

The SEC's Northern Lights Enforcement Action: Implications For Fund Directors

May 13, 2013

On May 2, 2013, the Securities and Exchange Commission (the "**SEC**") settled charges that the five trustees (the "**Trustees**") of two registered series trusts (the "**Trusts**"), the Trusts' CCO-service provider, Northern Lights Compliance Services ("**NLCS**"), and the Trusts' fund administrator, Gemini Fund Services, LLC ("**GFS**"), violated the Investment Company Act of 1940 (the "**Investment Company Act**") in 2009 and 2010. The charges against the Trustees arose from (i) the Trusts' disclosure to investors regarding the Trustees' approval of investment advisory contracts and (ii) the Trustees' approval of compliance manuals of investment advisers to the Trusts. Although this action did not result in the imposition of a monetary penalty on the Trustees, the Trustees consented to the entry of an SEC cease-and-desist order against them. The inclusion of the Trustees in this action highlights the SEC's apparent newfound willingness to bring enforcement actions against registered fund directors and may also be a warning to other directors.

Background

According to the SEC's Order Instituting Public Administrative and Cease-And-Desist Proceedings (the "**Order**"), during the two year period in question, the Trusts, which were used to provide a "turnkey" mutual fund operation to unaffiliated investment advisers, comprised up to 71 mutual fund series, most of which were managed by different advisers and sub-advisers. Pursuant to Section 15(c) of the Investment Company Act, the Trustees – as with any other registered fund directors – were required to approve, and periodically reapprove, the terms of the investment advisory contracts between the Trusts and their investment advisers. Because of the broad scope of the Trusts' operations, during the 15(c) processes that occurred in the two years in question, the Trustees made decisions on whether to approve 113 advisory and 32 sub-advisory contracts.

Several Investment Company Act provisions and rules relating to 15(c) processes are relevant to the SEC's charges against the Trustees. First, Form N-1A requires (pursuant to Investment Company Act Section 30(e) and Rule 30e-1) that shareholder reports of an open-end fund discuss the factors considered by the board in deciding whether to approve (or reapprove) an investment advisory contract, including any fee comparisons used. Second, Investment Company Act Rule 31a-2 requires a registered fund to maintain and preserve copies of the written materials considered by directors during their 15(c) processes. Third, Rule 38a-1 under the Investment Company Act generally provides that, among other things, a registered fund's board must approve the compliance policies and procedures of an investment adviser to the fund based on a finding by the board that such policies and procedures are reasonably designed to prevent the violation of the federal securities laws by the fund and the investment adviser. According to the Order, rather than reviewing an adviser's entire compliance manual, directors

'may satisfy their obligations under the rule by reviewing summaries of compliance programs prepared by the chief compliance officer,' which should 'familiarize the directors with the salient features of the programs . . . and provide them with a good understanding of how the compliance programs address particularly significant compliance risks.'

(quoting Investment Company Act Release No. 26299).

Primary Charges Against the Trustees

Although one could perceive in this action a general skepticism on the part of the SEC that trustees of “turnkey” mutual fund trusts could adequately oversee numerous unrelated advisers and sub-advisers, the SEC did not frame its charges in that manner. Instead, the SEC faulted the Trustees, not for their overall level of oversight, but for several more technical deficiencies relating to the approval of investment advisory contracts. These deficiencies fall into several different categories:

- *Misleading 15(c) Disclosure.* The SEC found that the disclosure in the Trusts’ shareholder reports regarding the 15(c) approvals consisted of boilerplate language that was misleading in several instances. As examples of this, the SEC noted that:
 - In one case, the disclosure stated that the Trustees had considered advisory fee peer group information when, in fact, none had been provided to the Trustees.
 - In two other cases, the disclosure implied that the advisory fees in question were not out of line with the peer group information reviewed by the Trustees when, in fact, the advisory fees were significantly higher. In particular, the SEC criticized the disclosure for stating that the Trustees had concluded that the advisory fees were acceptable “in light of . . . the level of fees paid by the funds in the peer group.” The SEC found that this disclosure (and similar disclosure in the second case) was misleading because it did not go on to clarify that the advisory fees of the peer group were lower than the fees approved by the Trustees.
- *Misleading Board Minutes.* The SEC found that board meeting minutes recording the Trustees’ 15(c) deliberations were misleading because they contained the same misleading statements contained in the 15(c) public disclosure described above. The SEC further found that the Trustees were a cause of the misleading public disclosure because they approved the misleading board meeting minutes on which the disclosure was based.

Based on its findings regarding the 15(c) disclosure in the Trusts’ shareholder reports and board minutes, the SEC found that the Trustees had caused the Trusts to violate Section 34(b) of the Investment Company Act, which generally prohibits making material misstatements or omissions in documents filed with the SEC (such as fund shareholder reports) or required to be kept by Section 31(a) of the Investment Company Act (such as board meeting minutes).

- *Improper Approval of Adviser Compliance Manuals.* The SEC also found that NLCS and the Trustees violated Investment Company Act Rule 38a-1(a)(1) by approving, in contravention of the Trusts’ compliance procedures, the compliance manuals of investment advisers to the Trusts without receiving either the manuals themselves or detailed descriptions of the manuals’ salient features. Instead, according to the SEC, the Trustees relied primarily on written and verbal assertions by NLCS that the manuals were “sufficient and in use,” “compliant” or “adequate.”

In addition to the charges against NLCS and the Trustees, the SEC also found that GFS violated the Investment Company Act by (i) not keeping in the Trusts’ records several documents considered by the Trustees in their 15(c) processes in contravention of Rule 31a-2(a)(6) under the Investment Company Act and (ii) failing to include disclosure in ten shareholder reports regarding the Trustees’ 15(c) deliberations in contravention of Investment Company Act Section 30(e) and Rule 30e-1.

Without admitting or denying the SEC’s findings, NLCS, GFS and the Trustees consented to the entry of the Order, which requires (i) NLCS and GFS each to pay a penalty of \$50,000 and (ii) NLCS, GFS and the Trustees to cease and desist from committing further violations of the Investment Company Act requirements described above. Further, the firms and Trustees have agreed to engage an independent compliance consultant to address the violations found in the Order.

Implications for Registered Fund Directors

Although the Trustees were not required to pay any monetary penalty to settle the SEC's charges, the Trustees were likely included in the enforcement action to highlight the SEC's increased scrutiny of directors of registered investment companies and as a warning to other fund directors. Indeed, the Order follows a recent SEC action from late 2012, where the SEC charged former directors of registered investment companies advised by Morgan Asset Management with securities laws violations for failing to establish appropriate valuation procedures for their funds. These actions illustrate a disturbing trend in SEC enforcement actions targeting directors of registered investment companies for alleged procedural failures.

In order to help address the procedural failures criticized by the SEC in this action, registered fund directors (in consultation with CCOs and counsel) should consider:

- 1) whether their funds' procedures for approving investor disclosures and board minutes have adequate checks to ensure that their funds' 15(c) processes, and any peer group fee information considered in those processes, are accurately described in the minutes and in the disclosures;
 - 2) whether their funds' procedures ensure that all written materials considered by the directors in a 15(c) review are appropriately preserved in the funds' records; and
 - 3) whether their funds' procedures for approving a service provider compliance program requires that the directors receive either the entire compliance manual or, alternatively, a summary or compliance matrix prepared by the CCO that, in the words of the SEC, "familiarize[s] the directors with the salient features of the program[] . . . and provide[s] them with a good understanding of how the compliance program[] address[es] particularly significant compliance risks."
- ▶ [See a copy of the Order.](#)
 - ▶ [See a copy of the SEC's press release.](#)

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