SULLIVAN & CROMWELL LLP

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SEC Chair Mary Jo White Remarks on the Evolving Role of Mutual Fund Directors

SEC Chair Comments on Steps Independent Directors Should Take in Exercising Vigilant Oversight and Assessing Risks

SUMMARY

On March 29, 2016, SEC Chair Mary Jo White, in her keynote address at the Mutual Fund Directors Forum 2016 Policy Conference, set forth her views on the role of mutual fund directors in assessing risks and exercising their oversight responsibilities. The Chair identified certain "tough" questions fund directors should be raising with advisers and managers of the funds they serve. Focusing on operational and liquidity risks, among others, the Chair also discussed past failures of certain fund directors and the lessons fund directors can derive from those experiences in continuing their critical role as overseers of funds.

BACKGROUND

The Mutual Fund Directors Forum 2016 Policy Conference,[1] an annual policy conference where fund directors, regulators and industry experts meet and discuss pressing issues facing funds, focused primarily this year on the oversight role of independent directors. In SEC Chair Mary Jo White's keynote address,[2] a significant follow-up to her discussion of SEC priorities in December 2015,[3] Chair White referred to the enactment of the Investment Company Act of 1940 (the "1940 Act"), which, in the Chair's words, "established a strong corporate governance framework for investment companies from the very beginning, but like the rest of the asset management industry, the role of independent directors has evolved and gained importance since the [1940] Act's passage." In its early years, the 1940 Act primarily tasked fund directors with "fair valuation determinations and approval of certain critical contracts and accounting services." In 1970, fund directors were further tasked with requesting and assessing information necessary to evaluate funds' advisory contracts. The obligations of fund directors have grown substantially in more recent years, and continue to do so as markets and investment products grow and increase in complexity and market conditions evolve.

Chair White reaffirmed the critical role that independent directors in particular play as "independent watchdogs" and stated that they are viewed by the SEC as partners in protecting shareholder interests. She emphasized that fund directors have a decisive role in protecting fund investors owing to their "access to the information and critical participants" involved in the management of funds. The Chair further highlighted the distinct role of independent directors as the persons who "understand the operations of funds" and can "probe in the right areas and ask the tough questions." As discussed below, Chair White also discussed several recent examples of alleged failures in board oversight.

With investors relying on fund directors, the Chair relayed the importance of independent directors remaining "vigilant in considering whether each fund is fully addressing current and potential future risks." The Chair discussed a host of issues facing the mutual fund industry, but honed in on a few critical topics in particular, including liquidity and valuation, SEC proposals relating to derivatives, cybersecurity and operations risks. The Chair underscored that "[a]s a director, it is incumbent upon you to consider what these and other risk areas could mean for your fund in the future."

LIQUIDITY RISK

In September 2015, the SEC proposed rule 22e-4, which would impose certain conditions upon registered open-end management investment companies (including open-end exchange-traded funds but excluding money market funds and exchange-traded funds organized as unit investment trusts) to manage and limit overall liquidity risk, including creating liquidity risk management programs, stratifying and monitoring assets by relative liquidity and a broadening of liquidity disclosure.[4] The Chair noted that the "proposal would, for example, require a fund's board, including a majority of the independent directors, to approve the fund's written liquidity risk management program and any material changes to the program, to designate the fund's adviser or officers responsible for administering the program, and to review annual reports on the effectiveness of the program."

The Chair amplified the importance of liquidity requirements and director vigilance in proactively thinking ahead and planning with a discussion of the events that befell Third Avenue Focused Credit Fund ("Third Avenue") in December 2015. Third Avenue, a high-yield and distressed debt open-end fund, reportedly sent shockwaves through the industry after suspending redemptions.[5] It was widely reported that Third Avenue was the first mutual fund ever to halt redemptions without SEC authorization.[6]

In January 2016, the Independent Directors Council (the "IDC"),[7] the Investment Company Institute (the "ICI"),[8] BlackRock, Inc. ("BlackRock"),[9] Fidelity Management & Research Company ("Fidelity")[10] and the Mutual Fund Directors Forum (the "MFDF"),[11] among others, commented on the SEC's proposed rule. Each endorsed and supported SEC efforts to promote high standards for liquidity risk management. The

ICI, in its comments, drew an analogy between the proposed rule and rule 38a-1, which it said "has enhanced a critical aspect of fund operations – compliance with the federal securities laws."[12] However, each of these commenters echoed concerns about the approach of the SEC's proposed rule. For example, the MFDF commented that "[i]t is simply not clear why this rigid and highly granular classification-based approach is the best or most effective way to achieve the [SEC's] goals."[13] Many of the commenters further remarked that the proposed rule blurs the line between board oversight and fund management by assigning to boards tasks of a management, rather than an oversight, nature.[14]

LEVERAGING RISKS

The Chair next turned to the SEC's more recently proposed rules concerning use of derivatives by funds, for which the comment period had closed the preceding day. The Chair summarized proposed rule 18f-4, which would provide registered investment companies and business development companies with an exemption from certain prohibitions and limitations under the 1940 Act to permit them to enter into derivative and financial commitment transactions, subject to compliance with the requirements of the proposed rule.[15] To fall under this exemption, a fund would need to, for example, limit the total leverage amount the fund could obtain through derivatives and financial commitment transactions.[16]

Chair White focused on the oversight function of fund directors, stating that the SEC's proposal "includes an oversight role for fund directors – requiring the board of a fund to approve one of two alternative portfolio limitations on the fund's use of derivatives and to approve policies and procedures for managing risks associated with the fund's derivatives transactions." Notably, if rule 18f-4 is adopted, certain alternative strategy funds – for example, leveraged ETFs – would no longer be able to operate as registered funds given the proposed rule's restrictions.[17] While the SEC acknowledged this consequence of the proposal and recommended such funds deregister under the 1940 Act,[18] the Chair, unsurprisingly given the context, made no mention of deregistration in her keynote address.

CYBERSECURITY AND OPERATIONS RISKS

Chair White went on to discuss SEC Investment Management Guidance on cybersecurity provided in April 2015 ("April 2015 IM Guidance"), which highlighted cybersecurity measures funds should consider instituting, including, for example, data encryption and data management systems strategies and cybersecurity training, policies and procedures.[19] The Chair asserted that fund directors may proactively avoid such cybersecurity failings by implementing risk-assessment processes, evaluating such processes and critically gauging whether current systems are in need of an overhaul. Chair White explained that as "[f]unds rely heavily on their computer networks," fund directors must "carefully consider[] the range of risks posed to those cyber systems." She further noted that funds will not be able to fully eliminate the risk of cybersecurity attacks, but remarked that, nevertheless, "it is incumbent upon funds and their advisers to employ robust, state-of-the-art prevention, detection, and response plans" and for fund boards to further ensure that the advisers and key service providers of the funds are also "taking the appropriate steps to do so."

The Chair called out specific recent examples of cybersecurity and operations failings in 2015 that, in her view, illustrate the need for proactive and diligent cybersecurity and operations risk management emboldened by independent fund director oversight. In September 2015, R.T. Jones Capital Equities Management ("R.T. Jones") was charged with violating Rule 30(a) of Regulation S-P under the Securities Act of 1933 by failing to adopt any formal policies and procedures that could have enabled secure protection of confidential personally-identifiable information and preemptively shield such information from the threat of unauthorized access.[20] In addition, R.T. Jones failed to periodically review or conduct any risk assessment of its cybersecurity measures.[21] She also referred to the widely publicized failure, in August 2015, at a major fund service provider to provide timely system-generated net asset values for numerous registered funds following corruption of critical software after a routine upgrade from a third-party vendor accounting system.

DISTRIBUTION IN GUISE ISSUES

The Chair also drew attention to SEC Investment Management Guidance provided in January 2016 on mutual fund distributions and sub-accounting fees ("January 2016 IM Guidance"), which followed a sweep survey of "mutual fund complexes, investment advisers, broker-dealers, and transfer agents."[22] Prior to the January 2016 IM Guidance, the SEC had largely been silent concerning the contours of rule 12b-1 since a 1998 letter[23] from the SEC staff to the ICI on fund supermarket fees, although the SEC had proposed a substantial revision to the rule in 2010.[24]

The January 2016 IM Guidance summarizes the provisions of rule 12b-1 and certain staff observations and views resulting from the sweep, and recommends, among other things, that fund directors have a "process in place reasonably designed to evaluate whether a portion of sub-accounting fees is being used to pay directly or indirectly for distribution" and receive "sufficient information" from fund management and service providers to assess "intermediary distribution and servicing arrangements for the mutual fund, including how the level of sub-accounting fees may affect other payment flows (such as 12b-1 fees and revenue sharing) that are intended for distribution."[25]

Chair White acknowledged that fund directors "are typically not involved in the day-to-day negotiations of particular distribution arrangements," but emphasized the staff's view that the board should focus on "understanding the overall distribution process as a whole to inform its judgment about whether certain fees represent payments for distribution." She further acknowledged that fund directors "should be able to rely on the adviser and other relevant service providers to provide information about these arrangements."

"TOUGH" QUESTIONS

Turning to the "tough questions" and the role of independent fund directors, Chair White noted that, in two recent proceedings, fund directors had settled charges involving fair valuation of fund assets (Morgan Keegan & Co.[26]) and fund advisory agreement review and approval (Commonwealth Capital Management[27]). She used these examples to emphasize her view that independent fund directors proactively "[a]sking tough questions of fund management now can help ensure that . . . funds are as prepared as possible and [fund directors] are informed as to how potential issues would be handled." The Chair expressly noted that fund directors should consider and ask the following questions in overseeing their funds while contemplating operational, liquidity and other risks:

1. Compliance Policies and Procedures, Business Continuity Plans and Back-Up Systems

- In a crisis, how will the "compliance policies and procedures, business continuity plans and back-up systems" of the fund and the fund's service providers address such crisis or business disruption?
- What are the "back-up systems and redundancies of the critical service providers that value the fund, keep track of fund holdings and transactions, and strike NAVs"?
- If the "compliance policies and procedures, business continuity plans and back-up systems" of the fund and the fund's service providers fail during a crisis or business disruption, what adverse events might the fund face?
- If the fund would face adverse consequences from such a failing, how could these adverse consequences be preemptively avoided and prevented?
- What alternative systems or work-arounds are in place or might be necessary to ensure continued operations of the fund during a crisis or business disruption?
- If the fund faces adverse consequences from such a failing, how will the fund ensure it responds "promptly and effectively" upon such an occurrence?

2. Liquidity Strategies and Risks

- In assessing liquidity risks, are the fund's investments "appropriately aligned with [the] anticipated liquidity needs and redemption obligations" of the fund?
- What caliber of information have directors been provided from management regarding fund liquidity?
- With what frequency is management reporting on fund liquidity to the board?
- How is management monitoring and managing the liquidity risk of the fund?
- What links, if any, are there between the liquidity and valuation of the fund?
- Is the strategy of the fund more likely to generate future liquidity challenges for the fund?
- For an open-end fund offering daily redemptions, are the fund's investments and investment strategy appropriate?

3. Diversity and Expertise of Fund Directors

- Does the board of the fund "include individuals with the necessary diverse skills, experience and expertise"?
- Should the board consider hiring "subject matter experts as consultants to the board"?
- Is the board of the fund sufficiently equipped in expertise to address risks "such as cybersecurity, derivatives, liquidity, trading, pricing and fund distribution" (all of which have "become increasingly complex")?

Even if proper responses or applicable policies and procedures seem to be in place today, fund directors should, the Chair advised, "be thinking about and asking fund managers whether these events could happen at your fund, how to prevent them from happening, and how to respond promptly and effectively if they do occur."

OVERSIGHT NOT MANAGEMENT

In response to several SEC proposals made in 2015, the MFDF and others have submitted comments expressing concern that the rules being proposed by the SEC were eroding the line between board oversight and management. For example, commenting on the derivatives rulemaking, MFDF stated:

> We are concerned that the Commission's description of the board's role goes beyond a board's oversight responsibilities, and, instead, forces the board to become involved in risk management. . . . Given other recent regulatory initiatives, we are troubled by both the overall burden that the Commission is imposing on fund boards and the pace of change that these initiatives would require.[28]

Chair White spoke to such concerns in her keynote address, noting that "much is expected of [fund directors] in [their] oversight role, but I also fully recognize the distinction from the role of management and that issues can occur even in funds with the strongest boards." The Chair reaffirmed bifurcation between "independent oversight" and "day-to-day management" of funds. While she acknowledged that "[d]etermining an appropriate dividing line is a challenge," the Chair stressed that "[t]he board's oversight function and how directors can best serve as gatekeepers in protecting shareholder interests will remain a key focus for . . . the SEC." Notwithstanding her otherwise challenging remarks about the role of independent fund directors, the Chair acknowledged that "most fund directors exercise their responsibilities effectively, performing their oversight role with diligence and skill," and such fund directors "should not fear enforcement, as judgments that directors make in good faith based on responsibly performing their duties will not be second guessed."

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ENDNOTES

[1] See 2016 Policy Conference, MUTUAL FUND DIRECTORS FORUM, http://www.mfdf.org/event-details?EVENTID=5306.

[2] See Speech of Chair Mary Jo White, *The Fund Director in 2016: Keynote Address at the Mutual Fund Directors Forum 2016 Policy Conference*, SEC (March 29, 2016).

[3] See Speech of Chair Mary Jo White, *Enhancing Risk Monitoring and Regulatory Safeguards for the Asset Management Industry*, SEC (December 11, 2015).

[4] See Carmen Germaine, *SEC Chair Says Fund Directors Must Remain Vigilant*, LAW360 (March 29, 2016) ("*Remain Vigilant*"); see also *SEC Issues Liquidity Risk Management and 'Swing Pricing' Proposal for Open-End Investment Funds*, SULLIVAN & CROMWELL LLP (October 2, 2015).

[5] See Mike Cherney, Corrie Driebusch & Leslie Josephs, *Junk-Bond Rout Deepens Sending Shockwaves Through Stocks and Other Markets*, WALL STREET JOURNAL (December 11, 2015) (the "*Junk-Bond Rout*").

[6] Not only did Third Avenue suspend redemptions, but the financial press reported this as an additional indicator that investors' confidence has waned in the ability of companies which had issued high-yield bonds to fend off default. See *Junk-Bond Rout*. In 2015, near the end of Q1, $57 billion dollars of high-yield debt had been issued, while issuance in 2016 for the same time period only reached $13.8 billion dollars. See Patti Domm, *This Would Signal Real Improvement in High Yield*, CNBC: MARKET INSIDER (March 8, 2016). See also Daisy Maxey & Gregory Zuckerman, *Junk Fund's Demise Fuels Concern Over Bond Rout*, WALL STREET JOURNAL (December 10, 2015); Matt Wirz & Gregory Zuckerman, *How the Third Avenue Fund Melted Down*, WALL STREET JOURNAL (December 23, 2015); Mohamed A. El-Erian, *Nine Lessons from Third Avenue's Liquidation*, BLOOMBERG VIEW (December 13, 2015).

[7] See Letter (*Re: Open-End Fund 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)*) ("IC-31835"), to Mr. Brent J. Fields, Secretary of the SEC, from Amy B.R. Lancellotta, Managing Director of Independent Directors Council (January 13, 2016) ("IDC Comment Letter").

[8] See Letter (IC-31835), to Brent J. Fields, Secretary of the SEC, from David W. Blass, General Counsel of the Investment Company Institute (January 13, 2016) ("ICI Comment Letter").

[9] See Letter (IC-31835), to Mr. Brent J. Fields, Secretary of the SEC, from Barbara Novick, Vice Chairman of BlackRock, Inc., and Benjamin Archibald, Managing Director of BlackRock, Inc. (January 13, 2016) ("BlackRock Comment Letter").

[10] See Letter (IC-31835), to Mr. Brent J. Fields, Secretary of the SEC, from Marc R. Bryant, Sr. VP and Chief Legal Officer of Fidelity Management & Research Company (January 13, 2016) ("Fidelity Comment Letter").

[11] See Letter (IC-31835), to Mr. Brent J. Fields, Secretary of the SEC, from David B. Smith, Jr., General Counsel of the Mutual Fund Directors Forum (January 13, 2016) ("MFDF Comment Letter").

[12] See ICI Comment Letter.

[13] See MFDF Comment Letter.

[14] See MFDF, BlackRock, Fidelity and IDC Comment Letters.

[15] See *Use of Derivatives by Registered Investment Companies and Business Development Companies, Securities Act Release No. IC-31933*, SEC (December 11, 2015), *available at* http://www.sec.gov/rules/proposed/2015/ic-31933.pdf (the "proposing release"); see also *Use of Derivatives by Registered Investment Companies and Business Development Companies*, SULLIVAN & CROMWELL LLP (December 18, 2015), *available at*

ENDNOTES (CONTINUED)

https://www.sullcrom.com/siteFiles/Publications/SC_Publication_Use_of_Derivatives_by_Registered_Investment_Companies.pdf (the "S&C Derivatives Memo").

16 See proposing release; see also the S&C Derivatives Memo.

17 See the S&C Derivatives Memo.

18 See proposing release.

19 See *SEC Investment Management Guidance Update: No. 2015-02*, SEC (April 2015).

20 See *SEC Charges Investment Adviser with Failing to Adopt Proper Cybersecurity Policies and Procedures Prior to Breach*, SEC (September 22, 2015) ("*SEC Charges Investment Adviser*").

21 See *SEC Charges Investment Adviser.*

22 See *SEC Investment Management Guidance Update: No. 2016-01*, SEC (January 2016) ("2016 Guidance").

23 See *No-Action Letter (Rule 12b-1) to Investment Company Institute*, SEC (October 30, 1998), *available at* https://www.sec.gov/divisions/investment/noaction/1998/ici103098.pdf.

24 See SEC Proposed Rule (Release Nos. 33-9128; 34-62544), 17 CFR Parts 210, 239, 240, 249, 270 and 274.

25 See 2016 Guidance.

26 See *Former Mutual Fund Directors Agree to Settle Claims They Failed to Properly Oversee Asset Valuation*, SEC (June 13, 2013) ("*Former Mutual Fund Directors*").

27 See *Former Mutual Fund Directors*.

28 See Letter (*Re: Use of Derivatives by Registered Investment Companies and Business Development Companies (File No. S7-24-15))*, to Mr. Brent J. Fields, Secretary of the SEC, from David B. Smith, Jr., General Counsel of the Mutual Fund Directors Forum (March 28, 2016).

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