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INVESTMENT COMPANY PERFORMANCE: THE BOARD'S OVERSIGHT ROLE

Mutual fund directors are entrusted with the critical task of overseeing fund performance. In the course of its oversight, a board of directors typically meets periodically with portfolio managers, reviews detailed reports of investment performance, and may utilize watch or focus lists for underperforming funds. The authors discuss the law and practice surrounding performance oversight, including potential action steps in the event of persistent underperformance.

By Rose F. DiMartino and Ryan P. Brizek *

Anyone who has seen an agenda for a mutual fund board meeting recently or has scanned the hundreds (in some cases, thousands) of pages of materials provided as part of a regular fund board meeting knows that boards of mutual funds and other registered investment companies regularly monitor a wide array of matters relating to the funds they oversee. While many of those matters are important, fund performance is clearly among the most important. For fund shareholders, fund performance is the measure of whether the fund is achieving its objective and the financial goal for which shareholders invested their dollars. Recognizing this, fund directors routinely review fund performance – and not just as part of the annual advisory contract approval process.

This article focuses on a fund board's duty to oversee fund performance and identifies actions boards can and do take to address underperformance. Recently, SEC chair Mary Jo White called mutual fund directors "gatekeepers" and said that the SEC is "focusing on deficient gatekeepers – pursuing those who should be serving as the neighborhood watch, but who fail to do their jobs." Chair White's comments did not relate to the board's performance oversight role. Nevertheless, it is critical that mutual fund directors fulfill all of their fiduciary responsibilities to avoid running afoul of regulators. But, more important, effective board oversight of fund performance can help assure that funds enable investors to achieve the financial goals that prompted their investment in the first place.

BOARD RESPONSIBILITY TO OVERSEE FUND PERFORMANCE

Boards oversee fund operations, but delegate day-to-day management to others, such as fund officers and third-party service providers. When day-to-day management is properly delegated, delegation requires continuing board oversight.[1] The oversight

[1] *See, e.g.,* In the Matter of Northern Lights Compliance Services, LLC; Gemini Fund Services, LLC; Michael Miola; Lester M.

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responsibility of directors is grounded in state law and the Investment Company Act of 1940, as amended (the "1940 Act").

State Law

Responsibilities of fund directors arise under the law of the state where the fund is formed or organized.[2] Although the applicable state laws governing some funds set forth the duties of directors, in other states the duties of directors have largely been delineated by court cases. While there are certain variations from state to state, these statutory provisions and cases delineate two basic duties under corporate law, traditionally referred to as the duty of care[3] and the duty of loyalty.[4] The board's responsibility to oversee fund performance can be thought of as an aspect of the general duty of care, although there is no specific state law obligation of which we are aware for a board to attend to whether the fund's investment operations are being appropriately carried out.

In exercising their performance oversight role, as in other areas under their purview, directors are protected by what is often referred to as the business judgment rule. The business judgment rule is a presumption that in making a business decision, directors acted on an informed basis, in good faith, and in the honest belief that the action taken was in the best interests of the company.[5] The effect of the rule is that a determination by a board would not be second-guessed by a court absent a showing that the board did not act in the best interests of a fund in a conscientious manner, or was ill informed or conflicted in its duty to the fund. In overseeing fund performance, boards typically are well informed, receiving regular comparative peer and index performance information relevant to their review on a fund-by-fund basis, and often enhancing the information reviewed over time in light of their experience with the nature of a fund and other relevant factors.

Investment Company Act of 1940

The board's duty encompassing fund performance oversight is particularized in Section 15(c) of the 1940 Act. While it is not the subject of this article, it is impossible to discuss the board's performance oversight responsibility without at least mentioning the board's statutory obligations under Section 15(c) to approve each advisory agreement and to consider its continuation annually. It is important to emphasize that, despite its Section 15(c) obligation, a board's duty to oversee fund performance is not a responsibility to be exercised just once per year. In fact, boards typically devote

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Bryan; Anthony J. Hertl; Gary W. Lanzen; and Mark H. Taylor, SEC Release No. IC-30502 (May 2, 2013); In the Matter of J. Kenneth Alderman, CPA; Jack R. Blair; Albert C. Johnson, CPA; James Stillman R. McFadden; Allen B. Morgan Jr.; W. Randall Pittman, CPA; Mary S. Stone, CPA; and Archie E. Willis III, SEC Release No. IC-30557 (Jun. 13, 2013).

[2] Most registered investment companies are organized under Delaware law as statutory trusts, Maryland law as corporations or statutory trusts, or Massachusetts law as business trusts.

[3] The duty of care requires directors to act with reasonable care and skill in light of their actual knowledge and any knowledge they should have obtained in functioning as directors. Generally, however, directors are held not to be "insurers" and will not be found liable for losses resulting from mere errors of judgment where reasonable care, diligence, and good faith have been exercised. *See, e.g., Briggs v. Spaulding*, 141 U.S. 132 (1891). Reasonable reliance on others, including counsel, accountants, or other experts, is generally permissible. *See, e.g.*, Md. Code Ann., Corps. & Ass'ns § 2-405.1(b) (LexisNexis 2013).

[4] The duty of loyalty means that, as a fiduciary, a director owes a duty to protect the best interests of the company and not pursue his or her own interests or those of a third party – such as the adviser – over the interests of the company. *See, e.g., Guth v. Loft, Inc.*, 5 A.2d 503 (Del. 1939); *Guttman v. Huang*, 823 A.2d 492 (Del. Ch. 2003). The duty of loyalty also encompasses the duty to act in good faith. *See, e.g., In re Walt Disney Co. Derivative Litigation*, 906 A.2d 27 (Del. 2006); *Stone v. Ritter*,

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911 A.2d 362 (Del. 2006); *Lyondell Chemical Co. v. Ryan*, 970 A.2d 235 (Del. 2009).

[5] *See Aronson v. Lewis*, 473 A.2d 805 (Del. 1984); *see also Gagliardi v. Trifoods Int'l Inc.*, 683 A.2d 1049 (Del. Ch. 1996).

substantial time at each regular meeting to fund performance.

Under the 1940 Act, a fund's advisory (and subadvisory) contracts must be approved initially and, after an initial two-year period, annually reapproved by a majority of (i) the entire fund board and (ii) the directors of the fund who are not parties to such contract or "interested persons" of the fund within the meaning of Section 2(a)(19) of the 1940 Act (the "Independent Directors"); the directors' votes must be cast in person at a meeting called for that purpose.[6] Under the 1940 Act, the directors of a fund have a duty to request and evaluate, and the investment adviser to such fund has a duty to furnish, such information as may reasonably be necessary to evaluate the terms of any contract whereby a person undertakes regularly to serve or act as investment adviser of such fund.[7] This approval and reapproval process – colloquially referred to as the "15(c) process" – typically involves board review and consideration of a detailed report of investment performance generated by an independent third-party service. The detailed report would show the fund's performance in relation to peer funds and the fund's benchmark over various time periods. Other performance measures may also be provided to the board for its review and consideration, such as risk measures and comparisons with other accounts managed by the adviser.

When a fund is managed with a mandate or in a manner that differs from other funds in the "peer" group provided by the third-party service, the board may review customized peer data developed in conjunction with the fund's adviser or administrator. For example, for certain funds employing more novel investment strategies, such as low volatility funds or funds employing liquid alternative strategies, the standard peer fund data provided by a third party may not give an entirely meaningful performance comparison, as third-party services sometimes lump these funds together with funds that are not managed in a similar way. While fund boards are often loathe to completely disregard objective third-party peer data and embark on a more subjective analysis tailored to particular funds, the fuller perspective that the second analysis provides may be a necessary complement in order to fairly evaluate a fund's performance.

[6] *See* Section 15(c) of the 1940 Act.

[7] *Id.*

DISCLOSURE OF THE BOARD'S DELIBERATIVE PROCESS AND CONCLUSIONS

Shareholder Reports

With the 2004 amendments to Form N-1A, the board's deliberative process in considering the approval and continuation of advisory (and subadvisory) agreements came into public view.[8] Form N-1A requires that disclosure regarding the factors the board considered when approving or reapproving an advisory fee or subadvisory fee must be included in the fund's next annual or semiannual report to shareholders following the approval or reapproval.[9] If the performance of the fund was not considered "relevant" to the board's conclusions, this must be noted and the reason for this position must be explained.[10]

Understandably, there tends to be some sensitivity around making public disclosure of a board's approval of the continuation of an advisory agreement when the fund significantly underperformed in relation to appropriate peers and benchmarks for a sustained period. In these situations, boards may work with advisers to identify and implement some of the types of concrete actions to address underperformance as described below.

Board Minutes

No specific disclosure requirements dictate the contents of the portion of minutes of regular board meetings where performance is discussed. For the annual advisory contract review, minutes are typically

[8] *See* Disclosure Regarding Approval of Investment Advisory Contracts by Directors of Investment Companies, SEC Release IC-26486 (June 23, 2004).

[9] Form N-1A, Item 27(d)(6) ("Factors relating to both the board's selection of the investment adviser and approval of the advisory fee, and any other amounts to be paid by the Fund under the contract . . . would include, but not be limited to, a discussion of the nature, extent, and quality of the services to be provided by the investment adviser; the investment performance of the Fund and the investment adviser; the costs of the services to be provided and profits to be realized by the investment adviser and its affiliates from the relationship with the Fund; the extent to which economies of scale would be realized as the Fund grows; and whether fee levels reflect these economies of scale for the benefit of Fund investors."); *see also Jones v. Harris Associates, L.P.*, 559 U.S. 335 (2010); *Gartenberg v. Merrill Lynch Asset Management, Inc.*, 694 F.2d 923 (2d Cir. 1982), *cert. denied*, 461 U.S. 906 (1983).

[10] Form N-1A, Item 27(d)(6), Instruction 3.

carefully crafted by counsel to address the factors the board considered in determining to continue the contract. Often the disclosure in the minutes of the 15(c) meeting is used almost verbatim in the fund's shareholder report disclosure. For board meetings other than 15(c) meetings, our experience is that the performance portion of the minutes varies widely, from a detailed recitation of the portfolio manager's presentation and investment outlook to a more streamlined approach that notes that a report was given and that a discussion of the report ensued.

In a recent SEC action, fund board members, including the Independent Directors, were held liable for causing the fund to violate Rule 38a-1 under the 1940 Act by failing to assure that minutes summarizing the 15(c) process were accurate.[11] In *Northern Lights*, the fund board minutes were prepared by the fund's administrator and reviewed by inside and outside counsel prior to board approval. Nonetheless, certain materials referenced in the minutes and the related shareholder reports as provided to the board were, in fact, not provided. This may suggest caution in drafting minutes related to fund performance either in the 15(c) meeting or at regular board meetings. However, when fund performance is challenged, boards may wish to consider minutes that reflect that the board members, as fiduciaries, inquired about the factors contributing to the underperformance and that record, for future follow-up, any course of action arising from the discussion. Obviously, minutes addressing performance issues should be carefully drafted with the advice of counsel and thoughtfully considered by the board prior to approval.

MEETINGS WITH PORTFOLIO MANAGERS AND USE OF WATCH LISTS

Performance oversight should not be a once-a-year task for fund boards. And it usually is not. Fund boards typically review the performance of all or some of the funds they oversee at each board meeting and periodically meet with fund portfolio managers. In a small fund complex, the board may meet with the portfolio manager of each fund at each meeting. For larger fund complexes and those using multiple subadvisers, meeting time constraints may not permit a board to meet with each portfolio management team at each meeting, even where the board has organized itself into multiple investment committees and increased the number of board and committee meetings. In these cases, it is common for a rotation to be created so that each portfolio management team is met with over a period of time, the frequency varying with the number of managers, funds, and meetings. When a fund's performance is challenged, it would be within the board's prerogative to meet with the fund's portfolio manager out of sequence or to increase the frequency of meetings with the portfolio manager.

To aid in their review of performance, fund boards typically review performance compared to a fund's peers and benchmark, using third-party data. As noted above, customized comparisons can also be presented when this third-party data is not considered to provide a meaningful comparison, such as when a particular fund's strategy is unique among its "peers." Many boards go beyond peer and benchmark comparisons as a means of assessing performance. Attribution analyses, showing the factors contributing to and detracting from performance on a more granular level, and risk metrics such as standard deviation, are used by many boards. Whatever the tools used to analyze performance, when a fund is considered to have subpar performance, boards of larger fund complexes often create a "watch" or "focus" list. While the criteria used to identify candidates for the list can vary, the purpose of the list is to isolate funds that warrant enhanced board attention. Often the reason relates to underperformance relative to a benchmark or peer group. Smaller fund complexes may not experience a need to create a watch list, being able to more easily monitor underperforming funds.

ACTION STEPS FOR PERSISTENT UNDERPERFORMANCE

Underperformance of a fund in relation to its peer group and benchmark is not surprising or necessarily a cause for alarm. For example, a portfolio manager's style may be out of favor in comparison with the fund's peer group (e.g., a "deep" value manager underperforming compared to other value managers). The board's inquiry into underperformance begins with a dialogue with the adviser or, if relevant, subadviser to identify the causes of the underperformance. It may be that, after inquiry, the board is comfortable that the fund's performance is consistent with its public disclosures and the way the portfolio manager would expect the fund to perform in the particular market environment. Depending on the reason for the underperformance, however, as well as its persistence and severity, it may be appropriate to consider actions to address it. Any action typically is the result of further dialogue between the board and the adviser (or subadviser), including the adviser's chief investment officer or the fund's portfolio managers, over a period of time. For most fund investment strategies, one or two

[11] *Northern Lights, supra* note 1.

quarters of underperformance would not provide a sufficient basis for evaluation.

In certain instances, a fund's underperformance in relation to a peer group or benchmark may indicate that the fund is being compared to the wrong peers and/or benchmark, and that the appropriate action is to modify or refine the peer group or benchmark. For example, with the recent proliferation of so-called liquid alternative funds, third-party data aggregators have had to try to catch up to industry developments. When a particular alternative strategy is launched in registered investment company format, there may be few other registered investment companies implementing the same strategy. In such an instance, a third-party data aggregator may simply include the fund in a more traditional fund category, which can lead to inapt comparisons. If a particular strategy proliferates, a third-party data aggregator may create a more useful peer group, as has occurred for long-short funds. In the interim, boards and advisers may create customized peer groups and/or benchmarks to provide a more useful gauge against which to measure fund performance. The use of this customized data would be expected to be referenced along with the third-party data in the 15(c) shareholder report disclosure.

In many respects, the board's and the adviser's interests in addressing underperformance are aligned, as persistent underperformance usually results in cash outflows, which reduce the adviser's management fee. Given this, board discussions with the adviser (or subadviser), perhaps at times involving a bit of prodding, usually result in recommendations from the adviser to address performance issues. In attempting to address such issues, a board should consider what action is most likely to result in improved performance. The goal is not to punish the adviser, or dictate how the adviser's business should be run or what personnel decisions the adviser should make, but rather to put the fund in a position that is more likely to result in improved performance.

Temporary Fee Reduction

In the face of sustained underperformance, a board and an adviser may agree to put a short-term fee reduction or fee waiver in place until performance improves. In considering this option, boards may wish to consider that underperformance often leads to increased redemptions resulting in lower assets on which the adviser's advisory fee is based, thereby having a financial impact on the adviser. Also, reducing the fee to the adviser, even temporarily, may be counterproductive, reducing the resources available to the adviser to devote to improving performance. If a fee waiver is chosen, it does not require shareholder approval to implement, although it may be reported as part of the 15(c) shareholder disclosure. Board approval normally would be sought and the fund may want to voluntarily disclose the fee waiver. To reflect a fee waiver in a fund's prospectus fee table, the waiver must be pursuant to a written contract between the fund and the adviser, and have a duration of at least one year.

Portfolio Manager Changes

A not uncommon action taken to address persistent underperformance is for the adviser to replace the portfolio manager(s) assigned to the fund or enhance the portfolio management team by adding additional portfolio managers or analytic resources. Changes in the portfolio management team may cause a rethinking of and consequent changes to the fund's investment strategy. Both portfolio manager changes and any material strategy changes require public disclosure, typically in the form of a supplement to the fund's prospectus. Changes of fundamental investment policies or restrictions require shareholder approval.

Subadviser Changes

If one or more affiliated or unaffiliated subadvisers are responsible for the underperformance, a solution may be to replace the underperforming subadviser with a new subadviser. This action is akin to replacing a portfolio manager; however, there can be more onerous regulatory consequences and higher costs of doing so. If the fund does not have a manager-of-managers exemptive order, then shareholder approval would generally be required to replace the subadviser, with all the attendant costs.[12]

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[12] A manager-of-managers exemptive order permits funds to replace unaffiliated subadvisers without seeking shareholder approval of the change, subject to certain conditions. *See, e.g.,* Equinox Funds Trust, et al., SEC Release IC-30673 (Aug. 23, 2013) (notice), SEC Release IC-30691 (Sept. 19, 2013) (order); Goldman Sachs Trust II, et al., SEC Release IC-30496 (Apr. 29, 2013) (notice), SEC Release IC-30542 (May 29, 2013) (order). Some manager-of-managers exemptive orders also permit funds to replace wholly owned subadvisers without seeking shareholder approval, subject to certain conditions. *See, e.g.,* Franklin Templeton International Trust, et al., SEC Release IC-30679 (Aug. 27, 2013) (notice), SEC Release IC-30698 (September 24, 2013) (order); Munder Series Trust, et al., SEC Release IC-30441 (Mar. 29, 2013) (notice), SEC Release IC-30493 (Apr. 24, 2013) (order). Under certain circumstances arising outside of a manager-of-managers exemptive order context, shareholder approval also may not be required. *See, e.g.*, Wells Fargo Bank, N.A., SEC

If the fund has a manager-of-managers order, it would be required to notify shareholders of the change using a document that is similar in content to a proxy statement, which could involve significant costs to prepare, print, and mail. Despite the costs of changing subadvisers, such a change could stem ongoing redemptions and reverse the performance issues the fund had been facing.

Reorganizations and Liquidations

At times, due to persistent significant underperformance, the board in consultation with the adviser may determine that the only viable course of action is to terminate the fund. This can be accomplished either by liquidating it or reorganizing it into another fund, each with differing tax consequences to shareholders. While it is beyond the scope of this article to discuss the pros and cons of either approach, suffice it to say that fund reorganizations and liquidations are actions to be taken only after other options are carefully evaluated. Nonetheless, fund reorganizations and liquidations are not unusual as a way to deal with an underperforming fund, particularly where the fund has not garnered or retained sufficient assets to remain economically viable. Reorganizing an underperforming fund into another fund within the same complex maintains the assets within the fund complex while typically offering investors an option with a better performance record. Fund reorganizations require board approval and may require shareholder approval.[13] In the alternative, a fund board may determine to liquidate the underperforming fund, which may require shareholder approval depending on the fund's organizational documents and state law, and return the proceeds from the liquidation to the fund's remaining investors.

Termination of Adviser

A drastic action to address sustained underperformance would be to change advisers by terminating the fund's contract with its current adviser and hiring a new adviser. Under Section 15(a) of the 1940 Act, advisory contracts must be terminable without penalty upon 60 days' written notice to the investment adviser.[14] Board approval of the termination of the advisory contract with the current adviser is required, and board and shareholder approval of the new advisory contract with the replacement adviser would be required. This option is logistically hard to implement for a single series of a registered investment company without merging the series into a new fund managed by the replacement adviser. Apart from the logistical difficulties, a decision to change advisers is a rare occurrence. Usually, one or more of the other actions described above appropriately addresses the situation, or an adviser may retain a subadviser to provide additional fund management resources. When a smaller-sized fund experiences subpar performance, liquidation or reorganization tends to be the preferred option for a number of reasons, including the costs of transferring the advisory contract of a smaller-sized fund, which may be prohibitive, and the difficulty of finding a replacement adviser.

CONCLUSION

Oversight of fund performance is one of the more critical tasks entrusted to directors. Performance oversight has never been a simple task. If anything, it is becoming increasingly difficult as more complicated strategies using more sophisticated instruments proliferate. Directors are devoting more time to understanding novel fund strategies and the related drivers of fund performance. The time and effort spent by directors on performance matters both at and between board meetings is not likely to decrease, as boards continue to try to assure that funds are meeting investors' goals and expectations. ■

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No-Action Letter (Mar. 31, 1998); s*ee also* Rule 2a-6 under the 1940 Act.

[13] Rule 17a-8 under the 1940 Act and applicable state law.

[14] Section 15(a)(3) of the 1940 Act.