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Directors and Officers

SEC Chair Outlines Expectations for Fund Directors

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By William V. de Cordova, *Hedge Fund Law Report*

The board of directors plays a central role in mitigating conflicts inherent in the relationship between a hedge fund and its manager. See "Conflicts Remain an Overarching Concern for the SEC's Asset Management Unit" (Mar. 12, 2015). In her keynote address at the Mutual Fund Directors Forum 2016 Policy Conference, SEC Chair Mary Jo White shared her view on the role of directors in assessing risks to mutual funds and conveyed her perspective on what fund directors should be considering and doing in 2016. Delivered to mutual fund directors, White's remarks also provide valuable guidance to hedge funds and other private investment funds as to SEC expectations for director oversight. Specifically, White suggested appropriate questions for fund directors to ask, explored the limits of director oversight and provided the enforcement perspective on fund directors. This article summarizes the portions of White's speech most relevant to hedge fund managers.

For more on hedge fund governance, see "Walkers Fundamentals Hedge Fund Seminar Addresses Fund Structuring Trends, Governance Best Practices, Fee and Liquidity Terms, Irish Vehicles, Marketing in Asia and FATCA" (Feb. 12, 2015); and "Former SEC Commissioner Roel Campos Discusses Hedge Fund Governance With Hedge Fund Law Report" (Mar. 8, 2012). For additional insight from White, see "SEC Chair Emphasizes Enforcement Focus on Strong Remedies and Individual Liability" (Nov. 12, 2015); "SEC Chair Highlights Two Types of Risks Hedge Fund Managers Must Consider" (Oct. 29, 2015); and "SEC Chair White Describes the SEC's Game Plan With Respect to the Asset Management Industry" (Dec. 18, 2014).

Appropriate Questions for Fund Directors to Ask

"As a director, it is incumbent upon you to consider what . . . risk areas could mean for your fund in the future," White said, outlining several recent events that resulted in operational harm to mutual funds. She argued that merely reacting to contingencies is insufficient in the current environment and markets; rather, "we all need to be proactively thinking ahead and planning."

As gatekeepers, directors must ask difficult questions when they do not understand, White explained, and they must also insist on full, complete and well-understood answers. Asking tough questions of fund management serves the following two goals:

1. Helping ensure that the fund is as prepared as possible; and
2. Keeping the directors informed as to how potential issues would be handled.

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White then enumerated several examples of issues worth raising, confirming or resolving, if necessary, for funds, beginning with some "obvious initial questions."

General Questions

First and foremost, directors should ask how the fund's and its service providers' compliance policies and procedures, business continuity plans and back-up systems address situations of potential risk. "If your funds and their service providers do not have robust plans and procedures, you have some urgent business to attend to," White argued.

However, simply having strong policies and procedures is not enough, she continued, because no continuity planning or compliance policies and procedures can address every issue and prevent all potential harm, no matter how thoughtful, comprehensive and well-intentioned they may be. Therefore, directors of funds must consider and ask fund managers whether those potential events could occur at the firm in question, how to prevent them from happening and how to respond promptly and effectively if they do occur.

White also recommended that directors move beyond generalities and ask specific questions.

Liquidity

"With respect to potential liquidity issues, boards should ask questions that will enable them to understand whether the funds' investments are appropriately aligned with their anticipated liquidity needs and redemption obligations," she advised. To do so, directors should consider the quality and frequency of information that the fund manager provides to the board, as well with how the manager monitors and manages liquidity risk.

In addition to examining the funds, White recommended that directors should ask themselves whether they understand the links that may exist between liquidity and valuation with respect to the funds they oversee and whether they are appropriately focused on funds with strategies more likely to face liquidity challenges. For example, in the mutual fund context, advisers and fund boards should consider whether an open-end fund's investments and investment strategy are appropriate for a fund offering daily redemptions.

Service Providers

Because funds rely on technology and third-party service providers for many key functions, the failure of just one of those functions can have serious consequences for the fund and its investors, White explained.

Consequently, in addition to simply asking service providers whether they have back-up plans, fund boards should ask several questions with respect to service providers, including the following:

1. Has fund management considered the back-up systems and redundancies of the critical service providers that value the fund; keep track of the fund's holdings and transactions; and strike the fund's net asset value?
2. Has fund management also considered specific alternate systems or work-arounds that may be necessary to continue operations or manage through potential business disruptions?

Cybersecurity

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Another critical risk faced by funds is cybersecurity, White said. Because funds rely so heavily on their computer networks, directors must carefully consider the risks posed to those networks.

"In our ever connected, ever more digitized world, cybersecurity is an area of the utmost importance," White argued, "and it is the shared responsibility of all regulators and market participants to safeguard the broader financial system, as well as particular funds, firms and other components of our market structure." Accordingly, in addition to the responsibility of funds and their advisers to employ robust cybersecurity prevention, detection and response plans, it is incumbent on independent directors to consider whether the funds and advisers are appropriately carrying out that responsibility.

White noted that the Investment Management Guidance Update on cybersecurity, issued by the SEC Division of Investment Management in April 2015, encourages funds to assess their ability to prevent, detect and respond to cyberattacks, detailing a number of measures that funds may consider. See "SEC Guidance Update Suggests a Three-Step Framework for Investment Manager Cybersecurity Programs" (May 7, 2015).

"These risks are not just theoretical ones . . . ," White explained, pointing out the SEC settlement with R.T. Jones Capital Equities Management, Inc. See "Investment Adviser Penalized for Weak Cyber Policies; OCIE Issues Investor Alert" (Oct. 1, 2015).

Director Expertise

Boards must broadly consider emerging problems and what issues they may be missing, White clarified. In doing so, directors need to consider whether the current board composition includes individuals with the necessary skills, experience and expertise, or whether subject matter experts should be hired as consultants. "As areas such as cybersecurity, derivatives, liquidity, trading, pricing and fund distribution become increasingly complex, boards need to [ensure] that they are equipped to address those challenges," she continued.

Applicability to Hedge Funds

"White focuses on operational risk," Roisin Addlestone, a principal at Carne Global Financial Services (Cayman) Limited (Carne), remarked to the Hedge Fund Law Report. "Independent directors on hedge fund boards already play an important role in helping to reduce operational risks by asking the right questions and providing informed, non-executive oversight. While there are still limits to the non-executive role, this should not deter directors from asking searching questions when they need to be asked."

"The regulated mutual fund space can often shine a light on issues that are key in the hedge fund space, and following the regulated space through the hedge fund lens is relevant," added Jennifer Collins, a director at Carne. "Many issues are consistent when safeguarding the investors' interests in both."

Collins noted that, like mutual funds, hedge funds also rely on service providers beyond the investment adviser for core services. In addition, managing liquidity for hedge funds can be an even greater risk than for mutual funds, given the broad investment universe they invest in, which often entails complex valuation risk. Finally, hedge funds frequently rely on technology, exposing them to cybersecurity risk as well.

"However, a key differentiator between hedge funds and mutual funds is the sophistication of the investors and what can be expected of them," Collins continued. "Hedge fund investors must ensure they or their advisers are sophisticated enough to interpret the information provided to

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them, as directors in the hedge fund space rely on the fact that terms are disclosed in the offering documents." Even if those terms are overly preferential to the adviser, the investor is deemed to have accepted them in return for access to the adviser.

Directors Are Responsible for Oversight – Not Management – of Funds

To balance her remarks on the expectations for fund directors, White clarified, "While I cannot overstate the importance of directors, especially independent fund directors, fully fulfilling their responsibilities to investors, it also is incumbent on regulators to avoid completely overloading directors with additional responsibilities, or confusing strong oversight with the management of a fund."

The fund's adviser is typically tasked with day-to-day management of a fund, and the fund's chief compliance officer is responsible for administering the fund's compliance policies and procedures. However, the board is meant to provide independent oversight of these and other critical functions, as well as to approve compliance policies and procedures (at least in the mutual fund context).

White acknowledged the need for the SEC to be sensitive to where a director's oversight responsibility could cross into day-to-day management, although determining an appropriate dividing line is challenging at times. She added that the SEC continues to grapple with this determination as it considers proposed reforms designed to address the increasingly complex portfolios and operations of mutual funds and exchange traded funds.

The SEC's recent rule proposals for the asset management industry reflect the importance of determining the role of the board in addressing funds' risks, White explained. Following the proposal in May 2015 for enhanced reporting for investment advisers and mutual funds, the SEC proposed liquidity risk management reforms in September 2015, including several requirements for a fund's board of directors. For more on the SEC's enhanced reporting proposal, see "A Roadmap to the SEC's Proposed Changes to Form ADV" (Jun. 4, 2015).

The proposed liquidity reforms would require a fund's board, including a majority of independent directors, to approve the fund's written liquidity risk management program and any material changes to the program; designate the fund's adviser or officers responsible for administering the program; and review annual reports on the effectiveness of the program, White clarified. In addition, the SEC approved a proposal in December regarding funds' use of derivatives, which includes an oversight role for fund directors.

"The board's oversight function and how directors can best serve as gatekeepers in protecting shareholder interests will remain a key focus for us at the SEC, as we move forward to address current risks in the asset management industry," White confirmed.

Although the above proposals apply to mutual funds, it is still important for hedge fund directors to pay attention to them. "Mutual funds in the U.S. are retail products whose investors need to be protected with regulation accordingly," commented Addlestone. Because hedge fund structures assume that investors are sophisticated or institutional, able to understand disclosures and risks involved, regulation is designed with a "lighter touch."

However, "independent directors in both types of fund act in a non-executive capacity, relying on monitoring and oversight to discharge their duties, rather than being involved in day-to-day management," Addlestone continued. "With that in mind, it is useful for proactive hedge fund

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directors to keep abreast of regulations and recommendations of best practice in the mutual fund space, as a version of the obligation or best practice may evolve in the hedge fund space to ensure that we are also safeguarding shareholder interests in that space too."

The Enforcement Perspective on Fund Directors

White also addressed the enforcement perspective on fund directors, beginning by emphasizing that most fund directors exercise their responsibilities effectively, performing their oversight role with diligence and skill. "And those directors should not fear enforcement, as judgments that directors make in good faith based on responsibly performing their duties will not be second guessed," she avowed.

However, she warned that, in light of their important role as gatekeepers, being a director does not provide immunity from charges. "When directors fail to perform their duties, they should expect action to punish and deter such conduct," she argued.

Two cases brought after White became Chair illustrate areas where directors can fall short, as in both, the directors in question failed to perform their responsibilities. In the first example, the directors delegated a statutory responsibility to the funds' investment adviser without following up to confirm the adviser was carrying out that responsibility, and in the second, the directors failed to obtain or clarify critical information before taking action on behalf of the fund.

While some have argued that the SEC acted too aggressively in pursuing action against the fund directors in the above cases, White disagreed, claiming that "a careful review of the facts involved should reassure conscientious directors. The message of these cases is that independent directors must be familiar with and carry out their responsibilities."

White postulated that most directors do their jobs, listing actions that would indicate the fulfillment of a director's duties:

- Carefully reviewing briefing materials they receive;
- Asking questions instead of rubber-stamping management recommendations;
- Investigating potential inaccuracies;
- Following up on unfulfilled requests;
- Ensuring that proper procedures are followed; and
- Confirming that investors' interests are served.

White stressed that the SEC's enforcement cases, while rare, serve to ensure that the above responsibilities are fulfilled.

For similar arguments about the liability of fund chief compliance officers, see "SEC Enforcement Director Assures CCOs They Need Not Fear SEC Action Absent Wrongdoing" (Nov. 19, 2015). See also "SEC Commissioner Speaks Out Against Trend Toward Strict Liability for Compliance Personnel" (Jun. 25, 2015); "SEC Commissioner Issues Statement Supporting Hedge Fund Manager Chief Compliance Officers" (Jul. 16, 2015); and "Commissioner Gallagher's Dissent in SEC Enforcement Action Against Hedge Fund Manager Misses the Mark" (Jul. 30, 2015).

"The key takeaway from White's speech is that directors should not be afraid to ask questions to ensure they understand the big picture for the product's operational and investment risks," Collins said, "but on the flip side, regulators (and investors) need to remember the directors are non-executive and manage their expectations of the level of involvement accordingly."

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White's complete speech may be found here.

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