

Update on Regulation and Litigation Affecting Funds and Their Boards

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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?