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March 25, 2015

Financial Stability Oversight Council
Attn: Patrick Pinschmidt
Deputy Assistant Secretary for the Financial Stability Oversight Council
1500 Pennsylvania Ave., NW
Washington, DC 20220

Re: Notice Seeking Comment on Asset Management Products and Activities; Docket No. FSOC-2014-0001

Ladies and Gentlemen:

The Independent Directors Council ("IDC")[1] appreciates the opportunity to respond to the request of the Financial Stability Oversight Council ("FSOC") for comments on aspects of the asset management industry.[2] The FSOC seeks comment as to whether asset management products and activities may pose potential risks to the U.S. financial system in the areas of liquidity and redemptions, leverage, operational functions, and resolution, or in other areas. The Notice references some of the pertinent regulatory requirements applicable to registered investment companies ("funds") but does not mention one of their key distinguishing features: that funds are required by statute to have a board of directors, a percentage of which must be independent of the fund's adviser. As the FSOC considers, as part of its review, the essential features of funds, it is important to understand the critical role of fund boards in overseeing the management and operation of funds. Other commenters will address more expansively the reasons that funds do not pose a threat to the stability of the U.S. financial system, and

[1] IDC serves the U.S.-registered fund independent director community by advancing the education, communication, and policy positions of fund independent directors, and promoting public understanding of their role. IDC's activities are led by a Governing Council of independent directors of Investment Company Institute ("ICI") member funds. ICI is the world's leading association of regulated funds, including mutual funds, exchange-traded funds, closed-end funds, and unit investment trusts in the United States and similar funds offered to investors in jurisdictions worldwide. ICI's U.S. fund members manage total assets of $17.5 trillion and serve more than 90 million U.S. shareholders. The views expressed by IDC in this letter do not purport to reflect the views of all fund independent directors.

[2] FSOC, Notice Seeking Comment on Asset Management Products and Activities, 79 Fed. Reg. 77,488 (December 24, 2014) ("Notice").

we agree with that view.[3] Our letter focuses on the board's role, principally in connection with the areas referenced in the Notice.

Before turning to the discussion of fund directors, we wish to address the potential next steps that might follow the FSOC's inquiry. As the FSOC notes, the Securities and Exchange Commission ("SEC") is undertaking several initiatives related to the areas discussed in the Notice.[4] We support the FSOC's plan to consider the impact these initiatives may have in reducing any perceived risks to U.S. financial stability associated with the asset management industry. The SEC's mission, statutory authority, and institutional knowledge render it well-equipped to address any concerns the FSOC may have regarding the management and operation of funds.

The FSOC also states that, depending on its analysis, it may consider potential responses. To the extent this might include the application of bank-like prudential standards to funds—such as requiring a fund to remain exposed to certain markets, avoid exposure to certain issuers, or maintain excess levels of cash or cash equivalents in its portfolio—we assert that such a response would be inappropriate, disruptive to the 75 years of success of the current regulatory framework, and harmful to fund shareholders. For example, requiring a fund to be managed with the goal of promoting the safety and soundness of the banking and financial system could be contrary to shareholders' interests and diminish the fund's value as an investment option. Moreover, such requirements would put the board in an untenable situation as they could conflict with directors' state-law fiduciary duties to the fund and its shareholders.

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[3] *See, e.g.*, Letter from Paul Schott Stevens, President and CEO, ICI to the FSOC (March 25, 2015).

[4] Those initiatives include considering recommending that the SEC propose:

- new rules under the Investment Company Act of 1940 addressing the use of derivatives by funds and related matters, including disclosure of fund use of derivatives;
- new requirements for stress testing by large asset managers and large investment companies (to implement section 165(i) of the Dodd-Frank Wall Street Reform and Consumer Protection Act);
- a new rule that would require registered investment advisers to create and maintain transition plans;
- a new rule requiring open-end funds to adopt and implement liquidity management programs and that the SEC provide enhanced guidance relating to required liquid assets in open-end funds; and
- amendments to the forms used by certain registered funds to report information about fund operations and portfolio holdings.

See Unified Agenda for Regulatory and Deregulatory Actions (Fall 2014); *see also*, SEC Chair Mary Jo White, Enhancing Risk Monitoring and Regulatory Safeguards for the Asset Management Industry (December 11, 2014), available at http://www.sec.gov/News/Speech/Detail/Speech/1370543677722#.VQGWDihXp-g.

Boards are a Critical Component of Funds' Structure and Regulatory Framework

Fund boards—particularly the independent directors—are a vital component of the structure of and regulatory framework applicable to funds, and their protection of shareholders' interests has the collateral benefit of protecting against the risk concerns raised in the Notice. Each fund may be established as either a corporation or a business trust under state law and must be registered with the SEC pursuant to the Investment Company Act of 1940 ("1940 Act"). Funds generally do not have their own employees; rather, they rely exclusively on the adviser and other service providers—*i.e.*, the custodian, fund administrator, transfer agent, and principal underwriter—to provide their day-to-day operations. Funds are subject to a comprehensive set of federal and state law requirements.

Each fund is required under the 1940 Act to have a board of directors, a proportion of which must be independent of the fund's adviser. The vast majority of fund boards today have 75 percent or more independent members.[5] The federal securities laws impose significant responsibilities on fund boards and on the independent directors in particular.[6] In addition, fund directors are subject to fiduciary duties of loyalty and care under state law. The 1940 Act entrusts the independent directors with the "primary responsibility for looking after the interests of the funds' shareholders," placing these directors in the role of "watchdogs" who furnish an independent check on the management of funds.[7] Owing to their independence, their expertise, and their fiduciary duties requiring them to be diligent and informed, fund directors vigorously promote and protect the interests of more than 90 million fund shareholders.

In short, fund boards oversee the management and operations of funds. In many cases, the responsibilities are specifically addressed by statute or regulation. In all cases, the board's oversight responsibilities flow from the directors' fiduciary duty to represent the interests of the fund and its shareholders. As most boards have a super-majority of independent directors, they serve as an important, independent check on management. Fund advisers are well aware that board oversight generally as well as approval of a variety of specific matters are critical to fund management and operations, and work to provide boards with clear, transparent information so that they can exercise their informed business judgment. In this way, the mere existence of the fund board imposes a discipline and accountability on management. Indeed, the board is a vital component of a fund's structure and provides a significant, additional layer of oversight, for the benefit of fund shareholders.

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[5] *See* IDC and ICI, *Overview of Fund Governance Practices, 1994-2012*, available at http://www.idc.org/pdf/pub_13_fund_governance.pdf.

[6] Among other things, the 1940 Act places responsibility on fund directors with respect to valuation. See Section 2(a)(41) of the 1940 Act. In addition, fund directors are required to approve the advisory contract and approve the principal underwriter and auditor. *See* Sections 15 and 32 of the 1940 Act.

[7] *Burks v. Lasker*, 441 U.S. 471, 484-85 (1979).

Moreover, it bears emphasizing that this oversight also serves to protect against the potential risks that are the subject of the Notice.

We discuss below some of the specific responsibilities of fund boards that relate to the issues raised in the Notice. It is important to note that board oversight is dynamic and evolves as the fund industry and financial markets evolve. For instance, certain developing issues may at times warrant closer attention by a fund board. Current examples include the potential impact of rising interest rates on the fixed-income markets and cybersecurity risk. Thus, boards fulfill their responsibilities not in a rote manner, but with an awareness of the implications of the broader environment on the funds they oversee.

Board Oversight of Valuation and Liquidity Management Supports Fund Share Redeemability

The FSOC seeks information about the liquidity and redemption risk management practices of funds. As discussed below, fund boards play a critical role in overseeing valuation and liquidity management to support the daily redeemability of mutual (*i.e.*, open-end) fund shares.

Funds must value their portfolio holdings on a daily basis in order to calculate the net asset value ("NAV") of the fund's shares. The daily NAV is the price used to process purchases, redemptions, and exchanges by shareholders. More specifically, a buying or redeeming investor receives the NAV price next calculated after receipt of the purchase order or redemption request.[8] Funds value their portfolio securities based on market values if readily available. If there is no current market quotation for a security or the market quotation is unreliable, the fund board has a statutory duty to "fair value" the security in good faith.[9] The SEC has stated that a fund must:

- adopt written policies and procedures that require the fund to monitor for circumstances that may necessitate the use of fair value pricing;
- establish criteria for determining when market quotations are not reliable for a particular security;
- establish a methodology or methodologies to determine the current fair value of a security; and
- regularly review the appropriateness and accuracy of the method used in valuing securities, and make any necessary adjustments.[10]

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[8] Rule 22c-1(a) under the 1940 Act.

[9] Section 2(a)(41) of the 1940 Act.

[10] *See* Compliance Programs of Investment Companies and Investment Advisers, SEC Release Nos. IA-2204 and IC-26299 (December 17, 2003) ("Fund Compliance Rule Release").

In general, the board approves the valuation policies and procedures, monitors their implementation, and periodically reviews the fair valuation determinations made by advisory personnel.[11]

Funds may use third-party pricing services as a source for evaluated prices, but they do not blindly accept those evaluated prices. Rather, funds follow processes to ensure that the values obtained from pricing services accurately reflect current market values. If a fund disagrees with a pricing service's valuation, it could challenge the valuation and seek to have the valuation revised based on the fund's information and analysis. Alternatively, or if a pricing service is not able to provide evaluated prices, a fund might use another pricing service (such as one they have contracted with as a secondary source) or use its own methodology to fair value the instrument.

The board's role regarding the valuation of the fund's holdings also relates to its oversight of liquidity management. A fund board oversees the adviser's management of the portfolio's liquidity as part of its oversight of the fund's compliance program and portfolio management more generally.[12] SEC guidelines require a mutual fund to maintain at least 85 percent of its portfolio in "liquid securities," which are any assets that can be disposed of in the ordinary course of business within seven days at approximately the value at which the fund has valued the investment on its books.[13]

Through their ongoing oversight, boards stay generally apprised of potential liquidity issues and redemption pressures. Fund flows and portfolio liquidity are generally discussed at every board meeting. Attending those discussions may be portfolio management and/or risk management personnel. Boards may receive risk-based reporting relating to liquidity, which may include scenario analyses (or results of stress testing) around potential liquidity events. Certain circumstances—such as, for example, significant outflows inconsistent with the fund's historical redemption and purchase patterns or volatility in the fixed income market—might warrant heightened attention by the board. Boards generally are alerted in between board meetings if significant liquidity issues arise.

Boards also approve and oversee the use of tools to manage redemption activity that may present certain challenges. For example, subject to the board's approval, a fund may impose a redemption fee or limit the number of trades an investor can make within a specified period as a way to

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[11] *See generally* ICI, IDC and ICI Mutual Insurance Company, *An Introduction to Fair Valuation* (June 2005), available at http://www.idc.org/pdf/05_fair_valuation_intro.pdf and *The Role of the Board* (January 2006), available at http://www.idc.org/pdf/06_fair_valuation_board.pdf.

[12] *See* below for a discussion of fund compliance programs. The board oversees portfolio management pursuant to its fiduciary duty to the fund and its statutory responsibilities to annually review and approve continuation of the adviser's contract with the fund under Section 15(c) of the 1940 Act.

[13] *See* Revisions of Guidelines to Form N-1A, SEC Release No. IC-18612 (Mar. 12, 1992). For money market funds, Rule 2a-7 under the 1940 Act imposes more stringent liquidity requirements.

discourage and limit excessive short-term trading. Other potential tools include:

- redeeming investors' shares in kind;
- interfund lending whereby funds within the complex may directly lend and borrow money for temporary purposes to and from one another; and
- lines of credit from individual banks.

Fund directors oversee these functions pursuant to their fiduciary duties during both normal times and periods of financial market stress or stress at the fund. The board's role, among other things, is to help the fund be prepared to weather such times of stress and to oversee the fund's and adviser's response on behalf of the fund's shareholders, such as through shareholder communications, fair valuation, and orderly redemptions. The board performs this oversight prudently and comprehensively—on behalf of those shareholders who wish to redeem their shares as well as those who wish to remain in the fund.

Investment Management and Risk Oversight Are Among a Fund Board's Key Responsibilities

The Notice inquires about funds' use of leverage, which is encompassed in the board's oversight of compliance and of investment and risk management. As part of its ongoing oversight of portfolio performance and risk, a fund board receives regular reports from the adviser regarding the fund's relative performance, portfolio structure, and investment risks.[14] These reports generally reflect—and the board's oversight includes—a fund's use of leverage, derivatives, and securities lending, if any, as part of the fund's investment strategy.

Funds are limited by the 1940 Act and related SEC guidance in their use of leverage (*e.g.*, selling securities short, purchasing securities on margin, or investing in derivatives). In addition, a fund's own policies may limit the extent to which it can enter into transactions involving leverage. Board oversight includes understanding how leverage is obtained and fits into the fund's investment strategy. To the extent that derivatives are used, fund boards oversee these investments as part of their general oversight of all portfolio investments. While many of the uses and risks of derivatives parallel those of other portfolio holdings, their particular features, benefits, risks, and resource requirements may warrant boards' additional attention.[15]

Some funds lend their portfolio securities as a way to increase the return on the securities. Under SEC-established guidelines, a fund's securities lending program is subject to approval and

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[14] *See* IDC Report, *Investment Performance Oversight by Fund Boards* (October 2013), available at http://www.idc.org/pdf/pub_13_performance_oversight.pdf.

[15] For more detail, *see* IDC Report, *Board Oversight of Derivatives* (July 2008), available at http://www.idc.org/pdf/ppr_08_derivatives.pdf.

oversight by the fund's board, including its independent directors. Board-approved policies generally establish parameters for the lending program, such as approved borrowers and the terms of lending agent compensation. As part of its ongoing oversight, the board periodically reviews the appropriateness of those policies and the program's performance and costs.

Fund Operations Are Subject to Stringent Board Oversight

The Notice includes inquiries about operational risk, which it defines as the risk arising from inadequate or failed processes or systems, human errors or misconduct, or adverse external events, such as business disruptions. The FSOC notes that it is particularly interested in risks associated with multiple asset managers relying on one or a limited number of third parties to provide important services. As noted earlier, funds do not have their own employees and instead rely on the adviser and other service providers to provide their day-to-day operations. Thus, board oversight of the fund's key service providers is critically important.[16]

The board's responsibilities in overseeing operations performed by the fund's service providers are a component of its general oversight of the fund's compliance and risk management functions.[17] A robust compliance program is an essential element of any successful business, and funds and their advisers have long made compliance a priority. The SEC mandated fund compliance programs in a 2003 rule that also presented fund boards with new tools for overseeing compliance and explicitly assigned them responsibilities related to the compliance function.[18] In particular, the rule requires that the fund adopt policies and procedures reasonably designed to prevent violations of the federal securities laws. The board must approve the fund's policies and procedures as well as those of the fund's principal service providers. The fund's and the adviser's compliance programs are subject to SEC examinations.

In addition, the rule requires funds to have a chief compliance officer ("CCO") who is responsible for administering the fund's compliance program and reports to the board. The CCO's designation, compensation, and removal must be approved by the board, including a majority of the board's independent directors. The CCO must provide to the board written reports relating to, among other things, the performance of the fund's service providers, and also must meet separately with the independent directors at least annually. In practice, many CCOs do so at every board meeting.

A significant operational risk posed for funds and their service providers is the disruption of normal operations that may impact the ability to service fund investors. Such disruptions could arise

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[16] *See* IDC Report, *Board Oversight of Certain Service Providers* (June 2007), available at http://www.idc.org/pdf/21229.pdf.

[17] For more detail, *see generally* IDC Report, *Board Oversight of Fund Compliance* (September 2009), available at http://www.idc.org/pdf/idc_09_compliance.pdf, and IDC and ICI Report, *Fund Board Oversight of Risk Management* (September 2011), available at http://www.idc.org/pdf/pub_11_oversight_risk.pdf.

[18] *See* Rule 38a-1 under the 1940 Act and Fund Compliance Rule Release, *supra* n. 10.

for a number of reasons, ranging from weather events to information security breaches. Boards are cognizant that, in some cases, there might be a limited number of providers of a particular service and that many fund complexes use the same service providers. For example, there are a limited number of pricing services and custodians available to provide services to funds. Nevertheless, choice does exist for funds and their boards. Each fund complex exercises its own due diligence and each demands a high quality of service from its providers, including with respect to readiness in the face of business disruptions. Indeed, boards have given heightened attention to cybersecurity risk, which—though not a new issue nor one unique to funds—has become a more prominent area of concern. Boards expect service providers to have in place robust business continuity plans. Fund complexes can and have changed service providers for a variety of reasons. Competitive pressures continue to instill in providers the incentive to maintain high standards of service.

Boards Provide Independent Oversight of Adviser or Fund Changes

The Notice seeks input regarding whether there are specific financial interconnections that could present risks if an asset manager, investment vehicle, or affiliate were to become insolvent, declare bankruptcy, or announce an intent to close or liquidate.

We explain below the role of a fund's board in the event that the fund replaces its adviser—for whatever reason, including the adviser's exit from the advisory business—and in the event that the fund merges into another fund or liquidates. Such events are routine in the fund industry and have not caused any distress in the financial markets. Thus, we are hard-pressed to see why these events would even raise the specter of systemic risk. Indeed, the structure of funds—whereby each fund is a legal entity separate from the adviser and from other funds in the complex—limits the effect of any closure or liquidation of an adviser on any funds it manages, or of a fund's liquidation on the adviser that manages it. A fund's adviser invests for the fund as an agent and does not have any claim on the fund's assets, which are held by the fund's custodian.

Sale or Merger of the Fund's Adviser

Fund advisers generally do not go bankrupt. Rather, if a fund adviser is not thriving, it usually is sold or merged into another firm. The adviser may be sold for other reasons as well, including a parent company's determination to sell this part of its business. The sale of an adviser's business results in the termination of the advisory contract with the fund, and the board is required to consider the approval of a new advisory contract with a new adviser. A new advisory contract also needs to be approved by fund shareholders. Because a fund's custody arrangements are governed by a separate contract between the fund and the custodian, changes in the adviser do not affect the fund's arrangement with the custodian (or its safeguarding of the fund's assets). The board simply provides the custodian with instructions regarding persons at the new adviser who are authorized to transact on behalf of the fund.

There also can be a change in the adviser if a board determines to terminate the contract with the adviser and engage a new one, but this circumstance is rare. If a board has concerns with the quality of the adviser's services or the fund's investment performance, it has the ability to effect more targeted changes to address those concerns. For example, a board can urge an adviser to hire a new portfolio manager for the fund, move to a team approach of portfolio management, increase its investment research capability, retain a subadviser, or merge the fund. If a board ultimately determines to terminate the advisory contract, a new adviser can be retained on an interim basis, subject to later shareholder approval, and without undue disruption to the fund and its shareholders.[19] This termination of the advisory contract and retention of a new adviser also would be the process the board would follow in the unlikely event that an adviser filed for bankruptcy protection and were no longer able to provide advisory services.

Fund Merger or Liquidation

Fund mergers occur for a variety of reasons. For instance, where the merger of two advisory organizations results in more than one fund with substantially similar investment objectives, those funds may be merged to create a larger fund. Or, a fund may merge with another fund because it may not be economically viable on its own, such as when a particular market sector in which the fund invests has fallen out of favor or a fund has failed to garner sufficient assets. Fund directors have the fiduciary duty to evaluate a proposed merger of any funds they oversee to determine whether, in their business judgment, the proposed merger is in the best interests of those funds and their shareholders.[20]

Funds also may liquidate for a variety of reasons, including a decline in assets, increased expenses, and poor performance. The fund's board typically must approve the liquidation, and shareholder approval also may be required.[21] In evaluating whether liquidation is in the best interests of the fund, the board may consider, among other things, the viability of alternatives to liquidation, including inaction or merging the fund into another fund. The board oversees the process for liquidation and dissolution, which includes setting aside reserves for liquidation-related expenses, paying any debts or other obligations, and converting portfolio securities to cash or cash equivalents. The remaining assets are distributed to the shareholders on a *pro rata* basis.

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[19] *See* Rule 15a-4 under the 1940 Act.

[20] SEC rules regulate the merger of affiliated funds and require a board—including a majority of the independent directors—to consider the relevant facts and circumstances with respect to a merger of affiliated funds and determine that the merger is in the best interests of each of the merging funds, as well as the interests of the shareholders of both the fund being acquired and the acquiring fund are not being diluted. *See* Rule 17a-8 under the 1940 Act; *see also* IDC Report, *Board Considerations of Fund Mergers* (June 2006), available at http://www.idc.org/pdf/ppr_idc_fund_mergers.pdf.

[21] Voting requirements for the approval of liquidation and dissolution are generally set forth in state corporate or trust law, in the fund's charter documents, or in both.

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The structure of funds and applicable regulatory framework, an important component of which is board oversight, provide appropriate safeguards to protect against the risks discussed in the Notice. Any concerns the FSOC may have regarding the management and operation of funds should be addressed by the SEC—the experienced and expert primary regulator of funds—and not through the application of prudential standards, which would disrupt the 75 years of success of the fund industry, to the detriment of investors.

If you have any questions about our comments, please contact me at (202) 326-5824.

Sincerely,

Amy B.R. Lancellotta
Managing Director
Independent Directors Council

cc: The Honorable Mary Jo White, Chair
The Honorable Luis A. Aguilar, Commissioner
The Honorable Daniel M. Gallagher, Commissioner
The Honorable Kara M. Stein, Commissioner
The Honorable Michael S. Piwowar, Commissioner

Mr. David Grim
Acting Director, Division of Investment Management

Securities and Exchange Commission