IDC Independent Directors Council
Promoting Excellence in Fund Governance

Fund Boards—Fulfilling their Promise to Shareholders

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Thank you for inviting me to participate in today's valuation roundtable. As a '40 Act lawyer, I look forward to these opportunities to engage in discussions of issues, like valuation, that are of such significance to funds, their boards, and, most importantly, their shareholders. And as managing director of IDC, I welcome the opportunity to discuss the important role of fund directors and what they do to promote and protect the interests of shareholders.

We in Washington tend to speak in terms of acronyms, and I have one of my own to describe the board's role — IOU — which stands for *independence, oversight* and *understanding*. This acronym applies to the role and responsibilities of fund boards generally — although valuation, as a very significant board responsibility, exemplifies it.

Let me explain what I mean, starting with the "U", which has a double meaning in this context. First, and foremost, directors make a promise to a collective "*you*" — the millions of fund shareholders for whom boards promise to work diligently and protect. Secondly, the letter "U" stands for understanding, which I will go back to.

As I stated, the "I" stands for *independence*. Fund directors must be independent — not just in compliance with the law, but in their thinking and perspectives. Their role as "independent watchdogs"

— protecting shareholders from potential conflicts of interest — continues to be the singular most important role they play. In the context of valuation, it is critical that the influence asserted by portfolio managers and others who have a potential conflict be limited by board-approved policies and procedures.

"O" is for the *oversight* role that boards play. It is crucial that boards' oversight function — particularly in the area of valuation — never morphs into a management role, either by directors' actions themselves or by regulatory actions.

Finally, turning once again to the "U," directors must *understand* the policies and procedures of their particular funds, including how they are being implemented. To ensure the appropriate level of understanding, boards must receive all relevant information and it must be in a digestible format — *not* via an overwhelming, indecipherable data dump. This is a key lesson learned from the valuation enforcement action that we will be discussing this morning on the first panel.

Let's turn now to portfolio valuation specifically. This is, of course, a cornerstone of the protections provided to investors purchasing and selling redeemable fund shares — as is evidenced by Congress's determination in 1940 to impose valuation responsibilities on fund boards as one of only four explicit statutory responsibilities. It goes without saying that in the decades since 1940, there have been significant changes in investment products and strategies, technology, and regulations. All have affected valuation practices.

Last year, however, we saw heightened interest in the topic and in the related role of fund directors. This was due in large part to the SEC's enforcement action against the former directors of the Morgan Keegan funds. In addition, Norm Champ — the Director of the SEC's Division of Investment Management — announced that valuation guidance was one of the division's top priorities.

So, where does this leave us for 2014? Let's start with potential SEC valuation guidance. In connection with the staff's work in this area, Norm Champ invited interested parties to meet with him to provide their views and perspectives. He and other SEC staff met with a number of parties, including IDC and several independent directors. Although I am not privy to the discussions that the SEC staff had with all of the various parties, it is my impression that they received markedly different responses to the question of whether additional valuation guidance is needed.

We at IDC told them that we did not believe additional guidance is wanted. Based on a number of conversations with a rather large sampling of directors, it seems that fund boards today are generally comfortable with the current guidance, which offers boards the flexibility to tailor policies and procedures to the funds they oversee, and to adjust and enhance their policies and procedures in response to market and regulatory developments. Unsuitable valuation guidance would be quite disruptive, to the detriment of fund shareholders.

In addition, valuation policies and procedures are more robust today than they were 10 years ago, when the SEC started working on valuation guidance. This is due to a number of developments including, for example, the fund compliance program rule, which went into effect in 2004. That rule has provided fund boards with a valuable resource that they previously did not have: a chief compliance officer. The CCO assists a board in performing its oversight responsibilities, and can provide unique insights regarding management's implementation of the fund's valuation policies and procedures.

The 2008-09 market crisis also contributed to the more robust policies and procedures we see today. While the freezing of the credit markets and loss of liquidity for many previously liquid securities presented significant valuation challenges for funds and their boards, those events also produced new insights that have now been incorporated into fund valuation policies and procedures.

Nevertheless, there are certainly others who have indicated that they would welcome additional guidance, and the SEC might very well determine to go forward. If it does, we would expect the SEC to propose any guidance for public comment before issuing it. And we would urge the SEC to keep a few things in mind.

First, any guidance — consistent with existing guidance — should reflect that the appropriate role for a fund board is *oversight*, and *not* administration of the fund's valuation policies and procedures. As an oversight body, a fund's board cannot be expected to be expert in the technical details of fair valuation.

While the board has the statutory responsibility to determine fair valuations in good faith, boards can and do delegate day-to-day responsibility for fair valuation and establish processes to oversee that function. Moreover, in fulfilling its oversight responsibilities, a board may place reasonable reliance on others who have relevant expertise, such as the fund's CCO, the fund and/or board counsel, and the independent auditor.

Fund boards do not abdicate their responsibilities by relying on the reports and expertise of others; rather, they incorporate the information provided to them, in exercising their own business judgment in overseeing the process.

Second, any guidance should be principles-based, and not set forth any "best practices" or specific guidance regarding any particular practice or type of investment. A principles-based approach would enable boards to continue to have the flexibility to tailor policies and procedures to the specific funds they oversee.

Those of you who have been in the industry as long as I have know that we've heard about the SEC staff's work on possible valuation guidance for, as I mentioned earlier, at least 10 years. What the division — and, ultimately, the SEC — will do with this current initiative is uncertain.

Senior staff members at the Commission have acknowledged that the SEC has other pressing priorities. We also have noticed that valuation guidance is no longer listed on the SEC's regulatory

agenda. So, this may no longer be a “front burner” priority for the SEC. But whether it is now on the back burner or off the stove altogether remains to be seen.

Now, what about SEC enforcement? In addition to the Morgan Keegan case, the SEC brought an enforcement action against the directors of two of the Northern Lights series trusts. While the Morgan Keegan case concerned failures in the valuation process, the Northern Lights case concerned alleged misrepresentations in shareholder reports about the 15(c) process. In neither case were the directors charged with fraudulent activities; rather, they were found to have caused the funds’ violations of rule 38-1 — the fund compliance program rule. In essence, they were held responsible for process failures.

Indeed, SEC Chair Mary Jo White has made clear that she sees fund boards as “critical gatekeepers” and that the SEC “will focus on ensuring that they appropriately perform their duties.”

These two cases and Chair White’s remarks seem to signal a shifting focus on fund directors. In this new environment, directors may need to bring a greater degree of vigilance to their roles. When a compliance violation occurs, the SEC is increasingly likely to ask: Where was the board? Rule 38-1 is potentially the SEC’s new catch-all for actions against directors. This means that directors should take a fresh look at their fund’s and adviser’s compliance policies and procedures, and obtain assurances that they reflect actual practices.

Many boards have revisited their valuation policies and procedures in light of the Morgan Keegan case, and might also review other policies and procedures required by rule 38-1, such as those relating to identification of affiliated persons, protection of non-public information, and investment limitations.

In her remarks, Chair White did state that the SEC will not be looking to charge a director who “did her job by asking the hard questions, demanding answers, looking for red flags and raising her hand.” Nevertheless, I am concerned that this emphasis on directors as “gatekeepers” suggests that the SEC believes that directors should be held responsible for failing to detect or prevent the misconduct of others.

Unlike the adviser — which is in the position to know and control the daily operations of the fund — a director serves in an *oversight* capacity, generally meeting four times a year and relying on the reports and information provided to them by the adviser, CCO, and others. Fund boards typically do not have independent staff, and are not equipped to investigate every red flag or potential fraud. Boards rely — and appropriately so — on compliance officials, counsel, auditors and others, who are engaged at the ground level to identify issues to bring to the board’s attention.

When it comes to describing the role of a fund director, I much prefer the term *fiduciary*, which is rooted in law and whose meaning is better understood. As fiduciaries, directors must satisfy the duties of care and loyalty. If directors meet these standards, they enjoy the protection of the business-judgment rule — a judicial doctrine that shields a director from personal liability for decisions made in the boardroom. These important principles are the framework within which directors fulfill their responsibilities, and

should serve as the prism through which the SEC views directors' conduct.

Indeed, these fundamental principles guide directors in any environment and with respect to any matter in fulfilling their "IOU" to shareholders. Even as funds and their portfolio securities become more complex and regulators apply greater scrutiny, directors should never lose sight of their fundamental duties of loyalty and care in fulfilling their promise to shareholders.
