Independent Directors: in the SEC's crosshairs?

A look at the regulator's expectations and how directors can make sure they responsibly perform their duties and otherwise try to avoid enforcement

By Lea Anne Copenhefer and Roger Joseph

Are independent directors in the Securities and Exchange Commission's crosshairs? When the SEC concludes that independent directors have not done their job properly, we think the answer to that question is yes, whether or not shareholders have been harmed.

The case against the independent directors of the Morgan Keegan Funds is a few years old at this point, but it represents a bit of a sea change. In that case, the SEC alleged that the directors had failed to fulfill their responsibilities with respect to valuation of fund investments. In settling the case with the directors, the SEC found that the directors had failed to adopt reasonably designed policies and procedures relating to fair valuation. It is notable that the SEC pursued the directors even after charging the funds' adviser with fraud, meaning it is likely even the directors were deceived. The SEC made no finding that the directors had not themselves acted in good faith — that is, in the belief that their actions were proper and in the best interests of the fund and its shareholders. At the end of the day, the SEC asserted, the directors simply got the funds' valuation procedures wrong.

In the Morgan Keegan matter there was no doubt that the funds' valuation deficiencies resulted in harm to shareholders, especially those who stayed in the funds and bore the full brunt of losses while other shareholders were able to redeem at inflated prices.

But harm to shareholders has not been a predicate for enforcement action against directors. In one recent case, the SEC settled a proceeding against a fund director who failed to disclose a business relationship with an affiliate of the fund's auditors apparently in the mistaken belief that the auditor and the firm with which he had a relationship were sufficiently separate from each other. The SEC made no showing, or indeed even any assertion, that this issue affected the fund's audit in any way or caused the fund's financial statements to be inaccurate.

The SEC has also brought enforcement cases against directors relating to the process for approval of advisory contracts, even though there was no indication that the directors had not acted in good faith, and even though there was no harm to the fund. Indeed, in a relatively recent case, the advisory fees in question were all waived.

SEC Chair Mary Jo White provided some insights as to the commission's thinking in pursuing these cases against independent directors in a recent speech, as well as in a not-so-recent one. In October 2013, White argued that no infraction was too small to be punished. She made an analogy to the NYPD's "broken windows" strategy to pursue subway turnstile jumpers as well as those who commit the most heinous crimes. This strategy is based on the theory that when something small like a broken window is not fixed, it is a signal that no one cares and lawlessness can prevail. In that speech, White said that the SEC would pursue not only the biggest frauds, but also violations such as control failures, negligence-based offenses and even violations of "prophylactic rules" with no intent requirement, referring to violations of rules intended to prevent harm, even if no actual harm resulted from the violation.

White also referred to enforcement actions against mutual fund boards. She said, "I hear and I am sensitive," to the concern that the SEC's focus on gatekeepers may drive away directors who might fear being second guessed or blamed for every issue that arises. She added, however, that being a director "is not for the uninitiated or the faint of heart." White also said regulators "will not be looking to charge a gatekeeper that did her job by asking the hard questions, demanding answers, looking for red flags and raising her hand."

But, it is reasonable to infer, the SEC will be looking to charge a gatekeeper that, in its view, did not ask the hard questions, demand answers, look for red flags, or raise her hand.

White's more recent speech is even more illuminating. It focused specifically on the role of fund directors. She noted that, since 1940, Congress and the commission have enhanced the responsibilities of fund directors. As directors already know, the SEC and its staff are proposing to expand those roles even further, given the additional responsibilities that would be imposed on directors under the liquidity and derivatives rules proposed by the SEC late last year. White, referring to the SEC staff's recent distribution in guise guidance, asserted an affirmative (and new) responsibility of directors to "ensure" that fund assets are not improperly used for distribution purposes. She also discussed directors' responsibility to exercise oversight of cybersecurity.

"Directors are critically important in overseeing what the fund is doing, by approving policies and procedures to prevent, detect and stop violations of the federal securities laws, and by responding promptly and effectively to problems that do occur," White said.

Enforcement cases are one way the SEC has to make sure that fund directors play the role the SEC intends. The SEC does not have much in the way of carrots to give directors who successfully perform this role, but, in the form of enforcement proceedings, they do have a stick.

What must directors do to stay clear of enforcement?

In concluding her speech, White said that "most 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." But she also said that being a director does not provide immunity from enforcement action. She added: "When directors fail to perform their duties, they should expect action to punish and deter such conduct."

While White referred to directors acting "in good faith," it is clear in context that good faith alone will not prevent directors from being second guessed. Directors must also "responsibly perform their duties."

What does that mean?

White said that, unlike the directors involved in the enforcement matters, most directors do their jobs, "carefully reviewing the briefing materials they receive, asking questions instead of rubber-stamping management recommendations, investigating potential inaccuracies, and following up on unfulfilled requests." And those directors "discharge their important gatekeeper function, assuring that proper procedures are followed and that the interests of investors are served."

It is not particularly reassuring that this list of what directors must do to avoid enforcement is both long and easier said than done. But at least this list provides some indication of what directors should be seeking to accomplish.

We would add that, when directors do not fully understand their responsibilities in a given area, they should ask their counsel for specific guidance. Similarly, when there is a presentation or proposal they do not fully understand, they should ask questions until the presentation or proposal becomes clear.

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If directors ask for information and it is not provided or it is incomplete, they should follow up.

What else should directors do?

First and foremost, all the members of the board should share the commitment to discharging their responsibilities and "getting it right." But even that is not enough.

The federal securities laws and rules to which mutual funds are subject are many and complex. The board is required to approve policies and procedures based on a finding that they are reasonably designed to prevent violation of these many complex laws and regulations by the fund and by each investment adviser, principal underwriter, administrator and transfer agent of the fund. The opportunity to fall short of that responsibility is great, particularly when conduct is observed through the 20/20 lens of hindsight.

In order for directors to discharge their responsibilities effectively, and with the diligence and skill that White (correctly we believe) ascribes to most directors, they need the right support and infrastructure: management that is committed to a culture of compliance and that is open and candid with the board; a chief compliance officer with the knowledge, skills, temperament and resources to do his or her job effectively; and experienced investment company counsel who can help guide the board through the regulatory thicket. Where these elements are present, the risk that there will be some violation, or that directors will be held responsible for it, is mitigated. If one or more of these elements are absent, directors should consider whether they are being set up for failure.

One more important thing: insurance

If something does go wrong and directors find themselves in the SEC's gun sights, the directors will need resources to marshal their case effectively to persuade the SEC enforcement staff that the directors should not be charged, and, if that can't be avoided, to mount a vigorous defense. Indemnification rights are useful, but indemnification claims will expend fund assets. Having enough insurance means that fund assets would not have to be used to satisfy indemnification claims. Insurance won't cover any penalties, but it can cover most defense costs. Remember that when things go badly, there may well be other claims on insurance, so directors will want comfort that sufficient insurance will remain available to them.

White is correct: service as a mutual fund director is not for the faint of heart. But, in our view, good directors should not be deterred from contributing to this dynamic industry and serving the shareholders who depend on their fund investments. If directors have the right support and seek to understand their responsibilities and perform them effectively and conscientiously, the rewards of being a mutual fund director will continue to far exceed the risks.

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