



# **MFDF IN FOCUS: BOARDS' RESPONSIBILITIES**

MUTUAL FUND DIRECTORS FORUM

SEPTEMBER 14, 2021|

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# What are a director's responsibilities and where do they come from?



# Board Responsibilities



## TOPICS COVERED

THERE IS A REASON BEHIND ALMOST EVERYTHING A BOARD IS ASKED TO DO—THESE REASONS CAN BE FOUND BURIED IN THE HISTORY OF MUTUAL FUND REGULATION AND IN THE PROVISIONS OF THE 1940 ACT AND RELATED RULES AND STATUTES.

IN THIS PRESENTATION, WE WILL DISCUSS:

- BACKGROUND OF MUTUAL FUND REGULATION
- DIRECTORS' RESPONSIBILITIES

Q&A: EVERYTHING YOU ALWAYS WANTED TO KNOW, OR “WHY DO WE DO HAVE TO DO THIS, ANYWAY?”

# Background of Mutual Fund Regulation



## FINANCIAL DISLOCATIONS LEAD TO REGULATION

### The Great Crash

It is interesting to note just how large the investment trusts were and how much money they lost following the crash. In September 1929 alone, immediately before the crash, \$600 million in investment trust securities were offered for sale. According to one of the original SEC commissioners, **investors lost \$3 billion in the months following the crash.**

Particular characteristics of the investment trusts and investment companies in the 1920s led directly to the structure of the 1940 Act and its key provisions:

- The trusts were frequently pyramided
- They had complex capital structures favoring insiders
- The funds were leveraged
- Unscrupulous managers “looted” the assets
- Self-dealing was rampant

# Background of Mutual Fund Regulation

## FINANCIAL DISLOCATIONS LEAD TO REGULATION

### The Investment Company Act

These abuses led to a statute that went beyond the disclosure philosophy of the Securities Act and the Securities Exchange Act to one that **directly regulated the “structure and operations of investment companies”** and required them to be **registered with and subject to the oversight of the SEC.**

**The statute is focused on conflicts of interest, safekeeping of assets, and representation of the interests of shareholders.**

**One of the key innovations of the 1940 Act was the interposition of the board in monitoring conflicts and in particular the requirement for independent directors.**



# Background of Mutual Fund Regulations

## Later disruptions led to key additions and changes to the 1940 Act.

### The 1970 Amendments

- Following three years of study, and significant industry growth, Congress comprehensively amended the Act in 1970.
  - Added a federal fiduciary standard (section 36) with respect to fees
  - Tasked fund directors with “evaluating information reasonably necessary” to approve the management agreement (section 15)

### Patriot Act (2001)

- In response to the events of 2001, investment companies were required to establish AML programs, including customer identification and suspicious activity reporting.

### Sarbanes-Oxley (2003)

- Accounting fraud scandals led to enhanced financial reporting. New rules covered:
  - SOX Codes of Ethics
  - Whistleblowing
  - Disclosure Controls and Procedures and officer attestations
  - Specific rules covering audit committees including Audit Committee Financial Expert, auditor rotation, and communications

### Compliance Rule (2003)

- Market timing led to adoption of Rule 38a-1—Compliance Programs and CCOs

### Money Market Reform (2016)

# Background of Mutual Fund Regulations

## Independent Directors as “Watchdogs”

In 1979, the Supreme Court, in *Burke v. Lasker*, famously summarized the role of the independent director of a mutual fund:

“Congress' purpose in structuring the Act as it did is clear. It "was designed to place the unaffiliated directors in the **role of independent watchdogs.**” Without question, “[t]he function of these provisions with respect to unaffiliated directors [was] to supply an **independent check on management** and to provide a means for the representation of shareholder interests in investment company affairs.” In short, the structure and purpose of the ICA indicate that Congress entrusted to the independent directors of investment companies, exercising the authority granted to them by state law, **the primary responsibility for looking after the interests of the funds' shareholders.**”

# Background of Mutual Fund Regulations

## State Law Fiduciary Duties

Under state law, directors are subject to certain fiduciary duties:

- The **duty of loyalty** requires that directors exercise their powers in the interests of the fund and not in the directors' own interests or in the interests of another person or organization. It also requires the avoidance of conflicts of interest that are detrimental to the fund.
- The **duty of care** requires the directors to act in good faith with the diligence, care and skill that an ordinarily prudent person in a like position would exercise under similar circumstances. The duty of care also requires that directors be fully informed of all relevant facts.

Absent a showing that the directors have breached these duties, board decisions are generally provided great deference under the so-called “**business judgement rule.**” The business judgment rule shields directors from liability unless plaintiffs can overcome the presumption by proving fraud, illegality, or conflict of interest.



# Board Responsibilities

## REGULATORY PURPOSE

To ensure that sponsors are solvent and reputable and that disclosures adequately describe the investment objectives and risks

## REGULATION

**Section 14(a)**—Promoter must contribute seed capital.

**Section 8**—Requires the registration of investment companies with the SEC. The registration statement must set forth:

- The fund's policies with respect to certain enumerated matters and which policies are changeable only by shareholder vote
- Investment policies that are matters of fundamental policy

**Section 24**—Requires the registration of both the fund under the 1940 Act and the shares of the fund under the Securities Act.

**Board must approve filing of registration statement, amendments and supplements.**

# Board Responsibilities

## REGULATORY PURPOSE

**To prevent managers from fundamentally altering risk or investment practices of the fund**

## REGULATION

**Section 8**—Requires the registration statement to disclose portfolio turnover and the fund's policies regarding:

- The type of investment company and whether it is open or closed end
- Borrowing money or issuance of senior securities
- Engaging in business of underwriting securities of other persons
- Purchase and sale of real estate or commodities and making loans

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# Board Responsibilities

## REGULATORY PURPOSE

**To prevent managers from fundamentally altering risk or investment practices of the fund**

## REGULATION

**Section 13**—Requires shareholder approval for a fund to change its policies relating to:

- Diversification
- Policies disclosed under Section 8 above or any other policies identified as fundamental
- Deviation from concentration policies set forth in prospectus

**Because the board must approve the calling of a shareholder meeting and approve the contents of the registration statement, the board has oversight as to any changes in fundamental policy that require a shareholder vote. The board must also approve any change to the investment objective of a fund. While typically these types of investment policies are within the purview of the adviser, the board can act as a check to protect shareholder interests.**

# Board Responsibilities

## REGULATORY PURPOSE

**To prevent and mitigate conflicts of interest that arise when the interests of control persons, including the investment manager, conflict with the interests of shareholders**

## REGULATION

**Section 17**—Closely regulates all transactions among and between a fund, the investment manager and their affiliated persons.

**Section 10(f)**—Prohibits a fund from purchasing securities in an underwriting in which the principal underwriter is an officer, director, member of an advisory board, investment adviser or employee of the fund or any affiliated persons of such persons.

**Boards are required to consider and approve multiple matters relating to these provisions, including:**

- **Cross trades, underwritings and certain brokerage transactions (CCO certifies)**
- **Joint insurance and allocations of premiums**
- **Mergers with affiliated funds**
- **Compliance with exemptive orders**

# Board Responsibilities

## REGULATORY PURPOSE

**To ensure good governance and independence of fund directors**

## REGULATION

**Sections 10 and 16**—Establish protocols for composition of board, including independence and selection. At least 40% (best practice is 75%) of board members must be independent; two-thirds of directors must have been elected by shareholders; and independent directors must select other independent directors.

**Governance Rule**—Board counsel must be independent; board must conduct annual self-evaluation; independent directors must meet separately quarterly.

**Board must comply with independence and board selection requirements. Annually and more frequently as necessary, board must determine whether counsel is independent and conduct a self-evaluation. Independent trustees should meet quarterly outside the presence of management.**

# Board Responsibilities

## REGULATORY PURPOSE

**To ensure that investment management fees are fair and bear a reasonable relationship to the services rendered**

## REGULATION

**Section 15**--Requires that the advisory agreement with the fund's investment adviser be approved by a majority of directors who are not parties to such contract or interested persons of any such parties. Imposes a duty on the directors of a registered investment company to request and evaluate, and on the investment adviser to furnish, "such information as may reasonably be necessary to evaluate the terms of any contract whereby a person undertakes regularly to serve or act as investment adviser of such company."

**Gartenberg and related cases**—Establish standard by which directors must evaluate the advisory contract.

**Board must request and review the necessary information and the adviser must provide it.**

**Gartenberg and its progeny as well as recent excessive fee cases brought under section 36(b) highlight the importance of a robust 15(c) process. Multiple courts have looked to "the level of expertise, conscientiousness, independence, and information with which the board acts" as a key factor in supporting the board's decision.**

# Board Responsibilities

## REGULATORY PURPOSE

**To ensure that distribution arrangements are fair to shareholders and that fund assets are not used to pay for distribution other than in the limited circumstances permitted by Rule 12b-1**

## REGULATION

**Section 15**—Requires that the distribution agreement with the fund’s principal underwriter be approved by a majority of directors who are not parties to such contract or interested persons of any such parties.

**Section 12(b)**—Prohibits an investment company from distributing its own shares.

**Rule 12b-1**—Provides a limited exemption under which a fund may pay for costs of distribution. Note that the rule defines distributing its own shares as “any financing activity which is primarily intended to result in the sale of shares....”

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# Board Responsibilities

## REGULATORY PURPOSE

**To ensure that distribution arrangements are fair to shareholders and that fund assets are not used to pay for distribution other than in the limited circumstances permitted by Rule 12b-1**

## REGULATION

Under Rule 12b-1, directors who are not interested persons of the fund and have no direct or indirect financial interest in the operation of the 12b-1 Plan or in any agreements related to the 12b-1 Plan may approve or decide to terminate the 12b-1 Plan.

In addition, the board must:

- Request and evaluate such information as may reasonably be necessary for an informed determination to approve or continue a Rule 12b-1 Plan.
- Review quarterly reporting on monies expended under the 12b-1 Plan.
- Have a process in place reasonably designed to assist the board in evaluating whether a portion of fund-paid sub-accounting fees, if paid to intermediaries that distribute fund shares, is being used to pay directly or indirectly for distribution.



# Board Responsibilities

## REGULATORY PURPOSE

**To ensure that shareholders can redeem at the price at which the securities are valued; the safekeeping of securities; and protection from embezzlement**

## REGULATION

**Section 2(a)(41)**—Defines valuation of securities.

**Section 2(a)(32)**—Defines redemption of securities.

**Section 22**—Specifies time at which value is determined and timeframes for return of redemption proceeds.

**Rule 22e-4**—Establishes the requirements for oversight of liquidity risk by the fund.

**New Rule 2a-5**—Effective September 8, 2022, the new Valuation Rule will govern the valuation of securities.

**Section 17(f)**—Establishes standards for safekeeping of portfolio securities.

**Section 17(g)**—Establishes requirements for fidelity bonding.

**Section 36**—Makes breach of fiduciary duty by adviser or distributor a federal crime.

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# Board Responsibilities

## REGULATORY PURPOSE

**To ensure that shareholders can redeem at the price at which the securities are valued; the safekeeping of securities; and protection from embezzlement**

## REGULATION

Taken together, these provisions impose multiple obligations on directors. Boards must:

- Approve appointment of fund custodian, custody contract and persons designated to give instructions to custodian.
- Approve arrangements for custody of any foreign assets, including monitoring, and approval of foreign custody agreement.
- Approve fidelity bond and determine adequacy of coverage.
- Set the time or times during the day that the current net asset value of the fund is computed.
- Approve the fund's liquidity risk management program and the person designated to administer the program and take any steps required under the program.
- Oversee valuation and when new rule takes effect, appoint a valuation designee and comply with the requirements of the Valuation Rule. Note that fair value is "as determined in good faith by the board of directors."

# Board Responsibilities

## REGULATORY PURPOSE

**To maintain the integrity of the fund's accounts**

## REGULATION

**Rule 30a-3**—Provides that “internal control over financial reporting” is a process that is effected by among others the board.

**Section 32 and Rule 32a-4**—Cover selection of auditors and provide for the establishment of an independent audit committee. Section 32 also requires the appointment of a principal accounting officer.

**SOX**—Provides further requirements with respect to the audit process and auditors and appointment of ACFE.

### Board should:

- **Appoint the auditors and approve the auditors' fees; appoint ACFE; appoint principal accounting officer.**
- **Receive the audit report and required communications, including with respect to independence of the auditor.**
- **Receive reporting on disclosure controls and procedures.**
- **Approve and pre-approve all audit and non-audit services.**

# Board Responsibilities

## REGULATORY PURPOSE

**To ensure compliance with the federal securities laws**

## REGULATION

**Rule 38a-1**—Requires investment companies to adopt and implement written policies and procedures designed to prevent violations of the federal securities laws and to appoint a chief compliance officer.

**The board must:**

- **Approve the policies and procedures of the fund, its investment adviser, principal underwriter, administrator and transfer agent, and any material changes to such policies and procedures.**
- **Designate the CCO and set the compensation of the CCO.**
- **Meet at least annually (and in most cases quarterly) with the CCO and receive the annual (and quarterly) report of the CCO.**
- **Approve the removal of the CCO.**

# Board Responsibilities

## REGULATORY PURPOSE

**To restrict leverage, pyramiding and other risky activities**

## REGULATION

**Section 12**—Regulates the functions and activities of investment companies. In particular, Section 12 implicates the structures of funds of funds.

**Section 18**—Regulates the share class structure of investment companies. The prohibition in Section 18 of senior securities has been interpreted to limit leverage in a fund.

**Directors must approve multi-share class plans (18f-3 Plans), by finding the plan, including the expense allocation, to be in the best interests of each class individually and the fund as a whole.**

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# Board Responsibilities

## **REGULATORY PURPOSE**

**To restrict leverage, pyramiding and other risky activities**

## **REGULATION**

**In addition, a spate of new rule-making impacting these two provisions will be coming into effect over the next year.**

**Fund of funds arrangements are generally limited by the “anti-pyramiding” provisions in Section 12(d)(1). Exemptive relief provided by the SEC staff had allowed these funds to operate. New Rule 12d1-4 eliminates the exemptive relief and replaces it with a new set of rules and conditions, including that the investment adviser to each of the acquiring and acquired fund must report certain evaluations and findings to the applicable fund’s board of directors.**

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# Board Responsibilities

## REGULATORY PURPOSE

**To restrict leverage, pyramiding and other risky activities**

## REGULATION

Derivatives transactions and certain other transactions are subject to Section 18 as “senior securities.” Under current law, funds have been required to segregate assets to comply with rule. New rule 18f-4, effective August 19, 2022, brings a new approach to the regulation of the use of derivatives by funds. Under the rule, funds must first determine if they meet a 10% threshold as a Limited Derivatives Fund. A fund that does not qualify as a Limited Derivatives Fund (called a VaR Fund) must adopt a Derivatives Risk Management Program, in which case, the board, including a majority of independent directors, must approve the designation of an officer (or committee of officers) of the fund’s investment adviser to act as the “derivatives risk manager.” Before implementing the DRM Program and at least annually thereafter, the Risk Manager must represent in a written report to the board that the DRM Program is reasonably designed to manage the fund’s derivatives risks and to incorporate all required elements of rule 18f-4. At intervals established by the board, the Risk Manager must report to the board the results of stress and back testing and any violations of the risk guidelines, among other matters.

# Board Responsibilities

Other responsibilities include:

**Oversight of Performance**—This is an important factor in renewal of the advisory contract under Section 15(c), and directors should receive regular performance reports from the adviser with appropriate information on performance drivers, portfolio characteristics and comparative performance.

**Risk Oversight**—While directors are not responsible for risk management, they should develop a common understanding with the adviser as to the sources and levels of risk appropriate to the funds and understand the current risk management processes. Risks can include investment risk, reputational risk, and operational risks, including cyber.

**Oversight of Service Providers**, including understanding their functions and whether they are meeting expected service levels.

**Special Requirements applicable to ETFs**. Outside the scope of this presentation but include compliance with Rule 6c-11 and exemptive relief, if applicable.



# Concluding Thoughts

In *Burke v. Lasker*, the Supreme Court made a prescient observation:

“This "watchdog" control was chosen in preference to the more direct controls on behavior ... Congress turned not to direct controls, but rather to stiffening the requirement of independence as the way to "remedy the act's deficiencies.”

While some argue that the regulatory regime imposes too great a burden on boards in their role as “watchdogs”, this regulatory approach informs a great deal of what directors are asked to do in their oversight role. Through careful attention to the board materials and approvals requested of them, directors provide a forcing function on the adviser to ensure that funds are managed in the best interests of shareholders.

