K&LNG Alert

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Investment Management/Financial Institutions

SEC Enforcement Action Targets Common Trust Fund

In a rare statement of position regarding the scope of the securities law exemptions for common trust funds, the Securities and Exchange Commission ("SEC") has used an enforcement action to send a clear message that its traditional approach of interpreting those exemptions narrowly will continue—and then some. Although the latest pronouncements were made in the context of cease-and-desist proceedings against a small trust company, the SEC's order suggests that historical differences of opinion between the SEC's staff and the banking industry about the functions and purposes of common trust funds are alive and well.

Among the more striking statements in the SEC's order in Dunham & Associates Holdings, Inc, et al.[1] was that "revocable trusts are . . . generally not established for a fiduciary purpose," and, consequently, a common trust fund holding the assets of such trusts may not rely on the securities law exemptions for a "common trust fund or similar fund maintained by a bank." This was coupled with the reiteration of the SEC's long-standing position that individual retirement accounts ("IRAs") also are ineligible to participate in common trust funds. On the other hand, the SEC's conclusions are not surprising when considered in light of the "bad facts" of this particular case.

THE DUNHAM ENTITIES

Jeffrey Dunham is the chairman, president, CEO, and principal shareholder of a holding company that in turn owns Dunham & Associates Investment Counsel, Inc., an investment adviser and broker-dealer dually-registered as such with the SEC ("DAIC"), and Dunham Trust Company, a Nevada state-chartered trust company ("DTC"). (The parties are sometimes referred to for convenience collectively as "Dunham.")

Between 1997 and 2002, DAIC organized 11 investment funds in the form of limited partnerships (the "LPs"). The LPs included ten "Stock Funds" and a "Government Fund" each having a specific investment objective.[2]

DTC served as trustee of a common trust fund ("CTF") formed in 1998. The CTF was designed to invest exclusively in the LPs through various "sub-funds." Thirteen sub-funds were designed to invest in corresponding LPs. Other sub-funds were "strategic allocation portfolios" that could invest in and among the LPs in varying combinations. All participants in the CTF were trusts for which DTC acted as trustee.

THE BUSINESS PLAN

Dunham's plan of operation had the appeal of relative simplicity. Investors could invest in the LPs either directly, if they qualified as "accredited investors," or indirectly through the CTF, if they did not. DAIC solicited investors for the LPs directly and, along with DTC, hired third-party brokers and advisers to bring in other investors to either or both of the LPs and the CTF. The SEC's cease-and-desist order pointedly characterized these efforts as a "public offering" of interests in the LPs and the CTF. Investors who did not qualify as accredited investors entered into trust agreements with DTC and directed an allocation of the trust assets among the LPs,

[1] Securities Act Rel. No. 8740, Securities Exchange Act Rel. No. 54489, Investment Advisers Act Rel. No. 2552, Investment Company Act Rel. No. 27495, all dated September 22, 2006; Administrative Proceeding File No. 3-12427.

[2] Two additional LPs identified as "Mortgage Funds" were not involved in the proceedings.

typically in consultation with the referring broker or adviser. Beyond conducting some fairly high-level initial and annual reviews of the trust accounts, DTC allegedly was not involved in investment decisions either for the trusts or the CTF.

By the end of 2003, the CTF had approximately 1,690 participating trusts, including 748 IRAs, and total assets of $353 million ($129 million or 36% of which was attributable to the IRAs). The CTF's holdings represented more than 10% of each of the LPs.

DUNHAM'S LEGAL POSITION

Dunham did not register the LPs or the CTF under the Investment Company Act of 1940 ("1940 Act") or interests in the LPs or CTF under the Securities Act of 1933 ("1933 Act"). With respect to the LPs, Dunham relied on the exception from "investment company" status afforded by 1940 Act Section 3(c)(1), which applies to an issuer that has no more than 100 beneficial owners and does not make (or propose to make) a public offering of its securities. Dunham also contended that interests in the LPs were exempted from 1933 Act registration pursuant to 1933 Act Section 4(2), which exempts "transactions by an issuer not involving any public offering," and the SEC's Regulation D, which provides a safe harbor for offerings limited to no more than 35 investors who are not "accredited investors."[3]

Dunham took the position that the CTF qualified as a common trust fund under 1940 Act Section 3(c)(3). That Section excepts from status as an investment company—

> any common trust fund or similar fund maintained by a bank exclusively for the collective investment and reinvestment of moneys contributed thereto by the bank in its capacity as a trustee, executor, administrator, or guardian, if—
>
> (A) such fund is employed by the bank solely as an aid to the administration of trusts, estates, or other accounts created and maintained for a fiduciary purpose;
>
> (B) except in connection with the ordinary advertising of the bank's fiduciary services, interests in such funds are not (i) advertised; or (ii) offered for sale to the general public; and
>
> (C) fees and expenses charged by the fund are not in contravention of fiduciary principles established under applicable Federal or State law.

Dunham also did not register interests in the CTF in reliance on 1933 Act Section 3(a)(2)(fifth clause), which exempts the offer and sale of interests in common trust funds described in 1940 Act Section 3(c)(3) from the 1933 Act's registration requirements.

THE SEC'S VIEW

The SEC concluded that none of the exclusions or exemptions Dunham relied on were applicable and, therefore, both the LPs and the CTF should have registered as investment companies under the 1940 Act and the offer and sale of interests should have been registered under the 1933 Act. As part of its settlement with the SEC, Dunham was required to pay civil money penalties aggregating $200,000 and to agree to various procedural undertakings designed to ensure compliance with the securities laws. Dunham already had undertaken other fairly substantial remedial actions, including registering the LPs under the 1940 and 1933 Acts and giving CTF participants who were eligible to do so the option of transferring their investments to the corresponding LPs or, subject to compliance with 1940 Act Section 3(c)(3), as interpreted by the SEC, remaining in the CTF.

SECTION 3(C)(3)

The bulk of the SEC's criticism was leveled at the CTF. In the SEC's view, the CTF functioned as a mere "investment vehicle" to facilitate investment by IRAs, revocable trusts, and other investors in the LPs. This approach is directly contrary to the SEC's long-standing position that a common trust fund described in Section 3(c)(3) must function as a vehicle for investment of accounts created for a

[3] "Accredited investors" include, among others, natural persons with a net worth exceeding $1 million or whose annual income exceeds $200,000 (or $300,000 with spouse).

"fiduciary," rather than an "investment," purpose—an interpretation the SEC pointedly mentioned had been "codified" by amendments to Section 3(c)(3) made by the Gramm-Leach-Bliley Act of 1999 (GLBA). Highlights of the SEC's analysis of how and why the CTF and DTC failed to satisfy other specific requirements of Section 3(c)(3) are summarized below.

The "Maintained" Requirement. Noting that Section 3(c)(3) extends to common trust funds maintained by trust companies (such as DTC) as well as banks, the SEC stated that DTC did not "maintain" the CTF. The term "maintained" is not defined in Section 3(c)(3) nor in the 1940 Act generally. Citing its own precedents, however, the SEC explained that, in order to "maintain" a common trust fund, a bank must have and exercise "substantial investment responsibility" with respect to the fund. Here, DTC merely conducted periodic "reviews" of the trust accounts—while the trust clients themselves determined how their trusts would be invested, through the CTF, in and among the LPs. In the SEC's view, DTC's limited monitoring functions fell far short of satisfying the "maintained" requirement.

"Fiduciary Purpose." DTC also failed, in the SEC's view, to use the CTF solely as an aid to administration of accounts created for a "fiduciary purpose." The "fiduciary purpose" provision, which was added to Section 3(c)(3) by the GLBA, has been a focal point of controversy between the SEC and the banking industry since at least as far back as the 1960s. Here, the SEC found fault with the "purposes" of both IRAs and revocable trusts. The SEC's assertion that IRAs are established "primarily for money management" rather than "fiduciary" purposes, and therefore are ineligible to participate in a common trust fund relying on Section 3(c)(3), was not surprising. This has been the SEC's view since IRAs came into existence in 1974.[4] Although the history of the controversies between the SEC and the banking industry over the nature of IRAs and their eligibility to participate in common trust funds is long and contentious, the banking industry largely conceded the SEC's position some years ago.

On the other hand, the SEC's blunt and, given the context, unnecessarily broad statements about revocable trusts were somewhat startling. The SEC did not question the validity of revocable trusts as fiduciary relationships under applicable state law. It asserted, however, that "revocable trusts are generally not established for a fiduciary purpose." While the SEC clearly was troubled by the fact that DTC's revocable trusts appeared, for all intents and purposes, to function essentially as conduits for investment in the CTF and thereby in the LPs, it did not explain why revocable trusts, as such and in general, lack a "fiduciary purpose."[5] Nor did it elaborate what "fiduciary" purposes would be sufficient to meet the standards of Section 3(c)(3).

The apparent paucity of general fiduciary services provided by DTC outside the CTF, along with DTC's failure to "maintain" the CTF (as discussed above), also seemed to lend support to the SEC's characterization of the trusts and CTF as mere investment vehicles. In this regard, the SEC noted that DTC devoted the bulk of its attention and services to the CTF, while "provid[ing] trust services for only a small number of accounts." Moreover, only "a small percentage" of DTC's customer accounts were irrevocable trusts and similar accounts that "received trust services traditionally provided by trust companies."[6] The CTF, moreover, was the primary focus of DTC's business: trusts participating in the CTF represented over 85% of DTC's total customer accounts.

As the SEC saw it, all of this demonstrated that "DTC used the . . . [CTF] as a vehicle for non-accredited investors to invest in the . . . [LPs], and any fiduciary service to the customer accounts was incidental to that investment."

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[4] Equally unsurprisingly, the SEC did not mention federal appellate cases holding that IRA trusts are in fact "fiduciary" accounts that banks are permitted to commingle for investment purposes under the banking laws. The order does not indicate whether the assets of the IRAs were held in trusts or custodial accounts, the latter of which are treated as "trusts" for purposes of Section 408 of the Internal Revenue Code.

[5] Issues surrounding revocable trust participation in common trust funds are not new. Indeed, at one time the Federal Reserve Board ("Board"), which had jurisdiction over national bank trust activities until 1962, and whose regulations originated the "fiduciary purpose" requirement, actually proposed (but never adopted) specifically to exclude from common trust fund participation "standardized trusts" providing for distribution of principal at the grantor's death to his or her estate. This presumably was based on the theory that, consistent with the Board's view at the time, such trusts did not evidence a "true fiduciary purpose." 25 Fed. Reg. 12479 (1960).

[6] The SEC also noted that only 20% of DTC's revenues was attributable to compensation for "traditional trust services." In contrast, approximately 60% to 70% of DTC's annual revenues represented fees charged for services provided to the CTF.

Accepting the SEC's characterization of the facts, its conclusions are logical given its historical interpretive positions. The SEC traditionally has targeted so-called "short-form" trusts designed to create trust relationships that are valid under state fiduciary laws, but whose only ostensible purpose and function is to facilitate participation in common trust funds. Based on its past precedents and the particular facts in Dunham & Associates, however, one gets the impression that it is the manner in which trust accounts and common trust funds are offered or made available to prospective customers, rather than the particular type or nature of trusts, that weighs—or should weigh—most heavily in the SEC's assessment of compliance with Section 3(c)(3).

In short, the SEC could have reached the same result in Dunham & Associates by focusing on the specific facts, without the need for a broad statement questioning the eligibility of revocable trusts categorically to participate in common trust funds. Although the SEC tempered its statement by indicating that revocable trusts "generally" are not created for fiduciary purposes, its analysis nonetheless introduces an element of uncertainty.

Marketing Activities. Finally, the SEC stated that DTC's marketing of the CTF was not consistent with Section 3(c)(3). As noted above, Section 3(c)(3) on its face permits advertising of common trust funds to the general public (a provision the SEC no doubt would construe very narrowly), but only if it is done in connection with the "ordinary advertising of the bank's fiduciary services." In this case, DTC allegedly "marketed and sold interests in" the CTF "as an alternative to registered mutual funds." In addition, the CTF's "marketing materials made only a general reference to DTC's fiduciary services not associated with investment in" the CTF. As discussed below, this promotional activity not only contravened Section 3(c)(3) with respect to the CTF, but also undercut Dunham's reliance on exemptions otherwise applicable to the LPs.

THE LPS

The SEC found several problems with Dunham's reliance on 1940 Act Section 3(c)(1) with respect to the LPs. For one thing, interests in the LPs were marketed and sold "nationwide" through the broker/adviser network as well as DAIC's internal marketing staff. LP interests also were offered through the same network to non-accredited investors who invested through the CTF. In the SEC's view, these facts demonstrated that, contrary to Section 3(c)(1)'s proscription of any public offering, interests in the LPs were "publicly offered."

The SEC also asserted that each of the Stock Fund LPs had more than 100 beneficial owners and thus was not entitled to rely on Section 3(c)(1). The SEC based this conclusion on the "look-through" rule of 1940 Act Section 3(c)(1)(A), which provides that if an investment company (or a company itself excepted under Section 3(c)(1) or 3(c)(7)) owns 10% or more of the outstanding voting securities of a Section 3(c)(1) entity, each of the company's beneficial owners is counted in determining the number of beneficial owners of the Section 3(c)(1) entity. Common trust funds normally are not subject to this "look-through" provision since they are excluded from the definition of "investment company" under the 1940 Act pursuant to Section 3(c)(3) and not Sections 3(c)(1) or (7). However, since the CTF itself was, in the SEC's view, not entitled to rely on Section 3(c)(3), the look-through rule applied to the trusts investing in the LPs through the CTF. Consequently, each of the trusts participating in the CTF must be counted in determining the number of the LPs' beneficial owners, with the result that the LPs had well over 100 beneficial owners.

CONCLUSION

The saying goes, "bad facts make bad law," and enforcement proceedings often reflect strict regulatory positions applied in the context of particularly negative facts. This case is no exception.

The SEC's analysis of 1940 Act Section 3(c)(1) is not particularly surprising or controversial. Its statements about Section 3(c)(3), however, are likely to generate a good deal of discussion, if not concern.

The merits of the SEC's views on many of the issues surrounding Section 3(c)(3) have never been tested or confirmed by a court. Nonetheless, the Dunham & Associates order signals that the SEC has no intention of relaxing its traditionally strict and narrow construction of the common trust fund exemptions. Given the context and the limited precedential value of enforcement proceedings, we

think the legal analysis in Dunham & Associates should be confined to the particular facts of the case. At the same time, however, the SEC's hard-line position underscores the need for banks to take such interpretations into account in designing common trust fund structures and, perhaps more importantly, the manner in which common trust fund interests are offered or made available to trust clients.

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Lawyers of Kirkpatrick & Lockhart Nicholson Graham LLP's Investment Management and Financial Institutions practice groups advise banks, trust companies, hedge fund managers and registered investment companies about a wide range of regulatory and transactional matters. We are available to work with clients in assessing the implications resulting from Dunham & Associates and related matters on request.

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