ROPES & GRAY

ALERT

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SEC Brings Suit against Independent Trustees, Adviser and Registered Fund Officers

On May 5, 2023, the SEC filed a civil complaint in the U.S. District Court for the Northern District of New York against a mutual fund's adviser for aiding and abetting violations of Rule 22e-4 (the "Liquidity Rule") by the mutual fund it advised (the "Fund") and whose Liquidity Risk Management Program ("LRMP") it administered. The complaint also claims that the Fund's two independent trustees, the Fund's portfolio manager and the Fund's CCO, aided and abetted the Fund's Liquidity Rule violations.

The action is the first-ever case concerning enforcement of the Liquidity Rule, which prohibits a mutual fund or ETF from investing more than 15% of its net assets in illiquid investments and requires funds to adopt an LRMP to assess and govern their liquidity risks. If a mutual fund or ETF's illiquid investments exceed the 15% limit, the Liquidity Rule requires the fund to promptly take remedial action.

In its complaint, the SEC alleges the following:

In General

1. From June 2019 through June 2020, the Fund held approximately 21% to 26% of its net assets in illiquid investments. The largest illiquid investment held by the Fund consisted of a medical-device issuer's shares (the "Company Shares") that the Fund acquired between 2007 and 2009 in private placement transactions.

2. The Fund's two independent trustees made up the Board's Valuation Committee and Audit Committee, and both committees typically met in executive session each quarter with the defendant Fund CCO and the Fund's counsel. As members of these two committees, the two independent trustees were responsible for, among other things, valuing the Company Shares and meeting with the Fund's auditor at the conclusion of every annual audit.

3. Through their valuation work on the Company Shares, the independent trustees knew that the Company Shares were illiquid because the Company Shares were subject to legal and contractual restrictions on transfer.

4. The portfolio manager and Fund CCO defendants also knew that the Company Shares were illiquid. On June 11, 2018, the Fund filed its annual report on Form N-CSR for the year ended March 31, 2018. In the report, signed by the portfolio manager and Fund CCO defendants, the Fund stated that the Company Shares, which represented more than 20% of the Fund's net assets, were illiquid securities.

Events Leading up to the Resignation of the Fund's Counsel

1. In 2018 and early 2019, the Fund's counsel repeatedly advised the Fund Board and the adviser of the Liquidity Rule's requirements and urged them to develop a strategy to comply with the 15% illiquid limit. In a February 2019 memo to the Board, Fund counsel reminded the Board that the Fund would be required to approve and put into operation an LRMP on or before June 1, 2019 and that the Board would have oversight responsibility for the LRMP. At the Board's March 2019 Board meeting, Fund counsel again reminded the Board and the adviser that the Fund was "well over" the 15% illiquid investment limit.

2. In response to questions from the SEC staff, in letters dated April 2, 2019 and May 17, 2019, the Fund told the SEC staff that that the Company Shares were an illiquid investment "as that term is defined in Rule 22e-4." The Fund's sole interested trustee worked with Fund counsel and the adviser to prepare the letters.

3. In late May 2019, the interested trustee informed the adviser that the Fund could claim the Company Shares were "less liquid" (as opposed to "illiquid") based on factually spurious grounds. The adviser, counseled by the interested trustee, decided that the Fund would classify the Company Shares as less liquid rather than illiquid under the Liquidity Rule based upon the portfolio manager's manufactured assertion that he could sell the shares within seven days because customers of the Fund's affiliated broker-dealer had purportedly expressed interest in buying the shares.

4. On May 31, 2019, Fund counsel emailed the adviser and the interested trustee with a recommendation that the Fund classify the Company Shares as illiquid due to the legal and contractual transfer restrictions on the Company Shares.

5. On June 2, 2019, Fund counsel circulated a draft LRMP to the trustees, noting that the portfolio manager and Fund CCO defendants had only asked her two days earlier to provide the draft. The draft LRMP stated that "[w]hile the Board of Trustees has appointed the Administrator to implement the Program, the Board of Trustees acknowledges that it has oversight responsibility for this Program as well as general oversight responsibility for the risks attendant to operations of the Fund."

6. On June 10, 2019, against the advice of Fund counsel, the portfolio manager and Fund CCO defendants and the interested trustee had the Fund send the SEC staff a letter, signed by the portfolio manager, stating that the Fund's LRMP administrator concluded that the Company Shares were a less liquid investment. The letter contained false and incomplete information to justify the less liquid classification of the Company Shares.

7. On June 11, 2019, Fund counsel sent a revised LRMP to the portfolio manager and Fund CCO defendants. In her email, Fund counsel commented that she had not realized until June 10 that the re-classification of investments currently classified as illiquid would occur without a discussion of the Board. She also strongly encouraged the adviser to discuss these issues with the Board at the meeting scheduled for June 14.

8. The June 14, 2019 Board meeting was attended by all defendants. Before any agenda item was discussed, Fund counsel announced her resignation and distributed a letter of resignation. Fund counsel then met privately with the independent trustees. In the full Board meeting, the independent trustees declined to disclose what they had privately discussed with Fund counsel.

9. At the meeting, the independent trustees were required to meet in an executive session with the defendant Fund CCO as independent trustees and as members of the Valuation Committee and Audit Committee. At the CCO's recommendation, the independent trustees decided not to hold the executive session.

10. Notwithstanding Fund counsel's advice that the full Board discuss changing the classification of the Company Shares from illiquid to less liquid, there was no discussion concerning the change in classification at the June 14, 2019 meeting.

11. At the meeting, the defendant Fund CCO informed the Board that the less liquid classification for the Company Shares had been "presented to the SEC," and that he and the portfolio manager defendant would "present the classification," as well as discuss the LRMP, at the September 2019 board meeting. In addition, the Board appointed the adviser as administrator of the LRMP, effective June 3, 2019, and approved the administrator's delegation of responsibility for implementing the LRMP to the portfolio manager and Fund CCO defendants.

Liquidity Discussions after Fund Counsel Resigns

1. On September 13, 2019, the Board met at the adviser's offices for its regularly scheduled quarterly meeting, which included the interested trustee providing the sequence of events that led to the less liquid classification for the Company Shares. One of the independent trustees stated that the Fund's auditor, which was not present at the meeting, had opined to him that the Company Shares were illiquid.

2. On December 20, 2019, following a conference call in which the Board and new Fund counsel participated, the interested trustee, on behalf of the Board and new Fund counsel, requested that the administrator (*i.e.*, the portfolio manager and Fund CCO defendants) provide a memorandum explaining the adviser's position regarding the liquidity classification of the Company Shares.

3. On December 22, 2019, the portfolio manager and Fund CCO defendants sent a memorandum to the Board regarding the liquidity classification of the Company Shares. The memorandum described fictitious potential buyers of the Company Shares and, in general, repeated the false and incomplete information in the Fund's June 10, 2019 letter to the SEC staff. The memorandum stated that the portfolio manager and Fund CCO defendants had concluded that the Company Shares satisfy the requirements of the less liquid classification under the Liquidity Rule.

4. On December 30, 2019, the Fund's new legal counsel had a phone call with the Fund's auditors to discuss the liquidity classification, at which time the auditors continued to express their belief that the Company Shares were illiquid.

5. At the Board's February 21, 2020 meeting, the Fund's new legal counsel advised that the Fund needed to consider classifying the Company Shares as illiquid. The minutes from the Board meeting do not reflect any decision made to reclassify the Company Shares as illiquid investments.

Fund Auditor Resigns

1. On April 23, 2020, the Fund's auditor resigned due to concerns about the valuations of the Company Shares and material weaknesses in the Fund's internal controls based on the defendant Fund CCO's "gross negligence" in performing asset diversification tests in 2018 and 2019, resulting in the Fund losing its tax status under the Internal Revenue Code over a period of six months.

2. The auditor stated that the Fund's refusal to follow Fund counsel's advice on the liquidity classification for the Company Shares was an additional consideration in the auditor's determination of a weakness in Fund internal controls and in the auditor's decision to resign.

The Fund Changes the Liquidity Classification

1. In May and early June 2020, the Fund's new counsel twice reminded the portfolio manager and Fund CCO defendants to determine whether the Fund needed to file Form N-LIQUID and to discuss it with the Board. The portfolio manager and Fund CCO defendants took no steps in response to new counsel's emails.

2. At some point between May 22 and June 2, 2020, the portfolio manager and Fund CCO defendants and the interested trustee decided that the Company Shares should be classified as illiquid.

3. On June 2, the Fund's new counsel emailed the defendant Fund CCO asking whether he had scheduled a call with the Board to discuss the Form N-LIQUID filing, necessitated by the illiquid classification of the Company Shares.

4. On June 16, 2020, the Fund filed a Form N-LIQUID with the SEC in which the Fund stated that its illiquid investments exceeded 15% of net assets on February 21, 2020 and that 24% of its net assets were then illiquid, consisting entirely of the Company Shares. On the same day, the defendant Fund CCO emailed the Board informing them of the filing.

The Fund Liquidates and Deregisters

On June 30, 2020, the interested trustee spoke with the SEC staff by phone, and the SEC staff expressed their concern that the Company Shares were not accurately valued and, as a result, the net asset value for the Fund might not be accurate. Immediately after this call, the Fund stopped selling shares. On August 28, 2020, the Board approved a wind-down proposal for the Fund, including the creation of a liquidating trust. On September 8, 2020, the Fund liquidated. The next day, the Fund filed a notice of deregistration with the SEC, which the SEC approved.

SEC Claims that the Defendants Aided and Abetted the Fund's Violations

The SEC complaint asserts the following aiding and abetting violations by the defendants:

a. Between December June 1, 2019 and June 15, 2020, the adviser and the portfolio manager and the Fund CCO defendants substantially assisted the Fund in classifying the Company Shares as less liquid instead of illiquid. They knew or recklessly disregarded that the Company Shares were illiquid and that there was no reasonable basis supporting a less liquid classification.

b. During the same period, the Fund did not review the liquidity classification of the Company Shares on a monthly basis as required by Section (b)(1)(ii) of the Liquidity Rule. Therefore, the adviser and the portfolio manager and CCO defendants substantially assisted the Fund's failure to comply with the Liquidity Rule and recklessly disregarded that the Fund was required to report to the Board any occurrence of the Fund's illiquid investments exceeding 15% of net assets within one business day of the occurrence as set forth in in Section (b)(1)(iv) of the Liquidity Rule.

c. Between December June 1, 2019 and June 15, 2020, the independent trustees, through failure of oversight, substantially assisted the Fund's classification of the Company Shares as less liquid. They knew or recklessly disregarded that the Company Shares were illiquid within the meaning of the Liquidity Rule, and that there was no reasonable basis supporting a less liquid classification.

d. In addition, "by failing to exercise reasonable oversight over the Fund's LRMP, the independent trustees violated their duties and responsibilities to the Fund." Therefore, the independent trustees knowingly or recklessly provided substantial assistance to the Fund with respect to its violations of the Liquidity Rule.[1]

Observations

Although this is the first enforcement action challenging compliance with the Liquidity Rule, the novel complaint serves as yet another reminder of the following foundational principles:

[1] In an order published on the same day that the SEC filed its complaint, the interested trustee settled an SEC administrative matter in which the SEC alleged substantially the same facts contained in the SEC's complaint. Without admitting or denying the findings in the SEC's order, the interested trustee agreed to be barred from industry employment for six months and to pay a fine of $20,000.

- Independent trustees are expected to serve as "independent watchdogs" in monitoring the fund's operations. Among other duties, a fund's board is expected "to monitor the conflicts of interest facing the fund's investment adviser and determine how the conflicts should be managed to help ensure that the fund is being operated in the best interest of the fund's shareholders."

- A fund trustee's duty of care includes a duty to be reasonably informed about an issue before making a decision, including inaction, concerning the issue. To become reasonably informed, a trustee is required to inform himself or herself of all material information concerning the issue that is reasonably available to the trustee. In becoming reasonably informed, a fund trustee may rely on reports provided by the adviser, auditors, fund counsel, the fund's CCO and any other experts, including committees of the Board, when making a decision, provided, however, the fund trustee is reasonable in his or her belief that the reports are trustworthy and proficient concerning the subject of the reports.

None of the foregoing should come as news to a current trustee, and some comfort can be drawn from the fact that the SEC's allegations in this case concerning the independent trustees indicate a very significant departure from the duty of care described above.

Separately, under the Liquidity Rule, a board is permitted to rely on an LRMP administrator. This "reliance" concept was established by the 2004 Compliance Rule, which mandated that funds have CCOs, and was subsequently extended by the SEC in the Liquidity Rule, the Derivatives Rule (creating a Derivatives Risk Manager) and the Fair Value Rule (creating a Valuation Designee). Moreover, the pattern is followed in the proposed swing pricing rule, which would create a Swing Pricing Administrator for boards to rely upon.

Thus, in monitoring a fund's operations, a fund trustee may rely on any of the designated subject matter experts permitted (and sometimes mandated) regarding matters under the relevant rule. However, as this case painfully reminds us, at some point, a fund trustee's continued reliance on a designated expert (and on a fund's adviser) may cease being reasonable.

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