

The logo for K&L GATES, featuring the text in white on an orange rectangular background.

K&L GATES

A blurred background image showing a grid of lights, possibly a data center or server room, with a mix of blue and yellow colors.

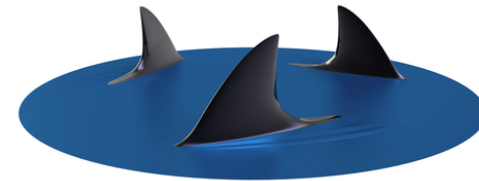
2016 INVESTMENT MANAGEMENT CONFERENCE

# Duties of Directors and Trustees

Donald W. Smith

# COMPETING/CONFLICTING PRESSURES ON BOARDS

- Expectations of Shareholders
- Fund Management
- SEC Mandates
- Plaintiffs Bar
- Increasing Complexity of Fund Operations



# INDEPENDENT DIRECTORS OF MUTUAL FUND BOARDS

- Focus on role of independent or “disinterested” fund trustees and directors
- Almost always, a majority of a fund’s board is independent
- 1940 Act, SEC and best practices composition requirements



## ROLE OF THE FUND BOARD

- Fund boards have distinctly different function than boards of operating companies
- Primary purpose is to monitor and manage conflicts with outside service providers—especially the sponsoring investment adviser
- Secondary purpose is to supervise various compliance functions
- Unlike boards of operating companies, the 1940 Act and SEC rules and pronouncements assign a number of specific duties to mutual fund boards

## ROLE OF THE FUND BOARD *(CONTINUED)*

- The specific duties expected of mutual fund boards often are much more granular and detailed than those of non-mutual fund boards
- Examples of key conflict management and compliance functions: brokerage and soft dollars, securities lending, valuation, annual advisory contract reviews, approval of fund compliance program, and affiliated transactions
- Also, general corporates duties such as: election of officers, approval of material service contracts, approval of share issuance, interaction with auditors and declaration of dividends
- However, fund boards are not expected to manage or supervise most day-to-day operations of the adviser and manager
- Difficult balance to strike

## INDEPENDENT DIRECTORS

- Who qualifies as an independent director under the 1940 Act
- Business relationships that must be disclosed
- Common issues regarding independence
  - Material business relations with the adviser and other service providers
  - Relationships with subadvisers
  - Updating questionnaires

## SEC REQUIREMENTS

- Board practices formally mandated by the SEC
  - Nomination of independent directors by independent directors
  - Annual self-assessments
  - Fair valuation of portfolio securities
  - “Independent Counsel” requirement
  - Approval of compliance policies and procedures

## SEC REQUIREMENTS *(CONTINUED)*

- An increasing number of requirements are being imposed on fund boards by the SEC staff through published guidance, the examination process and settled enforcement actions.
- These often appear to significantly decrease the ability of boards to delegate functions to management.



# GOVERNANCE DISCLOSURE RULES

- 2004 – Rules requiring enhanced disclosure regarding board consideration of advisory contracts
- 2010 – Additional disclosure required about the board’s leadership structure, including:
  - whether the same person serves as both principal executive officer and board chair;
  - whether the board chair is an “interested person” of the fund;
  - a description of the board’s role in risk oversight
  - why the registrant has determined that its leadership structure is appropriate, given the specific characteristics or circumstances of the registrant.
- Adopting Release recognized that “different leadership structures may be suitable for different companies depending on factor such as the size of a company, the nature of a company’s business, or internal control considerations, among other things”

# FIDUCIARY DUTY AND BUSINESS JUDGMENT

- What standards must a director meet under state law
  - Duty of loyalty
  - Duty of care
- Business judgment rule
  - Protects the board, but requires extensive process and documentation to be effective

## REVIEW OF ADVISORY CONTRACTS

- Review of advisory contracts
- Gartenberg standard
- Harris Supreme Court decision
- Disclosure of factors considered and findings made
- Review of changes in control of adviser and merger transactions



# PROTECTION FROM LIABILITY FOR DIRECTORS

- Advancement of legal expenses
- Indemnification by the fund
- Insurance



# THE BOARD'S ROLE IN THE AUDIT PROCESS

- The Audit Committee
  - Relationship with auditor
  - Auditor independence and pre-approvals
  - Audit Committee Financial Expert
  - Audit Committee charter



## SIGNIFICANT CURRENT TOPICS

- Valuation
- Oversight of intermediaries and distribution
- Cybersecurity
- Money market fund reform
- Securities lending and derivatives
- Liquidity risk management proposal
- Use of Rule 38a-1 in the examination and enforcement process



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