INDEPENDENT DIRECTORS COUNCIL

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October 16, 2017

Ms. Dalia Blass
Director
Division of Investment Management
Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549

Re: Modernizing Fund Directors' Responsibilities

Dear Ms. Blass:

Congratulations once again on your appointment as Director of the Division of Investment Management. As you begin your tenure and consider your priorities, the Independent Directors Council[1] requests that you prioritize an initiative of great interest to the independent director community: modernizing fund directors' regulatory responsibilities. In particular, we ask that the staff undertake a comprehensive review of fund directors' current responsibilities under the Investment Company Act of 1940 ("1940 Act"), with the intent of determining the regulatory modifications the staff and the Commission should make to enhance directors' effectiveness in today's environment on behalf of fund shareholders.

Independent fund directors play a critical role in protecting the interests of more than 100 million US fund shareholders. Commission rules should support and facilitate directors' oversight on behalf of those shareholders by placing them in the best position to serve shareholders' interests effectively. The rules should allow directors to dedicate the majority of their time and attention to the matters most important to shareholders' interests and where they can add the greatest value. We believe that the current regulatory regime should be improved to better achieve these goals.

[1] IDC serves the US-registered fund independent director community by advancing the education, communication, and policy positions of fund independent directors, and promoting public understanding of their role. IDC's activities are led by a Governing Council of independent directors of Investment Company Institute member funds. ICI is a leading, global association of regulated funds, including mutual funds, exchange-traded funds, closed-end funds, and unit investment trusts in the United States, and similar funds offered to investors in jurisdictions worldwide. ICI's members manage total assets of US$20.5 trillion in the United States, serving more than 100 million US shareholders, and US$6.7 trillion in assets in other jurisdictions. There are approximately 1,800 independent directors of ICI-member funds. The views expressed by IDC in this letter do not purport to reflect the views of all fund independent directors.

The collective set of regulatory requirements applicable to directors today is the cumulative result of SEC initiatives since 1940 imposing responsibilities on directors, some of which do not directly bear on shareholder interests. These additions have been made without a concomitant wholesale review of directors' responsibilities to consider whether any specific responsibility is outdated or unnecessary or whether, in the aggregate, the current set of responsibilities continues to be appropriate.

The expansion of director responsibilities has been a matter of concern in the director community for quite some time.[2] The concern is not merely with the number of regulatory requirements for directors, but more importantly, with the nature of some of the requirements, such as those that are outmoded or inconsistent with directors' oversight role. In addition, we are troubled by requirements that hold directors accountable (*i.e.*, liable) for functions that are more appropriately within the purview of fund management, whose business is to run the day-to-day operations of the fund.

The Division has in the past undertaken reviews of directors' responsibilities to consider whether any should be eliminated or modified.[3] The most recent review—the Director Outreach Initiative—was launched ten years ago.[4] Unfortunately, but understandably, the financial crisis of 2008-09 created other more pressing regulatory priorities, and the initiative did not result in any recommendations to the Commission.

Yet, the industry has continued to evolve, and directors have continued to take on new regulatory responsibilities, such as part of the money market fund reforms and under the new liquidity

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[2] Indeed, at a recent SEC Historical Society program, previous Division Directors Norm Champ, Andrew J. "Buddy" Donohue, and Paul Roye discussed directors' responsibilities. *See* Video of Rulemaking under the '40 Act (June 1, 2017), available at http://www.sechistorical.org/museum/programs/video-player.php?vid=5459650423001&title=Rulemaking%20Under%20the%20%2740%20Act. In particular, Mr. Roye suggested that the Commission consider the respective roles of fund management and fund directors, particularly the appropriate scale and scope of oversight expected of directors, the level of detail of directors' oversight responsibilities and the level of expertise expected of directors.

[3] *See* Keynote Address at the 2007 Investment Company Directors Conference by Andrew J. Donohue, Director, Division of Investment Management, SEC (Nov. 6, 2007) (describing the Director Outreach Initiative) ("Donohue Speech"), available at https://www.sec.gov/news/speech/2007/spch110607ajd.htm and Division of Investment Management, SEC, *Protecting Investors: A Half Century of Investment Company Regulation* (May 1992) ("1992 Study"), available at https://www.sec.gov/divisions/investment/guidance/icreg50-92.pdf.

[4] The Director Outreach Initiative sought to review directors' responsibilities in order to make recommendations to the Commission regarding steps it "should consider to improve the effectiveness of fund directors." *See* Donohue Speech, *supra* n. 3. IDC was a strong proponent of that initiative. *See* Letter from Robert W. Uek, Chair, IDC Governing Council to Andrew J. Donohue, Director, Division of Investment Management, SEC (February 26, 2008).

risk management rule.[5] We believe that it is time to take a fresh, comprehensive look at directors' responsibilities, with an eye towards bringing them under a rational and consistent rubric for appropriate board oversight.

A Division review of directors' regulatory responsibilities would be closely aligned with the guiding principles Chairman Jay Clayton has identified for his leadership of the SEC.[6] He noted, for example, that although incremental regulatory changes may not seem individually significant, in the aggregate, they can have a larger effect. He suggested that the SEC's analysis should be cumulative, as well as incremental. Chairman Clayton also pointed out that effective rulemaking does not end with adoption and that the SEC should review its rules retrospectively—listening to investors and others about where rules are, or are not, functioning as intended. Moreover, he said, the SEC must recognize the changes brought on by technology and innovation and strive to ensure that SEC rules reflect the realities of the capital markets.[7]

Consistent with the Chairman's principles, we believe that any review of directors' responsibilities should incorporate and reflect the significant industry, technological and regulatory developments that have occurred. Developments such as the industry's growth and increased complexity, and new regulatory responsibilities, help explain directors' current workload. The developments also present opportunities for rethinking directors' responsibilities and board governance requirements. For example, one of the most significant regulatory developments was the adoption of the fund compliance rule (rule 38a-1 under the 1940 Act) in 2003, which we discuss more fully below. The rule established a successful framework for board oversight that is well-accepted across the industry. The success of that framework suggests that it should serve as a model for modernizing other regulatory responsibilities of fund directors.

We provide our preliminary recommendations below. To establish context for our recommendations, we first provide background on the changes in the fund industry and the evolution of board responsibilities. We then suggest a framework for considering the nature of responsibilities

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[5] *See e.g.*, *Money Market Fund Reform; Amendments to Form PF*, Release Nos. 33-9616, IA-3879; IC-31166; File No. S7-03-13 (July 23, 2014); and *Investment Company Liquidity Risk Management Programs*, Release Nos. 33- 10233; IC- 32315; File No. S7-16-15 (October 13, 2016).

[6] *See* SEC Chairman Jay Clayton, Remarks at the Economic Club of New York (July 12, 2017), available at https://www.sec.gov/news/speech/remarks-economic-club-new-york.

[7] We note that effective board governance, including the elimination of outdated requirements, is a focus for another government agency. The Federal Reserve recently proposed changes to the requirements for bank boards of directors, stating that it believes that "revising or eliminating unnecessary, redundant, or outdated expectations, as appropriate, will allow boards to focus more of their time and resources on fulfilling their core responsibilities." *See* Federal Reserve System, Proposed Guidance on Supervisory Expectation for Boards of Directors, 82 Fed. Reg. 152 (August 9, 2017), available at https://www.gpo.gov/fdsys/pkg/FR-2017-08-09/pdf/2017-16735.pdf.

that are appropriate to impose on directors, consistent with their oversight role under the 1940 Act. In the Appendices, we provide examples of the types of modifications the staff might consider.

We provide a range of recommended changes—some of which could be addressed in the short-term, including through staff action. Some of our suggested rulemaking initiatives might take more time to develop—such as to modernize the board's fair valuation responsibilities—but those efforts could produce the greatest benefits for the board governance process and, consequently, warrant the staff's attention.

Introduction and Background

Significant developments in the fund industry and in technology, and new regulatory requirements, serve as an important backdrop for any review of directors' responsibilities and fund governance requirements.

The Fund Industry Has Grown and Evolved

The fund industry has grown significantly and become more complex over the years. For example, nearly twenty years ago, funds held approximately $5.7 trillion in net assets;[8] today, they hold over $20 trillion in net assets. The number of funds has grown over the same period from 8,000 to nearly 12,000,[9] while the number of mutual fund shareholders has grown from 74 million to 94 million.[10]

Innovations in the industry, in such areas as portfolio management and distribution, have accompanied this growth. For example, many funds make greater use of complex or alternative investment strategies, and funds across the industry generally hold larger amounts of derivative instruments and foreign securities.[11] The increased complexity of portfolio investments and strategies has contributed to a more extensive fair valuation process for certain portfolio investments. Advancements in technology have impacted trade execution and fund brokerage allocations, while also improving overall execution quality. Fund distribution is much more multifaceted now, as most funds

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[8] *See* 2017 Investment Company Fact Book ("Fact Book"), available at https://www.ici.org/pdf/2017_factbook.pdf, at 9. Households make up the largest group of investors in funds, and the growth of individual retirement accounts and defined contribution plans, particularly 401(k) plans, explains some of the increased reliance on funds during the past two decades. Fact Book at 11. Exchange-traded funds (ETFs)—a significant innovation of the fund industry—are an important component of the industry's growth. Total net assets of ETFs registered under the 1940 Act rose from $580 billion in 2007 to $2.5 trillion in 2016. Fact Book at 59.

[9] Fact Book, *supra* n. 8, at 22 (includes mutual funds, closed-end funds, and exchange-traded funds).

[10] *See* ICI Research Perspective, Ownership of Mutual Funds, Shareholder Sentiment, and Use of the Internet, 2016 (October 2016), available at https://www.ici.org/pdf/per22-06.pdf (referenced data does not include shareholders of closed-end funds or ETFs).

[11] For example, total net assets in alternative strategy mutual funds has grown from $42 billion in 2007 to $213 billion in 2016. *See* Fact Book, *supra* n. 8, at 215.

are sold through many third-party intermediaries that generally hold omnibus accounts with the funds. As a result, funds today have much fewer direct relationships with shareholders. Other important areas of evolution for funds include cybersecurity, business continuity, privacy, and securities lending.

Significant Developments Have Occurred in the Regulatory Landscape

As the industry has evolved, the SEC also has taken actions to attempt to address and accommodate these changes. The following regulatory developments are of particular relevance to a review of directors' responsibilities and fund governance.

Rule 38a-1

As previously mentioned, the fund compliance rule created an important and robust framework that has successfully enhanced fund compliance with the federal securities laws and assisted fund directors in fulfilling their oversight responsibilities with respect to compliance matters on behalf of fund shareholders.[12] Under the rule, the board must approve the fund's policies and procedures, as well as those of the fund's principal service providers, and also must approve the designation, compensation, and removal of the CCO. At least annually, the CCO must meet with the fund's independent directors in executive session and provide a written report to the board that addresses the operation of the policies and procedures and any material compliance matters. In the adopting release, the Commission stressed that the rule "provides fund boards with direct access to a single person with overall compliance responsibility for the fund who answers directly to the board" and noted that the rule "strengthens the hand of compliance personnel by establishing a direct line of reporting to fund boards that is not controlled by management."[13]

Governance requirements

The governance standards adopted in 2001 and 2004 have contributed to the enhanced independence and effectiveness of fund boards on behalf of shareholders. The standards require, among other things, that incumbent independent directors select and nominate new independent directors, any legal counsel for the independent directors be "independent legal counsel," and boards conduct annual self-assessments.[14] The SEC also had adopted two significant changes to fund governance—the independent chair and 75-percent independent director composition requirements.

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[12] *See* rule 38a-1 under the 1940 Act.

[13] *See Compliance Programs of Investment Companies and Investment Advisers*, SEC Release Nos. IA-2204 and IC-26299 (December 17, 2003).

[14] See rule 0-1(a)(7) under the 1940 Act.

While those two requirements were ultimately struck down by the courts, we note that most boards have voluntarily adopted them.[15]

Department of Labor Fiduciary Rule

The Department of Labor's fiduciary rule has provoked an unprecedented wave of change and innovation in fund distribution, which is likely to persist, regardless of its final fate.[16] Consequently, the board's role relating to distribution oversight generally, and more specifically, under rule 12b-1 and related rules and interpretations, is ripe for examination.

New director responsibilities

While directors' responsibilities have expanded with the growth and evolution of the industry, they also have increased as a result of new regulatory responsibilities. Over the years, the Commission has continuously added new responsibilities for fund boards, without eliminating or paring down existing ones. Many of the older rules have become outdated and no longer reflect the best use of directors' time and attention in today's environment.

Moreover, and perhaps more importantly, recent rulemaking initiatives—*e.g.*, the liquidity risk management rule and the derivatives proposal—expand directors' responsibilities under the 1940 Act beyond their core role of overseeing potential conflicts of interest and management integrity to involvement in investment management functions.[17] The rulemaking initiatives followed the previous

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[15] Nearly two-thirds of fund complexes have an independent board chair, and independent directors make up three-quarters of boards in 84 percent of fund complexes. *See* IDC/ICI, *Overview of Fund Governance Practices, 1994-2016*, at 1, available at https://www.idc.org/pdf/pub_17_fund_governance.pdf. As a ministerial matter, we note that, although the courts struck down the two governance requirements, the SEC has never followed up to remove those provisions from the "fund governance standards" definition in rule 0-1(a)(7) under the 1940 Act. To resolve the confusion that this has created, we request that the Commission remove paragraphs (i) and (iv) from the fund governance standards definition.

[16] We note that DoL has proposed an 18-month delay of the January 1, 2018, applicability date so that it can reexamine the fiduciary rulemaking and have time to work with the SEC as it determines how to modify the rulemaking. *See* 82 Fed. Reg. 41365 (August 31, 2017).

[17] For example, under the derivatives proposal, a board would be required to approve one of two alternative portfolio limitations and asset segregation policies and procedures, including for determining the risk-based coverage amounts. *See Use of Derivatives by Registered Investment Companies and Business Development Companies*, Release No. IC-31933; File No. S7-24-15 (December 11, 2015) ("Derivatives Proposal"). IDC objected to those proposed provisions because they would impose on fund boards responsibilities for management functions that are inconsistent with their oversight role. *See* Letter from Amy B.R. Lancellotta, Managing Director, IDC, to Brent J. Fields, Secretary, SEC, regarding Use of Derivatives by Registered Investment Companies and Business Development Companies; File No. S7-24-15 (March 28, 2016) ("IDC Derivatives Letter"), available at https://www.idc.org/pdf/16_idc_sec_derivatives_ltr.pdf. With respect to the liquidity risk management rule, although the Commission incorporated improvements in the adopted rule, IDC continues to object to the requirement that the board approve the designation of the person or persons who will serve as the fund's "liquidity program administrator." As we previously stated in our comment letter, requiring the board to approve specific advisory personnel inappropriately draws them into a management-type function that is inconsistent with an oversight role. *See* Letter from Amy B.R. Lancellotta, Managing Director, IDC, to Brent J. Fields, Secretary, SEC, regarding Open-End Fund

Chair's reference to directors as "gatekeepers,"[18] a previous Division Director's suggestion that fund directors should perform a quasi-regulatory role as the "eyes and ears" of the SEC,[19] and enforcement actions against independent directors under rule 38a-1 of the 1940 Act.[20] Those developments raised concerns that the SEC's view as to what constitutes an appropriate oversight role for fund boards is inconsistent with the director community's views. Although there is general agreement that the board's role is one of "oversight," there may be different views as to what functions fall within or outside of an oversight role—*i.e.*, where to draw the line between oversight and management.[21]

The potentially different views underscore why a thoughtful review and dialogue regarding the appropriate oversight role of directors would promote a clearer understanding among all interested parties on what that role should be and how directors can best serve shareholders in today's environment. The potential disconnect also should serve as a caution against the issuance of guidance for fund directors without giving the public notice and the opportunity for comment.[22]

Liquidity Risk Management Programs; Swing Pricing; Re-Opening of Comment Period for Investment Company Reporting Modernization Release; File Nos. S7-16-15 and S7-08-15 (January 13, 2016), available at https://www.idc.org/pdf/16_idc_sec_lrm_comment.pdf; *see also* Letter from Paul K. Freeman, Chair, IDC Governing Council, to Brent J. Fields, Secretary, SEC regarding Supplemental Comments on Liquidity Risk Management and Funds' Use of Derivatives Proposals; File Nos. S7-16-15 and S7-24-15 (June 22, 2016) ("IDC Supplemental Letter"), available at https://www.idc.org/pdf/16_idc_sec_supp_ltr.pdf. We urge the Commission to modify this requirement upon any future consideration of amendments to the rule.

[18] *See, e.g.*, Chair Mary Jo White, "A Few Things Directors Should Know About the SEC" (June 23, 2014), available at https://www.sec.gov/news/speech/2014-spch062314mjw and Chair Mary Jo White, Remarks at Securities Enforcement Forum (October 9, 2013), available at https://www.sec.gov/News/Speech/Detail/Speech/1370539872100.

[19] *See* Norm Champ, Director, Division of Investment Management, Remarks to the 2013 Mutual Funds and Investment Management Conference (March 18, 2013), available at https://www.sec.gov/news/speech/2013-spch031813nchtm.

[20] *See e.g., In the Matter of J. Kenneth Alderman, et al.*, Release No. IC-30557; Administrative Proceeding File No. 3-15127 (June 13, 2013), available at https://www.sec.gov/litigation/admin/2013/ic-30557.pdf.

[21] As former SEC Chair Mary Jo White observed, determining the appropriate dividing line between oversight and management "is a challenge" and one that the SEC grappled with in connection with the recent rule proposals. *See* Chair Mary Jo White, The Fund Director in 2016: Keynote Address at the Mutual Fund Directors Forum 2016 Policy Conference (March 29, 2016), available at https://www.sec.gov/news/speech/chair-white-mutual-fund-directors-forum-3-29-16.html.

[22] A related concern is with respect to the status of proposed guidance that is never finalized. For example, in 2008, the Commission issued proposed guidance regarding board oversight of portfolio trading, including the use of soft dollars, but never adopted final guidance. *See Commission Guidance Regarding the Duties and Responsibilities of Investment Company Boards of Directors with Respect to Investment Adviser Portfolio Trading Practices*, Release Nos. 34- 58264; IC-28345; IA-2763; File No. S7-22-08 (July 30, 2008). Despite the fact that the Commission never adopted final guidance and had received numerous comments on the proposal, there is concern that proposed guidance nevertheless reflects the staff's expectations for fund board practices.

In Light of These Developments, Directors' Regulatory Responsibilities Are Ripe For Modernization

For fund boards, a consequence of many of these industry and regulatory developments is a larger and more complex workload, but not necessarily a corresponding enhancement of protections for fund shareholders. For example, a fund board's oversight of such core functions as investment performance, fair valuation, fund distribution, and risk management have expanded as a result of the growth and evolution of the industry. At the same time, however, directors continue to bear other regulatory responsibilities that consume time and attention at board meetings, yet no longer reflect the best use of their time, expertise, and attention.

Although some of the tasks required under certain rules do not take up a large amount of directors' time, they are a distraction from the arguably more important matters before boards. As the Commission previously observed, tasks that "perform little useful purpose" and "actually interfere with the ability of boards to operate efficiently" are appropriate candidates for modification.[23] Moreover, by making directors liable for certain fund activities overseen by the fund's CCO and others, the regulations elevate their importance on board agendas beyond what is appropriate, given the universe of significant matters warranting directors' attention.

The developments described above present opportunities for revisiting and rethinking the regulatory framework for fund boards. For example, three important observations derived from the success of rule 38a-1 should be reflected in any update to board responsibilities. First, the rule's framework, which holds fund boards to an oversight role, should serve as a model for modernizing board responsibilities. Second, fund regulatory requirements are already subject to robust oversight under the compliance rule by the fund's CCO and the fund's board, making it superfluous, in many cases, to impose specific, additional responsibilities on fund directors. Finally, some regulatory responsibilities imposed on directors before the adoption of rule 38a-1 were of a compliance nature and may be more appropriate for the CCO. Indeed, some of those responsibilities have become ritualistic and duplicate work already being performed by the fund's CCO or other advisory personnel, who are in much better positions than the fund's directors to fulfill those responsibilities. (*See* Appendix B for examples of suggested changes to these types of responsibilities.)

The changing environment also presents the opportunity to reevaluate certain governance requirements, such as mandated in-person approvals for advisory contracts even during emergency situations or rules that apply to a director's "independence" status with respect to a remote relationship with a fund's unaffiliated sub-adviser, which we address in Appendix C. The growth and evolution in the fund industry (such as the more prevalent use of the multi-manager structure) as well as

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[23] *See Revision of Certain Annual Review Requirements of Investment Company Boards of Directors*, Release Nos. 33-6971; IC-19192; File No. S7-41-92 (Dec. 30, 1992) (proposing rule amendments based on staff recommendations following the 1992 Study).

advancements in technological capabilities are reasons to take a fresh look at governance requirements to determine whether some could be modernized to promote more flexibility and efficiency in board operations.

Framework for Determining Appropriate Board Responsibilities

When considering an appropriate fund governance system, it is critical to step back and focus on the role intended for independent directors under the 1940 Act. Even absent the 1940 Act and its rules, fund directors are subject to state law fiduciary duties of loyalty and care. These fiduciary duties require directors to use their positions of trust and confidence to further the interests of the fund and its shareholders ahead of their own interests and to perform their duties in good faith and in a manner reasonably believed to be in the best interests of the fund. Directors' fulfillment of their fiduciary duties provides essential protections for fund shareholders.

The responsibilities imposed on directors under the 1940 Act and its rules are in addition to, and build upon, these fiduciary duties. While directors' fiduciary duties guide them in their general oversight of fund management and operations, the 1940 Act prescribes certain governance requirements and imposes specific responsibilities that are primarily intended to address potential conflicts of interest situations. The 1940 Act places the independent directors in the role of "watchdogs" who furnish an independent check on management.[24]

It is important to recognize, though, that while the inherent structure of funds creates the potential for conflicts of interest, the interests of the adviser and the fund and its shareholders are, in many instances, generally aligned. For example, all parties want the fund to provide strong performance results, consistent with the fund's investment objectives. And the adviser—whose name often is in the fund's name—has a strong interest in retaining the trust of its investors and maintaining its reputation. Thus, the adviser generally has a strong incentive to minimize the risks of compliance or other failures that could damage its reputation.

With the 1940 Act's legislative purpose relating to fund governance in mind, we set forth below a framework for evaluating the appropriateness of directors' responsibilities. The primary goal of this framework is to focus the director's responsibilities on oversight of potential conflicts of interest. We first outlined an earlier version of this framework in our comment letter on the liquidity risk management and derivatives proposals as a basis for considering the appropriateness of new board responsibilities.[25] We believe it can also help guide a review of existing responsibilities to consider which ones may warrant modification or elimination so that boards may operate more efficiently and

[24] *See Burks v. Lasker*, 441 U.S. 471, 484-85 (1979).

[25] *See* IDC Supplemental Letter, *supra* n. 17.

effectively. The framework secondarily seeks to ensure that directors are not placed in a role that is more appropriate for fund management.

Regulations Should Focus on Board Oversight of Potential Conflicts of Interest

Consistent with the primary role of independent directors under the 1940 Act, the Commission should focus board responsibilities on those matters where there is a clear conflict of interest—not simply a theoretical one—and on tasks where directors can add tangible value.

In the staff's 1992 Study, it recognized that "independent directors perform best when required to exercise their judgment in conflict of interest situations" and that they are "unnecessarily burdened … when required to make determinations that call for a high level of involvement in day-to-day activities."[26] We strongly agree. In order to allow directors "to devote their time and attention to truly important matters," the staff recommended that "provisions that require directors to conduct reviews and [make detailed] findings that involve more ritual than substance should be eliminated."[27] Those sentiments—expressed over 25 years ago—persist today.

Where a clear conflict exists, it may be appropriate to impose specific responsibilities on fund directors. But, even in those circumstances, the responsibilities should be tailored to call upon directors to make business judgments on matters where they can add value. Directors should not be required to engage in management-type functions where they often do not have (and should not be expected to have) the required subject-matter expertise or in routine and (frequently) detailed regulatory functions. On matters where the interests of the adviser and the fund are generally aligned, there may not be a need for a specific regulatory responsibility for directors. In those cases, the directors would continue to oversee the interests of fund shareholders pursuant to their state law fiduciary duties.

Directors Should Not Duplicate the CCO's Responsibilities

As noted above, the fund compliance rule (rule 38a-1) already provides for robust oversight of a fund's compliance with federal regulatory requirements by the fund's CCO and the fund's board. Many director responsibilities were imposed before the adoption of the rule in 2003 (such as those required under rules 10f-3 and 17a-7, discussed in Appendix B), and in some cases the determinations required of directors duplicate work now also performed by the fund's CCO. Where a fund's compliance program adequately addresses the regulatory objective (such as an independent review of compliance with rule requirements), the Commission should not additionally impose on fund directors specific approval or determination responsibilities for the same matters.

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[26] 1992 Study, *supra* n. 3, at 266.

[27] *Id.*

Directors' Value is in Providing Oversight, Not Subject-Matter Expertise

Fund directors do not have, nor should they be expected to have, the deep subject-matter expertise that fund managers have. Indeed, their principal value is bringing to bear on the proposals and activities of the manager (and others) their own business and professional experience and expertise. A regulatory environment that expects or encourages fund directors to develop and maintain such expertise or requires a board to bring on directors to add that expertise is not in the fund shareholders' best interests. Directors serve in an oversight, rather than a management, role. As discussed further in Appendix A, this critical factor should be considered in areas such as valuation, where directors are well-positioned to oversee the adviser's valuation *process* but not the valuations of individual portfolio securities. Similar observations may be drawn in the areas of liquidity risk management and fund use of derivatives, where boards can rely on the professional expertise and judgment of portfolio managers and risk specialists, and in fund distribution and rule 12b-1, where market realities—primarily fund distributors' recommendations and the expectations of intermediaries—drive the structure of fund share classes and fund fee and expense arrangements.

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We strongly encourage the Division to conduct a long-overdue review of fund independent directors' responsibilities and take staff actions and make recommendations to the Commission for modifications, as appropriate. Modernizing directors' regulatory responsibilities will enhance their effectiveness in providing oversight of a fund's management and operations and protecting against potential conflicts of interest, to the benefit of fund shareholders.

We would welcome the opportunity to meet with you and your staff on this important initiative. If you have any questions about our preliminary recommendations, please contact me at (202) 326-5824.

Sincerely,

Amy Lancellotta

Amy B.R. Lancellotta
Managing Director
Independent Directors Council

Appendix A

Recommendations to Revise Directors' Responsibilities to Address Changes in the Industry

There are several requirements/prohibitions that, for one reason or another, do not necessarily make sense for independent directors today in light of significant changes in the industry. Below are two important areas of board responsibility that warrant updating to enable directors to focus on the areas where they add value through their independent oversight and to free them from management-type functions.

Fair Valuation

Fund directors have a statutory responsibility under the 1940 Act to determine in good faith the fair value of portfolio investments for which there are no readily available market quotations. While we are not aware of any definitive legislative history explaining why Congress imposed this responsibility on fund boards, we recognize that valuation can present a potential conflict of interest between the adviser and the fund. Thus, fund boards should retain a critical oversight role.

Nevertheless, we suspect that Congress did not anticipate the complexity and frequency of fair value determinations that exist today. Likewise, the Commission may not have anticipated the sophisticated and multi-variable analyses underlying current fair value determinations when it issued valuation guidance 47 years ago.[1] Indeed, the staff previously acknowledged that the Commission's releases were issued "at a time when financial markets were less diverse and funds had fewer investment alternatives."[2]

The staff has issued guidance seeking to address changes in the industry—such as increased holdings of foreign securities and funds' reliance on pricing services[3]—but the staff's guidance has been confined to the parameters established by the Commission's decades-old guidance. The result is a growing disconnect between the reality that pricing services and advisers have the expertise and day-to-day involvement to be in the best position to determine fair values and the regulatory framework that expects directors to be responsible in the first instance for those determinations.

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[1] *See e.g.*, Accounting for Investment Securities by Registered Investment Companies, Releases Nos. 40-6295, 33-5120, 34-0040, AS-118 (Dec. 23, 1970), available at https://www.sec.gov/rules/interp/1970/ic-6295.pdf (Commission interpretive release).

[2] *See* Letter from Douglas Scheidt, Associate Director and Chief Counsel, Division of Investment Management, SEC, to Craig S. Tyle, General Counsel, ICI, December 8, 1999 ("1999 Scheidt Letter"), available at https://www.sec.gov/divisions/investment/noaction/1999/ici120899.pdf.

[3] *See e.g.,* Letter from Douglas Scheidt, Associate Director and Chief Counsel, Division of Investment Management, SEC, to Craig S. Tyle, General Counsel, Investment Company Institute on April 30, 2001, available at https://www.sec.gov/divisions/investment/guidance/tyle043001.htm; 1999 Scheidt Letter, *supra* n. 2; and Division of Investment Management, Valuation Guidance Frequently Asked Questions, available at https://www.sec.gov/divisions/investment/guidance/valuation-guidance-frequently-asked-questions.shtml.

We urge the staff to take a fresh look at fair valuation, with the view toward proposing a rule that allows fund boards to serve in the capacity in which they add value—*i.e.*, to oversee the fair valuation *process*, with a focus on those elements of the process that may present conflicts of interest. In particular, a rule should permit a board to delegate to the fund's adviser the responsibility to determine fair values, subject to the board's oversight. We believe that the Commission has the authority to modify this statutory requirement in the 1940 Act by rule.

Rule 12b-1

Although the Commission has considered changes to rule 12b-1 on several occasions in the past, the rule continues as it was adopted in 1980. Among other things, the rule requires fund boards to review on a quarterly basis payments made pursuant to 12b-1 plans and to annually approve the renewal of these plans. In addition, the Commission suggested in the 1980 adopting release for the rule that boards consider certain listed factors when approving or renewing rule 12b-1 plans.[4]

Fund distribution has evolved considerably since rule 12b-1 was adopted, and continues to evolve. As previously noted, the Department of Labor's fiduciary rule has produced significant changes in a short period of time. Moreover, the purpose of rule 12b-1 fees has evolved considerably since the rule's adoption. Rule 12b-1 fees pay for the shareholder services that financial intermediaries provide to shareholders after the sale of shares to them, in addition to paying for distribution.

Directors' responsibilities under rule 12b-1 should be modernized. For instance, it is no longer productive for boards to review rule 12b-1 payments on a quarterly basis. In addition, many of the factors listed in the adopting release are no longer germane to today's business realities and have become part of an irrelevant checklist for boards to follow, rather than part of an effective and efficient board oversight process.

Indeed, fund distribution has advanced beyond the intended purpose of rule 12b-1. As funds distribute shares primarily through financial intermediaries, and intermediaries offer limited information to funds about their services, the existing regulatory construct is particularly challenging for fund boards.

[4] In the adopting release for Rule 12b-1, the Commission suggested that boards consider nine factors when reviewing a Rule 12b-1 plan for approval. *See Bearing of Distribution Expenses by Mutual Funds*, Release No. IC-11414 (November 7, 1980).

Appendix B

Recommendations to Eliminate Ritualistic Requirements

Certain board responsibilities have become routine and ritualistic and would be more appropriately handled by the adviser or possibly the fund CCO. While these responsibilities may not consume a great deal of time in the boardroom, they do require attention and focus and elevate their importance on board agendas beyond what is appropriate.

In general, board responsibilities should be updated to reflect the existence of rule 38a-1 and its robust framework. For instance, where a rule requires a fund to comply with specified conditions, the fund's compliance program will address whether the fund is complying with the conditions. In that case, the board's oversight of the compliance program will encompass oversight of the fund's compliance with the rule. A more appropriate use of the board's time and attention would be to approve related policies and procedures and oversee their implementation, including reviewing particular matters brought to the board's attention, such as exceptions.

We have set forth below specific recommendations to modernize the responsibilities of fund independent directors. We note that a number of these recommendations are ones that we have previously made to the staff.

Rule 5b-3

Rule 5b-3 involves fund boards in a level of fund operations that is not consistent with their oversight role. The rule allows funds to "look through" certain repurchase agreements for certain purposes of the 1940 Act so long as the obligation of the seller to repurchase the securities from the fund is "collateralized fully." The rule's definition of "collateralized fully" requires, among other things, that the fund's board or its delegate determine that each issuer of securities serving as collateral has an exceptionally strong capacity to meet its financial obligations and that the securities are sufficiently liquid that they can be sold at approximately their carrying value in the ordinary course of business within seven calendar days. While the rule permits a delegate to make the determination, we believe that, because this type of finding falls within the ambit of management functions, the rule should be amended to relieve the board of this responsibility.

Rules 10f-3, 17a-7, and 17e-1

In general, rules 10f-3, 17a-7 and 17e-1 under the 1940 Act permit funds to engage in certain affiliated transactions so long as the board, including a majority of the independent directors:

- adopts procedures that are reasonably designed to comply with the conditions of the pertinent rule;
- makes and approves such changes to those procedures as the board deems necessary; and

- determines no less frequently than quarterly that all transactions made pursuant to the pertinent rule for the preceding quarter were effected in compliance with the procedures.

The staff issued a 2010 no-action letter that made clear that directors cannot delegate the quarterly-determination responsibility but can rely on summary reports prepared by others, such as the CCO, in making the determination.[1] The letter's clarification that boards do not need to review each transaction in order to make the quarterly determination was helpful, but did not change the rule's requirement that the board is ultimately responsible for a determination that is purely compliance in nature. The rules should be amended to, at a minimum, eliminate the quarterly determination requirement.

Rule 17f-5

Rule 17f-5 requires the fund's foreign custody manager to provide written reports notifying the board of the placement of foreign assets with a particular custodian and of any material change in the custody arrangements. Effective board oversight of foreign custody arrangements need not include receiving reports concerning the placement of foreign assets, which are extraordinarily detailed, increase custody costs for shareholders, and provide little practical insight to a board. We recommend that the rule be modernized to allow directors to serve in an oversight role, and not to be involved in the minutiae associated with the regular placement of foreign assets.

Rule 17g-1

All funds are required to maintain a fidelity bond under rule 17g-1, which requires that the bond be in the form and amount as a majority of the board's independent directors approve, at least annually. Fund service providers, such as the adviser or administrator, have the expertise for determining the appropriate form and amount of a fidelity bond. Thus, the board approval required under this rule has become ritualistic and, accordingly, should be eliminated. In the case of joint insured bonds, however, where there is potential for conflict of interest among the insureds, the board should continue to have the specific responsibilities associated with joint insured bonds, such as approving the payment of premiums.[2]

Rule 18f-3

Funds with multiple share classes have become commonplace in the industry today. Under rule 18f-3, the board must approve the multi-class plan and also must make certain determinations in connection with expense allocations. In particular, with respect to any expense allocation method not set forth in the rule, the board is required to determine "that the annualized rate of return of each class

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[1] *See* Letter from Michael S. Didiuk, Attorney-Adviser, Division of Investment Management, SEC to Dorothy A. Berry, Chair, IDC Governing Council and Jameson A. Baxter, Chair, Mutual Fund Directors Forum (November 2, 2010), available at https://www.sec.gov/divisions/investment/noaction/2010/idc-mfdf110210.pdf.

[2] *See* Rule 17g-1(e).

will generally differ from that of the other classes only by the expense differentials among the classes." Fund accountants and fund administrators are well versed in these methodologies and are in a much better position than the board to make such determinations. Accordingly, we recommend that the rule be modified so that boards are not required to make these determinations.

Rule 22c-1

Rule 22c-1 under the 1940 Act requires that the board determine the time or times for computing the fund's net asset value (NAV), thus involving the board in a business decision that is more appropriately within the purview of the fund's adviser. Although setting the time for computing the NAV is not necessarily a time-consuming responsibility, we recommend that it be included in any Commission effort to address board responsibilities that are more appropriately handled by others. Because setting the time does not raise conflict of interest concerns, we recommend that the responsibility be placed with the appropriate fund service provider.

Appendix C

Recommendations to Revise Governance Requirements to Address Changes in the Industry

In light of changes in the fund industry and technological innovations, we recommend that certain governance requirements be reexamined to allow greater flexibility and efficiency in board operations while still providing strong shareholder protections.

In-Person Meetings and Voting Requirements

The 1940 Act requires that a fund's contracts with its adviser and underwriter be approved by a majority of the board's independent directors at an in-person meeting. The board's selection of the fund's independent public accountant and approval of a rule 12b-1 plan also must be made at an in-person meeting. The in-person requirement promotes active engagement and dialogue by the fund board, but, on some rare occasions, can be difficult or impossible to meet due to unforeseen circumstances. Severe weather or illness—or other events beyond directors' control—can at times prevent one or more directors from attending an in-person meeting, which could, in turn, prevent the required approval from taking place at that meeting. Scheduling another in-person meeting before, for example, the end of the 12-month term of the current advisory contract can be highly complicated, given the practical difficulties of coordinating the schedules of all of the people who must participate, including independent directors, board counsel, and advisory firm senior officers. In addition, another board meeting put together at the last minute is an unnecessary and potentially significant fund cost.

We do not believe that the burdens and costs associated with rescheduling a meeting are necessary in these circumstances, particularly in light of improvements in technology and communications that allow directors to be fully engaged without being physically present at a board meeting. Rather, the Commission should adopt a rule that allows a fund to be exempted from the in-person requirement if an unforeseen circumstance arises, so long as certain conditions are met. The board should be able to determine those circumstances in which the in-person requirement may be suspended. The conditions that were required for the temporary exemptive relief granted from the in-person requirement following the September 11 attacks could serve as a model for a rule.[1]

Independent Director De Minimis Ownership

In order for a person to be deemed "independent" for purposes of the 1940 Act, he or she cannot be an "interested person" of the fund. Section 2(a)(19)(B)(iii) defines an "interested person" of an investment adviser or principal underwriter to include "any person who knowingly has any direct or indirect beneficial interest in, or who is designated as trustee, executor, or guardian of any legal interest in, any security issued either by such investment adviser or principal underwriter or by a controlling person of such investment adviser or principal underwriter." This definition currently extends to

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[1] *See* Order Under Sections 6(c), 17(b) and 38(a) of the Investment Company Act of 1940 Granting Exemptions from Certain Provisions of the Act and Certain Rules Thereunder, Investment Company Act Release No. 25156 (September 14, 2001), available at https://www.sec.gov/rules/other/ic-25156.htm.

interests in a fund's unaffiliated sub-advisers and their parent companies, so that a director who owns one share of a subadviser's stock or the stock of a remote parent company, for example, would be deemed "interested," except as permitted under rule 2a19-3.

We believe independent directors should not be captured by this provision when they hold only limited, non-material/*de minimis* interests in these entities and recommend that the Commission adopt an exemptive rule to address this situation.[2] The restriction in section 2(a)(19)(B)(iii) imposes significant and unnecessary burdens on independent directors in relation to their interests in unaffiliated sub-advisers and their parent companies, yet adds no additional protections for fund shareholders. The restriction requires funds that use unaffiliated subadvisers to spend significant time and effort developing an ongoing monitoring process to avoid acquiring any interest in a fund's subadvisers or their parent companies. Moreover, an independent director can even become "interested" through no action of his or her own, for example, where an unaffiliated subadviser or its parent undergoes a change of control or acquires a new entity, or when a director acquires an interest in a subadviser through an inheritance, thereby potentially triggering a distressed sale. This can also occur each time a new subadviser is added. The restriction also forces independent directors of fund complexes that frequently utilize many unaffiliated subadvisers to forgo investment opportunities unnecessarily.

When the definition of an "interested person" was first adopted, funds were primarily managed by one investment adviser and the subadviser model was not commonly used. In these arrangements, the investment adviser negotiates the terms at arm's length and pays the unaffiliated subadviser out of its fees from the fund. Although the board is asked to approve each subadviser, the fund's adviser selects the subadviser in the first instance based on its research of the subadviser's capabilities and performance, and the independent directors have no involvement in the selection process. Consequently, the apparent conflict of interest the restriction is intended to prevent is significantly diminished due to the structure of the arrangement. Finally, we note that when the SEC proposed rule 2a19-3, it cited Congress's directive to apply the independence standards "in a flexible manner" and adopt appropriate exemptions.[3]

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[2] We note that during the period of 2009-2011 several exemptive applications were filed to request similar relief, but were never acted on by the staff. *See, e.g.*, Application of ING Equity Trust; File No. 812-13829 (as filed September 24, 2010), available at https://www.sec.gov/Archives/edgar/data/837276/000089843210001240/a40-app.htm.

[3] *See* Proposed Rule: Role of Independent Directors of Investment Companies, Release Nos. 33-7754; 34-42007; IC-24082 (October 15, 1999) (citing H.R. Rep. No. 1382, 91st Cong., 2d Sess. 15 (1970)).