

The image features a dark blue rectangular box in the top left corner containing the text 'K&L GATES' in white, sans-serif font. The background of the slide is a complex financial chart with a grid. It includes a candlestick chart with orange bars, a line graph with a wavy orange line, and a world map composed of blue dots. A vertical yellow line is positioned in the center of the chart. A red circle highlights a data point on the candlestick chart, and a white circle highlights a data point on the line graph. The text '+11,00.00' is displayed in orange above the chart.

K&L GATES

2018 WASHINGTON D.C. INVESTMENT MANAGEMENT
CONFERENCE – November 7, 2018

Fund Boards and Committees

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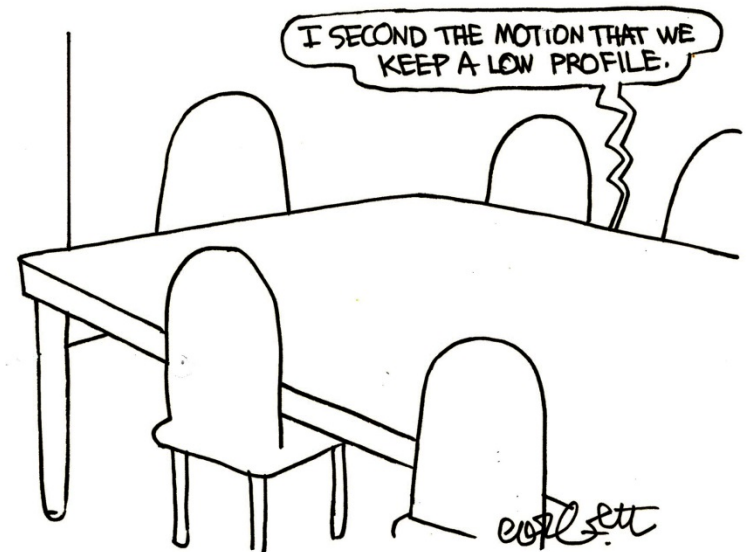
FUND BOARDS AND COMMITTEES

- Role of the Fund Board
- Board Composition and Independence
- SEC Fund Governance Requirements and Disclosures
- General Fiduciary Duties
- Board Oversight Responsibilities
- Board Committees
- SEC Board Outreach Initiative



COMPETING AND CONFLICTING PRESSURES ON MUTUAL FUND BOARDS

- Shareholder Expectations
- SEC Mandates
- Increasing Complexity of Fund Operations
- Section 36(b) Litigation
- Attorney-Client Privilege



ROLE OF THE FUND BOARD

- “Watchdogs” to furnish an independent check on management
- Primary purpose is to monitor and manage conflicts with outside service providers—especially the sponsoring investment adviser
- Secondary purpose is to oversee various management and compliance functions
- 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



ROLE OF THE FUND BOARD (CONTINUED)

- General Corporate Duties
 - Election of fund officers, approval of service contracts, approval of share issuance, review of audits, declaration of dividends
- Different from Boards of Operating Companies
 - Mutual fund boards are not expected to manage or supervise most day-to-day operations of the adviser and manager



BOARD COMPOSITION

- Fund boards must have a majority of independent directors:
 - Section 10(a) requires at least 40% of the board be independent from advisers
 - Section 10(b)(2) requires at least 50% of the board be independent of the underwriter
 - Exemptive Rules: If fund relies on common exemptive rules, at least 50% must be independent
 - Multi-Manager Orders: If fund relies on multi-manager order, at least 50% must be independent
- SEC adopted a 75% requirement in 2004, but it was never implemented because of court challenges
 - 1999 ICI Report recommended two-thirds be independent
 - 2006 MFDF Report recommended 75% be independent



INDEPENDENCE

- 1940 Act provides that a “non-interested” or independent director cannot be:
 - An “affiliated person” of fund, adviser or principal underwriter, or a family member of such person;
 - Fund legal counsel during the fund’s past two years; and
 - Within past six months, affiliated with person that executed portfolio transactions for fund, engaged in principal transactions with fund, distributed shares for fund, or loaned money or other property to fund
- SEC also can determine by order that a person is not independent based on “material business or professional relationship” that person has with a fund, adviser, underwriter, or certain other affiliates
- Independent directors cannot own even one share of stock of an adviser, subadviser, principal underwriter, or their “control persons”



PROCEDURES TO PROTECT INDEPENDENCE

- Independence is critically important to the regulatory scheme for registered investment companies and must be maintained at all times
- A questionnaire is sent to each director annually with questions designed to elicit information about any relationships with service companies that might raise an independence issue
 - Fund/independent legal counsel reviews the responses to the questions and follows up individually if there are incomplete responses or possible issues raised by responses



SEC FUND GOVERNANCE REQUIREMENTS

- 1940 Act Fund Governance Rules:
 - Independent Chair (Challenged)
 - 75% Independent Directors (Challenged)
 - Independent Directors Nominate Other Independent Directors
 - Independent Director Counsel Must Be Independent
 - Annual Self-Assessment
 - Quarterly Executive Sessions of Independent Directors
 - Independent Directors Must Have Authority to Hire Experts
- Mutual Fund Directors Forum: 33 “Best Practices”
 - Including 75% Independent Directors and Independent Chair
- Compliance is required for reliance on SEC exemptive rules (Rule 12b-1, Rule 18f-3, Rule 15a-4, Rule 17a-7, Rule 17a-8, etc.)

FUND GOVERNANCE DISCLOSURE RULES

- 2004 – Enhanced disclosure in annual report regarding board consideration of advisory contracts
- 2010 – Additional disclosure about board’s leadership structure, including:
 - Whether the same person serves as both principal executive officer and board chair;
 - Whether the board chair is independent;
 - The board’s role in risk oversight; and
 - 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 factors such as the size of a company, the nature of a company’s business, or internal control considerations, among other things”



STATE LAW FIDUCIARY DUTIES

- State law fiduciary duties for directors
 - Duty of care: directors must perform oversight responsibilities with the care of a prudent person under similar circumstances
 - Duty of loyalty: directors must act in the best interests of the fund and its shareholders, including: avoiding conflicts of interest with fund and shareholders; not putting personal interests before fund and shareholders; and not profiting from position as a fiduciary
- Business judgment rule: courts generally defer to reasonable business judgment of directors if:
 - Board is sufficiently experienced and educated;
 - Board is well informed of all relevant facts and circumstances;
 - Board members were careful and conscientious; and
 - Board members do not have a conflict of interest in the matter



FEDERAL LAW FIDUCIARY DUTIES

- Section 36(a) of the 1940 Act authorizes the SEC to bring court action against directors and certain other persons alleging a breach of fiduciary duty involving personal misconduct related to any registered investment company
- Section 36(b) of the 1940 Act authorizes suits by SEC or shareholders for breach of fiduciary duty by an adviser or its affiliates “with respect to compensation”
 - One factor courts consider is the care and conscientiousness of the independent directors



FOUR STATUTORY RESPONSIBILITIES REQUIRING BOARD VOTES

- Advisory Agreements
- Underwriting Agreements
- Valuation of Securities
- Approval of Independent Auditors



INVESTMENT ADVISORY AND PRINCIPAL UNDERWRITING AGREEMENTS

- Advisory and Underwriting Agreements (Section 15)
 - Board (including a majority of independent directors) must approve investment advisory and principal underwriting agreements at in-person meetings called for the purpose of voting on such approvals
 - Board has a duty to request and evaluate such information as may reasonably be necessary to evaluate the terms of any advisory contract
 - After an initial two-year period following approval, board must approve the renewal of advisory and underwriting agreements annually



VALUATION AND APPROVAL OF AUDITORS

- Valuation (Section 2(a)(41) and Rule 2a-4)
 - When market quotations are not readily available, securities must be valued at “fair value as determined in good faith by the board of directors”
 - SEC views fair valuation as a non-delegable responsibility
 - Board may appoint others to make fair value calculations pursuant to board-approved methodologies
- Approval of Independent Auditors (Section 32)
 - Fund may not file any financial statement signed or certified by an auditor unless selected by a majority of the independent directors



ADDITIONAL RESPONSIBILITIES

- Affiliated Transactions: Brokerage, Underwriting, Cross Trades
 - Board must adopt compliance procedures reasonably designed to provide that:
 - Affiliated brokers' fees are reasonable and fair compared to unaffiliated brokers' fees (Rule 17e-1);
 - Purchases of offerings underwritten by an affiliated broker-dealer comply with certain conditions (Rule 10f-3); and
 - Transfers between affiliated funds meet certain pricing and other standards (Rule 17a-7)
 - Board must review transactions quarterly and determine that they were effected in compliance with procedures
 - *Independent Directors Council* No-Action Letter (October 12, 2018): SEC Staff would not recommend enforcement action if, **rather than making the determination themselves**, the board receives a **quarterly representation from the** CCO that transactions effected in reliance on Rules 10f-3, 17a-7 or 17e-1 complied with the board-approved procedures



ADDITIONAL RESPONSIBILITIES (CONTINUED)

- Affiliated Fund Mergers
 - Board must confirm that (1) a merger between affiliated funds is in each fund's best interests and (2) the interests of each fund's existing shareholders will not be diluted as a result of the merger (Rule 17a-8)
- Code of Ethics
 - Fund and its adviser and principal underwriter must adopt, and board (including majority of independent directors) must approve, a code of ethics that contains provisions reasonably necessary to prevent access persons from engaging in prohibited personal trading
 - Board must approve any material change within 6 months
 - Fund and adviser and underwriter report annually to board describing any issues



ADDITIONAL RESPONSIBILITIES (CONTINUED)

- Compliance Program (Rule 38a-1)
 - Board must approve compliance policies and procedures of the fund and certain service providers
 - Board must approve CCO and compensation
 - CCO reports to board at least annually regarding operation of program, recent and proposed material changes, and material compliance matters
 - CCO meets annually with independent directors in executive session
- Distribution and Shareholder Servicing Payments
 - IM Guidance Update
 - Distribution in guise enforcement actions



ADDITIONAL RESPONSIBILITIES (CONTINUED)

- Liquidity Risk Management Program (Rule 22e-4)
 - Board must approve:
 - Liquidity Risk Management Program
 - May approve based on a summary
 - LRMP administrator
 - Board must review annually a written report of the LRMP's adequacy and effectiveness and any material changes to LRMP
 - Board receives reports if:
 - Fund falls below its "Highly Liquid Investment Minimum"
 - <7 calendar days: at next board meeting
 - >7 calendar days: within 1 business day
 - Fund exceeds its 15% illiquid holdings maximum



LIABILITY AND INDEMNIFICATION

- Fund governing documents may provide for limitation of liability and/or indemnification
 - State law and 1940 Act limitation for “disabling conduct”: willful misfeasance, bad faith, gross negligence or reckless disregard of duties
- Advancement of Legal Expenses
- Directors and Officers (“D&O”) Insurance



BOARD COMMITTEES

- Audit Committee
 - Maintains relationship with auditor
 - Assesses auditor independence and pre-approvals
 - Designates Audit Committee Financial Expert
 - Adopts Audit Committee Charter
- Compliance Committee
- Investment Committee
- Governance Committee
- Nominating Committee

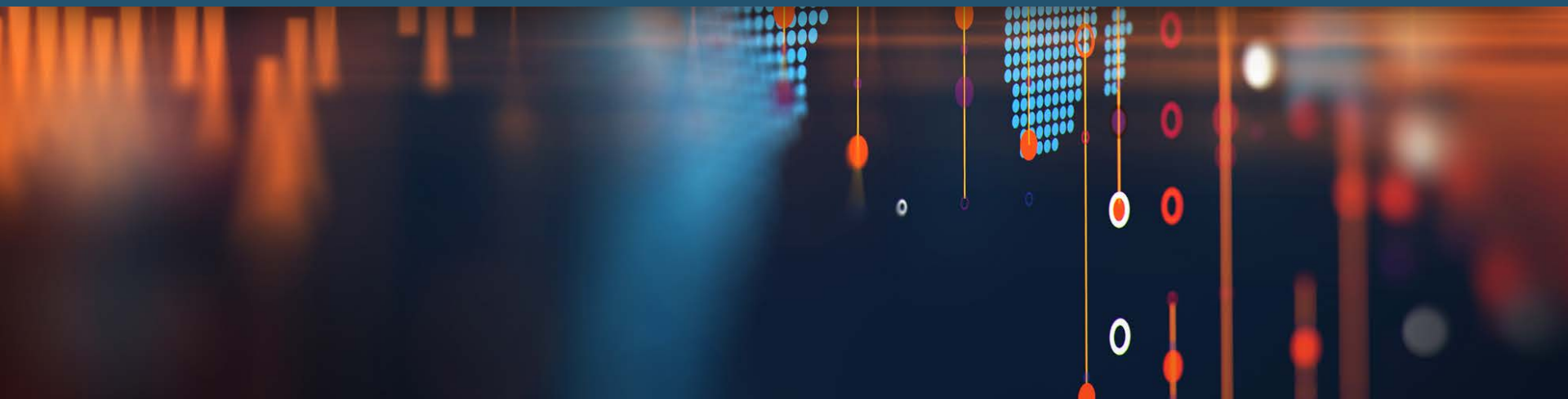


SEC BOARD OUTREACH INITIATIVE

- SEC Division of IM initiative to review board responsibilities
- Designed to “holistically revisit the responsibilities of the board” and “recalibrate” those responsibilities
- SEC Staff Framework for Board Responsibilities
 - Should a regulatory action require board engagement, and if so, what is the policy goal for the board’s involvement?
 - Is it necessary for the SEC to require a specific board action or can the SEC staff focus on a goal and let boards determine means of compliance?
 - Are prescribed board responsibilities consistent with the board’s oversight and policy role?
 - Are board responsibilities clear, up-to-date, and consistent with other regulatory actions?



QUESTIONS?



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