

# 2017 Fund Directors Conference

## Core Responsibilities of Fund Directors

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# Core Responsibilities of Fund Directors

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# Agenda

1. Overview
  - » Independence
  - » Overall Fiduciary Duty
  - » Board Governance Structures and Practices
2. Annual Contract Review
  - » Advisory Agreements
  - » Distribution and Rule 12b-1
3. Risk, Compliance and Insurance
  - » Oversight of Risk Management
  - » Valuation and Liquidity
  - » Relationship with CCO
  - » Indemnification and Insurance
4. Other Board Responsibilities
  - » Securities Lending
  - » Disclosure
  - » Affiliated Transactions
  - » Codes of Ethics
  - » Best Execution and Soft Dollars
  - » Proxy Voting

# Independence

## *Board Percentage*

- » Most funds must have a majority of independent directors
  - » Section 10(a): all funds
    - » at least 40% independent
  - » Section 10(b)(2): if principal underwriter affiliated with adviser
    - » at least 50% independent
  - » Fund governance rules: if fund relies on common exemptive rules
    - » at least 50% independent
  - » SEC adopted 75% standard in 2004, but it was never implemented due to court challenge
  - » IDC/ICI Study (2017); fund complexes with 75%+ independent
    - » 46% in 1996; 84% in 2017

# Independence

## *What does it mean to be independent?*

- » Specific statutory standard. Cannot be:
  - » “Affiliated person” of fund or adviser
  - » Fund legal counsel within past two years
  - » Within past six months, affiliated with person that executed portfolio transactions for fund, engaged in principal transactions with fund, or distributed shares for fund
- » SEC can determine by order that person not independent based on “material business or professional relationship” with adviser or distributor within past two years
- » Cannot own even one share of stock of adviser, subadviser, or distributor or their “control persons” (*i.e.*, affiliates)
- » Independence rules may also apply to trustee, executor and guardianship accounts
- » Process: initial and annual questionnaires; ongoing monitoring

# Overall Fiduciary Duty

- » Funds generally established under state law as corporation or trust
- » State law establishes overall fiduciary duties for director
  - » Overall duties same as those applicable to directors of operating companies
- » Duty of care
  - » Duty to perform oversight responsibilities with the care of an ordinarily prudent person in a like position under similar circumstances
  - » Duty of informed oversight

# Overall Fiduciary Duty

- » Duty of loyalty
  - » Duty to act in the best interests of the fund
  - » Includes obligation:
    - » to avoid conflicts of interest with the fund
    - » not to put his or her personal interests before the interests of the fund
    - » not to profit from his or her position as a fiduciary
- » Business judgment rule
  - » Courts generally defer to reasonable business judgments by director
  - » *Provided that*, director acts on informed basis, in good faith, and in best interests of fund

# Overall Fiduciary Duty

- » Federal law
  - » No specific fiduciary duty standard
  - » Section 36(a) of the 1940 Act authorizes the SEC to bring an action against directors and certain other persons alleging a breach of fiduciary duty involving personal misconduct related to any registered investment company

# Overall Fiduciary Duty

- » Contrast to operating company board
  - » Although the same state law standards apply, mutual fund director's role differs from that of an operating company
  - » Specific statutory requirements with focus on oversight of conflicts of interest (e.g., contract approval, affiliated transactions)
  - » Not the same focus on business planning, executive compensation and similar matters (compared to adviser's board)
- » Supreme Court – *Jones v. Harris* (2010)
  - » “The Act interposes disinterested directors as independent watchdogs of the relationship between a mutual fund and its adviser”
  - » “[A] fully informed mutual fund board is the cornerstone of the effort to control conflicts of interest within mutual funds”

# Board Governance Structure and Practices

- » Board Chairperson
  - » Governing documents generally provide that board shall elect chairperson from among its members
  - » Independent vs. interested
    - » No requirement of independent chair
    - » SEC adopted requirement in 2004
      - » Never implemented due to court challenge
- » Lead Independent Director
- » Annual IDC/ICI Study (*Overview of Fund Governance Practices*)
  - » 65% have independent chair
  - » 29% have lead independent director

# Board Structure Disclosure

- » Disclosure requirement
  - » Statement of additional information (SAI) and proxy statement
  - » Describe leadership structure of board, including whether the chairperson is independent
  - » If no independent chair, state whether there is a lead independent director and what specific role that director plays
  - » Indicate why the board believes that its leadership structure is appropriate given the specific characteristics or circumstances of the fund
  - » Disclose extent of the board's role in risk oversight of the fund
  - » Proxy statement: describe whether, and if so how, the board considers diversity; if policy on diversity, describe how policy is implemented and how board assesses its effectiveness

# Board Structures

- » Structures
  - » Unitary board (87% of complexes)
  - » Cluster boards (13% of complexes)
- » Meetings
  - » Quarterly in-person (61% of complexes)
  - » More frequent in-person (34% of complexes)
  - » Extra meetings
    - » contract renewal
    - » education
  - » Special meetings as needed
  - » Pre-meeting preparation activities

# Board Structures

- » Minutes
  - » Review
  - » Detail
- » Materials and notes
  - » Electronic vs. paper
  - » Video presentations
  - » Retention
- » Independent director compensation
  - » Process
  - » IDC/ICI annual study

# Board Practices

- » Orientation
- » Continuing education
  - » Industry conferences
  - » Adviser-provided programs
- » Retirement age and term limits
  - » 66% have mandatory retirement age; 75 average age (IDC/ICI study)
  - » 6% have term limits (15 years median)
- » Director investments in the funds overseen
  - » 33% mandate and 30% encourage (IDC/ICI study)

# Committees

## » General

- » No requirement that a mutual fund establish any board committee
- » Many fund boards establish committees to facilitate board oversight of particular activities
- » Closed-end funds whose shares are traded on exchanges are subject to committee requirements
  - » NYSE: Must have audit committee
- » Differing structures
  - » Committees of the whole
  - » Subsets of directors, meeting concurrently

# Committees

## » Audit Committee

- » Rule 32a-4 exempts a fund from the requirement to seek shareholder approval of its independent public accountant if:
  - » the fund establishes an audit committee composed solely of independent directors, and
  - » board adopts an audit committee charter setting forth the committee's structure, duties, powers and methods of operation
- » 1999 ICI Advisory Group Report recommendations
  - » establish audit committee composed entirely of independent directors
  - » audit committee meets with auditors at least once annually in executive session
  - » written committee charter

# Committees

- » Communications with the audit committee
  - » SEC rules require reporting of specific information by accountants to audit committee
    - » Critical accounting policies and practices; alternative accounting treatments
    - » Audit committees must pre-approve all services (and related fees) provided directly to the fund and certain services provided to affiliates that directly impact the fund
    - » Auditor must report on other services to affiliates (and related fees)
    - » Auditor must report on independence
      - » Recent issues under loan rule; Fidelity no-action (6/20/16)

# Committees

- » Audit committee financial expert
  - » Every fund must disclose that the board of directors has determined that the board either:
    - » has at least one audit committee financial expert serving on its audit committee, or
    - » does not have an audit committee financial expert serving on its audit committee
  - » If the board has an audit committee financial expert, the fund must disclose the name of the person and whether that person is independent
  - » If the fund does not have an audit committee financial expert, it must disclose why it does not have one
  - » IDC/ICI Study: 96% have an audit committee financial expert

# Committees

- » Nominating, Governance and/or Compensation Committee
  - » Many fund boards establish one or more committees designed to address governance-related issues not handled by the audit committee
  - » Committee often handles the director nomination process
    - » SEC fund governance rule requires that independent directors select and nominate any other independent directors of the fund
    - » SEC: “ [S]elf-selection and self-nomination of independent directors fosters an independent-minded board that focuses primarily on the interests of a fund’s investors rather than its adviser”
    - » Election by full board unless a shareholder vote is needed
  - » IDC paper: Considerations for Board Composition (2013)

# Committees

- » Contract Review Committee
  - » Some funds establish a contract review committee, including some or all of the independent directors, to oversee the annual review of advisory and distribution agreements
  - » Many fund boards handle this responsibility without the use of a committee
- » Investment Committee
  - » Some boards have established investment committees to focus on investment performance and related issues
  - » An investment committee may also focus on related issues, such as brokerage, soft dollars and derivatives

# Committees

- » Compliance Committee
  - » Some boards have established a committee designed to assist the board in the oversight of the fund's compliance program
- » Valuation Committee
  - » Some funds establish valuation committees to assist in the valuation process, in particular, determining fair value for securities
  - » Valuation committee memberships vary from fund to fund:
    - » Include independent director (rare); only fund officers (common)
- » New Liquidity Rule
  - » Varying practices for oversight of liquidity
  - » Full board? Audit? Valuation? New committee?

# Fund Governance Rules

- » Fund governance rules apply to funds that rely on one or more common exemptive rules (*i.e.*, virtually all funds)
- » Independent counsel
  - » If a fund's independent directors have legal counsel, that counsel must be an "independent legal counsel"
  - » "Independent legal counsel" defined to defer to the business judgment of independent directors:
    - » Independent if independent directors reasonably determine in their business judgment that the firm's representation of management organizations and control affiliates during past two years **"is or was sufficiently limited that it is unlikely to adversely affect the professional judgment of the person in providing legal representation"**
  - » Annual determination
  - » Directors can rely on information provided by counsel, unless they know or have reason to believe that the information is materially false or incomplete

# Fund Governance Rules

## » Annual self-assessment

- » Fund board must evaluate “at least once annually the performance of the board of directors and the committees of the board of directors, which evaluation must **include** a consideration of the **effectiveness of the committee structure** of the fund board and the **number of funds** on whose boards each director serves”
- » Intended to improve fund performance by strengthening directors’ understanding of their role, fostering better communications and improving cohesiveness
- » Assessment does not have to be written; minutes should reflect the substance of the matters discussed

# Fund Governance Rules

## » Executive Session

- » Independent directors must meet at least once quarterly in a session at which no inside directors are present
- » SEC: “[D]esigned to give independent directors the opportunity for a frank and candid discussion among themselves regarding the management of the fund, including its strengths and weaknesses”

## » Independent Director Staff

- » Independent directors must be authorized to hire employees and to retain advisers and experts necessary to carry out their duties
- » SEC: This provision “should help independent directors address complex matters and provide them with an understanding of the practices of other mutual funds”

# Agenda

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2. Annual Contract Review
  - » Advisory Agreements
  - » Distribution and Rule 12b-1
3. Risk, Compliance and Insurance
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# Advisory Contract Approval

- » All advisory contracts must be approved by board and majority of independent directors (Section 15)
  - » In-person meeting required
  - » Subadvisory contracts included
  - » Initial term: up to two years
  - » After initial term: annually
- » “It shall be the duty of the directors of a registered investment company to request and evaluate, and the duty of an investment adviser to such company to furnish, such information as may reasonably be necessary to evaluate the terms of any” advisory contract

# Advisory Contract Approval

- » Section 36(b): Adviser has fiduciary duty with respect to receipt of compensation; shareholders have right of action to recover excessive fees from adviser
- » Second Circuit's *Gartenberg* standard (1981) approved by Supreme Court in *Jones v. Harris* (2010):
  - » “[W]e conclude that *Gartenberg* was correct in its basic formulation of what §36(b) requires: to face liability under §36(b), an investment adviser must charge a fee that is so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been the product of arm’s length bargaining”

## *Jones v. Harris*

- » Supreme Court emphasized the importance of fund independent directors (not just court review under §36(b))
  - » “Under the Act, scrutiny of investment adviser compensation by a fully informed mutual fund board is the cornerstone of the effort to **control conflicts of interest** within mutual funds”
  - » “Board scrutiny of adviser compensation and shareholder suits under §36(b) are mutually reinforcing but **independent mechanisms** for controlling conflicts”

# *Jones v. Harris*

- » Court deference to board decisions if the process is robust:
  - » “Where a board’s process for negotiating and reviewing investment-adviser compensation is **robust**, a reviewing court should afford **commensurate deference** to the outcome of the bargaining process. Thus, if the disinterested directors considered the relevant factors, their decision to approve a particular fee agreement is **entitled to considerable weight**, even if a court might weigh the factors differently.”
- » Court review is more rigorous if the process is deficient:
  - » “[W]here the board’s process was **deficient or the adviser withheld important information**, the **court must take a more rigorous look** at the outcome.”
  - » “[T]he standard for fiduciary breach under §36(b) does not call for judicial second guessing of informed board decisions”

# Recent 36(b) Litigation

- » Since *Jones v. Harris*, cases have been filed involving 24 fund groups
- » 17 cases are pending
- » Most involve subadvisory relationships
  - » Two types (discussed on next slide)

# Recent 36(b) Litigation

- » Manager – subadviser funds
  - » Allegation: management fee excessive; subadviser performs “virtually all” services, yet manager retains significant portion of fee
  - » Focus on manager services, including subadviser selection and oversight, administration and compliance, and manager assumption of risks, including entrepreneurial risk
- » Single adviser funds
  - » Allegation: management fee is excessive; same adviser charges less to subadvise other funds
  - » Focus on additional services and risks

# Recent 36(b) Litigation

- » Motions to dismiss
  - » Most denied; courts see factual issues
- » Settlements (6)
- » AXA Equitable trial
  - » First 36(b) trial since 2009
  - » Plaintiff did not meet burden to show breach of fiduciary duty
  - » Witness credibility was crucial
  - » Judge examined board composition, structure and governance
- » Hartford Funds
  - » On summary judgment, court held that board process was robust
  - » After trial focused on services and profitability, court rejected plaintiff's claim

# SEC Enforcement Actions

- » Commonwealth Capital Management (2015)
  - » Independent directors and adviser sanctioned for deficiencies in 15(c) process
    - » Requested but did not receive comparable fee information
    - » Requested information on services, but response inadequate (not sufficiently specific for adviser and subadviser)
  - » Adviser sanctioned for providing inaccurate information
    - » Directors not sanctioned for inaccurate responses on comparable fee information, profitability, fee waiver and economies of scale

# Factors for Board Consideration

- » Section 15 sets forth no specific factors
  - » Consider factors and information “reasonably necessary”
- » Advisory contract review also subject to overall fiduciary duty
- » Two sources of factors commonly used by directors
  - » *Gartenberg* case (2d Cir. 1981)
  - » Shareholder report disclosure requirements based on *Gartenberg* (2004)

# Structure & Process

- » Many boards handle entire process at the board level
  - » Some use contract committee (which may be all independent directors or a subset)
- » Some boards have a two-meeting process
  - » First meeting to receive response; second for final consideration and vote
  - » Some boards receive response and take vote at a single meeting
- » Information requests and management presentations
  - » Some use formal request letter from counsel; some have presentation by management based on informal discussions/requests
  - » Some use consultants to assist in request and evaluation
  - » Performance data often from independent third party
- » 15(c) is a year-round process

# Structure & Process - Disclosure

- » Shareholder reports must “discuss in reasonable detail the material factors and the conclusions with respect thereto that formed the basis for the board’s approval”
  - » “Conclusory statements or a list of factors will not be considered sufficient disclosure”
  - » Consider process for drafting and reviewing disclosure

# SEC Enforcement Actions

- » Northern Lights (2013)
  - » Process for drafting minutes and disclosure resulted in boilerplate statements including material misstatements and omissions
  - » Other deficiencies: missing disclosure (10 approvals); recordkeeping omissions (Section 15(c) materials); compliance program approvals (certifications only)
  - » Directors cited for violations of Section 34(b) (untrue statements in reports) and Rule 38a-1 (failure to follow policy on compliance program approvals)

# *Gartenberg* and Disclosure Factors

- » Nature, extent and quality of services
- » Investment performance of the fund and the adviser
- » Profitability of adviser and its affiliates
- » Extent to which economies of scale would be realized as the fund grows, and whether fee levels reflect these economies of scale for benefit of fund investors
- » Fall-out benefits – benefits derived by adviser from the relationship with the fund, such as soft dollar arrangements
- » Comparisons of services and fees with those under other advisory contracts

# Nature, Extent and Quality of Services

- » Investment services
  - » Performance is part of review, but not all
  - » Process
  - » People
- » Administrative services
- » Compliance services
- » Risk oversight services
- » Securities lending services
- » Oversight and reporting services with respect to service providers, including subadvisers

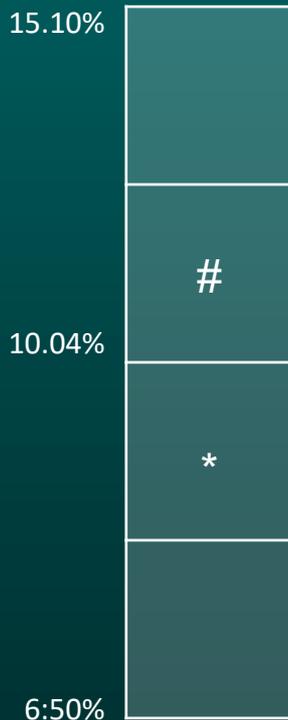
# Investment Performance

- » Annual 15(c) process builds on quarterly reviews
  - » Performance charts showing total returns:
    - » Quarter, 1-year, 3-year, 5-year, 10-year, since inception
  - » Comparisons to benchmark index (or indices):
    - » Prospectus benchmark, which must be “broad-based”
    - » Sometimes secondary benchmark, more closely aligned with investment strategy
  - » Portfolio manager presentations
- » Watch lists are often used
  - » Criteria varies widely
  - » Used as tool, not a conclusion

# Investment Performance – Peer Groups

- » Peer group comparisons are common
- » Who selects the peer groups?
  - » Management?
  - » Independent third party?
- » How are peer groups selected?
  - » Retail, institutional, variable insurance product funds
  - » Narrow vs. broad
  - » All similar investment strategies vs. competitors in marketplace

# Investment Performance – Peer Groups



# = Fund  
\* = Benchmark Index

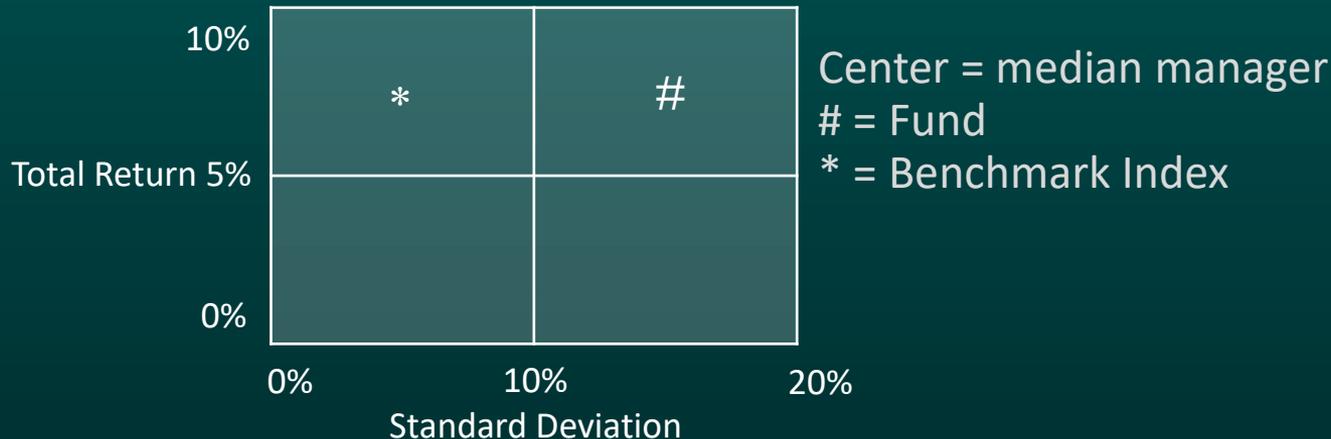
Quartile charts showing peer and benchmark relative performance over various periods:

- » Quarter
- » Year-to-date
- » One year
- » Three years
- » Five years
- » Ten years (or since inception)

Calendar year results provide another way of reviewing performance

# Investment Performance – Volatility

- » Performance comparisons may look to volatility of returns
- » Standard deviation is a common measure
- » Other risk-based return statistics may be used, such as Sharpe ratios



# Profitability

- » No standard approach used by courts or industry
  - » Firms do not generally calculate profitability by fund for business purposes
  - » Allocations are key part of process
- » No court has held any particular level of profitability to be excessive
  - » *Schuyt* (S.D.N.Y. 1987): pre-tax profitability up to 77.3%
  - » Court cautioned that it was not holding that 77.3% can never be excessive
- » Profitability may be of limited relevance with unaffiliated subadviser

# Economics of Scale

- » Challenge in determining economies of scale
  - » Advisers do not run business on fund-by-fund basis
- » Challenge 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

# “Fall-out” Benefits

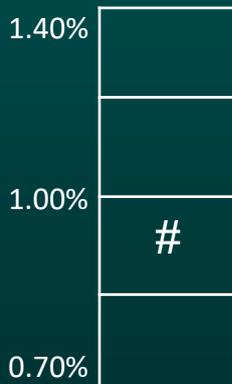
- » Adviser or affiliates may receive benefits other than the fee
- » *Gartenberg* (sweep money market): float on checks of redeeming shareholders; free credit balances in brokerage accounts from redemptions
- » Soft dollars
- » Other benefits may arise from affiliate arrangements with fund, including reputational benefits

# Fee Comparisons – Other Mutual Funds

- » Other registered funds advised by same adviser
  - » Fees usually vary depending on whether serving as overall adviser or only as subadviser; historical differences among funds
- » Comparisons with peers is common
- » Determination of peers is important
  - » May be different than performance peers
  - » Asset size generally considered relevant
- » *Jones v. Harris*:
  - » “[C]ourts should not rely too heavily on comparisons with fees charged to mutual funds by other advisers”
  - » “These comparisons are problematic because these fees . . . **may not be the product of negotiations conducted at arms-length**”

# Fee Comparisons – Other Mutual Funds

- » Sample peer comparisons
  - » Actual total expenses vs. larger universe
  - » Actual total expenses vs. smaller peer group based on asset size
  - » Contractual management fees at common asset level
  - » Contractual management fee at variety of asset levels (showing impact of break points)



# = Fund



# Fee Comparisons – Institutional Accounts

- » *Jones v. Harris*: There are no categorical rules
  - » “Since the Act requires consideration of all relevant factors, we do not think that there can be any categorical rule regarding the comparisons of the fees charged different types of clients”
  - » “Instead, courts may give such comparisons the weight that they merit in light of the similarities and differences between the services that the clients in question require, but courts must be wary of inapt comparisons”
  - » “Act does not necessarily ensure fee parity between mutual funds and institutional clients”

# Fee Comparisons – Institutional Accounts

- » *Jones v. Harris*: There may be important differences between funds and institutional accounts
  - » “As the panel below noted, there may be significant differences between the services provided by an investment adviser to a mutual fund and those it provides to a pension fund which are attributable to:
    - » the greater frequency of shareholder redemptions in a mutual fund,
    - » the higher turnover of mutual fund assets,
    - » the more burdensome regulatory and legal obligations, and
    - » higher marketing costs”
  - » “If the services rendered are sufficiently different that a comparison is not probative, then courts must reject such a comparison”

# Distribution

- » Distribution agreement
  - » Agreement with principal underwriter must be approved annually by Board
- » Distribution fees
  - » Rule 12b-1: fund may pay for distribution only through a 12b-1 plan
  - » Plan must be approved annually
  - » To implement or continue a plan, the directors must find “that there is a **reasonable likelihood that the plan will benefit the company [i.e., the fund] and its shareholders**”
  - » Directors’ finding must be based on “the **exercise of reasonable business judgment and in light of their fiduciary duties** under state law and under sections 36(a) and (b) of the [1940] Act”

# Distribution

- » Purpose of 12b-1 fees
  - » Rule 12b-1 initially intended to solve specific distribution problems, such as periods of net redemptions
  - » Today, most plans pay for distribution (including substituting for front-end loads) and/or pay for shareholder servicing or administrative services for existing fund shareholders
  - » Factors suggested by SEC in 1980 adopting release have little, if any, practical relevance to 12b-1 plans today
- » Proposed rule change (2010)
  - » Replace 12b-1 with rules eliminating specific board findings
  - » Not on SEC agenda

# Distribution-Intermediary Payments

- » IM Guidance Update 2016-01
  - » Recommends board process reasonably designed to evaluate whether portion of sub-TA fees are being used directly or indirectly for distribution
- » Are sub-TA payments for “distribution-in-guise”?
- » Enforcement actions where fund payments for distribution were not made under 12b-1 plan
  - » First Eagle (2015)
  - » William Blair (2017)
  - » Calvert (2017)

# Agenda

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3. Risk, Compliance and Insurance
  - » Oversight of Risk Management
  - » Valuation and Liquidity
  - » Relationship with CCO
  - » Indemnification and Insurance
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# Risk Management

- » Board role: oversight
  - » Overall fiduciary duty; annual contract renewal
  - » No specific rules similar to compliance programs
- » Management role: manage risks
  - » Investing involves risks
  - » Optimize investment risk based on objective and strategy
  - » Manage compliance and operational risks
- » SAI disclosure
  - » Board leadership disclosure must cover extent of board's role in risk oversight of the fund

# Risk Management

- » Defining risk
  - » Investment risks (e.g., liquidity, derivatives)
  - » Compliance risks (e.g., investment restrictions, personal trading)
  - » Operational risks (e.g., trade errors, cybersecurity, BCP)
  - » Reputational risks (often a result of other risks)
  - » Basic approach
    - » Market
    - » Counterparty
    - » Operational (everything other than the other two)

# Risk Management

- » Overseeing risk management
  - » No one way; tailor to funds/adviser
  - » Understanding adviser's structure
    - » Dedicated risk officer/function
    - » Coordinate with other control functions (e.g., internal audit, legal, compliance, portfolio oversight)

# Risk Management

- » Board reports
  - » Stress tests
  - » Scenario planning
  - » Risk assessments (with Board focus on top risks)
  - » Understanding management process, including internal escalation procedures
- » IDC paper: Fund Oversight of Risk Management (2011)

# Valuation

- » Section 2(a)(41) and Rule 2a-4
  - » Funds must value portfolio securities “for which market quotations are readily available” at current market value
  - » When **market quotations are not readily available**, securities must be valued at **“fair value as determined in good faith by board of directors”**
- » SEC staff guidance (1999; 2001)
  - » “Most boards fulfill their obligations by **reviewing and approving pricing methodologies**, which may be formulated by the board, but more typically are recommended and applied by fund management”
  - » “In our view, a board acts in **good faith** when its fair value determination is the result of a **sincere and honest assessment** of the **amount that the fund might reasonably expect to receive for security upon its current sale**, based upon all of the appropriate factors that are available to the fund”

# Valuation

- » Common practices
  - » Pricing service for most securities
    - » Equity (market quotes); fixed income (evaluated prices)
  - » Fair value process, including committee determinations
    - » “Such committees generally assist the board in developing methodologies by which fair values are to be calculated, and implement the board-approved methodologies on a day-to-day basis or as frequently as necessary”

# Valuation – Morgan Keegan (2013)

## » Background

- » 7 funds; 6 independent directors; 2 interested directors
- » Relevant period: January – August 2007
- » Majority of assets: structured products (e.g., CDOs, CMOs, CLOs), with significant investments in subordinated tranches
- » 50-60% of assets were fair valued

## » Process

- » Initially valued at purchase price
- » No change unless price confirmation or sale suggested 5% + charge
- » Limited price confirmation process
- » Limited board reporting

# Valuation – Morgan Keegan (2013)

## » Settlement order

- » “In 1970, .... the Commission emphasized that it is the responsibility of a fund’s board of directors to determine fair value and cautioned that, while a board may enlist the assistance of individuals who are not board members, it remains the **board’s duty [1] to establish the fair value methodology** to be used **and [2] to continuously review both** the appropriateness of the **methods** used involving each security **and** the **valuation findings** resulting from such methods”
- » “[T]he Directors did not **[1] calculate** the valuations themselves, and neither **[2] established clear and specific valuation methodologies** nor **[3] followed up their general guidance to review and approve the actual methodologies used and the resulting valuations**”
- » Directors caused funds to violate Rule 38a-1

# Valuation – Board Role

- » Procedures
  - » Clear? Comprehensive?
  - » Roles and responsibilities identified and understood?
  - » Are conflicts properly managed?
  - » Appropriate balance between specificity and flexibility?
- » Board reporting
  - » Periodic procedure reviews
  - » Pricing service presentations
  - » Sufficient detail, but not a data-dump
  - » Understanding role of experts

# Liquidity

- » Current requirements
  - » Maximum: 15% of net assets
  - » “Illiquid:” cannot be sold or disposed of in the ordinary course of business within 7 days at approximately the value used by the fund
- » New requirements (December 2018)
  - » Liquidity risk management program
  - » Optional swing pricing
  - » Enhanced reporting and disclosure

# Relationship with CCO

- » Rule 38a-1 (2004)
- » Compliance program
  - » Board approval of compliance policies and procedures of the fund and service providers
    - » Advisers (including subadvisers)
    - » Principal underwriter
    - » Transfer agent
    - » Administrator
- » CCO approval requirements
  - » Initial designation
  - » Compensation
  - » Removal

# Relationship with CCO

- » Annual CCO report to board
  - » Operation of program
  - » Material change over past year
  - » Recommended material changes
  - » Material compliance matters
- » Annual executive session with CCO (quarterly common)
- » Multiple roles?
  - » Fund only CCO (39%)
  - » Fund/adviser CCO (61%)

# Relationship with CCO

- » Common practices for communicating with CCO
  - » Compliance Committee
  - » Compliance assigned to other committee (e.g., audit)
  - » Designated director
- » Key issues
  - » Tone at the top; compliance culture
  - » Resources and support
  - » Risk assessments
  - » CCO involvement in business initiatives
- » SEC enforcement focus on 38a-1 and CCO
  - » BlackRock (April 2015) (adviser and CCO sanctioned for failure to disclose PM conflict)
- » IDC Task Force Report: Board Oversight of Compliance (2009)

# Indemnification

- » Director's first line of defense
- » Reimbursement from fund assets, for legal expenses and other liabilities
- » Includes (1) advances to cover legal expenses incurred during the course of litigation and regulatory investigations, and (2) settlements or judgments
- » Does not cover “disabling conduct” – willful misfeasance, bad faith, gross negligence or reckless disregard of duties
- » Availability governed by state law, SEC guidance, charter documents (or declaration of trust), and any agreement between the fund and the director
- » “Do the fund’s organizational documents grant directors the broadest indemnification rights permitted by law?”

# Indemnification - Advances

- » A director is entitled to payment of legal expenses during litigation and regulatory investigations (“advances”) provided the following procedure established by SEC staff is utilized:
  - » The director undertakes to repay the advance if it is not ultimately determined that the director is entitled to indemnification; and
  - » Either:
    - » The director provides security for the undertaking,
    - » The fund is insured against loss arising from such advances,
    - » A majority of a quorum of independent, non-party directors determines that there is reason to believe that such person ultimately will be found entitled to indemnification, or
    - » Independent legal counsel renders a written opinion stating that it has made such a conclusion

# Director and Officer and Errors and Omissions Insurance

- » Provides coverage to past, present and future duly elected or appointed directors and officers of a fund for claims made against them for “wrongful acts” committed in their capacities as fund directors or officers
- » Provides coverage to fund itself; affiliated entities can also be covered
- » Mutual fund D&O/E&O policies are usually “claims made” policies, which cover claims made during the policy period, and provide “aggregate” coverage (a fixed amount)
- » Neither state law nor the 1940 Act requires D&O/E&O coverage
  - » Virtually all funds have such policies
  - » Premiums paid by the fund, or allocated among entities covered

# D&O/E&O Coverage Types

- » A-Side:
  - » Individual coverage for fund directors and officers for claims not covered by fund indemnification (i.e., non-indemnifiable claims)
- » B-Side:
  - » Coverage for claims against directors and officers that are indemnified by the fund
  - » Protects the fund against loss resulting from its indemnification exposure
- » C-Side:
  - » Coverage for claims against the fund itself
- » In mutual fund world, these coverages are typically bundled in the basic D&O/E&O policy (different than operating companies)
- » IDL:
  - » Some policies provide coverage solely for independent directors

# Interplay between Indemnification and Insurance

- » A-Side: covers fund directors and officers directly in the event that the fund cannot indemnify the directors or officers
- » B-Side: reimburses fund for amounts that a fund has paid to its directors and officers pursuant to its indemnification obligations
- » The two insuring clauses work side-by-side
  - » If the fund can indemnify, the fund will be reimbursed by B-Side coverage
  - » If the fund cannot indemnify, the A-Side coverage may pay the loss on behalf of the directors and officers

# D&O/E&O Insurance Approval Requirements

- » Board review and approval:
  - » Subject to general oversight responsibilities and fiduciary duty
- » Rule 17d-1(d)(7) governs policies covering multiple affiliated entities, such as multiple funds, or the funds and the adviser
  - » Participation must be in the best interests of the funds, and the premium allocation must be fair and reasonable
  - » Board must review on an annual basis

# Factors to Consider - D&O/E&O

- » Not all D&O/E&O policies are the same; coverage terms and definitions can vary significantly
  - » E.g., are regulatory investigations, non-party witness expenses covered?
  - » Policy structures can vary (funds only v. joint fund/adviser)
  - » Board may have access to experts through adviser organization and outside counsel

# Fidelity Bonds

- » Bonds are required (Rule 17g-1)
  - » Funds must have a bond “against larceny and embezzlement, covering each officer and employee ... who may ... have access to securities or funds of the investment company ...”
- » Funds generally buy bonds with a broader scope of coverage
- » Rule specifies minimum size, \$50K to \$2.5M
- » Board annual review and approval required

# Agenda

1. Overview
2. Annual Contract Review
3. Risk, Compliance and Insurance
4. Other Board Responsibilities
  - » Securities Lending
  - » Disclosure
  - » Affiliated Transactions
  - » Codes of Ethics
  - » Best Execution and Soft Dollars
  - » Proxy Voting

# What is Securities Lending?

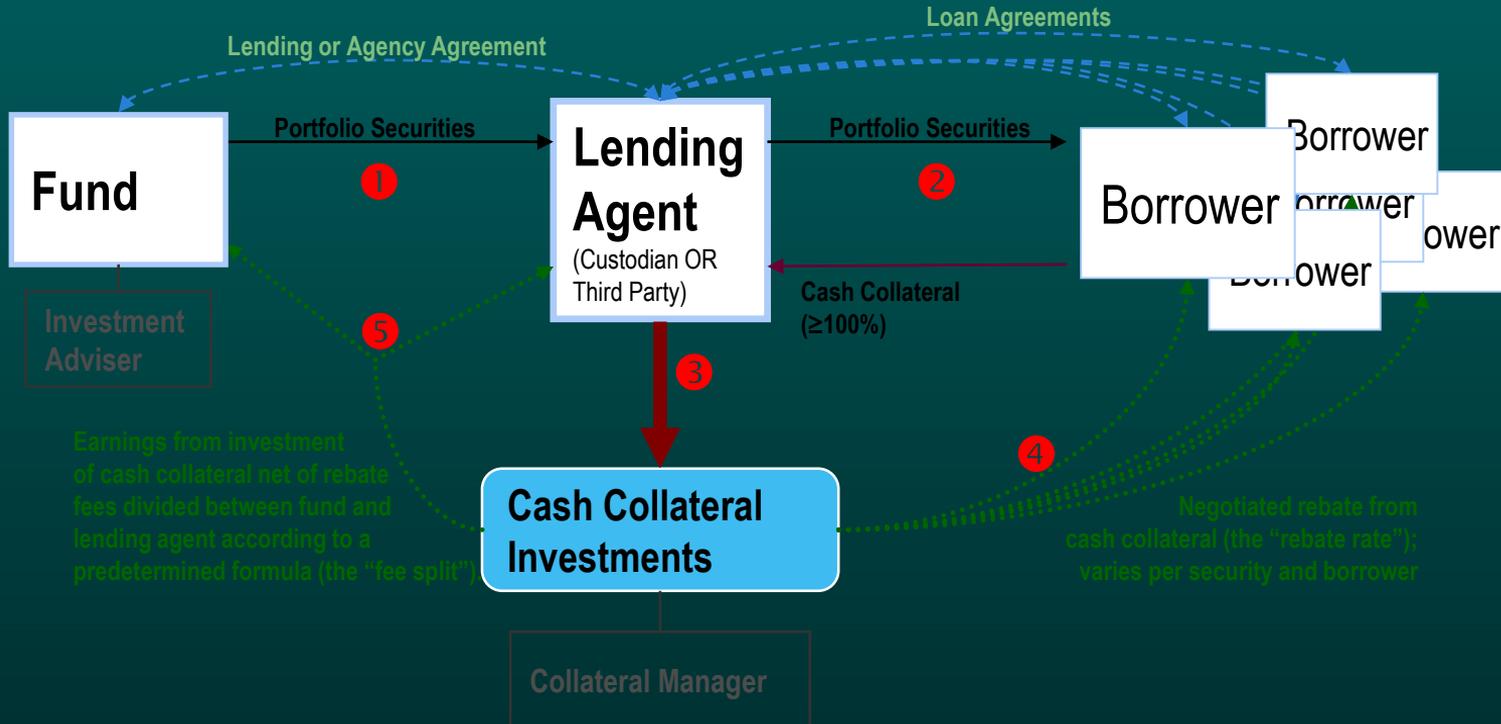
- » Fund lends security to borrower (e.g., short seller)
- » Borrower provides cash collateral to fund
  - » At least 100% of value of loaned security
- » Fund invests cash collateral
  - » Some earnings to borrower
  - » Some earnings to securities lending agent
  - » Some earnings to fund

# Benefits and Risks of Securities Lending

- » Benefits of securities lending
  - » Additional revenue to the fund
  - » Lending generally does not alter portfolio management
- » Risks of securities lending
  - » Borrower default
  - » Collateral investment risk
  - » Operational risk and compliance (e.g., lending agent does not follow agreements and procedures)

# Securities Lending Overview

## Traditional Program Structure



# Key Legal and Operational Requirements

- » Fund must receive collateral 100% of value of loaned security (102%-105% common)
- » Mark-to-market daily
- » Loans can be terminated within normal settlement period (3 days)
  - » Recalls related to sales and proxy voting
- » Cash collateral must be invested in fund-approved investments
- » Fund may pay non-affiliated securities lending agent a percentage of earnings
  - » Exemptive order required for percentage payment to affiliate
- » Fund may loan up to 33⅓ percent of its total assets

# Board Oversight

- » Approval and annual review of securities lending arrangement
- » Board (or adviser subject to board oversight) must approve
  - » List of borrowers
  - » Lending agent agreements
  - » Borrower agreements
- » Boards must make arrangements to vote with respect to a material event affecting the securities on loan (proxy recalls)
- » Focus on collateral investment
- » Changes due to money market fund reform

# Disclosure

- » Prospectus and Statement of Additional Information (SAI)
  - » Each director signs the registration statement, usually through power of attorney
  - » Section 11 of Securities Act of 1933
    - » Private right of action for material misrepresentations or omissions
    - » Potential defendants: signers, including directors, and “control persons”
    - » Due diligence defense: after reasonable investigation, defendant had reasonable grounds to believe (and did believe) that disclosure was correct
  - » Important for directors to understand process by which prospectus and SAI drafted and updated
  - » *Janus v. First Derivative Traders* (U.S. 2011) (adviser not “maker” of statement in prospectus under 10b-5 because it did not have ultimate authority over prospectus disclosure)

# Disclosure

- » Marketing Material
  - » Broker-dealer creating and using the material is primarily responsible
    - » Usually the principal underwriter (distributor)
    - » Not part of registration statement or filed under director signature
    - » Board oversight of distributor generally (as with any fund service provider)
      - » Focus is on process, not individual documents

# Affiliated Transactions

- » Affiliated brokerage (quarterly)
  - » Rule 17e-1: commission to affiliate must be reasonable and fair compared to commission for comparable transactions
  - » Potential conflict: adviser may have an incentive to use an affiliated broker and pay above market commission rates
- » Affiliated underwriting (quarterly)
  - » Rule 10f-3: if fund purchases in an offering where an affiliated broker-dealer is in the underwriting syndicate, purchase must meet certain standards
  - » Potential conflict: adviser affiliate could seek to dump unwanted securities on fund at unfair terms

# Affiliated Transactions

- » Cross trades (quarterly)
  - » Rule 17a-7: transfers between affiliated funds must meet certain pricing and other standards
  - » Potential conflict: transfer could benefit one fund over another, either because the price is not fair or because the security is not appropriate investment for receiving fund

# Codes of Ethics

- » Rule 17j-1
- » Board must approve code of ethics covering personal trading for each adviser and principal underwriter
- » Required determination: code contains provisions reasonably necessary to prevent access persons from engaging in prohibited conduct
- » Initial approval; approval of material change within six months
- » Quarterly reporting on material violations
- » Rule does not require quarterly reporting by independent directors, unless director knew or should have known that, during the 15 day period immediately before or after the director's transaction, the fund purchased or sold the security, or the fund or its adviser considered purchasing or selling the security

# Best Execution and Soft Dollars

- » Board role in trading practices
  - » Oversight
  - » Monitoring conflicts of interest
- » Legal basis
  - » Fiduciary duty
  - » Annual approval of advisory agreements

# What is Best Execution?

- » Adviser must **seek to** “execute securities transactions for clients in such a manner that the client’s total cost or proceeds in each transaction is the **most favorable under the circumstances**”
- » Consider factors beyond commission rates or spreads, including “full range and quality of a broker’s services in placing brokerage”
  - » Research, execution capability, financial responsibility, responsiveness
- » Direct costs
  - » Brokerage commissions, exchange fees, taxes
- » Indirect costs
  - » Bid/ask spread, price impact of placing order, missed trade opportunity cost
  - » Indirect costs vary based on factors such as anonymity, willingness to commit capital, speed of execution

# What are Soft Dollars?

- » Historical context
  - » 1975: SEC abolishes fixed rate commission
  - » Concern: adviser could be deemed to breach fiduciary duty by paying higher commission to obtain research
- » Section 28(e) of the 1934 Act (1975) (safe harbor):
  - » Adviser not liable for breach of fiduciary duty solely because the fund pays more than the lowest commission rate to receive brokerage and research services
  - » Adviser must determine in good faith that the amount of the commission was reasonable in relation to the value of the brokerage and research services

# Key SEC Guidance

- » 2008 proposed guidance for fund boards
  - » Adviser has fiduciary duty to fund, but may face conflicts of interest related to trading
  - » Boards should oversee trading practices of advisers, including soft dollar usage
  - » Boards should request certain information regarding the adviser's use of fund brokerage including soft dollars:
    - » Information regarding the adviser's brokerage policies
    - » How brokerage commissions and soft dollar commissions were allocated on at least an annual basis
  - » Brokerage practices should be considered when evaluating the advisory contract

# Proxy Voting

- » Board oversight role
  - » Subject to Board's overall fiduciary duty
  - » Board usually adopts its own policy or the policy of the adviser
    - » In manager-subadviser funds, manager policy may rely on policy of each subadviser
  - » Board or adviser policy may adopt, or rely significantly, on third-party service provider policy
- » Disclosure
  - » Summary of policy (or actual policy) in SAI
  - » Annual SEC filing of all actual votes (Form N-PX)

# Proxy Voting

- » Policy topics
  - » Typical topics include: corporate governance matters; anti-takeover provisions; management compensation; social responsibility issues
  - » How does the policy relate to the investment objective of the fund?
    - » Investment adviser has a fiduciary duty to fund in connection with vote
  - » Disclosure must cover how conflicts of interest are handled
    - » E.g., adviser has material relationship with issuer
    - » Options include committee structure with independence or reliance on third-party
- » Board reporting
  - » Periodic (often annual)
  - » Summaries, with a focus on conflict resolution

# Resources

- » IDC website
  - » [www.idc.org](http://www.idc.org)
  - » Fundamentals for Newer Directors, <http://fundamentals.idc.org>
  - » Foundations for Fund Directors; Videos
  - » Fund Governance: A Successful, Evolving Model, by A. Lancellotta, P. Pike and P.S. Stevens, Virginia Law & Business Review (Spring 2016)
- » IDC papers
  - » Overview of Fund Governance Practices, 1994-2014
  - » SEC Valuation and Liquidity Guidance (two volumes)
  - » Funds' Use of Proxy Advisory Firms
  - » Considerations for Board Composition: From Recruitment Through Retirement
  - » Investment Performance Oversight by Fund Boards
  - » Board Oversight of Exchange-Traded Funds
  - » Board Oversight of Target Retirement Date Funds

# Resources

- » IDC papers cont'd.
  - » Fund Board Oversight of Risk Management
  - » Board Oversight of Subadvisers
  - » Board Oversight of Fund Compliance
  - » Board Oversight of Derivatives
  - » Board Oversight of Certain Service Providers
  - » Board Consideration of Fund Mergers
  - » Director Oversight of Multiple Funds
  - » Board Self-Assessments: Seeking to Improve Mutual Fund Board Effectiveness

# Resources

- » SEC website
  - » [www.sec.gov](http://www.sec.gov)
- » ABA Fund Directors' Guidebook
  - » [www.abanet.org](http://www.abanet.org)
- » ICI Investment Company Fact Book
  - » [www.icifactbook.org](http://www.icifactbook.org)
- » Matt Fink, "The Rise of Mutual Funds" (Oxford Press, 2008)