

# Fundamentals of Fund Director Oversight

Session 1 of  
Core Responsibilities of Fund Directors  
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# Panel

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# Agenda – Fundamentals of Fund Director Oversight

- Overview of Statutory and Regulatory Responsibilities
  - » Director Independence
  - » Specific Responsibilities
- Fiduciary Duties of Directors
- General Oversight Responsibilities
  - » Conflicts of Interest
  - » Risk Management
- Board Structures and Governance Practices

# Independence

## *Board Percentage*

- Most funds must have a majority of independent directors
  - » Section 10(a): all funds
    - at least 40% independent
  - » Section 10(b)(2): if principal underwriter affiliated with adviser
    - a majority independent
  - » Section 16(a): election and selection of replacement directors
    - a majority of the Board must have been elected by shareholders
    - directors may be appointed if, after appointment, at least 2/3 elected
  - » Fund governance rules: if fund relies on common exemptive rules
    - a majority independent
  - » SEC adopted 75% standard in 2004, but it was never implemented due to court challenge
  - » *Overview of Fund Governance Practices* (based on IDC/ICI Study): funds with 75%+ independent
    - 46% in 1996; 85% in 2012

# Independence

## *What does it mean to be independent?*

- Specific statutory standard. Cannot be:
  - » “Affiliated person” or “interested person” of fund, adviser or principal underwriter
  - » Fund legal counsel within past two years
  - » Within past six months, affiliated with person that executed portfolio transactions for fund, engaged in principal transactions with fund, distributed shares for fund or loaned money to fund
- SEC can determine by order that a person is not independent based on “material business or professional relationship” with adviser or principal underwriter within past two years
- Cannot own even one share of stock of adviser, subadviser, principal underwriter or their “control persons” (*i.e.*, affiliates)
- Independence rules may also apply to trustee, executor and guardianship accounts
- Process: initial and annual questionnaires; ongoing monitoring

# Overview of Specific Responsibilities

## *More Details in Future Webinars*

- Boards of directors have specific legal and regulatory responsibilities, including with respect to:
  - » Advisory agreements
  - » Distribution fees (Rule 12b-1 fees)
  - » Oversight of service providers
  - » Compliance program
  - » Codes of ethics
  - » Valuation
  - » Fund brokerage and securities lending practices
  - » Affiliated transactions and arrangements
  - » Multiple classes
- Certain oversight and approval items require action by a majority of the independent directors.

# Overall Fiduciary Duty

- Funds generally established under state law as corporation or trust
- State law establishes overall fiduciary duties for directors
  - » Overall duties same as those applicable to directors of operating companies
- Duty of care
  - » Duty to perform oversight responsibilities with the care of an ordinarily prudent person in a like position under similar circumstances
  - » Duty of informed oversight

# Overall Fiduciary Duty

- Duty of loyalty
  - » Duty to act in the best interests of the fund and the fund's shareholders
  - » Includes obligation:
    - to avoid conflicts of interest with the fund and the fund's shareholders,
    - not to put his or her personal interests before the interests of the fund and the fund's shareholders, and
    - not to profit from his or her position as a fiduciary.
- Business judgment rule
  - » Courts generally defer to reasonable business judgments by director
  - » *Provided that*, director acts on informed basis, in good faith, and in best interests of fund

# Overall Fiduciary Duty

- Federal law – directors
  - » No specific fiduciary duty standard
  - » Section 36(a) of the 1940 Act: authorizes the SEC to bring an action against directors and certain other persons alleging a breach of fiduciary duty involving personal misconduct related to any registered investment company.
- Federal law - advisers
  - » Investment Advisers Act of 1940 imposes on an adviser a fiduciary duty to each client, including a mutual fund.
  - » Section 36(b) of the 1940 Act: imposes a fiduciary duty on investment advisers with respect to the receipt of compensation.

# Oversight - Conflicts of Interest

- Contrast to operating company board
  - » Although the same state law standards apply, mutual fund director's role differs from that of an operating company.
  - » Interests of adviser and fund do not always correspond.
  - » Specific statutory requirements with focus on oversight of conflicts of interest (e.g., advisory fees, contract approval, and affiliated transactions).
  - » Not the same focus on business planning, executive compensation and similar matters (compared to adviser's board).
- Supreme Court – *Jones v. Harris* (2010)
  - » “The Act interposes disinterested directors as independent watchdogs of the relationship between a mutual fund and its adviser.”
  - » “[A] fully informed mutual fund board is the cornerstone of the effort to control conflicts of interest within mutual funds.”

# Oversight – Risk

- Board role: oversight
  - » Overall fiduciary duty; annual contract renewal
  - » No specific rules similar to compliance programs
- Management role: manage risks
  - » Investing involves risks
  - » Optimize investment risk based on objective and strategy
  - » Manage compliance and operational risks
- Statement of Additional Information (SAI) disclosure
  - » Board leadership disclosure must cover extent of board's role in risk oversight of the fund

# Oversight – Risk

- Defining risk
  - » Investment risks
    - Strategies; instruments, such as derivatives
  - » Compliance risks
  - » Operational risks
  - » Reputational risks
- Overseeing risk management
  - » No one way; tailor to funds/adviser
  - » Understanding adviser's structure
    - Dedicated risk officer/function
    - Coordinate with other control functions (e.g., internal audit, legal, compliance, portfolio oversight)

# Oversight – Risk

- Board reports
  - » Stress tests
  - » Scenario planning
  - » Risk assessments (with Board focus on top risks)
  - » Understanding management process, including internal escalation procedures
- IDC papers on this topic include:
  - » *Fund Board Oversight of Risk Management* (Sept. 2011)
- Related future webinar topics:
  - » Investment Performance Oversight
  - » Oversight of Service Provider

# Board Structures and Governance Practices

- Agenda
  - » Board Leadership
  - » Board Structure Disclosures
  - » Board Structures and Meetings
  - » Board Governance Practices
  - » Board Committees
  - » Fund Governance Rules
- IDC papers on this topic include:
  - » *Overview of Fund Governance Practices, 1994-2012*
  - » *Considerations for Board Composition: From Recruitment through Retirement (2013)*

# Board Structures

- Board Chairperson
  - » Governing documents generally provide that board shall elect chairperson from among its members
  - » Independent vs. interested
    - No requirement of independent chair
    - SEC adopted requirement in 2004
      - » Never implemented due to court challenge
- Lead Independent Director
- *Overview of Fund Governance Practices* (based on IDC/ICI study)
  - » 62% have independent chair
  - » Additional 28% have lead independent director

# Board Structure Disclosure Requirements

- SAI and proxy statement disclosure
  - » Describe leadership structure of board, including whether the chairperson is independent, as well as committee structure
  - » If no independent chair, state whether there is a lead independent director and what specific role that director plays
  - » Indicate why the board believes that its leadership structure is appropriate given the specific characteristics or circumstances of the fund
  - » Disclose the extent of the board's role in risk oversight of the fund
  - » Proxy statement: describe whether, and if so how, the board considers diversity; if policy on diversity, describe how policy is implemented and how board assesses its effectiveness

# Board Structures and Meetings

- Structures - IDC/ICI Study
  - » Unitary board (82% of funds)
  - » Cluster boards (16% of funds)
- Frequency of meetings
  - » Quarterly
  - » More frequent?
  - » Extra meetings?
    - contract renewal
    - director education
  - » Special meetings as needed, including telephonic meetings

# Board Governance Practices

- Executive Sessions
- Minutes
  - » Review and detail
  - » Northern Lights Board enforcement action – 2013 (more details in future webinars)
    - Process for drafting minutes and disclosure resulted in boilerplate statements including material misstatements and omissions
- Materials and Notes
  - » Electronic vs. paper
  - » Retention
- Independent director compensation
  - » Process
  - » ICI/IDC annual study

# Board Governance Practices

- Orientation
- Continuing education
  - » Industry conferences
  - » Adviser-provided programs
- Retirement age and term limits
  - » 67% have retirement policy; 74 average age (IDC/ICI Study)
  - » Term limits less common
- Director investments in funds overseen
  - » 30% mandate; 30% encourage (IDC/ICI Study)

# Board Committees

- General
  - » No requirement that a mutual fund establish any board committee.
  - » Many fund boards establish committees to facilitate board oversight of particular activities.
  - » Closed-end funds whose shares are traded on exchanges are subject to committee requirements.
    - NYSE: Must have audit committee
  - » Differing structures:
    - Committees of the whole
    - Subsets of directors, meeting concurrently

# Board Committees

- Audit Committee
  - » Rule 32a-4 exempts a fund from the requirement to seek shareholder approval of its independent public accountant if:
    - the fund establishes an audit committee composed solely of independent directors, and
    - board adopts an audit committee charter setting forth the committee's structure, duties, powers and methods of operation.
  - » 1999 ICI Advisory Group Report recommendations:
    - establish audit committee composed entirely of independent directors
    - audit committee meets with auditors at least once annually in executive session
    - written committee charter

# Board Committees

- Communications with the audit committee
  - » SEC rules and PCAOB standards require reporting of specific information by accountants to audit committee:
    - critical accounting policies and practices
    - alternative accounting treatments that were discussed with management
    - material written communications with management (such as a management letter or a schedule of unadjusted differences)
  - » Audit committees must pre-approve all services (and related fees) provided directly to the fund and certain services provided to affiliates that directly impact the fund
  - » Auditor must report on other services to affiliates (and related fees)

# Board Committees

- Audit committee financial expert
  - » Every fund must disclose that the board of directors has determined that the board either:
    - has at least one audit committee financial expert serving on its audit committee; or
    - does not have an audit committee financial expert serving on its audit committee.
  - » If the board has an audit committee financial expert, the fund must disclose the name of the person and whether that person is independent.
  - » If the fund does not have an audit committee financial expert, it must disclose why it does not have one.
  - » IDC/ICI Study: 95% have an audit committee financial expert.

# Board Committees

- Nominating, Governance and/or Compensation Committee
  - » Many fund boards establish one or more committees designed to address governance-related issues not handled by the audit committee.
  - » Committee often handles the director nomination process and annual self-assessment process, if applicable
    - SEC fund governance rule requires that independent directors select and nominate any other independent directors of the fund.
    - SEC: “ [S]elf-selection and self-nomination of independent directors fosters an independent-minded board that focuses primarily on the interests of a fund’s investors rather than its adviser.”

# Board Committees

- Contract Review Committee
  - » Some funds establish a contract review committee, including some or all of the independent directors, to oversee the annual review of advisory and distribution agreements.
  - » Many fund boards handle this responsibility without the use of a committee.
- Investment Committee
  - » Some boards have established investment committees to focus on investment performance and related issues.
  - » An investment committee may also focus on related issues, such as brokerage, soft dollars and derivatives.

# Board Committees

- Compliance Committee
  - » Some boards have established a committee designed to assist the board in the oversight of the fund's compliance program.
- Valuation Committee
  - » Some boards establish valuation committees to assist in the oversight of the valuation process.
  - » Other boards discharge responsibilities through another Board committee (e.g., audit or compliance committee).
  - » More details on valuation in a future webinar.

# Fund Governance Rules

- Fund governance rules apply to funds that rely on one or more common exemptive rules (*i.e.*, virtually all funds)
- Independent counsel
  - » If a fund’s independent directors have legal counsel, that counsel must be an “independent legal counsel”
  - » “Independent legal counsel” defined to defer to the business judgment of independent directors:
    - Independent if independent directors reasonably determine in their business judgment that the firm’s representation of management organizations and control affiliates during past two years **“is or was sufficiently limited that it is unlikely to adversely affect the professional judgment of the person in providing legal representation”**
  - » Annual determination
  - » Directors can rely on information provided by counsel, unless they know or have reason to believe that the information is materially false or incomplete

# Fund Governance Rules

- Annual self-assessment
  - » Fund board must evaluate “at least once annually the performance of the board of directors and the committees of the board of directors, which evaluation must **include** a consideration of the **effectiveness of the committee structure** of the fund board and the **number of funds** on whose boards each director serves.”
  - » Intended to improve fund performance by strengthening directors’ understanding of their role, fostering better communications and improving cohesiveness
  - » Assessment does not have to be written. SEC release adopting the rule states that the minutes should reflect the substance of the matters discussed.
- The independent directors select and nominate any other independent directors to the Board.

# Fund Governance Rules

- Executive Session
  - » Independent directors must meet at least once quarterly in a session at which no inside directors are present.
  - » SEC: “[D]esigned to give independent directors the opportunity for a frank and candid discussion among themselves regarding the management of the fund, including its strengths and weaknesses.”
- Independent Director Staff
  - » Independent directors must be authorized to hire employees and to retain advisers and experts necessary to carry out their duties.
  - » SEC: This provision “should help independent directors address complex matters and provide them with an understanding of the practices of other mutual funds.”

# Resources

- IDC website: [www.idc.org](http://www.idc.org)
  - » Fundamentals for Newer Directors: <http://fundamentals.org>
  - » Papers on various topics
- SEC website: [www.sec.gov](http://www.sec.gov)
- ABA Fund Directors' Guidebook: [www.abanet.org](http://www.abanet.org)
- ICI Investment Company Fact Book: [www.icifactbook.org](http://www.icifactbook.org)
- Matt Fink, "The Rise of Mutual Funds" (Oxford Press, 2008)
- Robert Pozen & Theresa Hamacher, "The Fund Industry: How Your Money is Managed" (Wiley Finance, 2011)

## Future Webinars

- Advisory Contract Approval – April 2014
- Investment Performance Oversight – June 2014
- Oversight of the Fund’s Service Providers – September 2014
- Specific Regulatory Responsibilities – December 2014

## Panel Biographies

- **Diana M. Daniels** is an independent director of the Goldman Sachs Mutual Funds. She previously served as Vice President, General Counsel and Secretary of the Washington Post Company. Ms. Daniels received her B.A. from Cornell University and her J.D. from Harvard Law School. She is a member of the IDC Governing Council.
- **Christopher E. Palmer** is a partner and leader of the business law department in Goodwin Procter's Washington, D.C. office, and is a member of the financial services group. He represents mutual funds, investment advisers, insurance companies and broker-dealers on the development, regulatory approval, sale and administration of a variety of investment products, including mutual funds and variable and fixed life insurance and annuity contracts. He also represents mutual fund independent directors. Mr. Palmer advises companies on securities law matters, including reporting and corporate governance matters. He also represents companies in financial services litigation, SEC inspections and enforcement actions, and before state insurance departments. Mr. Palmer earned his BA, *egregia cum laude*, from St. John's University and JD, *magna cum laude*, from Georgetown University Law Center.

## Panel Biographies

- **James F. Perna** has served on the board of directors of the Homestead Funds since 1990 and now serves as its chairman. He has practiced law in Washington DC for over 30 years, specializing in tax, real estate finance, corporate, partnership, and investment matters. Mr. Perna previously served as a Peace Corps Volunteer in northeastern Brazil (1970-1972), and a trustee of the American University of Rome and is currently a director for the Fund for Education Abroad, and a Trustee of the George Woodward Co. Mr. Perna is a graduate in economics of Cornell University and received his MBA in Finance and JD from the University of California at Berkeley.
- **Karen L. Skidmore** is senior associate general counsel for Franklin Templeton Investments, located in San Mateo. She serves as vice president and corporate secretary to the Franklin Funds, officer of all other U.S. funds, and has responsibility for Franklin Funds' corporate governance and fund related matters. Before joining Franklin in 1992, Ms. Skidmore served with the Securities and Exchange Commission in the Division of Investment Management in Washington D.C. Ms. Skidmore holds a J.D. from the Fordham University Law School and a B.S. from the University of Virginia. She serves on several non-profit boards.