

# MAIN ISSUES THE NEW SEC CHAIR SHOULD PRIORITIZE THAT COULD BENEFIT THE FUND INDUSTRY AND FUND BOARDS IN PARTICULAR

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Departing SEC Chairman Mary Schapiro leaves some unfinished business relating to funds and their Boards. Not only have many of the rules required by the Dodd-Frank Act not yet been drafted by the staff, but other initiatives remain unresolved for funds and Board members, including money market fund reform, funds use of derivatives and fund valuation guidance, to which the new SEC Chairman could help in creating priorities for the SEC staff. Further, the SEC staff has an opportunity to address who is responsible for misstatements in fund prospectuses through new rules.

Here are several initiatives that the new SEC Chair could prioritize, to the benefit of the Fund industry and provide better guidance for fund Boards in determining where risks lie, and allowing fund Boards to manage risks.

## **FUND USE OF DERIVATIVES**

The new SEC Chair should support new guidance for fund investments in derivatives. Since the SEC issued a concept release on fund use of derivatives in August 2011, there has been no movement from the SEC staff concerning guidance on critical areas in the release to protect fund investors and give better guidance for fund Boards. Funds increased use of derivatives has created risk for fund investors while providing needed fund management tools for advisers. Meanwhile, fund Boards have struggled with how to assess these risks. As the ICI has suggested, guidance could include requiring asset segregation policies to meet losses from derivatives, including procedures for analyzing the criteria used to determine the amount of segregation, and whether advisers should look through derivatives

for purposes of diversification to the underlying assets. Asset segregation policies will help to create a buffer for any derivatives losses, protecting shareholders. Looking through derivatives determines a fund's real risk exposure, and is a more identifiable standard for investors. More guidance from the SEC could help to protect investors, while providing fund Boards and advisers with tools needed to monitor derivatives risks.

## **FUND VALUATIONS**

The new SEC Chair should provide additional guidance on valuations of fund securities. The SEC staff itself notes that a lot has changed around fund valuations since the SEC last issued guidance on valuations. Clarity around fund valuations should help to assist fund service providers and Boards in making valuation determinations to protect fund shareholders from losses for securities that are difficult to value. While the SEC staff has not issued guidance on valuation in several years, in a recent SEC enforcement action the SEC alleged that fund directors failed to receive adequate reports on valuation, sometimes without a basis for how a valuation was assigned. Future problems for fund Boards will exist in determining value of an investor's portfolio (which could result in under or over stated fund values) without clarity around how to apply valuations.

## **MONEY MARKET FUND REFORM**

The new SEC Chair should support money market fund reforms proposed by the FSOC. These reforms would help to avoid "runs" on money market funds in times of financial crisis or serious problems with particular issuers. The FSOC's floating NAV and floating NAV with a risk-adjusted buffer solutions may prevent shareholders from redeeming shares at the earliest sign of issuer or liquidity problems, and help shield all money fund investors. While these proposals

come with some increased oversight for money fund Boards, such as monitoring of the size of the buffer and how the buffer is paid for, these oversights may help to stabilize money funds and provide fund Boards with specific standards to monitor money funds. One SEC Commissioner has supported the idea of a floating NAV, and critics concerns that these reforms could result in fewer money fund investments and operational costs is off-set by enhanced investor protection and fund stability. While the FSOC admits that their solutions are not perfect, the FSOC's proposal, with industry commentary and suggested changes, may help to prevent a melt-down in the money fund industry if events similar to those experienced by some money funds in 2008 reoccur.

### **RULE-MAKING CONCERNING FUND SPONSOR LIABILITY FOR PROSPECTUS DISCLOSURES**

The new SEC Chair should support new rules to clarify who has liability for false statements in fund prospectuses. Since the U.S. Supreme Court's decision in Janus Capital Group v. First Derivative Investors, which said that fund sponsors are not responsible for false statements in fund prospectuses, fund Boards have been concerned that this liability may lie with the Board members. A July 2011 GAO report lent no support to expanding primary or secondary liability for fraud through Congressional action. The SEC staff should propose rule-making that clarifies whether fund sponsors, who are often responsible for prospectus disclosures, have liability under federal securities laws for false statements in fund prospectuses. SEC rule-making could at least help to determine where liability for false statements in prospectus disclosures lies, and help to give fund Boards comfort, or engage in protective practices, such as due diligence concerning prospectus disclosures, apportioning such liability through contract changes with fund service provider and indemnification.

The new SEC Chair will face challenges in stepping into the role, and implementing guidance on these issues early in their tenure could help to quantify positions on these open issues, for the benefit of the fund industry and Board members. Without making some of these suggested changes, fund investors may have less protection and confidence in the funds in which they invest, and Boards may have less identifiable standards to protect shareholders.

**Gino Malaspina** has over 20 years experience in the investment management industry during which he developed significant experience in the registered fund business, including registration statements, board governance, service provider agreements, operations, other SEC filings, and fund and adviser compliance. As a director at CCS, Gino provides advice concerning registration of investment advisers, including preparation of Form ADV, as well as due diligence for fund and adviser Rule 38a-1 and Rule 206(4)-7 reports.

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