

## SEC Enforcement on Common and Collective Trusts Catches Many by Surprise

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On October 1, 2020, the Securities and Exchange Commission (“SEC”) made substantial waves when it published a Cease and Desist Order (“Cease and Desist Order”) regarding the Great Plains Trust Company (“GPT”) that primarily focused on the level of oversight GPT had over its affiliated investment adviser Kornitzer Capital Management, LLC (“KCM”) acting as an adviser to certain common and collective trust funds. The Cease and Desist Order could have major ramifications for trustees of such funds who may delegate investment authority to others.

Specifically, the SEC’s Cease and Desist Order settled claims that GPT violated section 7(a) of the Investment Company Act of 1940 (“Investment Company Act”) for failing to register the funds with the SEC and section 5(a) of the Securities Act of 1933 (“Securities Act”) for selling interests in the funds without filing a registration statement. In reaching the positions described in the GPT Cease and Desist Order, the SEC claimed that GPT did not “maintain” the collective trust funds (“CITs”), as required by the Investment Company Act’s exemption from registration under section 3(c)(11), because GPT failed to exercise substantial investment authority over the trusts and provided minimal oversight over KCM. Similarly, the SEC claimed that the common trust funds (“Common Funds”) failed to qualify for the exemption under section 3(c)(3) of the Investment Company Act because (i) GPT failed to “maintain” the Common Funds when it provided minimal oversight over KCM, (ii) the Common Funds failed to maintain a fiduciary purpose when permitting revocable trusts to invest in the Common Fund, and (iii) GPT impermissibly advertised its Common Funds beyond the ordinary advertising of the bank’s fiduciary services.

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## Background

CITs and common funds exist at the crossroads of federal securities laws, state and federal banking laws, the Employee Retirement Income Security Act of 1974, as amended, (“ERISA”) and the federal tax code. To operate such funds, a bank must meet all of the requirements of its primary bank regulator, must employ a strategy to maintain the trust’s tax-exempt status, must be operated in compliance with ERISA and must either register under federal securities laws or qualify for applicable exemptions from registration (and in some cases, state “blue sky laws” may also be implicated). The intersection of these complex issues requires facility with all applicable laws. For instance, in order for a CIT or a common fund to function within each of these legal regimes, the fund must be “maintained” by a bank. Thus, when new developments arise around what this means, it is important to review them carefully.

Notably, the Cease and Desist Order is the first in many years to determine that a bank did not maintain a fund and the SEC has provided no recent interpretive guidance in this area. The primary guidance cited in the order is a release issued in 1980. While the SEC has issued several no-action letters regarding bank maintained CITs over the years – mainly in the 1980s - there has been no recent enforcement activity or guidance indicating that the SEC’s views have evolved regarding the requirements for the exemptions typically used by CITs and Common Funds. In 2006, the SEC took enforcement action against Dunham Trust Company and its affiliated adviser with respect to a set of Common Funds. In that order, the SEC determined that Dunham Trust Company’s account reviews were insufficient to establish that the trust company exercised substantial investment authority over the Common Funds. Several years later, in 2010, the Director of the SEC’s Division of Investment Management indicated that the Division’s enforcement staff was reviewing whether certain types of CITs in fact met the requirements for the Investment Company Act’s section 3(c)(11) exemption. This announcement was followed by a 2011 bulletin by the Office of the Comptroller of the Currency (“OCC”) specifically addressing the extent and types of oversight the OCC expects national banks to exercise over third party investment advisers. As CITs have grown in popularity, trustees continue to look to these sources to determine how to administer such funds in compliance with applicable banking laws and available exemptions from registration requirements under federal securities laws. Now trustees should also consider the SEC’s most recent action.

## Cease and Desist Order and Surrounding Facts

As noted above, the Cease and Desist Order described that GPT did not “maintain” the CITs and Common Funds in accordance with exemptions from registration described under sections 3(c)(11) and 3(c)(3) of the Investment Company Act because GPT did not have “substantial investment responsibility” over the CITs and Common Funds, as required under applicable SEC guidance. The SEC also took the position that the CITs and Common Funds failed to satisfy section 3(a)(2) of the Securities Act because the funds were not exempt from registration under the Investment Company Act.

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## GPT Oversight of Trusts

In reaching its conclusions in the Cease and Desist Order, the SEC described a structure that many of those within the collective fund space may find familiar. The Cease and Desist Order described that KCM performed all investment activities for the trust funds, including (i) performing due diligence, (ii) selecting investments on behalf of the trusts, (iii) purchasing and selling investments.

The SEC described GPT's board as providing "minimal oversight" of KCM. GPT received quarterly reports from KCM and met annually with a representative of KCM to discuss the funds. The SEC characterized GPT's review of the quarterly reporting materials as "cursory" and noted that the annual meetings "were focused on receiving information rather than having an active role in managing and exercising investment responsibility" for the funds. The SEC alleged that the annual reviews rarely resulted in changes to the trusts or provided feedback regarding KCM's strategy. The SEC noted that when GPT did request changes to the investment of the CITs or Common Funds, it failed to act timely resulting in a failure to implement the changes.

In a separate SEC action in December 2019 involving KCM, the SEC determined that, among other things, KCM caused the funds to hold high concentrations of equity and debt securities in a single company. In this order, the SEC outlined a much more detailed description of GPT's activities with respect to the funds. Specifically, during 2016-2018 GPT took the following steps:

- Q1 2016: GPT instructed KCM to develop a plan to reduce concentrations to 10% in 12-18 months;
- Q2 2016: GPT formally adopted new investment policies limiting concentrations of CIT assets to be invested in a single company. During the remainder of 2016, KCM reduced concentrations in each of the funds, but not as low as required by the IPS;
- Q2 2017: GPT again requested a plan from KCM regarding the timing and process to further reduce concentrations in the securities;
- Q3 2017: GPT requested in writing that KCM provide a plan for selling the securities. KCM instead extended the timeline to sell the securities;
- Q3 2017: GPT requested confirmation in writing from KCM that full compliance would be reached by February 2018 and requested that KCM make progress selling the securities in the near term. During this time the value of the securities was increasing, and therefore the securities grew as a percentage of the value of the funds;
- Q1 and Q2 2018: GPT engaged in ongoing discussions with KCM regarding concentrations in the securities; and
- Q3 2018: GPT requested that KCM replace the funds' portfolio manager and KCM agreed. The funds' new portfolio managers then submitted to GPT a plan to reduce the concentrations, which plan was complete within five months.

At the end of 2018, KCM and GPT made substantial contributions to the funds to address the investment losses suffered as a result of the over concentrations. In its order involving KCM, the SEC

specifically found that KCM breached its fiduciary duties to the funds “by failing to comply with directives” from GPT, including failing to develop a plan to reduce the funds’ holdings in the securities of a single company and failing to comply with the funds’ investment policies.

## Common Fund Issues

The Cease and Desist Order also described issues specific to the Common Funds. In this regard, the Cease and Desist Order described that the Common Funds were not established solely as an aid to a true fiduciary purpose when it permitted the investment of revocable trusts into the Common Funds. Consistent with *Dunham*, the SEC described that revocable trusts are not established for a fiduciary purpose.<sup>1</sup> The Cease and Desist Order also described that GPT advertised the Common Funds for sale to the general public, along with the investment strategies associated with the Common Funds, beyond the ordinary advertising of the bank’s fiduciary services.

## Saga Not Over

The saga did not end with the Cease and Desist Order. On the morning of October 2, 2020, SEC Commissioner Peirce [issued a dissent](#) from the authorization to enter into the Cease and Desist Order. Commissioner Peirce’s primary argument against the Cease and Desist Order was that the SEC should not enforce in an area where the Commission has not recently provided meaningful guidance on what it means for a collective fund to be maintained by a bank.

Moreover, Commissioner Peirce noted that GPT’s primary regulator is the Office of the State Banking Commissioner of Kansas and that the SEC should not enforce an area of the law where it is not the primary regulator. Commissioner Peirce’s dissent made no mention of the cease and desist order that the SEC entered into with KCM in December 2019.

## Conclusion

The GPT Cease and Desist Order is notable because of the concerns raised by the SEC regarding the level of oversight by GPT over its affiliated investment adviser in connection with the CITs and Common Funds. Read together with the SEC’s findings in the KCM order, however, it is not clear that GPT’s oversight was significantly less robust than might be expected from CIT and common fund trustees generally. In this case, the adviser and trustee were affiliates, and, perhaps unusually, the adviser’s name principal and his family appear to be the majority owners of GPT. This may have influenced GPT’s interest or ability to take more significant actions. However, whether the trustee and the adviser are affiliated or not, the level of oversight exercised by the trustee to “maintain” a common or collective fund requires ongoing analysis, consideration and significant documentation efforts. In light of the Cease and Desist Order and its surrounding facts, trustees and advisers to CITs and

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<sup>1</sup> Although not part of the facts here, we note that in the past the SEC, backed by a 1971 Supreme Court decision, has taken the position that unregistered Common Funds generally cannot be used as investment vehicles for individual retirement accounts.

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common funds should consider re-examining oversight of advisers. This analysis could include determining whether all appropriate actions are being taken to make certain that both the adviser and the trustee are documenting the steps necessary to ensure that the fund's practices mesh with the SEC's view on what it means for a bank to "maintain" a fund.

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