

Fund Directions

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In This Issue

Getting A Pass

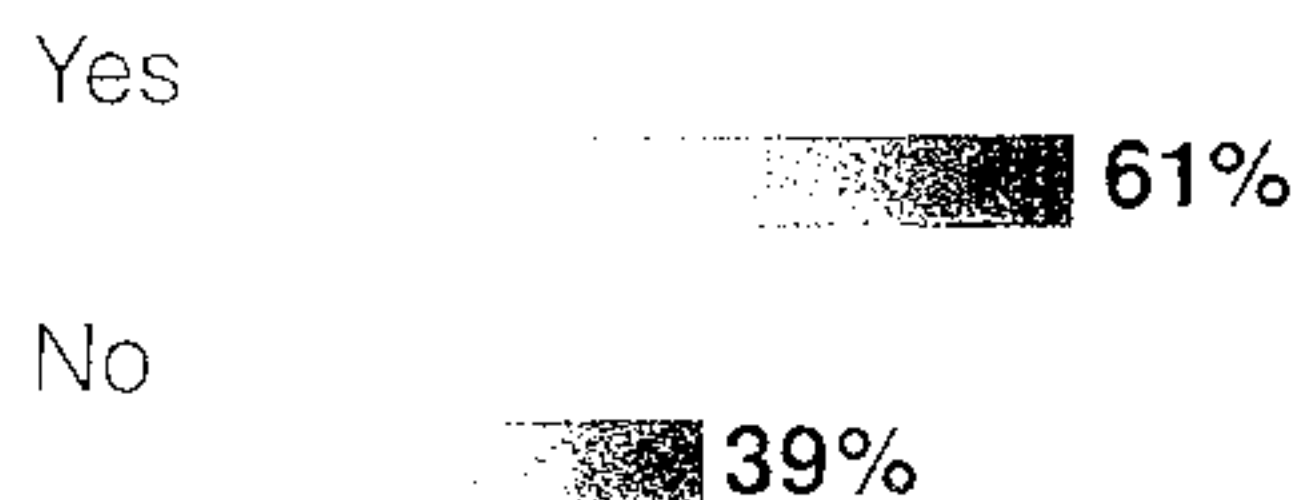
Directors were spared by *MarketWatch* columnist **Chuck Jaffe** when he handed out his annual Lump of Coal Awards in December. However, he scolded the **Securities and Exchange Commission** "for doing nothing at full force."

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POLL RESULTS:

Should boards overseeing sub-advised funds increase the amount of attention they pay to those relationships?



NEW POLL QUESTION:

What should top the SEC's list of Things To Do in 2012?

1. Money market fund reform
2. 12b-1 fees
3. Funds' use of derivatives
4. Put its own house in order

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Audit Firm Rotation Proposal Draws Brickbats

Independent directors are heading into 2012 with concerns they may soon be forced to rotate the audit firms their fund complexes use. Such a mandate—floated by the **Public Company Accounting Oversight Board** in a recent concept release—would increase costs to shareholders and add to the workload of audit committees and fund management firms, while potentially diminishing the quality of the audits themselves, according to individual directors and the trade groups that represent them.

The PCAOB issued its "Concept Release on Auditor Independence and

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Busy Year Ahead



What Directors Should Watch In 2012



Niels Holch

Niels Holch, executive director of Internet-based shareholder advocacy group **Coalition of Mutual Fund Investors**, sets the scene for the New Year with a look at what mutual fund directors should have on their radar screens and makes some predictions about what will—and will not—be accomplished on the regulatory front in 2012.

The Federal election on Nov. 6, 2012, likely will be remembered as a watershed event, one in which voters expressed their views

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IN THE BOARDROOM

Mortgage Fund Board Studies Valuation Model

The directors overseeing a new fund that invests in performing whole mortgages have spent the last several months learning about the fund advisor's proprietary valuation model to ensure the illiquid assets in the portfolio are being priced properly and the Vertical Capital Income Fund's daily net asset value is accurate.

The continually offered closed-end fund was launched by



Bayard Closser

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management. “The fundamental risk hasn’t changed in 300 years,” he wrote. “Following ‘top-down’-only strategies, ETFs and index trackers may be all very well when the herd is bullish, but when the bears take over, a solid balance sheet, transparent accounting and a history of delivering dividends beats perpetual growth hype every time.”

Malone reported that Aberdeen’s directors often attend due diligence sessions when fund managers quiz company management. “Witnessing that dialogue first-hand gives a rational basis for directors’ support for long-term investment decisions, even through market troughs. After all, the ideal share to own is one you never want to sell,” he said.

Malone has served as a director for Aberdeen Funds since 2001. The firm publishes *The Bulletin* twice a year, and spokeswoman **Alison duPont** told *FD* this is the first time Malone has written a piece for the magazine. *The Bulletin* is sent to about 150,000 shareholders of Aberdeen’s closed-end funds.

SEC Clears Role Of Columbia Funds Director

The **Securities and Exchange Commission** has granted no-action relief to **Columbia Funds**, a ruling that protects the fund complex against possible agency action stemming from activities of one of its independent directors. At issue is the fact that Columbia Funds Trustee **Anthony Santomero** also serves as an independent director of **Citigroup** and **Citibank**.

Santomero’s corporate directorships came into play on June 1 when the Columbia board officially took on oversight of the legacy RiverSource funds. **Ameriprise Financial** said in late 2010 that its RiverSource funds and **Columbia Management’s** Columbia Nations funds would be the responsibility of a single board following its acquisition of Columbia Management (*FD*, October 2010).

Marco Adelfio, a partner at **Goodwin Proctor** and counsel to the Columbia Funds board, told *FD* Columbia had received verbal assurances from SEC staff prior to June 1—when Santomero, a long-time Columbia trustee, was elected to the new board—and the request for no-action relief made the process official. The no-action relief was necessary because some of the legacy RiverSource funds purchase loan participations, he said.

Section 10(f) of the Investment Company Act

of 1940 bans funds from buying securities from a selling syndicate when one of its directors is an affiliated person to some company in the syndicate. It is designed to ward off the risk that underwriters might dump unmarketable securities on mutual funds. Citibank does participate in syndicates selling to Columbia Funds, but the SEC’s no-action letter shows that the staff is satisfied the connection is too limited to harm Columbia Funds.

In its letter requesting no-action relief Columbia said Santomero is an independent director overseeing a big commercial bank “and in this oversight role is not involved in any of the day-to-day activities of Citibank... [He] does not regularly receive any specific information about Citibank’s participation placement and trading activities and has no meaningful ability to influence such activities.”

The SEC response letter noted that Santomero has committed himself to abstain from voting on “any matters relating to the fund’s purchase of” participations offered by syndicates in which Citibank participates. It stated that Columbia’s linkage with Citibank due to Santomero being on both boards was “attenuated, such that the advisors and subadvisors have no incentive that might conflict with their obligation to make independent investment decisions about the funds’ purchases.”

What To Watch (Continued from page 1)



about who should lead this country out of a very difficult recession and what the role of the Federal government should be in the future.

Washington politicians will remain in a state of partisan gridlock for most of the year, especially on Federal budget, spending and tax issues. It is doubtful that any meaningful progress will be made on reducing the Federal deficit, addressing long-term entitlement spending, and reforming the Internal Revenue Code. These big issues will be the first items on the legislative agenda for Congress and the President after the November elections.

Despite the fact that Congress is expected to accomplish very little this year, the mutual fund industry should expect plenty of regulatory activity in Washington.

The **Securities and Exchange Commission** has had to place a number of mutual fund issues on the back burner as a result of the deadlines and pressures

placed on the agency by the enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act. However, the SEC intends to turn its attention back to these mutual fund issues this year.

Here are some of the regulatory areas at the SEC on which mutual fund boards can expect to see further action during 2012:

Money Market Funds

Money market funds have been subject to intense regulatory scrutiny since the Reserve Primary Fund “broke the buck” in 2008. Since that time, the SEC has promulgated a number of new rules to improve the regulatory framework for these funds. Under pressure from the **Federal Reserve** and the **U.S. Treasury Department**, the SEC is now expected to initiate another round of rulemaking. This rulemaking is a recognition that additional regulatory steps need to be taken to prevent “runs” on money market funds during a significant liquidity crisis in the capital markets.

According to SEC Chairman **Mary Schapiro**, there are two options on the table. The first option is to require money market funds to be priced in the same manner as traditional mutual funds, through a “floating” net asset value. This proposal is strongly opposed by the fund industry, as it would dramatically reduce investor interest in this investment product.

The second option under consideration is the creation of a capital buffer for each money market fund seeking to maintain a fixed price for its shares. This buffer would be a source of additional funding in an emergency and would involve monies that are segregated from other fund assets. This option is gaining support in Washington, and the SEC staff is working to develop a specific rulemaking proposal. If such a capital buffer is constructed correctly, it could provide significant protections for investors when a run occurs on a money market fund's shares.

Rule 12b-1 Reform

The SEC has been interested in reforming its Rule 12b-1 for a number of years. In 2010, the agency advanced a wide-ranging proposal to the Rule, but it was met with strong opposition from the mutual fund and brokerage industries.

In summary, the SEC's proposal would place

substantive limits on ongoing sales charges and it would restructure the Rule so that fees related to distribution can be assessed at the customer account level, rather than at the fund level. If adopted as a new regulation, investors could pay directly for many of the services they seek, instead of the current “one-size-fits-all” fee structure under Rule 12b-1. This proposal also would introduce price competition for the services of financial intermediaries.

Some of the SEC's proposed changes to Rule 12b-1 are welcomed by fund boards, as these reforms address a number of problems involving director oversight of fund distribution expenses. However, the direction that the SEC plans to take on this rulemaking in 2012 is unclear.

Mutual Fund Fee Initiative

The SEC has restructured its Enforcement Division into specialized units to focus attention on targeted issues and business practices. In the mutual fund arena, the Enforcement Division is working on a Mutual Fund Fee Initiative. This Initiative is designed to develop metrics for evaluating the extent to which retail investors are being charged excessive fees.

This Initiative will look at what investment advisors and fund boards are doing to scrutinize advisory fees, distribution-related fees, and the fees charged by various service providers to funds. The first mutual fund case brought by the Enforcement Division was against a fund adviser for paying sub-advisor fees to an entity that was not fulfilling its contractual obligations. This is probably just the beginning of a number of enforcement actions which will touch on mutual fund fees of all types.

In 2011, the SEC increased the number of enforcement actions it filed against investment advisers and funds by 30% over the previous year. Expect the number of enforcement actions to increase once again in 2012.

Derivatives

As a related activity to its Dodd-Frank responsibilities, the SEC is interested in how funds are using derivatives. To develop its understanding of the issues involved, the agency issued a Concept Release in September 2011, in order to obtain public comment on this topic. It is expected that the SEC may initiate a rulemaking in

this area to update its rules, or issue another Concept Release to gather more information.

Distribution of Fund Shares

In addition to reforming Rule 12b-1, the SEC also may take steps to alter the mutual fund distribution system, albeit indirectly. Its first regulatory action in this area is expected to be an effort to harmonize the standards of care provided to investors by broker-dealers and investment advisers. Broker-dealers providing personalized investment advice will likely be subject to some type of fiduciary duty, requiring them to act in the best interests of their customers when providing personalized investment advice.

This is a complicated issue for broker-dealers, as their business model permits them to act in different capacities, such as when a broker merely executes a trade at the direction of a customer. However, any resolution of this issue will impact the distribution of mutual fund shares, as broker-dealers are likely to be required to make additional disclosures to investors and to take more steps to address conflicts of interest. If the SEC takes a holistic view of these issues, it also will have to examine what type of point-

of-sale disclosures should be made to investors when transactions occur.

An Important Year

The year is likely to be known as the year that partisan gridlock reached its pinnacle. But it also is expected to be a busy year for mutual fund boards, as regulatory activity at the SEC could be significant and far-reaching for both the fund industry and its investors.

Money market funds will certainly face another round of rulemaking on significant structural issues. Rule 12b-1 is ripe for its own overhaul, which is likely to be controversial. The SEC's new enforcement focus on fund fees of all types will challenge the status quo for a number of funds. The use of derivatives by funds will be examined further and clarified. And a number of fund distribution issues will be impacted by any change to the standards of care provided by broker-dealers and by the disclosures they have to make to retail investors.

All of these regulatory activities should keep fund boards actively engaged in 2012. Beyond the presidential election and the partisan gridlock, it certainly will be an important year to pay attention to what is happening in Washington.

Mortgage Fund (Continued from page 1)

Vertical Capital Markets Group in late November and is comprised of a portfolio of quality mortgages income and growth features. It invests primarily in residential performing loans that are secured by first mortgages or deeds of trust. Because these assets are considered Level 3—those whose fair value cannot be determined by published market prices—they must be otherwise valued on a daily basis.

“One of the biggest hurdles is that these are all Level 3 assets, so how do you come up with a fair market valuation of all of these Level 3 assets? The board was instrumental in the review of and the input in how we built this valuation model in conjunction with a third-party consultant,” **Bayard Closser**, interested chairman and president of Vertical Capital Markets Group, told *FD*. Vertical Capital Markets Group worked with San Francisco-based **LCAP Advisors** to develop the valuation model.

Closser said the board will carve out time at its 2012 meetings to hear from portfolio managers and other representatives from the advisor about concepts for

additional funds. He said the firm—and fund board—is likely to consider funds that would invest all or some of their assets in non-performing residential mortgages and possibly be offered as total-return vehicles.

In putting together the board, Closser said he selected individuals with expertise in both the mutual fund business and board oversight. The independent trustees are **Robert Boulware**, managing director of **Pilgrim Funds** and an independent trustee of **Met Investors Series Trust**; **Mark Schlafly**, a former senior v.p. at **LPL Financial**; **Neil Bathon**, managing partner at **FUSE Research Network**; and **Jeffrey O'Donnell**, executive chairman of the board of **NB Therapeutics**. The board also includes interested trustee **Christopher Chase**, managing member of **Vertical Capital Asset Management**.

“We specifically set out to select individuals who...would bring a diverse degree of experience in both the broker/dealer community, as well as the asset management side of the business, to help guide us through many of the challenges that we're going to have,” Closser said. “I look at the board of trustees as an advisory board as well as fulfilling their fiduciary responsibilities.”