

Lessons Learned

Emerging Best Practices
Amid the Financial Crisis



MUTUAL FUND TRUSTEES SPEAK OUT

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Introduction

As the subprime credit crunch worsened into a full-blown crisis, it affected most corners of the financial world. Institutions have disappeared or been reshaped. The U.S. government, along with several others, has been forced to intervene in unfamiliar and untested ways. The equity markets have experienced rapid declines and worsening volatility.

The mutual fund industry is at the center of this hurricane. Liquidity and valuation challenges confront funds daily. Nervous shareholders are uncertain where to maintain their investments, particularly retirement savings. Investment performance has suffered, and one large money market fund broke the buck. After the dust settles, some wonder how differ-

ent the fund business, and indeed the whole financial services industry, will look.

Mutual fund boards are feeling the pressure. As stewards of shareholders' assets, boards need to, and want to, discharge their fiduciary duties effectively, yet these extraordinary times are creating a host of new questions for trustees.

BoardIQ convened a panel of mutual fund trustees, professionals and service providers to brainstorm how to tackle this crisis. The group outlined several emerging best practices and early lessons to be learned from the current financial turmoil. The results of their discussion follow.



WHO'S WHO

BoardIQ's Roundtable



Richard Armstrong is Chairman of the Board of the UBS Funds. He is chairman and principal of R.Q.A. Enterprises, a management consulting firm he founded in 1991. Mr. Armstrong's career included the presidency of Canada Dry International, Canada Dry Worldwide and the combined companies of Canada Dry and Dr. Pepper.



Thomas Brock is a Trustee of the Liberty All Star Funds. He has been CEO of Stone Harbor Investment Partners LP since April of 2006. Mr. Brock is an Adjunct Professor at Columbia University's Graduate School of Business, which he joined in 1998. He was Chairman and CEO of Salomon Brothers Asset Management, Inc. from 1993 to 1998.



Elizabeth Duggan is Vice President at Interactive Data Corporation, where she is responsible for creating and managing new product marketing initiatives. Ms. Duggan has 20 years of experience in market data services working with investment companies, investment advisors, broker/dealers and other financial institutions. She specializes in the advancement and launching of Interactive Data's new evaluation services. Prior to joining Interactive Data, Ms. Duggan served as a senior vice president of Thomson Financial Securities Management.



Gary L. French is Senior Vice President, Fund Administration for State Street Corporation. Prior to joining State Street, he was a Managing Director in charge of Deutsche Bank's fund operations unit, and President of UAM Fund Services. Earlier in his career, he was with Fidelity Investments where he served as Senior Vice President of Fund Accounting and as Treasurer of the Fidelity Group of mutual funds.



James Gerard is a Trustee of the Tocqueville Funds. He has been Principal of Juniper Capital Group, LLC, formerly known as Argus Advisors International, LLC, from August 2003 to the present. He has been a Managing Director of the Chart Group from January 2001 to the present. Mr. Gerard was Managing Principal of Ironbound Partners from October of 1998 to December of 2000.



Duane Hill is a Trustee of the Hartford Funds. He is a Partner with TSG Ventures L.P., a private equity investment company. From 1994 to October of 1998, Mr. Hill was a member of TSG Capital Group, a private equity investment firm that serves as sponsor and lead investor in leveraged buyouts of middle market companies. Mr. Hill is also a Director of Hartford HLS Series Fund II, Inc., The Hartford Mutual Funds, Inc., The Hartford Mutual Funds II, Inc. and The Hartford Income Shares Fund, Inc.



Elizabeth R. Krentzman is a Principal and serves as the Chief Advisor to the investment management sector of the Regulatory & Capital Markets Consulting practice of Deloitte & Touche LLP. In this capacity, she assists investment advisors, mutual funds, alternative investment firms, service providers and financial intermediaries in developing and deploying integrated programs for measuring, controlling, and monitoring compliance risks and in meeting operational needs. Ms. Krentzman formerly served as the General Counsel of the Investment Company Institute (ICI).



Bruce G. Leto is a Partner and Chair of the Investment Management Group at Stradley Ronon Stevens & Young, LLP. For over 22 years, he has counseled investment companies, investment advisors, independent trustees and broker/dealers on securities and corporate matters relating to pooled investment products, including registered and unregistered, open- and closed-end investment companies. He is a member of the firm's Board of Directors and has been Chairman of the firm's Investment Management Group since 1994.

ACTION STEP 1


Communicate more, refine your process, but don't micromanage.

The temptation during difficult times is to be more hands-on. Boards may feel the need to manage, rather than oversee, the adviser's practices. But the Panel urges trustees not to take on an inappropriate role. Trustees are charged with oversight — not micromanagement. Boards must make sure they focus strongly on supervision but that they stop short of usurping the duties of the adviser.

Both before and during the current crisis, the Securities and Exchange Commission and its staff have seemed to urge trustees to increase their involvement in the adviser's operations.

This, coupled with the added pressure boards are putting on themselves, can have the unforeseen result of decreasing trustees' effectiveness. By trying to do too much, they may find themselves less able to follow through on their main responsibilities.

Boards can heighten their efficacy by looking at time management. Review the allocation of responsibilities among trustees and determine whether there is room to streamline them. Can boards or their committees meet more often by telephone in order to eliminate redundant communications? Should each committee rely



Boards should supervise — not micromanage.

Bruce Leto

more on a single point person to gather information and report back to the group? Are there other ways to use board members' time better? Boards may need to hold more frequent meetings during a crisis, but there may be ways to conduct these meetings more efficiently.

Communication is key to the smooth functioning of a board, but it becomes even more essential in a crisis. For timely issues, such as valuation, a board may need to designate a single trustee as the adviser's main contact so that decisions can be made quickly. This trustee should have the board's confidence and should be able to serve capably as a proxy for the other trustees. In addition, trustees must speak up if they do not understand something the adviser is doing or the reasoning behind it. Nothing should be done so quickly that it bypasses the board's understanding and consideration.

The Panel suggests boards ensure they receive the reporting they need — both on an emergency basis and a periodic basis. Advisers must keep trustees informed about current actions and about the context for those actions. This includes industry trends, investment and operational patterns at the adviser, and the changing regulatory framework. For example, an important new release by the SEC should be summarized by the adviser to help trustees understand the release's implications, if any, for their fund group. Trustees want information, not a mass of data. Boards should seek executive summaries and explanations.

Turmoil is a good impetus for procedural change. Savvy boards are reviewing and refining their processes. They are making sure all board members are clear about the processes and that there is no confusion about

how to implement them. Because the fund industry — and the financial markets — are constantly evolving, no process can be static. Rather, it must be reviewed periodically and revised as necessary.

The Panel recommends boards ask management to conduct the same exercise with its procedures. Managers should ensure that procedures are comprehensive, detailed and regularly revisited. More importantly, the board should be sure the procedures are applied consistently across funds and in different scenarios. Systems and backup plans should be stress-tested by the adviser to confirm they will work as expected. The goal is to avoid any nasty surprises. For example, one fund group decided to test the lines of credit it has in place to meet unexpected redemptions. The board and the adviser wanted to be sure that cash would be available if the funds needed it.

THE PANEL'S CONCLUSIONS:

- 1** Resist the temptation to be managers rather than overseers.
- 2** Look for ways to use trustees' time more effectively.
- 3** Enhance communication within the board, as well as between the board and the adviser.
- 4** Ensure the board receives meaningful reports that summarize information in a broader context.
- 5** Boards and advisers should regularly review their own processes and refine them as necessary.
- 6** Stress-test systems to prepare for potential crises.

Understand valuation processes and procedures.

Valuation of portfolio securities has been a hot-button issue for several years, but as the markets have seized up, pricing has become even more difficult and time-consuming. Advisers report seeing three and four times as many pricing questions these days as they did in the past.

Fixed income securities and derivatives, in particular, are suffering from a lack of liquidity. Portions of these markets were thinly traded before the crisis. Today, there is even less trading activity. The Panel warns boards that today's illiquid markets give them reason to focus on the valuation process more than ever before. With so few trades to reference for a number of types of securities, and spreads widening so quickly, advisers should proceed with caution.

It may be difficult for advisers to verify prices and execution in these panicked markets, but the Panel suggests that boards can and should verify whether management has a comprehensive process for valuing securities fairly, accurately and on a timely basis. Most advisers have a standing pricing committee. The board is responsible for reviewing and understanding what the adviser's committee has done with regard to pricing. The key considerations, say Panelists, are whether the methodology is objective and whether the fund's valuation procedures are applied consistently — in good times and bad.

Trustee oversight should extend to independent pricing services. It may make sense to ask pricing services to present to the board to enhance the trustees' understanding of the issues and explain the vendor's procedures. Key questions and objectives might include:

1. What is your process for reviewing client challenges? How many challenges does the vendor receive, and how often does the vendor change its valuations?
2. What are the criteria for changing valuations in response to a client challenge? What processes does the vendor have in place to address potential conflicts of interest?
3. Evaluate the vendor's culture. Are they regulated? Do they have a chief compliance officer? Is there a code of ethics? Has the vendor completed a SAS 70 or similar third-party examination?

An adviser's valuation committee typically comprises management personnel from different disciplines. When deciding which personnel should sit on a pricing committee, there is a natural tension between the inclusion of portfolio managers and middle- and back-office employees. Portfolio managers generally have the most information about the securities, but they may also be subject to various conflicts of interest in the determination of a price. On the other side, lawyers, compliance personnel and accountants may not have the requisite investment-related knowledge of the securities, but they are able to weigh in on whether the price used is reasonable based on factors beyond investment data, and whether the fund's valuation procedures are being followed. Most groups have representatives from

the front, middle and back office either participate in the decision-making about fair valuations or attend fair value committee meetings. Trustees must be sure no single constituent has undue influence on pricing. Portfolio manager determinations should be checked and balanced by other opinions.

The adviser's valuation committee is often approved by the fund's board as part of its delegation to the adviser to handle day-to-day pricing issues. In some circumstances, fund boards have their own valuation committee, which provides high-level oversight of valuation issues.

In addition, boards must work to stay informed about the implementation of fair value prices. The Panel says trustees need to know what is going on at a macro level, including:

- What types of securities are being fair valued by the committee,
- How frequently they are being valued, and
- Why the committee is valuing each type of security.

The board should receive regular reports, in person or in writing, summarizing the meetings of the valuation committee. Trustees need to know the history and outcome of pricing issues. In addition, boards should be sure the adviser is back-testing fair value pricing. By comparing price estimates to later sale prices, management can evaluate how well its valuation procedure is working.

Management and boards should consider using data from multiple pricing vendors. Most fund groups use at least one independent pricing service, with a secondary backup vendor in the event technological or other

issues arise. But lately, more routine use of a secondary pricing source is looking like a worthwhile expenditure. Where a fund uses multiple vendors, the Panel recommends receiving data from each vendor on a daily basis. Weekly or monthly spot checks are not as effective for comparing the performance of different vendors. When multiple vendors are involved, the adviser should also have an approach for dealing with variations in the data provided by the vendors.

The adviser should not merely accept valuations from a pricing vendor without question. The Panel recommends there be someone at the adviser with the expertise to look at third-party valuations vigilantly. Fund accounting groups are hiring or training valuation experts who can offer in-depth knowledge and help to resolve challenges.

THE PANEL'S CONCLUSIONS:

- 1** Focus on the pricing process in volatile and illiquid market environments.
- 2** Verify that management has a comprehensive, consistent and objective process for valuing securities.
- 3** Be sure pricing committees represent a range of perspectives and interests.
- 4** Understand what is being fair valued, how often and why.
- 5** Ask advisers to back-test fair value pricing and report on the results.
- 6** Tap the expertise of independent pricing services.
- 7** When using two or more pricing services, do so on a daily basis.

TRUSTEES' RESPONSIBILITIES FOR OVERSEEING VALUATION PROCEDURES

Under the 1940 Act, mutual fund boards are responsible for fair valuing a fund's portfolio of securities when appropriate. The statute requires that a fund use readily available market quotations. If those are unavailable, the valuation must be at fair value, as determined in good faith by the trustees. As a practical matter, the board delegates the determination of individual fair value prices to the adviser, by approving valuation procedures that set forth the factors an adviser should take into account when determining fair values. The trustees then ratify the valuations after the fact, as having been done in accordance with the procedures.

Source: Stradley Ronon

KEY FINDINGS FROM THE DELOITTE & TOUCHE LLP SEVENTH ANNUAL FAIR VALUE PRICING SURVEY FOR 2008

- Sixty-four percent of survey participants stated that their board has a fair valuation committee, which is consistent with the percentage reported last year.
- Boards continue to rely on valuation experts to oversee the valuation process. They also involve non-board members in fair value committee meetings, including attorneys, portfolio managers and compliance officers.
- Ninety-one percent of respondents stated they perform due diligence on third-party pricing vendors, with 83% of these respondents indicating that they perform due diligence at least once a year.
- An important part of the process is back-testing fair valuations, with 88% of survey respondents stating that the results of back-testing are reported to the board in at least summary fashion on a quarterly basis.

Source: Deloitte LLP



Trustees are spending time understanding what is underneath the fund's pricing process and the vendor's evaluation process.


Liz Duggan

ACTION STEP 3

Watch for conflicts of interest.

Times of turmoil are ripe for emergence of conflicts of interest. At present, industry assets under management are shrinking due to market declines, fund outflows, and competitive pressures from other investment vehicles. As these trends negatively impact mutual fund profits, the Panel recommends boards watch for an increase in panicky judgments by management or the temptation to cut corners.

Equity funds are experiencing large flows in both directions: frightened investors fleeing to safer funds and asset allocators making purchases in order to keep their allocations intact. The Panel notes that, while always important, securities valuations have increased importance in times of significant fund flows. Boards must ask whether any group is being advantaged or disadvantaged. Trustees should also raise questions about the process



No shareholders
should be disadvantaged
— or advantaged —
by large fund flows.

Tom Brock

by which the adviser arrives at the right redemption and purchase prices. This area will require increased scrutiny as long as markets remain unsettled.

Interfund trading represents another potential conflict. Interfund trading involves a situation in which an adviser sells a security held by one fund to another fund it manages. The Panel suggests boards closely oversee, and advisers closely scrutinize, trades between funds in this environment. The goal is to verify that the transfer is appropriate and properly carried out for both the selling and purchasing fund.

Some advisers manage hedge funds and institutional funds, in addition to mutual funds. The Panel acknowledges this can be a tool to retain talented portfolio managers and enable advisers to provide broad product offerings. But such an arrangement creates the potential for trades that enrich the hedge or institutional funds at the expense of the mutual funds because, for example, the hedge funds generally have higher management fees. Some fund groups have the Chief Compliance Officer look at these trades and flag any trades that may warrant greater scrutiny. Trustees should know how any flagged trades are resolved and should make a determination that all trading ultimately is done in the best interests of the mutual fund shareholders.

The board of one fund complex was sensitive to potential problems arising because of the adviser's captive broker-dealer. In response to the current disorder in the markets, the board requested a meeting with the funds' head trader. They asked the trader about order flows between purchases and sales. The goal was to determine how the funds trade using the in-house broker-dealer to be sure the funds were not being disadvantaged by using the affiliated broker.

THE PANEL'S CONCLUSIONS:

- 1** Be vigilant about potential conflicts of interest at the adviser.
- 2** For funds with illiquid assets, boards should understand the adviser's mechanism for dealing with large fund flows. The goal is to avoid an unfair advantage for one group of shareholders at the expense of any other group.
- 3** Oversee interfund trading to be sure it benefits both funds.
- 4** If the adviser also manages hedge or institutional funds, someone should review trading activity to rule out conflicts.
- 5** Evaluate best execution during market dislocations.

FACTORS TO CONSIDER WHEN EVALUATING WHETHER A FUND IS RECEIVING 'BEST EXECUTION' IN TIMES OF ILLIQUIDITY

- Ability to get execution on a regular basis in dislocated or disorderly markets
- Willingness and ability to commit capital
- Volume weighted average price ("VWAP") at which trades are effected, if there are sufficient trades to make such a calculation
- Commission rate charged or bid/ask spread quoted

Source: State Street



**Ask the adviser to identify,
measure and monitor their
exposure to counterparties.**

Elizabeth Krentzman

Get back to the basics of enterprise risk management.

One of the main lessons of 2008 is the need to focus on risk management. The Panel stresses that this should not end with risks the funds are exposed to. It also includes enterprise risk. Boards should be sure the adviser knows the full extent of its exposure to other companies, both on a fund-by-fund basis and from the perspective of the organization as a whole.

Enterprise risk can harm the funds that boards oversee. In particular, counterparty risks can be deeper and more extensive than initially meets the eye (see box, page 16). A bright spot in the turmoil of recent months is that trustees and advisers have a clearer understanding of the principles of risk management than they did a year ago. Tellingly, those companies that were known for robust risk management regimes are faring better than others in the current environment.

In the event of a bankruptcy, such as that of Lehman Brothers, mutual funds may be intact, but advisers can suffer. The danger is that reputational risk from losses at the adviser will harm mutual funds by encouraging redemptions. Some boards may wish to draft hard and fast rules about exposure to other firms, such as concentration limits.

Before the events of 2008, many boards placed significant weight on — and derived significant comfort from — fund counterparties' reputation and company size. In today's world, however, it is apparent that even the largest, most well-established company can disappear overnight. Therefore, the Panel urges getting back to basics. Boards should be sure that advisers take advantage of the tried and true protections that have existed for some time. These include taking and segregating collateral, and avoiding concentration risk.

Segregating collateral is a practice designed to address the leveraging aspect of derivatives. Over the years, the SEC has put out a number of interpretations and releases stating that certain derivatives have a leveraging aspect and, therefore, expose funds to additional risk. Even if the adviser is not using the instruments for leverage, the SEC requires funds to earmark or segregate on the fund's or custodian's books a sufficient amount of securities to cover potential risk exposures.

Several practices involving counterparty risk are being questioned. These include securities lending. Some trustees may wonder whether securities lending is worth the risk. But the Panel cautions against throwing the baby out with the bathwater. Securities lending can serve a worthwhile purpose by making money for fund shareholders. Even though securities lending has been criticized lately for its role in fueling the short sale side of the market, the Panel suggests shorting has a part to play in the economy. Trustees can allow securities lending in good conscience, as long as advisers have put in place procedures that will protect funds in these transactions.

A dissenting view on the Panel, however, believes trustees should carefully reevaluate their funds' securities lending practices. This area deserves considerable attention, given the current environment. While not necessarily recommending funds suspend the practice, some trustees believe extreme caution is warranted.

THE PANEL'S CONCLUSIONS:

- 1** Examine enterprise risk as well as fund risk.
- 2** Be sure advisers understand the full extent of fund counterparty risk.
- 3** With counterparties, size does not equal security.
- 4** Consider tools such as concentration limits and watch lists to manage exposures to other companies.
- 5** Accept and segregate collateral.
- 6** Securities lending can still be worthwhile — if it's done safely.

MUTUAL FUND RISK EXPOSURES TO OTHER FINANCIAL INSTITUTIONS

When examining and quantifying the counterparty risks a fund is exposed to, trustees should inquire about all of the following:

- Open trades: purchases or sales
- Derivatives transactions: swaps, structured notes, OTC options
- Forward foreign currency transactions
- Debt security issuers/guarantors of notes, bonds, or commercial paper owned in the fund
- Collateral for securities on loan
- Open repurchase agreements, though lender has the right to the collateral
- Issuers of common stock or other equity held in the fund
- Brokerage counterparties
- Custody

ACTION STEP 5

Complex securities need to be studied, not scrapped.

Complex instruments such as credit default swaps and derivatives based on subprime debt have received plenty of bad ink in recent months. To be sure, many of these complicated securities were used more widely than they were understood.

But the majority of derivatives (for example, futures contracts) are time-tested instruments. They can quickly and efficiently adjust a portfolio's duration, market exposure or interest rate exposure, and are highly effective risk management tools.

The Panel believes a knee-jerk reaction to do away with derivatives, structured investment vehicles and other complex securities is short-sighted. Few investment managers can avoid such investments and remain competitive in the marketplace. Industry experts point out that, while many fund boards are expressing caution about increasing their use of derivatives, they are not going so far as to cease fund use of derivatives.

That said, boards must be sure management understands all the instruments that the funds hold. A crucial function of the adviser is to anticipate risks and devise ways to stress-test the complex instruments, such as swaps, that are being used. In order for that to occur, there must be a level of familiarity with the securities that goes beyond a single portfolio manager.

Boards, too, should know enough about derivatives to be able to oversee their use. And if they do not, they should ask to be educated. It may be useful for personnel at the adviser or outside experts to meet with boards to educate them regarding the various instruments held by the funds.

One red flag arises because regulation continues to lag behind market developments surrounding derivatives contracts. But if boards improve their knowledge, and if advisers adopt solid procedures for managing derivatives, it should help avoid the pitfalls.

THE PANEL'S CONCLUSIONS:

- 1** Derivatives can serve important purposes for investment management.
- 2** Mutual funds should not avoid derivatives entirely.
- 3** Be sure management understands these instruments well enough to manage the risks involved.
- 4** Pursue education for the board about complex securities.



**Make sure the board
has the right resources
to understand these
securities.**

Duane Hill

ACTION STEP 6

Support and then leverage your CCO.

The Panel points out that the value of the Chief Compliance Officer function has never been clearer than in the current tumult. CCOs serve as boards' men and women on the ground. They are positioned inside the adviser's operations, yet they report to the board and should be independent of the adviser's influence. Thus, the insights they can offer are invaluable. A strong and effective CCO can help the board improve its oversight, without crossing the line into micromanagement.

Boards should maintain a good relationship with their CCO. The Panel recommends boards meet regularly with CCOs in executive session. Ask the right questions, and let CCOs know they can and should raise sensitive issues. They may serve as early warning indicators of potential problems.

The Panel agrees that care and maintenance of CCOs is a critical role of the board. Just as CCOs help boards fulfill their fiduciary duties, so must boards help CCOs. Trustees can champion fair compensation for worthy CCOs. Boards also can ensure that if CCOs do not participate in employee benefits programs, their compensation will be adjusted accordingly.

Another way boards can show CCOs their support is to encourage a comfortable working relationship with management. The natural tension of the adviser/CCO relationship should not be allowed to harm the CCO's career prospects. A strong board can facilitate open communication between the two parties.

Boards should help CCOs create a culture of compliance at the adviser. If necessary, a standing compliance committee may show the adviser the value a board places on compliance. Regardless of the presence of such a committee, boards must review the compliance regime on a regular basis to be sure it meets regulatory requirements and best practices. Subadvisers and transfer agents can have cultures of their own that differ from that of the adviser (see box, page 20). Boards and CCOs must work together to oversee these third parties and to bring their compliance practices up to the adviser's level.

Independent auditors are another key resource, notes the Panel. Boards should invest time in solidifying this important relationship. Here, too, meeting in executive session can be useful for identifying potential weak points.

THE PANEL'S CONCLUSIONS:


- 1** Rely on the Chief Compliance Officer to enhance the board's effectiveness.
- 2** Meet regularly with the CCO in executive session.
- 3** Support CCOs in their career path and relationship with management.
- 4** Partner with the CCO in creating a culture of compliance.
- 5** Oversee subadvisers and transfer agents with particular care.
- 6** Meet regularly with the independent auditors in executive session.

BOARD OVERSIGHT OF TRANSFER AGENT OPERATIONS

Trustees should routinely monitor the following items at the transfer agent:

- Timeliness of shareholder trade processing — number of “as of” shareholder transactions processed
- Accuracy of shareholder trade processing
- Telephone statistics — wait time, abandoned calls, and the like
- Timeliness and completeness of various reconciliation processes — both cash and shares
- Timeliness of shareholder confirmations and periodic account statements
- Nature and extent of shareholder complaints
- Backlog of unopened mail and accumulation of paper — may require a personal visit from the adviser

Source: State Street



The care and
maintenance
of the CCO is
a critical board
function.

Dick Armstrong

CASE STUDY: HOW THE HARTFORD FUNDS BOARD HELPED THE CCO ENCOURAGE A CULTURE OF COMPLIANCE

In May of 2007, Tom Jones, Chief Compliance Officer for The Hartford Funds, presented his annual compliance report to the board. His plan for the upcoming year included several key tactical issues, including valuation, trading and subadviser oversight. “But the board gave me insightful guidance,” says Jones. “They said that my main job is to further a culture of compliance.”

Jones went to work on a company-wide campaign he called “Everyone Owns Compliance.” The main message is that compliance is not just the responsibility of the legal department and the CCO. Rather, everyone in the company must play a part in ensuring that the adviser is doing the right thing every day for shareholders. “It’s not just about complying with securities laws,” Jones continues. “It’s about fostering a fiduciary mindset that we manage money for investors and their interests come first.”

The “Everyone Owns Compliance” campaign is delivered in several ways. First, employees receive a series of emails, each one of which includes a short video accompanied by music and graphics. In the videos, Jones discusses key fiduciary duties and the role all employees play in supporting the compliance culture. Second, the campaign is communicated through several internal publications that reach different business audiences. Third, posters displayed through The Hartford’s office buildings remind employees that the company’s culture of compliance depends on each one of them.

The compliance campaign has extended the emphasis on accountability to everyone at The Hartford. “I know the importance of having the right compliance culture,” Jones concludes. “But I wouldn’t have made it such a keen focus if the board hadn’t asked me to make it my top priority. Their guidance and support was critical to this initiative, which has really strengthened our compliance program.”

Shareholders matter. Get the word out to them.

In times of crisis, the Panel agrees, there is no such thing as too much communication. Boards should urge advisers to stay in close touch with investors during turbulent periods. Especially in the current situation, when so much continues to change from day to day, investors want their questions to be answered. They derive a level of comfort when they receive an unprompted communication from the adviser.

The Panel reminds boards that they are responsible for overseeing shareholder communications but they should not drive the process. The frequency and content of letters to shareholders are the adviser's bailiwick — not the board's. Boards should, however, encourage advisers to reach out to skittish investors. Missives that fall outside the regular annual and semi-annual report schedule may be welcomed in the current environment.

One basic approach could be to update investors about how their funds are being managed. Placing today's events in the context of a fund's consistent investment strategy can be beneficial to shareholders. For advisers who manage mutual funds and institutional funds, it may also be worth addressing fears of conflicts of interest.

Boards should ask advisers about the possibility of fund disclosures becoming stale. Prospectuses and statements of additional information should be reviewed by advisers often and in depth, and refreshed as needed.

In general, perception problems tend to arise when shareholders expect one thing and get another. Those who think their investments are liquid may react badly if that turns out not to be the case. Those who believe they own a low-risk fund likely will be outraged if they suffer sharp losses. In their oversight, therefore, boards must be sure advisers are effectively communicating with shareholders to help them understand what they own.

THE PANEL'S CONCLUSIONS:

- 1** Communication with shareholders is key — especially in times of upheaval.
- 2** Encourage the adviser to communicate, but do not dictate the process.
- 3** Have the adviser scrutinize fund disclosures to be sure they do not become stale.
- 4** Work to eliminate problems of perception by ensuring shareholders know what they own.



It is important that the adviser consistently updates its investors on how difficult the markets are.

Jamie Gerard

Be prepared for long-term fallout from the credit crisis.

How will the mutual fund industry look in a year or two? What changes will the credit crunch have wrought? The Panel suggests trustees brace themselves for a tsunami of new regulation. This, in turn, will require advisers to ramp up their compliance function. Costs are likely to increase as fund companies scramble to fulfill their new responsibilities.

Most advisers have already experienced lost revenues due to market declines and shareholder redemptions. As profit margins become thinner, cost cutting will take hold. Boards should find out where the cuts will come from and how it will affect their ability to oversee the funds. They should not expect expense ratios to continue declining. In fact, expenses may trend higher for a time.

In this grim environment, the viability of some advisers may become a topic of discussion for boards. The Panel recommends trustees ask what the fallout portends for the management company. Boards should understand the adviser's strategy for surviving industry consolidation, but should not seek to direct that strategy.

Trustees of funds managed by smaller advisers will want to know how management can compete. For example, a small adviser who manages a money market fund may find it too big of a challenge to create a capital support program. Barriers to entry in the fund advisory business are going to increase. Trustees need to know what the impact will be on the funds they oversee.

For larger fund companies, the Panel recommends trustees find out whether there are plans to merge or close any funds. It may be difficult to manage a large fund family well and cost-effectively. Doing away with outlier funds may be a good strategy for ensuring the viability of the remaining funds. If the adviser is considering selling the management company, the board needs to be kept informed.

The Panel suggests boards schedule periodic "big picture" discussions with management. The goal is to understand the adviser's strategy so the board has context for decisions it must make, but trustees should resist the urge to intrude on advisers' strategic plans.

The fallout from the current environment is yet to be fully understood. A further challenge is the unknown — what events and repercussions still await the industry? Each adviser will come through this time differently. Firm structure and size, fund family composition, distribution channel, and other key characteristics all will have an impact.

The Panel warns boards they will hear messages from the SEC and the press urging them to take action. They must resist these calls to arms. The trustee's role is one of oversight. In times of crisis, the natural tendency is to seek to do more. But the Panel believes if trustees become managers, they will lack the time and perspective to ask the right questions and monitor the adviser.

THE PANEL'S CONCLUSIONS:

- 1** Prepare for new regulations and new compliance expenditures.
- 2** Ask what the fallout portends for the management company.
- 3** Understand — but do not direct — the adviser's strategy for surviving industry consolidation.
- 4** Conduct regular sessions with management in order to stay informed about developments that could affect the funds.
- 5** Remember that trustees are there not to manage the adviser or the fund but to oversee the management of the fund.

A tsunami of regulation is about to hit us.

Gary French



Conclusion

Mutual funds are experiencing unprecedented market upheaval and financial uncertainty. Boards are looking for guidance as they seek to help funds survive the crisis and emerge even stronger. The Panel convened by *BoardIQ* suggests eight key steps fund boards can take to fulfill their responsibilities effectively in times like these.

The Eight Action Steps

1 Communicate more, refine your process, but don't micromanage.

2 Understand valuation processes and procedures.

3 Watch for conflicts of interest.

4 Get back to the basics of enterprise risk management.

5 Complex securities need to be studied, not scrapped.

6 Support and then leverage your CCO.

7 Shareholders matter. Get the word out to them.

8 Be prepared for long-term fallout from the credit crisis.

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