SEC Settles with Service Providers and Trustees of two Mutual Fund Trusts for Inaccurate Disclosures Regarding Section 15(c) Advisory Contract Approval Process

On May 2, 2013, the SEC filed an order instituting settled administrative proceedings against the trustees ("Trustees") and certain service providers of two "turnkey" open-end series investment companies, Northern Lights Fund Trust and Northern Lights Variable Trust (collectively, the "Trusts"), relating to alleged disclosure, reporting, recordkeeping and compliance violations of the Investment Company Act of 1940 (the "1940 Act"). The violations related to the Trustees' advisory contract approval process under Section 15(c) of the 1940 Act and the approval by the Trustees of certain subadvisers' compliance programs. The SEC's order underscores the heightened scrutiny on the part of the SEC Enforcement Division's Asset Management Unit on the 15(c) advisory contract approval process, as well as the Asset Management Unit's concerns regarding the governance of "turnkey" mutual fund complexes.

Between January 2009 and December 2010, the Trusts included up to 71 funds, many of which were managed by different unaffiliated advisers and sub-advisers. A common board of five trustees oversaw both Trusts. For both Trusts and their respective funds, Gemini Fund Services, LLC ("Gemini") acted as administrator and its affiliate, Northern Lights Compliance Services, LLC ("NLCS"), provided chief compliance officer services. According to the order, the Trustees held 15 board meetings during the period, at which they approved 113 advisory contracts and 32 sub-advisory contracts. The SEC's focus on the number and nature of the board meetings at which the Trustees approved the continuance or renewal decisions on advisory contracts pursuant to Section 15(c) of the 1940 Act, together with certain statements made in the SEC's related press release, appear to signal its concerns regarding the governance of turnkey mutual fund programs.

Disclosure Violations

The SEC alleged that certain fund shareholder reports drafted by Gemini during the relevant period contained disclosures regarding the Trustees' 15(c) evaluation process that were materially untrue or misleading in violation of Section 34(b) of the 1940 Act. In one example, the SEC noted disclosure in a fund shareholder report which stated that the Trustees had compared the fund's management fees to those of a peer group although the adviser had not provided peer group information to the Trustees for their consideration. In another example, the SEC stated its view that disclosure in shareholder reports that the Trustees "discussed the comparison of management fees and total operating expense data and reviewed the Fund's advisory fees and overall expenses compared to a peer group of similarly managed funds [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" implied that certain funds were paying fees that were not materially higher than the average fees paid by a peer group. The SEC found this statement to be materially misleading as the approved advisory fees for the relevant funds were nearly double or more than double the peer group's mean fees.

The SEC also faulted the Trustees for approving board minutes containing boilerplate language and untrue or misleading statements concerning the Trustees' Section 15(c) evaluation process, which minutes were used in drafting the shareholder report disclosure. Accordingly, the SEC found that the Trustees caused the funds' violations of Section 34(b) with respect to the fund shareholder reports.

Reporting and Recordkeeping Violations

The SEC also found that Gemini caused certain funds' reporting and recordkeeping violations under the 1940 Act. In certain instances, Gemini failed to ensure that certain shareholder reports contained the required discussion of the Trustees' 15(c) evaluation process, causing the funds to violate Section 30(e) of the 1940 Act and Rule 30e-1 thereunder. In addition, Gemini failed to ensure that certain funds properly maintained and preserved all written information that the Trustees considered in approving the funds' advisory contracts, causing those funds to violate Section 31(a) of the 1940 Act and Rule 31a-1(a)(6) thereunder.

Compliance Program Violations

The SEC also found that NLCS and the Trustees caused violations of Rule 38a-1 under the 1940 Act by approving compliance programs of service providers through improper reliance on brief written and oral statements by NLCS representatives as to the sufficiency of the programs. Pursuant to the Trusts' own compliance manual (the "Compliance Manual"), in approving such service providers' compliance programs, the Trustees could rely on summaries of such programs prepared by persons familiar with the programs, provided that the summaries familiarized the Trustees with the salient features of the programs and gave the Trustees a good understanding of how the programs addressed particularly significant compliance risks. The SEC stated that NLCS and the Trustees improperly deviated from the Compliance Manual by approving compliance programs based on (1) a brief written statement by NLCS that the advisers' compliance manuals were "sufficient and in use" and that the code of ethics and proxy voting policies were "compliant," and (2) a verbal representation by an NLCS representative at the relevant board meeting that the adviser's policies and procedures were adequate. According to the SEC, such representations did not constitute an adequate summary upon which the Trustees could rely to satisfy their obligations under Rule 38a-1.

Sanctions

Without admitting or denying the findings, NLCS and Gemini each agreed to pay a fine of $50,000. In addition, Gemini, NLCS and the Trustees agreed to retain an independent compliance consultant to review compliance procedures applicable to the advisory contract review process, disclosure, recordkeeping, and reporting obligations.

Implications for Fund Complexes and Trustees

- The Northern Lights enforcement action demonstrates the SEC's focus on Section 15(c) advisory contract review and approval processes, including the disclosure of the specific factors that were considered by the board and the board's evaluation of such factors.
- Further, the SEC's detailed observations in this enforcement action regarding the large number of advisory contracts approved by the Trustees suggests heightened SEC scrutiny of fund boards that oversee large numbers of unaffiliated advisers to mutual funds.
- More broadly, this enforcement action demonstrates the SEC's increased attention to fund governance procedures and the Enforcement Division's willingness to institute administrative proceedings where directors are alleged to have not fulfilled their responsibilities under applicable law. Earlier this year, for example, the SEC settled with the directors of five registered investment companies advised by Morgan Asset Management, Inc., alleging the directors had failed to properly carry out their duties during several months in 2007 with respect to overseeing the determination of the "fair value" of certain fund assets.

If you would like to learn more about the developments discussed in this Alert, please contact the Ropes & Gray attorney with whom you regularly work or any member of the Ropes & Gray Investment Management group listed below.

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