

## Role of the Mutual Fund Director in the Oversight of the Risk Management Function

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# Foreward

Since the *Role of the Mutual Fund Director in the Oversight of the Risk Management Function*<sup>1</sup> (the *Risk Paper*) was last published in 2020, the world has changed drastically. Fund complexes have faced new challenges and opportunities as a result. In addition to evergreen risks the fund industry faces, this paper highlights emerging risks facing fund complexes, including new regulations; new investment opportunities; and evolving investment philosophies such as the increasing focus on environment, social, and governance (ESG) issues. The paper lays out questions for directors to consider in their risk oversight role. While each organization faces different risks and has its own unique risk management frameworks and programs, this paper can serve as a guide to help directors in the face of the ever-evolving risk landscape.

## INTRODUCTION

Boards of registered funds (hereafter referred to as fund directors, directors, fund boards, or boards) have an important role in risk oversight. In doing so, directors may find it helpful to distinguish between risks that are necessary to meet the funds' objectives and other unexpected risks. An open, ongoing, transparent dialogue among the directors, adviser, and other key service providers is important to supporting board risk oversight.

This paper<sup>2</sup> sets forth key concepts, principles, and some initial questions that fund directors may find useful as they seek more information to support their risk oversight responsibilities. This paper builds and expands upon the previous May 2020 paper, noting where enhanced or new content has been provided. As with the earlier paper:

- The first section lays out a fund director's role and duties.
- The second section sets forth common risk management program elements and practices to help fund directors better understand how investment advisers and service providers manage risks to the funds they oversee.
- The final section discusses specific areas of existing, evolving, and emerging risks that impact the investment management industry.

The Mutual Fund Directors Forum recognizes that a "one-size-fits-all" approach to risk oversight and risk programs is not feasible or beneficial. Consequently, when discussing funds' risks and programs necessary to manage those risks, directors should consider the factors relevant to their particular funds, such as the funds' investment objectives, asset size, and complexity.

Importantly, fund directors should be aware of whether their fund's adviser and other key service providers have appropriate risk management programs and practices in place for identifying, analyzing, managing, and ultimately reporting existing, evolving, and emerging material fund risks across all risk categories.

## ROLES AND DUTIES OF FUND DIRECTORS

Fund directors are responsible for understanding and overseeing how the fund's adviser manages a fund's risk. While there are no regulatory-defined duties with respect to risk for fund directors, fund directors can establish a solid foundation for risk oversight by developing an understanding of the:

- Obligations arising under state law, the Investment Company Act of 1940 (1940 Act) and the Securities Act of 1933 (1933 Act)
- Applicable guidance from courts and the Securities and Exchange Commission (SEC) and its staff regarding their expectations for directors
- Most significant strategic, investment, operational, regulatory, and emerging risks affecting a fund and fund complex, and
- Risk management programs and processes implemented by the adviser and fund service providers to identify, manage, and mitigate risk.

## Obligations under state law, the 1940 Act, and the 1933 Act

Funds are organized under state laws and, as a result, a director is considered a fiduciary to the fund.<sup>3</sup> As a fiduciary, a director owes two basic duties to the fund: the “duty of care” and the “duty of loyalty.”

- The duty of care requires a director to act with reasonable care and skill in light of their actual knowledge and any knowledge they should have obtained in functioning as a director. Under state law, directors are generally permitted to reasonably rely on experts, including counsel, the fund’s adviser, accountants, and others.
- The duty of loyalty means that a director owes a duty to protect the best interests of the fund and not to pursue their own interests or those of a third party over the interests of the fund. The duty of loyalty also encompasses the duty to act in good faith.

In assessing the actions of directors, courts apply the “business judgment rule.” The business judgment rule insulates a director from liability for a business decision made in good faith if: (i) the director is not interested in the subject of the business decision; (ii) is sufficiently informed to make the business decision; and (iii) rationally believes that the business decision is in the best interests of the company.<sup>4</sup>

In addition to state law fiduciary duties, the 1940 Act and its regulations, together with SEC statements, also impose duties on directors in three general areas:

- Evaluating fees charged to the fund and valuing the fund’s assets<sup>5</sup>
- Dealing with conflicts of interest<sup>6</sup> and
- Assessing third-party service providers.<sup>7</sup>

Lastly, the 1933 Act also imposes certain legal duties on fund directors with respect to registration statements, requiring a majority of the board to sign the registration statement of a fund prior to its filing and imposing individual liability for any untrue statement of material fact or material omission in the registration statement.<sup>8</sup>

## Court and SEC guidance

The US Supreme Court, SEC, and SEC staff have consistently emphasized that the fundamental obligation of a fund director is to protect the interests of a fund’s investors.

As a general matter, effective oversight contemplates that a fund’s directors understand a fund’s investment, operational, and regulatory risks. To gain an understanding of these risks, directors should:

- Request information regarding the fund’s activities and the critical services provided to the fund to enable directors to develop an appropriate appreciation of the risks inherent in the operation of a fund and to then assess the effectiveness of risk practices and controls implemented by the adviser and other service providers.
- Receive regular updates regarding the risks associated with outsourced services and how they are being managed by the adviser or appropriate service provider, and other parties within the extended enterprise.
- Evaluate on an ongoing basis whether fund policies and procedures are reasonably designed and operating effectively to prevent the fund’s operations from violating applicable federal securities laws.<sup>9</sup>

While fund directors could be tempted to become drawn into the day-to-day operations of a fund, a fund director’s primary responsibility is to provide oversight and operate as an independent check on those charged with day-to-day management of the fund’s activities.<sup>10</sup> A fund’s investment adviser executes its own responsibilities, unless the fund’s directors appropriately delegate day-to-day management responsibilities to the fund’s investment adviser and other third-party service providers.

Fund directors should work with the fund’s investment adviser and service providers and consult with outside experts—as applicable—to understand and oversee how risks are identified, assessed, and managed. In addition to consulting with the adviser’s risk management personnel, the fund’s chief compliance officer (CCO) can be a significant resource for boards in overseeing risk management effectively. While the CCO is not responsible for managing risks, the CCO may learn valuable information about operational and other risks as part of the administration of the fund’s compliance program. In addition, fund directors should understand the relevant scope, plans, and outcomes of the adviser’s internal audit function and other integrated business functions to facilitate the boards’ oversight responsibilities.

## THE RISK MANAGEMENT FRAMEWORK AND PROGRAM

As outlined in the introduction, effective risk management is not a one-size-fits-all exercise and should be tailored to the fund and fund complex's size, structure, and other relevant attributes. While fund directors are not responsible for risk management, they should understand the adviser's risk framework, the program for risk identification, assessment, mitigation, monitoring, and reporting. Fund directors should appreciate how the adviser tailors its risk management program to address the existing risks it faces, as well as to emerging risks.

Despite the diversity in how risk management programs and practices may be designed and implemented, most risk management programs follow a similar approach and principles. Risk management programs should be designed to identify, measure, and manage the most significant risks to within an acceptable risk appetite or tolerance level, not eliminate or fully mitigate every risk. Moreover, as advisers grow, their product offerings evolve, and external factors change (e.g., regulatory environment), their risk management programs should as well.

Regardless of the particular risk management program or model that is used by the adviser and other service providers, there are significant elements and processes that are typically included in an effective risk management program as discussed in more detail in the following sections.



**An effective risk management framework and program allows the adviser and other service providers to identify and manage risks that are relevant to a particular fund and fund complex.**

**Risks** evolve over time and vary depending on the fund's particular facts and circumstances, such as the fund's investment objective, principal strategies, and its internal operating environment including outsourced service providers, as well as external forces such as industry and regulatory changes. In general, risk can be broadly divided into four categories:

**Investment risks (page 8)**, which are risks related to a fund's portfolio composition, including but not limited to market, credit, liquidity, and leverage risks.

**Operational risks (page 15)**, which include risks related to people, process, and systems including technology and information/cybersecurity.

**Strategic risks (page 21)**, which are those that could disrupt the objectives and assumptions that define an adviser's business strategy, including risks to competitive position, reputation, and strategy execution.

**Regulatory risks (page 22)**, which are related to regulatory changes and how regulations are interpreted and implemented as well as compliance with various existing regulations.

## Elements of an effective risk management program

### **Governance, tone at the top, and risk culture**

Good governance is essential to an effective risk management program, and good governance starts with the attitudes and principles of those in the most senior positions at an adviser or service provider.<sup>11</sup> These attitudes and principles are referred to as “tone at the top” and should cascade throughout the firm. This should become the tone throughout the organization and embedded as a fundamental principle and belief that risk is everyone’s responsibility. The tone at the top along with these embedded beliefs help define a firm’s risk culture.

Thus, the “tone at the top” is important to understand when considering the adviser or other service provider’s risk philosophy and approach to risk management. While the tone at the top may be difficult to empirically evaluate, fund directors can gain insight by engaging in discussions with senior management, as well as external auditors and outside counsel, to help understand and appreciate the tone at the top and overall risk culture.

In further evaluating the risk culture at a firm, a fund director may find it helpful to determine how the risk management program operates, which can be facilitated by meeting with key risk management personnel. In doing so, fund directors may find the following questions helpful to consider:

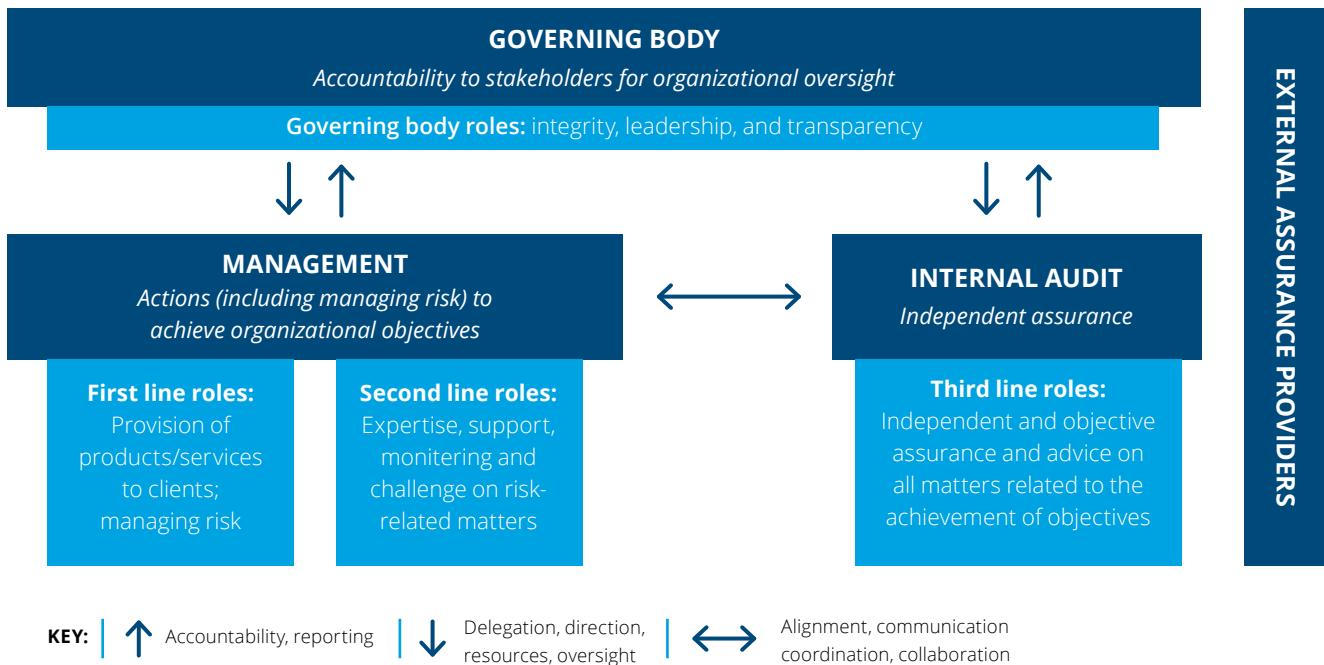
- Who is responsible for overall risk management and what is the governance structure? Is there an enterprise-wide risk management committee or other governing body?
- Are risk manager roles within business units or outside of them, or both? Are there well-defined first- and second-line risk roles and responsibilities?
- How has risk management evolved over the past one to two years due to changes in the working environment (e.g., virtual, hybrid)?
- What is the process for identifying and monitoring existing, evolving, and emerging risks? How is ongoing risk monitoring performed?
- How are key risks determined, agreed upon, or ratified? How are key risks—and the process, controls, and plans to mitigate these risks—monitored, reported, and challenged within the organization?
- How does the adviser encourage an appropriate risk culture? How does the adviser incentivize appropriate risk-taking (and not incentivize inappropriate risk-taking)?

### **The Three Lines Model for good risk governance**

It is also important for fund directors to understand how roles and responsibilities for executing the risk and control processes have been delineated in the organization. In many organizations, different teams have risk management responsibilities, including enterprise, operational, and investment risk professionals; compliance officers; internal audit professionals; control assurance specialists; and other risk and control professionals who are embedded in or supporting the business. These teams each have a unique perspective and role but are collectively working together to help the adviser manage and evaluate risk. While every adviser is unique and, as a result, there is no single or right way to organize risk functions, responsibilities should be clearly delineated and understood and the work coordinated when possible and practicable.

One commonly used framework for defining roles and responsibilities is the Institute of Internal Auditors’ (IIA) Three Lines Model. In this model, the first line is responsible for risk identification and mitigation, the second line provides support, challenge, and risk monitoring capabilities, and the third line provides independent assurance. Each of these three lines plays a distinct role within the organization’s wider governance framework. The fund’s CCO and, when applicable, the chief audit executive should also have a direct line to the board/audit committee (the “governing body” in the model on the next page<sup>12</sup>).

**THE IIA's Three Lines Model**



**Risk communication and reporting**

When evaluating the appropriateness and sufficiency of risk-related communications and reporting, the board may wish to consider:

- The adviser's or service provider's communication of risk management protocols and expectations, including those related to risk event escalation and reporting, to all those involved; and
- Ongoing risk-related reporting.

The board should work with the adviser and key service providers to develop reporting to support the fund board's understanding of the risk management program, as well as ongoing fund-related risk reporting (e.g., key risks and key risk indicators, or KRI). Such reporting is essential to the board so it can understand the adviser's and service provider's current risk management programs and how well they are managing the risks to the funds.

In addition to the reporting and communications the fund board receives, directors should examine how the board structures and addresses its risk oversight responsibilities. For example, some boards may find it helpful to have a board risk committee, whereas others prefer to address risk as part of another committee's responsibility (e.g., audit or compliance) and still others have risk remain at the full board level. This decision will impact how the board interacts with the adviser and service providers and sets expectations for ongoing risk-related reporting, communication, and discussions.

As fund directors consider their expected risk-related communications and reporting, the following questions may be helpful:

- How often should the adviser and service providers review and discuss their risk management programs and activities with the fund board? Who is responsible for these discussions? Does this reporting provide the directors with an appropriate level of visibility into the risk management program and how it is functioning?
- What is the current risk and risk management-related reporting to fund directors? Does the current risk reporting meet director expectations?
- How is the reporting reviewed and discussed? How does this risk reporting compare to the reporting received by the risk management governing bodies of the adviser or service provider (e.g., enterprise-wide risk committee)?

### **Risk identification and assessment**

The adviser's risk management program should include a process to timely identify and assess risks. Understanding the risk identification and assessment processes of an adviser or other service providers is an important aspect of the overall risk program. While there are no standardized approaches to identify and assess risk, there are some common principles such as understanding organizational objectives and supporting end-to-end processes and underlying people, processes, and technology that may contribute to the risk that an organization faces.

To understand risk identification and assessment, fund directors may find it helpful to raise the following questions:

- What is the adviser's approach to identifying and assessing risk?
- How frequently does the adviser undertake such risk identification and assessment activities?
- Who is typically involved in the risk identification and assessment process?
- What happens when there are changes to the organization, processes, people, or technology, and how is that factored into the risk identification and assessment process?
- Are there any tools utilized to enable and/or facilitate the risk identification and assessment process?
- What is the process to review and approve the results of the risk identification and assessment?

### **Risk appetite and risk tolerances**

Risk appetite is defined as the amount of risk, on a broad level, an entity is willing to accept as it tries to achieve its goal and provide value to stakeholders. Risk tolerance is the acceptable level of variation relative to achievement of a specific objective.<sup>13</sup>

Within an adviser, risk appetite and related-risk tolerances set expectations for acceptable variations of risks across the fund complex to monitor actual risk levels as compared to the established tolerances around specific objectives. Establishing and using risk tolerances to monitor risk can allow the adviser to better understand, manage, and monitor whether the risks are in line with the fund's objectives and the expectations of its shareholders.

Understanding the risk appetite of an adviser or other significant service provider, however, can be challenging due to the highly subjective nature of identifying and articulating risk appetite across an entire organization and the varied approaches to defining and monitoring risk tolerances. There are no common standards, and different advisers may use different methodologies, language, and metrics (e.g., KRI), which can be both qualitative and quantitative or some mix of both.

To understand risk appetite and related-risk tolerances, fund directors may find it helpful to raise the following questions:

- What is the adviser's approach to defining risk appetite, and how is risk appetite used to monitor overall levels of risk?
- Are risk tolerances or risk thresholds established to monitor risk levels, and—if so—how?
- How are actual levels and/or key risks measured against the risk appetite? If KRIs are used, how are they defined and reported?
- What happens if a particular level or key risk is out of tolerance? And if multiple risks are out of tolerance?
- How is the overall, firm-wide level of risk monitored in comparison to risk appetite?
- How often are risk appetite statements and/or risk tolerances reviewed?
- What is the process to review and approve changes to risk appetite statements and/or related-risk tolerances?

### **Risk events and incidents**

Risk events or incidents can include information security or cyber breaches; investment guideline or restriction breaches; trading, pricing, or valuation errors; or other incidents affecting the fund or its shareholders. Understanding the adviser's (as well as other service providers') risk event or incident management process is important to the board's risk oversight and also beneficial to understanding how risk is managed in an ongoing, day-to-day business.

Immediately following the identification of a risk event or incident, an adviser should focus on correction and/or remediation to eliminate or minimize harm to the fund(s) or shareholders. Subsequently, the adviser should have an in-depth process for identifying the root cause of the incident as an important step in preventing future occurrence. Once the root cause (or sometimes multiple causes) for the incident has been determined, the adviser can then focus on preventing recurrence in the future.

Fund boards should understand the policies, procedures, and reporting in place to fully oversee this end-to-end process. Boards also should understand how the adviser and service providers seek to prevent reoccurrence in the future.

As boards consider the incident management program and process, the below questions may be helpful:

- How are incidents timely identified, remediated, and managed?
- What is the process for understanding the root cause, or causes, and how to prevent them in the future?
- How and to whom are incidents escalated to ensure appropriate response and awareness? Under what circumstances is the board notified of incidents?
- How are risk events and incidents considered in the identification and assessment of potential or current key risks?
- What specific reporting should the fund board receive to fully understand the process and impacts to the fund?

#### ***Risk mitigation strategies and control activities***

Control activities are actions (generally described in policies, procedures, and standards) that help management mitigate risks. Control activities may be preventive or detective in nature and may be performed at all levels of the organization. They include management-level controls and internal controls in the business processes and activities as well as those performed by oversight functions (e.g., financial controls, risk management, compliance).

It may be helpful for a board to understand how each responsible party supports the control structure with respect to how controls are developed, maintained, and assessed in the normal course as well as how controls are adapted as risks evolve.

In understanding the adviser's control activities, directors may wish to consider the following:

- How does the adviser manage and develop controls to mitigate risks?
- How does the adviser assess the effectiveness of controls? Is there strong coordination and collaboration between the various risk and assurance functions (see below)? How are the results of such assessments communicated to the board?
- What is the role of the internal audit function in testing and reporting on control activities? How is the audit plan developed? Does the plan align to key risks? Does internal audit have agile processes in place to respond to emerging risks?
- How are emerging risks integrated into the control structure? For example, how has the remote working environment influenced the design of new or modified controls?
- Does the adviser monitor automated control activities differently from those that rely on more manual processes? If so, how does the monitoring differ?
- Does the adviser leverage automation (e.g., robotic process automation) and/or cognitive technologies (e.g., machine learning, natural language processing) to perform more intelligent testing/continuous monitoring of controls?
- Does the adviser engage with third-party subject-matter specialists to support assessing/monitoring specific risks (e.g., cyber)?

#### ***\*\*New in 2022\*\* Benefits of risk and assurance alignment and integration***

As advisers and service providers plan and execute risk management and assurance activities, frequent coordination and collaboration among risk and assurance functions is necessary. As functions throughout the business address the various risks facing their line of business, there is a chance of risk reporting becoming siloed, leading to redundancies and extra costs. For particularly complex organizations, integrated assurance can help prevent some of these redundancies.

At a minimum, an organization should ensure alignment across the functions that includes thoughtful planning, an understanding of cross-functional responsibilities, addressing any unhelpful overlap of risk and assurance activities, and

coordinated scheduling of assurance activities. Cross-functional considerations should be woven into the execution cycle with frequent, meaningful discussions around themes and insights. As an example, risk themes should be collectively considered by risk and assurance functions during the reporting cycle.

As a next step, some organizations are moving past alignment to adopt a more integrated risk and assurance model anchored in (1) identifying drivers of business value, (2) understanding risks associated with delivering business value and (3) aligning risk monitoring, reporting, and related assurance activities around these risks.

Together, these practices provide the building blocks to implementing both a holistic and tailored integrated risk and assurance model.

### ***Risk framework and program evaluation***

An adviser should continuously evaluate its risk management framework and program to keep pace with the evolving business, shareholder expectations, market conditions, and regulatory focus. Chief risk officers (CROs), or other appropriate risk management leaders, should provide insights to fund boards as to how and how often the organization evaluates the risk management framework and program and what actions are taken in response.

In discussions with the adviser about ongoing risk monitoring, fund boards may wish to consider the following questions:

- How effective has the risk management program been in reducing risks?
- How do the risk leaders determine whether a risk program has been effective?

### ***Adaptive risk monitoring***

The concept of adaptive risk monitoring refers to the ability to sense or identify risk that is developing at its earliest stages so the risk can be investigated, and decisions can be made to timely eliminate or manage the risk before it adversely impacts the adviser and/or the funds. Adaptive risk is an emerging area that may become more prevalent as technology and risk frameworks evolve.

Historically, risk management has been based on a more reactive program. As previously discussed in the Risk events and incidents section, errors or risk events would occur, and management would perform a root-cause analysis to better understand why the event occurred and would assess the internal controls and operational practices to determine if they needed to be strengthened. Reactive risk event review and root-cause analysis should still be part of the risk monitoring framework; however, solely relying on this approach misses an opportunity to identify risks before they can result in a risk event. Sound risk management practices can be designed today so that significant risk conditions are detected at their earliest stages with rapid response.

To transition to an adaptive risk model framework, the adviser should first determine any predictable risks. That is, risk events that could occur and impact the funds. By thinking proactively, risk event “warning” signals can be identified, supported by an efficient process and reporting, that can alert risk managers to these conditions and begin working through the adaptive risk model to mitigate potential adverse outcomes. Consequently, efforts can then be focused on addressing the most impactful risk conditions in a timely manner while enabling an efficient use of resources.

### ***Key considerations for fund directors***

Fund boards may want to consider if the adviser has adopted an adaptive risk model framework, how has risk response and reporting improved?

## **SPECIFIC RISK AREAS IMPACTING THE INVESTMENT MANAGEMENT INDUSTRY**

While an overarching risk management program can help address the many risks impacting advisers, service providers, and ultimately the funds, there are additional specific risks to consider. These risks fall into four categories: investment risk, operational risk, strategic risk, and regulatory risk.

### **Investment risk**

Oversight of investment risk is a critical component of a director’s responsibilities. Investment risk includes both intended or expected risk from investment exposure and process and unintended risk that may result from decisions, assumptions, and other factors. Investment risk and returns are closely linked. Without understanding and considering the level and type of risk in a fund’s portfolio of investments, it is difficult for a director to effectively review the performance of the fund. Every investment opportunity contains some form and level of risk and offers the potential of some measure of theoretical return (positive or negative). Investment professionals typically differentiate between absolute risk and relative risk. Absolute risk generally refers to the variability of the value of an investment, whereas relative risk represents the difference in expected return between an investment vehicle or product and an appropriate index or benchmark return. While investment professionals may agree on how much risk is typical for active or passive management products, opinions may differ regarding what level of relative risk is appropriate for a given investment strategy or across an adviser’s fund complex in the case of correlated risks.

In overseeing investment risk, boards may find it helpful to consider:

- Trend levels of investment risk over time, in both absolute and relative terms
- Returns versus peer groups and benchmarks over time on both an absolute and risk-adjusted basis
- Funds with consistently weak performance, and
- Unexpected performance results and/or instances of significant over/under performance.

A fund’s disclosure documents can help a board determine how a fund’s risks are communicated to shareholders. Established procedures that include a comparison of a fund’s actual risks (e.g., alignment with the fund’s guidelines, position limits, counterparty credit limits, concentration limits, expected return volatility range) against the fund’s risk disclosures can help determine whether the risks being taken are appropriate or require adjustment.

While monitoring risk on a fund-by-fund basis is vital, such a narrow approach could expose the fund complex to added risk. For example, a risk may be relatively minor for an individual fund but could have a significant impact on the adviser's organization when aggregated, such as heightened investment risk due to exposure to a security or underlying investment across multiple funds. Therefore, in addition to discussing the fund-by-fund risk, fund directors should explore how the adviser monitors risk on a complex-wide basis.

#### **Key considerations for fund directors**

Directors may find the following questions helpful as they consider a fund's investment risk:

- Are the levels (and types) of investment risks that the adviser is taking with respect to the fund in line with a fund's prospectus and Statement of Additional Information (SAI)?
- How does the adviser measure and quantify the risks taken by the fund? Does the adviser have systems or resources in place to measure and manage those risks? What are those resources?
- How has the alpha added compare to the benchmark and peer group when measured on a risk-adjusted basis?
- Is an appropriate benchmark (of similar risk profile) used for comparison of investment results?
- What types of reporting does the board receive regarding performance attribution? How often do directors receive these reports?

#### **Valuation risk**

Valuation risk is the risk that a fund inappropriately determines the value of one or more of its investments, which may result in an inaccurate net asset value for the fund. Under such circumstances, certain shareholders may be treated inequitably, bearing either more or less of returns or losses than they would otherwise. Broadly, valuation risk includes the risk that:

- Methods utilized by the adviser and reviewed and approved by the board for determining fair value are not consistent with generally accepted valuation practices
- The established methods for determining fair value have not been applied consistently and/or accurately, or
- The established methods are no longer appropriate, due to changing market conditions or other factors.

The 1940 Act requires that directors determine the fair value of securities for which market quotations are not readily available. The SEC adopted Rule 2a-5: Good Faith Determinations of Fair Value,<sup>14</sup> with a compliance date of September 8, 2022, which expressly allows the board to designate the adviser to perform certain valuation functions. The rule requires directors to engage in active oversight regarding valuation risks, fair value methodologies, pricing services, written fair value policies and procedures, testing of fair value methodologies, and record retention.

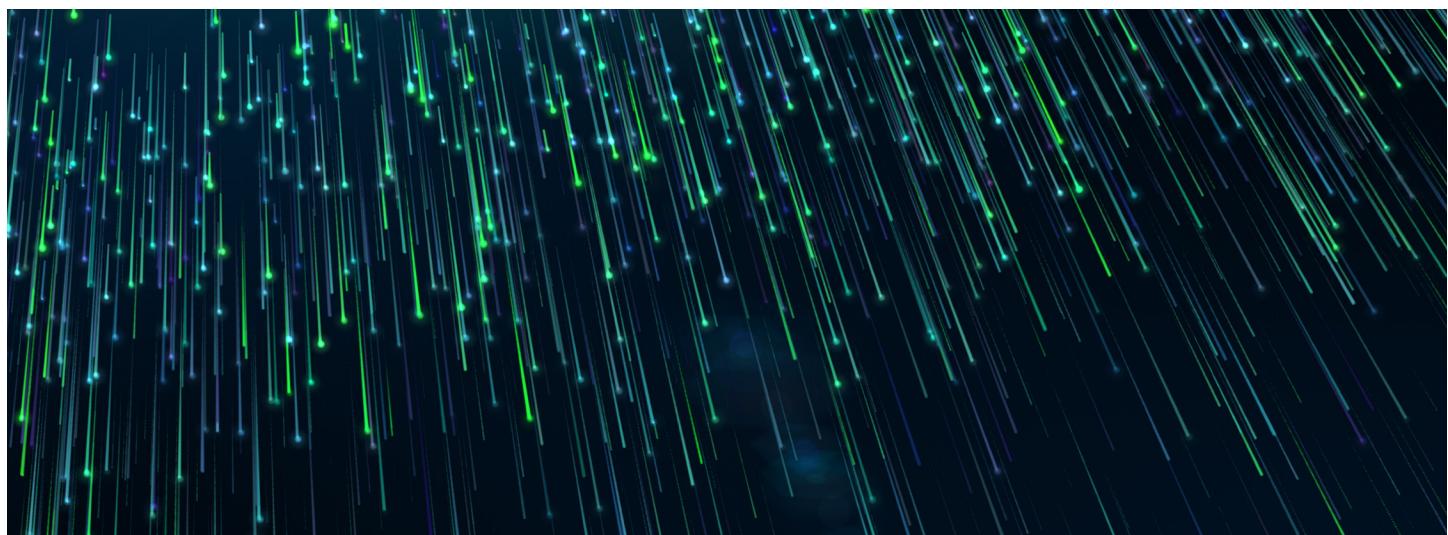
Since the last *Risk Paper* publication, the SEC has adopted Rule 2a-5, which specifically requires the periodic assessment of material risks associated with the determination of fair value, including material conflicts of interest. Rule 2a-5 also requires the identified valuation risks to be managed. The frequency of the reassessment of material risks is not established by the rule and may vary depending on including the types of the fund's investments, significant changes in a fund's investment strategy or policies, market events, and other relevant factors. While the rule does not specify which risk(s) need to be addressed, the release provides a "non-exhaustive" list of valuation risks that may be considered:

- The types of investments held or intended to be held by the fund and the characteristics of those investments
- Potential market or sector shocks or dislocations and other types of disruptions that may affect a valuation designee's or a third party's ability to operate
- The extent to which each fair value methodology uses unobservable inputs, particularly if such inputs are provided by the valuation designee
- The proportion of the fund's investments that are fair valued as determined in good faith, and their contribution to the fund's returns
- Reliance on service providers that have more limited expertise in relevant asset classes; the use of fair value methodologies that rely on inputs from third-party service providers; and the extent to which third-party service providers rely on their own service providers (so-called "fourth-party" risks), and
- The risk that the methods for determining and calculating fair value are not consistent with generally accepted valuation practice or that such methods are not being applied consistently or correctly.
- Additional risks may be relevant, depending on the specific funds and the nature of the investments they hold, such as private equity. Refer to the Risk related to private equity investments and Model risk sections below for further considerations related to private equity investments.

### Key considerations for fund directors

Directors may find the following questions helpful as they consider a fund's valuation risk:

- Has the appropriate valuation designee been identified?
- What are the valuation methodologies documented in the fund's valuation policies and procedures? Does the valuation designee evaluate the valuation methodologies and processes for new and evolving asset classes?
- Are there different valuation processes for different types of assets? For example, if a fund invests in private equity investments, what is the valuation process and how does it differ from other types of assets?
- What constitutes a "material" valuation risk?
- Do the procedures account for unusual market conditions, such as when particular markets are closed for long periods of time?
- What is the role of portfolio managers and traders in the valuation process?
- How frequently should a valuation risk assessment be performed?
- How are valuations tested?
- What kind of periodic testing does the valuation designee use to test the quality of evaluated prices?
- How does the board monitor compliance with policies and procedures? Has the board considered the effectiveness of controls over the valuation process?
- How does the valuation designee evaluate new or current third-party pricing services, including pricing vendors, brokers, and others?
- What sort of information is provided by the fund or its advisers to third-party pricing services?
- What information does the board receive regarding pricing services that provide the fund with evaluated prices?
- What are the policies and procedures regarding price challenges? Does the board receive reporting regarding price challenges?
- What are the policies and procedures (including escalation procedures, if applicable) of the adviser or administrator regarding pricing overrides? Does the board receive reporting regarding overrides?
- Has the adviser identified conflicts of interest that could arise in the valuation process? Has the adviser communicated such conflicts of interest and mitigation techniques to the board?
- Does the board receive information that such conflicts are addressed and managed by controls and other safeguards?
- Do the valuation policies and procedures identify events where the board must be involved or must be notified? Are the "material" events that require board notification per Rule 2a-5 defined?
- Has the valuation designee identified key valuation indicators for each asset class that notify/inform fund directors of potential price uncertainty in the market?
- Does the valuation designee consult with pricing experts on difficult and/or complex fair valuation matters?
- Does the board have an adequate understanding of the fair valuation models used by the adviser or administrator?





### \*\*New in 2022\*\* Liquidity risk

Ensuring that shareholders can redeem shares in an open-end mutual fund is fundamental to a fund's operation. Rule 22e-4 requires open-end funds to develop liquidity risk management programs. The rule defines liquidity risk as "the risk that the fund could not meet requests to redeem shares issued by the fund without significant dilution of remaining investors' interests in the fund."<sup>15</sup> Broadly, liquidity risk includes the risk that:

- The fund does not have sufficient liquid assets or borrowing capacity to meet shareholder redemption requests in an orderly manner consistent with SEC requirements without harming remaining fund shareholders
- Established methods to determine liquidity have not been applied consistently and/or accurately
- Established liquidity determination methods, approaches, and/or inputs are no longer appropriate, due to changing market conditions or other factors, to strictly address Rule 22e-4 requirements due to changing market conditions or other factors
- The fund's valuation procedures and policies do not appropriately consider liquidity in the valuation process to achieve accurate security valuations, and/or
- Long-term market closures due to natural disasters, political turmoil, etc. may impact an asset's liquidity.

The rule places specific responsibilities on fund directors in their oversight of liquidity risk. Fund directors are required to:<sup>16</sup>

- Approve the fund's liquidity risk management program
- Approve the designation of the person(s) designated to administer the liquidity risk management program
- Receive a report at least annually regarding the liquidity risk management program, which should include notice of any material changes in the program

- Approve any changes to the fund's highly liquid investment minimum if the fund seeks to change the minimum when already below the established minimum, and
- Be informed within one day if the fund's illiquid investments exceed 15% of the fund's portfolio.

Liquidity and valuation are closely intertwined. An asset is illiquid if the fund reasonably expects it cannot be sold in current market conditions within seven calendar days without significant changes to the market value of the investment. Further, illiquid assets frequently have to be fair valued because they do not have a readily available market quotation. Thus, there can be a direct link between the valuation of the asset and its liquidity status. Fund directors should be aware of the possibility that selling illiquid securities to meet redemptions in stressed conditions may result in the fund receiving less than the determined "fair value" for such securities.

#### ***Key considerations for fund directors***

Directors may want to consider the following questions while discussing liquidity risk with advisers:

- Does the adviser have a system to identify when funds are at risk of exceeding the established liquidity threshold?
- Does the adviser keep the board apprised of changes to the fund's liquidity risk management program?
- Is the adviser's report regarding the liquidity risk management program comprehensive?
- Does the adviser have protocols in place to notify the board, within one day, if the fund's illiquid investments exceed 15% of the fund's portfolio?

### Model risk

With the increased reliance on technology to enhance and standardize the investment processes, more funds rely on models. Advisers use models for asset selection, risk management, allocation of positions between funds, and other operational functions. Model risk is the potential risk for adverse consequences from decisions based on incorrect or misunderstood model outputs and reports. Model issues can lead to monetary loss, harm to clients, erroneous financial statements, improper investment or managerial decisions, and/or damaged reputation resulting from poorly constructed, interpreted, and maintained models.

Model issues have occurred where:

- New models or model updates/changes are not appropriately developed, tested, or validated.
- Model elements (e.g., algorithmic formulas) are not properly maintained and updated when new data becomes available.
- Modification to existing model data is not well managed or understood by those relying on the model.
- Model assumptions are not tested adequately resulting in faulty results.
- Models or model changes are not fully understood by those relying upon them.

Regardless of the cause, model issues and failures may be very costly to identify, investigate, and remediate—potentially causing significant erosion in value, including reputational loss, regulatory sanctions, and economic and financial losses.

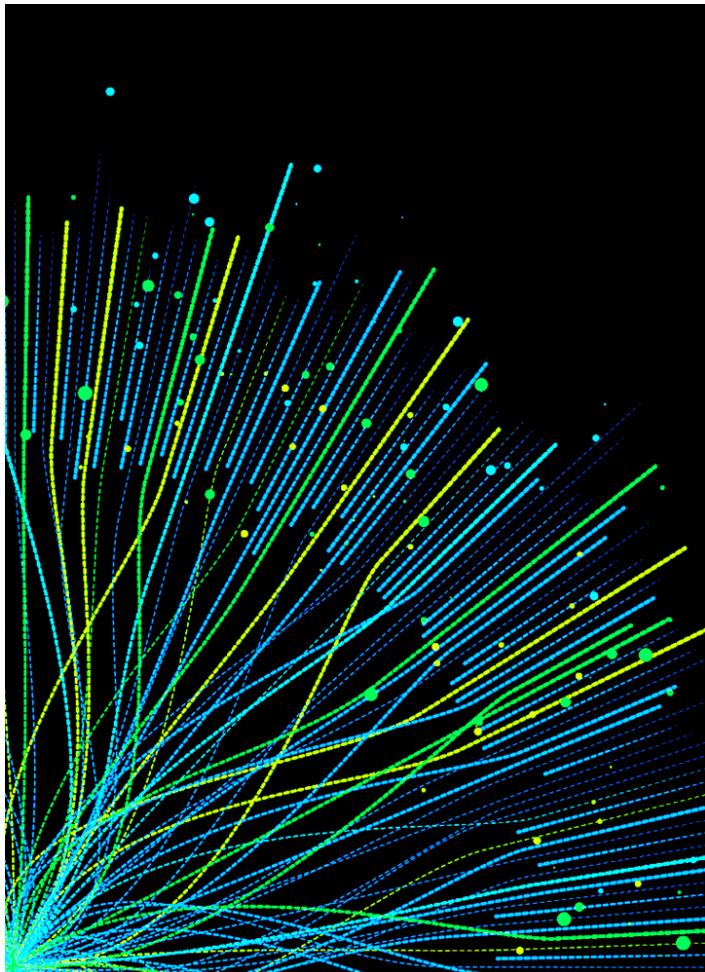
### ***Key considerations for fund directors***

Directors may find the following questions helpful as they consider a fund's model risk:

- How does the adviser define models?
- How does the adviser manage model risk? Does the adviser have a robust model risk management program?
- What is the difference between models that make automated investment and tools used as inputs in the portfolio manager's decision process?
- Who in the organization oversees model risk, and do they have the ability and authority to effectively challenge model owners? Are models subject to independent validation prior to being put into production?
- Who reviews model recommendations prior to implementation?
- How does the adviser review and test third-party or vendor models?
- What type of regular reporting does the board receive on significant model risks, both for specific models and in the aggregate?
- Does the adviser have change management procedures and controls in place to appropriately capture and record model changes over time?
- Does internal audit or a third party perform a periodic audit to determine that model risk activities, framework, and model outputs/valuations are being performed adequately based on policy?

### **New product and investment strategy risk**

Advisers continue to launch new investment strategies, structures, and vehicles. The fund industry has recently witnessed growth in a number of types of funds, including alternative strategy funds, direct indexing offerings, and factor-based products. The types and degree of risk and the oversight practices required to manage these risks will necessarily vary, across all the categories of risk, depending on the fund strategy, structure, investment portfolio, and ongoing supporting processes.



### **Key considerations for fund directors**

Directors may wish to consider the following relating to the risk associated with new products and/or investment strategies:

- What risks do the fund's new strategies and/or new complex investment vehicles pose? Is the new strategy/investment appropriate for the fund structure? Does the fund adviser have the right resources/talent/skills, controls, and risk capabilities to manage such risks at the time of the change/launch/investment?
- If the fund is sub-advised, does the adviser have adequate access and transparency into the sub-adviser to perform appropriate oversight? Is the sub-adviser experienced in managing the strategy within the confines of a fund regulated under the 1940 Act? Has the adviser or sub-adviser ever managed money before under a similar proposed strategy, such as in a separately managed account or other institutional account?
- Is the adviser able to execute the new strategy while also adhering to any existing limitations (e.g., leverage, liquidity), whether due to regulatory restrictions or policy/strategy restrictions? Are these products periodically stress tested under various historical and hypothetical scenarios?
- What systems, operations, personnel, and technology support will the new strategy or new investment require? How may existing operations and systems be enhanced to support the new strategy or investment effectively?
- Are there scale limitations on the adviser's ability to handle the new strategy or investment type?
- Are the fund's valuation policies, procedures, and controls sufficient to support the new strategy or investments? Are there sufficient skills in place or does the operating model include outsourcing those capabilities?
- Are the new strategies accurately described to investors in the prospectus, fund marketing materials, and other fund offering documents? If a fund begins to invest heavily in a new type of investment, has that new investment risk been disclosed to shareholders?
- Are risk disclosures consistent between the fund prospectus, marketing materials, and financial reporting?
- How will the fund board reporting need to be updated to provide appropriate oversight for the management of these new risks?



*Below are some examples of specific investment risks that asset managers face today. While these may evolve as new products are launched, the considerations below can serve as a "blueprint" for considering risks introduced by future emerging new strategies.*

**\*\*New in 2022\*\* Private equity (PE) investment risk**

Private equity, both from a direct investment and a private equity fund investment perspective, may offer advisers the ability to earn additional alpha and diversify investment risk from public equities. As a result, registered funds are increasing their holdings in private equity, as evidenced by the Deloitte Fair Valuation Pricing Survey 19th Edition.<sup>17</sup>

Private markets require stronger emphasis on due diligence and valuation considerations. PE investments have several unique structural features including lack of liquidity, reliance on fair valuation instead of mark-to-market, quarterly performance reporting, uncertainty about the timing of capital deployment, and a reduced transparency into the underlying holdings. As such, funds allocating investment dollars to PE present several additional factors for their directors to consider, including:

- Is the investment objective of the fund compatible with an allocation to PE, given the unique nature of private markets?
- What are the policies and controls surrounding allocations to PE?
- How does the adviser assess the risk levels associated with the PE investments? Does the adviser have the right skills to account for, report, and value such PE investments? Illiquid assets are inherently hard to model by risk systems, exacerbated by a lack of quality and transparent data.
- Does the adviser have a rightsized and properly resourced due diligence team to analyze the investments?
- How are the holdings fair valued?

***Considerations prior to investing in companies going public through SPAC transactions***

There has been exponential growth in the number of private companies utilizing special-purpose acquisition companies (SPACs) as a means of accelerating their ability to go public via an initial public offering (IPO).

A SPAC is a publicly-traded company that uses a combination of IPO proceeds and additional financing to fund the acquisition of a private company (known as the "target company"). Deal announcement to deal closing dates vary widely but can be as short as four to six months. This accelerated timeline has been instrumental in the growing number of companies going public through SPAC transactions.

***Key considerations for fund directors***

Directors may find the following questions helpful as they perform oversight over the adviser's decisions to invest in SPACs:

- Has the adviser performed due diligence regarding the SPAC?
- Has the adviser considered risks unique to the SPAC structure? Is an investment in SPACs consistent with the fund's investment objectives?
- Are there particular valuation concerns about acquiring pre-IPO securities through a SPAC rather than directly through a private placement?

***\*\*New in 2022\*\* Environmental, social, and governance (ESG) risk***

Investing according to ESG principles continues to garner attention from investors, the public, and regulators. Advisers who wish to incorporate ESG factors into their investment processes face many challenges, including:

- The lack of an agreed-upon definition of what constitutes ESG in the United States
- An evolving market and regulatory landscape both inside and outside the United States
- Appropriate market or company proprietary data to support ESG investments and reporting can be difficult to obtain, and investment decisions may also include qualitative factors that make comparisons among potential investments difficult, and
- Advisers engaging sub-advisers have the additional challenge of understanding the ESG approach utilized by each sub-adviser, creating additional complexities.



While there are currently no formal ESG requirements in the United States, ESG has been cited as an area of focus by the administration and regulatory leaders. In recognition of the ongoing debate as to whether ESG investing may improve or hurt investment performance, in October 2021 the Department of Labor proposed a rule to allow climate change and other ESG factors to be considered when evaluating investments for retirement plans.<sup>18</sup> In the fall of 2021, the SEC's regulatory agenda included consideration by the SEC's Division of Investment Management of a recommendation that the SEC propose amendments to Rule 35d-1 (often referred to as the Fund Names Rule), which could make certain ESG funds subject to that rule.<sup>19</sup>

SEC Chair Gary Gensler recently mentioned that he has "directed staff to consider recommendations about whether fund managers should disclose the criteria and underlying data they use."<sup>20</sup>

#### ***Key considerations for fund directors when discussing ESG investments***

Directors may find the following questions helpful when discussing ESG investments:

- How is ESG defined and applied to a fund that uses ESG factors as part of the investment process?
- What is the process to monitor that a fund's investments are consistent with what is described in the prospectus?
- Are the metrics used to measure a holding's ESG factors utilized consistently across investment products? If they differ, is that due to intentional differences in the funds? If a rating tool is used, are the minimum thresholds and contemplated factors the same across products and if there are differences, are they described and explained?
- Are legal, risk, compliance, operations, investments, and other appropriate groups carefully following regulatory developments with respect to ESG, and are they prepared to quickly implement changes for compliance if needed?
- For organizations utilizing sub-advisers, what steps is the adviser following to ensure ESG criteria are being described and applied appropriately?

## **Operational risk**

### ***Information technology (IT) risk***

Technology enables virtually every activity that an adviser and the funds' other service providers undertake. The reliability and the security of technology is critical. Additionally, the rising trend in migrating to cloud service providers (CSPs) from traditional on-premises infrastructure has increased the importance of appropriate oversight and governance (see below). Weak governance and controls can lead to failed IT investments, system failures, processing errors, unauthorized transactions, and compliance breaches. Further, regulators continue to focus on the safety and soundness of data and technology in addition to compliance with laws and regulations. Ultimately, the effective management and governance of IT risk depends on both the senior executive team—including, as applicable, the chief technology officer (CTO), CRO, and chief information security officer (CISO)—as well as a broad set of accountable managers from across the organization. While IT risk management frameworks vary from organization to organization, effective IT risk management helps drive a practical and consistent operating model across all IT domains (e.g., IT strategy, data management, service delivery, and operations) to identify, manage, and address risks.

Directors are not required to be IT experts to oversee technology risks, but they should understand the IT landscape in order to fulfill their oversight responsibilities.



#### **Cloud adoption considerations**

Industry-leading CSPs offer organizations new business and valuable IT capabilities. Organizations have increased their adoption of cloud technologies for reasons such as lower costs, integrated security, scalability, flexibility, and availability of intelligent analytics. Advisers should proactively institute risk assessment and mitigation plans to safely realize the benefits of cloud.

### **Key considerations for fund directors**

Directors may find the following questions helpful as they consider a fund's IT risk environment:

- Is IT risk appropriately covered in the risk reporting provided to the fund board?
- What key IT initiatives are under consideration or underway that will impact the funds, and what information does the board receive on these initiatives and impacts?
- What is the relevant technology infrastructure, and the suitability/condition of the infrastructure, at the adviser and other key service providers?
- What key operations of the IT platform and structure have been outsourced?
- If the adviser or other key service providers are considering migrating infrastructure to a cloud service provider, is the cloud migration strategy and road map aligned with IT and organizational goals? Does management have appropriate resources in place to identify and manage incremental cloud security risks? Are these resources continually trained in the latest and greatest practices to drive secure cloud adoption? Has management considered enhancing current incident management capabilities and processes to scale for the evolving cloud threat landscape?
- Is there effective due diligence, monitoring, and vendor management over outsourced IT services? Are service provider and subscriber responsibilities clearly defined and does vendor management over IT services appropriately consider legal liability, insurance coverage, and roles during incidents and investigations?

### **Information (cyber) security risk**

The SEC staff has consistently indicated that cybersecurity is a priority in their examinations of market participants, including advisers, as evidenced by the recent newly proposed cybersecurity rule.<sup>21</sup> In the SEC's assessment of how firms prepare for a cybersecurity threat, safeguard customer information, and detect potential identity theft flags, it has focused on a number of areas including governance and risk assessment, access rights and controls, data loss prevention, vendor management, incident response, and training, among others.

For additional considerations surrounding cyber risk, refer to the *Mutual Fund Directors Forum cybersecurity and the evolving threat landscape* paper.

### **Data risk**

Ineffective data management can cause a number of issues, including business disruption and loss, fund financial and regulatory reporting issues, privacy issues, and/or loss of investors' trust. Additionally, regulatory agencies are expressing strong interest in data management capabilities, given that advisers depend on reliable, accurate, and timely data. Organizations also are increasingly combining external third-party licensed data with internal data, adding new layers of complexity to data management and, potentially, new risks. Rigorous data management capabilities rest on data governance or policies, and procedures that support accuracy, reliability, and timeliness of data, and clear data accountability, appropriate use, and maintaining appropriate integrity. Controlled creation, transformation, storage, and archival/disposal of data are central to the concept of data management.

### **Key considerations for fund directors**

Directors may find the following questions helpful as they consider a fund's data management risk:

- Has the adviser adopted a data standards framework?
- How are data governance, standards, and ongoing management processes integrated with business, information security, privacy, and IT processes?
- What key initiatives are planned to enhance or improve the adviser's data management capabilities?
- How should the fund board keep apprised of data-related risks and initiatives on an ongoing basis?

### **Business resilience**

Business continuity (BC) and IT disaster recovery are concepts that have been implemented at corporations since the late 1980s. The challenges of the 2020s have prompted organizations to work to identify even seemingly remote potential scenarios that could impact their business services. They have reconsidered those traditional concepts and designed a new framework that enables organizations to respond swiftly to potentially implausible yet severe disruptions and significant crisis situations. These five steps can serve as a guide to help achieve operational resilience:

- Proactive monitoring of trends and events that could impact brand
- Development of playbooks that are easily accessible in digital formats and can be deployed quickly
- Focus on “heartbeat,” or essential, business services that have low-impact threshold for outages
- Centralized resiliency data, ideally gathered in an automated fashion
- Demonstrated resiliency capabilities through rigorous testing and exercises

This new resilience framework helps organizations make strategic choices by balancing control, agility, efficiency, and innovation. Those organizations that implement resilience concepts have a high degree of confidence that the essential business functions can be recovered.

### **Key considerations for fund directors**

When discussing how advisers and service providers manage resiliency, directors may want to consider:

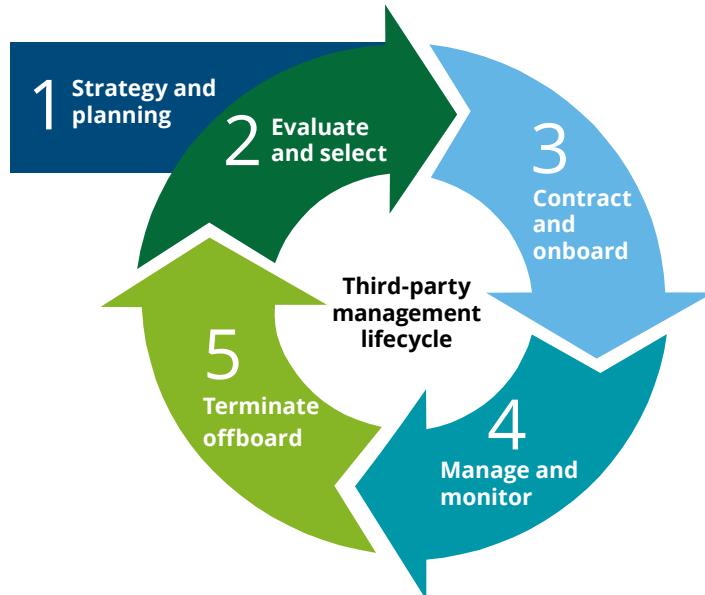
- Is the adviser and/or service provider reliant on traditional static BC plans that describe a sequential recovery process? Has the adviser and/or the service provider replaced traditional plans with playbooks that can be accessed on mobile devices and business strategies that can be deployed quickly?
- Has the adviser and/or service provider identified the “heartbeat” business services that have a low-impact threshold for outages? Does the adviser and/or service provider understand those heartbeat services from end to end, including the systems, roles, and third parties upon which they are dependent? Has the adviser and/or service provider undertaken an effort to map out processes, starting with critical products/services and tracing them down to supporting processes/sub-processes?
- Has the adviser and/or service provider centralized resiliency data? Is the resiliency data being gathered in an automated fashion, when possible? Is that data utilized to drive decision-making during a crisis scenario?
- Does the adviser and/or service provider perform routine rigorous testing and exercises? Does the adviser and/or service provider follow up to address any gaps that are identified and gathered during the testing and exercises?

### **Third-party provider risk**

The fund industry continues to increase its reliance on service providers to perform a variety of critical activities, including those performed by advisers/sub-advisers, fund administrators, custodians and accounting agents, transfer agents, pricing vendors, and sub-accounting organizations, as well as internal service providers (e.g., affiliates). The chart on the next page illustrates how complex these relationships can be.

Third-party service providers play a major role in the growth of advisers, but this is not without risk: Due to financial and other pressures, organizations have come to rely on service providers to handle many core business activities, and each of those activities represents potential risk outside direct management. Outsourcing has meant expanding core business outside traditional organizational walls, and this spike in third-party partnerships has increased risk.

Third-party risk management (TPRM) has evolved to overseeing an ecosystem of third parties including service providers and vendors, and it has proved to be essential. In addition, the SEC staff continues to emphasize the importance of adequate third-party oversight through its guidance on business resiliency connected to the use of third parties as well as through its priority focus areas during examinations in areas such as third-party cybersecurity.

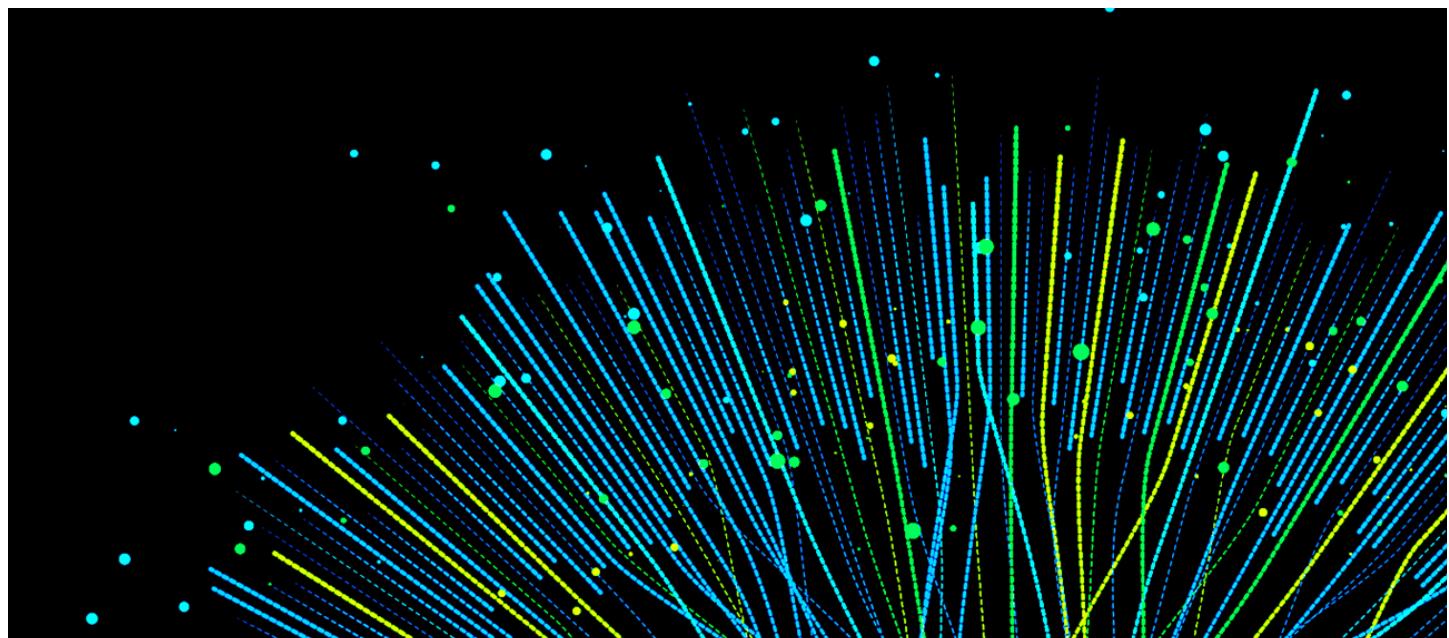
**The third-party risk management life cycle**

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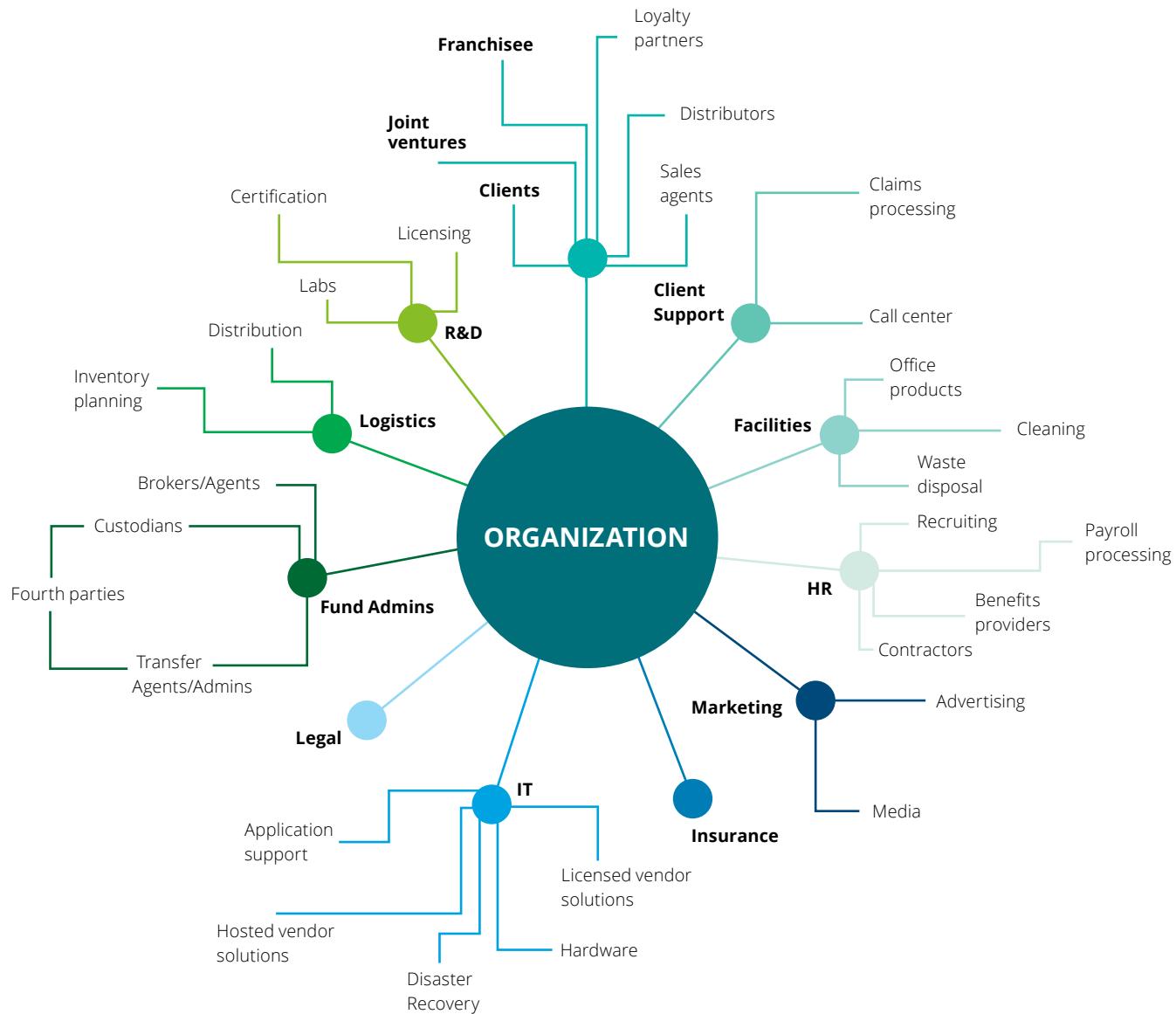
**Moving toward next-gen TPRM**

More than ever before, organizations must keep tabs on threats and vulnerabilities 24/7, something that traditional TPRM may not do. Technology plays a key role in helping organizations compile and analyze risk information, generating a transparent, constantly updated “single source of truth” that decision-makers can see and employ. In the near future, TPRM programs may evolve in a number of ways, including:

- Using technology, focusing on AI-based monitoring of third-party service providers and synthesis of information for executives organization-wide, to improve transparency and challenge the traditional, more costly methods of oversight;
- Helping leaders see and counter vulnerabilities as they materialize in real time; and
- Turning third-party risk into opportunity.

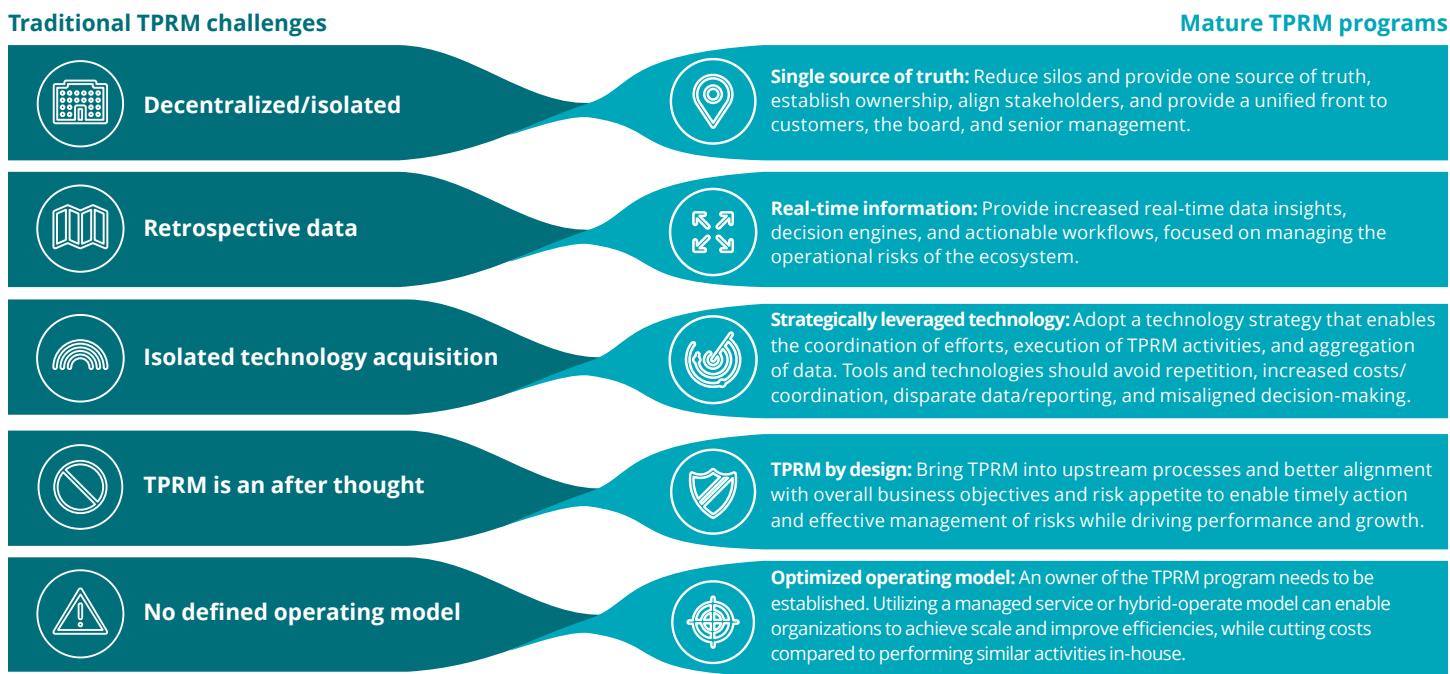


**A typical investment management organization may use thousands of third parties to meet its business objectives. Do you know who you are doing business with?**



## Mature third-party risk management programs can address risks while adding value

Organizations need practical, flexible programs that enable the transparent and effective management of their third parties.



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### Key considerations for fund directors

Directors may find the following questions helpful as they consider a fund's third-party service provider risk:

- Is the adviser aware of the particular risks presented by each of its service providers, and are processes in place to mitigate these risks, such as through an onboarding process and/or ongoing monitoring?
- Does the adviser know which third parties are performing critical activities, and are these services monitored on a continuous basis?
- Who is responsible for the governance and oversight of third parties? Is there a dedicated owner or group for third-party risk?
- Are the oversight practices (e.g., internal control review, site visits, service level agreement (SLA) monitoring) commensurate with the level of risk the third party presents?
- How is third-party risk and the oversight of third parties communicated to the board?
- Does the adviser have mechanisms to manage and track third-party performance and contract compliance, including aggregate performance and trends over time?
- Does the adviser have an approach to manage and oversee internal service providers/affiliates?
- How does the adviser and other third-party service provider oversee fourth-party servicers? Does the adviser have any controls on such engagements?
- Has the adviser evaluated risks associated with critical vendors upon which the third party relies (so-called fourth-party risk)?

### **Moving toward next-gen TPRM**

More than ever before, organizations must keep tabs on threats and vulnerabilities 24/7, something that traditional TPRM may not do. Technology plays a key role in helping organizations compile and analyze risk information, generating a transparent, constantly updated “single source of truth” that decision-makers can see and employ. In the near future, TPRM programs may evolve in a number of ways, including:

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- Helping leaders see and counter vulnerabilities as they materialize in real time; and
- Turning third-party risk into opportunity.

## **Strategic risk**

### **Reputational risk and crisis management**

Reputational risk can be viewed as a loss of trust in or increase in negative perception of the fund or the fund's adviser that can lead to negative publicity, fund redemptions, and loss of future fund investments, with follow-up impacts to the fund's operations as a result. As such, reputational risk should be proactively managed. Many advisers now have formal programs that focus on reputation management and are well prepared to respond to reputation damaging or crisis situations. Additionally, when the mutual fund complex is only one of the adviser's lines of business, issues in another part of the business may impact the funds. Therefore, fund directors should appreciate how the fund fits within the adviser's overall business and the risks to the funds associated with these additional business lines.

### **Key considerations for fund directors**

Directors may wish to consider the following relating to reputational risk and crisis management:

- Does the risk management program consider the most important stakeholders' concerns around reputational risk and monitor their perception?
- How are risks, risk events, or actions that may cause reputational damage identified and monitored? Does the adviser perform reputational risk sensing or intelligence gathering activities?
- Does the adviser take proactive steps to build trust and strengthen brand and reputation?
- How does the adviser apply a reputation lens to existing risks, decisions, and new ventures?
- Is the adviser crisis-ready and well prepared to navigate a reputational event? Are crisis response plans periodically tested and improved upon?
- How is the fund board engaged and informed of potential reputational risk events and crisis mitigation strategies?

- Does the adviser and/or the service provider have a mechanism to proactively monitor the trends and events that could impact their brand and reputation? Do they use risk intelligence (e.g., artificial intelligence and machine learning) tools to proactively understand the potential disruptions on the horizon?



### **Business change-related risk**

#### **\*\*New in 2022\*\* Diversity, equity, and inclusion**

Recently, there has been an increase in regulatory scrutiny of diversity, particularly with respect to disclosures, including the recently approved Nasdaq rule that applies to NASDAQ listed companies. The SEC Asset Management Advisory Committee<sup>22</sup> (AMAC) has also focused on diversity with research showing investor and market interest in disclosure by investment management organizations. Organizations that do not prioritize diversity, equity, and inclusion (DEI) could be vulnerable to increased risk. DEI risks may include:

- Investment outflows as investors (including institutional investors) include diversity as an investment criterion
- Reputational risks as organizations without diversity may come under increasing scrutiny
- Loss of talent to competitors with more diverse workforces, and
- Regulatory risk as the SEC and other regulators increase interest in DEI.

As fund directors consider addressing risks associated by not addressing DEI, they may want to consider both their own goals related to DEI and how the adviser addresses DEI:

- Does the firm track diversity metrics? If so, how? How does the firm use this data to become more diverse, equitable, and inclusive?
- How are hiring managers made aware of diversity goals and measured against them?
- What measures are taken by management to improve promotion outcomes for diverse professionals?
- How is diversity considered during succession planning for key roles including portfolio management?
- What workforce initiatives exist to attract, retain, and advance diverse talent?

## Regulatory risk

### Regulatory compliance risk

Regulatory compliance risk includes both the risk that the fund and the fund's adviser fail to comply with existing regulatory requirements and the follow-up associated risk of fines, litigation costs, or enforcement actions by regulators as well as the risk of failing to identify and timely implement new or evolving regulations.

The current regulatory environment is dynamic and increasingly complex. In addition to regulations from the SEC, other regulations may have a profound impact on the fund industry as well. Further, the increasingly global footprint of the industry has also added to the complexity of overseeing regulatory risk management efforts, as foreign regulatory or legislative actions may impact the operations of US funds or their advisers.

Evolving regulation impacts a fund's internal resources, compliance and internal controls, third-party services providers, and a fund's systems and technology. For example, a changing regulatory environment may add significant compliance costs that are either absorbed by the adviser or passed on to investors as a fund expense. To avoid these costs, advisers may choose to alter their business, types of investments, and product lines to avoid or curtail costs that new regulations may bring. In addition to possible compliance costs (or opportunity costs of foregone activities), the SEC enforcement activity against a fund can be costly in terms of the time and money necessary to defend against a regulatory action as well as possible reputational harm.

### Key considerations for fund directors

- How does the adviser monitor evolving regulatory issues?
- How does the adviser track enforcement and regulatory actions by regulators other than the SEC, as applicable?

### Disclosure risk

The 1933 Act requires, among other things, that a majority of the board sign a fund's registration statement prior to filing, imposing liability for any untrue statements. Thus, directors need to be aware of the risk that disclosures and statements could be made in fund documents that are not true.

The SEC has pursued enforcement actions against fund groups for disclosures that have failed to properly inform shareholders of potential risks. In certain cases, these actions were based on a lack of disclosure regarding how a fund's returns would change as the fund grew, the impact of IPOs, and pricing policies. Most recently, the SEC has stressed the importance of adequate disclosures given the current health and economic crisis.

### Key considerations for fund directors

- Do the adviser, fund counsel, and others relied upon by the board have sufficient controls to determine that disclosures and statements included in fund documents are relevant?
- Do the adviser, fund counsel, and others relied upon by the board have appropriate controls to identify new relevant disclosures or new risks as the funds enter new investment types?

### Money laundering risk

Money laundering risk is the risk of disguising illegal funds to make it appear that they originated from legal sources. With increased regulatory pressure on the banking industry and substantial dollars flowing to and from money laundering and terrorist organizations, funds may be viewed as an alternative place for illicit dollars. The increased prevalence of digital assets and cryptocurrency also can serve as an alternative place for illicit dollars, adding further complexity to anti-money laundering (AML) programs. Failure for the fund itself to identify its customers, including complying with beneficial ownership regulations, to detect and report potential money laundering as necessary and to comply with sanctions screening and other regulatory standards can damage the fund's reputation. Funds are required to have AML and sanctions compliance programs that include:

- Implementing customer identification programs including understanding and collecting beneficial ownership
- Explicit processes for due diligence for certain high-risk customers (e.g., foreign correspondent accounts);
- Screening customer and transactions for potential sanctions matches
- Monitoring and identifying suspicious activity and timely reporting it, and
- Various reporting and recordkeeping requirements and information sharing with law enforcement and financial institutions.

### Key considerations for fund directors

In evaluating a fund's AML policies, directors of funds with particular risks in this area may wish to ask the following questions:

- Does the adviser have a process to review recent AML enforcement actions to determine whether a fund's AML program, or its policies and procedures, should be changed or enhanced?
- Does the adviser delegate aspects of its AML program to a third party (e.g., a transfer agent), and if so, does it have the appropriate oversight and metrics to demonstrate effective governance of the AML program as well as third parties that support it?
- Has the fund's administrator, transfer agent, or custodial bank been subject to an enforcement action? If so, what, if any, effect did the enforcement action have on the fund's investors?

# Conclusion

As fund complexes face an ever-evolving set of risks, the Board has an important role in risk oversight. This paper has provided some key questions directors may consider discussing with advisers, related to both evergreen risks in the fund industry and emerging risks related to investment risk, operational risk, strategic risk and regulatory risk. While each fund complex may face unique risks, this document was intended to serve as a guide to help directors navigate aspects of their oversight role.

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# Endnotes

1. [https://www.mfdf.org/docs/default-source/default-document-library/publications/white-papers/mfdfriskoversightpapermay2020.pdf?sfvrsn=95c2cce4\\_4#:~:text=While%20fund%20directors%20could%20be.management%20of%20the%20fund's%20activities.](https://www.mfdf.org/docs/default-source/default-document-library/publications/white-papers/mfdfriskoversightpapermay2020.pdf?sfvrsn=95c2cce4_4#:~:text=While%20fund%20directors%20could%20be.management%20of%20the%20fund's%20activities.)
2. This report has been reviewed by the Forum's Steering Committee and approved by the Forum's Board of Directors, although it does not necessarily represent the views of all members in every respect. The Forum's current membership includes more than 887 independent directors, representing 122 fund groups. Each member selects a representative to serve on the Steering Committee. Nothing contained in this report is intended to serve as legal advice. Each fund board should seek the advice of counsel for issues related to its individual circumstances.
3. Mutual funds are most commonly organized as statutory trusts under Delaware law, corporations under Maryland law, or business trusts under Massachusetts law. Though state law requirements and the organizational documents of a particular mutual fund may vary, the state law concepts discussed in this section are generally applicable to all directors of a mutual fund, regardless of its form of organization.
4. The business judgment rule, however, does not provide for the exculpation of a director in all cases. In this regard, note that the 1940 Act does not permit a fund to exculpate a board member from liability to which the board member may be subject by reason of bad faith, willful misfeasance, gross negligence or reckless disregard of the board member's duties. See Section 17(h) of the 1940 Act.
5. See, e.g., Section 15(c) of the 1940 Act; Section 2(a)(41) of the 1940 Act.
6. The SEC has explicitly stated, "directors play a critical role in policing the potential conflicts of interest between a fund and its investment adviser" and the SEC has concurred, indicating that "[t]o be truly effective, a fund board must be an independent force in fund affairs rather than a passive affiliate of management. Interpretive Matters Concerning Independent Directors of Investment Companies, 1940 Act Release No. 24083 at 3 (Oct. 14, 1999) ("Interpretive Matters Adopting Release"); Investment Company Governance, 1940 Act Release No. 26520 at 3 (July 27, 2004) ("Fund Governance Adopting Release").
7. See, e.g., Rule 38a-1 under the 1940 Act, which requires a fund's board to approve the policies and procedures of the fund's investment advisers, underwriter, administrator, and transfer agent. See also Interpretive Matters Adopting Release. ("The [1940] Act requires that a majority of a fund's independent directors: approve the fund's contracts with its investment adviser and principal underwriter; select the independent public accountant of the fund; and select and nominate individuals to fill independent director vacancies resulting from the assignment of an advisory contract. In addition, rules promulgated under the [1940] Act require independent directors to: approve distribution fees paid under rule 12b-1 under the [1940] Act; approve and oversee affiliated securities transactions; set the amount of the fund's fidelity bond and determine if participation in joint insurance contracts is in the best interest of the fund.")
8. A mutual fund's investment adviser, and not its directors, typically take the lead in the drafting of a mutual fund's registration statement. In *Janus Capital Group v. First Derivative Traders*, 131 S. Ct. 2296 (2011) ("Janus"), the US Supreme Court held that a mutual fund's investment adviser could not be found liable pursuant to an anti-fraud provision of the Securities and Exchange Act of 1934 for misstatements in the fund's registration statement because the adviser did not "make" the statements at issue in the case. The Court ruled that only those who "make" misstatements can be liable, and the Court expressly limited the provision to reach only those who have "ultimate authority over the statement" and those to whom the statement is publicly attributed. While Janus did not significantly modify the regulatory framework for registration statement liability, particularly as it relates to fund directors, the case served as a reminder of the importance of a director's role in overseeing a fund's public disclosure.
9. See, e.g., J. Kenneth Alderman, CPA, et al., 1940 Act Release No. 30557 (June 13, 2013), in which the SEC found former mutual fund directors to have caused their funds to violate Rule 38a-1 under the 1940 Act, which requires a fund registered under the 1940 Act to adopt and implement written policies and procedures reasonably designed to prevent violation of the federal securities laws by the fund.
10. <https://www.theiia.org/globalassets/site/about-us/advocacy/three-lines-model-updated.pdf>
11. See Proxy Disclosure Enhancements, SEC Release No. 33-9089; 34-61175; IC-29092; File No. S7-13-09 (December 16, 2009) at 43-44. The release adopted rules requiring funds to describe the board's role in risk oversight. In that release, the Commission acknowledged that "risk oversight" was a more appropriate way to describe the board's responsibilities for risk than "risk management." The Commission stated that the disclosure could provide important information about how a fund perceives the role of its board and the relationship between the board and its adviser in management material risks faced by the fund.
12. In many cases, considerations for advisers should also be applied to third-party service providers.
13. See Frank J. Martens and Larry Rittenberg, *Risk appetite – critical to success: Using risk appetite to thrive in a changing world*, Committee of Sponsoring Organizations of the Treadway Commission (COSO), 2020.
14. Securities and Exchange Commission (SEC), 17 C.F.R. Parts 210 and 270 (2020).
15. SEC, 17 C.F.R. 274 (2018).
16. Ibid.
17. Paul Kraft, Rajan Chari, and Tom Wines, *Fair valuation pricing survey, 19th edition, executive summary*, Deloitte, 2021.
18. Employee Benefits Security Administration, "[US Department of Labor proposes rule to remove barriers to considering environmental, social, governance factors in plan management](#)," news release, October 13, 2021.
19. SEC, "[SEC announces annual regulatory agenda](#)," press release, June 11, 2021.
20. SEC Chair Gary Gensler, "[Prepared remarks before the Principles for Responsible Investment 'Climate and Global Financial Markets' webinar](#)," speech, SEC, July 28, 2021.
21. SEC, "[SEC proposes cybersecurity risk management rules and amendments for registered investment advisers and funds](#)," press release, February 9, 2022.
22. <https://www.sec.gov/files/amac-recommendations-di-subcommittee-070721.pdf>



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