Client Alert

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SEC Sanctions Fund Trustees for Inadequate Disclosures and Failure to Follow Compliance Policies

By Kelley A. Howes and Jay G. Baris

The Securities and Exchange Commission today charged the trustees of two "turnkey" mutual fund trusts with causing untrue or misleading disclosures about their review of the funds' advisory contracts. The Commission also charged the trustees with failure to follow their own procedures in connection with approving compliance policies and procedures of certain service providers, and charged the funds' administrator and the firm providing the funds with chief compliance officer (CCO) services with related violations.

The staff said that it "will aggressively enforce investors' rights to accurate and complete information about [fund trustees'] process and decision-making." The staff also noted its concerns that "turnkey" funds raise "significant governance concerns."

Background. The five trustees, including four independent trustees, oversaw two fund structures, encompassing more than 70 series portfolios, which serve as platforms for various unaffiliated investment advisers to manage mutual funds. These so-called "turnkey" funds provide multiple advisers with the corporate, regulatory and compliance infrastructure needed to operate mutual funds which would be too costly or burdensome to operate individually.

Disclosure regarding Advisory Contract Review. Under Section 15(c) of the 1940 Act, fund trustees are required to annually evaluate and approve a fund's investment advisory contract. Section 15(c) imposes a specific duty on fund trustees to request and evaluate, and investment advisers to provide, such information as may be reasonably necessary for the trustees to evaluate the terms of each investment advisory contract.

When a fund's board approves or renews any advisory contract, its next shareholder report must discuss, in reasonable detail, the material factors and conclusions that formed the basis of the trustees' approval of the contract. Those factors include, at a minimum:

- The nature, extent, and quality of the services to be provided by the investment adviser;
- The investment performance of the fund and the investment adviser;
- 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;
- The extent to which economies of scale would be realized as the fund grows; and
- Whether fee levels reflect these economies of scale for the benefit of fund investors.

After an examination of the fund complex in this case, the SEC staff found that some shareholder reports either

misrepresented material information considered by the trustees, or omitted material information about how the trustees evaluated certain factors in reaching their decisions on behalf of the funds and their shareholders. The Commission's order cited three specific examples of how "boilerplate" disclosures did not reflect the actual information presented to the trustees. For example, in one case, the Commission noted that the shareholder report disclosed that a series was paying fees that were not materially higher than the middle of its peer group, when in fact those fees were nearly double the mean fee of the peer group.

The Commission found that the shareholder reports contained misleading information, or omitted material facts necessary to prevent a statement from being misleading, in violation of Section 34(b) of the 1940 Act, which makes it unlawful for a person to make an untrue statement of a material fact in a document filed with the SEC. The trustees were charged with causing this violation because the disclosures were based on board minutes that were reviewed and approved by the trustees.

Compliance programs. Pursuant to Rule 38a-1 under the 1940 Act, fund trustees must adopt and implement policies and procedures reasonably designed to prevent a fund from violating federal securities laws. The trustees must also approve the policies and procedures of fund service providers through which the fund conducts its activities. The SEC has stated that trustees can satisfy this obligation by reviewing summaries of such procedures prepared by the CCO, if such summaries "familiarize the [trustees] with the salient features of the programs."

In this case, the funds' compliance policies required the trustees to review copies of the investment advisers' policies and procedures or a summary of the advisers' compliance programs sufficient to provide the trustees with a good understanding of how the advisers' compliance programs addressed particularly significant risks. The Commission charged that, rather than complying with the funds' own compliance policies, the CCO simply reported to the trustees that the compliance policies and procedures maintained by the various investment advisers were "sufficient and in use."

The Commission claimed that the CCO and the trustees "caused" the funds to violate Rule 38a-1(a)(1), and that the trustees failed to ensure that each fund implemented its own policies and procedures upon which the trustees could rely in approving the compliance manuals of the funds' advisers.

Undertakings. As part of the settlement, the respondents have undertaken to hire an independent compliance consultant to review the funds' compliance procedures and those of the individual series portfolios. Within 180 days, the independent compliance consultant must submit a report addressing these issues and making recommendations for improvements. The respondents must implement those recommendations within 30 days.

Sanctions. Without admitting or denying the allegations, the trustees consented to cease and desist from future violations of Section 34(b) of the Investment Company Act of 1940 (1940 Act) and Rule 38a-1(a)(1) under the 1940 Act. The funds' administrator and its CCO each agreed to pay a civil money penalty of $50,000.

Comment. This case demonstrates the Commission's willingness to peer into the board room and review the adequacy of boards' governance processes related to investment advisory contract renewals and oversight of fund compliance programs. Specifically, the Commission delved into shareholder reports, materials presented to the boards, and how the board documented its deliberations. This is the second time in less than six months that the Commission has demonstrated its willingness to enter a fund's board room (see our December client alert), signaling a departure from its prior approach.

The Commission is sending some strong messages to fund trustees. For example, fund trustees should ensure that:

- the disclosure in shareholder reports of the factors that they considered when approving investment advisory contracts must accurately reflect the information they received and considered;
- CCO reports concerning sub-advisers or multiple advisers comply with the funds' own compliance policies and Rule 38a-1; and
- the number of funds that they oversee is appropriate and manageable.

The case also signals that the Commission considers turnkey mutual fund operations and fund complexes with multiple advisers to be active areas of inquiry.

Conclusion. In September 2010, Robert Khuzami, then the SEC's Director of the Division of Enforcement, testified before Congress that the Division's Asset Management Unit had established a Mutual Fund Fee Initiative to develop analytics related to the fees charged to mutual fund investors. He said that he anticipated that these analytics would result in examinations and investigations of investment advisers and fund boards concerning their duties under the 1940 Act. It is possible, therefore, that this case could be followed by others. In any event, it is clear that the staff continues to focus on mutual fund fees and fund boards' governance obligations related to such fees.

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