

Opinion

Avoiding Mistakes in Investor Disclosures

BoardIQ [subscription required]

http://boardiq.com/c/1444643/166583/avoiding_mistakes_investor_disclosures?referrer_module=issueHeadline&module_order=3

September 6, 2016

Niels Holch is executive director of the Coalition of Mutual Fund Investors.

Mutual fund directors face many new challenges overseeing disclosures and monitoring whether they are accurate, meaningful, complete and timely.

Over the past several years, the Securities and Exchange Commission has increased the disclosure requirements for cyber security, fair valuation, money market funds, derivatives, sub-transfer agent fees, fixed-income risks and changing market conditions. The SEC has also initiated enforcement cases involving inaccurate or inadequate disclosures, with sanctions being imposed on both independent directors and fund management. And these SEC actions are in addition to the 2011 Supreme Court ruling in *Janus v. First Derivative Traders*, which arguably places the ultimate responsibility for inaccuracies in prospectus statements on fund directors instead of fund management.

Given these new regulatory pressures and the large number of funds overseen by each fund director, it is easy for fund boards to overlook disclosure mistakes. To avoid problems, boards should develop robust oversight processes to help them perform appropriate due diligence on the issues that are the subject of investor disclosures and to ensure that disclosure mistakes are minimized.

Directors should focus their attention on four areas where mistakes can be made in disclosing material information to investors.

Inaccurate Information

The biggest regulatory risk for fund directors is when inaccurate information is provided to them and is then repeated in an investor disclosure. This was highlighted by a 2015 enforcement case against the adviser to the Buffalo Funds. In that case, the SEC fined Kornitzer Capital Management for providing inaccurate cost-allocation information to the Buffalo Funds board, making it impossible for the board to do its job properly.

To avoid inaccurate disclosures, directors should be aggressive in asking probing and substantive questions of fund management. They should not accept superficial or incomplete responses to their inquiries. Directors need to understand each and every disclosure statement and should be comfortable with their accuracy and completeness. Directors should also work with fund

management to establish a comprehensive and ongoing due-diligence process so that inaccuracies can be identified in due course and eliminated before disclosures are made public.

Boilerplate Language

Directors need to ensure that disclosures contain specific information that is meaningful to investors. They should avoid using boilerplate language that contains general or conclusive statements. Directors should also avoid repeating the same language in disclosures year after year and across multiple funds in the same complex.

This problem was identified in the 2013 Northern Lights enforcement case. In that case, boilerplate language failed to provide fund shareholders with all material facts concerning the board's review of the annual advisory contract. Directors can avoid this mistake by ensuring that disclosures of material issues are specific, understandable and directly related to the topic at hand. Language that follows a template and is repeatedly used should be replaced with disclosures that provide fresh and meaningful information to investors.

Complete Picture

Directors always face a dilemma about how much disclosure is the right amount. While SEC rules and guidance encourage funds to make detailed disclosures, some plaintiff's attorneys have succeeded recently in using these kinds of disclosures to help them overcome early procedural obstacles in excessive fee lawsuits. In other cases, though, fund boards seeking to avoid litigation have been encouraged by their attorneys to disclose fewer details.

To resolve this dilemma, fund directors should determine what information current and prospective fund investors need to know. They should put investors first instead of focusing on litigation risk. In almost all cases, disclosures that go beyond the minimum are more useful to investors than a truncated presentation of a material issue. Disclosures can also be layered, with a summary of the information presented in the prospectus and more detailed information provided in the Statement of Additional Information.

Timely Discussion

Disclosures about fund risks need to keep up with changing market conditions. Those that are out of date and do not reflect fast-moving market events do not serve investor interests. They could also subject the fund to enforcement scrutiny. Some topics that directors could address in their disclosures include the impact of the Federal Reserve interest-rate hikes on fixed-income funds and the fallout from the Brexit vote on European equity funds.

Guidance from the SEC in March clarified that fund boards need to review and update their risk disclosures on an ongoing basis and in a manner that reflects changing market conditions. While disclosures can be updated each time a fund report is issued, fund directors should consider whether more frequent communications through website postings and/or letters to shareholders should also be used when rapidly changing market conditions affect fund risk factors.

SEC guidance and enforcement actions provide a pathway for fund boards to avoid many disclosure errors and regulatory risks. Fund boards should proactively develop internal processes with fund management to ensure their disclosures are accurate, meaningful, complete and timely. They should base their disclosure decisions on what is in the best interests of fund shareholders, both current and prospective.