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Legal Update

Wake-Up Call? SEC Enforcement Action Against Trust Company for Unregistered Collective Trust Funds

The US Securities and Exchange Commission ("SEC") recently announced a settled administrative proceeding against a non-depository Kansas state-chartered trust company (the "Bank") for, among other things, operating unregistered investment companies in violation of the Investment Company Act of 1940 (the "1940 Act") and for the public offer and sale of investments in collective trust funds (the "Collective Funds"), as well as common trust funds (the "Common Trust Funds" and, with the Collective Funds, the "Funds"), in violation of the Securities Act of 1933 (the "Securities Act").[1]

The Bank asserted that its Collective Funds were excepted from the definition of "investment company" under Section 3(c)(11) of the 1940 Act. This section provides an exception for any collective trust fund "maintained by a bank" that consists solely of assets of one or more employee stock bonus, pension or profit-sharing trusts that meet the requirements for qualification under section 401 of the Internal Revenue Code of 1986 or governmental plans described in section 3(a)(2)(C) of the Securities Act. According to the SEC, the "maintained by" element of the exception requires that the bank have and exercise "substantial investment responsibility" when managing the collective trust funds.[2]

The Bank also contended that its Common Trust Funds qualified for the exception from the definition under Section 3(c)(3), which excepts, among others, a common trust fund "maintained by a bank" exclusively for the collective investment of moneys contributed to the fund by the bank in its capacity as a trustee, executor, administrator or guardian. To rely on this exception, the common trust fund must be employed by the bank solely as an aid to the administration of trusts, estates or other accounts created and maintained for a fiduciary purpose. Consistent with this, 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.

The Bank did not prevail.

Facts and SEC Findings

The Bank, regulated by the Office of the State Bank Commissioner of Kansas, sponsored and organized the Funds, and acted as their trustee, administrator and custodian. The Bank's five-member board of trustees (the "Board") was ultimately responsible for the Funds, including the oversight of an affiliated investment adviser (the "Adviser"), which provided investment advisory services to the Funds since their inception.

Among the services the Adviser provided to the Funds was portfolio management.[3] In an earlier action against the Adviser, the SEC alleged that the Adviser had failed to follow client instructions and had failed to adopt or implement reasonably designed written policies and procedures connected to client objectives and restrictions. Specifically, the Adviser invested the Funds in the securities of a single issuer that consisted between 30 percent and 89 percent of the assets held by any one Fund. These holdings were maintained even after the Board directed the Adviser to reduce the Funds' holdings of the single issuer to less than 10 percent of each Fund's assets. While the Adviser eventually reduced the holdings to satisfy the 10 percent threshold, the Funds suffered significant losses as a result of the Adviser's actions.

Although the Bank met the definition of "bank" in the 1940 Act, the SEC found that the Bank did not maintain the Funds as required by Sections 3(c)(3) and 3(c)(11). Specifically, the Collective Funds failed to satisfy the "maintained" by a bank requirement because the Bank did not exercise substantial investment responsibility over the Collective Funds. According to the SEC, the Bank engaged in "minimal oversight" of the Adviser and failed to exercise its own investment responsibility. The SEC also found that the Common Trust Funds did not qualify for the Section 3(c)(3) exception. Like the Collective Funds, the Common Trust Funds failed to satisfy the "maintained" by a bank requirement because the Bank did not exercise substantial investment responsibility over the Common Trust Funds. Specifically, according to the SEC:

- Although the Bank retained ultimate investment control over the Funds, the Adviser performed all investment activities for the Funds, including conducting due diligence, selecting investments, purchasing and selling investments, monitoring the investment portfolios for performance and risks and changing investment strategies.
- The SEC alleged that the Board engaged in minimal oversight of the Adviser and failed to exercise substantial responsibility over the Funds. The SEC focused on the following:
  - The Board received quarterly reporting materials from the Adviser for each Fund, but the reviews were cursory.
  - The Board met once a year with a representative of the Adviser to discuss the Funds, but these meetings focused on the Board merely receiving information rather than having an active role in managing and exercising investment responsibility for the Funds.
  - Further, the annual meetings rarely resulted in any changes to the Funds or any feedback regarding Adviser's management strategy.
  - In those cases where the Board requested changes (such as requiring reduced concentrations of an investment in certain Funds), the Board repeatedly failed to act in a timely manner so that the changes were actually implemented.
  - The Board's failures to require the Adviser to comply with concentration limits mandated by the investment policies of the Funds within a reasonable timeframe resulted in substantial losses in certain Funds.

In the case of the Common Trust Funds, there were additional failures. The Bank did not employ the Common Trust Funds solely as an aid to the administration of trust accounts maintained for a fiduciary purpose because the Bank permitted revocable trusts to invest in the Common Trust Funds, and these trusts are generally not established for a fiduciary purpose.[4] Lastly, the Bank also advertised the Common Trust Funds for sale to the general public. The Bank broadly advertised the Funds' investment strategies and objectives on its website, beyond the ordinary advertising of the bank's fiduciary services.[5]

To add insult to injury, because the Funds did not qualify for these 1940 Act exceptions, they also did not qualify for an exemption from registration under Section 3(a)(2) of the Securities Act or for any other exemption from registration thereunder.

SEC and Staff Guidance

In the Release (from 1980), the SEC provided the following guidance on the "maintained by" element of Section 3(c)(11):

> The word "maintained" has been interpreted by the Staff to mean that the bank must exercise "substantial investment responsibility" over the trust funds administered by it. Thus, a bank which functions in mere custodial or similar capacity will not satisfy the "maintained" requirement.

The Release also states that a bank could "hire an investment adviser to assist" so long as "the final decision whether or not to invest [is] made by the bank."

Numerous no-action letters followed the Release, and most are quite dated. In some letters, the bank could solicit advice and recommendations on the fund's management from outside sources and retain a sub-adviser for these purposes, but the bank must bear sole responsibility for the final decisions on investments.[6] In another letter, Section 3(c)(11) was available where a collective trust fund's investment adviser was an indirect majority-owned subsidiary of a bank and subject to the bank's immediate and direct influence.[7] Given the quite fact-specific staff guidance over the years, it is notable that in this proceeding, the SEC did not voice criticism about the Bank for delegating day-to-day investment decision making to the affiliated adviser.

An SEC enforcement action followed in 2006. This was a settled administrative proceeding involving Section 3(c)(3). According to the SEC, the common trust funds did not satisfy the requirements of that exception because, among other things, the trust company did not "maintain" the common trust funds as required by Section 3(c)(3). The SEC stated that the "maintained" provision requires that a bank have and exercise "substantial investment responsibility" with respect to a common trust fund, citing to the Release. The SEC found that the trust company exercised no investment responsibility over the common trust funds and, at most, the trust company conducted an initial and an annual review of the common trust fund investor accounts.

However, the most recent SEC or staff focus on the "maintained by" element appears to have been in 2010, during a speech by the then-current director of the SEC's Division of Investment Management, who stated, in part:

> The premise underlying [the Section 3(c)(11)] exclusion is that banks exercise full investment authority over the pooled assets, among other things. As collective investment trusts become more popular and their structures more varied, the Division is looking at whether, under certain conditions, this exemption is properly relied upon and consistent with the Act and whether it denies investors appropriate protections. For example, are banks operating merely in custodial or similar capacity while providing a place for an adviser to simply place pension plan assets of its clients? As we learn more about the structure and operation of these platforms, we will be considering this and other issues and whether there may be a need for any regulatory recommendations.

There were no formal or public regulatory recommendations following that speech.

Commissioner Dissent

A few days after the administrative proceeding against the Bank was published, Commissioner Hester Peirce published a pointed dissent.[8] In sum, the crux of her dissent appears to be as follows:

- To date, the SEC has not spoken directly to the question of what it means to be "maintained by a bank."
- The only SEC guidance is from the Release (recall, this was published back in 1980), which identifies two scenarios where the staff would conclude that the bank did not maintain the trust: where it acted only as a custodian and where it delegated to a third party, such as an investment adviser, the final decision to invest.[9]
- There is an enormous amount of uncertainty as to precisely what constitutes exercising substantial investment responsibility, especially in those instances where the bank employs an investment adviser.
- This enforcement action provides guidance, but such an action is an inappropriate way for a regulator to communicate its interpretation of the law.
- Using an enforcement action to communicate with entities that the SEC does not directly regulate (recall that the Bank's primary regulator is the Kansas banking authority) is concerning, especially when alleged failures would pose a question of great importance to the Bank's primary regulator.
- The SEC could have handed the matter off to the banking regulators or could have consulted with bank regulatory colleagues. In fact, Commissioner Peirce recommended that the SEC should have convened a working group with state and federal bank regulators to define the scope of the exception and issue interpretive guidance to aid banks in determining what they need to do to qualify for the exception.

The Bank Regulatory Perspective

Some may wonder, as Commissioner Peirce did, why the SEC would bring an enforcement action against a bank (as defined by the 1940 Act), particularly when the SEC Director of Investment Management said in 2010 that "[c]ollective investment trusts are regulated by the banking agencies."[10] Below we have a few thoughts:

- As discussed above, the exception for collective trust funds that are maintained by a bank is in the 1940 Act. Unlike other areas of securities law, the SEC has sole authority to interpret these provisions of the 1940 Act. Additionally, banks may be subject to SEC regulation in other areas of investment management law.[11] Accordingly, one might argue that the SEC serves as the gatekeeper in ascertaining which collective trust funds may be regulated by the banking agencies.
- National banks are subject to the Office of the Comptroller of the Currency's ("OCC") extensive body of law and supervisory expectations regarding collective investment funds.[12] While the OCC's guidance may inform industry practices, it was not at issue here and it is not binding on the SEC or controlling with respect to compliance with the 1940 Act on the part of state-chartered banks.[13]
- State banks may be subject to the OCC's body of law on collective investment funds, either under state laws expressly or implicitly adopting similar requirements or because the banks wish to obtain favorable tax treatment for a common trust fund.[14] Again, however, the OCC's body of law would not be controlling on the SEC's actions but does address similar concepts, such as "maintained by a bank."
- It is unclear if the Bank's conduct would have satisfied the OCC's requirements for supervision of the delegation of investment management to an investment adviser. The SEC's order indicates that bank supervision (particularly by the Board) was lacking (e.g., "minimal oversight"), which would be

consistent with a failure under the OCC's guidance but does not describe more generally how the Bank's third-party risk management program was operated.

- The Bank is a non-depository state-chartered trust company that is primarily regulated by the Office of the State Bank Commissioner of Kansas. There is no federal banking regulator for the Bank, and, therefore, the SEC may have been less concerned that it would infringe on the "turf" of a fellow federal regulator.

Conclusion

One may be tempted to dismiss this administrative proceeding as simply a bad set of facts compounded by significant investor losses. After all, the lack of diligence and oversight by the Bank appears to be egregious. Further, as discussed above, this proceeding followed an administrative proceeding against the Adviser at the end of 2019. But banks and advisers involved in the operation or maintenance of collective or common trust funds should carefully consider this development and their level of oversight. Often, one case will reposition regulatory attention to other, similar cases. Banks and advisers involved with common trust or collective trust funds would be wise to carefully review the oversight, reporting, allocation of investment authority and related processes and practices they have in place for these type of funds.

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Endnotes

[1] *Investment Company Act Release No. 34037* (Sept. 30, 2020), https://www.sec.gov/litigation/admin/2020/33-10869.pdf.

[2] *See Employee Benefit Plans*, Securities Act Rel. No. 6188 (Feb. 1, 1980) [Release].

[3] The facts relating to the Adviser's actions are derived from a separate enforcement action that the SEC brought against the Adviser in December 2019. *See* Press Release, *SEC Charges Investment Adviser and CEO for Disregarding Client Instructions* (Dec. 10, 2019), https://www.sec.gov/enforce/ia-5416-s.

[4] Securities Act Release No. 8740 (Sept. 22, 2006) [2006 Proceeding].

[5] *See* 2006 Proceeding.

[6] *See, e.g., The Provident Bank*, SEC Staff No-Action Letter (publicly avail. Sept. 24, 1991) (the bank will make the final decision as to specific investment to be purchased and will have the sole authority to select the investments for the funds, citing to the Release); *Citytrust*, SEC Staff No-Action Letter (pub. avail. Feb 12, 1988); *National Bank of Commerce Investment Fund*, SEC Staff No-Action Letter (pub. avail. Oct. 10, 1986); *Frank Russell Trust Company*, SEC Staff No-Action Letter (pub. avail. Sept. 2, 1982); *Frank Russell Trust Company*, SEC Staff No-Action Letter (pub. avail. Aug. 25, 1980); *First Liberty Real Estate Fund*, SEC Staff No-Action Letter (pub. avail. July 14, 1975)). *See also Traders National Bank of Kansas City*, SEC Staff No-Action Letter (publicly avail. March 25, 1978) [Traders] (the decision to invest or not to invest in a particular investment, and the selection of the particular investment, is within the sole discretion of the bank as trustee).

[7] *See The Philadelphia National Bank*, SEC Staff No-Action Letter (publicly avail. Nov. 2, 1975) (the investment adviser is a wholly-owned subsidiary of direct parent, 80 percent of the outstanding voting stock of which, in turn, is owned by the bank; senior executive officers of the bank are active members of the board of directors of the investment adviser; through this structure, the bank exercises immediate and essentially direct influence over the adviser's activities; the bank's discretion in retaining its investment adviser subsidiary, or any other such agent, would be subject to the overriding requirement, stated explicitly in the trust agreement and mandated by federal banking regulations, that the collective trust fund at all times be subject to the bank trustee's exclusive ultimate management).

[8] *Statement of Commissioner Hester M. Peirce - Great Plains Trust Company* (Oct. 2, 2020), https://www.sec.gov/news/public-statement/peirce-dissent-great-plains-2020-10-01.

[9] As mentioned above, there has been "no-action" guidance from the SEC staff.

[10] Andrew J. Donohue, *Remarks Before the Practising Law Institute's Investment Management Institute 2010* (Apr. 8, 2010).

[11] *See, e.g.,* 15 U.S.C. § 80b-2(a)(11) (subjecting separately identifiable departments and divisions of banks to regulation as investment advisers).

[12] *See, e.g.,* OCC, *Collective Investment Funds*, https://www.occ.treas.gov/topics/supervision-and-examination/capital-markets/asset-management/collective-investment-funds/index-collective-investment-funds.html.

[13] However, non-depository trust companies may want to consider the OCC's and other federal banking agency guidance, particularly with respect to third-party risk management, to bolster the way in which they manage risk related to third-party relationships, including investment advisers to a collective investment fund. *See, e.g.,* OCC Bull. 2011-11, *Risk Management Elements: Collective Investment Funds and Outsourced Arrangements* (Mar. 29, 2011); OCC Bull. 2013-29, *Third-Party Relationships: Risk Management Guidance* (Oct. 30, 2013).

[14] *See* OCC Interp. Ltr. No. 865, n.1 (May 26, 1999).

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