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SEC Settles Suit for Misleading Advisory Contract Approval Disclosure

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Settlement with mutual fund directors and service providers serves as a reminder of responsibilities for disclosures relating to the approval of investment advisory contracts and provides insight into SEC enforcement priorities.

On May 2, the **Securities and Exchange Commission** (**SEC**) settled an enforcement action against the board of trustees (Trustees) of the Northern Lights Fund Trust and the Northern Lights Variable Trust (Trusts), Northern Lights Compliance Services (NLCS), and Gemini Fund Services (Gemini) in relation to disclosure, reporting, recordkeeping, and compliance violations stemming from the Trusts' advisory contract approval and reporting process.[1] The settlement answers a number of questions that many within the mutual fund industry had with respect to the underlying facts of this proceeding since the Trusts publicly disclosed receipt of a Wells Notice in 2012. At the time, the Wells Notice generated particular attention because the disclosure indicated that the Trustees had been personally named in the SEC's claims.[2] The settlement, however, leaves some important questions unanswered.

The matter reminds boards that the 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"[3] and that fund governance and the role of fund directors in the contract renewal process is an examination priority for the SEC staff.[4] The matter also comes on the heels of the SEC's settlement with former fund directors in connection with alleged deficiencies in fair valuation practices.[5] Taken together, these matters suggest a broader trend of SEC inquiry into fund governance procedures, a closer look at the actions of fund boards, and a potentially increased willingness by the SEC to bring enforcement actions in this area.

These developments should lead funds and fund boards to take a fresh look at their practices and procedures and, in particular, their practices with respect to contract renewals, approvals, disclosure,

and recordkeeping.

Background

Each of the Trusts is a turnkey mutual fund platform that provides various investment advisers with the ability to create and launch mutual funds using NLCS's compliance services and Gemini's administrative and operational services.

The five Trustees, which include four independent trustees,[6] served as the board of each Trust. For a two-year period beginning in January 2009, the Trusts comprised 71 different funds managed by many different unaffiliated advisers and sub-advisers. The Trustees held 15 board meetings during that period, at which they approved 113 investment advisory contracts and 32 sub-advisory contracts pursuant to section 15(c) of the Investment Company Act of 1940 (Investment Company Act).[7] In the order, the SEC staff specifically highlighted that, at two board meetings during the relevant period, the Trustees approved more than 20 contracts during each board meeting.

Prior to each board meeting, the Trustees would request information from the applicable advisers and sub-advisers to evaluate the proposed agreements and such information was then reviewed by the Trusts' outside counsel. After each board meeting, Gemini paralegals would prepare a skeleton draft of the meeting minutes based on a minutes template. The draft minutes were then supplemented by the Trusts' secretary, reviewed and revised by outside counsel, and then reviewed and approved by the Trustees. The discussion of the Trustees' approval process included in the meeting minutes was then used to draft the disclosure in the Trusts' shareholder reports.

The Enforcement Order

In the enforcement order, the SEC alleged that the Trustees caused violations of section 34(b) of the Investment Company Act; NLCS and the Trustees caused violations of Rule 38a-1(a)(1) under the Investment Company Act; and Gemini caused violations of sections 30(e) and 31(a) of the Investment Company Act and Rules 30e-1 and 31a-2(a)(6) thereunder.

Section 34(b) of the Investment Company Act makes it unlawful for any person to make any untrue statement of a material fact or omit a material fact in any shareholder report. The SEC found that the Trustees were a cause of the section 34(b) violation that resulted from the inclusion of untrue statements of material fact and omissions necessary to prevent statements from being materially misleading in the portion of shareholder reports that covered the discussion of the board's advisory contract approval process. According to the SEC, because the Trustees reviewed and approved board meeting minutes that contained inaccurate boilerplate language and materially untrue or misleading statements, the Trustees were a cause of the section 34(b) violation that occurred.

In one example cited by the SEC, a shareholder report disclosed that the Trustees considered and discussed a fund's advisory fee and total expenses compared to the advisory fees and total expenses of a peer group of similarly managed funds. The shareholder report further disclosed that the board concluded that the fee was acceptable in light of the quality of the services received by the fund from the adviser and the level of fees paid by funds in the peer group. However, in this particular example, the adviser did not provide any advisory fee or total expense peer group information to the Trustees. In another example cited by the SEC, a fund's advisory fee was "nearly double" the peer group's mean fee and "materially higher" than all of the fees in the peer group. The SEC staff found that the shareholder report's boilerplate reference to the fact that the Trustees concluded that the fund's

advisory fee was acceptable in light of the "level of fees paid by funds in the selected peer group" without further meaningful discussion about the adviser's comparable fee was materially misleading.

The SEC also determined that the Trustees and NLCS each caused violations of Rule 38a-1 under the Investment Company Act, which requires a registered investment company to adopt and implement written policies and procedures reasonably designed to prevent violations of federal securities law. Consistent with Rule 38a-1, the Trusts' compliance policies and procedures required NLCS to provide the Trustees with either the policies and procedures of each adviser or a summary of each adviser's compliance program. In practice, however, NLCS provided the Trustees with a written statement that NLCS had reviewed the advisers' compliance programs and that they were "sufficient and in use" and that NLCS had reviewed the advisers' code of ethics and the proxy voting policies and that they were "compliant." NLCS then verbally confirmed these statements at the board meetings. As a result of this deviation from the Trusts' written policies and procedures, the SEC alleged that each of the Trustees and NLCS caused the Trusts' violations of Rule 38a-1.

In addition, the SEC's order stated that, in its role as fund administrator, Gemini caused the Trusts' failure to comply with requirements set forth in section 31(a) of the Investment Company Act and Rule 31a-2 thereunder by failing to maintain all board materials considered in approving a fund's advisory contract. These materials included documents containing fee comparisons for peer groups and summaries that were prepared by the Trusts' outside counsel as part of the Trustees' approval process. The SEC stated that, in some instances, Gemini discarded such information after the meetings or returned it to the advisers due to the advisers' concerns with confidentiality. The SEC also alleged that Gemini caused the Trusts to violate section 30(e) of the Investment Company Act and Rule 30e-1 thereunder by failing to ensure that certain shareholder reports included the required discussion of the Trustees' 15(c) process.

The Trustees settled without paying a fine or other sanction. Both NLCS and Gemini agreed to pay a $50,000 fine and to engage an independent compliance consultant to address the violations found in the SEC's order.

Compliance Implications

This settlement highlights the SEC's recent attention to mutual fund advisory contract approvals and fee arrangements and provides some insight as to the Enforcement Division's views on funds' obligations to disclose their boards' 15(c) approval process in both board minutes and fund shareholder reports. In addition, when combined with other recent SEC actions, this case indicates that the SEC may be more inclined to take formal action against boards and board members than in the past.

The settlement also underscores the importance of boards' understanding and execution of their legal obligations in connection with the evaluation and approval of advisory contracts. This case suggests that this is particularly true for boards that oversee a large number of funds and/or investment advisers. In the order, the SEC voiced concern about whether a board could adequately evaluate and approve more than 20 advisory contracts during a meeting lasting a single day. However, the settlement does not offer boards any actionable guidance about how they should analyze whether they have adequate resources to fulfill their duties.[8] For example, when a single board oversees multiple funds, the board typically will rely on procedures that delegate certain responsibilities to service providers. It is not clear whether the settlement arose out of a particular defect in the advisory contract approval process, such that a better process would have allowed the Trustees to fulfill their duties. This settlement serves as an important reminder that boards retain overall responsibility for

the advisory contract approval process and must exercise proper care and oversight. Boards must ensure that any delegation to service providers does not detract from the overall adequacy of this process.

The SEC also seemed critical of the Trusts' process for memorializing discussion and approvals at board meetings. The SEC noted that Trustees typically only received minutes for approval "weeks or months after the meeting occurred." The SEC also determined that a short written summary from NLCS, coupled with an oral confirmation at the meeting that advisers' compliance programs were adequate, was inconsistent with the Trusts' policies and procedures, but it did not indicate whether such a process would be insufficient in all circumstances. The settlement also does not provide insight into what constitutes "boilerplate" or how boards and their service providers should strike a balance between individualized discussion and a process-oriented approach to diligence and contract review.

In the wake of this settlement, boards—particularly boards that oversee a large number of funds and/or investment advisers—should take a fresh look at their current processes. Among other things, boards should examine their processes for requesting and reviewing information in connection with contract approvals, memorializing that process via meeting minutes and internal recordkeeping policies, and disclosing that process to fund shareholders. Fund complexes should also take measures to ensure that policies and procedures across various service providers are consistent with one another because compliance and operational processes that may work at each level may fail to work together overall.

Finally, funds should evaluate their processes for shareholder report disclosure to ensure that all disclosures are accurate reflections of the actual process employed. The board minutes and other meeting materials must accurately reflect the board's consideration of advisory contracts, including the information it receives as part of its evaluation. Funds that use template language as a starting point for drafting minutes and shareholder disclosures must have processes in place to appropriately tailor that language to the particular matter at issue. In light of the violations cited by the SEC, funds may also want to double-check their current processes for reviewing and approving the compliance programs of third-party service providers and for maintaining records of board meetings.

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[1]. View the order here.

[2]. View the Northern Lights Fund Trust filing disclosing the receipt of the Wells Notice here. A Wells Notice indicates that the SEC is investigating the party that receives it in furtherance of potential proceedings against them.

[3]. Press Release 2013-78, SEC, SEC Charges Gatekeepers of Two Mutual Fund Trusts for Inaccurate Disclosures About Decisions On Behalf of Shareholders (May 2, 2013), *available* here.

[4]. *See* SEC Office of Compliance, Inspections and Examination, Examination Priorities for 2013 (Feb. 21, 2013) ("Fund governance and assessing the 'tone at the top' is a key component in assessing risk during any investment company examination. The SEC staff will confirm that advisers are making full and accurate disclosures to fund boards and that fund directors are conducting reasonable reviews of such information in connection with contract approvals, oversight of service providers, valuation of fund assets, and assessment of expenses or viability."), *available* here.

[5]. *See In re Alderman*, Investment Company Act Rel. No. 30300 (Dec. 10, 2012), *available* here.

[6]. The Investment Company Act distinguishes between trustees of a registered investment company who are "interested persons" of such investment company, the investment adviser of the investment company or the principal underwriter of the investment company, and the trustees who are not such "interested persons." The latter trustees are often referred to as the "independent trustees" or the "disinterested trustees." "Interested person" is defined in section 2(a)(19) of the Investment Company Act. The Investment Company Act gives the independent trustees a special role in the oversight of an investment company, in many instances requiring that action may not be taken by an investment company without the approval of the independent trustees in a separate vote on the matter.

[7]. Section 15(c) of the Investment Company Act requires a registered investment company's board of trustees/directors to request and evaluate "such information as may reasonably be necessary" to their decision to approve or renew an advisory agreement. The Investment Company Act does not indicate what type of information a board should request and evaluate, but a number of cases under section 36(b) of the Investment Company Act have, in practice, heavily influenced this process, and the SEC has implemented several disclosure requirements to better inform fund shareholders about the board's 15(c) process (e.g., proxy statements and shareholder reports as required by Item 27 of Form N-1A).

[8]. *See* Rule 0-1(a)(7) of the Investment Company Act (requiring boards to conduct an annual self-evaluation). *See also* Investment Company Governance, Investment Company Act Rel. No. 26,520 (July 27, 2004), available here.

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