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## Investment Fund Boardroom Fiduciary Duties

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## Investment Fund Boardroom Fiduciary Duties

November 4, 2015

### Panelists

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## Cybersecurity

- Funds and their advisers can mitigate exposure to cybersecurity risk through adopting compliance policies and procedures
  - The SEC has stated that the compliance program of a fund or an adviser should address risk as it relates to identity theft and data protection, fraud and business continuity, as well as other disruptions in service that could affect the ability to process shareholder transactions

## Valuation Guidance

- The 2014 Money Market Fund Reform FAQs reiterate that a mutual fund board has a non-delegable responsibility to determine:
  - Fair value;
  - That all factors to determine fair value have been considered (as well as continuously monitor the valuation methodology); and
  - The delegation of actual valuation to other parties follows the board's approved fair valuation methodologies.
- In this area, the SEC clarified that their intention was not to change or expand the board's responsibility to oversee the valuation process, rather the intention was simply to emphasize that it is crucial for each board to:
  - Take its responsibility of valuation oversight seriously;
  - To ensure that it or its delegated appointee provide thorough review of the valuation methodology; and
  - To ascertain that the fair value methods used conform to the board's approved fair valuation methodology.

## Valuation Guidance (Continued)

- SEC's adopting release contained guidance relating to valuation that went beyond money market funds with respect to:
  - The use of amortized cost for instruments that mature in less than 60 days; and
  - SEC expectations relating to the use of pricing services that provide evaluated prices for fixed income funds.
- In response to this guidance, many fixed income fund managers are providing fund boards with additional information about the “inputs, methods, models, and assumptions used by the pricing service to determine its evaluated prices, and how those inputs, methods, models, and assumptions are affected (if at all) as market conditions change.”

## 15(c) Process

- In a recent case, the SEC charged a mutual fund adviser, its principal and three fund trustees with failing to satisfy their statutory obligations in connection with advisory contracts.
- According to the SEC, the advisory firm provided incomplete or inaccurate information to two fund boards, and the adviser's majority owner caused the violations. The SEC stated that the trustees of the funds violated the provision by approving the advisory contracts without having all the information they requested as reasonably necessary for evaluation.
  - Although the trustees requested certain information, the responses offered did not provide all of the requested information or provided inaccurate information, and the trustees approved the contracts without having all of the information they requested.
  - The SEC alleges the adviser and the trustees failed to satisfy obligations imposed by Section 15(c), requiring fund board members to request and evaluate, and advisers to furnish, information reasonably necessary for evaluating the terms of any advisory contract, and the adviser's owner caused the firm's violations.
  - The SEC also found that the adviser's affiliated administrator failed to include a summary of the 15(c) evaluation process in a fund's shareholder report and caused the fund to violate Section 30(e) of the Act and Rule 30e-1 thereunder.

## Distribution in Guise

- The SEC issued its first enforcement action regarding distribution in guise, alleging that mutual fund assets used for distribution and marketing services were passed off as sub-transfer agent expenses. Use of a fund's assets as distribution-related payments must be made pursuant to a written Rule 12b-1 plan
- The SEC order begins to frame the items that the SEC views as distribution versus shareholder servicing. The end result will be a more careful policing and understanding of a fund's marketing and shareholder servicing agreements on the part of a fund's board.

## Testimonial Rule and Social Media

- The SEC has reminded firms about self-selection of testimonials in social media:
  - The SEC considers testimonials inherently misleading in advertisements because they generally only include positive reviews (and disregard negative reviews)
  - The interactive nature of social media raises concerns as to whether comments about advisers would constitute “impermissible” testimonials in violation of Rule 206(4)-(1)(a)(1)

## Conflicts Everywhere

- 2015 areas of focus have been:
  - Close review of the 15(c) process;
  - Compliance with issues regarding fund distribution, including compliance with Rule 12b-1; and
  - Conflicts of interest by advisers and breaches of fiduciary duty.
- Going forward, the SEC will continue to identify potential conflicts, review the disclosure of the conflicts to investors, including fund boards, and ensure that steps are taken to either eliminate or mitigate the conflicts

## Alternative Funds and Liquidity

- SEC Commissioner Stein stated that the Investment Company Act has important built-in protections (including protections of retail investors).
- Expressed concerns that certain financial products are taking undue risks, particularly in the areas of liquidity and leverage.

## Broken Windows

- SEC Chairwoman White remarked that the SEC's focus on smaller violations is analogous to the New York City Police Department's "broken window" of policing
  - Key takeaways are:
    - SEC enhancement of data analysis tools and expertise;
    - Greater SEC focus on deficient "gatekeepers" (including fund boards and auditors); and
    - SEC focus on fixing "broken windows" which includes pursuing smaller violations and attacking wrongdoing.

## Auditor Independence

- SEC brought an administrative proceeding against an independent auditor to three closed-end funds, an independent trustee and the fund's administrator for violation of auditor independence rules
  - The independent trustee had an undisclosed relationship with an associated entity of the fund auditor that negatively affected the auditor's independence
  - However, questionnaires did not cover the business relationships with the auditor's affiliates
    - In settlement, the SEC took into account the administrator commenced working with its clients' boards and their counsel to enhance auditor independence policies and procedures

## Acceptance of Gifts and Entertainment by Fund Advisory Personnel

- Section 17(e)(1) of the Investment Company Act prohibits fund affiliates from receiving compensation in connection with the purchase or sale of property
- This prohibition could be applicable to gifts and entertainment that are received by investment advisers from broker-dealers who transact business with funds

## Liquidity Risk Guidance

- The SEC's rule proposal on liquidity risk management for mutual funds and ETFs, if adopted, will require significant changes to fund operations, disclosure and reporting requirements. The following are items that Chief Compliance Officers and boards of directors may want to consider in addressing liquidity risk today:
  - Liquidity risks include risks that a fund could not meet requests to redeem shares issued by the fund that are expected under normal conditions, or are reasonably foreseeable under stressed conditions, without materially affecting the fund's net asset value;
  - Key factors to consider when assessing the "liquidity risk" include,
    - short-term and long-term cash flow projections;
    - the fund's investment strategy and liquidity of portfolio assets;
    - use of borrowings and derivatives for investment purposes; and
    - holdings of cash and cash equivalents, as well as borrowing arrangements and other funding sources.

## Liquidity Risk Guidance (Continued)

- Check redemption policies in prospectus – the SEC believes a fund may have liability for failure to redeem on a next-business day basis when the prospectus states the fund generally or usually redeems on a next-business day basis;
- Key factors to consider when assessing the liquidity of individual portfolio holdings include,
  - The existence of an active market for the asset, including whether the asset is listed on an exchange, as well as the number, diversity and quality of market participants;
  - The frequency of trades or quotes for the asset and average daily trading volume of the asset (regardless of whether the asset is a security traded on an exchange);
  - The volatility of trading prices for the asset;
  - The bid-ask spreads for the asset;
  - Whether the asset has a relatively standardized and simple structure;
  - For fixed income securities, the maturity and date of issue;
  - Restrictions on trading of the asset and limitations on transfer of the asset;
  - The size of the fund's position in the asset relative to the asset's average daily trading volume and, as applicable, the number of units of the asset outstanding; and
  - The relationship of the asset to another portfolio asset

## Liquidity Risk Guidance (Continued)

- Funds that engage in in-kind redemptions should adopt and implement written policies and procedures which would address the process for redeeming in-kind, as well as the circumstances under which the fund would consider redeeming in-kind; and
- The SEC seems to generally endorse the thoughtful use of borrowing arrangements as a liquidity risk management tool, but the SEC has expressed some concerns about the use of ETF portfolio holdings as a liquidity risk management tool.

## Registration Statements

- In reviewing registration statements for new funds as well as annual updates, the Division of Investment Management has used the comment process to provide comments on substantive issues, ultimately resulting in compliance ramifications. Examples include:
  - Staff comments that funds that write CDSs are expected to cover the notional amount rather than mark-to-market to meet obligations under Section 18 of the Investment Company Act; and
  - A staff position regarding the “name rule”, investments in private funds and what constitutes appropriate industry classifications for certain investments.

## Responding to Informal Guidance

- Focus on Governance at Both the Fund and Adviser Level
  - It is essential for funds to have a strong governance structure as the SEC will not shrink from bringing an enforcement action against fund directors whom they believe are failing to carry out their oversight responsibilities.
    - While fund governance has received a great deal of attention, the governance structures of the fund’s other service providers, especially the investment adviser, is just as important.
- Taking a Fresh Look at Your Procedures
  - Fund and adviser compliance teams may want to consider reviewing compliance policies de novo with a skeptical eye to confirm that the language in the policies and procedures is accurate, precise and comprehensive and consider whether there are other means to achieve the compliance goals.

Questions?