

## ACCOUNTABILITY AND TRANSPARENCY

Are Your Corporate Governance Practices Putting You at Risk?

### Investment Fund Boardroom Fiduciary Duties

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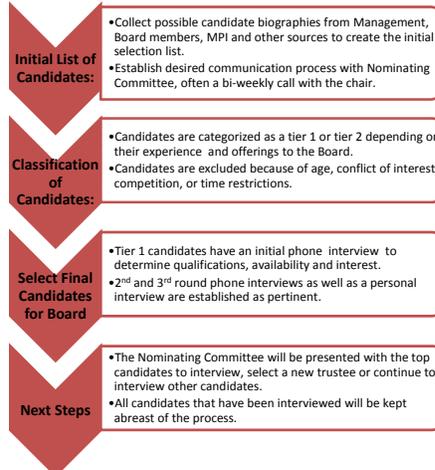
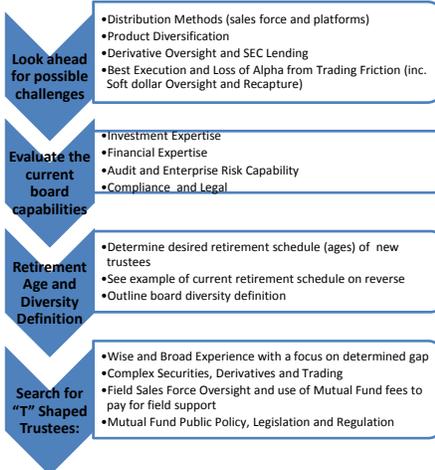
# Board Responsibilities and Duties

November 6, 2014

## Guideline to Trustee Selection Process

### Setting the Trustee Search Criteria:

### Continuing with the Search Process:

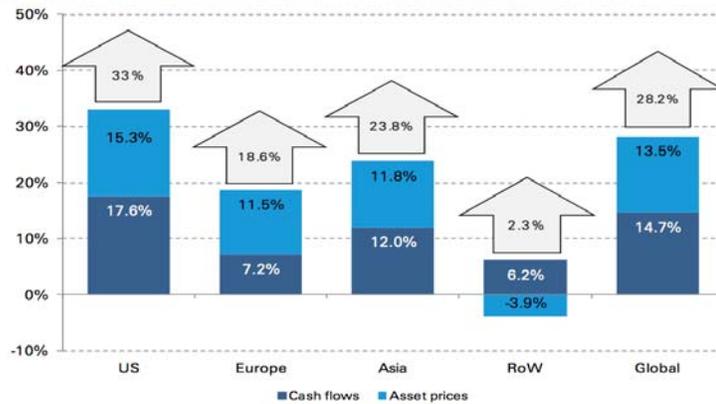


# ETF Case Study

# High Growth of ETFs

- Global AUM to reach \$2.7 - \$3 trillion in 2015

Figure 1: Cash flows contribute to growth, asset prices reverse ETF asset gains



Source: Deutsche Bank, Bloomberg Finance LP

## Ecosystems of Exchange Traded Funds

- The ecosystem of ETF consists of the following five key constituents
  - 1) securities exchanges (NYSE/Nasdaq)
  - 2) broker-dealers/participating agents
  - 3) investment management firms
  - 4) regulators
  - 5) end investors
- They each play a unique role and board directors should be acutely aware of the potential conflict of interests between these parties.

## Additional Risks of ETFs

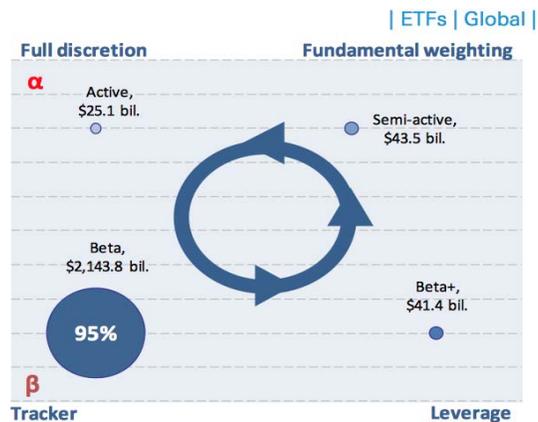
- ETFs have further facilitated the globalization of capital flow. While these new products have provided additional exposure and access to individual investors, it also introduces additional risks and considerations.
- For example, an ETF listed on the US exchange which provides market exposure to a basket of foreign stocks also introduce further risks or rewards in
  - 1) currency exchange rates
  - 2) interest rates
  - 3) tax exposures.

## Other Governance Issues on ETFs

- Synthetic ETFs – What are these?
- Use of Derivatives and Swap contracts in ETFs
- “ETFs” vs. “40 Act Funds” vs. “Private Funds” (Hedge Funds, Private Equity Funds)
- Board Diversity (Female & Minority Members)
- Too big to fail issue?
  - BGI (Barclays Global Investors) now owned by BlackRock
  - Largest ETF providers (by market shares %)
    - i-Shares ~ 40%, SSgA ~ 17%
    - Vanguard ~15%, PowerShares ~4%, Deutsche Bank ~2.3%

## Active vs. Passive ETFs

- Increasing overlap between Alpha & Beta products.



Source: Deutsche Bank, Reuters, Bloomberg Finance LP

## What is the Board's Role?

- Imagine proposal to launch an actively managed ETF
- Will face issues old and new:
- Role of the “CEO” in moving this new product to market
- Who are the stakeholders if the CEO function does not get this product launch right?
- Pricing of product: fees
- Fund operations: valuation
- Conflicts of interest: information leakage

## Investment Company Act

- Board of Directors
  - Role is different than operating company
  - Independent directors are “watchdogs” – majority required to be independent
  - Independent directors select and nominate other independent directors
  - Board may fill vacancies between meetings if 2/3 of resulting directors are shareholder-elected

## Investment Company Act

- **Fiduciary Duties**
  - Directors have general fiduciary duties of care and loyalty under state law
  - ICA imposes specific duties for a board and its independent directors:
    - Approving advisory and sub-advisory contracts
    - Approving distribution plans and contracts
    - Oversight of affiliate transactions
    - Oversight of the fund's compliance program

## Investment Company Act

- Approving the fund's fidelity bond coverage
- Accurate valuation of portfolio securities and fund shares
- Monitoring the fund's investment performance
- Reviewing fund disclosure documents
- Approving agreements with other service providers
- Selecting the fund's independent auditors
- Reviewing the allocation of the fund's brokerage transactions
- Monitoring quality and cost of services provided to the fund

## Investment Company Act

- Duties – Investment Adviser
  - 15(c) Process: board reviews adviser
  - Director duty to request and evaluate
  - Independent director approval
  - Section 36(b): Adviser has fiduciary duty regarding receipt of compensation
  - *Gartenberg* standard for adviser liability
  - *Jones* ruling gives deference to board
- Other Duties

## Investment Company Act

- Portfolio Management
  - Section 8(b): Fundamental Policies
  - Guidelines
    - Section 5: diversification
    - Sections 10, 17: affiliated transactions
    - Section 12(d): restrictions on investment
    - Section 13: changes to portfolio
    - Section 18: limits on leverage
    - Section 35: fund names

## External Management

- The Board must take into consideration the “social compact” between the management company and fund shareholders.
- Investors can and will “vote with their feet”
- Investors have reacted predictably in proxy fights between “management” and the full board
- Board’s naturally defer to management on product strategy, but focus on fairness and investor protection.
- After getting to “go” on the new fund, what will it cost?

## Understanding the objectives of analyzing fund profitability

- Assess fairness of annual contracts
- Confirm the financial stability of the advisor
- Highlight any differences in side by side management of other investment vehicles and other management activities
- Limited guidance, few quantitative guidelines or benchmarks other than a 1982 Gartenberg case

## Legal precedents: the Gartenberg line of cases (circa 1982)

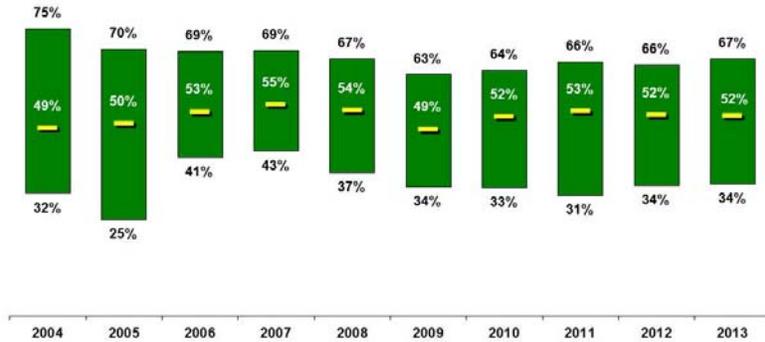
- A fee must *not* be so disproportionately large that it bears no reasonable relationship to the services provided
- Securing the lowest possible fee is not the goal of the board, especially through negotiations which might damage the capacity to serve the shareholders' interest
- High profits earned by the advisor are not necessarily indicative of an excessive fee
- The advisor is entitled to recoup their costs and make a fair profit
- The fees must not be so excessive that they could not reflect the results of arm's length bargaining
- A cost-plus type of contract is not intended
- Establishes the only existing numerical benchmarks

## Following the Gartenberg process

- Process is king; but process is not substance
- Requires fund by fund analysis of profitability of the advisory fee and "fall-out" benefits
- Marketing and distribution costs should not be considered when evaluating the profitability of the advisory fee
- Shareholder servicing may be included
- Gives the board authority to ask for appropriate profitability data

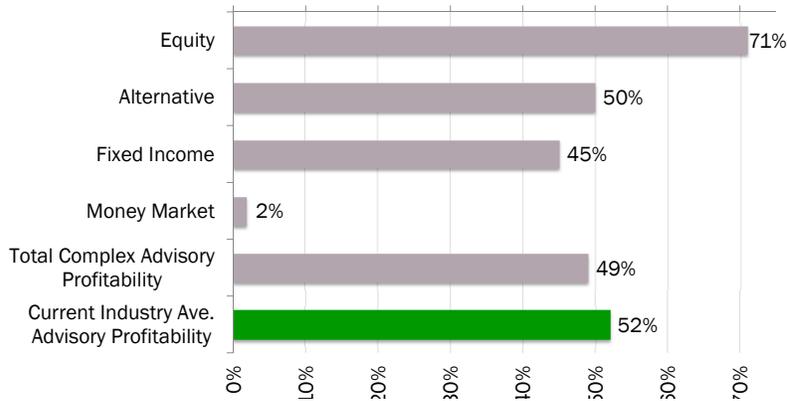
Summary of Pre-tax Profit from **Advisory Activities** (excluding distribution) of Selected Publicly-held Companies Significantly Engaged in Mutual Fund Management

Range of Pre-Tax Profit as a % of Advisory Revenue, 2004 - 2013



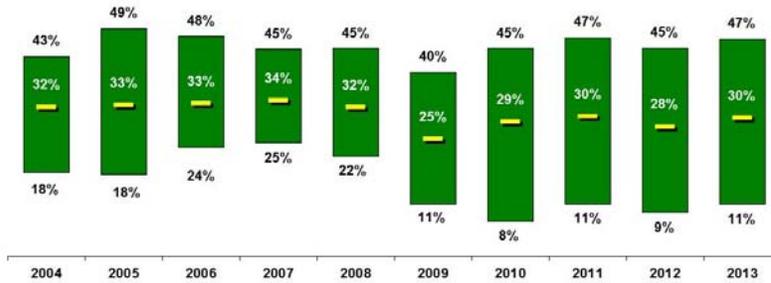
Fund-by-Fund Advisory Profitability

Illustrative Advisor Profitability by Product and Total Advisory Profitability Benchmark



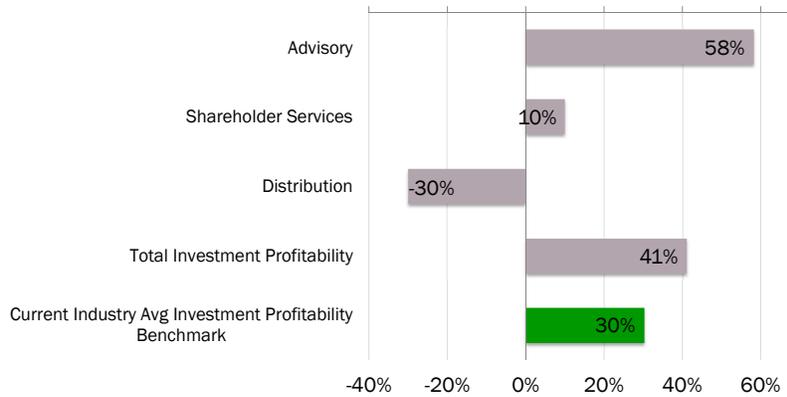
**Summary of Pre-tax Profit on all Investment Activities (including distribution) of Publicly-held Companies Significantly Engaged in Mutual Fund Management**

Range of Pre-tax Profit as a % of Investment Revenue, 2004 - 2013



**Fund families typically earn higher margins on advisory functions, less on shareholder servicing and lose on distribution**

Illustrative Fund Channel Profitability and Comparative Benchmark



## Conflicts of Interest

- Does Gartenberg gets in the way?
- Assuming the board's share of mind is focused on Gartenberg
- Is that a safe assumption?
- Is Gartenberg enough?

## 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) 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 the fund's investment adviser.
- Old conflict – inter-positioning; new context – ETFs
- How can you spot the conflict *unless* you get the business model?

## Mutual Funds as Operating Companies

- In at least one respect, mutual fund boards can not outsource a specific function to management company
- More than a “watch dog” – but personally responsible
- Fund directors are the front line on valuation of fund shares

## Boards and Oversight of Fair Valuation

- Enforcement action that was brought against eight former members of the boards of directors overseeing five Memphis, Tenn.-based mutual funds for violating their asset pricing responsibilities under the federal securities laws.
- According to the SEC's order instituting administrative proceedings against the eight directors, the directors delegated their fair valuation responsibility to a valuation committee without providing meaningful substantive guidance on how fair valuation determinations should be made.

## Boards and Oversight of Fair Valuation

- Enforcement action does not stand for the proposition that boards of directors 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 cannot blindly assign fair valuation responsibility to a committee or the investment adviser.
  - Board must have regular and meaningful oversight of the process.

## Key Action Items for Boards:

- Reviewing 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 by the fund's investment adviser.
- When securities are being fair valued, ensuring that the board receives a report regarding these securities that provides sufficient information for the board to understand the pricing methodology that is being used.

## Directors Should Be Alert to the Following Pitfalls:

- Directors 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.
- Directors 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.

## Directors Should Be Alert to the Following Pitfalls:

- Directors 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.
- Directors 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.

## Directors Should Be Alert to the Following Pitfalls:

- Directors 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.

## Take Aways

- The Board will hear from product champions
- The Board will hear from consultants that will help you summarize and organize data around a detailed agenda designed to manage conflicts of interest
- But you will face known – unknowns
  - What level of probing the basis of management’s conviction is appropriate?
  - What level of deference to management is due?
  - Process: not an event.

## Appendix

- Securities Act Issues
- Senior Securities
- SEC inspection process

## The Securities Act

- Civil Liability
  - “Materiality”
  - Section 11 of the Securities Act and Due Diligence Defense
  - Section 12 of the Securities Act
  - Section 17 of the Securities Act
  - Statutes of Limitations

## SEC Examinations

- Types of examinations:
  - “Routine” inspections occur on a regular cycle for the purposes stated above.
  - “For Cause” inspections occur whenever the SEC has evidence that a problem exists.
  - “Sweep” examinations seek information from a number of funds on a particular issue.

## SEC Examinations

- Requirement for examination and reasons for routine examinations:
  - All books and records are subject at any time to such reasonable periodic, special, and other examinations as the SEC may prescribe.
  - Conducted primarily to ascertain whether a fund is conducting its practices and procedures in compliance with federal securities laws.
  - A secondary purpose is to keep the SEC informed of developments in the investment company industry.

## SEC Examinations

- Frequency of routine examinations:
  - Higher risk advisers are examined every three years.
  - Lower risk advisers are selected randomly.

## SEC Examinations

- Steps in an examination:
  - Single person is designated as the liaison between the fund and SEC examiners.
  - If sensitive or confidential documents are provided, should consider requesting that the SEC return the documents.
  - SEC may interview officers or employees of the fund (CCO should be present).
  - Request an exit interview and take notes of exit interview.

## SEC Examinations

- Results of examinations:
  - SEC examiners seek to complete the entire examination within 120 days after the end of the on-site portion of the examination.
  - Generally one of three results: (1) no further action; (2) a deficiency letter; or (3) a referral to enforcement.
  - A “deficiency letter” requests a response within 30 days that specifies the corrective steps being taken.
  - Most examinations end with a deficiency letter.

## SEC Examinations

- Board responsibilities if material deficiencies or material compliance problems found:
  - Determine the cause.
  - Determine the adequacy of any proposed solutions.
  - Determine shareholders have not been harmed.
  - Determine that procedures in place to prevent a repeat deficiency.

## SEC Examinations

- SEC considerations in determining whether to make an enforcement referral:
  - Whether there was significant investor harm.
  - Whether the adviser or its employees profited by the violation.
  - Whether fraud occurred.
  - Whether a breach of fiduciary duty occurred.
  - Whether violations were intentional.

## Revised 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 and require the board to respond to certain of the examination findings.

## Senior Securities

- With regard to short sales, written options, forwards, total return swaps, and other derivatives (“derivative transactions”), a fund is required to either: (1) segregate or earmark liquid assets to limit the potential leverage in such transactions or (2) otherwise “cover” these transactions with an offsetting position so as not to be in violation of Section 18 (prohibition on issuing senior securities).

## Senior Securities

- Board should examine board education on this topic:
  - Do board members understand derivative transactions?
  - Does the board understand how derivative transactions are used in the fund?
  - Does the board understand the benefits and risks of derivative transactions?

## Distribution Rule 12b-1 Plan

- 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.

## Distribution Rule 12b-1 Plan

- 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.

## Distribution Shareholder Servicing

- 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 supermarkets.

## Distribution Shareholder Servicing

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

## Distribution Shareholder Servicing

- 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 funds in general for such services.

## Distribution Shareholder Servicing

- 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.”

## Distribution Shareholder Servicing

- 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.

## Distribution Shareholder Servicing

- 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.

## Distribution Shareholder Servicing

- 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.

## Distribution Shareholder Servicing

- 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 investments, regardless of how many different fund complexes the shareholder has invested with.