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SEC Charges Mutual Fund Board Members and Investment Adviser with Violations of Section 15(c) For Deficient Advisory Contract Approval Process

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On June 17, 2015, the SEC charged Commonwealth Capital Management ("CCM"), an investment adviser to various mutual funds within ***World Funds Trust*** ("WFT") and ***World Funds, Inc***. ("WFI"), for violating Section 15(c) of the Investment Company Act by providing incomplete and inaccurate information to two mutual fund boards, and CCM's majority owner John Pasco with causing the violations. It further charged three former trustees of the WFT board, J. Gordon McKinley III, Robert R. Burke, and Franklin A. Trice III, with Section 15(c) violations because they did not follow up with CCM to obtain the requested information that was never provided. Instead, they approved CCM's advisory contracts for the WFT Funds without the reasonably necessary information needed to evaluate the terms of the contracts.

Section 15(c) requires that a majority of the fund's independent directors approve the terms of any advisory contract between the investment adviser and the fund. It further imposes a duty on the directors to request and evaluate, and a duty of an 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 such company." 15 U.S.C. § 80a-15(c). Although Section 15(c) does not define the term "reasonably necessary," the SEC has provided guidance that this analysis may be informed by certain factors, commonly known as the Gartenberg Factors. See *Disclosure Regarding Approval of Investment Advisory Contracts by Directors of Investment Companies*, Investment Company Act Release No. 26486 at n.31 (June 23, 2004). The Gartenberg Factors include:

(i) the adviser's cost in providing the services;

(ii) the nature and quality of the adviser's services;

(iii) the extent to which the adviser realizes economies of scale as the fund grows larger;

(iv) the profitability of the fund to the adviser;

(v) fee structures for comparable funds;

(vi) fall-out benefits accruing to the adviser or its affiliates; and

(vii) the independence, expertise, care, and conscientiousness of the board.

Gartenberg v. Merrill Lynch Asset Mgmt., Inc., 694 F.2d 923, 930 (2d Cir. 1982). These factors provide the basis of the SEC's disclosure requirements to "encourage funds to provide a meaningful explanation of the board's basis for approving an investment advisory contract." Investment Company Act Release No. 26486.

Prior to evaluating and approving the CCM advisory contracts for the WFT Funds, the Trustees, with the assistance of Independent Counsel and Commonwealth Shareholder Services, Inc., ("CSS"), the fund administrator to WFT and WFI, requested certain materials and information from CCM and a sub-adviser as part of the Section 15(c) process, which included a questionnaire concerning the Gartenberg Factors and specifically requesting comparable fee information. Pasco reviewed and certified the questionnaire responses on behalf of CCM. In addition, Independent Counsel prepared a Gartenberg Memorandum for the Trustees that described their Section 15(c) duties, including that they should request and compare the management fees paid by comparable mutual funds in determining whether an adviser's fee is reasonable.

CCM failed to provide the Trustees with information regarding the fees paid by comparable funds. Despite this failure on behalf of CCM, the Trustees approved the advisory contracts because they considered the advisory fees to be within an acceptable range.

Further, the SEC found that CCM provided incomplete responses, and the Trustees failed to follow up on the incomplete responses, relating to the nature and quality of services provided by CCM. CCM provided only limited disclosures that vaguely described its duties. For example, the advisory and sub-advisory contracts described CCM's and the sub-advisor's duties using identical language, except that the sub-advisor's duties were subject to CCM's supervision.

Likewise, in the August 2009 approval of the WFI Fund advisory contract, CCM did not furnish, and the Board did not consider, complete and accurate information on comparable advisory fees and expense ratios. CCM provided a table, albeit incomplete, that contained fund share classes with different distribution fee structures, assets at share-class level rather than total-fund level, different types of funds, and funds with different fee structures. In other words, the chart did not provide a suitable comparison.

The August 2009 questionnaire also requested CCM to provide two years of financial statements and to provide CCM's basis and methodology for allocating costs to assist the board in assessing CCM's profitability. CCM, however, only provided an income statement for only one year and did not provide any description of its allocation methodology. The August 2009 questionnaire also requested information relating to an Expense Limitation Agreement and the adequacy of WFI Fund breakpoints, both of which CCM failed to provide.

CCM's failure to provide all the reasonably necessary information requested by the boards, and McKinley, Burke, and Trice's failure to follow up with CCM for such information resulted in the SEC finding that they willfully violated Section 15(c). In response to this failure, Julie M. Riewe, Co-Chief of the SEC Enforcement Division's Asset Management Unit commented that "The advisory fee typically is the largest expense reducing investor returns. The WFT trustees fell short as the shareholders'

watchdog by essentially rubber-stamping the adviser’s contract and related fee.”

CCM, Pasco (who caused CCM’s violations), McKinley, Burke and Trice agreed to settle the SEC’s charges. They neither admit nor deny the SEC’s findings and agreed to cease and desist from committing any violations. Further, McKinley, Burke, and Trice each agreed to pay a penalty of $3,250, and Pasco, CCM, and CSS (who was contractually responsible for preparing the shareholder reports on behalf of the WFI Fund), agreed to jointly and severally pay a $50,000 penalty.

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