SEC Issues Guidance to Boards Reviewing Certain Affiliated Transactions

The staff of the Securities and Exchange Commission (“SEC”) recently published long-awaited guidance “clarifying” the responsibilities of mutual fund directors when they make the determinations required by Rules 10f-3, 17a-7 and 17e-1 of the Investment Company Act of 1940 (the “1940 Act”). The guidance was delivered in the form of a letter to the Independent Directors Council and the Mutual Fund Directors Forum (the “Letter”).¹ The Letter marks the culmination of SEC Division of Investment Management Director Andrew “Buddy” Donohue’s “Director Outreach Initiative” and offers some relief for boards when reviewing transactions between a fund and its adviser under Rule 10f-3 (permitting a fund to purchase securities from an affiliated syndicate), Rule 17a-7 (permitting a fund to engage in certain cross-trading) or Rule 17e-1 (permitting a fund to use an affiliated broker). Among other things, these Rules require that the board of a fund that relies on the Rules undertake quarterly reviews and make certain determinations related to the potential conflicts of interest present.

In meetings with many fund boards during a period of about two years, Director Donohue received significant feedback from directors asking that the SEC allow the directors to delegate to third parties (such as a fund’s CCO) certain determinations currently required by various rules under the 1940 Act. The SEC staff’s recent guidance stops short of allowing boards to delegate the required determinations to others. However, the Letter does contain helpful guidance that validates the ability of fund boards to base their determinations under these Rules on reports and summaries prepared by third parties.

Specific Guidance

The Letter stated that the “clear wording of each rule . . . requires a fund board to make a determination, no less frequently than quarterly, that each transaction made during the preceding quarter was effected in compliance with procedures reasonably designed to provide that the transactions comply with the requirements of the relevant rule.” The Letter further stated that a board may delegate “to a directorial committee or other persons associated with the investment company the drafting task of preparing recommended procedures to be considered by the board as a whole.” However, the Letter stressed that, under the Rules, “the board is responsible for any procedures that it ultimately chooses.”

The Letter acknowledges that the Rules “do not specify how fund boards should make such determinations” and noted that the Rules “do not specifically require the directors to review each transaction in order to make the required determinations.” The Letter explained that, depending on the circumstances, the staff believes “that

¹ Letter from Michael S. Didiuk, Attorney-Adviser, U.S. Securities and Exchange Commission, to Dorothy A. Berry, Chair – Governing Council, Independent Directors Council, and Jameson A. Baxter, Chair, Mutual Fund Directors Forum (Nov. 2, 2010).
fund boards may, where consistent with the prudent discharge of their fiduciary duties, make these determinations in reliance on summary quarterly reports of the transactions effected in reliance on one or all of these rules in the prior quarter.” The Letter outlined various ways a fund board may meet its responsibilities under these rules:

- **Via review of each transaction.** Some boards, such as “boards to those funds with fewer transactions[,] may determine to review each transaction,” though that is not specifically required.

- **Via compliance officer summaries.** Boards “may decide to make the required determinations based on summary quarterly reports (prepared by the fund’s [CCO] or other designated persons).” The staff added, however, even if fund boards do not review the details of each transaction under these rules, “boards nonetheless should have a process in place reasonably designed to ensure that transactions are effected in a manner that is consistent with the board-approved procedures and the relevant rules.”

- **Via information from other experts.** The staff stated that “under appropriate circumstances, fund boards also would have the flexibility to tap other relevant expertise to assist in the quarterly review process (e.g., some combination of fund counsel, counsel to the independent directors, investment adviser personnel, and/or independent third parties).”

### Avoiding Conflicts

The Letter also emphasized that because of inherent conflicts of interest between a fund and its adviser in the context of these rules, “[e]ven if boards rely on the CCO or others . . . to provide them with summary quarterly reports . . . boards still retain ultimate responsibility for making the quarterly determinations required by these three rules, and boards cannot delegate such responsibility.” Stating the staff’s concern that some have characterized a board’s process in reviewing these affiliated transactions as “mechanical,” the Letter cautioned that, “even if the directors rely on others to investigate the details of each transaction, [directors] need to be appropriately vigilant to ensure that they have sufficient information to be alerted to issues raised by these conflict transactions.” As such, the Letter stated that “it is essential that all involved in reviewing these conflicts transactions and in preparing summary reports do so diligently.”

The Letter explained that a “particularly important” aspect of a board’s diligent evaluation of affiliated transactions is “meaningful dialogue.” A board “can most effectively manage the conflicts of interest inherent in these transactions where the board culture encourages rather than stifles open and frank discussion of what is in the best interest of the fund,” the Letter stated.