MUTUAL FUND DIRECTORS FORUM

The FORUM *for* FUND INDEPENDENT DIRECTORS

June 20, 2017

The Honorable Jay Clayton
Chairman, United States Securities and Exchange Commission
100 F Street NE
Washington, DC 20549

Dear Chairman Clayton:

Congratulations on your confirmation as Chairman of the Securities and Exchange Commission. While we understand that you have many priorities as you assume this new role, we would like to bring your attention to some issues affecting mutual funds, particularly those that are important to the independent fund directors who protect the interests of the millions of fund investors. With over $15 trillion in assets, mutual funds play a critical role in helping American investors finance their most important life goals, including purchasing their first home, sending their children to college and ultimately saving for a financially secure retirement. The safety and effectiveness of funds is of fundamental importance to these Americans.

We at the Mutual Fund Directors Forum ("the Forum") look forward to working with you to help ensure that registered investment companies ("RICs") are regulated to help mutual fund investors achieve their savings goals. The Forum is an independent membership organization, consisting entirely of independent fund directors, devoted to improving the ability of fund directors to fulfill their important fiduciary obligations and protect the interests of those who invest in the funds they oversee. We accomplish this goal through a variety of offerings, including in-person educational programs, webinars and the publication of white papers and other materials providing guidance to directors on the many issues they face. We also seek to work with the Commission and other regulators to help them understand how the regulatory regime affects directors and how directors can be better enabled to represent the interests of fund shareholders. Indeed, the Forum was founded in conjunction with the Commission and other industry experts in 2002 and today is an established and recognized representative of fund directors.[1]

While investment pools like mutual funds are common around the world, the manner in which mutual funds are regulated in the United States is virtually unique. Since its enactment in 1940, the Investment Company Act has required every mutual fund to have a board of directors, separate from the fund's investment manager, to oversee the fund on behalf of its shareholders. These boards play a number of critical roles, including approving the management fee, management contract and the agreements with other key service providers, protecting fund

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[1] The Forum's current membership includes over 993 independent directors, representing 127 mutual fund groups. Each member group selects a representative to serve on the Forum's Steering Committee. This comment letter has been reviewed by the Steering Committee and approved by the Forum's Board of Directors, although it does not necessarily represent the views of all members in every respect.

1501 M Street NW, Suite 1150 • Washington, DC 20005 • T: 202.507.4488 • F: 202.507.4489
www.mfdf.org

investors from the conflicts of interests inherent in asset management, and overseeing the fund's and its adviser's compliance with relevant laws and regulations.

This regulatory structure is uniquely flexible. In particular, it allows directors to play an important role in protecting fund investors rather than relying on granular, detailed regulations, often prohibitory in nature, to guide the day-to-day activities of funds. As a result, the U.S. fund industry is the most successful in the world. In particular, American fund investors pay fees that are among the lowest in the world while at the same time benefiting from a large and varied number of products and investment strategies. Similarly, while individual funds have, at times, been subject to regulatory scrutiny or enforcement action, fund investors have largely been treated fairly by the investment advisers and others who manage and operate their funds.

As you assume your duties as Chair of the Commission, we hope that you will recognize the important role that directors play and take steps to foster their ability to act effectively and decisively on behalf of the millions of Americans who rely on mutual funds. We believe that the most important factor influencing a board's success is its (and its individual members) ability to exercise its business judgment on behalf of the fund investors it represents. While there are common themes and issues in the fund industry that influence the work of directors, every fund complex (and indeed every fund within a complex) is different and faces its own unique issues. Moreover, these issues – and the markets and regulations that underlie them – can change rapidly. Directors are thus required to be quick, flexible and able to react effectively to changing circumstances. In contrast, a rigid and inflexible regulatory structure that places unnecessary or irrelevant burdens directly on directors can easily become an impediment to a board's ability to act in its shareholders interests.

We are concerned that the Commission's approach in recent years has placed too many burdens on directors, has gone too far in implicitly impelling them to become involved operationally in their funds activities, and thus has inhibited their ability to spend time on issues that matter most to their shareholders and to exercise their business judgment flexibly on behalf of those shareholders. We therefore believe that it is imperative that the Commission carefully and systematically analyze and define the role it intends for directors to play.

The Commission has been successful in the past at empowering directors, including through the adoption of Rule 38a-1, which mandates that each fund have a CCO who reports to the independent directors and its requirement that counsel to the independent directors be independent. However, in the dozen or so years since these rules were adopted, the Commission has imposed new duties and obligations on directors in a piecemeal fashion, generally as part of other regulatory initiatives. As a result of these initiatives, directors are now tasked with monitoring how the Commission's regulatory initiatives are implemented by the fund industry. For example, the Commission has required that directors:

- Become more deeply involved in the process of valuing portfolio securities, particularly by suggesting that directors need to understand complex valuation techniques at a high degree of granularity rather than permitting boards to fulfill their statutory responsibility by reasonably relying on management and other experts involved in the valuation process.

- Approve highly detailed liquidity management policies and procedures and directly to approve who is designated as a fund's liquidity risk manager (rather than, for example, including oversight

of liquidity risk management as part of the board's overall oversight of compliance under Rule 38a-1).

- Monitor the relationships that funds have with the intermediaries who sell their shares and the payments that are made to them in connection with the services they provide fund shareholders. Given the significant information asymmetry that exists in the funds' relationships with the intermediaries, boards (and, for that matter, fund management) often lack access to the depth of information the Commission expects, and the Commission has not given directors the tools necessary to compel the production of necessary information. In addition, while the staff has recognized that many of the necessary findings required under Rule 12b-1 are no longer relevant in the current fund industry, the Commission itself has yet to take action.

- Continue to oversee routine compliance matters, such as compliance with many of the affiliated transaction rules under Section 17. The staff has been wary of allowing boards to delegate these oversight functions to the fund CCO and other appropriate fund personnel. At the same time, the Commission continues to impose additional oversight duties on boards as part of routine grants of exemptive relief.

This letter is not intended to identify specific provisions of the regulatory regime that ought to be changed. Rather, at a time when the federal government is increasingly seeking to identify ways to reduce the burden of the regulatory environment in our country while at the same time making those regulations more efficient and effective, we believe that this is an important time to step back and reconsider, in a holistic manner, the role played by directors under the current regulatory regime, the tasks imposed on directors by that regime, and whether the specific tasks given to directors in fact succeed in enabling directors to better protect the interests of shareholders. In doing so, we hope that the Commission will recognize that while boards play a critical role in ensuring that funds are operated in the interests of their shareholders, the board (or, perhaps more precisely, the board's time and expertise) is a limited resource that must be used effectively.

In undertaking the task, we encourage the Commission to keep in mind the following factors:

- The Commission has provided directors with many resources, including a CCO who reports directly to the board, independent auditors, a requirement that legal counsel serving the board is independent of the fund's adviser and the ability to use fund assets to hire other advisers and consultants. The Commission should recognize that these resources give directors significant ability to monitor and oversee the activities of the funds for which they are responsible, both from a compliance and economic standpoint. Given these resources, there should be less need for the Commission to mandate that directors consider specific factors in overseeing various activities of their funds.

- The Commission should avoid requiring directors to make specific compliance-related findings or become operationally involved in the funds they oversee, and instead recognize that the board's primary compliance-related activities are encompassed by the requirement of Rule 38a-1 that the boards approve and oversee written policies and procedures reasonably designed to prevent the fund from violating the securities laws.

- Given that boards typically do (and should) meet only four to eight times a year, the Commission should reemphasize the ability of the board to delegate many of its tasks (ranging from routine monitoring of the fund's use of exemptive relief to tasks such as valuation that require significant expertise and are performed on a regular, if not daily, basis) to appropriate fund or adviser personnel. Given the resources that the Commission has made available to fund boards, appropriate delegations will permit the board to operate more efficiently and focus on those tasks and activities that it believes, in its business judgment, most directly benefit fund shareholders.

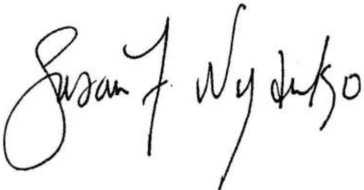
- Work to further protect directors from the costs and distraction of Section 36(b) litigation, especially in light of the Supreme Court's recognition in *Jones v Harris* that the business judgment of an independent and informed board should not be second-guessed or otherwise disturbed (in the same way as provisions included in the CHOICE Act as recently passed by the House of Representatives).[2] The burdens of unnecessary litigation otherwise seriously detract from the ability of directors to focus on more important activities. Similarly, the Commission should recognize that boards should be able to structure the contract renewal process in a way that they believe will produce the best results for their shareholders, rather than implicitly requiring directors to follow a set structure or consider a rote list of factors.

- Generally recognize in all contexts -- ranging from valuation to oversight of 12b-1 plans to approval of the contracts between the fund and its adviser and other key service providers – that the business judgment of an informed board should not be second-guessed by the Commission absent indications of important compliance failures.

In making these suggestions, we are not implying that the work of directors should be insulated from review. Rather, we are encouraging the Commission to streamline its approach to fund governance in a manner that recognizes an independent, engaged and informed board is in the best position to determine how to structure its activities in a manner designed to produce the most benefits for the shareholders that they represent.

In conclusion, we look forward to working with you in the coming years to continue the important work of protecting our capital markets and those who rely on and invest in them. We encourage you to reach out to Susan Ferris Wyderko, the Forum's President, at any time at 202-507-4490 to further discuss these or any other issues.

Sincerely,



Susan Ferris Wyderko
President

cc: Commissioner Kara M. Stein
Commissioner Michael S. Piwowar
David Grim, Division Director

[2] *See* H.R. 10, sect. 831 ("The Financial Choice Act of 2017).