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Funds and Current Issues Facing Fund Boards

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Today's Presenters



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Background

Boards and Other Fiduciaries

- Registered investment companies (mutual funds, closed-end funds and exchange traded funds) must have a board of directors, including disinterested directors.
- Private investment companies (private funds) are not required to have a board of directors.
- However, a private fund's general partner, managing member, or, if applicable, board of directors are fiduciaries to the fund's investors:
 - Practical result is that investment adviser to the private fund is a fiduciary.

Focus of SEC Examinations

- In years past, primary purpose of the inspection was to catch problems at an early stage, and have them corrected.
- Some indications that there are now more “got you” moments that lead to enforcement actions:
 - An increasing number of the enforcement division's investigations stem from examination findings.
 - Harsher tone in examination letters: more references to “significant weaknesses” and “failures” to comply.
 - Examination letters increasingly speak directly to boards of directors or other fiduciaries, requiring a specific response from them.

Oversight of Valuation

Oversight of Valuation

- SEC Focus on Private Funds:
 - Valuation of illiquid assets.
 - Test effectiveness of policies and procedures as part of overall compliance program.
- SEC Focus on Registered Funds:
 - Enforcement action against board of directors overseeing mutual funds for violating their asset pricing responsibilities under the federal securities laws.
 - The directors delegated their fair valuation responsibility to a valuation committee without providing meaningful substantive guidance and oversight.

Oversight of Valuation

- Enforcement action does not stand for the proposition that boards of directors or other fiduciaries must approve or ratify every fair value determination, nor that the board must itself formulate the fair value pricing procedures.
 - In a letter to the Investment Company Institute dated December 8, 1999, the Staff of the SEC stated that in complying with their obligations under the Investment Company Act directors may review and approve pricing procedures formulated by fund management.
 - Board or fiduciary cannot blindly assign fair valuation responsibility to another.
 - Board or fiduciary must have meaningful oversight of the process.

Oversight of Valuation

- Review fund pricing policies and procedures on a regular basis to ensure (a) that they specify (to the extent practicable) acceptable pricing sources and pricing methodologies for each significant category of asset held by the fund that might require fair valuation and (b) that they address requirements for the approval of pricing methodologies that will be used internally.
- When securities are being fair valued, ensure that the board or fiduciary receives a report regarding these securities that provides sufficient information to understand the pricing methodology that is being used.

Oversight of Valuation

- Oversight should include pricing source due diligence, including relevance and reliability of pricing methodologies and techniques, inputs used and internal controls.
- For third-party pricing vendors, understanding vendor experience with security types and asset classes, availability of internal control reports (such as SSAE 16 reports) and business continuity plans and controls

Oversight of Valuation

- Examples of valuation monitoring activities may include:
 - Back-testing of sales transactions
 - Price challenge monitoring and results of such challenges
 - Comparisons of primary sources to secondary sources
 - Analyzing reliability of broker quotations and whether they are indicative of formed market consensus
 - Performing reviews of manually priced securities, including frequency of calculations, methodologies used and reasonableness of inputs

Oversight of Valuation

- Fiduciaries should be careful not to overlook information indicating that the fair valued prices being used are no longer reliable. For example, in one enforcement action, the SEC found that a board did not follow up on pricing issues when presented with specific information about deteriorating credit quality and questions concerning the liquidity of high-yield bonds held in a fund's portfolio.
- Fiduciaries should ensure that they do not approve fair valued prices that are based on valuation methodologies that are inconsistent with SEC guidance. For example, in one case, an administrative law judge found that a thinly traded security was fair valued based on the price expected to be received in a subsequent active market, rather than the price that would be received in the current market.

Oversight of Valuation

- Fiduciaries should not ignore specific information made available to them concerning an issuer's current financial condition and future prospects. For example, in one case, an administrative law judge found that directors did not adequately consider the security's delisting from a stock exchange, the issuer's bankruptcy proceedings, and the issuer's consistent failure to meet management's income projections.
- Fiduciaries should not continue to rely on prices provided by a pricing service when they are given information indicating that these prices do not reflect the fair value of the securities. For example, in one case, the SEC found that directors should have instructed the fund's pricing committee to stop using a vendor's prices after the directors were advised by the fund's portfolio manager that the vendor's prices were inaccurate.

Oversight of Valuation

- Fiduciaries should not approve fair valuation policies and procedures and consider their jobs done, rather than being alert for circumstances indicating that the procedures are not being followed. For example, in one enforcement action, the SEC found that directors failed to follow up on their requests for information from the investment adviser, when the directors were on notice of problems with the prices of the fund's securities.

Conflicts of Interest

Conflicts of Interest

- SEC Focus on Private Funds:
 - Conflicts of interest related to compensation arrangements.
 - Conflicts of interest related to allocation of investment opportunities.
 - Conflicts of interest related to custody of assets.
- SEC Focus on Registered Funds:
 - Conflicts of interest related to custody of assets.
 - Conflicts of interest related to affiliates.

Conflicts of Interest

- Conflicts of interest related to compensation arrangements:
 - Undisclosed fee or solicitation arrangements.
 - Undisclosed referral arrangements (particularly to affiliated entities).
 - Receipt of payment for services allegedly provided to third parties.

Conflicts of Interest

- Conflicts of interest related to allocation of investment opportunities:
 - Do they manage funds that do not pay performance fees side by side with funds that do pay performance-based fees?
 - Do portfolio managers manage similar funds with different performance fees.

Conflicts of Interest

- Safety of client assets:
 - What measures are taken to protect client assets from loss or theft?
 - What policies and procedures are in place?
 - With regard to the custody rule, are advisers appropriately recognizing situations in which they have custody; complying with the “surprise exam” requirement; satisfying the “qualified custodian” requirement; and following the terms of the “audited financial statement” exception.

Conflicts of Interest

- Shareholders of a family of exchange-traded funds have brought suit against the ETFs' investment adviser and trustees for allegedly excessive compensation paid to a securities lending agent affiliated with the investment adviser.
 - The plaintiffs argue primarily that the fee split between the ETFs and the affiliated securities lending agent harmed shareholders by "siphoning off securities lending profits" for the benefit of the affiliated securities lending agent at the expense of the ETFs.
 - They allege that the ETFs received 60% of securities lending income and the affiliated securities lending agent received the remaining 40%, and that the amount received by the affiliated securities lending agent was disproportionate to the performance of the agent.

Conflicts of Interest

- The case serves as a good reminder that potential conflict of interest transactions need to be approached with great care.
- The SEC has made it clear that the board of directors (particularly the independent directors) and other fiduciaries need to be vigilant in overseeing the use of fund assets to ensure that fund shareholders are not harmed, especially when there is a potential conflict of interest with affiliates.
- Ensure processes are in place to identify potential conflicts on an ongoing basis.

Disclosure to Investors

Disclosure to Investors

- SEC Focus on Private Funds:
 - Marketing and performance.
 - Consistency and transparency.
- SEC Focus on Registered Funds:
 - Risk disclosure.
 - Derivatives.
 - Consistency and transparency.

Disclosure to Investors

- Marketing and performance:
 - Focus on accuracy of advertised performance, including hypothetical and back-tested performance.
 - What assumptions and methodologies are utilized?
 - Are record keeping requirements maintained?
 - Aberrational performance is a potential indicator of fraudulent or weak valuation procedures or practices.
- Carefully review disclosures made to investors for consistency and transparency.

Disclosure to Investors

- Risk factors:
 - Ensure principal risks clearly disclosed in plain English.
 - Ensure clear how principal risks line up with investment strategy and that two are consistent.
 - Make sure they are tailored to fund.
- Derivatives:
 - Ensure disclosure spells out how derivatives are used in investment strategy.
 - Ensure risks are highlighted and tailored to fund.

Oversight of Distribution and Financial Intermediaries

Oversight of Distribution and Financial Intermediaries

- SEC Focus on Private Funds:
 - Broker-dealer compliance.
 - Marketing materials.
- SEC Focus on Registered Funds:
 - Rule 12b-1 compliance.
 - Payments in guise.
 - Shareholder servicing through financial intermediaries.

Oversight of Distribution and Financial Intermediaries

- Broker-dealer compliance:
 - Investment adviser pays its personnel transaction-based compensation for selling interests in a fund.
 - Investment adviser has personnel whose only or primary functions are to sell interests in a fund.
 - Investment adviser has personnel who receive transaction-based compensation for investment banking activities.

Oversight of Distribution and Financial Intermediaries

- Rule 12b-1 Plan permits a fund to pay for distribution of its shares.
- Independent directors bear the principal responsibility for evaluating any 12b-1 Plan.
- The independent directors must acquire sufficient data to enable them to make an informed determination of the advisability of approving or continuing a 12b-1 Plan.
 - Determine plan is reasonably likely to benefit fund and its shareholders.
 - Determine the amounts to be paid by fund are reasonable in light of the services to be performed.

Oversight of Distribution and Financial Intermediaries

- Board should carefully review the terms of the 12b-1 Plan to ensure they are complying with the terms of the plan, as the plan may impose obligations beyond those specifically contained in Rule 12b-1.

Oversight of Distribution and Financial Intermediaries

- Shareholder servicing and administration fees may not be used for distributing fund shares.
 - Such fees normally relate to sub-accounting; shareholder account set up and maintenance; shareholder assistance; transaction processing and settlement; and preparation and distribution of account statements and transaction confirmations.
 - Such fees are often paid in connection with mutual fund supermarkets.

Oversight of Distribution and Financial Intermediaries

- The Division of Investment Management has stated that directors of mutual funds are responsible for determining whether any portion of a fund supermarket fee to be paid by a mutual fund is for shareholder servicing and administration, and may be paid by the fund.
- The Division of Investment Management also stated that the directors are responsible for determining whether the portion of a fund supermarket fee paid by a mutual fund is reasonable in relation to (a) the value of the services and the benefits received by the mutual fund and its shareholders and (b) the payments that the mutual fund would be required to make to another entity to perform the same services.

Oversight of Distribution and Financial Intermediaries

- The directors need to be comfortable that the fees paid are reasonable for the shareholder servicing and administrative services provided.
 - A number of funds follow the “avoided cost” method in which they attempt to determine the “savings” in fees for such services that they realized from participating in fund supermarkets.
 - While the “avoided cost” method is utilized by a number of funds, it is not the only permissible method and payments in excess of the avoided costs may be considered reasonable if such payments are comparable to those paid by mutual funds in general for such services.

Oversight of Distribution and Financial Intermediaries

- SEC has indicated that it will be focusing on payments for distribution in guise.
 - The SEC Staff’s 1998 letter to the ICI warned that “OCIE [S]taff will closely scrutinize any increase in a fund’s investment advisory fee that appears to be for the purpose of compensating the fund’s investment adviser for paying the fund’s supermarket fee,” and that “in light of the importance of the board’s role in overseeing a fund’s participation in a fund supermarket, OCIE [S]taff will closely review the actions taken by boards of funds that participate in fund supermarkets.”

Oversight of Distribution and Financial Intermediaries

- Because the agreements between funds and financial intermediaries often involve both shareholder servicing and distribution components, it is difficult to distinguish between the sub-transfer agency and distribution fees paid by funds.
- The blurring of the line between shareholder servicing and distribution costs is exacerbated by observations that fund management is often willing for funds to pay increased fees “as a toll in order to gain a presence” on omnibus platforms, fund supermarkets, 529 college savings plans and other sought-after national distribution portals.

Oversight of Distribution and Financial Intermediaries

- SEC input on supermarkets and sub-transfer agency fees:
 - Payments of fees for participating in fund supermarkets may be made pursuant to or outside of Rule 12b-1, depending on the purpose of the payments and the party making the payment.
 - The determination of the purpose of the payment must be made by the fund's board of directors and requires careful consideration and monitoring.
 - When determining whether a particular payment is for distribution or non-distribution services, the board should review both the distribution and non-distribution services provided by the fund supermarket sponsor.

Oversight of Distribution and Financial Intermediaries

- Fund boards should not lose sight of the fact that the omnibus account model provides benefits to beneficial fund shareholders, and fee increases may be warranted for the legitimate shareholder services omnibus platforms provide, especially when those services are of high quality and exhibit consistent compliance with fund disclosure and regulatory obligations.
 - Not all financial intermediaries hosting omnibus platforms provide the same shareholder services, and it might be reasonable for a fund to compensate different intermediaries with different fee schedules.

Oversight of Distribution and Financial Intermediaries

- Investors get, in one-stop shopping, financial planning expertise and personalized advice; recordkeeping and tax reporting; and a wide variety of investment choices, among other things.
- Having the intermediary deliver these services, instead of the fund complex or its transfer agent, provides the shareholder a simple method to manage his or her mutual fund investments, regardless of how many different fund complexes the shareholder has invested with.

Use of Social Media

Use of Social Media

- SEC Focus on Private Funds:
 - Elimination of prohibition against general solicitation.
 - Investment adviser's use of social media must comply with the securities laws.
- SEC Focus on Registered Funds:
 - Issued guidance on when it constitutes advertising.

Use of Social Media

- Elimination of prohibition against general solicitation:
 - Greater measures to verify accredited investor status.
- Guidance on what constitutes advertising:
 - Depends on its content, context and presentation.
 - If fund performance is discussed and specific mention is made about the elements of a fund's performance it is advertising.
 - Merely using the word "performance" does not make it advertising as long as does not mention specific elements of fund's performance.

Use of Social Media

- Must comply with securities law, including the antifraud, compliance, and recordkeeping provisions.
- Evaluate effectiveness of compliance program with respect to use of social media.
- Adopt policies and procedures regarding third-party postings.
- Maintain records regarding social media communications.

Questions & Answers

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- **2013 NDI Checkpoint Sessions**
 - August 21, 2013
 - December 4, 2013
- **Save the Date! NDI Executive Exchange**
 - November 13, 2013 – Chicago, IL – Invitation-only
- **Nominate a Director of the Year**
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