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SEC Targets Another Fund Board in Recent Enforcement Case

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The authors examine the implications of a recent order by the U.S. Securities and Exchange Commission instituting proceedings against the administrator and compliance services provider, as well as current and former members of the boards of trustees, of two registered investment companies in connection with alleged disclosure, reporting, recordkeeping, and compliance violations.

The U.S. Securities and Exchange Commission ("SEC") recently issued an Order Instituting Proceedings ("Order") against the administrator and compliance services provider, as well as current and former members of the boards of trustees, of two registered investment companies in connection with alleged disclosure, reporting, recordkeeping, and compliance violations.[1] The entities and individuals agreed to settle the SEC's charges without admitting or denying the SEC's allegations, which focus in large part on disclosures made surrounding the approval and renewal of the investment companies' advisory contracts by the boards of trustees.[2]

The SEC's unusual decision to name personally the board members underscores the SEC's increased scrutiny of directors of registered investment companies.[3] Historically, the SEC rarely pursued enforcement actions against board members. However, last December, the SEC charged former

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directors of funds advised by Morgan Asset Management, Inc. with securities violations for their role in overseeing the valuation of securities held by the funds.[4] The SEC recently announced a settlement with the fund directors.[5] Bruce Karpati, the former chief of the SEC Enforcement Division's Asset Management Unit, is reported to have warned that the SEC is "looking at directors very closely" and that the case should send a "significant deterrence message…to the industry."[6]

The Order also underscores the increased scrutiny the SEC is placing on the contract approval process and related disclosures.[7] As a result, funds and their boards may want to work with counsel to reassess their own procedures and practices in order to identify any areas of weakness similar to those alleged in the Order.

BACKGROUND

The registered investment companies at issue in the Order are Northern Lights Fund Trust and Northern Lights Variable Trust (together, the "Trusts"), each of which is an "administrator-sponsored" series trust that provides a platform for various investment advisers to launch mutual funds without incurring the organizational costs normally associated with launching a stand-alone fund family. According to the Order, the Trusts together consisted of up to 71 series ("Funds") during the time period at issue,[8] with most of the Funds managed by different, unaffiliated advisers and sub-advisers. The Trusts utilized the chief compliance officer services and administrative services of Northern Lights Compliance Services, LLC ("NLCS") and Gemini Fund Services, LLC ("GFS"), respectively, and shared a board of trustees consisting of five trustees ("Trustees").[9] The Trustees, NLCS, and GFS (collectively, the "Respondents") are the subjects of the Order.

The Order focuses in large part on the Trustees' contract approval or "Section 15(c)" process and the disclosure regarding that process. Section 15 of the Investment Company Act of 1940, as amended (the "1940 Act"), requires that, among other things, a registered investment company's advisory contract be approved by the vote, cast in person, of a majority of its directors who are not parties to the contract or interested persons (as defined in Section 2(a)(19) of the 1940 Act) of any such party ("independent direc-

tors") at a meeting called for the purpose of voting on such contract. The contract's initial term is limited to two years, and may continue thereafter only with annual approvals by the board of directors or shareholders and, in either case, by a majority of the independent directors. In connection with their consideration of an advisory contract, Section 15(c) imposes a duty on fund directors "to request and evaluate…such information as may reasonably be necessary to evaluate the terms" of the contract. Disclosure regarding the advisory contract approval and renewal process is required to be included in a fund's shareholder reports.[10]

The Order contains various details regarding the Trustees' contract approval and renewal process. For example, the Order indicates that, during the relevant time period, the Trustees considered a total of 113 advisory contracts and 32 sub-advisory contracts over the course of 15 meetings. The Order further indicates that, although the number of contracts considered at each meeting varied, the Trustees often considered several new contracts and renewals at each meeting and considered over 20 contracts at two different meetings. According to the Order, minutes of these meetings were prepared by GFS paralegals and the Trusts' secretary and reviewed by the Trusts' outside counsel, after which they were submitted to the Trustees for review and approval "typically weeks or months after the meeting occurred." The Order notes that the minutes were then used by GFS to draft the disclosure regarding the Trustees' approval of the advisory contracts for inclusion in the Funds' shareholder reports.

THE SEC'S ALLEGATIONS

Inadequate and Misleading Minutes and Disclosures Regarding the Contract Approval Process

The Order alleges that the Trustees caused violations of Section 34(b) of the 1940 Act in connection with minutes and disclosures relating to the Trustees' contract approval and renewal process. Under Section 34(b), it is unlawful for a person to make an untrue statement of a material fact in certain documents — including minute books and shareholder reports — or to omit to state a fact necessary in order to prevent the statements in such documents from being materially misleading in light of the circumstances

under which they are made. The Order alleges that, as a result of certain misstatements and omissions included in the Funds' minute books, the Trustees *caused* certain Funds' violation of Section 34(b) of the 1940 Act through their approval of the minutes. In addition, because the minutes were used by GFS to draft disclosure regarding the contract approval and renewal process for inclusion in the Funds' shareholder reports, the Order alleges that the Trustees caused the Funds' violation of Section 34(b) in connection with this disclosure. Thus, even though both documents were authored by other persons (who had independent obligations for their accuracy), the SEC determined that the Trustees' failure to identify and correct errors in the documents provided to them for approval was a cause of the securities law violations.[11]

The SEC's allegations focus on the inclusion of certain "boilerplate" language in the minutes and disclosures. The Order notes that in drafting the meeting minutes the GFS paralegals prepared initial drafts using a "minutes template" that included boilerplate language regarding the Trustees' Section 15(c) advisory contract approvals and renewals. The Order notes that the Trusts' secretary supplemented initial drafts of the minutes with details and that the Trusts' outside counsel reviewed the minutes. The Order alleges, however, that there were instances during the applicable period in which certain Funds' shareholder report disclosures, which were based on the minutes, "were materially untrue or misleading, in that the boilerplate disclosures either misrepresented material information considered by the Trustees or omitted material information concerning how the Trustees evaluated certain factors." The Order includes the following examples of such instances:

- The disclosure relating to the renewal of an advisory contract for a Fund indicated that the Trustees had been provided with certain comparative information about the Fund's advisory fees and total operating expenses, including how the Fund's advisory fees compared to the fees charged to comparable funds or accounts and how the Fund's fees and expenses compared to those of a peer group. The disclosure stated that the Trustees had discussed certain of this information and concluded that the Fund's advisory fee was acceptable in part based on the level of fees paid by peer funds. The Order alleges that this disclosure was materially untrue because the Trustees had not received advisory fee peer group information from the adviser.

- The disclosure relating to the renewal of an advisory contract for a Fund indicated that the Trustees discussed data comparing the Fund's advisory fees and total operating expenses to those of a peer group and "concluded that the Fund's advisory fees and expense ratio were acceptable in light of the quality of the services the Fund currently receives from the Adviser, and the level of fees paid by a peer group of other similarly managed mutual funds of comparable size." Although this language is, in a literal sense, a description solely of the Trustees' reaction to the fee rather than of the fee itself, the Order nevertheless alleges that this disclosure was materially misleading because it failed to convey that the Fund's advisory fee was nearly double the peer group mean and materially higher than the fee for all 74 peer funds. According to the Order, the "boilerplate statements were materially misleading since they implied that the fund was paying fees that were not materially higher than the middle of its peer group…." In this regard, the Order alleges that the reference to the fees paid by peer funds without inclusion of additional details failed to provide shareholders with "all necessary material facts concerning the basis for the Trustees' conclusion that the [Fund's] advisory fee was acceptable."
- Similarly, the disclosure relating to the approval of an advisory contract for a Fund indicated that the Trustees concluded that the advisory fee and expense ratio for the Fund were acceptable, based in part on the level of fees paid by peer funds, without conveying that the advisory fee was more than double the peer group mean and materially higher than the fee for all 17 peer funds. As in the example above, the Order alleges that this disclosure was materially misleading.

Failure to Retain Complete Section 15(c) Files

The Order alleges that GFS (as opposed to the Trustees) caused record-keeping violations by certain Funds through its failure to maintain certain documents considered by the Trustees in connection with the approval or renewal of the Funds' advisory contracts as required by Rule 31a-2(a)(6) under the 1940 Act.[12] The Order notes that, as the Funds' administrator, GFS was contractually required to ensure that the Funds maintained the documents required by Rule 31a-2(a)(6) under the 1940 Act. The Order provides various

examples of instances in which GFS allegedly failed to ensure that the Funds maintained the required records, including three instances in which written financial information was returned to the advisers or discarded by GFS following board meetings based on the advisers' confidentiality concerns and four instances in which written management fee peer group comparisons provided by the advisers were not maintained. In addition, the Order alleges that written summaries prepared by the Trusts' outside counsel to aid the Trustees in the Section 15(c) process were not maintained by certain Funds for much of the relevant two-year period.

Omission of Required Disclosures from Certain Shareholder Reports

The Order also alleges that GFS (as opposed to the Trustees) caused violations of Section 30(e) of the 1940 Act and Rule 30e-1 thereunder by certain Funds as a result of its failure to include disclosure regarding the Trustees' contract approval/renewal process in certain shareholder reports as required by Item 27(d)(6) of Form N-1A.[13] The Order notes that, as the Funds' administrator, GFS was contractually obligated to prepare the Funds' shareholder reports, including the shareholder report disclosure required by Item 27(d)(6) of Form N-1A. The Order alleges that GFS failed to include this disclosure in certain shareholder reports on ten occasions during the relevant two-year period.

Compliance Violations Relating to Approval of the Advisers' Compliance Policies and Procedures

The Order's final allegations relate to approval of the investment advisers' compliance policies and procedures. Specifically, the Order alleges that the Trustees and NLCS failed to ensure that certain Funds implemented their compliance policies and procedures in connection with such approvals, thereby causing the Funds' violation of Rule 38a-1(a)(1) under the 1940 Act.[14]

The Order indicates that, as part of the Funds' compliance program, the Trustees had adopted compliance policies and procedures relating to the approval of the compliance programs of Fund service providers in accordance with Rule 38a-1(a)(2).[15] In connection with the consideration of service providers' compliance programs, the Funds' policies and procedures required the

Chief Compliance Officer (the "CCO") to provide the Trustees with either (i) the compliance manuals, policies, procedures, and practices of the service providers or (ii) summaries of the compliance programs prepared by the CCO, legal counsel, or others familiar with such programs. In this regard, the Order indicates that the Funds' policies and procedures stated that "[t]he summaries should familiarize directors with the salient features of the Compliance Programs (including Compliance Programs of Fund Service Providers) and provide them with a good understanding of how the Compliance Programs address particularly significant compliance risks."[16] The Funds' compliance policies and procedures placed responsibility for implementing the Funds' policies and procedures in this regard on both the CCO and the Trustees.

The Order alleges that, in connection with the approval of the compliance programs of the Funds' investment advisers, NLCS did not provide the Trustees with the materials specified in the Funds' compliance policies and procedures. According to the Order, the Trustees instead approved the advisers' compliance programs based in large part on NLCS's written statement that such programs "were 'sufficient and in use'" and that the advisers' "code of ethics and proxy voting policies were 'compliant.'" The Order notes that NLCS also verbally represented that such compliance programs were adequate at the applicable board meeting, but alleges that the written statement and oral representation did not provide the level of detail about the service providers' compliance programs required by the Funds' compliance policies and procedures. For this reason, the Order alleges that NLCS and the Trustees both caused the Funds to deviate from their compliance policies and procedures in violation of Rule 38a-1(a)(1).

PENALTIES

Under the Order, GFS and NLCS were fined $50,000 each. The Trustees were not subject to any fines, but they and the other Respondents were ordered to cease and desist from further violations of the applicable 1940 Act sections and rules. A cease and desist order does not provide the basis for a statutory disqualification under Section 9(a) of the 1940 Act and also cannot provide the basis for a sanction under Section 203 of the Investment Advisers

Act of 1940, as amended. However, if a cease and desist order is violated (e.g., by the subsequent conduct of directors continuing in the same role), the SEC has the authority to, *inter alia*, seek monetary penalties.[17] In addition, the Respondents agreed to hire an independent compliance consultant to conduct a review of the relevant compliance policies and procedures of the Funds.

CONCLUSION

The Order highlights the increased scrutiny the SEC is placing on fund boards in connection with the Section 15(c) process and other approval processes and demonstrates the SEC's willingness to hold fund boards accountable for their processes and related disclosures even in cases where an apparent lack of care by others might be a contributing factor to an oversight or misstatement. In light of the Order, funds and their boards may want to consider working with counsel to reassess their current procedures and practices to determine whether they are sound and do not otherwise raise the concerns identified by the SEC in the Order.

NOTES

[1] In the Matter of Northern Lights Compliance Services, LLC, *et al.*, Investment Company Act Release No. 30502 (May 2, 2013); Admin. Proc. File No. 3-15313.

[2] It is important to note that, because the Order represents a settlement of the charges rather than the results of adjudication, it includes only the information the parties agreed to make public and is of limited precedential effect. Nonetheless, the Order is significant for the reasons discussed in this article.

[3] In a recent speech, Norm Champ, the Director of the SEC's Division of Investment Management, spoke about the importance of fund boards in the context of the Division's new Risk and Examinations Group ("REG"). In connection with the REG's analysis of the investment management industry, Mr. Champ noted that he and the REG staff are in the process of meeting with senior management personnel and fund boards from various fund complexes. Describing fund directors as "gatekeepers" and "the eyes and ears of fund investors," Mr. Champ noted some important areas that he and the REG hope to discuss with fund boards, including "areas where directors believe they are adding value and, in contrast…areas where they feel that their oversight is more

difficult to manage." *See* Norm Champ, Director, SEC Division of Investment Management, Remarks to the 2013 Mutual Funds and Investment Management Conference (Mar. 18, 2013). This recent initiative is yet another indication of the SEC's enhanced focus on fund boards.

[4] In the Matter of J. Kenneth Alderman, *et al.*, Investment Company Act Release No. 30300 (Dec. 10, 2012); Admin. Proc. File No. 3-15127.

[5] In the Matter of J. Kenneth Alderman, *et al.*, Investment Company Act Release No. 30557 (June 13, 2013); Admin. Proc. File No. 3-15127. The directors consented to the entry of the settled order without admitting or denying the findings. The directors were ordered to cease and desist from committing or causing any future violations of the law.

[6] *See* Jean Eaglesham and Kirsten Grind, *Fund Directors Are Feeling the Heat*, Wall St. J., Mar. 24, 2013.

[7] The press release issued by the SEC in connection with the Order notes that "[t]he SEC Enforcement Division's Asset Management Unit has been taking a widespread look into the investment advisory contract renewal process and fee arrangements in the fund industry." *See* Press Release, SEC Charges Gatekeepers of Two Mutual Fund Trusts for Inaccurate Disclosures About Decisions On Behalf of Shareholders (May 2, 2013).

[8] The order covers events during the period from January 2009 through December 2010.

[9] One Trustee was an indirect owner of GFS and NLCS. The other four Trustees were "independent trustees," including one who retired from the boards in December 2011.

[10] Specifically, Item 27(d)(6) of Form N-1A requires that, where a fund's board of directors has approved (or renewed) a fund's advisory contract, the fund's next shareholder report (whether annual or semi-annual) must include a discussion of "the material factors and the conclusions with respect thereto that formed the basis for the board's approval" of the contract. Item 27(d)(6) sets forth various specific factors to be discussed, including the nature, extent, and quality of the services provided; investment performance; costs of the services provided and profitability of the adviser; economies of scale; and whether the board considered comparative information with respect to services and fees and, if so, the comparative information considered and how it assisted the board in its decision to approve the contract. If any such factor is not relevant to the board's consideration of an advisory contract, the instructions require disclosure of the reasons the factor is not relevant.

[11] Although the Order recited that the Trustees were "a" cause of these particular violations, as yet no other party has been similarly charged with being a cause.
[12] Under Section 31 of the 1940 Act, registered investment companies must maintain and preserve such records, for such periods, in each case as the SEC by rule requires. Rule 31a-2(a)(6) thereunder requires a registered investment company to preserve for not less than six years any documents or other written information considered by its directors in approving an advisory contract under Section 15(c).
[13] Section 30(e) of the 1940 Act and Rule 30e-1 thereunder require registered investment companies to submit semi-annual and annual reports to shareholders. Under Rule 30e-1, a shareholder report must contain the information required by the registered investment company's registration statement form (in the case of open-end companies, Form N-1A). As noted above, Item 27(d)(6) of Form N-1A requires that, where a fund's board of directors has approved (or renewed) a fund's advisory contract, the fund's next shareholder report (whether annual or semi-annual) must include a discussion of "the material factors and the conclusions with respect thereto that formed the basis for the board's approval" of the contract.
[14] Rule 38a-1(a)(1) under the 1940 Act requires a registered investment company to adopt and implement written policies and procedures reasonably designed to prevent the registered investment company's violation of the federal securities laws. The rule specifies that such policies and procedures should include those providing for the oversight of compliance by each investment adviser, principal underwriter, administrator, and transfer agent of the registered investment company.
[15] Rule 38a-1(a)(2) under the 1940 Act requires approval by the board of directors of a registered investment company of the compliance policies and procedures of each investment adviser, principal underwriter, administrator, and transfer agent of the registered investment company, which approval must be based on the board's finding that the compliance policies and procedures are reasonably designed to prevent the violation of the federal securities laws by the registered investment company and such service providers.
[16] The Order notes that the language of the Funds' compliance policies and procedures tracked language from the SEC's release adopting Rule 38a-1 under the 1940 Act.
[17] *See* Section 42(e) of the 1940 Act.