

Specific Regulatory Responsibilities

Session 5
Core Responsibilities of Fund Directors

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Panelists

- **George J. Gorman, Moderator**
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Agenda

- Valuation
- Disclosure
- Board Relationship with Fund CCO
- Codes of Ethics
- Affiliated Transactions
- Audit Committee
- Proxy Voting
- Securities Lending

Valuation

- Section 2(a)(41) and Rule 2a-4
 - Funds must value portfolio securities “for which market quotations are readily available” at current market value
 - When **market quotations are not readily available**, securities must be valued at **“fair value as determined in good faith by board of directors”**
- SEC staff guidance (1999; 2001)
 - “Most boards fulfill their obligations by reviewing and approving pricing methodologies, which may be formulated by the board, but more typically are recommended and applied by fund management”
 - “In our view, a board acts in good faith when its fair value determination is the result of a sincere and honest assessment of the amount that the fund might reasonably expect to receive for security upon its current sale, based upon all of the appropriate factors that are available to the fund”

Valuation

- Pricing service for most securities
 - Equity (market quotes); fixed income (evaluated prices)
- Fair value process, often including valuation committee
 - SEC staff: “Such committees generally assist the board in developing methodologies by which fair values are to be calculated, and implement the board-approved methodologies on a day-to-day basis or as frequently as necessary”
- Fair value examples
 - Private placements
 - Trading halts
 - Foreign fair value process
 - Recent survey: almost 50% adjust values daily (*i.e.*, zero trigger)

Valuation – Current Focus Areas

- Valuation procedures
 - Clear? Comprehensive? Roles and responsibilities specified?
 - Are conflicts properly managed? Portfolio manager involvement?
 - Appropriate balance between specificity and flexibility?
 - What is the price challenge process?
- Board reporting
 - Periodic procedure reviews
 - Recent survey: 74% revised procedures over past year
 - Pricing service presentations
 - Sufficient detail, but not a data-dump
 - Understanding role of experts

Valuation – Morgan Keegan

- Background
 - 7 funds; 6 independent directors; 2 interested directors
 - Relevant period: January – August 2007
 - Majority of assets: structured products (e.g., CDOs, CMOs, CLOs), with significant investments in subordinated tranches
 - 50-60% of assets were fair valued
- Process
 - Initially valued at purchase price
 - No change unless price confirmation or sale suggested change of 5% or more
 - Limited price confirmation process
 - Limited board reporting

Valuation – Morgan Keegan

- Settlement order
 - “In 1970, the Commission emphasized that it is the responsibility of a fund’s board of directors to determine fair value and cautioned that, while a board may enlist the assistance of individuals who are not board members, it remains the **board’s duty [1] to establish the fair value methodology** to be used and [2] to **continuously review both** the appropriateness of the **methods** used involving each security **and** the **valuation findings** resulting from such methods”
 - “[T]he Directors did not [1] **calculate** the valuations themselves, and neither [2] established **clear and specific valuation methodologies** nor [3] followed up their general guidance to **review and approve the actual methodologies used and the resulting valuations**”
 - Directors caused funds to violate Rule 38a-1

Valuation – Money Market Fund Release

- SEC release adopting money market fund rule changes
 - July 2014
 - “Guidance” on valuation issues applicable to all funds
- Use of amortized cost valuation
 - Long permitted for all funds for securities with remaining maturity of 60 days or less
 - Fund may use only if it can reasonably conclude, each time it makes a valuation determination, that amortized cost valuation is approximately the same as fair value
- Pricing services
 - Evaluated prices are not, by themselves, readily available market quotations or fair values
 - Board has non-delegable responsibility to determine whether evaluated price constitutes fair value

Disclosure

- Prospectus

- Each director signs the registration statement, usually through power of attorney
- Registration statement includes prospectus and statement of additional information (SAI)
- Section 11 of Securities Act of 1933
 - Private right of action for material misrepresentations or omissions
 - Potential defendants: signers, including directors, and “control persons”
 - Due diligence defense: after reasonable investigation, defendant had reasonable grounds to believe (and did believe) that disclosure was correct
- Important for directors to understand process by which prospectus drafted and updated
- *Janus v. First Derivative Traders* (U.S. 2011) (adviser not “maker” of statement in prospectus under 10b-5 because it did not have ultimate authority over prospectus disclosure)

Disclosure

- Marketing Material
 - Broker-dealer creating and using the material is primarily responsible
 - Usually, the principal underwriter (distributor)
 - Not part of registration statement or filed under director signature
 - Board oversight of distributor generally (as with any fund service provider)
 - Focus is on process, not individual documents

Relationship with CCO

- Rule 38a-1 (2004)
- Compliance program
 - Board approval of compliance policies and procedures of the fund and service providers
 - Advisers (including subadvisers)
 - Principal underwriter
 - Transfer agent
 - Administrator
- CCO approval requirements
 - Initial designation
 - Compensation
 - Removal

Relationship with CCO

- Annual CCO report to board
 - Operation of program
 - Material change over past year
 - Recommended material changes
 - Material compliance matters
- Annual executive session with CCO
- Multiple roles?
 - Fund only CCO
 - Fund/adviser CCO

Relationship with CCO

- Communication with CCO
 - No specific structure required
 - Common:
 - Compliance Committee
 - Compliance assigned to other committee (e.g., audit)
 - Designated director
- Key issues
 - Tone at the top; compliance culture
 - Resources and support
 - Relationship to risk management and oversight
 - CCO involved at the beginning of business initiatives
- IDC Task Force Report: Board Oversight of Compliance (2009)

Codes of Ethics

- Rule 17j-1
 - Board must approve code of ethics covering personal trading for each adviser and principal underwriter
 - Required determination: code contains provisions reasonably necessary to prevent access persons from engaging in prohibited conduct
 - Initial approval; approval of material change within six months
 - Rule does not require quarterly reporting by independent directors, *unless* director knew or should have known that, during the 15 day period immediately before or after the director's transaction, the fund purchased or sold the security, or the fund or its adviser considered purchasing or selling the security

Affiliated Transactions

- **Affiliated brokerage (quarterly)**
 - Rule 17e-1: commission to affiliate must be reasonable and fair compared to commission for comparable transactions
 - Potential conflict: adviser may have an incentive to use an affiliated broker and pay above market commission rates
- **Affiliated underwriting (quarterly)**
 - Rule 10f-3: if fund purchases in an offering where an affiliated broker-dealer is in the underwriting syndicate, purchase must meet certain standards
 - Potential conflict: adviser affiliate could seek to dump unwanted securities on fund at unfair terms

Affiliated Transactions

- Cross trades (quarterly)
 - Rule 17a-7: transfers between affiliated funds must meet certain pricing and other standards
 - Potential conflict: transfer could benefit one fund over another, either because the price is not fair or because the security is not appropriate investment for receiving fund
- SEC staff guidance on Board role
 - 2010 letter to IDC and MFDF
 - Board may make determination based on summary reports from CCO and/or other persons with relevant expertise (e.g., counsel)
 - Board cannot delegate the responsibility to make the determination

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

Audit Committee

- Communications with the audit committee
 - SEC rules 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)

Audit Committee

- 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
- IDC industry segment calls
 - Next Audit Committee Chair call on December 17, 2014

Proxy Voting

- Board oversight role
 - Subject to Board's overall fiduciary duty
 - Part of fund's overall compliance program
 - Board usually adopts its own policy or the policy of the adviser
 - In manager-subadviser funds, manager policy may rely on policy of each subadviser
 - Board or adviser policy may adopt, or rely significantly, on third-party service provider policy
- Disclosure
 - Summary of policy (or actual policy) in SAI
 - Annual SEC filing of all actual votes (Form N-PX)

Proxy Voting

- Policy topics
 - Typical topics include: corporate governance matters; anti-takeover provisions; management compensation; social responsibility issues
 - How does the policy relate to the investment objective of the fund?
 - Investment adviser has a fiduciary duty to fund in connection with vote
 - Disclosure must cover how conflicts of interest are handled
 - E.g., adviser has material relationship with issuer
 - Options include committee structure with independence or reliance on third-party
- Board reporting
 - Periodic (often annual)
 - Summaries, with a focus on conflict resolution

What is Securities Lending?

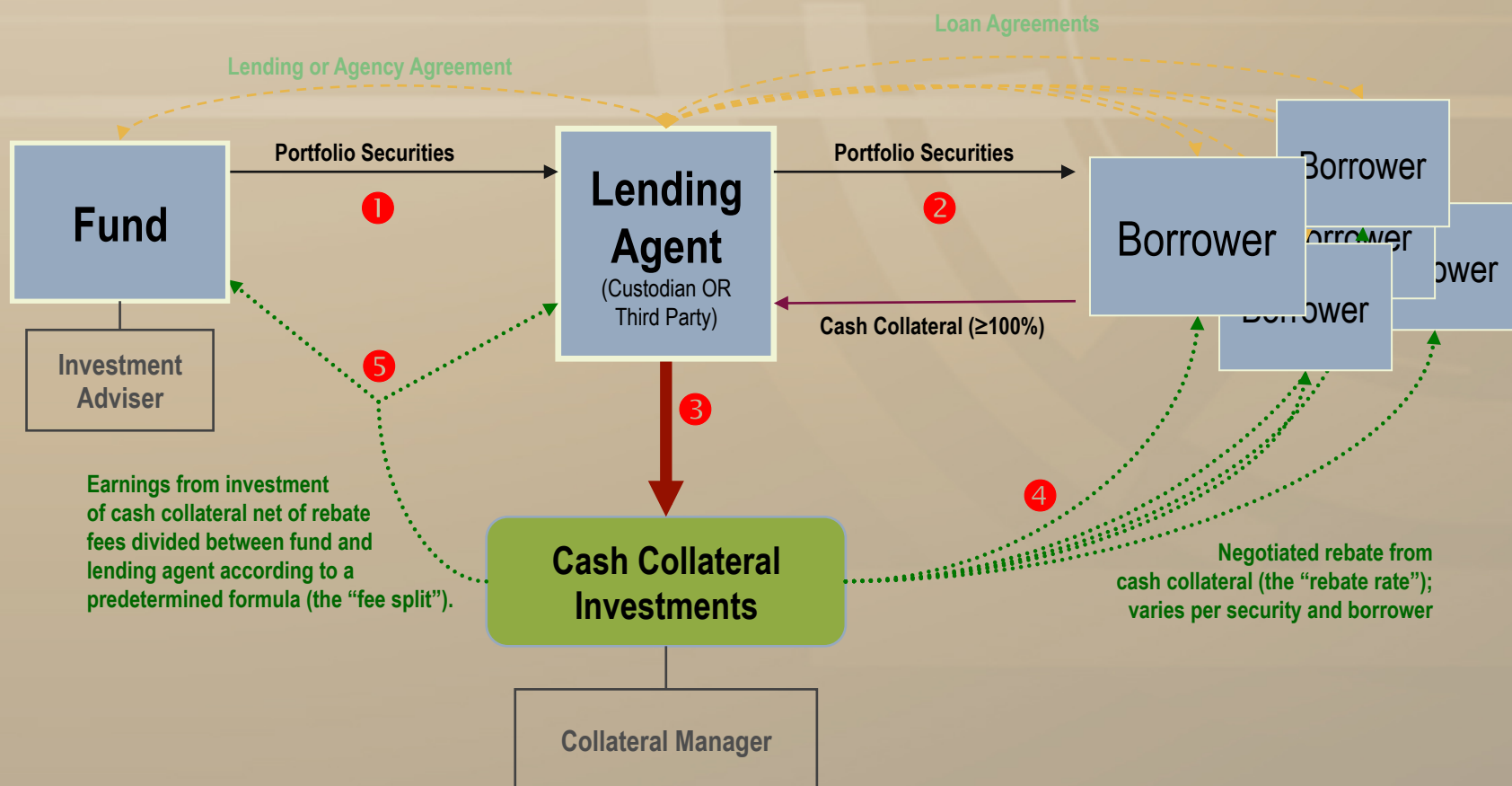
- Fund lends security to borrower (e.g., short seller)
- Borrower provides cash collateral to fund
 - At least 100% of value of loaned security
- Fund invests cash collateral
 - Some earnings to borrower
 - Some earnings to securities lending agent
 - Some earnings to fund

Benefits and Risks of Securities Lending

- Benefits of securities lending
 - Additional revenue to the fund
 - Lending generally does not alter portfolio management
- Risks of securities lending
 - Borrower default
 - Collateral investment risk
 - Operational risk and compliance (e.g., lending agent does not follow agreements and procedures)

Securities Lending Overview

Traditional Program Structure



Key Legal and Operational Requirements

- Fund must receive collateral 100% of value of loaned security (102%-105% common)
- Mark-to-market daily
- Loans can be terminated within normal settlement period (3 days)
 - Recalls related to sales and proxy voting
- Cash collateral must be invested in fund-approved investments
- Fund may pay non-affiliated securities lending agent a percentage of earnings
 - Exemptive order required for percentage payment to affiliate
- Fund may loan up to 33-1/3% of its total assets

Board Oversight

- Approval and annual review of securities lending arrangement
- Board (or adviser subject to board oversight) must approve
 - List of borrowers
 - Lending agent agreements
 - Borrower agreements
- Boards must make arrangements to vote with respect to a material event affecting the securities on loan (proxy recalls)
- Focus on collateral investment
 - Will money market reform affect collateral strategy and risks of collateral investment?

Resources

- IDC website
 - www.idc.org
 - Fundamentals for Newer Directors, <http://fundamentals.idc.org>
- IDC papers
 - Considerations for Board Composition: From Recruitment Through Retirement
 - Investment Performance Oversight by Fund Boards
 - Overview of Fund Governance Practices, 1994-2012
 - Board Oversight of Exchange-Traded Funds
 - Board Oversight of Target Retirement Date Funds
 - Fund Board Oversight of Risk Management

Resources

- IDC papers cont'd.
 - Board Oversight of Subadvisers
 - Board Oversight of Fund Compliance
 - Board Oversight of Derivatives
 - Board Oversight of Certain Service Providers
 - Board Consideration of Fund Mergers
 - Director Oversight of Multiple Funds
 - Board Self-Assessments: Seeking to Improve Mutual Fund Board Effectiveness
 - Implementing the Independent Chairperson Requirement

Resources

- SEC website
 - www.sec.gov
- ABA Fund Directors' Guidebook
 - www.abanet.org
- ICI Investment Company Fact Book
 - 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)

Panelist Biographies

George J. Gorman is an Independent Trustee of the Eaton Vance Funds, having joined that Board in June 2014. Prior to the Eaton Vance Funds Board, George was on the Board of the Bank of America Money Market Funds from 2011 to 2014, for which he chaired the Audit Committee; and on the Board of the Ashmore Funds from 2010 to 2014, for which he was Lead Independent Trustee and Audit Committee Chair. Through June 2009, George was the Senior Asset Management/Mutual Fund Partner for Ernst & Young in Boston, MA.

Mark N. Polebaum is Executive Vice President and General Counsel of MFS Investment Management ® (MFS®). He is also a member of the firm's Management Committee. Mark joined MFS in 2006. Prior to that, he spent 26 years at Wilmer Cutler Pickering Hale & Dorr, LLP, where he was a partner and co-chair of the Bankruptcy and Commercial Department. Mark graduated *summa cum laude* from Middlebury College (Vermont) in 1974 with a Bachelor of Arts degree. He was awarded a J.D. from New York University School of Law in 1979, where he served as research editor on the Law Review.

Panelist Biographies

Christopher E. Palmer is a partner in Goodwin Procter's Financial Institutions Group and is the leader of the Business Law Department in the firm's Washington, D.C. office. For more than 25 years, Chris has worked with insurance companies, mutual funds, mutual fund independent directors, investment advisers and other investment management industry participants on a wide range of legal, regulatory and compliance, and governance matters. He advises clients on the development, regulatory approval, sale and administration of a variety of investment products, including registered and unregistered funds and variable and fixed life insurance and annuity contracts. He advises mutual fund independent directors on legal, governance and industry practice issues. He works with the Goodwin Procter litigation team on securities and insurance litigation cases as well as SEC examinations and enforcement matters. Chris earned his J.D., *magna cum laude*, from the Georgetown University Law Center, and his B.A., *egregia cum laude*, from St. John's University (Minnesota).