. GOVERNANCE § 4.01, at 134-35 (1994).

²⁰⁵ Delaware allows directors to be exculpated for duty of care breach but not duty of loyalty breach. CODE ANN. tit. 8 § 102(b)(7) (providing that a corporation’s certificate of incorporation may include a provision exculpating a director for a breach of fiduciary duty not including that of loyalty). The duty to monitor has also been called the “duty of oversight.” 18B Am. Jur. 2d *Corporations* § 1475 (2011). Also, the SEC stipulates that fund directors must monitor the adviser’s performance: “the board does have a duty to monitor the adviser’s performance of its duties under the advisory contract, and to consider replacing the adviser if necessary. The directors’ decision to renew an investment advisory contract, in effect, constitutes the selection of the investment adviser.” *2004 Disclosure Rule*, *supra* note 1.

²⁰⁶ Henry L. Stern, *The General Standard of Care Imposed on Directors under the New California General Corporation Law*, 23 U.C.L.A. L. REV. 1269, 1271 (1976). The SEC has also been reticent about interpreting the scope of a director’s fiduciary duties under Section 36(a) and (b). *See* Bearing of Distribution Expenses by Mutual Funds, Securities Act Release No. 6254, Investment Company Act Release No. 11,414, 45 Fed. Reg. 73,898 (Oct. 28, 1980). Also, Paul Royce, the former Director of the Division of Investment Management at the SEC states that the SEC enforces “minimum standards of behavior” while encouraging the fund industry to adopt the highest or “best practice” level of behavior. Paul Royce, Director, Div. of Invest. Mgmt., Sec. & Exch. Comm’n., Speech by SEC Staff: The

For the purposes of determining the specific fiduciary duties of directors in the particular 15(c) process contexts discussed below, it is helpful to divide the sources for which the bases of those duties exist into three tiers. These tiers are: (1) court decisions, SEC rules and enforcement actions, and private actions; (2) statements from the SEC and its staff; and (3) industry practices, including “best practices.”²⁰⁷

The first tier may provide clear and authoritative guidance as to the duties of fund directors in circumstances sufficiently similar to those in the cases, and otherwise provide persuasive guidance in very similar, but not identical, circumstances. This tier, in addition to encompassing SEC enforcement and private actions brought under Section 15(c), also includes Section 36(b) cases. More specifically, the *Gartenberg* factors compel directors to receive and assess information sufficient to analyze each factor.²⁰⁸ The result is that information relating to the “*Gartenberg* factors” becomes reasonably necessary for purposes of compliance with Section 15(c).

The second tier, while not dispositive, remains important because this class of sources reflects the opinion of the primary regulator or the opinion of an important person, such as a commissioner or division director.

The final tier is probative of the appropriate standard of care owed by fund directors. The principles espoused by trade groups and prominent commentators, as far as they have become prevalent through the standard practice of the directors themselves, enunciate and clarify the fund director’s fiduciary duty of care.²⁰⁹ While

Challenge of Making Best Practice, Common Practice (Dec. 4, 2000), available at <http://www.sec.gov/news/speech/spch438.htm>; PRINCIPLES OF CORP. GOVERNANCE § 4.01 (1994).

²⁰⁷ *Moses v. Burgin*, 445 F.2d 369, 383 (1st Cir. 1971)(recognizing the guideposts for determining the fiduciary duties of directors in particular circumstances as “custom,” “convention,” or “court decision.”).

²⁰⁸ See *Gartenberg v. Merrill Lynch Asset Mgmt., Inc.*, 694 F.2d 923, 928 (2d Cir. 1982) (creating the “*Gartenberg* factors”).

²⁰⁹ See, e.g., PRINCIPLES OF CORP. GOVERNANCE § 4.01 (1994) (providing a detailed explanation of the duty of care of directors). The *Corporate Director’s Guidebook* and the *Business Roundtable Statement* were intended as corporate practice recommendations rather than as rules of law. Nevertheless, they reflect the fact that the affirmative establishment and maintenance of law compliance programs is widely accepted business practice today. See Marshall L. Small, *The Evolving Role of the Director in Corporate Governance*, 30 HASTINGS L.J. 1353, 1360–61 n.35 (1979) (“[I]n

standard practices of fund boards compellingly suggest an appropriate standard of care that fund directors owe, the state of Delaware acknowledges that even “best practices” of directors influence a determination of whether directors have met their duty of care.²¹⁰ At a minimum, industry and best practices may impart a process obligation on fund directors to adequately determine, if applicable, why the fund does not follow an industry or best practice.²¹¹

The following sections consider the aforementioned tiered analysis of the duty of care in discussing fund directors’ responsibilities in various contexts. The first section focuses on fund directors’ procedural responsibilities in the 15(c) process. The next two sections discuss special circumstances and structural challenges directors confront during the 15(c) process.

B. Procedural Issues for Directors

The following paragraphs discuss three aspects of the 15(c) process: (1) the directors’ responsibility to request information from the adviser; (2) the special challenge for directors to analyze the

light of developing trends it would be foolhardy of directors not to receive assurances that appropriate loss prevention and legal compliance programs are in place.”); E. Norman Veasey & William E. Manning, *Codified Standard—Safe Harbor or Uncharted Reef? An Analysis of the Model Act Standard of Care Compared with Delaware Law*, 35 BUS. LAW. 919, 930 (1980) (“[T]he expected role of a director has grown to include the installation of legal compliance systems.”).

²¹⁰ *In re The Walt Disney Co. Derivative Litig.*, 906 A. 2d 27, 55 (Del.2006) (finding it “a helpful approach” to compare directors’ conduct with a “best practices” or “best case” scenario). Also, while it is noteworthy to acknowledge some controversy over the general standard of care to be applied to directors (*i.e.*, gross negligence vs. negligence) when making decisions, this article is focused on utilizing fiduciary principles to understand the fund board’s obligations in the 15(c) process.

²¹¹ See E. Norman Veasey & Christine T. Di Guglielmo, *What Happened in Delaware Corporate Law and Governance from 1992-2004? A Retrospective on Some Key Developments*, 153 U. PA. L. REV. 1399, 1506-08 (2005); *In re Walt Disney Co.*, 906 A. 2d at 56-60; Corporate Compliance Committee, ABA Section of Business Law, *Corporate Compliance Survey*, 63 Bus. Law. 195, 212 n. 119 (2008); Brett H. McDonnell, *Professor Bainbridge and the Arrowian Moment: A Review of The New Corporate Governance in Theory and Practice*, 34 Del. J. Corp. L. 139, 170 (2009).

advisory fee; and (3) the fund board's hiring of experts to assist them in the process.

1. Fund Directors “[S]hall Request . . .”

First and foremost, the fund board has a responsibility to request information from the adviser. As set forth in Section 15(c), the requirement essentially codifies the fiduciary duty to inform: it is the “duty of the directors of a registered investment company to request and evaluate . . . such information as may reasonably be necessary to evaluate the terms” of the advisory contract.²¹²

In some circumstances, the adviser provides information to the fund board without, or prior to, a board request. Conceivably, that adviser could provide the fund board with all information necessary to adequately evaluate the terms of the advisory contract, but a fund board's reliance on this information would be foolhardy for at least two reasons.

First, if the fund board does not make a request, it risks being criticized for not analyzing the question of what specific information it would like to receive, placing the fund board at the mercy of the adviser to provide information.²¹³ The adviser, after all, has a conflict of interest between its obligation to the fund board to provide all the information reasonably necessary to evaluate the advisory contract and its financial incentive in renewing the advisory contract and increasing profits for its own shareholders.²¹⁴ Second, a board's failure to make a request logically means that the board will not contemplate follow-up questions. The purpose of Section 15(c),

²¹² Investment Company Amendments Act of 1970, Pub. L. No. 91-547, 84 Stat. 1413, 1420 (1970) (codified as amended at 15 U.S.C. 80a-15(c) (2006)).

²¹³ This may be similar to the SEC's argument that an independent chair is important. *See, e.g.*, Investment Company Governance, Investment Company Act Release No. 26,520, 83 SEC Docket 1384 (July 27, 2004) (“We are adopting an amendment to require that any fund that relies on an Exemptive Rule have a chairman of its board who is an independent director.”); SEC. & EXCH. COMM'N., EXEMPTIVE RULE AMENDMENTS OF 2004: THE INDEPENDENT CHAIR CONDITION 53-64 (2005), *available at* <http://www.sec.gov/news/studies/indchair.pdf> (discussing the importance and effectiveness of an independent chairman of a board as it relates to fulfillment of the board's responsibilities).

²¹⁴ For a discussion of the adviser's conflict of interest, see Knickle, *supra* note 172 and accompanying text.

however, is to ensure that directors are making an informed decision. Therefore, if the fund directors neither make a request nor define what information they believe to be material to evaluating the advisory contract, then such inaction amounts to an abdication of the directors' responsibility to properly inform themselves.²¹⁵

Since the statute explicitly states that the directors have the obligation to make a request for relevant information in the 15(c) process, an important question is: When do directors have an obligation to make a follow up request? Typically, there are two scenarios in which directors may have a duty to follow up on the initial response by the adviser. First, directors have a duty to follow up on incomplete responses. Second, directors must follow up if the initial response or other facts indicate to the directors that the initial request did not result in the receipt of all material²¹⁶ information. Either of these circumstances should raise a "red flag" for directors.

²¹⁵ See *Francis v. United Jersey Bank*, 432 A.2d 814, 822 (1981) (explaining that directors cannot abdicate their responsibility to act as a "sentinel"). It is possible that the adviser could give the directors all of the information that they are statutorily due without a request. But without making a request, how would the directors know they have actually received all of the information they need?

²¹⁶ The word material here means "important" and "relevant" to the 15(c) process. *Brehm v. Eisner*, 746 A.2d 244, 259 n.49 (Del. 2000) ("The term 'material' is used . . . to mean relevant and of a magnitude to be important to directors in carrying out their fiduciary duty of care in decision making."); see also *Moses v. Burgin*, 445 F.2d 369, 376 (stating that the investment adviser and affiliated directors have a duty to fully disclose information "in every area where there [is] even a possible conflict of interest between their interests and the interests of the fund"); *Imperial Fin. Servs., Inc.*, Fed. Sec. L. Rep. (CCH) ¶ 77,287, at 82,464 (Aug. 26, 1965) (explaining that the 1940 Act requires investment advisers to provide directors with "sufficient information so as to enable them to participate effectively in the management of the investment company"); *Investment Company Governance*, Investment Company Act Release No. 26,520, 83 SEC Docket 1384 (July 27, 2004) ("Directors should frame their information requests broadly to obtain complete information relevant to their consideration of the advisory contract, and should include inquiries related to the adviser's material conflicts of interest with the fund and how the adviser deals with those conflicts."); *Compliance Procedures and Practices of Certain Investment Companies*, 17 C.F.R. § 270.38a-1(e)(2) (2011) (defining "Material Compliance Matter," in part, as "any compliance matter about which the fund's board of directors would reasonably need to know to oversee fund compliance").

The first scenario seems easy to explain, but may be difficult for fund directors to address. The directors first should be making a repeat request, and then making approval of the advisory contract contingent on compliance with the request and incorporate compliance as a requirement in future contracts. The more practical challenge for directors occurs when non-compliance by the adviser becomes material²¹⁷ and chronic.

In some circumstances where directors determined that advisor non-compliance in the 15(c) process was both material and chronic, the directors therefore recommended that fund shareholders hire a new fund adviser to replace the non-compliant one.²¹⁸ In at least one instance, however, fund shareholders ultimately rejected this recommendation and re-hired the non-compliant adviser, while commentators stated that the SEC did not intervene in support of the directors.²¹⁹ Nonetheless, the directors likely met their fiduciary obligations through their recommendations by: (1) putting the shareholders on notice in the strongest terms that the directors believed the adviser was acting inappropriately; and (2) providing the choice to the shareholders to either vote to retain the problematic adviser or, armed with the specific notice by the fund directors, sell their fund shares.

Directors should be making a follow-up request during the second scenario. Flowing from the duty to be informed, information provided to the directors that indicates further information is necessary to properly evaluate the terms of the contract should

²¹⁷ Again, the use of “material” here means important and relevant for compliance with the 15(c) process. *See supra* note 220 and accompanying text.

²¹⁸ For a detailed explanation of the adviser contract termination process, see Robertson, *supra* note 2, at 6.06 (describing the process and results of terminating adviser contracts); *Navellier v. Sletten*, 262 F.3d 923, 932-33 (9th Cir. 2001) (describing how defendants, as independent trustees of a mutual fund, replaced the fund’s investment adviser after concluding that the adviser’s response to their request for information was insufficient).

²¹⁹ *See Navellier*, 262 F.3d at 933-4 (reciting background about how appellants, as shareholders of the mutual fund, filed claims for breach of fiduciary duty under the ICA after the fund board failed to renew the adviser’s contract); Anna Robaton, *Independent Mutual Fund Directors Seek Backing: Hey, SEC, We Can’t Do It Alone*, INVESTMENT NEWS (Mar. 8, 1999), <http://www.investmentnews.com/article/19990308/SUB/903080719> (reporting that mutual fund directors want more assistance from and backing by the SEC when reviewing adviser contracts and fees).

trigger a follow up request.²²⁰ Of course, an adviser's inadequate or improper response to the directors' requests for information may likewise trigger a red flag, instigating the directors to investigate further.

Finally, even if the directors do not ask specifically for certain information, the adviser has an obligation to provide information. At the very least, the information provided by the adviser must adequately address the "*Gartenberg* factors."²²¹

In sum, the directors' duty of care is acutely relevant to the 15(c) process through two principles: (1) the 15(c) request and its details; and (2) the directors' follow-up to the adviser's 15(c) response. A 15(c) request by the fund board should be thorough and the 15(c) response may trigger the duty to investigate further through secondary requests.

2. Analysis of the Fee

Fund directors face a number of fee-related issues during the 15(c) process. These issues include: (1) the method and criteria of comparing the fund's fees to other fund fees; (2) the comparison of the fund's fees to relevant non-fund fees; (3) the comparison of fund's fees to sub-advisory and other less captive fees; and (4) fee breakpoints at certain asset levels. While the directors face a duty to inform themselves when analyzing the fee, once informed they must also "act with [the] requisite care in the discharge of their duties."²²²

A key decision for the fund board, it must choose appropriate comparable funds in order to assess the material terms of the proposed advisory contract. These terms broadly encompass the nature and quality of advisory services and the proposed advisory fee. More specifically, 15(c) report provides performance and fee

²²⁰ See *Schuyt v. Rowe Price Prime Reserve Fund, Inc.*, 663 F. Supp. 962, 984 (S.D.N.Y. 1987) (observing that the defendant directors "not only carefully analyzed and debated the information they were given, but also . . . actively questioned the Adviser and requested additional information when they needed it.").

²²¹ There is other statutorily specific information that needs to be provided to the fund board inside and outside the 15(c) process, including information required by Rule 38a-1 and, if applicable, Rules 17a-7 and 17e-1. 17 C.F.R. §§ 270.38a-1, 270.17a-7, 270.17e-1 (2011) (detailing what information the fund board must review).

²²² *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1983).

analysis typically broken down by quartile or quintile categories of funds.²²³ Fund directors should understand the method and criteria used in this review in order to appreciate the data they are receiving.

Also, in light of *Jones*, fund boards now have the responsibility to inquire and evaluate the fees charged by the fund's adviser to other non-fund clients.²²⁴ That is, if the adviser's clients are receiving similar services,²²⁵ the fund board has a responsibility to request and evaluate information about fees an adviser is charging other clients when reviewing the terms of the proposed advisory contract.²²⁶ It is the responsibility of the fund board to decide whether the other advisory clients are receiving similar services to which the fund board can make a meaningful comparison.²²⁷ In cases where the fund board may reasonably make a meaningful comparison of fees, even when the services received by the comparable clients are different than those received by the fund, the information may still be probative and appropriate for the fund board to review.²²⁸

The fund board also can attempt to evaluate fees paid by funds that were provided similar services through a sub-advisory or similar non-sponsored relationship, where the adviser charging the

²²³ See *Advisory Contract Renewal Services – 15(C) Reports*, LIPPER, <http://www.lipperweb.com/products/AdvisorContractRenewalServices.aspx> (last visited April 30, 2011) [hereinafter *Lipper*] (advertising the firm's 15(c) reporting services and ability to provide performance and fee analysis).

²²⁴ See *Jones v. Harris Assocs.*, 130 S. Ct. 1418, 1430 (2010) (acknowledging that fund boards rely on "comparisons with fees charged to mutual funds by other advisers").

²²⁵ *Gallus v. Ameriprise Fin., Inc.*, 561 F.3d 816, 824 (8th Cir. 2009) (opining that such comparisons are particularly appropriate where "the investment advice may have been essentially the same for both accounts").

²²⁶ See *Gartenberg v. Merrill Lynch Asset Mgmt., Inc.*, 694 F.2d 923, 928 (2d Cir. 1982).

²²⁷ See *Jones*, 130 S. Ct. at 1429, n.8 (noting that "a showing of relevance requires courts to assess any disparity in fees in light of the different markets for advisory services").

²²⁸ If, for example, the comparable fee is provided to a client receiving similar but not the same services, and the difference can be reasonably quantified, the duty of the board would seem to encompass this analysis. As this issue has long been prominently debated between the Investment Company Institute and the plaintiffs' bar, there is a wealth of studies on either side to educate fund boards as to the appropriateness of making comparisons in different contexts.

fee has less control over the fund.²²⁹ The principle that funds may act more independently when their existence does not depend on the sponsorship and capital of the advisor suggests that non-sponsored funds have more bargaining power than sponsored ones. Presumably, instances where similar services are provided to the non-sponsored fund will suggest what fee would result if the fund and the adviser were truly bargaining at arm's length.²³⁰

Finally, fee breakpoints at certain asset levels are an important component of the fee agreement.²³¹ In order to assess the viability of breakpoints, the fund board must determine the profitability, or cost, to the adviser for providing services at various asset levels. In other words, the fund board will have to determine whether the cost to the adviser of providing its services decreases on an asset-level basis as the assets of the fund increase. If the cost does decrease, then fund boards have a responsibility to consider varying the fee at different asset levels.²³²

In sum, the duty of care guides the fund board in its analysis of the advisory fee. Most importantly, because it is the fund board's obligation to negotiate the advisory fee with the adviser, the board

²²⁹ A sponsored fund is created by the adviser and has advisory representatives as officers and directors of the fund.

²³⁰ See generally *Jones*, 130 S. Ct. at 1428-29 (discussing the usefulness of comparing different funds' fees). Again, if the difference in services is easily quantifiable, then the fees should be considered comparable, with appropriate consideration given to the difference, if any, in services provided. It is still important to consider issues apparent in those circumstances, such as the size of the fund.

²³¹ See *Schuyt v. Rowe Price Prime Reserve Fund, Inc.*, 663 F. Supp. 962, 969-71, 977-81 (S.D.N.Y. 1987) (discussing defendant fund board's use of "fee breaks" in negotiating the adviser's contract); Investment Company Governance, Investment Company Act Release No. 26,520, 83 SEC Docket 1384 (July 27, 2004) (according to the SEC, the fund board has the "obligation to negotiate . . . the fee."). See generally *Krinsk v. Fund Asset Mgmt., Inc.*, 875 F. 2d 404 (2d Cir. 1989) (discussing breakpoints).

²³² See generally *MFDF Handbook*, *supra* note 149, for an example of a complex scenario where there are breakpoints based on certain assumptions including future asset levels, but then these future asset levels never come to fruition. It may be the responsibility of the board to adjust the levels based on the anticipated cost and revenue projections of the never-achieved asset level.

must actively consider: (1) all parameters for receiving fee related information; and (2) the structure of the fee.²³³

3. Hiring Experts

An important procedural aspect of the 15(c) process is the decision whether the fund board should hire outside experts. Typically, the fund hires a firm, like Lipper, to provide performance and fee analysis.²³⁴ But most fund boards consider hired independent counsel as the most prominent expert.²³⁵

The issue of hiring independent counsel has been discussed by courts and by the SEC for years. Momentum gathered behind the concept in the 1980's after courts expressed concern that fund boards relied on attorneys who also represented the adviser.²³⁶ Since then,

²³³ See generally, PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS, ROLE OF DIRECTORS AND SHAREHOLDERS IN TRANSACTIONS IN CONTROL AND TENDER OFFERS (2008) (discussing control and tender offer issues and the Delaware cases such as *Van Gorkum*, *Revlon*, *Unocal* and other similar cases). Also, the Johnson-Bogle debate emphasizes the conflict of the adviser in negotiating its fee with the directors. See *Knickle*, *supra* note 214, at 241 (reviewing the Johnson-Bogle debate).

²³⁴ See *Lipper*, *supra* note 227 (detailing Lipper's role in the 15(c) process); *News and Products*, ADVISORONE (Nov. 2006), <http://www.advisorone.com/article/news-products-15> (reporting that Lipper is the largest service provider for purposes of the 15(c) process).

²³⁵ See Role of Independent Directors of Investment Companies, Securities Act Release No. 7754, Exchange Act Release No. 42,007, Investment Company Act Release No. 24,082, 70 SEC Docket 1867, (Oct. 15, 1999) (describing the hiring of independent legal counsel as a "recognized method of enhancing the independence and effectiveness" of independent directors). The SEC has characterized independent counsel as "one of the most useful advisers" to the independent directors. Investment Company Governance, Investment Company Act Release No. 26,520, 83 SEC Docket 1384 (July 27, 2004).

²³⁶ See, e.g., *Fogel v. Chestnut*, 668 F. 2d 100, 117-118 (2d Cir. 1981); *Tannenbaum v. Zeller*, 552 F.2d 402, 428 (2d Cir. 1977), *cert. denied*, 434 U.S. 934; see also *Schuyt v. Rowe Price Prime Res. Fund, Inc.*, 663 F. Supp. 962, 965, 982, 986 (S.D.N.Y. 1987), *aff'd*, 835 F.2d 45 (2d Cir. 1987) (emphasizing that the fund board was represented by its own counsel throughout); *Gartenberg v. Merrill Lynch Asset Mgmt., Inc.*, 694 F.2d 923, 927 (2d Cir. 1982) (mentioning that the board was represented by counsel independent from fund's advisor); Role of Independent Directors of Investment Companies, Securities Act Release No. 7754, Exchange Act

numerous courts have cited the importance of having disinterested counsel for the directors, separate from the counsel for the adviser.²³⁷ Some courts have specifically discussed the importance of hiring outside experts as a factor in determining whether the fund board satisfied its duty of care.²³⁸

Since 1999, the SEC has heightened its attention to the importance of having independent counsel for the fund directors. A roundtable held by the staff of the SEC for fund directors cited this issue, particularly during the 15(c) process.²³⁹ Specifically, the SEC created a rule explicitly “authoriz[ing] [independent directors] to hire employees and to retain advisers and experts necessary to carry out their duties.”²⁴⁰

In citing the importance of the fund board hiring independent counsel, the SEC set forth:

One of the most useful advisers independent directors should consider engaging is their own counsel . . . [W]e agree with the American Bar Association’s view that “[t]he complexities of the Investment Company Act, the nature of the separate responsibilities of independent directors and the inherent conflicts of interest between a mutual fund and its managers effectively require that independent directors seek the advice of counsel in understanding and discharging their special responsibilities.” American Bar Association, *Report of the Task Force on Independent Director Counsel, Subcommittee of*

Release No. 42,007, Investment Company Act Release No. 24,082, 70 SEC Docket 1867, (Oct. 14, 1999); Richard M. Phillips, *Mutual Fund Independent Directors: A Model for Corporate America?*, INVESTMENT COMPANY INSTITUTE 3 (Aug. 2003) (showing that even prior to the SEC’s proposed rules on independent counsel in 2001, the ICI provided a set of “best practices” that included independent counsel).

²³⁷ Fross, *supra* note 199, at 5.

²³⁸ See, e.g., *In re American Mutual Funds Fee Litig.*, No. CV 04-5593GAF(RNBx), 2009 WL 5215755, at *35 (C.D. Cal. 2009) (commenting on the cooperation between directors and advisor counsel).

²³⁹ See Sec. & Exch. Comm’n., Conference on the Role of Independent Investment Company Directors, transcript of Part 2 (Feb. 23-24, 1999), available at <http://www.sec.gov/divisions/investment/roundtable/iicdrndt2.htm> (discussing importance of independent counsel).

²⁴⁰ 17 C.F.R. § 270.0-1(a)(7)(vii) (2011).

Investment Companies and Investment Advisers, Committee on Federal Regulation of Securities, Section of Business Law: Counsel to the Independent Directors of Registered Investment Companies at 3 (Sept. 8, 2000). See generally James D. Cox, *Symposium: Lessons from Enron, How Did Corporate and Securities Law Fail? Managing and Monitoring Conflicts of Interests: Empowering the Outside Directors with Independent Counsel*, 48 Vill. L. Rev. 1077 (2003). If independent directors do hire their own counsel, and their fund relies on any of the Exemptive Rules, such counsel must be an “independent counsel.” Rule 0-1(a)(7)(iii).²⁴¹

Former SEC Commissioner Paul Carey further articulated his goal of encouraging independent counsel as follows:

[T]he Commission and fund shareholders are relying on independent directors to safeguard the interests of the fund shareholders—to be the “independent check” on fund management, referred to by the Supreme Court in *Burks v. Lasker*—to be the fund shareholders’ representatives in their fund’s relationship with its investment adviser . . . Any independent director who serves on a fund board and understands the importance of his or her role should view independent counsel as a condition for serving as a director—just as one would not serve on a board without D&O liability insurance. . . .

Independent directors often seek counsel’s advice, for example, during the 15(c) process, on the standards and considerations that apply to the setting of the management fee to be paid to the fund’s adviser . . . Is it realistic to expect that the shared counsel, when engaged in dual representation of the adviser and the directors, will advise the independent directors that the adviser’s compensation may be

²⁴¹ *Investment Company Governance*, *supra* note 217, at 68.

viewed as excessive by a court, except in the most egregious situations?²⁴²

Even though the SEC did not explicitly require fund boards to hire independent counsel in every circumstance, the SEC's position clearly impacted both the standard of fiduciary care owed by directors as well as court decisions noting the importance of hiring independent counsel.²⁴³ In fact, so many regulatory and industry groups note the importance of hiring independent counsel that a fund board failing to hire will have difficulty justifying the decision if criticized by the SEC or a plaintiff. To summarize, hiring independent counsel is an SEC-imposed responsibility in some cases and a best practice in others. Hiring independent counsel is only a factor that will be considered by courts to determine if fund boards have met their duty of care. In light of the prominent use of independent counsel by mutual funds, fund boards appear to have a responsibility to seriously consider such engagements and to have a justification if they fail to do so.²⁴⁴

C. Primary Red Flags for Section 15(c) Process

Certain circumstances encountered by fund directors can be characterized as red flags, which trigger heightened review.²⁴⁵ These circumstances imply specific fiduciary duties of directors emanating from the duty of care. The following paragraphs discuss the

²⁴² Paul R. Carey, Commissioner, Sec. & Exch. Comm'n, Speech by SEC Commissioner: The Independent Counsel Requirement for the Fund Governance Proposal, (November 10, 2000), *available at* <http://www.sec.gov/news/speech/spch423.htm>.

²⁴³ See INVESTMENT COMPANY INSTITUTE & INDEPENDENT DIRECTORS COUNCIL, OVERVIEW OF FUND GOVERNANCE PRACTICES 1994-2008 16—18 (2009) (attributing sharp increase in use of independent counsel at least in part to 2001 SEC rules relating to independent counsel).

²⁴⁴ *Id.* at 18.

²⁴⁵ See PRINCIPLES OF CORP. GOVERNANCE § 4.01, *supra* note 210 and accompanying text (discussing exceptions to the business judgment rule regarding suspicious circumstances or other unusual facts which may warrant future inquiry); *Hoye v. Meek*, 795 F.2d 893, 896 (10th Cir. 1986) (holding that when suspicions are aroused, or should be aroused, directors must make necessary inquiries); *Francis v. United Jersey Bank*, 431 A.2d 814, 822 (N.J. 1981) (determining that directors must keep informed, suggesting that “the sentinel asleep at his post contributes nothing”).

application of the three major sources of red flags for the purpose of identifying specific director obligations resulting from the circumstances.²⁴⁶

1. Poor Performance

One of the most important and complex issues fund directors face is dealing with managers that have performed poorly.²⁴⁷ In the language of *Gartenberg* and its progeny, the “nature and quality” of the services provided by the adviser encompass performance.²⁴⁸ Fund directors have fiduciary duties to inform, monitor and address poor performance,²⁴⁹ as well as obligations to ask “probing and discerning” questions when confronted with poor performance.²⁵⁰

²⁴⁶ See PRINCIPLES OF CORP. GOVERNANCE § 4.01, at 134-35 (determining that it is acceptable for directors to rely on the standard information available provided to them “unless suspicious circumstances or other unusual facts would make it unreasonable not to make further inquiry”).

²⁴⁷ Clearly, the two most important service components to shareholders are cost and performance, but as long as compliance with the federal securities laws is adequate, it is all about performance and expenses. See MICHAEL D. GREENBERG, DIRECTORS AS GUARDIANS OF COMPLIANCE AND ETHICS WITHIN THE CORPORATE CITADEL: WHAT THE POLICY COMMUNITY SHOULD KNOW 52 (2010) (stressing the critical nature of compliance); 1970 Amendments, *supra* note 6, at 232-38 (describing the overview of how directors should approach under performing fund managers); *Wharton Report*, *supra* note 8 (arguing that extraordinary performance likewise merits close scrutiny, thus proving that one of the most critical “red flags” for funds is when performance is an outlier).

²⁴⁸ See Lipper, *supra* note 227 (stating that third party service providers such as Lipper frequently provide reports for fund directors in the 15(c) process to analyze the fund’s performance and comply with their duty to be informed).

²⁴⁹ See PRINCIPLES OF CORP. GOVERNANCE § 4.01, *supra* note 210 (indicating that directors must inform themselves with respect to the business judgment to meet their duty of care); *id.* at 145-47 (explaining that having been so informed, they must then act with requisite care in the discharge of their duties); *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1983) (“[D]irectors have a duty to inform themselves, prior to making a business decision, of all material information reasonably available to them.”).

²⁵⁰ See Robert C. Clark, *Corporate Governance Changes in the Wake of the Sarbanes-Oxley Act: A Morality Tale for Policymakers Too*, 22 GA. ST. U. L. REV. 251 (2005); Stuart R. Cohn, *Demise of the Director’s Duty of Care:*

The subject of performance review by fund directors, however, has been emphasized by courts and the SEC in numerous ways. More specifically, the following principles exist in descending order of source importance: (1) the SEC makes it clear that fund directors have an obligation to monitor the performance of fund managers;²⁵¹ (2) the “*Gartenberg* factors” dictate that performance is a material factor for directors to evaluate as part of the 15(c) process;²⁵² (3) the 2004 disclosure rule arguably has the unstated effect of requiring directors to consider and articulate its evaluation of performance;²⁵³ (4) the opinion in *In the Matter of NY Life* criticizes the 15(c) process that led to high fees and poor performance;²⁵⁴ and 5) a wealth of industry practices exist on how directors are and should be addressing performance issues.²⁵⁵

While the SEC and court decisions have remained silent regarding the specific paths directors should take to address poor performance, the fund industry has filled the gap by providing guidance for fund directors.²⁵⁶ This guidance stresses that “chronic”

Judicial Avoidance of Standards and Sanctions Through the Business Judgment Rule, 62 TEX. L. REV. 591, 616-17 (1983).

²⁵¹ See Acquisition and Valuation of Certain Portfolio Instruments by Registered Investment Companies, Release No. IC-14607, 50 FR 27982 (July 9, 1985) n. 42 (stating that the proposed rule does not “alter the responsibility of the board of directors to monitor the performance of the fund’s investment adviser”); see also 15 U.S.C. § 80a-15(c) (1970).

²⁵² See *Gartenberg v. Merrill Lynch Asset Mgmt., Inc.*, 694 F.2d 923, 930 (2d. Cir. 1982).

²⁵³ Disclosure Regarding Approval of Investment Advisory Contracts by Directors of Investment Companies; Final Rule, 69 Fed. Reg. 39,798, 39,798 (June 30, 2004) (“The amendments require a registered management investment company to provide disclosure in its reports to shareholders regarding the material factors and the conclusions with respect to those factors that formed the basis for the board’s approval of advisory contracts during the most recent fiscal half-year.”).

²⁵⁴ See *N.Y. Life*, *supra* note 3, at 16-19 (explaining that as a result of an adviser failing to provide board with sufficient information the resulting advisory contract provisions were not justified in light of the fees and performance of the fund).

²⁵⁵ See Payne, *infra* note 262 (discussing effective alternatives that address and correct poor performance). See generally MFDF, *supra* note 40.

²⁵⁶ Frequently, trade groups such as the ICI and MFDF attempt to provide guidance through calling their suggestions “best practices” so as not to imply they are fiduciary principles. However, they are still probative to determining the “prudent” course of conduct for a director.

performance problems should be addressed by determining the reason for poor performance and considering, where appropriate, the implementation of a monitoring program to track poor performance.²⁵⁷

More succinctly, there are three categories of appropriate action by directors to address poor performance. In the order of least to most drastic, Directors may take appropriate action: (1) an organizational approach; (2) a response through fee adjustments; and (3) structural changes to the fund or adviser.²⁵⁸ The organizational approach contemplates the following actions: (a) directors providing extra support for the portfolio manager, *i.e.*, creating a portfolio team; (b) directors changing the portfolio manager; and (c) directors adding sub-advisers. A fee response involves lowering or temporarily waiving the fee and/or implementing a performance based fee. Finally, a structural approach could involve: (a) merging the fund; (b) having the adviser make an acquisition to significantly increase the resources available to the fund; (c) delaying the introduction of new funds; and (d) closing the underperforming fund.

²⁵⁷ BILL DING & RUSS WERMERS, *MUTUAL FUND PERFORMANCE AND GOVERNANCE STRUCTURE: THE ROLE OF PORTFOLIO MANAGERS AND BOARDS OF DIRECTORS* (2009), *available at* http://www.bus.wisc.edu/finance/workshops/documents/revision_8.pdf (discussing a recent study indicating that directors' oversight of poor performance can include negotiating lower fees, monitoring portfolio manager behavior, and taking disciplinary action against poor performing managers):

[W]e find that independent directors are crucial for terminating underperforming seasoned portfolio managers, as outflows are not sufficient to pressure the management company to do so. In fact, our evidence indicates that independent boards impact pre-expense performance much more significantly than their prior-documented impact on fund fees. We also find a role for internal governance: inside directors and large management company complexes appear to better monitor performance due to 'hidden actions,' as well as terminating underperforming inexperienced managers.

²⁵⁸ C. MEYRICK PAYNE, *Mutual Fund Directors' Response to Poor Performance*, MANAGEMENT PRACTICE INC., <http://production.mfgovern.com/content/view/54/137/> (last visited Nov. 07, 2011) (describing three organizational alternatives aimed at correcting poor performance).

In sum, the SEC and the courts have highlighted the fiduciary obligations of fund directors to monitor fund performance. While the SEC and court decisions have not prescribed steps directors should take to address performance problems, industry guidance and best practices seem to fill the gap. While the industry practices are not mandatory, they are probative when assessing the appropriate conduct of directors. Directors should, at a minimum, be aware of the options and be prepared with reasons should they choose not to follow them.

2. Providing Affiliate Services and Other Related Conflicts of Interest

The potential for the fund's adviser to breach his duty of loyalty makes the fund board's duty of care more burdensome. This relationship creates three areas of prime concern for directors: fund brokerage, soft dollars and initial public offering allocations. In confronting these conflicts of interest, directors face challenges in three primary areas of concern.²⁵⁹

i. Fund Brokerage

Unlike performance issues, the SEC has frequently highlighted deficient oversight of affiliated entities providing brokerage services.²⁶⁰ Fund brokerage provides opportunities for unscrupulous advisers to exploit funds in these assets.²⁶¹ The enforcement matters discussed previously show that directors should closely scrutinize when adviser-affiliated entities provide substantial services to the fund. The most prominent of these affiliated entity matters, *Value Line*, included an egregious misuse of fund brokerage by the adviser. Additionally, two other cases, *Citi Asset Management*²⁶² and *Bisys*,²⁶³ emphasize the oversight challenges for fund directors when there are adviser affiliated broker-dealers or transfer agents providing services to the fund.

²⁵⁹ See MFDF, *supra* note 40 (recommending several courses of actions to aid directors in eliminating potential conflicts of interests).

²⁶⁰ See Ball, *supra* note 174.

²⁶¹ Fross, *supra* note 199, at 7 ("When the adviser is also a broker, the fund's trading offers a potential for exploiting the fund.").

²⁶² *In re Citigroup, Inc. Sec. Litig.*, 330 F. Supp. 2d 367 (S.D.N.Y. 2004).

²⁶³ *In re BISYS Sec. Litig.*, 397 F. Supp. 2d 430 (S.D.N.Y. 2005).

The SEC has also commented on the fiduciary duties of directors to ensure that fund brokerage commission are used appropriately.²⁶⁴ Additionally, the industry frequently has opined on the appropriate practices for fund directors in the realm of fund brokerage.²⁶⁵

This heightened duty of care, to monitor the affiliated entities, involves measuring the quality of broker execution and the approval of the board of the reporting methodology.²⁶⁶ In 2008, the SEC proposed guidance for fund directors in the area of fund brokerage.²⁶⁷ The SEC emphasized the fiduciary duties of directors to monitor this fund asset:

²⁶⁴ See, e.g., *Commission Guidance infra* 267.

²⁶⁵ See *infra* note 271.

²⁶⁶ See MFDF, *supra* note 40, at 14; Fross, *supra* note 199, at 7 (stating that the approval of a reporting methodology is important to the process of measuring the quality of broker execution).

²⁶⁷ SEC, Commission Guidance Regarding the Duties and Responsibilities of Investment Company Boards of Directors with Respect to Investment Adviser Portfolio Trading Practices, 34 Fed. Reg. 58, 264 (Jul. 30, 2008) (to be codified at 17 C.F.R. pt. 275); Letter from Allan S. Mostoff, Pres., Mutual Fund Director's Forum, re: Commission Guidance Regarding Client Commission Practices Under Section 28(e) of the Securities Exchange Act File No. S7-09-05, to Jonathan G. Katz, Secretary, SEC (Nov. 25, 2005) (on file at the SEC website), available at <http://www.sec.gov/rules/interp/s70905/asmostoff9454.pdf> (explaining the SEC in the context of discussing appropriate soft dollar oversight, also noting the importance of directors' oversight of fund brokerage: the directors of an investment company have a continuing fiduciary duty to oversee the company's brokerage practices); see SEC, Commission Guidance Regarding Client Commission Practices Under Section 28(e) of the Securities Exchange Act of 1934, Release No. 34-54165 (July 24, 2006) (to be codified at 17 C.F.R. 241) (citing Order Approving Proposed Rule Change and Related Interpretation under Section 36 of the Investment Company Act, Investment Company Act Release No. 11662 (Mar. 4, 1981) [46 C.F.R. 16012 (Mar. 10, 1981)]), <http://www.sec.gov/rules/interp/2006/34-54165.pdf>; see also TAMAR FRANKEL, REGULATION OF MONEY MANAGERS 67 (1978) ("The directors should examine the adviser's practices in placing portfolio transactions with broker dealers and the use of the brokerage business for the benefit of the adviser or its affiliates, and ensure that there are no violations [] of the law . . .") (citing *Lutz v. Boas*, 39 Del. Ch. 585 (1961)); *1970 Amendments*, *supra* note 6 (discussing soft dollar interpretation for directors).

Although directors are not required or expected to monitor each trade, they should monitor the adviser's trading practices and the manner in which the adviser fulfills its obligation to seek best execution when trading fund portfolio securities. In doing so, the fund's board should demand, and the fund's adviser must provide, all information needed by the fund's board to complete this review process.²⁶⁸

One trade group elaborated on the type of "information needed" to properly monitor fund brokerage by recommending the fund board implement the following practices: (1) providing the fund "most favored nation" status for purposes of brokerage commissions to ensure that the fund is not paying higher commissions than any other client; (2) requiring the adviser to provide the board information to determine and verify brokerage costs for other clients of the adviser; (3) making detailed reviews of trades to compare execution quality achieved by the affiliated broker in comparison to other clients; and (4) approving the methodology of reporting the information to the fund.²⁶⁹

In sum, fund directors have at their disposal numerous SEC enforcement actions and statements stressing the importance of close scrutiny over affiliated entities' inappropriate use of fund brokerage. Unlike other red flag categories, the SEC and other organizations have proposed ample guidance on how fund directors should be monitoring fund brokerage to ensure that it is not misused by the fund's adviser or its affiliates.

²⁶⁸ Commission Guidance (2008), *supra* note 271, at 5. The SEC further stated that, "without sufficient oversight by the fund's board, transaction costs might inappropriately include payment for services that benefit the fund's adviser at the expense of the fund and that the board believes should be paid directly by the adviser rather than with fund assets." *Id.* See 17 C.F.R. §§ 270.17a-7, 270.17e-1, 270-38a-1 (2003).

²⁶⁹ Fross, *supra* note 199, at 7 (elaborating that the approval of reporting methodology by the independent directors is necessary to review the quality of the execution by a broker).

ii. Soft Dollars

Similar to fund brokerage, the SEC has provided specific guidance on the duties of fund boards to oversee soft dollar transactions. While soft dollars are actually a subset of fund brokerage, it is discussed separately because it is a prominent source of self-dealing by fund advisers.

The SEC has made specific statements regarding its expectations in the 15(c) process.²⁷⁰ In connection with recently proposed guidance, the SEC said that Form ADV Part II was not designed to provide directors with all of the information necessary to satisfy their obligations pursuant to the 15(c) process.²⁷¹ The SEC also noted that the information required to be evaluated by the fund boards may vary depending on the following factors:

- (i) the scope and nature of the soft dollar program;
- (ii) the level of clarity and utility of the materials provided; (iii) the board's confidence in the adviser's relevant policies and procedures; and (iv) the adviser's compliance record.²⁷²

The SEC said that the fund board should, at a minimum, request the following information in the 15(c) process: (1) the adviser's brokerage policies and (2) how brokerage commissions and the adviser's use of soft dollar commissions were allocated.²⁷³ According to the SEC, the directors should also determine whether the adviser properly accounted for use of fund brokerage commissions to purchase research that benefits a different client of the adviser.²⁷⁴

Finally, it is worth noting that one trade group specifically highlighted the difficulty of a fund board to properly value certain exchanges in the context of soft dollars.²⁷⁵ The group believes that if the fund board is unable to quantify a substantive benefit to the adviser as a result of fund brokerage, the board's fiduciary duty of

²⁷⁰ See Commission Guidance (2008), *supra* note 271.

²⁷¹ Commission Guidance (2008), *supra* note 271, at 34-35.

²⁷² *Id.*

²⁷³ *Id.*

²⁷⁴ *Id.*

²⁷⁵ *Id.*

care to inform itself and monitor the use of fund assets cannot be met.²⁷⁶

iii. IPO Allocations

Initial public offering participation potentially creates a conflict of interest because the adviser frequently controls its application. IPO participation has been a significant asset at varying times over the past twenty years.²⁷⁷

The conflict becomes most acute when the IPO allocations are based on brokerage directed by the investment adviser. In such cases, the brokerage may be created partially or substantially by the fund. Thus, the same analysis in the previous paragraphs would be appropriate. The benefits of fund brokerage are an asset to the fund, and a fiduciary, such as the adviser, has an obligation to properly disclose conflicts of interest to the fund board. Likewise, the board has an obligation to properly monitor the application of IPOs.

More specifically, fund boards first should determine if the eligibility of the adviser to participate in IPOs is an asset to the fund. If IPO participation is an asset of the fund, the board should decide whether it is appropriate for the fund to participate directly in the IPO, or whether the IPO should be considered a quantifiable asset or

²⁷⁶ *Id.*

²⁷⁷ See The Dreyfus Corp., Investment Advisers Act Release No. 1870, Securities Act Release No. 7857, Investment Company Act Release No. 24450 (May 10, 2000), available at <http://www.sec.gov/litigation/admin/33-7857.htm> (explaining that investment in IPOs, particularly “Hot IPOs” represent valuable investment opportunities because they tend to increase in price during the first trading day); Monetta Fin. Serv. Inc., Investment Advisers Act Release No. 2136, Securities Act Release No. 8239, Exchange Act Release No. 48001, Investment Company Act Release No. 26070 (June 9, 2003), available at <http://www.sec.gov/litigation/opinions/33-8239.htm> (“Registered investment adviser . . . failed to disclose that investment adviser was allocating shares of initial public offerings to accounts of certain investment company directors and trustees.”); Amendments to Regulation M: Anti-Manipulation Rules Concerning Securities Offerings, RIN 3235-AF54 n. 11 (proposed Dec. 9, 2004) (to be codified at 17 C.F.R. 228-30, 240, 242) available at, http://www.sec.gov/rules/proposed/33-8511.htm#P48_10898.

a “fall-out benefit” for the adviser.²⁷⁸ If it should be considered a fall-out benefit, then the fund board can incorporate it in its analysis of the fund fee in the 15(c) process.

3. Material Compliance Issues

The fund’s board of directors has the task overseeing the compliance policies and procedures for the fund generally, which includes overseeing material compliance matters, such as valuation issues.²⁷⁹ The directors, therefore, have an obligation to handle

²⁷⁸See Ryan Bollman & Mark Andreau, Note, *Jones v. Harris Associates L.P.: The Search for Investor Protection Continues...*, 65 U. MIAMI L. REV. 717, 739 (2011) (defining fall-out benefits).

²⁷⁹ Valuation is a prominent example of material compliance issues. The fund’s board has both a fiduciary duty to monitor the valuation decisions of the adviser and a statutory duty to determine the fair value of those securities for which market quotations are not readily available. 15 U.S.C. § 80a-2(a)(41) (2010). Two of the more prominent matters in the area of valuation of securities are Hammes, Administrative Proceeding File No. 3-11351, Securities Act Release No. 8346, Investment Company Act Release No. 26290 (SEC, Dec. 11, 2003), *available at* <http://www.sec.gov/litigation/admin/33-8346.htm>; and Evergreen Investment Management Co., LLC., Administrative Proceeding File No. 3-13507, Exchange Act Release No. 60059, Investment Company Act Release No. 28759 (SEC, Jun. 8, 2009), *available at* <http://www.sec.gov/litigation/admin/2009/34-60059.pdf> (finding that a fund’s management team failed to take readily-available information into account when valuing securities). In Hammesthe, SEC alleged the fund’s board had a duty to “monitor” valuations based on the registration statement. But the matter also indicated that the duties of the directors went further than satisfying an assumed obligation. More specifically, the directors:

[D]id not adequately discharge their responsibility to participate meaningfully in the valuation of Funds. While mutual fund directors are permitted to delegate some responsibility for pricing a fund’s securities to a separate committee, each director retains responsibility to be involved in the valuation process and may not passively rely on securities valuations provided by such a committee.

See Hartl and Lipman, Administrative Proceeding File No. 3-8224, Securities Act Release No. 7031, Exchange Act Release No. 33165, Investment Company Act Release No. 19840, 1993 WL 468571, at *4-5

compliance issues that may arise. While receiving compliance reports may be part of ongoing communications with the adviser and the chief compliance officer, directors have a further obligation to respond accordingly to the compliance information it receives, particularly in the context of approving the advisory contract.

The duty to oversee the compliance policies and procedures is recognized as having its basis in the recent compliance procedures rule promulgated by the SEC.²⁸⁰ But eight years prior to that rule in 1996, the Delaware Chancery court in *In re Caremark International Inc. Derivative Litigation* addressed the fiduciary duties of directors in the context of compliance.²⁸¹ In Caremark the court held that the fiduciary duty of directors encompasses the adoption and maintenance of a compliance program.²⁸² In 2006, the Delaware Supreme Court affirmed the Caremark holding in *Stone v. Ritter*.²⁸³ The Stone court emphasized that the board of directors had both a duty to ensure the implementation of an effective compliance program and to exercise oversight. This establishes that the fund board of directors' statutory and general fiduciary duty to address

(Nov. 8, 1993) (alleging the fund provided false and misleading valuations not in accordance with its valuation policy). Furthermore, a director's failure to review financial statements, reports, contracts, and other documents relevant to the financial condition of the issuers of a fund's securities can result in the director's personal liability. *Id.* See generally Staff of the Division of Investment Management, *Valuation of Portfolio Securities and other Assets Held by Registered Investment Companies—Select Bibliography of the Division of Investment*, (last modified July 8, 2011), <http://www.sec.gov/divisions/investment/icvaluation.htm> (providing several sources relating to the valuation of securities).

²⁸⁰ 17 C.F.R. §270.38a-1 (2003) (requiring board to adopt procedures to prevent violations of laws that must be approved annually by a majority of the board, including a majority of independent directors, and appointment of a chief compliance officer).

²⁸¹ *In re Caremark Int'l Inc. Derivative Litig.*, 698 A.2d 959, 970 (Del. Ch. 1996) (holding that directors must establish information and reporting systems within the company to provide the board with enough information to make an informed decision regarding the company's compliance).

²⁸² *Id.* (holding boards must implement "information and reporting systems . . . that are reasonably designed to provide to senior management and to the board itself timely, accurate information sufficient to allow management and the board, each within its scope, to reach informed judgments concerning both the corporation's compliance with law and its business performance.").

²⁸³ *Stone v. Ritter*, 911 A.2d 362, 370 (Del. 2006).

ongoing compliance issues and potentially to modify the compliance program as a part of its obligation in review of the program.²⁸⁴

The directors have an obligation to consider such compliance issues in their review of the nature and quality of services provided by the adviser, as long as the issues are caused by the adviser. These duties oblige the directors to review the compliance issues in conjunction with the 15(c) process and adequately weigh its impact on the overall quality of services provided to the fund.

D. Section 15(c) Special Contexts

The following three structures can have important ramifications for fund directors in the 15(c) process: the subject areas of sub-adviser management, closed-end funds, and insurance contract funds and their relevance to the 15(c) process are discussed below.

Sub-Advisers

The hiring of sub-advisers has become popular in recent years.²⁸⁵ These arrangements raise specific challenges for fund directors to meet their fiduciary duty in overseeing sub-advisers. The sub-advisory status deserves particular attention in the 15(c) process because the directors have the same fiduciary duty to the fund's sub-advisers as they have with the sponsoring adviser. That is, sub-advisers utilize fund brokerage, have their own compliance challenges and collect a fee from the fund just as the typical sponsoring adviser.

In addition to the same statutory application to sub-advisory relationships as sponsored advisers, there is much to indicate that directors have an obligation to ensure proper oversight of sub-advisers.²⁸⁶ While it may be more of a challenge for fund boards to properly oversee sub-advisers than sponsoring advisers, the fund board is not relieved of that duty simply because the adviser is a sub-

²⁸⁴ See Greenberg, *supra* note 251, at 52 (emphasizing the importance of compliance).

²⁸⁵ See COMM. ON FED. REGULATION OF SEC., *supra* note 184 (“As of April 2009, nearly 40 percent of mutual funds (including funds that underlie variable insurance products) use at least one subadviser to manage at least a portion of the fund’s portfolio, compared to 25 percent 10 years ago.”).

²⁸⁶ See *supra* note 289 and *infra* 291 (discussing various issues to consider in sub-adviser oversight).

adviser.²⁸⁷ The SEC has recognized the obligation of proper oversight of sub-advisers in the 15(c) process context.²⁸⁸ The SEC has emphasized these duties, for example, in *American Birthright*²⁸⁹ and *Morgan Stanley*.²⁹⁰

In light of the aforementioned SEC statements and enforcement actions, and the practices highlighted by the industry, the most prominent principles espoused for boards to consider in the context of sub-advisers include: (1) details regarding the sub-adviser such as why the sub-adviser is recommended, how was it chosen, *i.e.*, methodology, what are its organizational capabilities, *i.e.*, portfolio management, compliance, etc.; and (2) the proposed fees and their divisions among advisers must be reasonable considering the delegation of duties between the adviser and sub-adviser.²⁹¹

2. Closed-End Funds

Close-end funds are unique and, therefore, face unique challenges. Unlike mutual funds and exchange-traded funds, closed-end funds must manage the differential between their net asset value and their publicly traded price. The differential usually manifests itself as a discount to the net asset value, thereby encouraging a sponsoring adviser to establish and execute anti-takeover provisions.

²⁸⁷ MUTUAL FUND DIRECTORS FORUM, PRACTICAL GUIDANCE FOR DIRECTORS ON THE OVERSIGHT OF SUB-ADVISERS (2009), *available at* http://www.mfdf.org/images/uploads/resources_files/Sub-AdviserGuidance.pdf.

²⁸⁸ Jay S. Neuman & Frederick C. Leech, SEC Proposed Rule: Exemption Certain Subadvisory Contracts from Shareholder Approval (2003), *available at* http://www.reedsmith.com/_db/_documents/SEC%20Update%20102303.pdf (noting that, in carrying out its obligations under section 15(c) of the Investment Company Act, a board should consider any material business arrangements between the adviser or principal underwriter and the subadviser, including the involvement of the subadviser in the distribution of the fund's shares).

²⁸⁹ See *American Birthright*, *supra* note 104 (alleging that fees in light of services provided by sub-adviser was excessive).

²⁹⁰ See *Morgan Stanley*, *supra* note 72 *et seq.*

²⁹¹ See *MFDF Practical Guidance*, *supra* note 291 (asserting that directors should understand why a sub-adviser is recommended by the adviser, understand how the adviser searched and selected the sub-adviser, understand the sub-advisers organization and compliance programs, and understand the fees paid under the agreement).

Thus, as independent watchdogs for the fund shareholders, fund directors must address: (1) when to decrease the discount through purchases of the fund shares or other structural actions; (2) whether to consider converting the fund to open-end; and (3) whether to take defensive measures to prevent shareholders from mounting a takeover to force the fund to close and sell its assets or convert to open-end status so the shareholders can sell at net asset value.

A number of sources shed light on such questions, including prominent cases from Delaware²⁹² and recent statements coming from the SEC staff regarding the appropriateness of anti-takeover positions by closed-end funds.²⁹³ More specifically, in 2009 the former director of the Division of Investment Management, Andrew Donohue, discussed his opinions regarding the appropriate conduct by fund boards in the context of management entrenchment of closed-end funds:

A federal district court in Maryland has held that a closed-end fund's serial use of poison pills was valid and was consistent with provisions in the Act . . . As such, one might conclude that such actions by a fund, or more particularly its board, may be in the best interests of a fund. In my view, however, I submit that the adoption of a poison pill, or restricting the voting rights of a "dissident" shareholder even where state law authorizes it, may be inconsistent with federal law and not in the best interest of the fund and its shareholders.²⁹⁴

²⁹² See *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 954 (Del. 1985) (holding that in the context of a takeover, the business judgment rule applies to the board's decision of whether the takeover is in the best interest of the corporation); *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986) (holding that when takeover is inevitable, directors are charged with the duty of getting the best value for shareholders).

²⁹³ Andrew J. Donohue, Director, SEC Division of Investment Mgmt, Keynote Address at the Independent Directors Council Investment Company Directors Conference (Nov. 12, 2009) (suggesting that although anti-takeover tactics may comport with state law, independent directors must consider whether such tactics are in the best interest of the fund and its shareholders).

²⁹⁴ *Id.*

Mr. Donohue also raised the question of whether sections of the 1940 Act could be violated by anti-takeover measures implemented by closed-end fund advisers, thereby compromising the fiduciary duties of fund directors to properly manage their adoption and execution. He made the following comments, stating that fund directors need to be careful not to breach their fiduciary duties when overseeing such provisions:

I raise these points today to highlight for your consideration as directors that these are issues which you must consider carefully when faced with a request by management to adopt a poison pill, to invoke voting restrictions on control shares, or to pursue other strategies that have the effect of entrenching existing management.²⁹⁵

In summary, closed-end funds create unique governance challenges for fund directors, particularly when the fund directors are assessing advisory contracts. Fund directors should understand the position of the adviser in addressing the market value discount in the context of the nature and quality of services provided.

3. Insurance Contract Funds—Fall-out Benefits

Investment companies created by life insurance companies and owned by insurance companies' separate accounts create special structural challenges for oversight by fund boards of directors.²⁹⁶ Fund boards in these circumstances owe duties to the actual contract holders, who essentially act as shareholders because they are the beneficial owners of the shares. The SEC has it made clear that voting rights for those fund shares should be passed through to the actual contract holders.²⁹⁷

²⁹⁵*Id.* (“When considering such options and determining what is in the best interests of the fund and its shareholders, directors should take guidance from Section 1(b) of the Act and should heed that section’s declared skepticism of actions that would tend to entrench management if such action is harmful to shareholders.”).

²⁹⁶ See FED. REGULATION OF SEC. COMM., *supra* note 183, at 79-81.

²⁹⁷ Periodic Repurchases by Closed-End Management Investment Companies, *etc.*, 1992 WL 188984 (Securities Act Release No. 33-6948)

The laws governing the approval of a mutual fund's investment advisory agreement do not specifically refer to dedicated funds or variable insurance products. However, where a dedicated fund is advised by an insurance company (or an affiliate of an insurance company) issuing insurance products investing in the fund, the interrelationship between the fund and the insurance company should be considered by the board of the dedicated fund in this context.²⁹⁸

Therefore, one of the most interesting challenges to fund boards in the insurance fund context is fall-out benefits. The insurance payments paid to the adviser or its affiliate by fund shareholders are fall-out benefits appropriately considered in determining the fee in the 15(c) process.²⁹⁹

V. Conclusion

The 15(c) process was created by Congress and has been interpreted by the SEC and courts to emphasize the fiduciary obligations of the fund's adviser and board of directors to provide integrity to the advisory contract approval process. There is nothing more integral to the 1940 Act than having independent directors properly consider and approve the advisory contract.

The foregoing discussion of fiduciary principles is essentially a mosaic composed of SEC enforcement actions, judicial decisions, and industry practices. While the "red flags" discussed above provide guidance for fund advisers and directors, the most important standard for them to follow is a robust process that involves appropriate consideration of all of these issues.

(July 28, 1992) ("The Commission construes section 48(a) [15 U.S.C. § 80a-47(a)] to require pass-through voting on fund matters when a registered separate account is organized as a [unit investment trust]."); *see* Separate Accounts Funding Flexible Premium Variable Life Insurance Contracts, 52 Fed. Reg. 11187-02 (proposed Mar. 30, 1987) (adopting amendments to SEC Rule 6e-3(T)).

²⁹⁸ *See supra* note 183, at 80.

²⁹⁹ *See* FED. REGULATION OF SEC. COMM., *supra* note 183.

Finally, recent SEC activities and Section 36(b) cases have significantly influenced the 15(c) process, especially the scope of fiduciary duties of fund advisers and directors during the process. And the current attention by the SEC on the 15(c) process promises to make further strides in clarifying the responsibilities of fund advisers and directors in the realm of the advisory contract.