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A Way Forward on Modernizing Fund Director Responsibilities

In recent years, the workload for boards of US regulated funds has grown heavier and more complex—owing in part to the fund industry's growth and evolution, but due largely to a raft of new responsibilities established in Securities and Exchange Commission (SEC) rulemakings and other initiatives.

However well intended, many of the responsibilities imposed on fund boards today have become counterproductive, out of date, or out of sync with directors' conventional oversight role. More pressing priorities so far have kept the SEC from completing a much-needed update. But as the new director of the Commission's Division of Investment Management, Dalia Blass, begins her tenure, she has an opportunity to take on this important work.

How should the division approach it? In my view, the division should take a fresh look at all the board responsibilities that have accumulated over the years—to ensure that they fit with an oversight (not a management) role, that they task directors primarily with overseeing potential conflicts of interest, and that they strengthen boards' ability to serve shareholders. At least three areas of focus, which I outlined as part of a letter to the division in October, fit with this model.

Rethinking Ritualistic and Duplicative Responsibilities

One area of focus is to relieve boards of responsibilities that have become ritualistic and duplicative, and of responsibilities that would be handled better by other fund personnel or service providers.

Under the fund compliance rule, for example, chief compliance officers (CCOs) are responsible for ensuring that their funds comply with regulations, and boards oversee the fund's compliance program itself. Yet many regulations still require boards to perform tasks already handled by CCOs. These regulations should be updated, so that boards aren't duplicating CCOs' work and can devote more time and attention to areas where they can add value, such as overseeing investment performance.

Similarly, responsibilities for making technical determinations should move from boards to the professionals who are better equipped to handle them. Among others, these responsibilities include reviewing the minutiae associated with the placement of assets in foreign custody arrangements, and making certain expense-allocation determinations for funds with multiple share classes.

Reflecting an Evolving Industry

A second area of focus is to revise board responsibilities to reflect how the industry has evolved.

Consider fair valuation. When Congress required fund boards to determine the fair value of portfolio investments back in 1940, it could not have anticipated the sophisticated, multivariable analyses underlying fair valuation today. Nor could have the SEC, when it began issuing valuation guidance in the 1960s.

The reality today is that directors are well positioned to oversee the fair-valuation *process*, but do not have the technical expertise and daily involvement with pricing that the adviser does to determine the fair values of individual securities—or even to determine the proper methodologies for doing so. The division would do well to recognize this—and to recommend a rule allowing a fund board to delegate fair-value determinations to the fund's adviser, subject to its stringent oversight of the process.

Distribution is another example. The Department of Labor's fiduciary rule has prompted an unprecedented wave of change and innovation in how funds distribute their shares, which will likely persist regardless of what ultimately happens to the rule. Consequently, the rules governing board oversight of distribution—including Rule 12b-1 and related rules and interpretations—are ripe for examination. Rule 12b-1's requirement that boards review distribution payments quarterly, for instance, is no longer a productive use of their time.

Increasing Flexibility and Efficiency

A third area of focus is to make fund governance requirements more flexible and efficient.

A good candidate here is the requirement that a board can approve a fund's contracts with its adviser and underwriter only at an in-person meeting. Although in-person meetings promote active engagement and dialogue by the fund board, unforeseen circumstances—such as severe weather or illness—can prevent one or more directors from attending a meeting. This could block the board from approving a required contract in a timely manner. In those circumstances, funds should be exempt from the in-person requirement, because the communication technology available today enables directors to be fully engaged in a board meeting without being physically present.

More than 100 million fund shareholders depend on independent directors to promote and protect their interests, so it's imperative that directors are in a strong position to fulfill their oversight role effectively. Let's modernize the regulatory regime to help them fulfill it as best they can.

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