Foundations for Fund Directors®

An Orientation Program for Board Members

September 16-17, 2020

IDC
INDEPENDENT DIRECTORS COUNCIL

Welcome!

More than 100 million fund shareholders depend on diligent, informed, and active independent fund directors like yourself, who have promised to protect and promote those shareholders' interests. The Independent Directors Council looks forward to helping you fulfill that commitment.

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Today's Facilitators

Kathleen T. Barr
Independent Director
Professionally Managed Portfolios
William Blair Funds

Ronald E. Toupin, Jr.
Independent Director
Guggenheim Funds

Erik Sirri
Independent Director
Natixis Funds, Loomis Sayles Funds and Natixis ETFs

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Course Overview

This course will provide fund directors with a practical understanding of their core oversight responsibilities.

1. Introduction: Mutual funds and the fund industry
2. Guiding principles for director oversight
3. Statutory, regulatory, and general oversight responsibilities
4. The 15(c) process
5. Investment management and performance
6. Fair valuation and liquidity risk management
7. Compliance and risk management

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Introduction:
Mutual Funds and the Fund Industry

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Investment Company Assets in YE 2019

$26.0 trillion — Assets under management in U.S.-registered investment companies		
$21.3 trillion — Assets in mutual funds	$4.4 trillion — Assets in exchange-traded funds	$357 billion — Assets in closed-end funds and unit investment trusts

The largest segment of the asset management business in the United States is made up of registered investment companies.

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Mutual Funds as Financial Products

What are the strengths and weaknesses of mutual funds as a financial product?

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Role of Intermediaries

Types of intermediaries	Services provided by intermediaries
— Broker-dealers — Banks — Fund supermarkets — Insurance companies — Registered investment advisers — Retirement plan administrators	— Maintain the financial records and account information of shareholders — Disburse dividend and capital gains distributions — Provide trade confirmations, periodic account statements, shareholder reports, and prospectuses — Complete year-end tax reporting — May provide financial advice and counseling to shareholders

Intermediaries have become the primary bridge between mutual funds and fund shareholders.

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How Intermediaries are Compensated by Fund Complexes

Most funds use intermediaries to distribute their shares	Intermediaries may be compensated for their distribution and shareholder services in the following ways:

- By the fund for distribution services and for transfer agent and shareholder services
- By the adviser out of its own profits in a practice called "revenue sharing"
- By the shareholder, who pays a sales charge

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New Developments in Distribution

SEC adopted new standards of conduct for broker-dealers and advisers

- Effective June 30, 2020
- **Regulation Best Interest** imposes an enhanced standard for broker-dealers that provide recommendations to retail customers: they must act in the customer's best interest and cannot place their own interests ahead of the customer's interests
- The new standards could result in changes to funds' distribution models, including existing and future share classes

Distribution in the COVID era

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Guiding Principles for Director Oversight

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Guiding Principles

Describe the obligations of independent directors and provide a framework for how directors govern and provide oversight

Maintain independence

Fulfill fiduciary duties

Oversee management of conflicts of interest

Protect shareholders' interests

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Differences Between Mutual Fund and Corporate Boards

Owe shareholders the duties of loyalty and care

Mutual Fund Board

- Oversee the management and operation of the fund by the adviser and other service providers
- Monitor potential conflicts of interests that may arise between the adviser/service providers and the fund
- Oversee the compliance program, including approval of the designation and compensation of the chief compliance officer (CCO)

Corporate Board

- Oversee the management, operation, and strategy of the company
- Hire Chief Executive Officer (CEO) and set executive compensation

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Independence

What makes a director independent under the law:

- Cannot have any business or financial interests in the adviser or its affiliates
- Includes the adviser's parent and any subadvisers of the fund
- Also applies to any immediate family members of the director

Independence requirements for a fund's board:

- At least 40% of directors must be "independent"
- Funds that rely on any 1 of 10 common exemptive rules (Rule 12b-1 is one of them) must have at least a majority of independent directors

- **Independent directors should review the business and financial relationships they and their immediate family members have with the adviser, subadvisers, principal underwriter, and affiliates.**
- **Management or counsel usually provide a detailed questionnaire annually.**

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Fiduciary Duties

Duty of care

- Duty to perform responsibilities in good faith, in a manner reasonably believed to be in the best interests of the fund and its shareholders, and with the degree of care that an ordinarily prudent person in a like position would exercise under similar circumstances
- Includes obligation to be informed and devote appropriate time and attention to fund matters

Duty of loyalty

- Duty to use position of trust and confidence to further the interests of the fund and its shareholders ahead of the director's private interests
- Includes obligation to avoid self-dealing and conflicts of interest that are detrimental to the fund

Business judgment rule:
Courts generally defer to the reasonable business judgment of a director, provided that the director acted on an informed basis, in good faith, and in the best interests of the fund.

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Conflicts of Interest

Key responsibility

- Interests of adviser and fund are not always aligned
- Specific statutory requirements with a focus on board oversight of conflicts of interest (e.g., advisory contract approval and fair valuation)

According to the Supreme Court, independent directors have "the primary responsibility" for looking after the interests of the fund's shareholders and serve as "independent watchdogs" who "furnish an independent check" upon the management of the fund.

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When are the interests of the adviser and the fund not aligned?

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Protect Shareholders' Interests

Is this in the best interest of the fund and its shareholders?

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Table Activity: Frostmark New Jersey Bond Fund

Consider the following in your discussion:

— As a Fund trustee are you comfortable with management's merger proposal? Why or why not?

— What do you anticipate saying to management at the meeting when asked your opinion of the merger?

— How will you vote on the proposal?

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Statutory, Regulatory, and General Oversight Responsibilities

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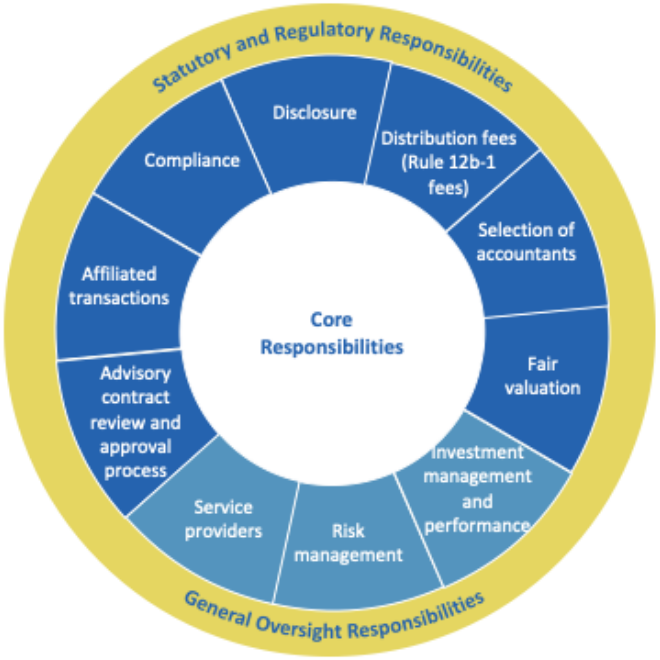
Overview



For broader discussion during our session…

- Advisory contract review and approval process (15(c) process)
- Distribution fees
- Investment management and performance
- Fair valuation
- Liquidity risk management
- Compliance
- Risk management

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Advisory Contract Approval (15(c) Process)

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Advisory Contract Approval

The 15(c) Process	All advisory contracts must be approved by the board and a majority of independent directors.

- In-person meeting required
- Initial term: up to two years
- After initial term: annually

Section 15(c) requires the board to "request and evaluate," and the adviser to furnish, "such information as may reasonably be necessary" for the board "to evaluate the terms" of the advisory contract.

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Structure and Process

There are many different approaches to handling the process:

- Many boards handle entire process at the board level
- Some use a contracts review committee (which may be all or a subset of independent directors)
- Many boards have a multi-meeting process
- Information requests and management presentations
  - Some use formal request letter from counsel; some have presentation by the adviser/management based on informal discussions/requests
  - Performance data often from independent third party
  - Consultants are sometimes involved in the performance preparation process and fee analysis
- 15(c) is a year-round process

The process should be structured in a way that makes sense for your fund complex and board.

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Background on *Gartenberg*

Second Circuit's *Gartenberg* decision (1982) sets forth the standard for court review of Section 36(b) claims

— Whether the fees charged were so disproportionately large that they bear no reasonable relationship to the services rendered and could not have been the product of arm's-length bargaining

The *Gartenberg* factors that courts use to review a Section 36(b) case are also considered by independent directors as part of the 15(c) process.

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Gartenberg Factors

- Nature and quality of the services
- Comparison of fees
- Economies of scale
- Profitability
- "Fall-out" or ancillary benefits

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Nature and Quality of Services

Are the right processes, people, and services in place?

- Performance is a large part of the review
- Investment services
  - Process
  - People
- Administrative services
- Compliance services
- Risk oversight services
- Oversight and reporting services with respect to service providers, including any subadvisers

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Comparison of Fees

How does the fund's fees compare to those of peer group funds or other clients of the fund's adviser?

- Comparisons with funds in peer group
  - Determination of peers is important
  - May be different than performance peers
  - Asset size generally is considered relevant
- Comparisons with other accounts managed by the fund's adviser
  - Institutional accounts (e.g., pensions funds)
  - Subadvisory accounts
  - Level of services provided for the fee may be different

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Economies of Scale

Are economies of scale being shared with the shareholders?

- Challenge in determining economies of scale
  - Advisers do not run business on fund-by-fund basis
- Challenges in determining how economies are shared
  - Breakpoints
  - Initial fee rates
  - Fee waivers
- Courts have rejected claims that economies of scale should be assumed as assets grow

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Profitability

Is the allocation methodology of expenses reasonable?

- No standard approach used by courts or industry
  - Firms do not generally calculate profitability by fund for business purposes
  - Allocations are critical part of process
- No court has held any particular level of profitability to be excessive
  - 77.3% profitability found not to be excessive in one case (though court cautioned that it was not holding that 77.3% can never be excessive)
- Profitability may be of limited relevance with unaffiliated subadviser

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"Fall-out" or Ancillary Benefits

Does the adviser derive benefits from managing the fund in addition to its fees?

- Adviser and/or its affiliates may derive benefits other than the fees paid by the fund because of their management of the fund
- Examples include use of soft-dollars or client commission agreements to pay for investment research or use of the same portfolio model for an institutional or other client
- Other benefits may arise from affiliate arrangements with the fund, including reputational benefits

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Other Annual Agreements

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Other Annual Agreements

Principal Underwriter Agreement

Section 15(c) requires annual approval by a majority of the fund's board, including a majority of the independent directors, at an in-person meeting.

12b-1 Plan

The 12b-1 plan must be renewed annually upon approval of the board, including a majority of independent directors, at an in-person meeting.

Other Agreements

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Table Activity: Approval of the Advisory Contract

Consider the following in your discussion:

- In light of the significant increase in assets and strong prospects for growth, should the board consider negotiating for a reduction in the advisory fee at this time?
- If so, what type of a fee reduction might the board consider?
- What are some reasons the adviser might have for wanting to maintain the current advisory fee?
- What additional information would you want the adviser to provide to help you evaluate the appropriateness of a breakpoint or other form of fee reduction?

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Day One Wrap-Up

Today

- ✓ Overview of the Fund Industry
- ✓ Guiding Principles of Director Oversight
- ✓ Statutory, Regulatory, and General Oversight Responsibilities
- ✓ The 15(c) Process

Tomorrow

Program starts at Noon (ET)

Concludes at 3:45 pm (ET)

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Table Activity: Minimac Alternative Investments Fund

Consider the following in your discussion:

- What questions would you have for the adviser? What additional information would you want?
- Should the board approve the product at this time? Should there be any conditions to the approval?
- If the board should not approve the product at this time, why not?

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Oversight of Investment Management and Performance

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Key Board Responsibilities

Oversight of investment management and performance involves…

- Understanding the characteristics and performance expectations
- Understanding the adviser's investment organization and processes
- Evaluating the fund's performance
- Addressing performance issues

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Investment Characteristics and Performance Expectations

Expectations of investment performance	A fund's benchmarks and its peer group establish the basis for evaluating the fund's relative performance.

- In evaluating fund performance, consider the following key investment characteristics:
  - The fund's investment objectives (e.g., total return, capital preservation, current income, and/or capital growth), policies, and restrictions
  - Asset classes in which the fund may invest
  - The fund's benchmarks, as disclosed in the prospectus
  - Peer groups of the fund

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Investment Characteristics and Performance Expectations – Benchmarks and Peer Groups

Benchmarks

- Broad-based market index disclosed in prospectus (e.g., S&P 500® Index)
- Narrowly based indices (e.g., S&P Global BMI Gold Capped Index)
- Custom and blended indices (i.e., selecting and combining benchmark indices)
- Understand the rationale

Peer Groups

- Third-party vendors establish peer groups
- Funds assigned to peer group based on the fund's investment objectives, as well as the characteristics of its holdings
- Understand the differences between the fund and other funds in the peer group

Conduct periodic reviews of performance over specified time periods. Consider investment risk, including expected volatility (absolute and/or relative to the fund's benchmarks and peer group).

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Adviser's Organization and Processes

Directors should understand the adviser's processes for selecting the fund's portfolio managers, monitoring the portfolio structure, and evaluating performance.

Directors also should understand the:

- Qualifications and roles of the portfolio manager(s) as well as those of research analysts, traders, and other investment personnel
- Portfolio manager's overall investment philosophy toward achieving the fund's investment objective and outperforming peers and its benchmarks
- Investment processes for implementing that philosophy

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Adviser's Organization and Processes–Information to Request

Investment Organization

- Organization charts
- Biographies of key investment personnel
- Types of duties and responsibilities of key investment personnel
- Recruitment and selection process
- Staffing and succession plans
- Portfolio management team vs. "star" manager
- Compensation structure of key investment personnel

Investment Philosophy and Processes

- Information about the portfolio manager's approach to selecting securities
- A description of the portfolio manager's research and its decision-making process
- Information about any model used
- Investment risk management

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Evaluating Performance – Board Reports

- Oral and written performance reports provided in connection with each board meeting
- These reports typically include graphical/tabular depictions of the fund's total returns over a period of time relative to benchmarks and peer groups

Attribution analysis is a detailed assessment showing the primary factors or securities contributing to and detracting from the fund's performance.

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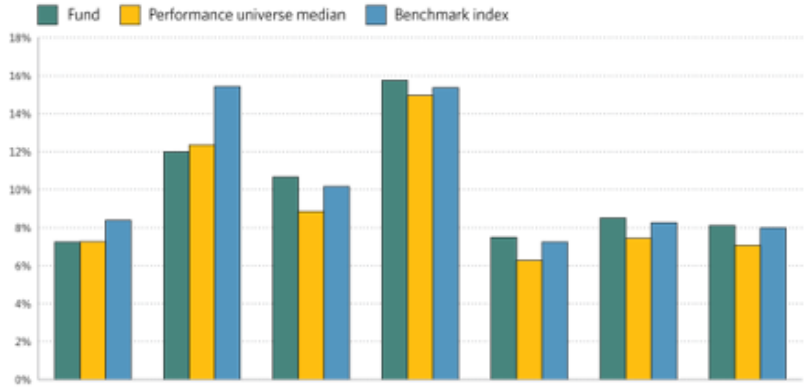
SAMPLE REPORT

ANNUALIZED RETURN



	6 Months Ended 12/31/19	1 Year Ended 12/31/19	3 Year Ended 12/31/19	5 Year Ended 12/31/19	10 Year Ended 12/31/19	Since Inception 6/30/09 to 12/31/19	Mgr Tenure 05/31/10 to 12/31/19
Fund	7.24%	11.99%	10.66%	15.75%	7.49%	8.50%	8.11%
Percentile	49%	56%	9%	24%	12%	14%	15%
Quartile	2nd	3rd	1st	1st	1st	1st	1st
Average	7.22%	11.75%	8.20%	13.40%	7.04%	7.79%	7.26%
Median	7.26%	12.35%	8.85%	14.96%	6.27%	7.44%	7.06%
Benchmark Index	8.38%	15.43%	10.16%	15.37%	7.24%	8.26%	7.99%

Performance Universe

The Performance Universe consists of the Fund and all other funds with similar investment objective, regardless of asset size or primary channel of distribution.

Sharpe Ratio

Information Ratio

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Addressing Fund Underperformance (or Outperformance)

Initial areas of evaluation

- Temporary and persistent performance issues
- Contributors to and detractors from performance:
  - Asset class or strategy
  - Management's investment process

Triggers for enhanced monitoring (e.g., placement on "watch list")

- Repeated underperformance relative to benchmarks
- Risk outside of target range or negative risk adjusted returns
- Increased portfolio turnover or transaction costs

Adviser's remediation steps

- Dedicate additional resources
- Adjust investment process, portfolio structure, or level of risk
- Make long-term structural changes, such as changes to asset classes
- Restructure portfolio managers or investment team
- Liquidate or merge the fund

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Investment Risk

Starts with an understanding of

Investment Risk

Role of the Fund Director

- In order to achieve investment returns, a fund must incur investment risks.
- The fund's "risk profile" is found in disclosures made to investors.
- Manage investment risks by limiting certain risk exposures and using active investment techniques.

- A fund board's role is to oversee the management of the fund's risks.

The goal of investment risk management is to ensure that those risks are understood, intended, and compensated.

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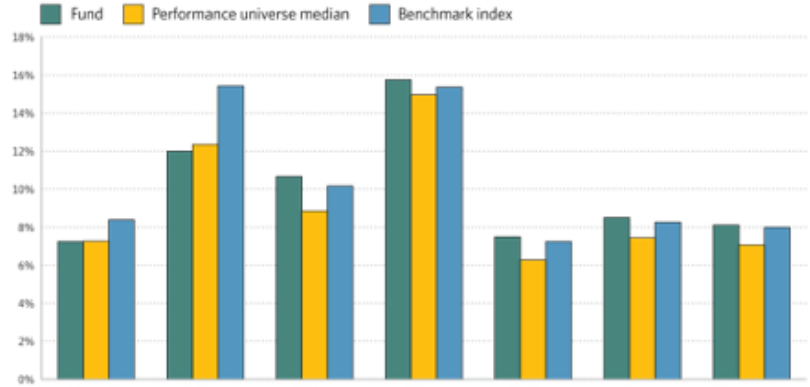
SAMPLE REPORT

ANNUALIZED RETURN



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Sharpe Ratio

Information Ratio

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Key Questions to Ask: Investment Performance

- What is the fund's objective and strategy?
- What is the portfolio manager's investment and risk management process?
- What is the investment selection process?
- What are the fund's investment guidelines and restrictions in accordance with the prospectus and statement of additional information?
- What are the fund's concentration and diversification policies?
- Does the fund use derivatives? If so, what types? How are they monitored?
- What are the benchmarks and peer groups against which performance is compared?
- Who selects the peer group and how are they selected? (ask third-party data provider)
- What are the performance results for 1, 3, 5, 10 years, and through inception?
- What are the sources of returns and risks, relative to the fund's benchmark?
- What are the factors that have accounted for either the underperformance or the outperformance of the fund?
- What kind of volatility is associated with the fund?

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Oversight of Valuation and Liquidity

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Valuation Overview

- Shareholders buy and sell shares at daily net asset value (NAV).
- The daily process for striking the NAV is critically important.
- Daily redeemability of shares is a defining feature of mutual funds.

$$\text{Daily NAV} = \frac{\text{Assets} - \text{Liabilities}}{\text{Number of outstanding shares}}$$

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Regulatory Framework

1940 Act requires that portfolio holdings be valued in one of two ways:

Current market value	Fair value
— Securities for which a market quotation is readily available must be valued at "current market value" (unless the quotation is not reliable or otherwise "readily available").	— Securities and other assets for which a market quotation is not readily available must be valued at "fair value as determined in good faith by the board of directors."

Congress imposed the responsibility for fair valuation on fund boards to address potential conflicts of interest.

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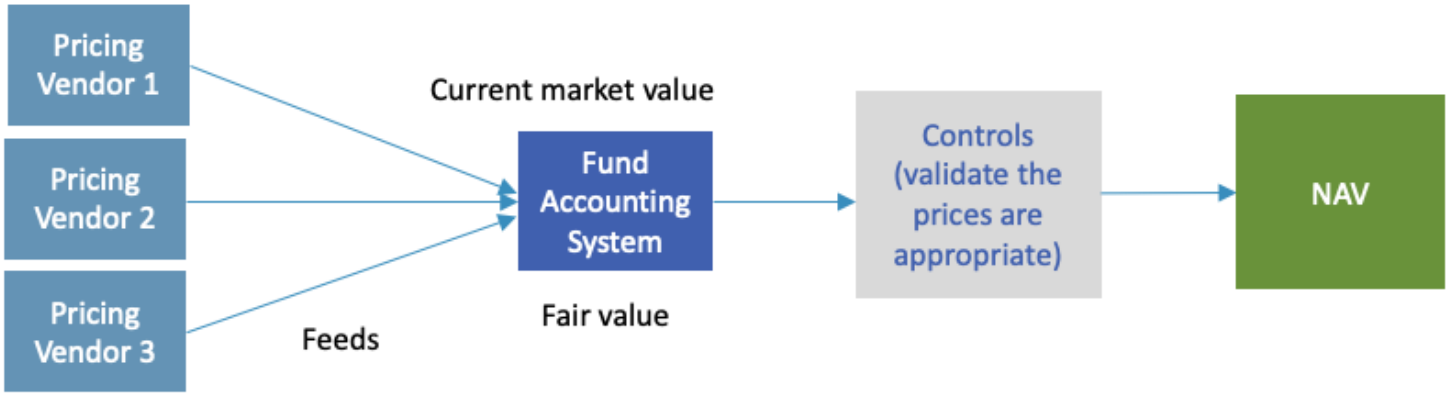
How Valuation Works



Most funds use pricing vendors to provide values, whether "market" or "fair" values.

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Common Practices for Board Oversight of Fair Valuation

- Approve fair valuation policies and procedures
- Oversee the implementation of the fair valuation policies and procedures
- Periodically review the fair valuation decisions made by the adviser
- Review reports on pricing analyses, such as relating to back testing

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Fund Valuation Policies and Procedures May Address:

- Selection of primary and secondary pricing vendors/brokers
- Late pricing feeds
- Price challenges with and without market data
- Use of internal and external models
- Company-specific events or corporate actions that cause a halt in trading such company's stock
- Identification and monitoring of illiquid securities
- Identification and monitoring of difficult-to-price instruments
- Significant events that occur in places where markets close before 4:00 p.m. ET

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Liquidity Risk Management

Overview

- Daily redeemability is a defining feature of a mutual fund.
- Must have sufficient liquidity to meet investors' redemption requests within seven days, as required under the 1940 Act.
- Failure to do so carries potential liability and significant reputational risks; SEC relief would be required if a fund cannot timely meet redemption requests.
- The fund's adviser manages the fund's liquidity.
- Large holdings of cash and highly liquid investments may have an impact on performance.
- A fund can only invest 15% of its net assets in illiquid investments.

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Liquidity Risk Management Rule

Fund requirements

- Classify investments into one of four liquidity categories.
- Determine a minimum percentage of net assets to invest in highly liquid investments.
- Limit illiquid investments to 15% of net assets.

Board responsibilities

- Approve the fund's liquidity, risk management program as well as the designation of an administrator for the program.
- Oversee compliance with highly liquid investment minimum and illiquid investments limit.
- Annually review a written report on the operation of the program.

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Oversight of Compliance

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Compliance Program Rule

Requirements under Rule 38a-1

- Each fund must adopt and implement written policies and procedures.
- The board (including a majority of the independent directors) must approve the fund's policies and procedures and those of each of the following principal service providers to the fund:
  - Investment adviser
  - Principal underwriter
  - Administrator
  - Transfer agent
- Each fund must have a Chief Compliance Officer (CCO) responsible for administering the fund's policies and procedures.

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Chief Compliance Officer (CCO)

Board's relationship with the CCO is significant

- Board approves the CCO designation and compensation and the CCO's removal
- CCO and independent directors must meet in executive session at least annually (many do so at each board meeting)
- At least annually, CCO must report to the board about the adequacy of the policies and procedures and the effectiveness of their implementation and any recommended material changes
- CCO may serve as a "fund-only CCO" or as CCO for both the adviser and the fund

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Elements of a Culture of Compliance

Clear Communication
Engaged Workforce
Reporting Encouraged
TONE AT THE TOP
Consistency
QUESTION PAST PRACTICES
Engage in dialogue
EDUCATE EMPLOYEES
TRANSPARENCY
RESPONSIVE
ETHICAL BEHAVIOR
ADOPT NEW POLICIES
Leadership that "walks the talk"
IDENTIFY CONFLICTS OF INTEREST
accountability
Open Communication

Compliance is everyone's responsibility.

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Oversight of Risk Management

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Table Activity: Risk Oversight

Consider the following in your discussion:

- What questions or considerations might the board raise to understand the problem and the short-term steps to take?
- What processes might the board consider employing to stay informed and engaged during the risk event?
- After the immediate crisis is resolved, what questions might the board ask to learn about the impact of the risk event and the steps that could be taken to reduce the impact of such an event in the future?

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Potential Fund Risks

INVESTMENT

ENTERPRISE

valuation

LEGAL/COMPLIANCE

LIQUIDITY

reputation

OPERATIONAL

A board's role is to provide oversight, not to manage risks.

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Oversight of Risk Management

Key board responsibilities

- Fund director's responsibilities are derived from fiduciary duties of care and loyalty.
  - Federal securities laws do not impose specific obligations.
- Board's role is to oversee the management of the fund's risks by the adviser and other service providers.
  - Board oversight includes understanding the primary risks of the fund and the adviser's risk management processes.
  - It also includes asking questions and obtaining appropriate assurances about the processes.

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Oversight of Risk Management

Board practices

- Educational sessions (e.g., adviser, legal counsel)
- Reports to the board
  - Risk identification and description (risk probability, impact)
  - Risk metrics/dashboards
  - Stress tests/scenario planning
  - Management process, including internal escalation procedures

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Thank you!

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