Audit Committee Institute Mutual Funds Program

Program recap

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What mutual fund board members need to know to protect themselves—and fund shareholders

Cybersecurity risks. Business model disruptions. Valuation questions. Regulatory and compliance complexities. Tax reform fallout. All of these issues impact mutual funds and the individuals who sit on their boards of directors.

These were among the topics addressed at KPMG's Audit Committee Institute Mutual Funds Program in New York City, which took place in January 2018. The speakers and panelists, which included mutual fund board members, and an attorney who advises numerous mutual funds, and KPMG professionals, offered observations, insights, forecasts, and advice regarding the challenges facing mutual funds and their boards.

This report offers a recap of the program:

I. What's going on at the SEC?

Moderator: Matt Giordano, Deputy Lead Audit Partner for the Public Investment Management Practice, KPMG

Panelist: Andrew (Buddy) Donohue, Of Counsel, Shearman & Sterling LLP

In the first program segment, Matt Giordano, KPMG Partner and formerly the chief accountant of the Division of Investment Management at the SEC, conducted a "fireside chat" with Andrew (Buddy) Donohue, who served as director of the SEC's Division of Investment Management (June 2006–November 2010) and chief of staff under former SEC chair Mary Jo White (May 2015–January 2017). Donohue has also served on the boards of business development companies, and registered open-end funds, closed-end funds, Cayman funds, and UCITS based in Dublin and Luxembourg. He was recently appointed to the board of the OppenheimerFunds.

SEC shifting direction

With a new administration, SEC chairman (Jay Clayton), and director of Investment Management (Dalia Blass), it should come as no surprise that there appears to be a shift in the SEC's direction. When taken together with the potential repeal of some sections of Dodd-Frank sought by the administration, Donohue observed that there seems to be a move toward simplification and deregulation.

Accordingly, we may see new rules regarding exchange traded funds (ETFs), variable annuities, and summary prospectuses and some simplification of filing requirements, as well as a review and reassessment of board directors' responsibilities. What's more, some initiatives that have been priorities under Mary Jo White's tenure—like the derivatives rule, third-party assessments for investment advisers, and the adviser business continuity and transition rules—have either been completely eliminated from the rulemaking agenda or moved to long-term agenda items.

Donohue also touched on some key issues that mutual fund boards should be focusing on, including cybersecurity, valuations, fees, disruptions as a result of technology innovations, and fiduciary duties.

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Cybersecurity: Mutual funds—and their boards—should be concerned about safeguarding investor information and other critical data regarding the fund and its shareholders. Cybersecurity is one of the few areas where the SEC has levied fines for failure to have adequate policies and procedures in place even though there was *no* actual loss of investor data.

While the board is not responsible for overseeing day-to-day issues and operations, it is charged with oversight and should, at a minimum, question management, including the chief information officer (CIO) and/or chief information security officer (CISO), regarding the effectiveness of the fund's internal cybersecurity risk programs. The board should also inquire whether the fund's service providers are offering the same protection. For example, it should be asking whether effective policies and procedures are in place, if the right people will be notified in the event of a breach, and what actions will be taken to mitigate the breach.

Fees: The board's focus should be on obtaining value and quality for the services the fund gets from third-party providers, including the investment adviser. Getting the appropriate price is important, but the board should also ensure that the service providers, including the investment adviser, will devote the resources needed to properly manage the affairs of the fund for which they are responsible and deal with issues effectively as they arise.

Fiduciary duty: Donohue was somewhat cautious about the changes that may be made to rules regarding a financial adviser's fiduciary duties. He observed that because the SEC's fiduciary rules interact with numerous federal and state laws and regulations that exist in the adviser space, it will be somewhat challenging to harmonize everything.

His parting advice to board members was that they should "worry about what they don't know" and take the time and effort to continue learning and exploring the landscape. "When you know that there's something to worry about, you can at least take steps to address it," he stated. "But it's the things you don't see coming that can really hurt your fund and your shareholders."

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II. Tax reform impact on mutual funds? No harm, no foul

Presenter: Deanna Flores, Tax Principal, KPMG

Deanna Flores discussed the impact of tax reform on mutual funds and the fund industry. She indicated that, for the most part, the mutual fund industry emerged in good shape, and that many of the changes that were feared did not come to pass. For example:

- Retirement plan rules largely remained unchanged. For example, the new law did not require mandatory Roth treatment of plan contributions.
- Municipal bonds retained their tax-exempt status (for the most part), although the tax preference for municipal bond funds may not be as valuable due to the reduction in the top tax rates (i.e., the delta between the tax rate for taxable income and tax-exempt income is not as large).
- There was no reform of the derivatives taxation.
- A mandatory FIFO (first-in, first-out) rule for sales of securities was not enacted.

She also covered tax law changes that might impact certain segments of the mutual fund industry. For example, individuals can take a 20 percent deduction for certain business income, which includes qualified REIT dividends. As a result, individual investors are now better off buying a REIT directly rather than as part of a mutual fund that invests in REITs; dividends from the mutual fund do not qualify for the 20 percent deduction. Not surprisingly, mutual fund and REIT industry groups are seeking regulatory guidance that would extend comparable treatment to qualified dividends from mutual funds that invest in REITs.

Mutual funds that invest globally may be impacted by the new tax law's treatment of foreign earnings and investment. That is, the tax law limits or eliminates the tax incentives for companies holding or sending earnings offshore in order to defer tax.

Because of these and other tax law changes, Flores suggested that mutual funds—and their boards—review their financial statement disclosures. They need to satisfy themselves that the disclosure language adequately puts investors on notice that their fund holdings may be subject to new taxable income or other requirements due to tax reform.

Upcoming changes? The law was enacted in record time; it took less than two months from the bill's introduction in Congress to it being signed into law. As a result, observed Flores, there are provisions that may need correction and/or are unclear and need clarification. But in light of the political turmoil in Washington, do not expect to see these corrections or clarifications to the new law any time soon. It will likely take the Treasury Department and Internal Revenue Service some time to issue guidance regarding the new law.

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III. Guarding against cybersecurity risks

Presenter: Glenn Siriano, Cyber Investigations Principal, KPMG

It is no longer a matter of **if** your mutual fund firm will be hit with a cyber attack. Rather, it is a question of **when** it will be attacked and **what** you will do about it.

According to Glenn Siriano, that is why cyber risk is at or near the top of the list of concerns for most mutual fund boards. They know that investors, governments, and global regulators are increasingly demanding board members to demonstrate diligence and expertise in this area and are expecting personal information to be protected and systems to be resilient against cyber attacks.

Siriano briefly reviewed the evolution of cyber attackers from "recreational" hackers living in their basements to the current and far more sophisticated, well-funded, and dangerous organized crime and state-sponsored cyber attackers. What's more, there is a growing number of domestic and international cybersecurity and privacy laws that mutual funds need to be aware of and comply with.

He then offered a number of security frameworks that mutual funds and their boards may want to consider. These frameworks can enable them to build a systematic set of controls that may help prevent cyber attacks, or at least mitigate the damage they can cause.

Taking a layered approach: Cybersecurity must involve all aspects of a mutual fund's organization, including legal and compliance, leadership and governance, human factors, information risk management, business continuity and crisis management, and operations and technology. And the board must exercise oversight over this framework.

Siriano noted that most boards are advised on cybersecurity matters by their chief security officers (CSO) and/or chief information officer (CIO). They are obligated to question the CSO or CIO and not simply accept what they are being told. Pertinent questions to ask might include:

— Is our cybersecurity program adequately funded?

— Do we have the right tools, technology, and people in place?

— How are we training people in our organization and making them aware of the cyber threat environment?

— Does our cybersecurity framework comply with regulations and standards recognized in the United States and internationally? And do we measure and self-assess ourselves against those regulations and standards?

Siriano also suggested that board members ask about the types of key performance indicators (KPIs) used to measure the effectiveness of their organization's cybersecurity program, and confirm that they are the appropriate ones to use. For example, he pointed out that reporting on the number of attempts made to hack a firm's firewall may be a meaningless statistic. What's more important are KPIs showing how cyber risk has been reduced over time or that highlight areas where more attention is needed to reduce risk.

As a best practice, many boards participate in "tabletop" exercises that simulate a data breach. This can help prepare a mutual fund organization in the event of an actual breach. By going through the process of detecting a breach, attempting to contain it, escalating the issue to the right people, and so on, the board can learn where cybersecurity works or needs to be bolstered.

Siriano concluded by suggesting that mutual fund boards obtain a cybersecurity maturity assessment. This can be done internally by the fund's cybersecurity team, although many firms find that it may be more effective having it performed by an independent third party, such as KPMG.

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IV. Board member experiences and observations

Moderator, Matt Giordano, Deputy Lead Audit Partner for the Public Investment Management Practice, KPMG

Panelists: Jerry Maginnis, Cohen & Steers; Margery Neale, Partner and Cochair of the Asset Management Group of Willkie Farr & Gallagher; Robert Troccoli, Invesco Funds

The last segment of the conference was a wide-ranging discussion featuring two retired KPMG partners, Jerry Maginnis and Robert Troccoli, who are now serving on mutual fund boards, and Margery Neale, who acts as legal counsel to several boards. The panelists addressed some of the hot topics raised earlier in the program, like cyber risks and deregulation, and also offered observations and advice regarding board operations and the challenges that board members face.

Board member challenges: Maginnis noted that as a new board member, one of his biggest challenges was simply getting to know the players; for example, the management team of the adviser, legal counsel to the independent directors, fellow board members, and third-party service providers to the funds. He added that it is important to learn the landscape in terms of risk, culture, and understanding the funds and their investment philosophy.

"There's a delicate balance between taking the time to listen and learn, but also not being afraid to ask questions," stated Maginnis.

Troccoli observed that many boards are seeking to become more diverse, both in terms of gender and/or ethnicity while still maintaining the highest standards of quality.

Succession planning is another area that boards have to deal with. The panelists agreed that the best practice here is to start early; in some cases, it may be advisable to begin the process a few years before a scheduled retirement comes up.

Neale said that as part of the recruitment process, many boards have a matrix identifying the skill sets and expertise they are looking for. But it can take quite a bit of time to find the right person. Depending on the size of the board, it can easily take many months for the candidate to meet with all of the appropriate stakeholders and then go through the due diligence process to make sure there are no conflicts or other issues.

Areas of focus: All of the panelists acknowledged that cyber risk is a current area of focus. Troccoli echoed what Siriano had mentioned earlier; that it is important to ask the right questions and make sure the organization has the right security people in place. A good way to accomplish this is to have the fund's chief security officer and/or chief information security officer present to the full board periodically and encourage board members to ask questions. Another suggestion is to have the board take a tour of the cyber operations room and talk to the personnel there about what they do. Neale offered the reminder that, as with other operational risks, the mutual fund board's role is one of oversight.

Maginnis added that mutual funds also need to be aware of and address the cyber risks presented by the many vendors, third parties, and service providers they deal with.

A board's valuation responsibilities was another area of focus. Maginnis stated that he would like to see more specific guidance from the SEC staff on the role of mutual fund directors in connection with fair valuation practices, but he was not optimistic we would be getting any in the near future. He observed that it would be very challenging to develop useful, specific, and detailed rules that could be broadly applied to many different situations.

Accordingly, he advised board members to ask questions that would enable them to better understand the logic behind valuation conclusions. For example, he noted that it was important to understand the fund's valuation policies and the controls that are in place. What's more, when markets get choppy, he suggested that boards may want to be more involved in questioning and understanding the basis of valuation conclusions.

Neale expressed cautious optimism about the new SEC administration's willingness to offer some relief to the regulatory burden on mutual fund board members, possibly with respect to valuation responsibilities (and several other areas where board oversight has become somewhat administrative, including the use of 12b-1 fees). But until such time as that occurs, she observed that, depending on the type of assets involved, getting independent, third-party advice regarding valuation inputs and techniques could be a useful part of the process.

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Final thoughts

Significant changes have taken place in the mutual funds industry over the past several years. Margins are under pressure, and investors are driving funds to provide higher levels of service for lower fees. Technology and regulatory changes abound, and the threat of cyber attacks and disruption continues to grow.

The industry needs to adopt more efficient operating models and become more digital because that is how investors, partners, and stakeholders are communicating with each other. There is a need to invest in innovative technology, upgrade cybersecurity risk protection programs, and stay in front of domestic and global tax and regulatory developments.

Forums like the Audit Committee Institute Mutual Funds Program are designed to educate mutual fund board members and broaden their awareness of issues concerning the industry. They also offer a setting where board members can share experiences, insights, and leading practices. By talking to other board members and assorted professionals with knowledge in relevant subjects, participants may find an approach that can help benefit their organizations and protect their investors.

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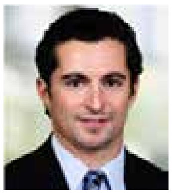

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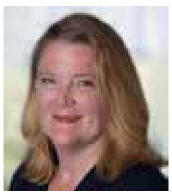

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