Association of Corporate Counsel
Corporate Governance Seminar

Mutual Fund Governance – Independent Directors Rule

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Baruch Performing Arts Center – Engelman Recital Hall
55 Lexington Ave
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Sponsored by Carter Ledyard & Milburn LLP
Program Description: Mutual funds and closed end funds are subject to unique governance requirements under the Investment Company Act of 1940. These will be highlighted in the program, along with a discussion of how board governance is implemented by funds and their boards.

A detailed outline on the history and development of the Investment Company Act of 1940 (“ICA”) and the Investment Advisers Act of 1940 (“IAA”) is being provided in addition to this presentation.
Introduction and Brief Background

- Mutual funds and closed end funds are managed pools of securities and other assets that are required to register with the SEC as “management” investment companies under the ICA.

- A mutual fund is “open end”, meaning that the fund sells shares every day, and also holds itself open for shareholder redemptions, at the current net asset value (NAV) per share on the date of redemption.

- In contrast, a closed end fund offers its shares in an initial public offering and once it receives the proceeds of the offering, stops issuing shares. The shares are typically listed on a stock exchange, and traded on the secondary market at prices that may be at a discount or premium to NAV. Historically, closed end funds did not redeem their shares, but today some offer liquidity through periodic tender offers.

- All funds offer investors the ability to “pool” their money with others to invest in the stocks and bonds of public companies and other enterprises, through a professional asset manager, or investment adviser.
Introduction and Brief Background– cont’d

- The ICA imposes structural and governance requirements on all registered investment companies along with SEC oversight – an unusual exercise in federal jurisdiction. The IAA requires investment advisers to register with the SEC, provide disclosure about themselves and their businesses to clients, and imposes fiduciary duty and anti-fraud standards on them.

- Regulation results from the unique nature of investment companies, which are almost always launched by sponsors in the financial services industry who then collect asset-based fees for managing the funds, and sometimes commissions or payments for distributing fund shares, either directly or through affiliates. The fund sponsor/distributor has an incentive to increase assets under management, and to charge what the market will bear. Shareholders are, as a practical matter, separated from the day-to-day management and control over their assets.
Introduction and Brief Background – cont’d

- The ICA resulted from a comprehensive SEC Study during the 1930’s that described and evaluated the investment trust industry as it existed at the time. The common law business trust form of organization was most common, hence the term “investment trust.”

- During the 1920’s, a myriad of abuses occurred with closed end funds through insider self-dealing, affiliated transactions, excessive fees, lack of disclosure, boards that were not independent from the managers, borrowing and use of margin, and “pyramid” structures, in which funds invested and traded in other investment funds, each fund bearing its own fees and costs. Closed end funds were popular with small investors who wanted to participate in the Wall Street boom. During the stock market crash of October 1929, closed end shares fell into the abyss with other securities, damaging their reputations with investors.
Introduction and Brief Background – cont’d

- Another form of investment company, the unit investment trust or UIT, was also common in the 1920’s and 1930’s. A UIT is a passive pool of securities, with the assets held by a trustee, and the units of the trust sold by the UIT sponsor to investors. A UIT has a set term ranging from one to ten years. At the end of the trust, the securities are sold and the proceeds paid to the unit holders (or rolled by a unitholder into another UIT).

- Mutual funds were first offered in the 1920’s, by sponsors in Boston, Massachusetts. Their growth accelerated during the 1930’s, perhaps due to the problems that had occurred the previous decade with closed end funds.

- The SEC’s Investment Trust Study documented problems with the organization, operations and management of all these funds. The SEC recommended legislation, and after Congressional hearings and negotiations with the industry, the ICA and IAA were enacted.
Introduction and Brief Background – cont’d

- Today, mutual funds of all manner and stripe comprise the bulk of the investment company industry. There are money market funds, U.S. equity and bond funds, international and global funds, index funds for every part of the stock and bond market, and many more. A recent variant, the exchange traded fund, or ETF, allows for open end funds to trade on the secondary market, while retaining purchase and redemption at NAV for large market participants.

- The Investment Company Institute, the industry trade association, reports in the ICI 2015 Factbook that more than 90 million Americans invest almost $16 trillion in almost 8,000 mutual funds. This amounts to over 53 million households, more than 43% of all American households. Almost half of this money is invested in various types of retirement plans, including IRA’s. And there is approximately $2 trillion more in other investment companies.
An understanding of the fund governance model is important for investors, market participants, and financial services companies. It is important for corporate counsel who may be responsible for vetting a company’s obligations under retirement plans, the use of a money market fund by the corporate treasurer, considering the impact of funds as investors in a public company’s securities, pursuing potential litigation against mutual fund management and evaluating the conflicts and potential liability issues when executives are asked to serve on fund boards.

Independent trustees/directors are key to fund governance – they have specific responsibilities and great power under the ICA. In many ways these individuals have veto power over the fund sponsor’s ability to run its business, although they have no economic stake in the business other than their receipt of board fees from the mutual funds they oversee.
The Regulatory Structure

- Funds are organized under state law, most typically as Massachusetts business trusts, Delaware or other state statutory trusts, or as corporations under Maryland law.

- Independent control. Each fund has a board of trustees or directors elected by shareholders, 40% of whom must be independent of management. For most funds this threshold rises to at least a majority, under SEC governance standards imposed in 2001 for funds that rely on any of ten exemptive rules designed to facilitate and enable fund compliance with ICA requirements. Most fund sponsors have several and often many funds within their fund complex, so it is typical for funds within a complex to share a common board. Sometimes large complexes will have two or more boards over their funds. The “interested” directors are usually executives of the sponsor or fund management company.
The Regulatory Structure – Cont’d

- Unique Nature of Fund Boards. Like corporate boards, fund boards are charged with serving the interests of shareholders, with the attendant duties of loyalty and care imposed under state law. In the corporate board context, there is a general presumption that the interests of shareholders are aligned with those of management – both will do well if management performs, especially because management is usually paid in part with equity and most compensation is based on performance. The corporate board provides strategic advice as well as fiduciary oversight, and may be deeply involved with company affairs. While there are circumstances where the outside directors of a corporate board act independently of executive management, or even in opposition to management, in general the working relationship is close.
The Regulatory Structure – Cont’d

- Fund boards, on the other hand, cannot operate on the assumption that the fund’s interests are served by whatever might be in the fund sponsor’s interest. There are potential conflicts of interest, and the need for additional oversight, that makes service on a fund board unique, especially for independent directors.

- Such a conflict may arise in connection with the approval of the investment advisory contract and fee. But conflict can occur in other areas – an example is the use of an affiliated broker by the adviser to execute securities transactions of the funds managed by the sponsor.

- The ICA attempts to resolve conflicts by its strict independence standards, which preclude family and business relationships between the independent directors and fund management, and in assigning specific tasks and responsibilities to the independent trustees.
The Regulatory Structure – Cont’d

NOTE: The above generalizations are qualified by the observation that there has been increasing emphasis by various parties on the role and tasks of corporate independent directors, coming out of Sarbanes-Oxley, exchange listing standards and recent court decisions in Delaware on the duties of board members.

- While all fund directors have the same fiduciary duty, the independent directors of a mutual fund must separately:
  - Approve the investment advisory contract on an annual basis; the adviser has a fiduciary duty under ICA section 36(b) to not take “excessive compensation”, but the board has the job of deciding what is appropriate and potential liability to shareholders along with the adviser for the adviser’s receipt of such compensation.
  - Approve the fund’s distribution arrangements and fees and ICA Rule 12 b-1 arrangements that use fund assets to pay for marketing and distribution.
The Regulatory Structure – Cont’d

- Oversee “revenue sharing” by the investment adviser and distributor with third parties that assist in distribution.
- Select the fund’s independent public accountants.

There are other key elements overseen by the entire fund board:

- A simple capital structure. Borrowing is limited, and only closed end funds can issue preferred stock on senior debt securities. Mutual funds issue only equity shares with equal voting rights, although there may be classes with varying expense levels related to transfer agent, sales and marketing costs, to appeal to different types of shareholders who desire or need a specific distribution structure, or who fit into a certain investor segment. Examples are classes for 401K and other retirement plans, large institutional investors, and investors who purchase shares through large “supermarket” platforms, and classes reflecting different types of sales loads – front end, pay as you go (or level load), and back end.
Custody of assets. Portfolio securities, cash and other assets of funds must be held by a qualified custodian – usually a large bank that specializes in custodial activities, operationally independent from the fund sponsor.

Transfer agent. Fund shares are held in book entry form for investors or their nominees by a transfer agent registered with or, in the case of a bank transfer agent, regulated by, the SEC.

NAV. Oversee NAV determination and the valuation pricing of underlying portfolio securities, especially when securities must be “fair valued.”

Affiliated Transactions. Affiliates of the fund must not knowingly purchase from or sell securities or other property to the fund, unless permitted by SEC rule or order. Lending and borrowing are similarly prohibited. Generally, using an affiliated party of the fund or its adviser or distributor will trigger special review for conflicts of interest and fairness. Use of an affiliated broker for agency transactions is permissible, but commissions must be standard and reviewed by the independent directors. Fund mergers within a fund complex are another example where special scrutiny by the independent directors is required.
Joint Transactions. Arrangements between a fund and an affiliate of any sort are prohibited absent an SEC rule or order.

Fidelity Boards and Other Insurance. Each fund must maintain a bond against larceny and embezzlement. Virtually all funds also purchase E&O, D&O insurance, often jointly with other funds in the fund complex and sometimes as a shared policy with the fund sponsor on titles.

Code of Ethics. The fund and its advisor must each have a code of ethics to prevent insider trading and other fraudulent abuses in the personal trading of advisory personnel (e.g., so-called “front running”) who are “access persons” (those close to fund investment decisions).

Proxy Voting. The Fund must have and disclose policies used to determine how to vote proxies, file a complete proxy voting record with the SEC and make the record available to fund shareholders. This comes from concern that the adviser might vote proxies in its own interests rather than that of the fund.
The Regulatory Structure – Cont’d

- Chief Compliance Officer. ICA Rule 38a-1 and a companion rule under the IAA require all funds and advisers to have a CCO to oversee a program of compliance policies and procedures that is reasonably designed to prevent, detect and remedy violations of the federal securities laws. The CCO must perform an annual compliance review and prepare a report on any material compliance violations. In the case of funds, the CCO must be approved by and have a reporting line to the independent directors, who must approve the CCO’s compensation. The independents must meet with the CCO at least annually in executive session. The compliance rules became effective in 2004 and have resulted in the development of compliance programs that range in complexity for both advisers and funds.

- Generally, the independent directors are responsible for being aware of potential conflicts in the operations of the fund, and following up to ensure that the interests of fund shareholders are protected.
In sum, there are many parties around the fund, with independent directors as the check and balance.

Note: While the above “external management” model is most typical, a very few funds have “internal” management – employees who perform investment management, operating and other work for their fund.
The Role of the SEC (Five Minutes)

- The Division of Investment Management:
  - Reviews and processes fund registration statements (prospectuses, SAI’s, exhibits) - they follow special investment company forms adopted by the SEC that combine disclosure under the Securities Act of 1933 with ICA requirements.
  - Evaluates exemptive applications for relief from statutory requirements and recommends/issues orders of exemption – policy and public interest considerations pertain. This authority permits industry innovation and development by allowing conditioned exceptions to the ICA and IAA.
  - Considers and issues, when deemed appropriate, “no action” letters that permit specified activity without risk the SEC will bring enforcement action. Other registrants may reasonably rely on such letters subject to compliance with applicable representations and conditions.
  - Develops rules under the ICA and IAA. Rules often codify the terms of frequently issued exemptive orders.
  - Responds to requests for information from Congress.
  - Works with other regulators, including state securities regulators and NASAA.
The Role of the SEC – cont’d

OCIE & the Division of Enforcement

- The Office of Compliance Inspections and Enforcement runs the SEC’s inspection program. The Office may request records and visit funds, their investment advisers and other fund service providers to gain information about the industry, check compliance, look for deficiencies and develop data to help the SEC in its regulatory program. OCIE refers problems to Enforcement.

- The Division of Enforcement investigates and brings actions against funds, advisers, distributors and other parties for violations of the ICA and IAA. Often this is done in administrative proceedings, but actions may be brought in federal court as well. Criminal matters are referred to the Department of Justice. In early cases, the SEC brought actions that interpreted the ICA and IAA and established standards of fiduciary duty.

- After the financial crisis, the Division established a specialized asset management unit which has brought a number of cases involving valuation of securities, prospectus disclosure, board oversight, and compliance programs.
The Fund Governance Model At Work

- The mutual fund industry encompasses a range of business models, with fund boards to match.
- An investment advisor may have only one or a few funds under management, often to serve investors who cannot meet investment management minimums for separate account clients.
- Some advisors have a unique investment style or strategy with funds to match – arbitrage, bank loan, mortgaged backed securities, small, mid or large cap, value or growth.
- Some fund sponsors are large organizations – advisers, banks, insurance companies, that have a full range of products – sometimes hundreds of funds, including money market funds.
- Some fund managers operate funds of funds, where a fund will invest in other registered funds or private hedge funds.
There are also “manager of managers” funds, or sub-advised funds. All fund sponsors have the common denominator of answering to the independent directors who almost always hold a board majority, and often a supermajority.

But the fund sponsor bears the economic risk of the fund enterprise, which is operationally complex and subject to intense competition.

Independent directors comprise the audit committee and the nominating committee; they often establish other key committees to accomplish the necessary oversight – examples are compliance, pricing and valuation, brokerage and soft dollar oversight, and contract review (to do all the analysis and assessment required for approval of the advisory, distribution and other key contracts). They also set their own compensation.
The Fund Governance Model At Work (cont’d)

- Independent Directors are viewed as “watchdogs” for the fund and its investors by the SEC.
- The relationship of independent directors with fund management has an automatic tension, but it is essential for there to be trust between the parties.
- There are two independent director trade associations, the Independent Directors Council, operated within the ICI umbrella, and the Mutual Fund Directors Forum. Both support the education, communication and development of policy positions for independent directors. They submit policy views to Congress and regulators, and file amicus briefs in regulatory and private litigation.
Note on Mutual Fund Legal Practice

- Initially, fund legal work was incidental to and part of corporate practice, augmented by tax and litigation expertise, when necessary.
- As the fund industry expanded along with financial markets, the SEC kept up by issuing rules, exemptive orders, no action letters and other guidance. It is hard to simply read the statute or rule, and be able to give good advice, without practical experience.
- Today, ’40 Acts practice is recognized as highly specialized with sub-areas of concentration – distribution, custody, securities lending and compliance are examples. Lawyers often have SEC experience.
- The American Bar Association and New York City Bar Association have committees dedicated to investment management regulation, and there are informal groups in many locations.
Note on Mutual Fund Legal Practice (cont’d)

- There is a consolidation of talent in certain law firms, primarily in larger cities and in areas with a high concentration of financial service firms.
- Funds are heavily regulated, therefore the fund industry is very lawyer intensive.
- Counsel to independent directors must be independent of fund management, under SEC rules.
- A typical fund complex will have in-house lawyers, outside counsel for the fund, and outside counsel for the independent directors. Special counsel may be brought in for investigations, litigation and special projects.
Conclusions

- Fund Industry is heavily regulated and very specialized.
- Active enforcement by the SEC, including against fund directors.
- Private litigation also active against fund sponsors – most often challenging fund fees, distribution practices and prospectus disclosure - complaints often name the directors.
- The industry continues to thrive and grow.
- Role of independent directors is key to it all.

Questions