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It's Time: SEC Proposals Show the Need to Reexamine the Role of Fund Boards

By Amy Lancellotta

The proper role for fund independent directors—the role where they are best-positioned to represent shareholder interests—is to oversee the work of fund management. The sharp distinction between directors' oversight role and management's on-the-ground, day-to-day responsibilities has been a major factor in the modern fund industry's 75-plus years of success.

These days, that distinction is becoming blurred—and, if we're not careful, fund governance could change in unintended ways. In theory, no one disputes that the board's role should be one of oversight (and not management). But in practice, how the SEC now [appears to be interpreting that role](#) strays from how independent directors view their job.

Nowhere is this more evident than in a pair of pending rule proposals from the Commission: one that would [reform how funds manage liquidity risk](#), and another that would [mandate how funds can use derivatives](#). Both proposals call for strict oversight from fund boards—yet both assign directors responsibilities that fall squarely in the realm of fund management.

Factors to Consider

It's time for the SEC to reassess the types of responsibilities that fit with independent directors' conventional oversight role, and to reassess the types that should be reserved for fund management. The Commission would be wise to consider three factors—at least as a starting point—when determining where new regulatory responsibilities should fall:

- *Potential conflict of interest.* The '40 Act requires that fund boards include independent directors primarily to oversee matters that could involve a potential conflict between the interests of the fund and those of the adviser. If the matters at hand do not present such a conflict—as is the case for liquidity risk management and use of derivatives—they do not warrant heightened independent scrutiny by a fund board.
- *Fund compliance program.* New regulatory requirements already are subject to funds' compliance programs, which are diligently overseen by fund boards. If a fund's compliance program can adequately address the regulatory concern in question—such as the specific risk-management requirements contemplated in the two proposals—the SEC should avoid imposing specific approval responsibilities on the fund's board.
- *Director expertise.* Fund directors do not have the deep subject-matter expertise that fund managers do. If a new regulatory responsibility would require directors to develop and maintain such expertise, it should not be imposed on them. The fact that both proposals would require in-depth understanding of technical matters is inconsistent with the prevailing view of what an oversight role entails.

The Consequences of Not Getting It Right

Using these three factors as a framework, the SEC should hold a roundtable to build a common understanding of the responsibilities that are appropriate to impose on fund directors. Failure to draw the oversight–management line correctly could lead to several harmful consequences for the future of fund governance—and, ultimately, for fund shareholders:

- First, it could set directors up for failure—and expose them to greater liability—by requiring them to develop and draw on knowledge in areas outside the expertise that boards should be expected to have.
- Second, it could alter the composition and dynamic of fund boards in a way that would make them less effective, cohesive, and

collegial. It also could force them to rely too much on individual experts for decisionmaking, rather than on the board as a group, while limiting the pool of qualified candidates to replace a departing director.

- Third, it risks taking directors down a slippery slope—a gradual yet significant shift in the line between oversight and management that would be difficult to stop, let alone reverse. This shift would push boards increasingly into management functions, and divert their focus from the areas where they add the most value to shareholders.

Fund directors should be responsible for vigilant, vigorous oversight on behalf of fund shareholders. That's the role envisioned in the '40 Act—and the role where [directors have proven most effective](#) for more than 75 years. Imposing management-type responsibilities on directors, even when categorized as “oversight,” would contravene that role, and undermine directors' historic success. The SEC—and all policymakers, for that matter—must keep this in mind when considering new regulatory requirements that could affect fund boards.

Amy Lancellotta was Managing Director of the Independent Directors Council (IDC).