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SEC Action Highlights Risks for Investment Advisers Sharing Legal Expenses with Fund Clients

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This action highlights the need for investment advisers to exercise caution when contemplating any situation in which legal fees will be shared with clients. On April 29, 2024, the Securities and Exchange Commission (the "*SEC*" or the "*Commission*") entered an administrative cease and desist order (the "*Order*") against a registered investment adviser (the "Adviser")[1] finding that the adviser had an "impermissible joint legal fee arrangement" with its client, Mutual Fund Series Trust ("*Trust*"), an SEC-registered open-end investment company.[2] This action highlights the need for investment advisers to exercise caution when contemplating any situation in which legal fees will be shared with clients. **Joint Legal Fee Arrangement** The Order states that the Adviser advised a series of the Trust that "experienced significant losses from its options-trading investment strategy." Inquiries from regulators and private lawsuits soon followed, and the Adviser and the Trust retained the same counsel to represent them; neither the joint engagement letter nor the invoices explained "how legal fees and other expenses would be allocated between the Adviser and the Trust."[3] Because the Trust was insured for legal expenses and the Adviser was not, the Adviser "arranged to have all of the legal bills" from the joint engagement "paid by the Trust and subsequently submitted to the Trust's insurer" to maximize insurance coverage. According to the Order, the Adviser said it intended to reimburse the Trust for any amounts not covered by insurance. Notably, the Adviser and the Trust entered this joint legal fee arrangement "without knowledge or approval of the independent trustees of the Trust's Board of Trustees ('*Board*') and without making an application to the Commission . . . pursuant to Rule 17d-1 under the Investment Company Act."[4] From May 2017 to March 2020, the Trust paid nearly $2.5 million in legal fees and costs relating to the joint representation. The Adviser paid nothing during this period.[5] In April 2020, almost three full years after the Trust's first payment, the Adviser contributed by paying $781,250 of the Trust's share of a legal settlement in one of the private lawsuits. For the remainder of 2020 the Trust continued to pay nearly 80% of new legal fees incurred while the Adviser paid the other 20%.[6] The SEC contacted the Adviser in early 2021 about the joint arrangement, and afterwards, the Trust, "in consultation with Counsel and independent trustees' counsel," allocated $1,277,388 of the legal fees to the Adviser. After accounting for the $781,250 already paid, the Adviser paid the remaining $472,403 to the Trust and, at the Board's request, an additional $30,726 in interest.[7] The Trust's insurer subsequently determined that it would cover "$183,757 less than the amount the Adviser and the Trust had agreed would be allocated to the Trust." In connection with efforts to resolve the SEC's investigation, "[the Adviser] voluntarily repaid the Trust $183,757 for those legal expenses."[8] **Violations and Penalties** The SEC found that the Adviser's joint legal fee arrangement violated "Section 17(d) of the Investment Company Act and Rule 17d-1 thereunder, which generally prohibit any affiliated person of a registered investment company, acting as principal, from participating in . . . any . . . joint arrangement . . . in which such registered investment company is a participant, absent an order issued by the Commission."[9] It also found that the Adviser violated "Section 206(2) of the Advisers Act, which makes it unlawful for any investment adviser . . . to engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client."[10] The adviser settled the matter without admitting or denying the SEC's findings. As part of its settlement, the

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Adviser was ordered to pay disgorgement of $280,902 (which included “time value of money benefit” and an “offset” of $183,757 based on the Adviser’s last payment to the Trust), prejudgment interest of $30,081, and a civil penalty of $200,000 to the SEC.

Analysis & Key Takeaways

- Investment advisers should exercise caution before entering into joint legal fee arrangements with clients.
- If considering joint representation with a client, investment advisers should ensure that legal fees and other expenses are invoiced separately from the outset of the arrangement and should ensure that the allocation of expenses is approved by any independent board or other necessary decisionmakers of the client.
- Registered investment companies must seek an order from the SEC pursuant to Rule 17-d under the Investment Company Act before entering any into joint legal fee arrangements with clients.
- Investment advisers should not defer any share of their legal expenses to the client. Instead, investment advisers should pay expenses as they are incurred.

Conclusion The SEC’s settlement highlights the risks associated with joint legal fee arrangements with clients. The SEC will closely scrutinize such arrangements and, even when the investment adviser pays its full share of legal expenses, may still take enforcement action for delaying the proper allocation, approval, or payment of expenses, or for failing to seek an order from the SEC pursuant to Rule 17-d of the Investment Company Act. _____ [1] Order Instituting Administrative and Cease-and-Desist Proceedings, Pursuant to Sections 203(e) and 203(k) of the Investment Advisers Act of 1940 and Sections 9(b) and 9(f) of the Investment Company Act of 1940, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order, Release No. 6597 (April 29, 2024). [2] *Id.*, Paragraph 1. [3] *Id.*, Paragraph 4. [4] *Id.*, Paragraph 5. [5] *Id.*, Paragraph 6. [6] *Id.*, Paragraph 8. [7] *Id.*, Paragraph 9. [8] *Id.*, Paragraph 10. [9] *Id.*, Paragraph 11. [10] *Id.*, Paragraph 12.

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