

SEC Brings Action Against Independent Fund Trustees and Provides Gloss on Section 15(c) Process

May 09, 2013

May 9, 2013 -- The SEC has settled a noteworthy enforcement action against mutual fund trustees - including *independent* trustees -- and service providers in renewing and approving advisory contracts under Section 15(c) of the Investment Company Act. The action is noteworthy, because the SEC:

- rarely brings actions against independent trustees and
- lays out what the SEC believes trustees and service providers should do to fulfill their duties in the renewal or approval of advisory agreements.

The SEC Order is Investment Company Act of 1940 [Release No. 30502](#) (May 2, 2013) and the announcing SEC Press Release is [No. 2013-78](#) (May 2, 2013). The mutual funds involved are the Northern Lights Fund Trust and the Northern Lights Variable Trust (each a "Trust" or together the "Trusts"). The service providers involved are the Northern Lights Compliance Services, LLC ("administrator"), and the Gemini Fund Services, LLC ("chief compliance officer service provider"). **A. SEC Action** Generally, the action relates to disclosure, reporting, recordkeeping, and compliance violations by two Trusts. Violations arose from the fact that disclosures and documents regarding the trustees' Section 15(c) evaluation process were untrue, incomplete, or misleading, because, for example:

- the service providers failed to provide, and the trustees failed to consider, Trust advisory fees and overall expenses *compared* to a peer group of similarly managed funds, and
- the Trusts were actually paying advisory fees and experiencing expense ratios that were materially *higher* than a peer group of similarly managed funds.

More specifically, the SEC charged that the *trustees* -- including the independent trustees -- caused:

- *shareholder reports* to contain untrue or misleading disclosures of the basis for the trustees' renewal or approval of advisory contracts, in violation of Section 34(b);
- *board meeting minutes* to contain untrue or misleading documentation of the material factors considered, and conclusions reached, by the trustees in renewing or approving advisory contracts, in violation of Section 31(a); and
- *compliance policies and procedures* to be improperly implemented by the trustees based on insufficient summaries from the chief compliance officer service provider, in violation of Rule 38a-1(a)(1).

The SEC charged that the *administrator* caused the Trusts to fail to:

- maintain and preserve copies of all documents considered by the trustees in renewing or approving advisory contracts, in violation of Section 31(a) and Rule 31a-2(a)(6); and
- send shareholder reports that contained discussion, required by Form N-1A, of the material factors considered, and conclusions reached by the trustees, in renewing or approving advisory contracts, in violation of Section 30(e) and Rule 30e-1.

The SEC charged that the *chief compliance officer service provider* caused compliance policies and procedures to be improperly implemented by providing the trustees with insufficient summaries, in violation of Rule 38a-1(a)(1). The settlement requires the trustees and the two service providers to cease and desist their violative conduct and requires each service provider to pay a fine of \$50,000. The settlement also requires the trustees and the two service providers to:

- hire an "Independent Compliance Consultant" to review compliance procedures applicable to the renewal or approval of advisory contracts and submit a report to the trustees, the two service providers, and the SEC staff recommending improvements to the policies and procedures and a process for implementing the recommendations;
- adopt all recommendations or, as to any recommendation that a person considers unnecessary or inappropriate, propose in writing an alternative policy, procedure or system designed to achieve the same objective, subject to a process for handling any disagreement; and
- foot the entire bill for the compensation and expenses of the Independent Compliance Consultant, without any contribution from Trust assets.

B. Observations Independent Trustees. It is unusual for the SEC to bring action against independent trustees. The SEC traditionally has given independent trustees the benefit of the doubt

and excused their lapses based on circumstances such as lack of knowledge of technical legal requirements. Here, however, the SEC stated that the independent trustees "knew" and "understood" their responsibilities regarding shareholder reports and meeting minutes, but failed to follow through with the appropriate review of the language set out in those documents. The SEC Order can be read to send what may be characterized as a "wake-up call" to all independent trustees.

Disclosure. The SEC particularly faulted what it described as "boilerplate language" that was inconsistent with the trustees' actual consideration during the Section 15(c) process. The SEC said, for example, that disclosure of the trustees' consideration of advisory fees "did not provide current and prospective fund shareholders with all necessary material facts concerning the basis for the trustees' conclusion that the advisory fee was acceptable." The SEC Order can be read to encourage trustees to consider and evaluate the terms of advisory contracts in detail and to disclose that consideration and evaluation in detail. **Enforcement.** The SEC press release states that the "investigation was conducted by [named] Asset Management Unit members" based on an "examination" by other named staff members. Neither the press release nor the SEC Order states whether that Unit, the Office of Compliance Inspections and Examinations known as OCIE, or the staff examiners in the Division of Investment Management conducted the examination. Further, neither the press release nor the SEC Order explains how the three groups of examiners coordinate the examination and investigation of funds and development of enforcement policy. **Turnkey Trust.** The SEC Order describes the Trusts as being "marketed as a turnkey investment company platform to advisers who want to manage small to mid-size mutual funds (each a series of the Trust) without having to administer the day-to-day operations of a fund, including the management of corporate, board and regulatory governance." The two Trusts had "up to 64 and 7 series, respectively, many of which were managed by different advisers and sub-advisers." However, the violations here do not seem peculiar to turnkey trusts, and the SEC Order would seem to be applicable to all funds.

Underlying Fund. One of the Trusts is described by the SEC as a "variable insurance trust" serving life insurance company separate accounts as an underlying funding medium. That fact does not appear to be relevant to the violations that the SEC charged. **Consultant Cost.** The SEC Order does not state whether the cost of the Independent Compliance Consultant allocable to independent trustees will actually be paid by those trustees or whether, for example, the service providers or a D&O insurance carrier will relieve the independent trustees of paying out of their own pockets. The SEC Order states that the Consultant's compensation and expenses "shall be borne exclusively" by the trustees and the service providers "or any of their affiliates" and that "[u]nder no circumstances will such compensation and expenses be borne by the Trusts or their respective series." But it is conceivable that the Trusts paid the premiums for D&O insurance or paid compensation to the trustees so they could buy individual insurance, with the result that the independent trustees ultimately could benefit from the use of Trust assets. **Fund Counsel.** The SEC Order refers to the fact that the Trusts had "outside counsel who led the Trustees in the Section 15(c) process and participated in each meeting," "requested information from the relevant adviser," and "reviewed for accuracy, revised and approved" the draft minutes. Although the SEC Order finds violations of the Section 15(c) process that was followed, including the information provided to the trustees and

recorded in the minutes, the SEC Order does not comment on the role that the outside counsel played. **Independent Trustee Counsel.** The SEC Order does not state whether the independent trustees had independent outside counsel, and the registration statements do not disclose such counsel. The SEC Order does not find fault with the absence of such counsel.

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