SEC ENFORCEMENT ACTION CITES BANK FOR OPERATING COLLECTIVE INVESTMENT FUNDS AS UNREGISTERED INVESTMENT COMPANIES: KEY TAKEAWAYS FOR BANKS AND ADVISERS

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Banks and trust companies maintaining collective investment funds (CIFs) took notice when the U.S. Securities and Exchange Commission (SEC) announced enforcement proceedings on 30 September 2020 against Great Plains Trust Company, Inc., a Kansas state-chartered trust company (Great Plains).[1] In a "bad facts; bad outcome" situation, the SEC found that Great Plains operated its CIFs as unregistered investment companies in violation of the Investment Company Act of 1940 (1940 Act) and the Securities Act of 1933 (1933 Act). Specifically, the SEC concluded Great Plains failed to satisfy the requirements of 1940 Act exclusions and corresponding 1933 Act exemptions (collectively, Exemptions) for CIFs "maintained by a bank."[2] According to the SEC, the primary issue stemmed from Great Plains' failure to "exercise substantial investment authority" over the CIFs.

The SEC also asserted that Great Plains could not rely on the Exemptions for its common trust funds for the additional reason that those funds consisted principally of revocable trusts and were advertised to the general public as investment vehicles.

For context, the SEC's order in the Great Plains proceedings should be read together with the separate enforcement action against Great Plains' affiliated (commonly owned) registered investment adviser, Kornitzer Capital Management (Adviser), announced approximately nine months earlier.[3] The SEC in that case sanctioned the Adviser for violations of the Investment Advisers Act of 1940 relating to some of the same CIFs, including the Adviser's failure to follow CIF investment guidelines and Great Plains' directions related thereto.

These actions do not further define the term "maintained by a bank" or what it means to "exercise substantial investment authority;" however, they are an important reminder of the importance of these terms, and an opportunity, for banks maintaining CIFs, as well as investment advisers retained to provide advisory services to CIFs, to review their current processes, policies and procedures to confirm that they provide an adequate structure to maintain compliance with the Exemptions.

"MAINTAINED BY A BANK"

The Great Plains action marks the first time since 2006 that the SEC has published a formal interpretation of the "maintained by a bank" requirement of the Exemptions. The action also is noteworthy for an SEC commissioner's dissent (Dissent), which questioned whether enforcement action, rather than issuing interpretative guidance after working with state and federal banking regulators regarding what it means to be "maintained by a bank," was the appropriate means to address the SEC's concerns, particularly given the lack of clear regulatory guidance on the subject.[4]

There is nothing in the Exemptions themselves or their legislative histories that mandates a particular level or type of investment activity for a bank maintaining a CIF. The SEC, on the other hand, through releases, no-action letters, and various other pronouncements of its staff, some dating back to the 1970s, has taken the position that a bank "maintaining" a CIF must exercise investment responsibility at a level sufficient to be subject to regulation by the banking regulators. In its 1980 release on employee benefit plans,[5] the SEC staff stated that, in order to "maintain" a CIF, a bank must exercise "substantial investment responsibility" over the CIFs and that a bank would not satisfy the requirement if it acts merely in a custodial or similar capacity. Citing earlier no-action letters, the SEC staff noted that a bank could retain an investment adviser to assist it in managing a CIF, but "the final decision whether or not to invest must be made by the bank.[6]

In the Great Plains situation, the trust company engaged the Adviser to provide investment advisory services to the CIFs. Although under the agreements with the Adviser, Great Plains retained ultimate investment authority over the CIFs, and the Adviser in fact conducted all day-to-day discretionary investment activities for the CIFs with very little (or, according to the enforcement order, only "cursory") oversight by Great Plains. The SEC's investigation and subsequent enforcement proceedings were apparently triggered by "substantial losses" suffered by four of the CIFs as a result of the Adviser's concentration of CIF investments in securities of a single issuer (the concentration in one case reaching close to 90% of one of the CIF's assets). The Great Plains board attempted for more than two years to force the Adviser to reduce the concentration, but to no avail. The Adviser resisted Great Plains' requests to reduce the concentration, citing market conditions and other investment considerations, and only capitulated after a change in management at the Adviser. By then, the damage had been done; private litigation instituted by CIF shareholders against Great Plains and the Adviser and regulatory enforcement proceedings followed.

The SEC found that Great Plains failed to meet the standard of exercising substantial investment responsibility over the Funds, thereby disqualifying Great Plains from relying on the Exemptions. In settling the matter, Great Plains paid a $300,000 civil penalty and was issued a cease and desist order. The dissenting commissioner issued a public statement (a highly unusual event) criticizing the use of enforcement to address the SEC's concerns. The commissioner noted the "enormous amount of uncertainty" as to what constitutes exercising "substantial investment responsibility" over a CIF, especially where a bank employs an investment adviser. According to the commissioner, the SEC instead should have collaborated with bank regulators to provide more definitive guidance as to what banks need to do in order to satisfy the "maintained" requirement.

COMMON TRUST FUND ISSUES

With respect to Great Plains' common trust funds, the SEC asserted two additional substantive deficiencies that prevented Great Plains from relying on the Exemptions. First, Great Plains allowed a significant number of revocable trusts to participate in the funds (noting that more than 80% of the trusts in the funds during 2015 to 2019 were revocable). Second, Great Plains' website stated that it "offers a number of individual investment options, including private [common trust funds]" and provided a link to "detailed investment objectives and strategies" for each of the funds. Great Plains also "marketed the common trust funds directly to its own clients, including many clients with revocable trusts."

On these facts, the SEC concluded Great Plains did not satisfy two primary requirements of the common trust fund Exemptions. The requirement that a bank employ common trust funds "solely as an aid to the administration of trusts . . . created and maintained for a fiduciary purpose" was not satisfied because, in the SEC's view, revocable trusts are "generally not established for a fiduciary purpose."[7] The SEC also concluded the information included on Great Plains' website violated the Exemptions' restrictions on common trust fund advertising.[8]

KEY TAKEAWAYS

As noted, SEC's actions are a good reminder that CIF management procedures are important, and that banks, trust companies, and investment advisers should not ignore the requirement under the Exemptions that CIFs be "maintained by a bank." However, the two related enforcement proceedings are notable in that they do not provide further clarity to the industry regarding what it means to be "maintained by a bank" or to "exercise substantial investment authority." As such, there remains uncertainty regarding what types of processes, polices or procedures are necessary to comply with the Exemptions, particularly when the bank or trust company engages a third party investment adviser. Notwithstanding this uncertainty, the issuance of the two related enforcement proceedings present a good opportunity and reminder for banks, trust companies, and investment advisers to do a "health check" of their processes, policies and procedures, particularly those relating to investment decision making where the bank uses an investment adviser or another third party to implement the investment strategy of the CIF. The content of the policies and procedures, and whether any modifications are necessary or advisable to current processes, will depend on the facts and circumstances of each institution. The common elements of all such policies and procedures, however, should include substantial investment authority exercised by bank or trust company personnel at least through monitoring of the investment adviser. The enforcement action against the Adviser also is a reminder that responsibility for compliance with the Exemptions lies not only with the bank or trust company but with the investment adviser as well. As such, it makes sense for investment advisers providing services with respect to the CIFs to review their policies, procedures and processes for CIF management.

The scope of any review of CIF management policies and procedures should encompass, in addition to SEC's interpretations of the Exemptions, pronouncements of other regulatory authorities. These include, primarily, Regulation 9 of the Office of the Comptroller of the Currency, which expressly allows a national bank maintaining a CIF to delegate investment responsibility where it is prudent to do so; state banking laws, which in most cases defer to or are consistent with Regulation 9, U.S. Department of Labor interpretations relating to prohibited transaction exemptions for CIFs under ERISA; and the Internal Revenue Service interpretations relating to common trust funds under Internal Code Section 584.

The persons listed below may be contacted for additional information or assistance.

FOOTNOTES

[1] In the Matter of Great Plains Tr. Co., Inc., Securities Act of 1933 Release No. 10869 (Sept. 30, 2020), Inv. Company Act of 1940 Release No. 34037 (Sept. 30, 2020). The SEC order is available here.

[2] *See* Investment Company Act of 1940, section 3(c)(3) and Securities Act of 1933, Section 3(a)(2) (5th clause) regarding common trust funds, and 1940 Act Section 3(c)(11) and 1933 Act Section 3(a)(2) (7th clause) regarding collective trust funds for employee benefit trusts.

[3] In the Matter of Kornitzer Cap. Mgmt., Inc. & John C. Kornitzer, Inv. Advisers Act of 1940 Release No. 5416 (Dec. 10, 2019).

[4] SEC, Statement of Commissioner Hester M. Peirce (Oct. 2, 2020). The statement is available here.

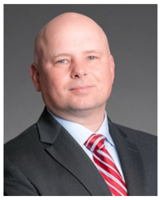
[5] SEC, Release No. 33-6188 (Feb. 1, 1980). The release is available here.

[6] *Id*, citing First Liberty Real Est. Fund, SEC No-Action Letter (Jun 12, 1975) and Sterling Nat'l Bank & Tr. Co. of New York, SEC No-Action Letter (Feb. 10, 1976).

[7] In support of this position, the SEC cited its earlier enforcement action in In Re Dunham, Securities Act Release No. 8740 9 (Sept. 22, 2006). See William P. Wade and Donald W. Smith, *SEC Enforcement Action Targets Common Trust Fund*, INVESTMENT LAWYER (Nov. 2006) (discussing *In Re Dunham* enforcement action).

[8] *See* Investment Company Act of 1940, Section 3(c)(3) ("except in connection with the ordinary advertising of the bank's fiduciary services, interests in . . . [a common trust] fund [may] not [be] . . . advertised; or offered for sale to the general public . . . ").

KEY CONTACTS



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