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2016 INVESTMENT MANAGEMENT CONFERENCE

Registered Fund Board of Directors and Fund Governance Issues

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OVERVIEW

- Northstar Overview and Related Developments
- Update on Section 36(b) Litigation
- SEC Rulemaking and Impact on Fund Boards

Northstar Overview

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NORTHSTAR OVERVIEW

- Northstar Financial Advisors Inc., v. Schwab Investments et al ("*Northstar*") (March 2015)
- Ninth Circuit Court of Appeals permitted 3 novel state law claims advanced by mutual fund shareholders
- Claim: fund did not follow "fundamental" investment policies
- Ruling: claim permitted to proceed on 3 state law theories:
  - **Breach of "contract" against the fund** (represented by the fund's declaration of trust, proxy statement and prospectus)
  - **Breach of fiduciary duty against the adviser and trustees** (allowed directly, without demand on the board, rather than derivatively)
  - **Breach of contract against the adviser** (shareholders as "third-party beneficiaries" of the advisory contract)

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NORTHSTAR OVERVIEW (CONT.)

- October 5: U.S. Supreme Court declined to review *Northstar*
  - As binding precedent for District Courts in the Ninth Circuit, could make the Ninth Circuit a magnet for shareholder litigation
- October 5: District Court dismissed breach of contract claims against Schwab
  - Held that Securities Litigation Uniform Standards Act bars state law claims regarding misrepresentations in connection with the purchase or sale of securities
  - Plaintiffs have appealed back to the Ninth Circuit

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POTENTIAL *NORTHSTAR* RESPONSES

- Considerations vary for open-end funds/closed-end funds and new funds/existing funds
- Potential Responses:
  - Amend Declarations of Trust for existing funds
  - Change form of organization for existing funds from Massachusetts Business Trusts to Delaware Statutory Trusts
  - Establish new funds as Delaware Statutory Trusts or keep as Massachusetts Business Trusts with enhanced declarations of trust
  - Add relevant disclosures to registration statements

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CONSIDERATIONS IN RESPONDING TO *NORTHSTAR*

- Most important issue in *Northstar* was what the trust documents said, not the form of organization (the Court's legal analysis was based on both Massachusetts and Delaware law)
- Before choosing to convert to a Delaware Statutory Trust or create a new fund as a Delaware Statutory Trust, need to consider among other things:
  - Burdens that may be associated with an initial fund launch as a Delaware Statutory Trust
  - Draft new organizational documents
  - New SEC registration must be declared effective
  - Operational and legal costs
- Authority regarding organizational documents
  - Delaware statute establishes that declaration of trust provisions control
  - In Massachusetts, the same principle is well established by judicial authority
  - We do not view this difference as major

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CONSIDERATIONS IN RESPONDING TO *NORTHSTAR*

- Court sophistication and case law – No clear advantage
  - Sophisticated Delaware Chancery Court and developed corporate law
  - Shareholder derivative suits nearly certain to be litigated in the Business Litigation Session of the Massachusetts Superior Court which is similarly sophisticated
- Favorable Universal Demand Requirements in Massachusetts
  - In order to maintain a derivative action under Massachusetts law, the plaintiff must first make a demand on the Board (with limited exceptions). If the plaintiff fails to do so, the case will be dismissed.
  - Under Delaware law, a plaintiff can argue that a demand would be futile if the Board is controlled by interested trustees
- Books and Records
  - Under Massachusetts law, a shareholder's rights to books and records is narrow and limited to specific corporate documents and there is a clear mandatory stay of discovery pending a motion to dismiss a derivative suit
  - Under Delaware law, a shareholder's rights to books and records is greater and extends to a broader variety of corporate records and allows a books and records request after filing of a derivative suit

Update on Section 36(b) Litigation

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SECTION 36(B) DESIGNED TO ADDRESS EXCESSIVE FEE CONCERNS

- Less than arm's-length relationship
- Existing fund governance not effective
- Market not effective
- Shareholders tend not to move
- State corporate law ineffective
  - Action for "waste"
  - Difficult substantive standard
  - Demand required
  - Approval of fees by directors or shareholders

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SECTION 36(B)

- For purposes of this subsection, the investment adviser of a registered investment company shall be deemed to have a fiduciary duty with respect to the receipt of compensation for services, or of payments of a material nature, paid by such registered investment company, or by the security holders thereof, to such investment adviser or any affiliated person of such investment adviser.

The Result:

- Fiduciary duty of adviser
- Fiduciary standard of compensation
  - Fiduciary may not charge an “excessive” fee
  - Fee must have the “earmarks of an arm’s length bargain”

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SECTION 36(B) LITIGATION OVERVIEW

- Over twenty cases now pending
- New cases continue to be filed
- New plaintiffs' law firms appearing
- Core theories and strategies unchanged

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THIRD WAVE OF SECTION 36(B) CASES

- Traditional 36(b) cases (approximately 3 currently in process)
- Manager of managers cases (approximately 12 currently in process)
  - Adviser/manager contracts with fund
  - Adviser subcontracts portfolio management services
- Sub-adviser cases (approximately 7 currently in process)
  - Manager contracts to sub-advise other funds
  - Fees as sub-adviser are lower
- Fund of fund cases (approximately 5 currently in process)
  - Adviser receives fees from underlying fund
  - Adviser receives “Acquired Fund Fees”
  - Adviser acts as manager of managers
- Administration fee claims

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SECTION 36(B) SCORECARD

- Plaintiffs usually prevail on pretrial motions
  - Eight motions to dismiss denied
  - Two motions for summary judgment denied
- Defendants prevail on standing grounds
- Cases are going to trial
  - One trial completed
  - Others anticipated in 2017
- Few settlements

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THE GARTENBERG STANDARD

- *Gartenberg v. Merrill Lynch Asset Mgmt., Inc.*
  - To violate Section 36(b), "the adviser-manager must charge a fee that is so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been the product of arm's-length bargaining"
  - "[T]he test is essentially whether the fee schedule represents a charge within the range of what would have been negotiated at arm's length in the light of all of the surrounding circumstances"
- Supreme Court adopts in *Jones v. Harris Associates LP*

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GARTENBERG FACTORS

- Consideration of “all facts in connection with the determination and receipt of such compensation,” including:
  - The nature and quality of services rendered
  - The profitability of the fund to the investment adviser
  - Economies of scale
  - Comparative fee structures
  - Fall-out benefits
  - The independence of the unaffiliated directors and the care and conscientiousness with which they performed their duties
- Supreme Court endorses in *Jones v. Harris*

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DIRECTORS/TRUSTEES

The conscientiousness of Directors/Trustees is a key factor

- “House directors”
- Oversight of multiple funds
- “Conflicted counsel”
- Procedural flaws in the 15(c) process
- Papering the record
- Lack of understanding of issues

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SECTION 36(B) DEFENSE STRATEGY

- Focus on the “fee as a whole”
  - Are the shareholders paying a fair or reasonable price for what they are receiving notwithstanding how fee is divided?
- Overall profitability
  - Is profit appropriate in light of risks borne by adviser?
- Integrity of 15(c) process
  - How much do directors see?
- Focus on independent directors
  - Can they explain their decision as an appropriate judgment?

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SECTION 36(B) DEFENSE STRATEGY

- Business judgment of independent directors
  - Were they informed?
  - Did they act in good faith?
  - Is the decision reasonable?
- Preparation starts with process
- Back to *Gartenberg*
  - Reasonable relation to services rendered
  - Within the range of negotiated fees

Impact of Recent SEC Actions on Boards

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MONEY MARKET FUND REFORM

- Amendments to Rule 2a-7 effective in October 2016
- Money Market Funds now classified as either Government, Retail or Floating NAV Funds
- Considerations for Government MM Funds
  - Must have a policy of investing at least 99.5% if total assets in cash, government securities and repurchase agreements collateralized by government securities
- Considerations for Retail MM Funds
  - Adoption of policies and procedures reasonably designed to limit all beneficial owners to natural persons as part of Rule 38a-1 Program
- Considerations for Institutional (Floating NAV) MM Funds
  - Consider any necessary amendments to Valuation Procedures
  - Securities must be priced to the nearest basis point

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MONEY MARKET FUND REFORM (CONT.)

- Valuation:
  - Adopt policies and procedures for valuation appropriate to each fund
  - May continue to rely on existing procedures for fair value, including:
    - Use of evaluated prices from pricing services for securities with maturities of greater than 60 days
    - Amortized cost for securities with maturities of 60 days or less
  - In choosing a pricing service, the Board may want to consider:
    - The quality of the evaluated prices provided;
    - The inputs, methods, models and assumptions used; and
    - Timing differences between the calculation of the evaluated price and fund's NAV calculation.

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MONEY MARKET FUND REFORM (CONT.)

- Liquidity Fees / Redemption Gates:
  - Board must make a best interest determination in implementing / removing a liquidity fee or a redemption gate
    - If weekly liquid assets is less than 30% of its total assets in weekly liquid assets then the Board must consider
    - If weekly liquid assets is less than 10%, the fund must impose the default liquidity fee unless the Board meets and determines that it is not in the best interests of the fund
  - Fees and gates must be removed when weekly liquid assets rise above 30% and a redemption gate must be removed after 10 business days.
  - Must make decision based on actual circumstances – a blanket decision not to impose fees or gates is not appropriate.
  - A brief discussion of the primary considerations or factors taken into account by the Board in imposing a fee or gate, or determining not to in the event that weekly liquid assets are below 10% is required to be disclosed in Form N-CR

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LIQUIDITY MANAGEMENT RULE

- New Rule 22e-4 adopted on October 13, requires mutual funds and other open-end management investment companies, including ETFs, to establish liquidity risk management programs
- With respect to the Board Rule 22e-4 requires:
  - Approve the fund's liquidity risk management program
  - Approve the designation of the fund's adviser or officer to administer the program
  - Receive reports on shortfalls in the highly liquid investment minimum of a Fund
  - Receive reports related to any breach of the 15% illiquid investment restriction and assess whether the manner in which the Fund will be brought back into compliance is in the best interests of the Fund
  - Review, at least annually, a written report on the adequacy of the program and the effectiveness of its implementation.
- Compliance for most funds required by Dec. 1, 2018
- Compliance for complexes with less than a $1 billion in net assets would be required by June 1, 2019.

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SWING PRICING

- Amendments to Rule 22c-1 under the 1940 Act adopted on October 13, 2016 will permit registered open-end management investment company (except a money market fund or exchange-traded fund), under certain circumstances, to use “swing pricing
- Swing pricing is the process of adjusting the fund’s NAV to effectively pass on the costs shareholder purchase or redemption activity to the shareholders associated with that activity
- As amended, Rule 22c-1 requires that Boards do the following with respect to swing pricing:
  - Approve and periodically review the Funds’ swing pricing policies
  - Receive periodic reports related to the adequacy of the swing pricing policies
  - Approve the Funds’ upper swing factor limit, swing pricing threshold and any changes thereto
- Compliance required 2 years after publication in Federal Register

Recent SEC / Staff Guidance

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BOARD OVERSIGHT OF SERVICE PROVIDERS

- Recent service provider outages have highlighted the need for Boards to take a more proactive approach to assessing and managing Funds risks, including operational, technology and liquidity risks
- Boards should be asking tough/specific questions of management and service providers, including about
  - Policies and procedures
  - Business continuity, disaster recovery and back-up plans
  - How management of the Funds monitors and manages liquidity risks
  - How management would calculate value the funds in the event of a service provider outage
- Boards consider whether the Fund's strategy is appropriate for a fund offering daily redemptions
- Highlighted by Mary Jo White in a speech to the MFDF in March

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DISTRIBUTION IN GUISE

- Recent Division of Investment Management Guidance provided written guidance on payments made by mutual funds to intermediaries for distribution and non-distribution related services

  (See IM Guidance Update, No. 2016-01, January 2016)

- Among the recommendations in the guidance are expectations that:
  - The Board have a process in place that is reasonably designed to provide them with enough information to make an informed judgment as to whether any portion of sub-accounting fees paid by the fund are being used to pay directly or indirectly for distribution
  - That the Board use its reasonable business judgment in making the determination
  - That service providers provide the Board with information necessary to obtain the overall picture of distribution and servicing arrangements
  - Certain arrangements may provide indicia of distribution

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BUSINESS CONTINUITY

- Recent Division of Investment Management Guidance highlights the importance of business continuity planning for fund complexes

  (See IM Guidance Update, No. 2016-04, June 2016)
- Identified the following notable practices:
  - BCP Plans cover facilities, technology, employees and key service providers
  - Broad cross section of employees involved in planning (including CCO)
  - BCP Presentations are provided to fund boards annually by key service providers
  - Annual testing of BCP Plans
  - Outages by fund complex and service providers are monitored and reported to the Fund Board
- Additional considerations for critical service provider:
  - Fund complexes should examine backup processes and redundancies
  - Put procedures in place to monitor outages
  - Planning should be coordinated across service providers and account for multiple scenarios