

2017 Fund Directors Conference

October 23–25 | Fairmont Chicago Millennium Park | Chicago, IL

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2017 Fund Directors Conference

Core Responsibilities of Fund Directors

October 23–25

Chicago, IL

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”

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 - » Distribution and Rule 12b-1
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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

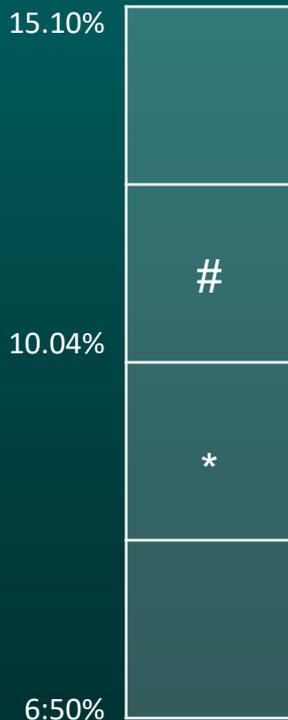
Investment Performance

- » 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

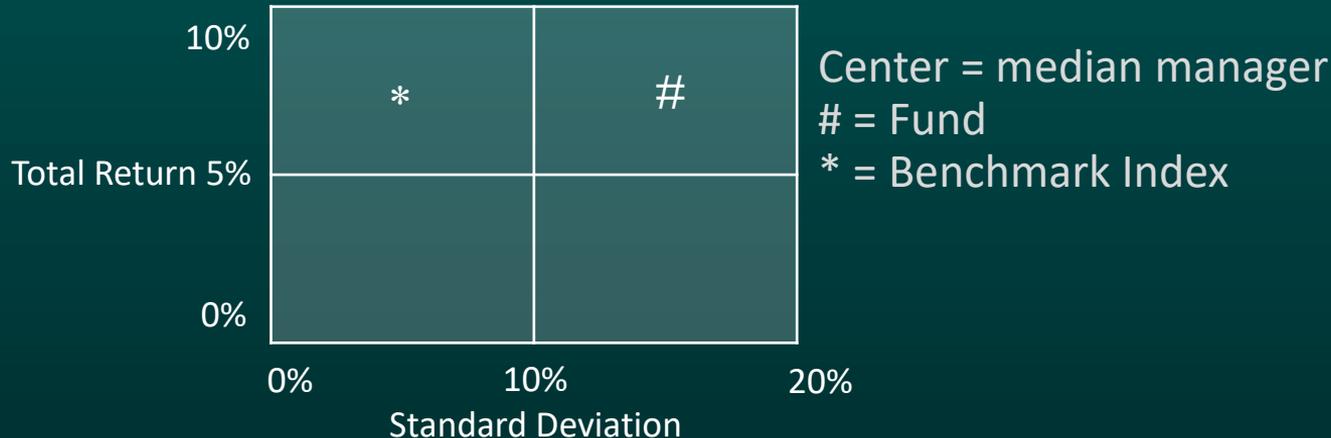
Quartile charts showing peer and benchmark relative performance over various periods:

- » 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

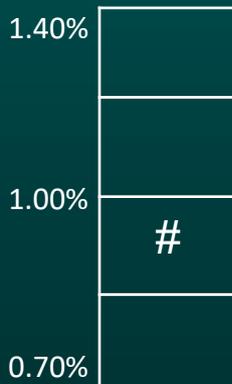
- » Adviser or affiliates may receive benefits other than the fee
- » *Gartenberg* (sweep money market): float on checks of redeeming shareholders; free credit balances in brokerage accounts from redemptions
- » Soft dollars
- » Other benefits may arise from affiliate arrangements with fund, including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

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3. Risk, Compliance and Insurance
 - » Oversight of Risk Management
 - » Valuation and Liquidity
 - » Relationship with CCO
 - » Indemnification and Insurance
4. Other Board Responsibilities

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?

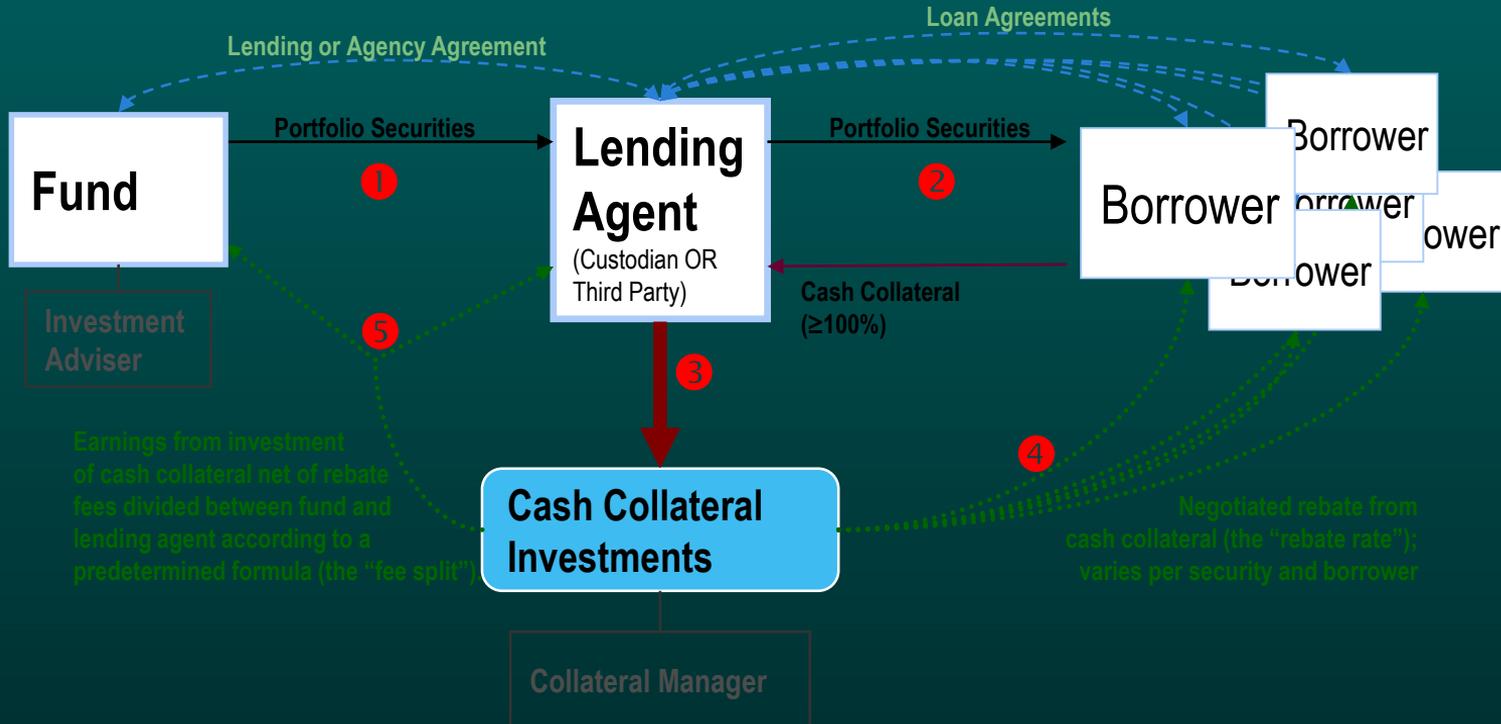
- » Fund lends security to borrower (e.g., short seller)
- » Borrower provides cash collateral to fund
 - » At least 100% of value of loaned security
- » Fund invests cash collateral
 - » Some earnings to borrower
 - » Some earnings to securities lending agent
 - » Some earnings to fund

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
 - » 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
- » ABA Fund Directors' Guidebook
 - » www.abanet.org
- » ICI Investment Company Fact Book
 - » www.icifactbook.org
- » Matt Fink, "The Rise of Mutual Funds" (Oxford Press, 2008)

Fund Boards Today

Jonathan F. Zeschin

Independent Director, Matthews Asia Funds
Chair, IDC Governing Council

Annette Capretta

Deputy Managing Director, IDC

- » Collecting data since 1994
- » Governance practices
- » Director compensation
- » Peer group analysis
- » For participants only

2017 Directors Practices Study PRACTICES AND COMPENSATION

REPORT TO PARTICIPANTS
August 2017

1,800

INDEPENDENT DIRECTORS

MORE THAN

\$20 trillion

IN ASSETS

OVERSEE

11,000

REGISTERED FUNDS

100 million

SHAREHOLDERS

Profile of independent directors

Average
age

66
years

Average
tenure

12
years

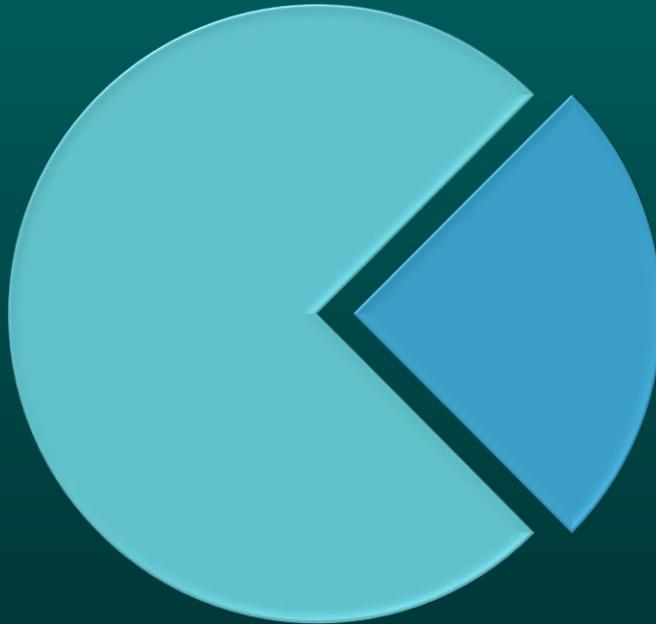
Average number
of funds served

58

Average net
assets served

\$120
billion

Gender Diversity



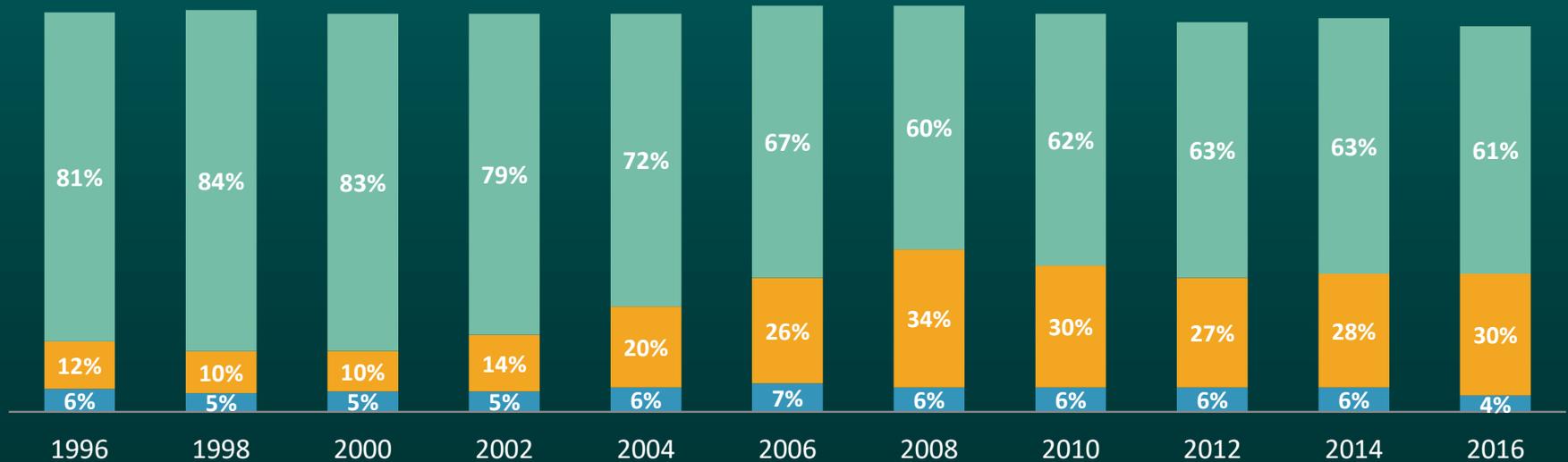
25%

of fund independent
directors are female

Regularly Scheduled In-person Board Meetings per Year

1996–2016

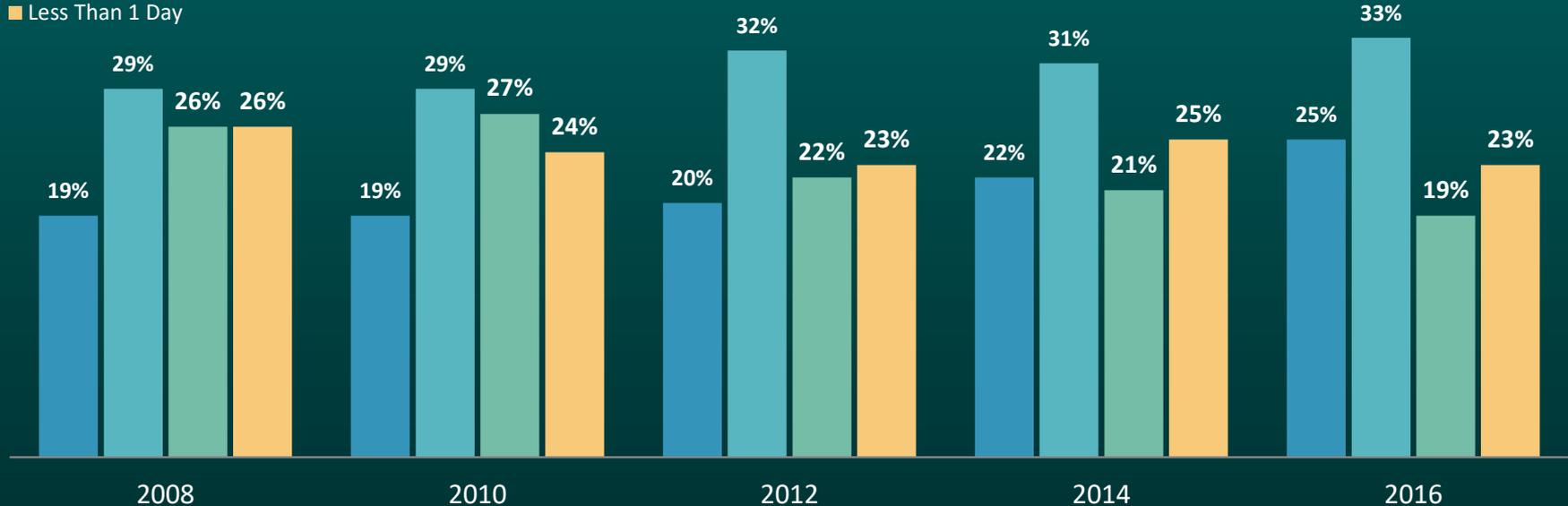
- Four
- Five or Six
- Seven or More



Length of Board Meetings

Percent of complexes, 2008–2016

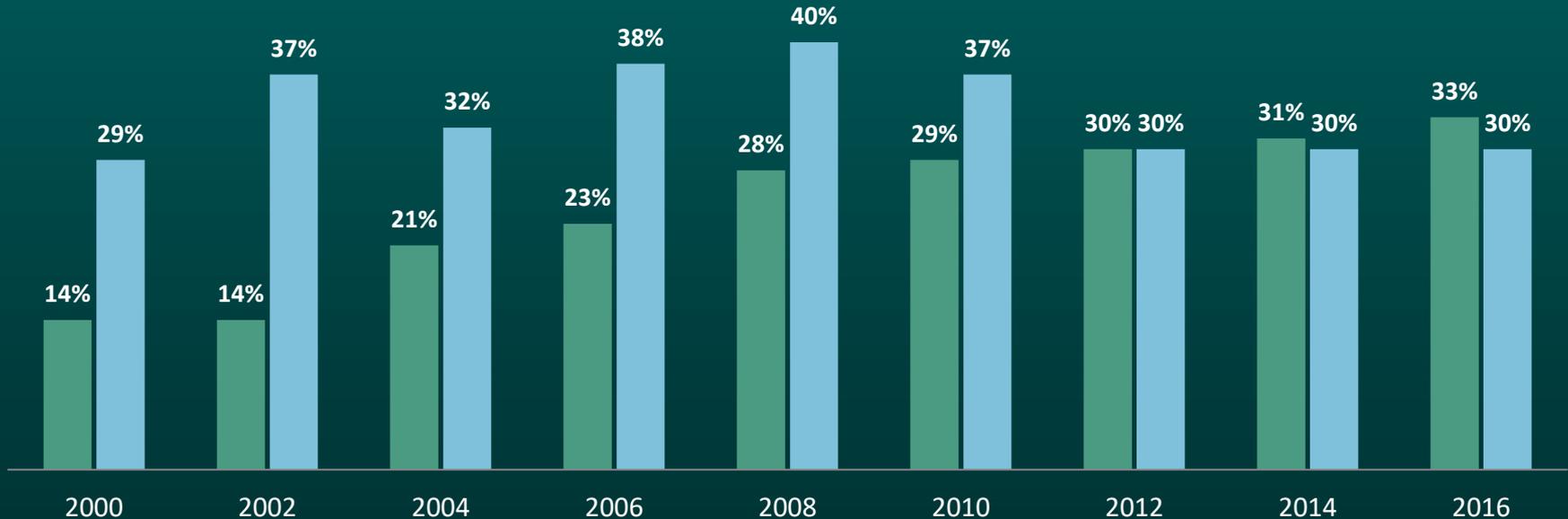
- 2 or More Days
- 1.5 Days
- 1 Day
- Less Than 1 Day



Policies on Share Ownership by Independent Directors

Percentage of complexes, 2000–2016

- Formal Policy Requiring Share Ownership
- Complex Encourages Share Ownership



Continuing education

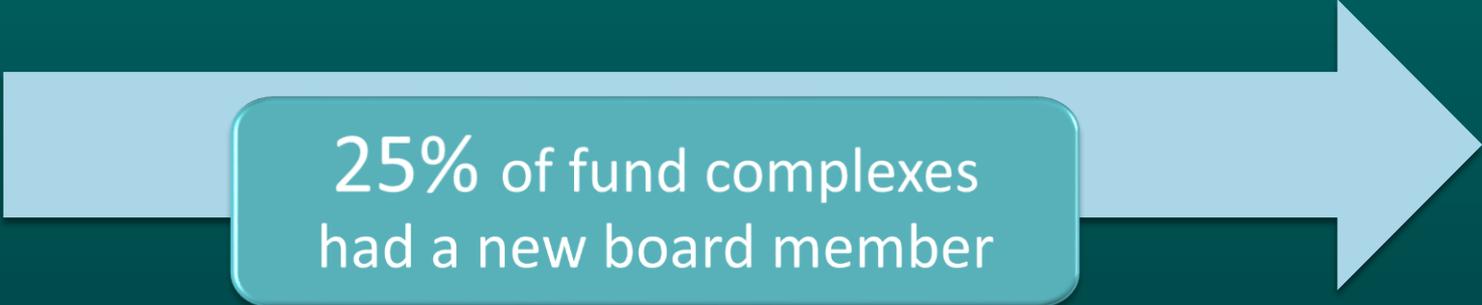
- » Formal orientation or education program
 - » Most fund complexes encourage or require completion by new independent directors
- » Continuing education
 - » Most fund complexes encourage or require participation by independent directors

Mandatory Retirement Policy

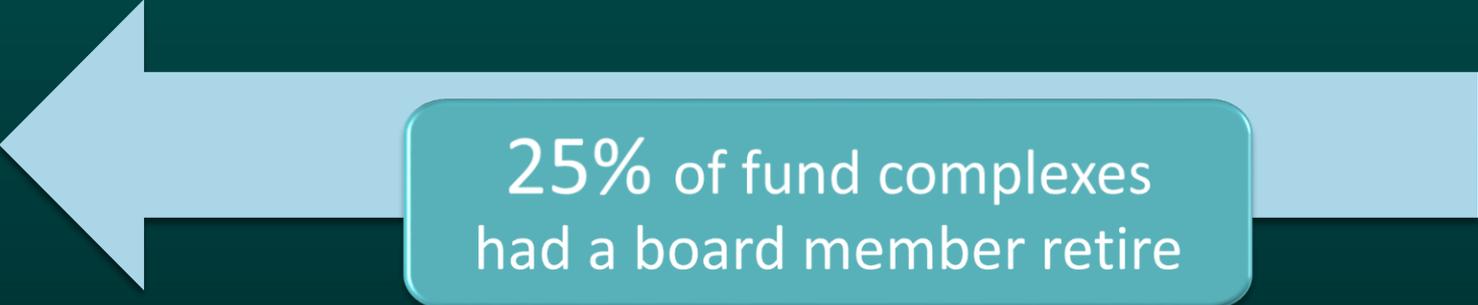
1996–2016



Recruiting



25% of fund complexes
had a new board member



25% of fund complexes
had a board member retire

Foundations for Fund Directors

An Orientation Program for Board Members

Two Primary Components

Online Training

- » 1–2 hours
- » Prerequisite to in-person training



In-Person Training

- » 8 hours, two ½ days
- » Case studies

Foundations for Fund Directors

Winter 2018

- » Los Angeles, January 10-11

Spring 2018

- » Chicago, April (TBD)

Fall 2018

- » New York/Boston (TBD)

Industry Trends and Implications for Fund Boards

Brian Reid, Moderator
Investment Company Institute

Kyle C. Andersen
Edward Jones

Susan B. McGee
U.S. Global Investors, Inc.

Maureen Mitchell
Natixis Funds/Loomis Sayles Funds

Overview

- » What are the broad market trends affecting the fund business, and what forces are driving them?
- » How are these trends affecting fund fees and conversations with fund boards?
- » How are these trends affecting fund distribution, and what are we seeing in the adoption of new share classes?
- » How are these competitive pressures affecting asset managers, and what issues are fund boards facing?

Polling Question #1

What is the most significant challenge facing your funds? *Select one.*



Use the Q&A icon in the mobile app to respond

Polling Question #2

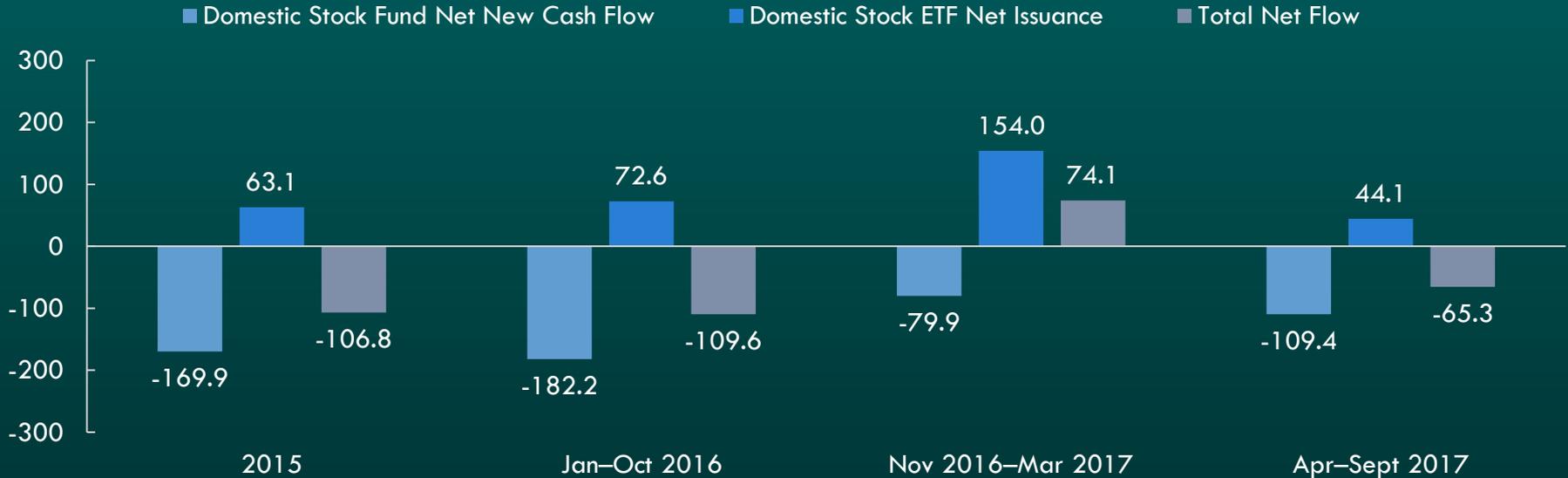
Which statement best reflects how the demand for lower cost funds has affected your 15(c) process?
Select one.



Use the Q&A icon in the mobile app to respond

Domestic Stock Fund Flows Have Been Negative Other Than Immediately After the Election

Billions of dollars, 2015–September 20, 2017



Source: Investment Company Institute

International Stock Fund Flows Remain Strong

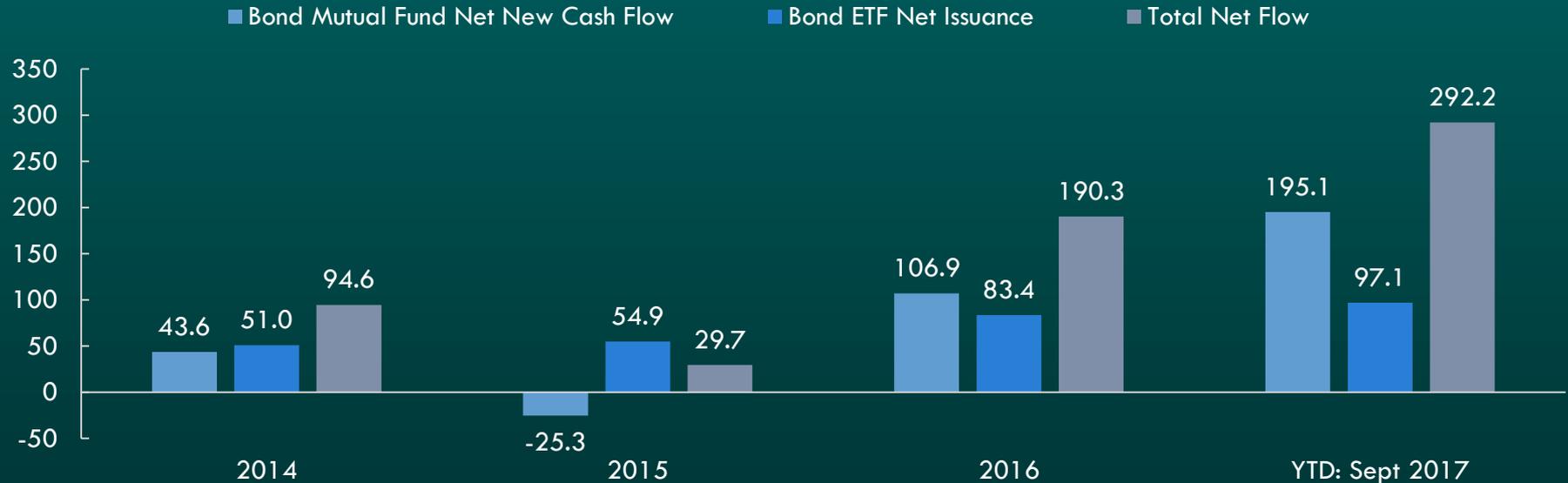
Billions of dollars, 2015–September 20, 2017



Source: Investment Company Institute

Investor Flows into Bond Mutual Funds and ETFs Continue to Accelerate

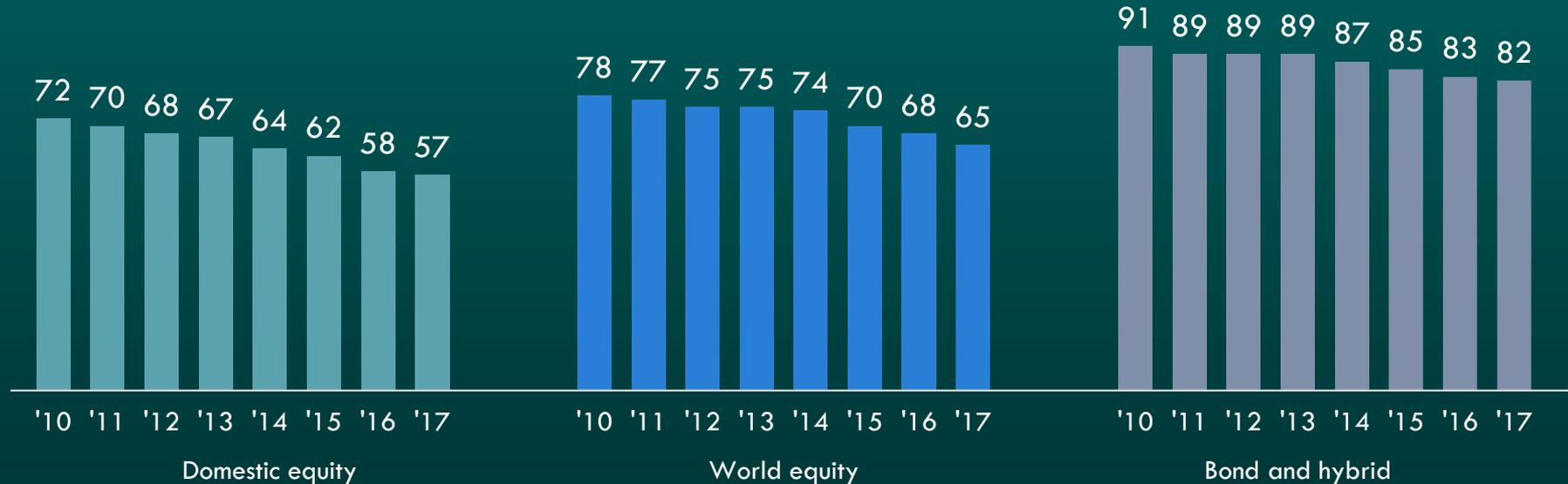
Billions of dollars, 2014–September 20, 2017



Source: Investment Company Institute

Actively Managed Funds' Share of Mutual Fund and ETF Assets Continues to Decline

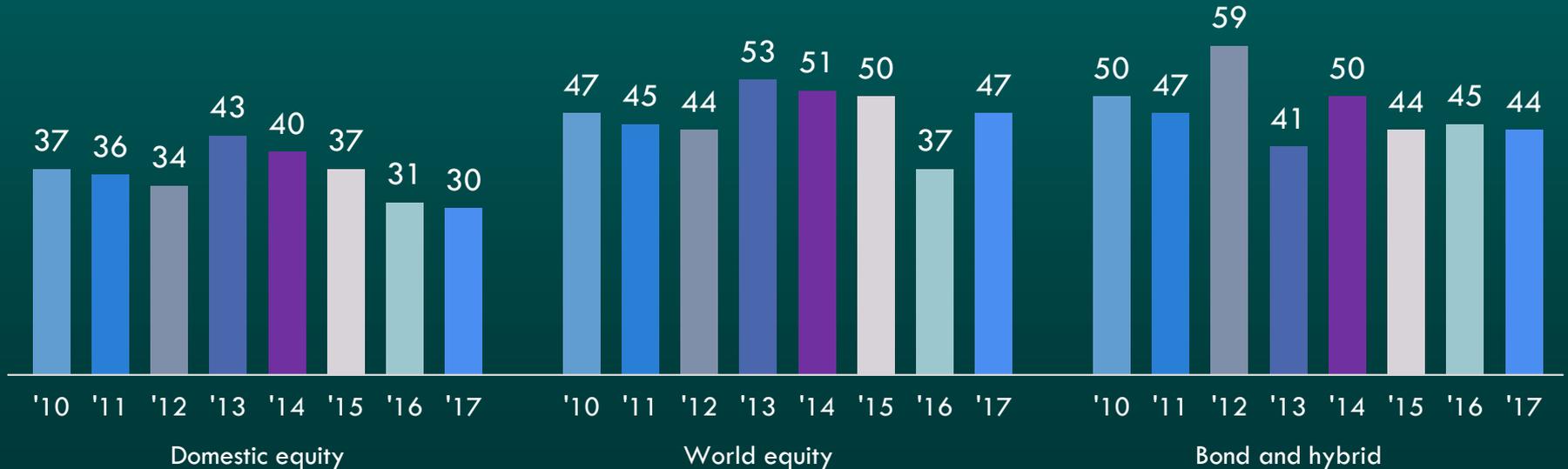
Percentage of total net assets actively managed within respective investment objective, 2010–July 2017



Source: Investment Company Institute

Less Than Half of Equity and Bond Mutual Funds Had Net Inflows in 2017

Percentage of funds with inflows by investment objective, 2010–July 2017



Source: Investment Company Institute

Share of Top-Rated Domestic Equity Mutual Funds With Net Inflows Has Edged Lower in Recent Years

Percentage of classes with positive net new cash flow, 2005 and 2017

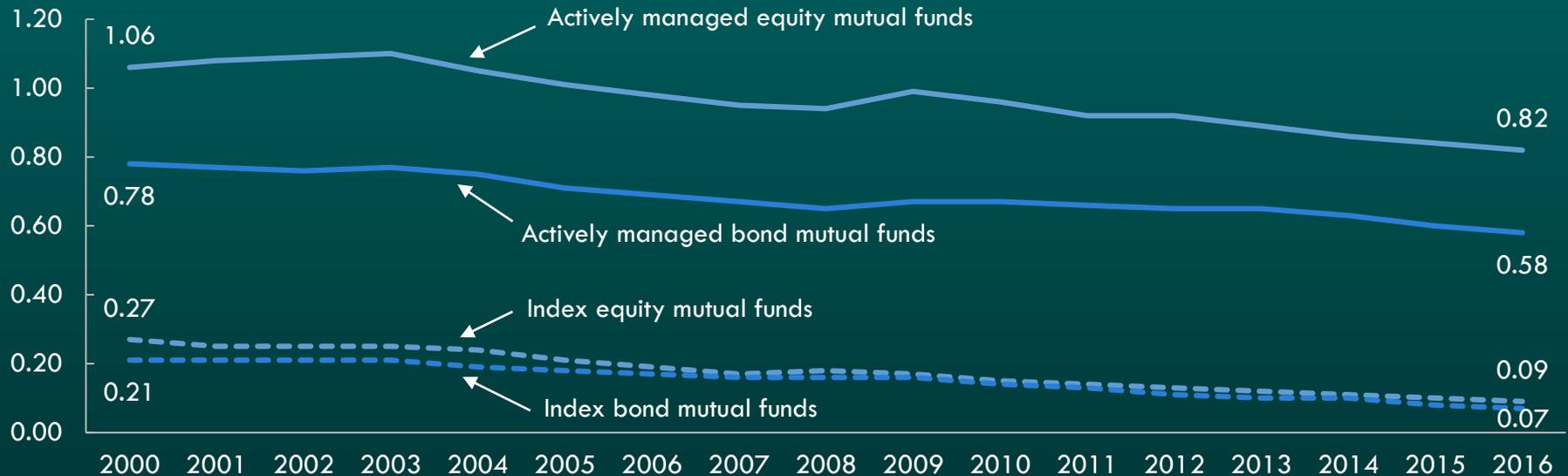
■ 2005 ■ 2017



Sources: Investment Company Institute and Morningstar

Expense Ratios Shareholders Pay for Actively Managed and Index Mutual Funds Continue to Fall

Percent, 2000–2016

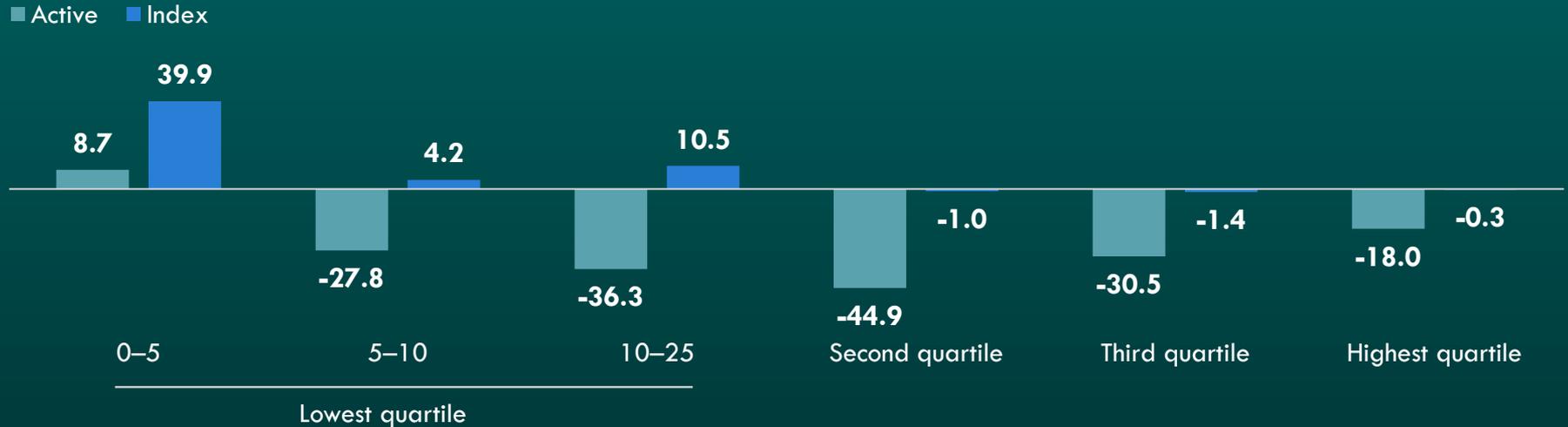


Note: Expense ratios are measured as asset-weighted averages. Data exclude mutual funds available as investment choices in variable annuities and mutual funds that invest primarily in other mutual funds.

Sources: Investment Company Institute, Lipper, and Morningstar

Low-Cost Domestic Equity Mutual Funds Receive Most of the Net New Cash Flow

Net new cash flow in billions of dollars, January–July 2017

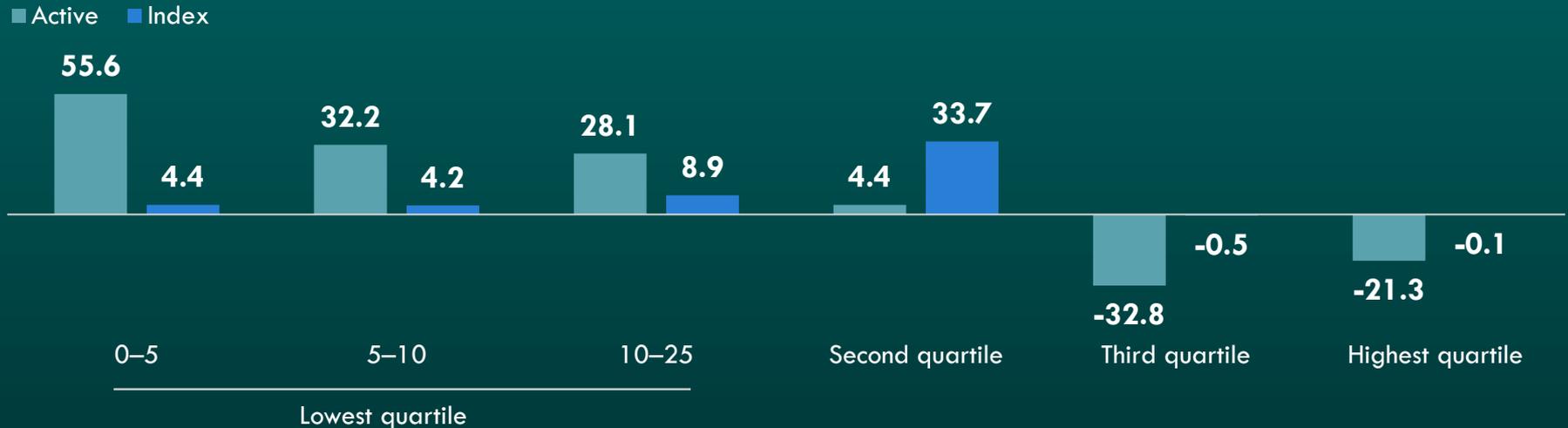


Quartiles for domestic equity mutual fund expense ratios

Sources: Investment Company Institute and Morningstar

Net New Cash Flow is Positive for Bond and Hybrid Mutual Funds with Expense Ratios Below the Median

Net new cash flow in billions of dollars, January–July 2017



Quartiles for bond and hybrid mutual fund expense ratios

Sources: Investment Company Institute and Morningstar

Polling Question #3

How has your funds' adviser and board addressed the changing distribution landscape? *Select all that apply.*



Use the Q&A icon in the mobile app to respond

Polling Question #4

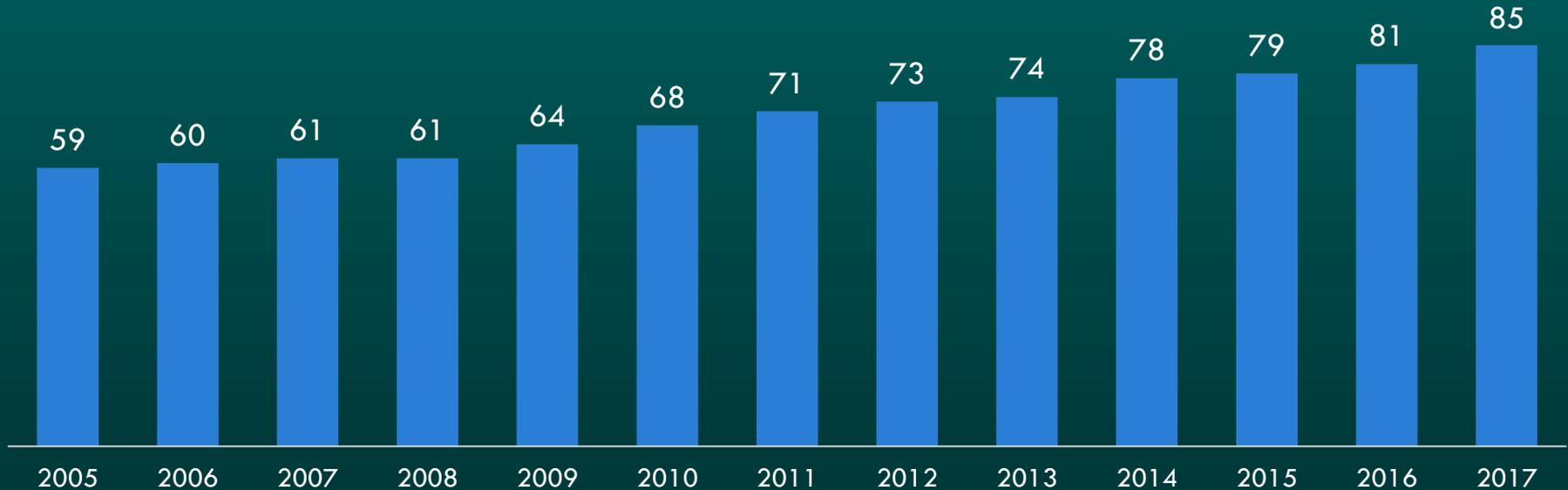
Have market dynamics led your funds' adviser to discuss any of the following with your board? *Select all that apply.*



Use the Q&A icon in the mobile app to respond

More Than 80 Percent of Sales Go to Funds Without Loads and 12b-1 Fees

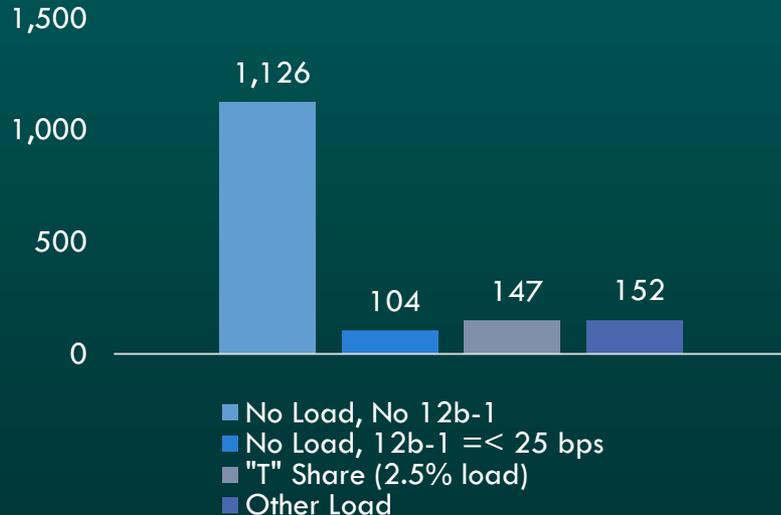
Percent of all long-term mutual fund sales in funds without loads and 12b-1 fees, 2005–July 2017



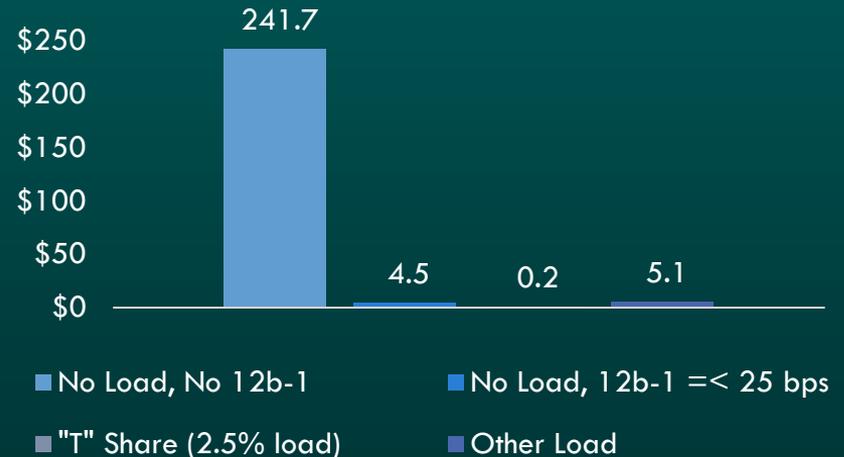
Sources: Investment Company Institute, Lipper, and Morningstar

Majority of Share Classes Launched in 2017 Are Pure No Load and Have Collected Most Assets

Number of New Share Classes

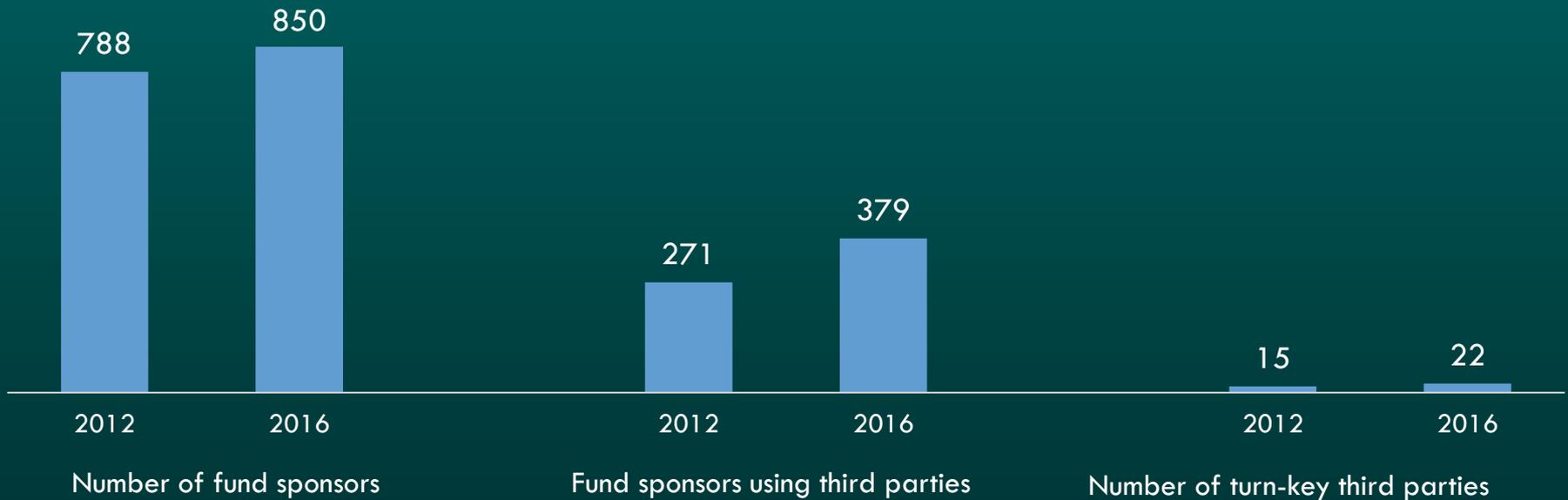


Assets in New Share Classes
(in Billions)



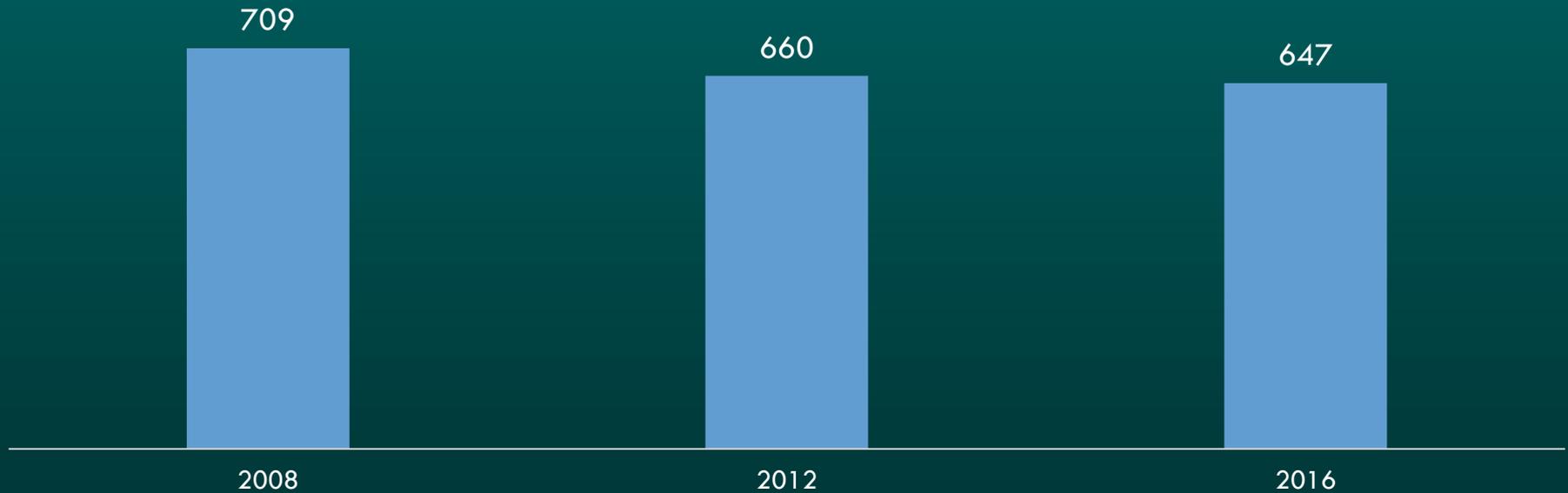
Source: Investment Company Institute

An Increasing Number of Small Asset Managers Are Managing Funds Through Third Parties



Source: Investment Company Institute

Number of Fund Boards of ICI Member Funds



Source: Investment Company Institute

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Technology Trends in Asset Management

Janet L. Yeomans, Moderator
Delaware Funds

Marty Burns
Investment Company Institute

John M. Griffin
PricewaterhouseCoopers

Lisa Shea
Northern Trust

Discussion Themes

- » State of the industry and business imperatives for adaptation
- » Emerging technologies poised to impact the mutual fund business
- » How these technologies might impact funds and shareholders in the future
- » Governance, risk, regulatory, and compliance considerations

Polling Question #1

Has your board had education session(s) to learn about emerging technologies such as blockchain, robotic process automation and artificial intelligence?



Use the Q&A icon in the mobile app to respond

Ready or Not, They're Here



» Deployed Blue Prism's RPA Solution¹

Morgan Stanley

» Deployed Addepar's Robotics Solution¹



» Deployed 150+ Bots¹



» Deployed Blue Prism's RPA Solution¹



» Developed RPA Tools¹



» Deployed Automated Trading Solutions¹

BLACKROCK[®]

» Currently in talks for a stake in a FinTech company²

Significant Investment in Key Emerging Technologies



8%

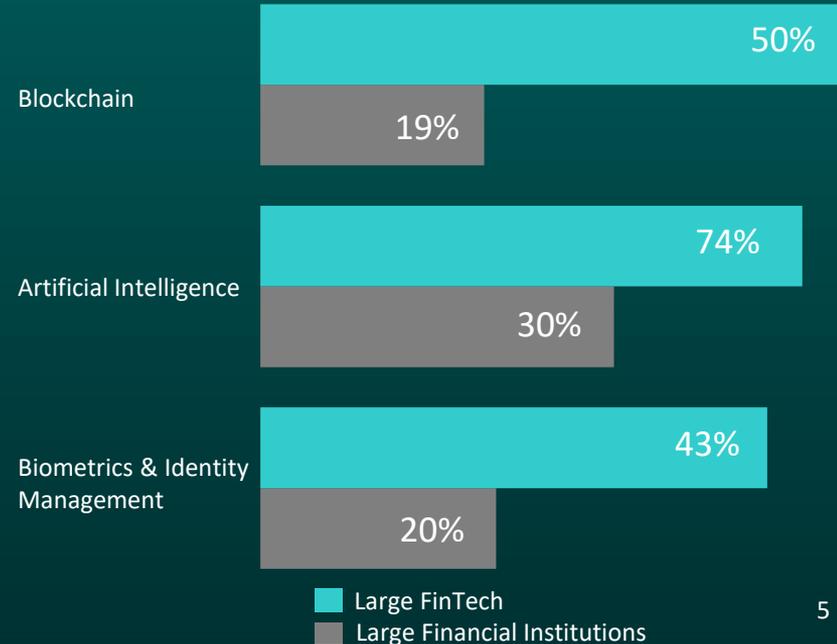
**Percentage of Financial Service
Companies' Technology Budget
Spent on Innovation**

Significant Investment in Key Emerging Technologies

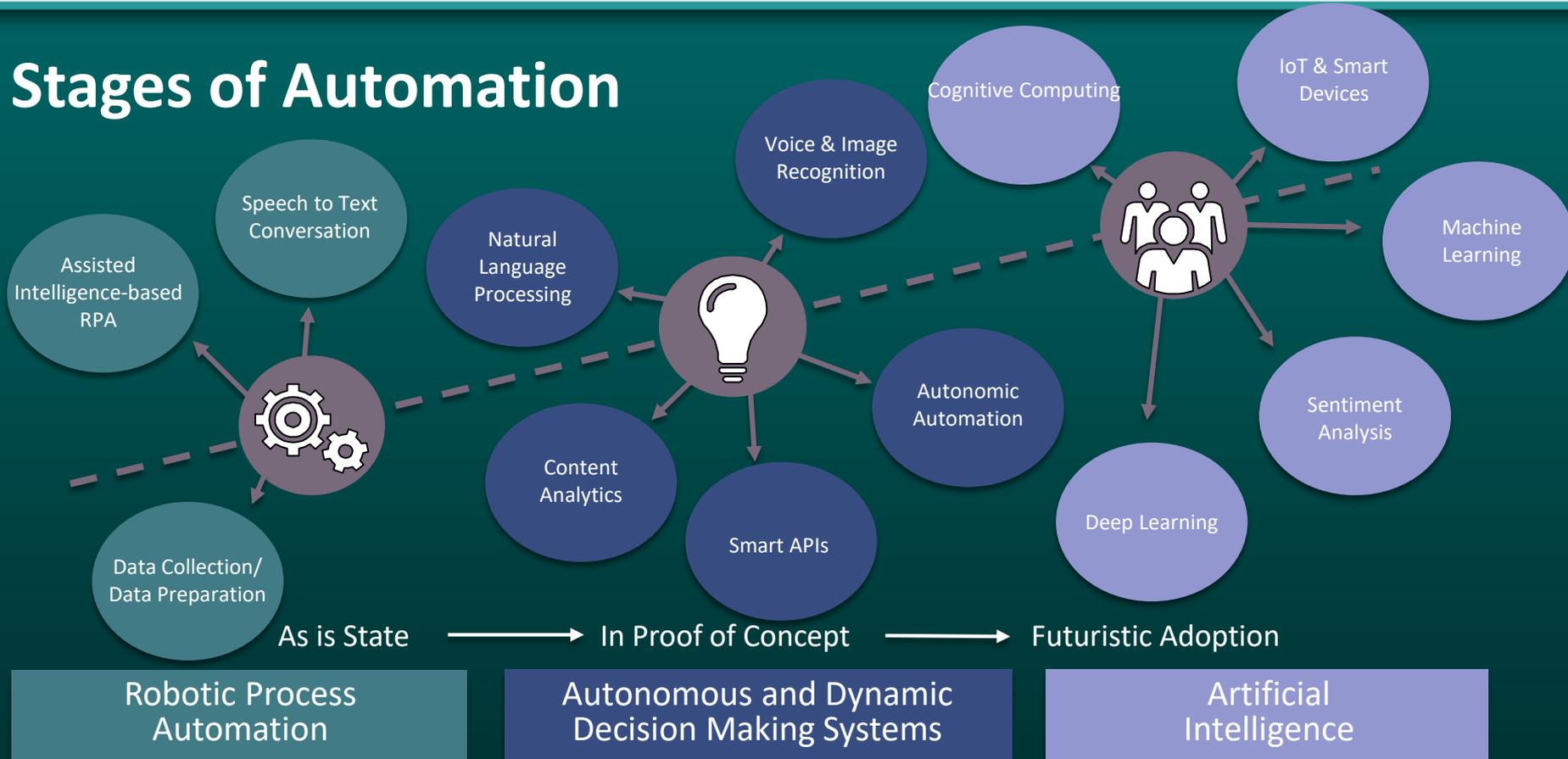
Technological Areas of Investment



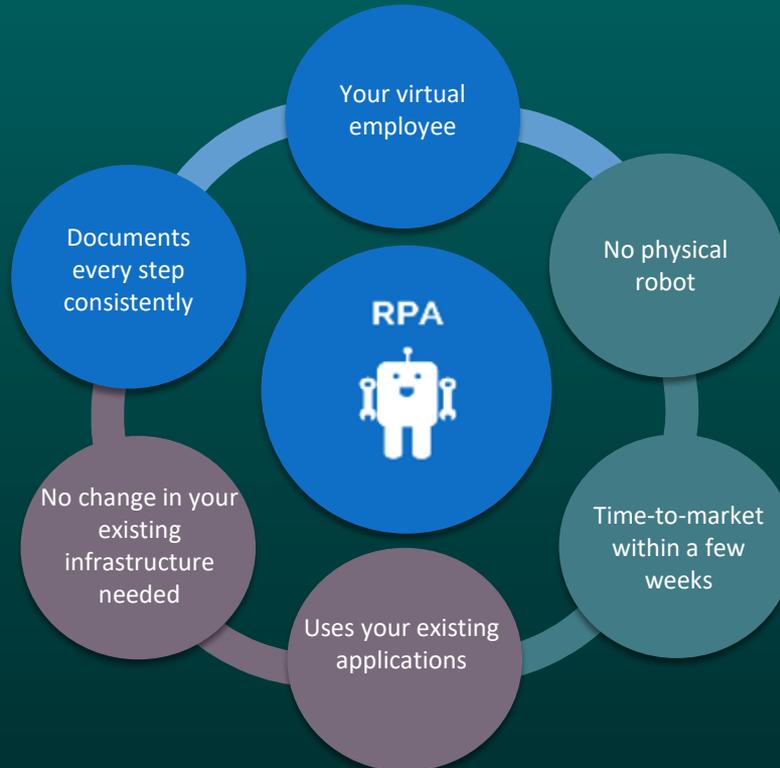
Focus on Emerging Technologies



Stages of Automation



Robotic Process Automation (RPA)



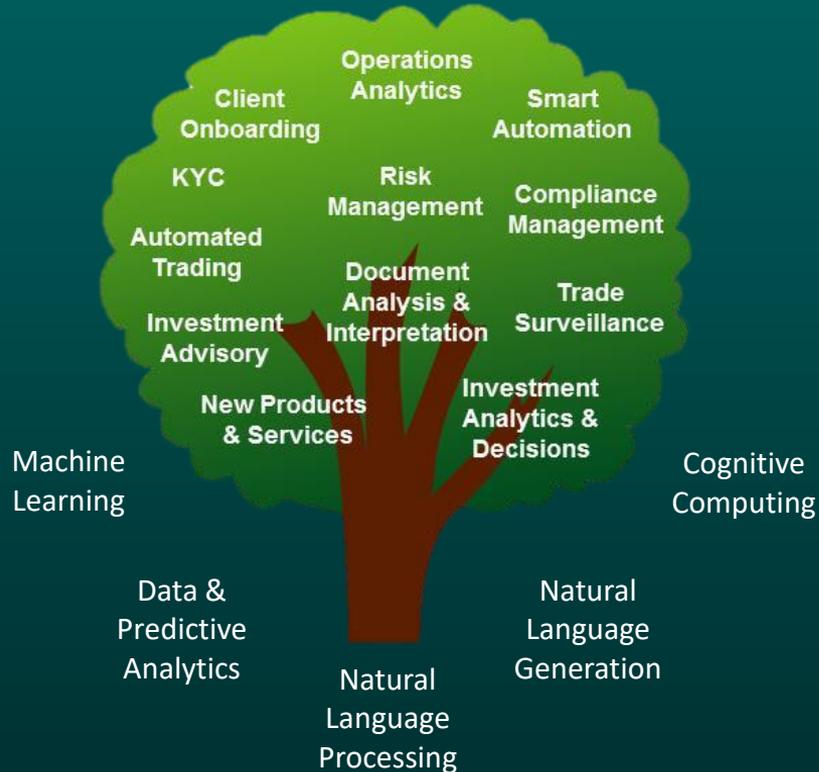
Polling Question #2

When do you think it is appropriate for boards to weigh in on major emerging technology initiatives?



Use the Q&A icon in the mobile app to respond

Artificial Intelligence



Artificial Intelligence Service Providers

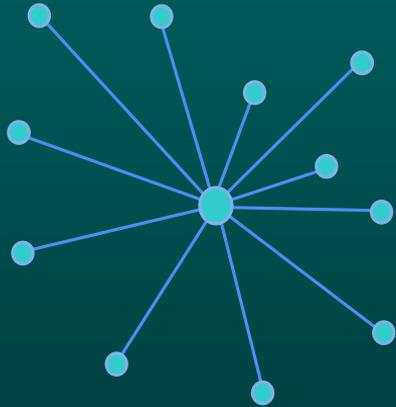
Emerging Companies



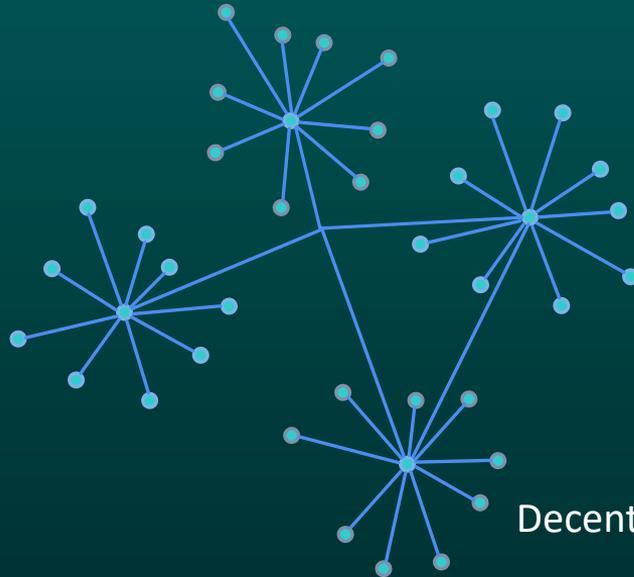
Capabilities

- » B2B Cognitive Advisory platform providing customized insights/advice to wealth managers through analysis of capital markets data, news, research, proprietary data and client information
- » AI for quantitative trading and investment strategy optimization
- » Automated portfolio creation and monitoring

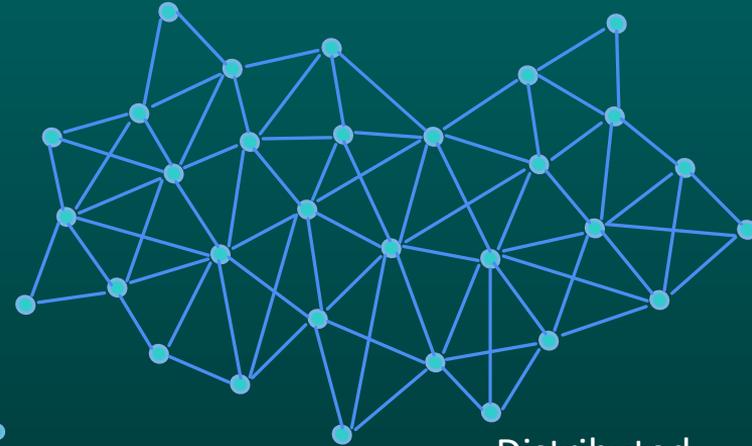
What is Blockchain?



Centralized

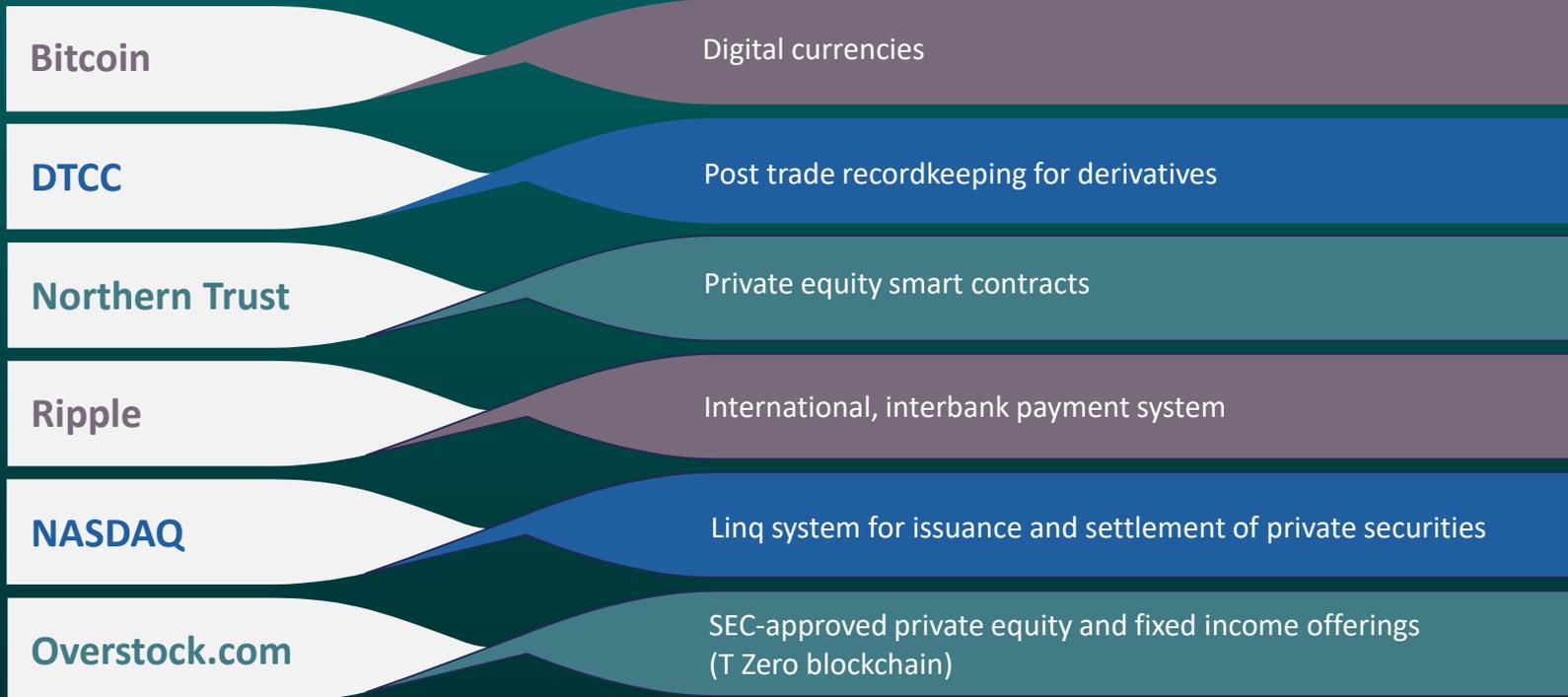


Decentralized



Distributed

What is Blockchain/Is it Real?



Polling Question #3

How confident are you that the risk management function at your investment management company can manage a changing risk profile resulting from introduction of emerging technologies?



Use the Q&A icon in the mobile app to respond

Governance, Risk, and Compliance Considerations



Leading Ahead - Things to Consider

- » With a significant paradigm shift, like the use of emerging technologies, how does your board handle the changes?
- » What should we be doing now in our roles as Trustees/Directors to lay the groundwork for the arrival of these technologies?
- » What external resources are available/recommended to help us get and stay up to speed?

Closing Thoughts

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Update on Regulation and Litigation Affecting Funds and Their Boards

Amy B.R. Lancellotta, Moderator
Independent Directors Council

Barry P. Barbash
Willkie Farr & Gallagher LLP

David A. Kotler
Dechert LLP

Maryanne Roepke
MFS Funds

Agenda

- » Regulatory Developments
 - » Liquidity Risk Management Rule
 - » DoL Fiduciary Rule; SEC Best Interest Standard of Conduct
 - » Data Reporting Forms: Form N-PORT and N-CEN
 - » MiFID II Investment Research
 - » Proposed Derivatives Rule
- » Modernizing Fund Directors' Responsibilities
- » Litigation
 - » Update on Section 36(b) Litigation
 - » Attorney-Client Privilege

Liquidity Risk Management Rule

- » All mutual funds (other than MMFs) and most ETFs must establish liquidity risk management programs containing elements such as:
 - » Assessment, management and periodic review of a fund's liquidity risk
 - » Classification of the liquidity of portfolio investment
 - » Determination of a "highly liquid investment minimum"
 - » Limitation on illiquid investments
 - » Board oversight
- » Implementation date: December 1, 2018 for fund complexes with \$1 billion or more in net assets; June 1, 2019 for complexes with less than \$1 billion

Liquidity Risk Management Rule (cont'd)

- » Board oversight
 - » Must approve liquidity risk management program
 - » Must approve the designation of the fund's adviser or officer to administer the program
 - » Review, at least annually, a written report on the adequacy of the program and effectiveness of implementation
 - » Must be informed within one business day if the fund's holdings of illiquid investments exceed 15% of its net assets
 - » Must be informed no later than the next regularly scheduled meeting of a shortfall of the fund's highly liquid investments, the cause and extent of it, and any action taken in response; additional reporting required if a shortfall lasts more than 7 consecutive calendar days

Liquidity Risk Management Rule (cont'd)

- » Challenging implementation issues:
 - » How the rule operates
 - » Definitional issues
 - » Vendor readiness
 - » Scope of asset classes covered by individual vendors
 - » Cost of compliance
- » Management presentations to fund boards
- » Industry request for 18-month extension and re-examination of the four bucket classification requirement

DoL Fiduciary Rule: SEC Best Interest Standard

- » DoL fiduciary rule – proposed delay until July 1, 2019
- » SEC Chair Clayton statement soliciting views on a “best interest standard of conduct” for broker-dealers
- » Industry seeking a single best interest standard of conduct for broker-dealers across retail and retirement accounts, adopted by the SEC and used by the DoL as a streamlined exemption to its fiduciary rule
- » Boards approving new share classes; discussing distribution matters with management

Data Reporting Forms: N-PORT and N-CEN

- » Form N-PORT
 - » Extremely detailed monthly reporting to SEC
 - » Both portfolio and position-level reporting
 - » Made public for every third month, 60 days after the fund's quarter-end

- » Form N-CEN
 - » Replace Form N-SAR
 - » Filed annually, census-type reporting

- » Industry concerned about SEC's cyber security controls; request delay of implementation date

MiFID II Investment Research

- » The revised Markets in Financial Instruments Directive (MiFID II) requires “unbundling” of research and execution costs and, thus, will fundamentally change how investment advisers pay for research in Europe
- » Compliance with MiFID II could raise issues under US securities laws for funds and advisers that are subject to MiFID II or are part of a group that includes an investment firm subject to it
- » Industry groups have requested relief from SEC staff to allow asset managers to continue to run their trading and research programs on a global basis

Proposed Derivatives Rule

- » Proposed Rule 18f-4 would have 3 main elements:
 - » Portfolio limitations
 - » Asset segregation requirements
 - » Risk management program
- » Each of these elements places new responsibilities on boards
- » SEC received numerous comments on the proposal and is in the process of going through them

Modernizing Directors' Responsibilities

- » IDC submitted recommendations to SEC staff to update directors responsibilities to allow them to dedicate a majority of their time on matters where they add value and promote shareholder protections
- » It is time to review directors responsibilities:
 - » Directors responsibilities have increased
 - » The fund industry has grown significantly and become more complex over the years
 - » Regulatory developments have impacted fund governance

Modernizing Directors' Responsibilities (cont'd)

- » IDC suggested a framework for determining appropriate board responsibilities, applicable for looking at existing responsibilities as well as proposing new ones
 - » Regulations should focus on board oversight of potential conflicts of interest
 - » Directors should not duplicate the CCO's responsibilities
 - » Directors' value is in providing oversight, not subject-matter expertise

Section 36(b) Litigation: An Update On Pending Cases

- » Since the filing of the first post-*Jones* case in 2011:
 - » 20+ different fund complexes sued
 - » A variety of different structural attacks (manager of managers, advisers who also subadvise, mutual fund vs. institutional accounts, fund of funds, BDCs)
 - » Total exposure for the industry, across all cases, exceeded \$7B at its high point – and is still more than \$6B today

Section 36(b) Litigation: A Report On Pending Cases (cont'd)

- » Scoreboard, as of today:
 - » Motions to Dismiss: none granted with prejudice in a mutual fund case*
 - » Summary Judgment: none granted in full on the merits
 - » Trial: two defense rulings, none affirmatively endorsing adviser or its business model
 - » Five settlements; two voluntary dismissals with prejudice
- » Lessons Learned
- » “Fiduciary Exception” update
- » What’s Next?

Luncheon and Keynote Address

Chad Renfro

Head of Enterprise Cybersecurity

Fidelity Investments

Fidelity's Reach

- » More than **45,000** associates at **10** regional sites with more than **190** U.S. Investor Centers in **8** different countries¹



10,000+
Customer
representatives

800+
Investment
management professionals

10,000+
Technology
associates

500+
Enterprise
Cybersecurity
associates²

2017 Breaches

1+ Trillion Credentials for Sale

EQUIFAX MISHANDLED DATA BREACH THAT AFFECTED 145.5M WORLDWIDE

DELOITTE CYBER-ATTACK COMPROMISES CLIENT EMAILS

91% of cyberattacks start with a phishing email

SURVEY SHOWS DATA BREACH CONSEQUENCES: DECLINING CUSTOMER BASE AND BRAND REPUTATION

Equifax

Deloitte

Securities & Exchange
Commission/EDGAR

E-Sports Entertainment Association
(ESEA)

Xbox 360 ISO and PSP ISO

InterContinental Hotels Group
(IHG)

Arby's

River City Media

Verifone

UNC Health Care

America's Job Link

FAFSA: IRS Data Retrieval Tool

Chipotle

Gmail

Bronx Lebanon Hospital Center

Brooks Brothers

DocuSign

OneLogin

Kmart

University of Oklahoma

Washington State University

Deep Root Analytics

Union Bank & Trust (UBT)

Leavitt Group

Bridge Investment Group

Humana

Frontier Airlines

Blue Cross Blue Shield

AT&T

Citibank, NA

Viacom, Inc.

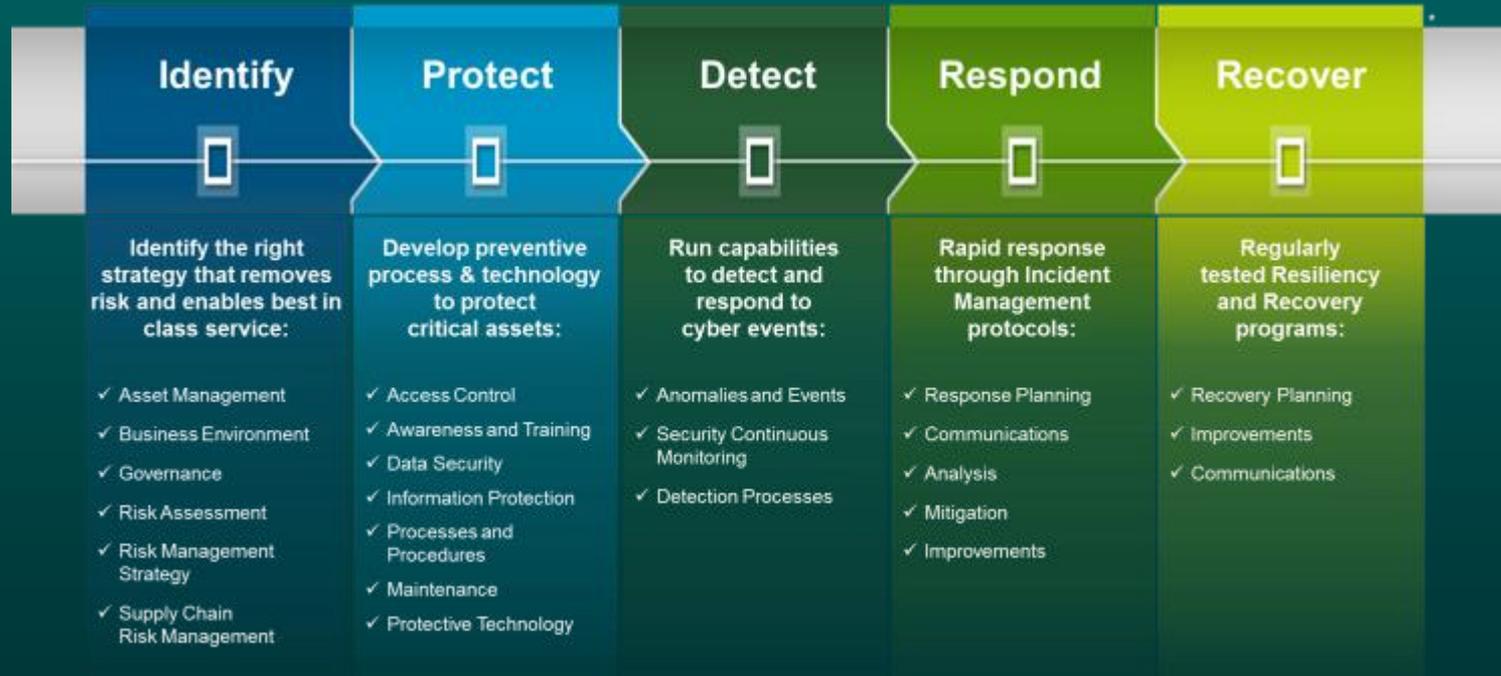
Rite Aid Online Store

Ameriprise Financial Services, Inc.

Capital One

Sabre Corp

Fidelity's Cybersecurity Framework



Strategic Forces Shaping Cyber

THREAT ACTORS:



Criminals



Insiders



Hacktivists



Nation States

2017 HEADWINDS



Security Product Explosion
(Legacy + Cloud)



Geo-Political & Regulatory
Instability



High-Stakes Targets in
Infrastructure and Persons



Critically Dependent
Infrastructure



Ransomware is King



Credential Reuse Attacks



Enterprise Cybersecurity Strategic Solutions

Customer Protection

Customer Authentication
Web | Voice/Live | Mobile

System Authentication
SSO | Aggregators

Strategic Labs
Digital Identity | Fraud Fusion

Insider Threat

Privileged Access
Management (PAM)

Identity & Access
Management (IAM)

Data Loss Prevention
Endpoint Security
Security IQ

External Defense

Security Operations and
Incident Management
(SOC, CIRT)

Code Security
(CI/CD Integration)

Vulnerability Remediation

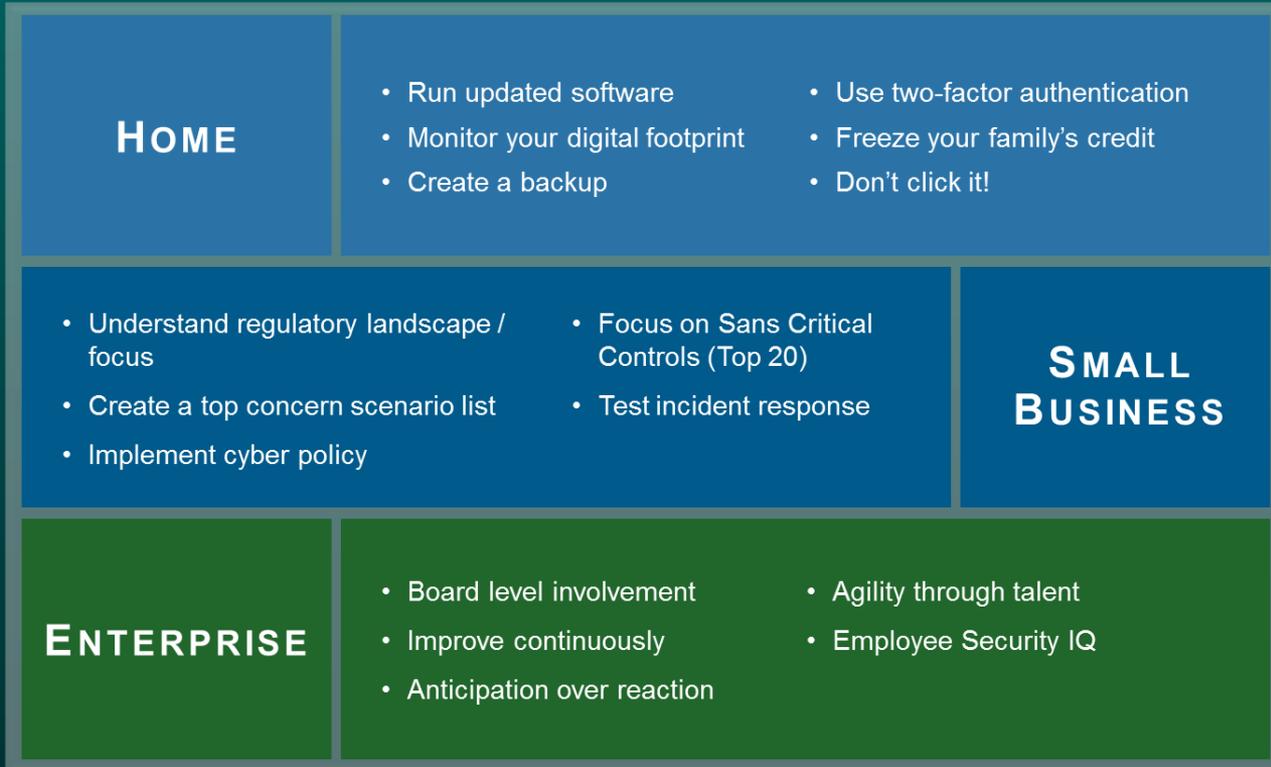
Perimeter Security

Vendor Risk Management

Infrastructure Security
Secure Platform

Business Resiliency
Enterprise Business Continuity

Cybersecurity Top Considerations



[BACK TO TOC](#)

Concurrent Session B: In-Depth Analysis of Derivatives

William R. Ebsworth

Moderator

Wells Fargo Funds

S. Ryan Kagy

PIMCO

Mark Perlow

Dechert LLP

Claire A. Walton

BlackRock Funds

Board oversight framework

- » Philosophy
- » Process
- » People

Demystifying Derivatives

Derivatives: What, Why, and How

What is a derivative?

- » A financial instrument that derives its value from movements in an underlying security
- » Includes futures, options, swaps

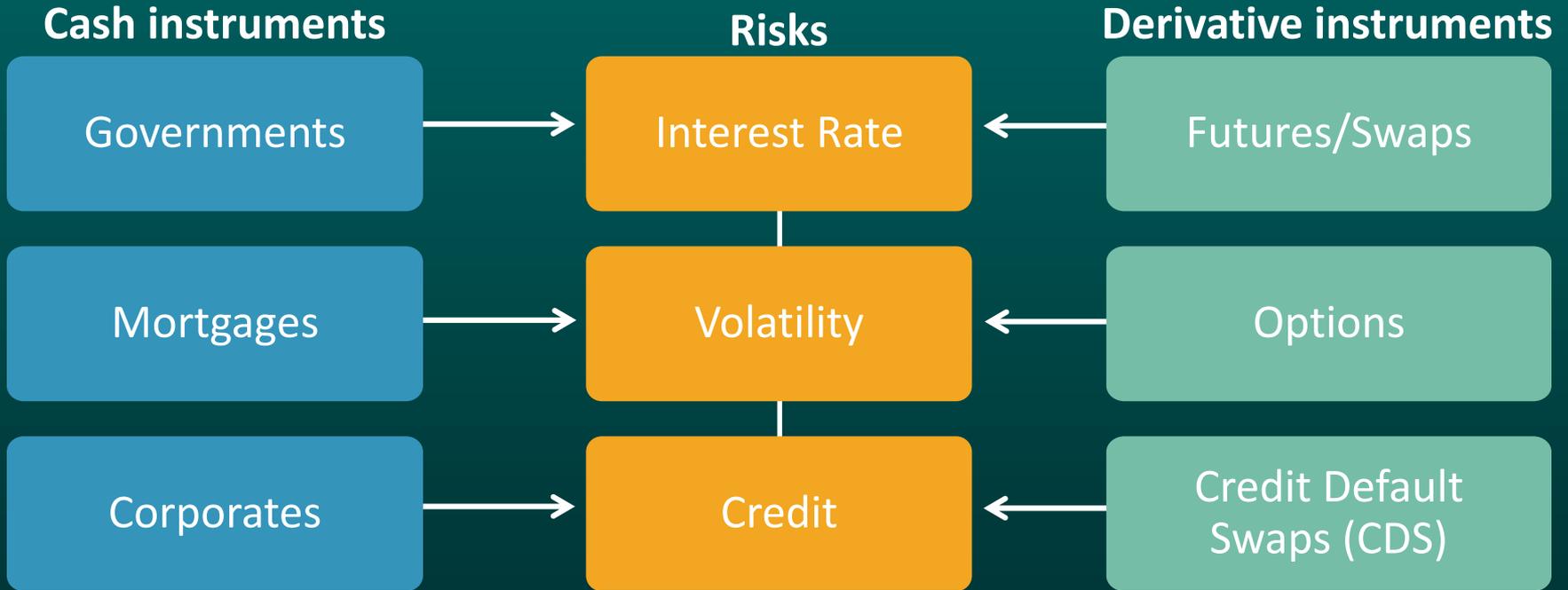
Why use them?

- » It can provide greater flexibility in structuring portfolios and many managers use them
 - » Modify portfolio risk characteristics
 - » Facilitate cash-backing strategies
 - » Security substitution
 - » Alpha generation
 - » Improve portfolio liquidity

What increases the risk?

- » Lax risk management
 - » Potential to leverage the portfolio
 - » Inadequate monitoring of derivatives' effect on portfolio risk characteristics
 - » Counterparty and basis risk

Derivative and Cash Risk Exposures are Similar



Types of Derivatives: Futures

A futures contract is a highly standardized agreement to exchange cash for an asset at a future date



- » Hedging
- » Managing duration and curve exposure

Source: PIMCO
Refer to Appendix for additional risk information.

Futures Applications: Hedging

Current portfolio duration: 5.75 years; target portfolio duration: 4.75 years

Instrument	Duration	Exposure	Duration Contribution
German bund	8.00 years	\$50M	4.00 years
Mortgage bond	3.00 years	\$25M	0.75 years
Corporate bond	4.00 years	\$25M	1.00 years
Total		\$100M	5.75 years
Sell 10 year futures	8.00 years	(\$12.5M)	(1.00 year)
New portfolio duration		\$100M	4.75 years

Reasons for using the futures market:

- » Liquidity
- » Ability to target specific risk exposures

Source: PIMCO

Refer to Appendix for additional risk information.

Sample for illustrative purposes only.

Eurodollar futures

Eurodollar (ED), Euribor, Eurosterling, etc.

- » Contracts indexed to 3-month LIBOR (London Interbank Offered Rate) for deposits in USD, EUR, GBP (respectively)
- » \$1,000,000 notional value per contract, large “notional” value
- » Duration is very small, typically 3-months (0.25 Years)
- » Exchange traded, highly liquid, cash settled
- » Important to look to contribution to duration

Instrument	Duration	Percent of portfolio	Duration contribution
10-year Treasury note	8.45 years	11.80%	1 year
Eurodollar future	0.25 years	400%	1 year

Sample for illustrative purposes only.



Source: PIMCO

Refer to Appendix for additional risk information.

What about leverage?

- » Accounting leverage exists whenever gross assets are greater than net worth
- » Economic leverage exists whenever a portfolio's expected volatility exceeds that of a reference point or range

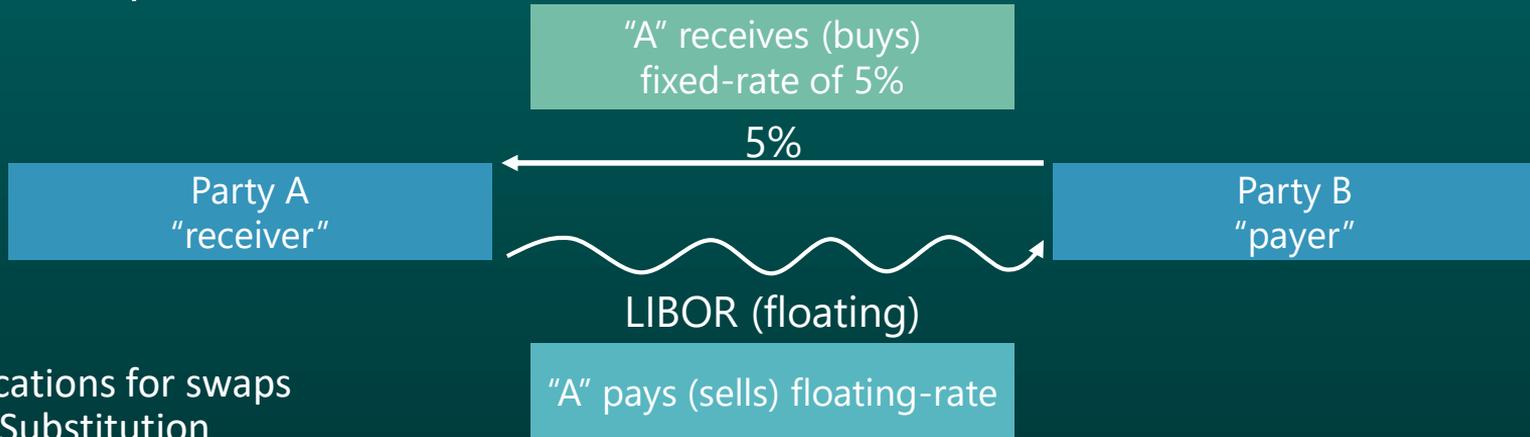
Asset		L + NW	
Cash	\$100	Net worth	\$100
Unsettled trade	\$100	Trade liability	\$100
Gross assets	\$200	L + NW	\$200

Duration Range 8 years +/- 2 years

Non-levered portfolio		Levered portfolio	
Long futures	8 yrs	Long futures	8 yrs
Cash collateral	0.25 yrs	Long bond	8 yrs
Total duration	8.25 yrs	Total duration	16 yrs

Types of Derivatives: Swaps

A swap is an agreement between two or more parties to exchange cash flows over a set period of time



Applications for swaps

- » Substitution
- » Hedging
- » Managing duration and curve exposure

Source: Robert Kolb

Example of OTC bi-lateral swap

Refer to Appendix for additional risk information.

Swaps: Dealing with Counterparty Risk



SWAPS vs FUTURES

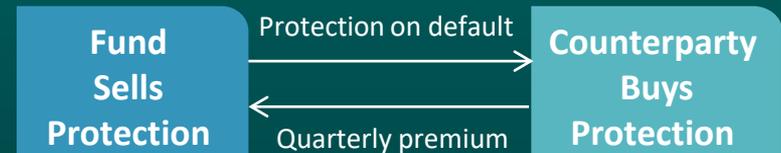
	FUTURES	OTC SWAPS	CLEARED SWAPS
Contract Terms	Standardized	Customizable	Standardized
Counterparty Risk?	No/Reduced	Yes	No/Reduced
Financing Cost	Implicit	Explicit	Explicit
Underlying	Physical security	Reference rate	Reference rate
Collateral	Daily exchange of cash	Collateralized Gain/Loss	Daily exchange of cash

Source: PIMCO
Refer to Appendix for additional risk information.

Credit Default Swaps (CDS)

- » An over-the-counter agreement between two parties to exchange the credit risk of an issuer or basket of issuers
 - » Protection seller:
 - » assumes credit risk
 - » receives payments expressed as spread over LIBOR
 - » agrees to purchase underlying bond at par in event of default
 - » Protection Buyer:
 - » Pays a premium to the seller for the right to sell the underlying bond at par when there is a credit event as defined in the agreement
- » Buyer is protected against defined credit events (e.g. default, bankruptcy, etc.)
 - » Buy Protection = “Short Credit”
- » Sell Protection: Receives a premium from the buyer and must buy the bond at par in the case of a credit event
 - » Sell Protection = “Long Credit”

CDS cashflows before maturity/default



Type of Derivatives: Options

Definition: The right (not obligation) to buy or sell an asset at a set price by (or at) a specific time

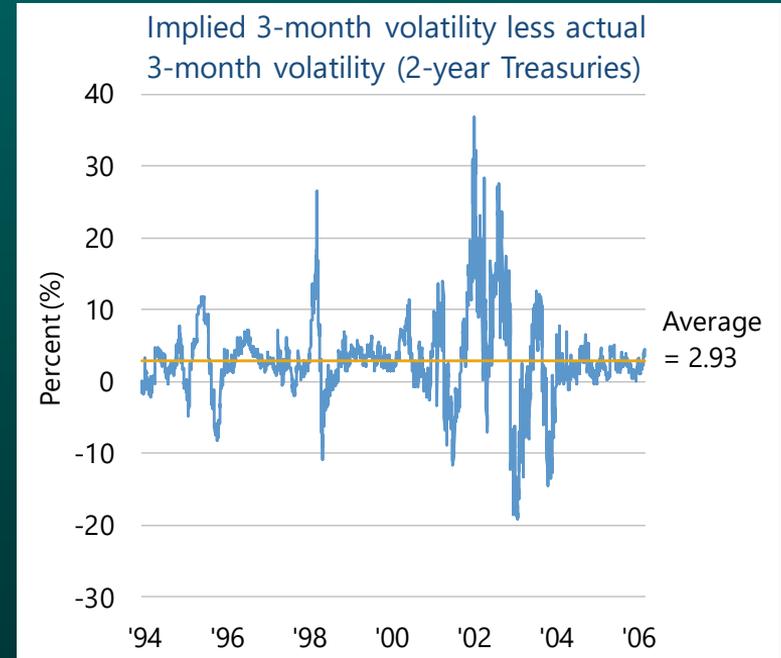
- » Call option: The right to purchase the underlying asset
- » Put option: The right to sell the underlying asset

Applications

- » Hedge (long options)
- » Long put options may protect a portfolio from falling asset prices
- » Buying call options may allow a portfolio to benefit from rising asset prices
- » As a substitute for physical security
- » To add yield (written options)

Selling Volatility

- » Realized volatility frequently lower than that implied by option's price
- » As a result, option buyers typically overpay for insurance
- » Selling options may provide a means to generate alpha



Option seller captures the market premium

Funds' Use of Derivatives

Derivatives Rules of Thumb

- » Adding “risk” or yield
 - » Buy a bond
 - » Go long a future
 - » Receive fixed on a swap
 - » Sell a put, buy a call
- » Reducing “risk”
 - » Sell a bond
 - » Short a future
 - » Pay fixed on a swap
 - » Buy a put, sell a call

Derivatives Rules of Thumb

Leveraging the portfolio

- » Invest cash into “non-cash-like” instruments

Legal Framework and Board Process

Board considerations

- » Depth of board involvement
- » Leverage risk oversight
 - » Portfolio leverage
 - » Senior securities/asset segregation
- » Counterparty risk oversight
 - » Collateral management
 - » Custody
- » Operational/infrastructure considerations
- » Clear disclosure of derivatives investment strategy and risks
- » Management's process to vet new derivatives

Other Items: Partial Checklist

- » Liquidity
- » Valuation
- » Custody rule compliance
- » Contracts (ISDAs)
- » Stress testing: portfolio and counterparty
- » Diversification/concentration/names rule compliance
- » Portfolio constraints/disclosed investment restrictions compliance
- » CFTC/NFA compliance
- » Accounting/tax treatment
- » SEC regulatory developments: N-PORT, S-X

Questions?

Appendix

» **HYPOTHETICAL EXAMPLE**

Hypothetical example for illustrative purposes only. No representation is being made that any account, product, or strategy will or is likely to achieve profits, losses, or results similar to those shown. Hypothetical or simulated performance results have several inherent limitations. Unlike an actual performance record, simulated results do not represent actual performance and are generally prepared with the benefit of hindsight. There are frequently sharp differences between simulated performance results and the actual results subsequently achieved by any particular account, product or strategy. In addition, since trades have not actually been executed, simulated results cannot account for the impact of certain market risks such as lack of liquidity. There are numerous other factors related to the markets in general or the implementation of any specific investment strategy, which cannot be fully accounted for in the preparation of simulated results and all of which can adversely affect actual results.

» **INVESTMENT STRATEGY**

There is no guarantee that these investment strategies will work under all market conditions and each investor should evaluate their ability to invest for a long-term especially during periods of downturn in the market. No representation is being made that any account, product, or strategy will or is likely to achieve profits, losses, or results similar to those shown.

» **OUTLOOK**

Statements concerning financial market trends or portfolio strategies are based on current market conditions, which will fluctuate. There is no guarantee that these investment strategies will work under all market conditions, and each investor should evaluate their ability to invest for the long-term, especially during periods of downturn in the market. Outlook and strategies are subject to change without notice.

» **RISK**

Investing in the bond market is subject to certain risks including market, interest-rate, issuer, credit, and inflation risk. Mortgage and asset-backed securities may be sensitive to changes in interest rates, subject to early repayment risk, and while generally supported by a government, government-agency or private guarantor there is no assurance that the guarantor will meet its obligations. Certain U.S. Government securities are backed by the full faith of the government, obligations of U.S. Government agencies and authorities are supported by varying degrees but are generally not backed by the full faith of the U.S. Government; portfolios that invest in such securities are not guaranteed and will fluctuate in value. Derivatives may involve certain costs and risks such as liquidity, interest rate, market, credit, management and the risk that a position could not be closed when most advantageous. Investing in derivatives could lose more than the amount invested. Swaps are a type of derivative; while some swaps trade through a clearinghouse there is generally no central exchange or market for swap transactions and therefore they tend to be less liquid than exchange-traded instruments. Credit default swap (CDS) is an over-the-counter (OTC) agreement between two parties to transfer the credit exposure of fixed income securities; CDS is the most widely used credit derivative instrument.

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Concurrent Session C: ETFs

Shelly Antoniewicz

Moderator

Investment Company Institute

Lawrence R. Maffia

JPMorgan Exchange-Traded
Funds

W. John McGuire

Morgan Lewis

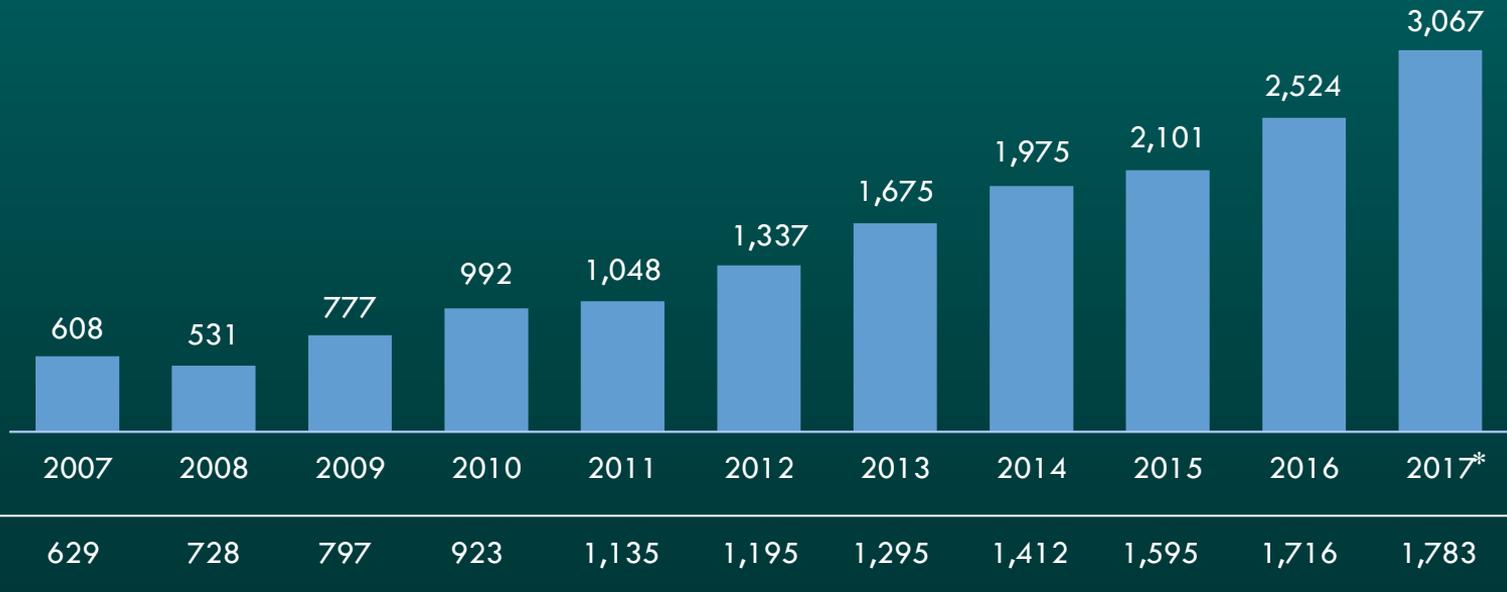
Anthony Rochte

Fidelity Investments

ETF Industry Statistics and Trends

ETFs Continue to Grow Rapidly

*Billions of dollars; year-end, 2007–2017**

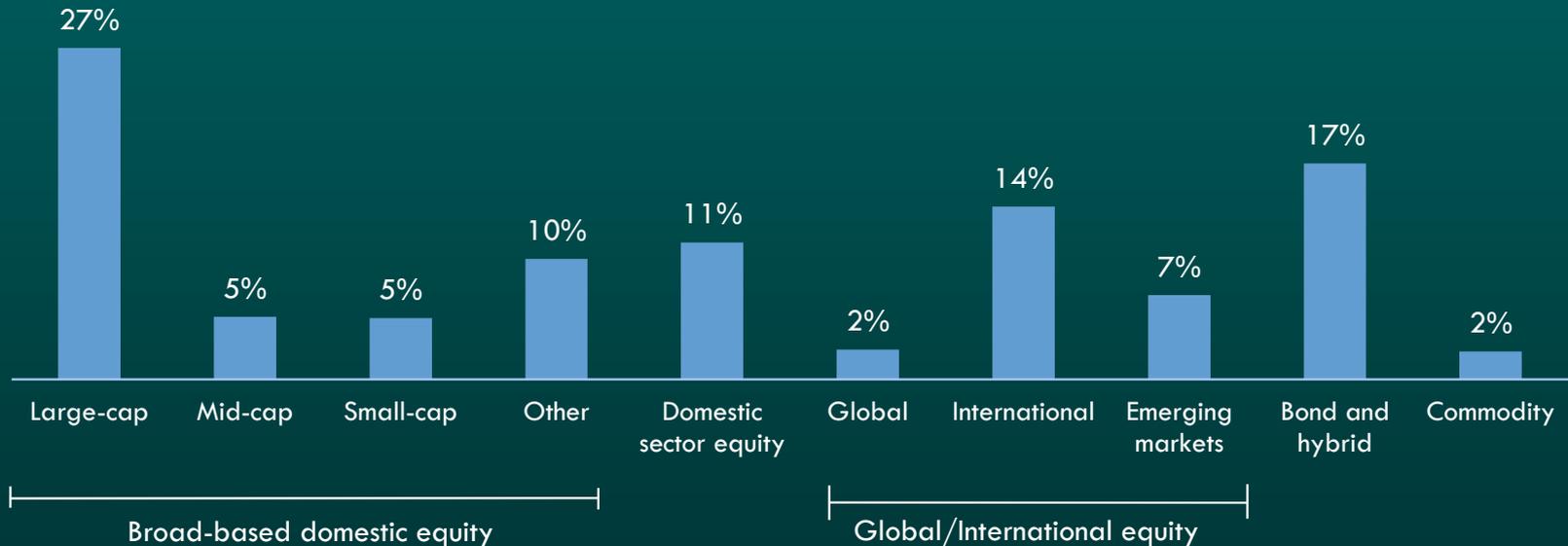


*Data as of August 2017

Source: Investment Company Institute

Assets of ETFs Concentrated in Large-Cap Stocks

Percent of total net assets; August 2017

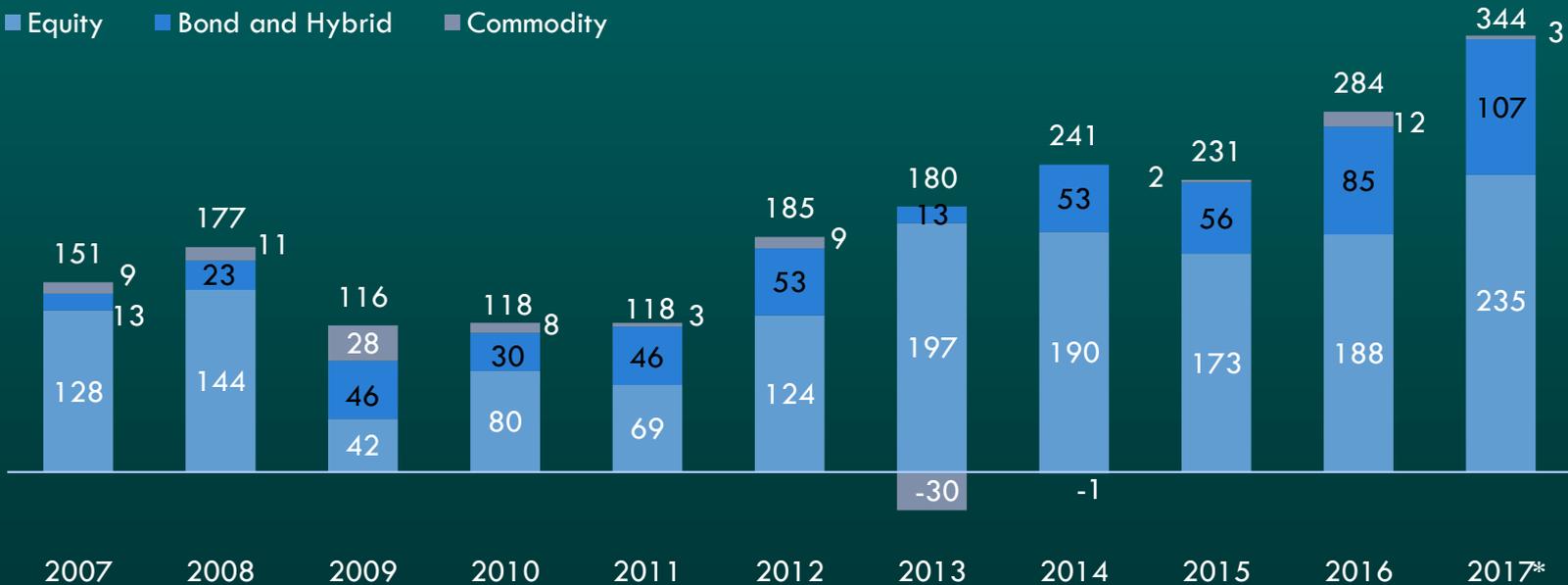


Source: Investment Company Institute

Investor Demand for ETFs

Net share issuance; billions of dollars; 2007-2017*

■ Equity
 ■ Bond and Hybrid
 ■ Commodity



*Data as of October 11, 2017, not at an annual rate.

Source: Investment Company Institute

What is an ETF?

ETFs Similar in Concept to Mutual Funds, But There Are Key Differences

Similarities to Mutual Funds

- Pool of stocks, bonds, and other assets
- Offer diversification and access to specific asset classes, markets, and strategies
- Strike net asset value (NAV) at 4pm
- Fund management fee charged via expense ratio
- Investor protections of the Investment Company Act of 1940 (vast majority of ETFs)

Differences from Mutual Funds

- Trade like a stock on an exchange
- Need a brokerage account to buy/sell ETFs
- ETF price continuously changing during trading day
- Purchases/sales of ETF can occur at prices greater than, less than, or equal to the ETF's NAV
- ETF investors responsible for trading decisions (e.g., order types and timing)

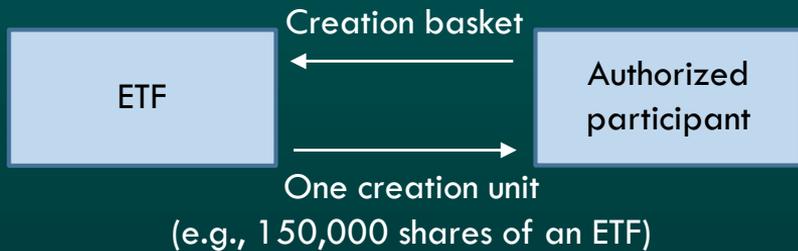
Basic Structure of an ETF

- » Registered investment company with shares that trade on an exchange like shares of stock
- » ETF shares can only be created and redeemed directly with the fund by Authorized Participants, commonly referred to as “APs”
- » Most ETFs disclose information about portfolio holdings to the public daily
- » All ETFs disclose estimate of underlying market value of portfolio throughout the trading day (e.g., every 15 seconds)
- » ETF shares tend to trade at market prices close to the value of their underlying assets
 - » Facilitated by holdings transparency and the ability to create/redeem ETF shares

Investors Never Interact Directly with an ETF

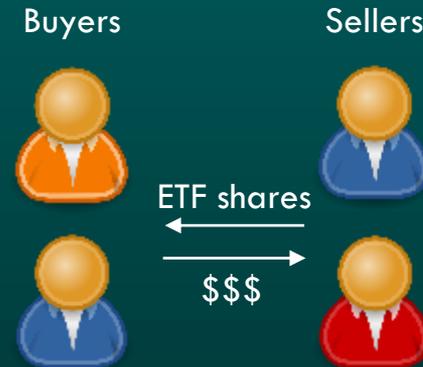
Investors acquire ETF shares by buying them on an exchange or via APs as their clients

Primary market



Directly involve underlying securities

Secondary market



Do not directly involve underlying securities

In Contrast, Investors Can Interact Directly with a Mutual Fund

Investors acquire mutual fund shares by buying them directly from the fund or through an intermediary.



Regulatory Framework for ETFs

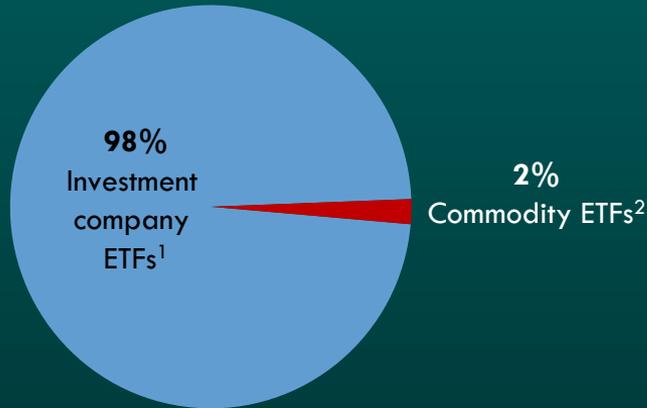
How Are ETFs Regulated?

- » Vast majority of ETFs are registered as investment companies under the Investment Company Act of 1940 (ICA)
 - » Regulated by the SEC Division of Investment Management
 - » Still subject to the same core regulatory requirements as mutual funds (e.g., custody of assets, limits on leverage, prohibitions on affiliated transactions)
- » Also subject to regulatory oversight by the SEC Division of Trading and Markets and exchange listing requirements

Most ETFs Registered under the Investment Company Act of 1940

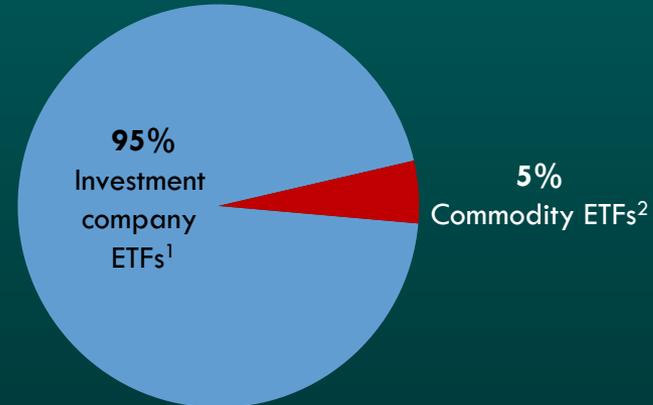
August 2017

ETF Total Net Assets



Total: \$3.1 trillion

Number of ETFs



Total: 1,783

¹Registered under the Investment Company Act of 1940 and the Securities Act of 1933.

²Registered under the Securities Act of 1933 with some also regulated by the Commodity Futures Trading Commission under the Commodity Exchange Act of 1936.

Source: Investment Company Institute

Independent Directors' Duties Between Mutual Funds and ETFs

Independent Directors' Duties: Advisory Contracts

Mutual Funds

- » Investment advisory and sub-advisory contracts and fees must be approved
 - » Advisory fees typically are just for advisory services
 - » Other than index funds, the investment goal is usually to beat the market

Exchange Traded Funds

- » Investment advisory and sub-advisory contracts and fees must be approved
 - » Advisory fees are usually a unitary fee covering most fund expenses
 - » Most ETFs are index funds and investment goal is to track an index

Independent Directors' Duties: Valuation

Mutual Funds

- » 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 the board of directors.”
- » In reality, most boards delegate daily valuation duties to the investment adviser

Exchange Traded Funds

- » 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 the board of directors.”
- » In reality, most boards delegate daily valuation duties to the investment adviser

Independent Directors' Duties: Distribution

Mutual Funds

- » Distribution (or principal underwriting) contracts and fees must be approved
 - » Distributor sells fund shares directly or enters into dealer agreements with brokers
 - » Mutual funds often have multiple classes with different distribution arrangements

Exchange Traded Funds

- » Distribution (or principal underwriting) contracts and fees must be approved
 - » Distributor enters into authorized participant agreements with brokers
 - » ETFs only sell their shares to brokers, who then resell those shares on the market

Independent Directors' Duties: Compliance Programs

Mutual Funds

- » Funds must implement written compliance programs covering the funds and certain key service providers
 - » A key component is an anti-money laundering program
 - » Compliance program should also cover any exemptive orders the fund relies on

Exchange Traded Funds

- » Funds must implement written compliance programs covering the funds and certain key service providers
 - » A key component is compliance with ETF exemptive relief conditions
 - » Even though of minimal concern, the fund must have an anti-money laundering program

Adviser Mergers and Acquisitions

Ronald E. (“Ron”) Toupin Jr.

Moderator

Guggenheim Funds

Rose F. DiMartino

Willkie Farr & Gallagher LLP

Alan Goodson

Aberdeen Standard Investments

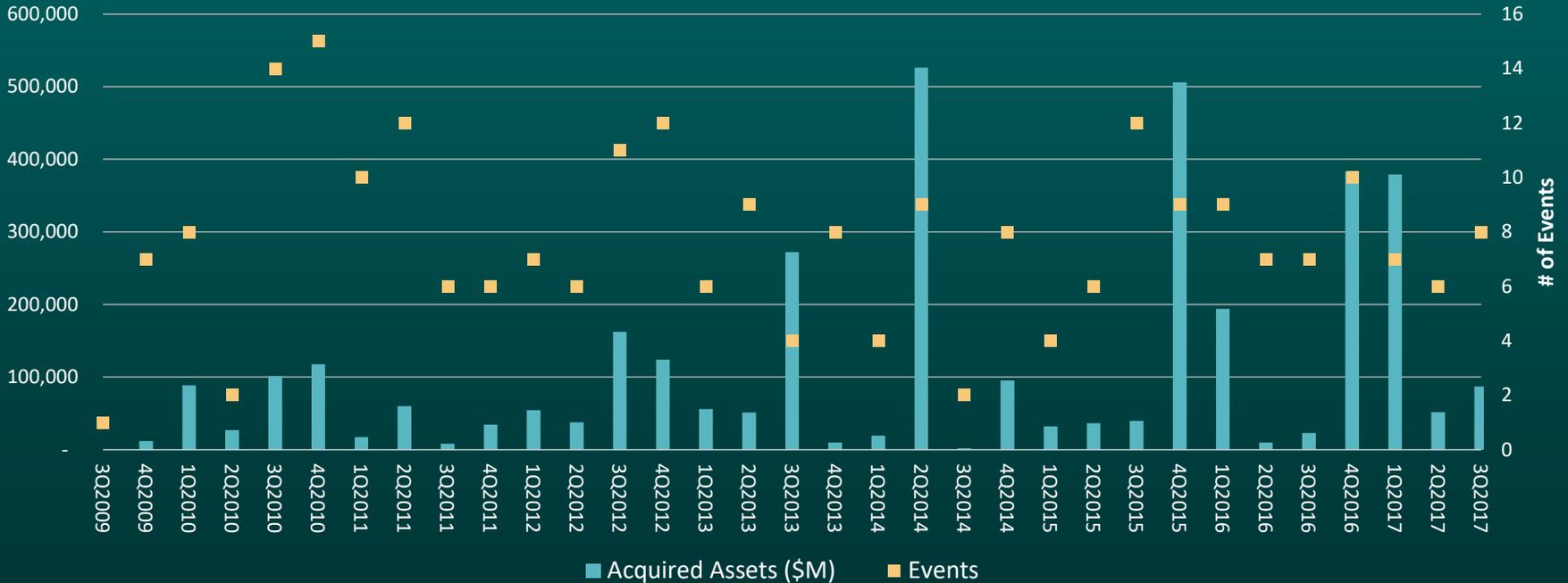
Terence J. (“Terry”) Toth

Nuveen Funds

Panel Outline

- » Historical Quarterly M&A Activity
- » Legal Context
- » Discussion Topics
 - » Deal structures
 - » Role of Independent Directors
 - » Considerations in merging or closing funds
 - » Fund board mergers

Historical Quarterly M&A Activity



Legal Context

No “Assignment” Provisions of Investment Company Act

- » Section 15(a) : Advisory contract for registered fund automatically terminates if it is assigned
- » Section 15(b): Principal underwriting agreement between a registered fund and its principal underwriter automatically terminates if it is assigned
- » Purposes of “no assignment” provisions
 - » No trafficking in advisory contracts
 - » Persons entrusted with fiduciary obligation to manage other people’s money should not transfer the obligation without the consent of their clients

Consequences of “Assignment” = Advisory Contracts Terminate

- » Section 15(a): new agreements for each Fund must be approved by that Fund’s shareholders prior to the merger closing
 - » Can be an interim agreement of up to 150 days post closing
 - » No exception for reapproval of contracts on same terms
- » Voting requirement = “1940 Act majority”
 - » Lesser of 67% of those voting at a meeting where a quorum is present Or a majority of outstanding shares
 - » Vote is non-routine: brokers cannot vote for clients
- » Distribution agreements can be re-approved by Board action alone: shareholder approval not required

When is a Contract “Assigned”?

- » Definition of “assignment” is
 - » Direct or indirect transfer of a contract or
 - » Direct or indirect transfer of a controlling block of voting securities.
- » Definition of “control” is
 - » Rebuttal presumption of control when a person beneficially owns more than 25% of a company’s voting securities or
 - » The power to exercise a controlling influence over the management or policies of a company.
- » Transfer of a controlling block of an adviser’s parent company is an assignment of the advisory contract

Discussion Topics

- » Deal structures
- » Role of Independent Directors
 - » If on the board of the Seller
 - » If on the board of the Buyer
- » Considerations in merging or closing funds
- » Fund board mergers

Managing Board Materials

Elizabeth J. Reza

Moderator

Ropes & Gray

Cecilia Herbert

iShares Funds

Salient Funds

Frank Nasta

JP Morgan

Victoria B. Rogers

Causeway Funds

TCW Funds

Panelists

- » Cecilia Herbert - Independent Director
- » iShares and Salient Funds
 - » iShares -- \$1.2T, 330 ETFs, 10 directors (8 independent), 7 committees (Risk/Compliance, Equity Performance, Fixed Income Performance, Audit, Nominating/Governance, Securities Lending, 15(c)). All directors serve on 15(c) committee.
 - » Salient Funds -- \$3.3B, 18 mutual funds, 11 directors (9 independent), 3 committees (Compliance, Audit, Nominating/Governance). Only independent directors serve on committees.

Panelists

- » Frank Nasta, Head of JPMorgan Funds Management Legal
 - » JP Morgan Funds -- \$525B, 143 mutual funds, 13 directors (all independent), 6 committees (Equity, Fixed Income, Money Market/Alternatives, Governance, Audit, Nominating).
 - » JP Morgan ETFs -- \$2B, 13 ETFs, 6 directors (5 independent), 2 committees (Audit and Valuation, Governance/Nominating). Only independent directors serve on committees.

Panelists

- » Victoria Rogers - Independent Director
- » TCW Funds and Causeway Funds
 - » TCW Funds -- \$16.9B, 21 mutual funds, 9 directors (7 independent), 3 committees (Audit, Nominating/Governance, Executive). All independent directors are members of Audit and Nominating/Governance Committees.
 - » Causeway Funds -- \$13B, 6 mutual funds, 4 directors (all independent), 2 committees (Audit, Nominating/Governance). All directors serve on all committees.

Topics

- » Communication
- » Committee structure
- » Reliance on board counsel and other experts
- » Ways to enhance materials

Sample Agenda

Treasurer's Report

Ratification of Dividends and Distributions

The Board is required to approve/ratify any income and capital gain distributions made from the Funds to shareholders. Distributions for the quarter covered by this meeting are presented for ratification by the Board. Also, included for your information is the schedule of upcoming distributions.

Expense Cap Report

The report shows the current expense cap in place for each Fund, as well as its expiration date.

Changes to Foreign Custody Arrangements

Under Rule 17f-5, the Funds' Board of Trustees has delegated certain of its responsibilities regarding the custody arrangements applicable to foreign securities. Under the Rule, the Funds' custodian provides the Board with a report that summarizes any significant event that has occurred within the custodian network.

Compliance with Subchapter M and Section 817H of the Internal Revenue Code of 1986

The Funds are required to comply with Subchapter M of the Internal Revenue Code of 1986, as amended in 1997, at each Fund's respective tax quarter end. Also, the Insurance Trust Portfolios are required to comply with Section 817H of the Internal Revenue Code of 1986 at each Fund's respective tax quarter end.

Sample Agenda

Compliance Report

Rule 17a-7 Transactions

Section 17(a) of the 1940 Act prohibits a Fund from buying securities from, or selling securities to, an affiliate of the respective Trust, or an affiliate of an affiliate, absent an exemption. This section, therefore, prohibits a transaction between Funds of a Trust, between a Fund and an account or collective fund advised by the Adviser, or a principal trade with the Adviser or a Sub-Adviser. Rule 17a-7 permits one Fund to engage in purchase and sale transactions with respect to marketable securities with another Fund or an account, collective fund or common fund managed by the Adviser provided certain conditions are satisfied.

(Note: Rule 17a-7 does not provide an exemption for principal trades with an Adviser or Sub-Adviser). The Board has adopted procedures to ensure compliance with Rule 17a-7 which requires that the Adviser report Rule 17a-7 transactions on a quarterly basis.

Sample Agenda

Rule 17e-1 Transactions

Section 17(e) and Rule 17e-1 of the 1940 Act set forth the circumstances in which an affiliate of the Trusts may act as a broker for the Funds' transactions. These provisions require that the brokerage commissions or other fees paid be reasonable and fair compared to the commission or other fees that other brokers would charge in comparable transactions involving similar securities being purchased at the same time. The Board has adopted Rule 17e-1 procedures to promote the Funds' compliance with these provisions, which require that the Adviser report on Rule 17e-1 transactions on a quarterly basis.

Rule 10f-3 Transactions

Section 10(f) of the 1940 Act prohibits a fund from acquiring a security during a public offering (either a primary or secondary offering) if an affiliate of the Trusts is a member of the selling syndicate. Rule 10f-3 provides an exemption from this prohibition provided several conditions are satisfied including the requirement that the securities be purchased at the initial public offering price from a non-affiliate member of the syndicate.

The Board has adopted procedures to promote compliance with Rule 10f-3, which require that the Adviser report Rule 10f-3 transactions on a quarterly basis.

