

## **Section 3 Fund Governance**

### **A. Composition of the Board—The Independent Director**

#### **1) Desirability of Independent Directors Generally**

The 1940 Act contemplates independent oversight and monitoring of investment company operations based upon principles of corporate democracy. The typical investment company, however, has no employees, and the primary loyalty and pecuniary interests of the adviser and other service providers generally lie with themselves. The interests of the investment company and its shareholders are of undivided concern only to the independent directors. Their status as other than “interested persons” is intended to permit them to act with genuine independence in addressing conflict-of-interest situations.

The S-O Act also contains director independence requirements primarily in connection with the audit committee. The ICI and MFDF best practices reports identify a variety of practices beyond those required by law for investment company boards and their independent members to consider.

When significant mistakes that have an adverse effect on a fund, or violations of law, do occur, the independent directors are expected to investigate the matter on behalf of the fund and resolve the problem with the adviser or other responsible service providers in an appropriate manner under the facts and circumstances of the situation. Appropriate remedial action may include prompt and full disclosure of the problem to shareholders or, on occasion, to the SEC and possibly reimbursement by a service provider to the investment company and/or its shareholders. Other remedial action, such as implementing improved internal controls and compliance procedures, may also be appropriate depending upon the circumstances.

#### **2) 1940 Act Independence Requirements**

Section 10(a) of the 1940 Act provides generally that at least 40% of the members of an investment company’s board of directors be independent, meaning that they not be “interested persons” as defined in the 1940 Act. In 2001, the SEC adopted a special set of governance standards (the “SEC governance standards”) contained in Rule 0-1(a)(7) that serve as conditions to ten exemptive rules adopted by the SEC including Rule 12b-1 (permitting use of fund assets to pay distribution expenses) and rules that permit funds to engage in certain types of transactions with affiliates. Each of the exemptive rules contains the condition that the board of directors of the fund must satisfy the SEC governance standards. As a practical matter, the SEC governance standards apply to most funds because few funds can operate without having the ability to rely upon one or more of the exemptive rules subject to the conditions. The SEC governance standards require that a majority of the directors be independent. Most fund complexes have adopted this practice. The ICI best practices report recommends that at least two-thirds of an investment company’s board members be independent and the MFDF report recommends that at least 75% be independent.

In 2004, the SEC adopted amendments to the SEC governance standards that would require an investment company board to have at least 75% independent directors (66⅔% in the case of a three-member board). The U.S. Chamber of Commerce has initiated a number of legal challenges to these requirements. In response to one of these challenges, the U.S. Court of Appeals for the D.C. Circuit has stayed the effective date of the requirements—originally January 16, 2006—while it considers the Chamber’s challenge. Until resolution of the pending legal proceedings, there is no legal requirement for 75% independent director membership on a fund board.

The term “interested person” is defined under Section 2(a)(19) of the 1940 Act to include (i) certain categories of persons with interests potentially in conflict with the investment company, (ii) persons with any beneficial or legal interest in securities issued by the investment adviser or principal underwriter or their control persons, (iii) a registered broker-dealer executing transactions involving the investment company or a related entity, (iv) persons loaning money or other property to the investment company or a related entity, and (v) legal counsel for the adviser or principal underwriter. The term also encompasses persons with close familial or substantial financial or certain professional relationships with management. A person who has been convicted of certain securities laws violations, enjoined from engaging in certain securities-related activities or prohibited by the SEC or by court order from serving as a director because of willful violations of the securities laws is ineligible to serve as a fund director.

The ICI best practices report recommends that former officers or directors of an investment company’s investment adviser, principal underwriter or related entities not serve as independent directors. The MFDF best practices report recommends that such independent director should not have been affiliated with the fund’s adviser or its affiliates for at least five years. In addition, SEC rules require broad disclosures about independent directors, including information that could potentially raise conflict-of-interest concerns. Consequently, it is important that the status and relationships of a potential director be considered carefully by counsel prior to his or her joining the board.

Generally, fund shareholders elect directors in accordance with state law and the SEC’s proxy solicitation rules. Many open-end funds are not required under applicable state law to hold annual meetings of shareholders. In Maryland, where many open-end funds are incorporated, a fund’s charter or bylaws may eliminate the need for an annual meeting of shareholders in any year in which election of directors is not required under the 1940 Act. Funds organized as trusts, which are governed by their declarations of trust, also are generally not required to hold annual shareholder meetings. Closed-end funds with securities listed on an exchange are currently required to have annual shareholder meetings. See Section 9. Under the 1940 Act, vacancies on a board generally may be filled by the directors (without a shareholder vote) if, after the new director takes office, at least two-thirds of the board has been elected by shareholders. If the number of shareholder-elected board members decreases to less than half of the board, a fund must hold a shareholder meeting for the purpose of electing directors within sixty days. Special provisions generally require a shareholder vote to fill vacancies among the independent directors subject to Section 15(f) compliance.

### **3) Independent Chairman**

The SEC has adopted another amendment to the SEC governance standards that would require an investment company to have an independent director serve as chairman of its board of directors. The independent chairman must preside over board meetings and have substantially the same responsibilities as would any chairman of a board. As with the 75% independent director requirement, the U.S. Chamber of Commerce has initiated challenges to the independent chairman requirement, and the U.S. Court of Appeals for the D.C. Circuit has delayed the rule's original effective date of January 16, 2006 pending further court consideration. Until resolution of the pending legal proceedings, there is no legal requirement for an independent chair, although many fund groups do appoint an independent director as chairman of the board.

Where there is no chairman or the role of chairman is filled by a "management" director, the independent directors should consider designating one of their number to act as a lead independent director. This director can serve as the focal point for governance and operational practices enhancing the role of the independent directors, including other matters related to the requirements of the S-O Act and the SEC governance standards.

#### **4) Importance of Maintaining Independence**

The consequences of failing to maintain the requisite number of independent directors required by Section 10(a) of the 1940 Act or by the SEC governance standards can be severe. The 1940 Act requires that certain matters and contractual arrangements—including the advisory and distribution arrangements—be approved by a majority of independent directors. An investment advisory agreement approved by an improperly constituted board under Section 10(a) of the 1940 Act may not be valid, and, among other things, the adviser may be required to return fees received under the contract or provide its services at cost. Similarly, funds that do not satisfy the SEC governance standards, including the requisite number of independent directors as defined in Rule 0-1(a)(7), would not be able to rely upon any of the exemption rules. For example, payments made by a fund to its distributor or underwriter under a Rule 12b-1 distribution plan that has not been approved by a properly constituted board under the SEC governance standards may also be recoverable. To the extent the requisite number of independent directors has not been maintained, other board actions may be subject to challenge as well.

Changes in outside affiliations of independent directors should be reviewed to help ensure that an independent director does not inadvertently become an interested person of the fund or become otherwise disqualified. It is common practice for independent directors to complete, on an annual basis, a questionnaire on business, financial and family relationships, if any, with the adviser, principal underwriter, other service providers and their affiliates. If a questionnaire is used, it is important that the responses be reviewed carefully by counsel or compliance personnel.

#### **5) Service on More Than One Board in a Complex**

It has long been industry practice for fund boards to include directors who serve on more than one board in a fund complex. For complexes with a large number of funds, this is a practical necessity. Although there are areas of common interest among the funds, the directors must

exercise their specific board responsibilities on a fund-by-fund basis. Broadened exposure to the operations of a complex can be valuable to a board member and provide a better context for carrying out board functions, such as serving the independent directors' "watchdog" role. Service on multiple boards also facilitates administrative convenience.

The SEC has taken the position that service on multiple boards of the same fund complex does not make a director an "interested person" under the 1940 Act. Maryland and other state laws provide that a director who is not an "interested person" under the 1940 Act shall be presumed to be independent under state law. The ICI best practices report recommends that investment company boards of directors generally be organized either as a unitary board for all the funds in a complex or as cluster boards for groups of funds within a complex, rather than as separate boards for each individual fund. In recent years, there has been litigation challenging the independence of directors who serve on multiple boards of funds within the same fund complex. None of these challenges has been successful to date.

Effective January 16, 2006, the SEC governance standards will provide that the board of directors must evaluate, at least annually, the performance of the board. This annual self-assessment must include a consideration of, among other things, the number of funds on whose boards each director serves. For a more in-depth discussion of the self-assessment requirement, see Section 3.D(7).

## **B. Board Committees**

Boards of investment companies often find it useful to appoint committees of the board to which specified functions and responsibilities are delegated. The board must have an audit committee and frequently have nominating committees. Other special or *ad hoc* committees may be established for special purposes such as to investigate allegations of wrongdoing, or a pricing or valuation problem, or in connection with a governmental investigation or unusual conflict situations. The Guidebook does not address these special situations. Also not addressed are the difficult issues faced by special litigation committees appointed to determine the proper course of action to take when derivative litigation is brought against directors.

Where specific responsibilities are legally assigned to the full board or to the independent directors, the board may ask a committee to consider these matters preliminarily and to make recommendations to the full board (or to the independent directors). If action is required to be taken by the independent directors only, any committee to which the matter is assigned for preliminary consideration should consist solely of independent directors. The full board (or the independent directors), however, must act upon matters where there is a legal obligation to do so and will bear full responsibility for the action taken. In other instances, a director who is not a member of a committee may generally rely upon committee action under state law if (i) the composition of the committee is appropriate for its purpose and the committee has been properly constituted, (ii) the full board makes reasonable efforts to keep abreast of the activities of the committee and is kept informed of committee activities, and (iii) the committee acts within the limits of its authority under applicable law and charter provisions.

### **1) Audit Committees**

The S-O Act mandates requirements for the audit committee for closed-end listed funds in terms of its composition and its role and authority. The S-O Act requirements do not, however, supplant or lessen the importance of the 1940 Act requirements as to director independence and the extensive role of independent directors in the regulatory regime of the 1940 Act.

**(a) Composition of the Audit Committee**

Although not applicable to open-end funds, the listing requirements of national securities exchanges provide that each member of the fund's audit committee be independent according to specified criteria that are different from those under the 1940 Act. See Section 9.G(1). The listing requirements are directly applicable only to closed-end funds with listed securities, but may serve as a "best practices" guide for open-end funds.

There are no required qualifications for service on an audit committee under the 1940 Act. Open- and closed-end funds must, however, identify in its annual report filed with the SEC at least one audit committee member that the board of directors has determined to be an "audit committee financial expert" ("ACFE") as defined by SEC rule. If such fund does not have an ACFE serving on its audit committee, it must so disclose and explain why. If the fund has more than one ACFE, it may, but it is not required to, disclose more than one name. To determine whether a person is an ACFE, the board of directors must find that the person possesses specified attributes and has acquired such attributes through a broad range of specified types of professional experience. The board decision as to whether someone is an ACFE for these purposes and the decision as to the number to be named in the annual report should be made in a considered manner with the help of counsel.

The primary benefit of having an ACFE serve on the audit committee, according to the SEC, is to provide a resource for the audit committee as a whole in carrying out its functions. The SEC provides a safe harbor provision in the audit committee disclosure item (Item 3(d) of Form N-CSR) for the ACFE under federal securities (but not necessarily state) law:

- A person who is determined to be an ACFE will not be deemed an "expert" for any purpose, including without limitation for purposes of Section 11 of the 1933 Act, as a result of being designated or identified as an ACFE pursuant to the disclosure item; and
- The designation or identification of a person as an ACFE pursuant to the disclosure item does not impose on such person any duties, obligations or liabilities that are greater than the duties, obligations and liability imposed on such person as a member of the audit committee and board of directors in the absence of such designation or identification.

The SEC has stated that the designation or identification of a person as an ACFE does not affect the duties, obligations or liability of any other member of the audit committee or board of directors.

**(b) Role and Authority of the Audit Committee**

The basic purpose of an audit committee is to enhance the quality of a fund's financial accountability and financial reporting by providing a means for the fund's independent directors to be informed as to, and participate in the review of, the fund's internal and external audit functions. Other objectives are to ensure the independence and accountability of the fund's outside auditors, to review the extent and quality of the auditing efforts and to provide an added level of independent evaluation of the fund's internal accounting controls. The audit committee also seeks to identify problems in the fund's accounting, auditing and financial reporting functions and increase the likelihood that any problems so identified will receive prompt attention.

The S-O Act provides extensive requirements for audit committees in terms of their role and authority. The listing requirements provide that the audit committee is directly responsible for the appointment, compensation, retention and oversight of the auditors. The audit committee is authorized to evaluate and, if necessary, terminate the auditor. In addition, Section 32(a) of the 1940 Act provides that independent auditors of registered investment companies must be selected for each fiscal year by a majority vote of the independent directors. See Section 6.B(8). In connection with the annual approval of the audit engagement, the audit committee must receive information from the auditors to enable the committee to evaluate the independence of the auditor.

The auditor is required to submit an annual report to the audit committee that must include (i) all critical accounting policies and practices used and disclose all alternative treatments of financial information within generally accepted accounting principles that have been discussed with management, (ii) the ramifications of such alternate treatments and (iii) the auditor's preferred course. The auditor must also report any accounting disagreements between the auditor and management.

The audit committee should meet periodically with the auditor, without the participation of management, to review the reports of the auditor. In this setting, the auditors typically are asked whether there are any matters regarding the fund, its financial reporting and record keeping and its operations that make the auditors uncomfortable; whether adequate accounting systems and controls are in place; whether management has adequate staffing; and whether there is any weakness in systems and controls that needs strengthening and, if so, the auditors' recommendations as to such strengthening.

Because of concern that management consulting services offered by accounting firms have created a substantial conflict that has eroded the independence of auditors, the S-O Act specifies a number of non-audit services that an auditor cannot provide to its client, such as financial information systems design and implementation, bookkeeping and other services related to the accounting records or financial statements. The auditor also may not provide a variety of other non-audit services, such as internal audit outsourcing, legal services and investment advisory services.

An auditor may perform non-audit services (including certain types of tax services) that are not on the prohibited list for an audit client only if the activity is approved in advance by the audit committee. Preapproval by the audit committee is also required for permissible non-audit

services provided to the fund's investment adviser, and any entity controlling, controlled by or under common control with the investment adviser that provides ongoing services to the fund, if the engagement relates directly to the operations and financial reporting of the fund. The audit committee is not required to preapprove audit or non-audit services provided to an unaffiliated sub-adviser that primarily provides portfolio management services to the fund. The audit committee may delegate the authority to preapprove non-audit services to one or more members of the audit committee. Audit committee approval of non-audit services must be disclosed in the periodic reports filed with the SEC. The SEC auditor independence and audit committee pre-approval rules include provisions that treat services by auditors to other members of a fund's investment company complex like services to the fund in many cases.

The lead partner and reviewing audit partners on the audit team are subject to a five-year rotation requirement. There is a one-year cooling-off period for anyone on the audit team who seeks to be employed in a senior financial management capacity with respect to the fund.

It is unlawful for any officer or director, or person acting under his direction, to improperly influence the auditor for the purpose of rendering the financial statements materially misleading. The SEC rules provide that, in the case of funds, persons acting under the direction of officers and directors of the fund may include, among others, officers, directors and employees of the investment adviser, sponsor, distributor or other service providers. The SEC has stated that conduct it believes might constitute improper influence includes (i) threatening to cancel or canceling existing non-audit or audit engagements if the auditor objects to the fund's accounting and (ii) seeking to have a partner removed from the audit engagement because the partner objects to the fund's accounting. The independent directors must take care to avoid engaging in conduct with respect to the auditors that could be construed as improper influence. In their discussions with the auditors, the audit committee should make inquiries as to whether anyone has tried to improperly influence the auditors.

It is unlawful for a fund to retaliate against an employee or "agent" who has provided information about possible fraud or violations of federal law enforcement authorities and others (so-called whistleblower protection). The listing requirements provide that the audit committee must establish procedures for handling complaints and for confidential, anonymous submissions by employees regarding accounting/auditing matters and such procedures are a best practice for all funds.

## **2) Nominating Committees**

To help ensure director independence, the SEC governance standards require independent directors to select and nominate other independent directors. The governance standards do not mandate a committee in this regard. If there is a nominating committee, it should be properly structured, with a designated chair and with procedures designed to ensure that, as a matter of appearance as well as reality, the selection of nominees is made by the nominating committee.

The investment adviser may play an appropriate role in the selection and recommendation of candidates for election to the fund's board. The adviser has a legitimate

interest in ensuring that the independent directors are qualified and are not unduly associated with competitors. On the other hand, the adviser should not be permitted to participate in the process in a manner that limits the independent directors' discretion.

### **3) Pricing and Other Committees**

Other standing committees are sometimes created by fund boards to focus on specific areas. Thus, a board may have, for example, pricing, legal compliance, brokerage, proxy voting and governance committees. In each case, the purpose is to designate an appropriate number of directors as a committee to devote time to the particular matter under review and make recommendations to the board. For example, a pricing committee may review the criteria used by a fund to determine when to use fair value pricing and review the methodology used in valuing portfolio securities for which market quotations are not readily available. A governance committee might be charged with responsibility for developing, recommending and evaluating a set of corporate governance principles applicable to the fund and procedures for conducting performance evaluations of the board.

## **C. Compliance Program**

### **1) Required Policies and Procedures**

Under the 1940 Act, all funds and their investment advisers are required to adopt and implement written policies and procedures that are reasonably designed to prevent violations of the federal securities laws. The fund's board, including a majority of the independent directors, must approve these policies and procedures. Directors may satisfy their obligations by reviewing summaries of the compliance program. The SEC has stated that fund compliance policies and procedures should address, at a minimum, the pricing of the fund's portfolio securities, the processing of orders for its shares, the identification of affiliated persons, the protection of nonpublic information regarding the fund, adherence to fund governance requirements, and policies as to market timing.

See Section 6.A(3) for a discussion of the directors' general oversight responsibilities to monitor the risk management, internal control and compliance practices of the investment adviser and others to whom responsibilities have been delegated.

### **2) Role of the Chief Compliance Officer**

Each fund must have a chief compliance officer, or CCO, who is responsible for administering the fund's compliance program and monitoring potential conflicts of interest. The CCO has been called the "eyes and ears" of the fund's independent directors. The fund board, including a majority of the independent directors, must approve the appointment and compensation of the CCO, as well as any changes in that compensation. At any time, the board may remove the CCO, who may not be terminated as the fund's CCO by the investment adviser or another service provider without the board's consent. The CCO may also be the CCO for the investment adviser and may be compensated in whole or in part by the adviser. This is not inappropriate and, in the Release adopting the compliance rule (the "Adopting Release"), the SEC states that it expects that often the fund's CCO will be employed by the adviser and also be

the adviser's CCO. Directors should be aware of both the potential benefits and the potential conflicts of interest that may arise from this arrangement.

The CCO is responsible for keeping the board apprised of significant compliance events at the fund and its service providers and for advising the board of needed changes in the fund's compliance program. The fund's CCO reports directly to the fund board and at least annually must furnish the board with a written report on the operation of the fund's policies and procedures and those of its service providers. The report must address, as a minimum: (i) the operation of the policies and procedures of the fund and each service provider since the last report, (ii) any material changes to the policies and procedures since the last report, (iii) any recommendations for material changes to the policies and procedures as a result of the annual review, and (iv) any material compliance matters since the date of the last report. While the rule requires annual reports to the board to discuss material compliance matters that occurred since the date of the last report, the Adopting Release notes that the reporting to the board of all such compliance matters cannot necessarily be delayed until the next annual report. The CCO must meet in executive session with the fund's independent directors at least once a year. Many boards meet more frequently with the CCO and some boards designate an independent director to serve as a liaison with the CCO between board meetings.

### **3) Oversight of Service Providers**

The fund's board, including a majority of the independent directors, are required to approve the written compliance policies and procedures of the fund's principal investment adviser, underwriter, its administrator, its transfer agent and any subadvisers. As is the case when reviewing fund compliance programs, fund directors may rely on summaries of the compliance programs of the service providers. The fund's CCO typically oversees the compliance programs of these service providers on behalf of the board. The CCO's written annual report must include an assessment of the operation of the compliance policies and procedures of the service providers.

## **D. Board Operations**

### **1) Operating Style**

Boards of directors should conduct their proceedings in a way calculated to encourage, reinforce and demonstrate the board's role in providing independent oversight of the fund's affairs and the performance of its investment adviser. Board practice will, over time, significantly affect the extent to which a board of directors is likely to discharge its obligations in a manner that effectively protects and advances the interests of the fund's shareholders.

No single operational style fits all situations, and there is considerable diversity of practice among fund complexes. A board's operational style may be influenced by many factors, such as the number of funds in the complex, the amount of assets under management and the fund's distribution methods. Each fund or fund group should develop a style appropriate to its nature and circumstances. Fund directors may find it useful to compare the practices of other fund groups as well as evolving practices in the corporate world. The best practices reports of

the ICI and MFDF identify a number of practices followed by fund groups in their governance activities, which may or may not be suitable for every fund board depending upon individual circumstances.

Independent directors should consider having periodic separate meetings to review the appropriate corporate governance policies and standards relating to the manner in which the board conducts its operations. Topics to be considered may include the size of the board and its overall composition, the frequency of the meetings, the adequacy of the agendas, the quality of the information being received, the adequacy of access to the personnel of the adviser and others, the adequacy of access to qualified legal counsel sufficiently independent from the adviser and its affiliates and the adequacy of continuing education as to board members' duties and responsibilities, retirement policies and peer reviews. See Section 3.D(7).

## **2) Size of Board of Directors**

There is substantial variation in the size of fund boards. Each fund or fund group should determine optimum board size with a view to ensuring sufficient independent directors to perform the required oversight functions and effective functioning in terms of discussion and decision-making. When directors serve on boards for multiple funds in a complex, factors that might influence board size include the number of funds, the range and diversity of investment categories and the complexity of distribution arrangements. If there is concern as to whether the directors can handle the responsibility and workload with respect to the number of funds, the board sizes may be expanded or the complex may add an additional cluster in a separate board. In accommodating these needs, board size should not be expanded to such an extent as to interfere with effective functioning by making full and free discussion of issues at board meetings impractical. Larger boards may make increased use of board committees to allocate the workload.

## **3) Director's Time Commitment**

The time commitment expected of directors is a subject that should be reviewed by the board and communicated to existing and prospective directors. Directors should take care not to over commit themselves, and nominating committees should consider a board candidate's ability to devote the necessary time. Directors should expect to attend, in person, all regularly scheduled meetings. Disclosure is required in the fund's proxy statement of those directors who attend fewer than 75% of the aggregate board and committee meetings during the prior year. Independent directors are expected to devote sufficient time and attention to the affairs of the fund or fund complex to permit them to prepare for, attend and participate in meetings of the board and board committees and to keep themselves generally informed about the fund's affairs. The time required varies widely. Fund directors should expect to devote appropriate amounts of time, depending upon the number of meetings and the number and complexity of the funds involved. An independent chairman or a lead independent director generally will commit substantially more time than other independent directors in light of the greater responsibilities of those positions. In times of crisis, directors will be required to devote additional time.

## **4) Meetings**

It is generally regarded as a “best practice” for directors to be physically present at regular board meetings. Under the 1940 Act, the independent directors are required to meet in person to approve investment advisory and distribution arrangements and the selection of independent auditors. Telephonic meetings are generally permissible under applicable state law and may be useful and appropriate for special or emergency meetings.

The number of meetings a fund board finds necessary or useful varies with the circumstances. Some boards prefer more frequent and shorter meetings. Others prefer fewer but lengthier meetings. In any event, directors should ensure that they have allotted sufficient time for all items to receive sufficient attention. Industry practice ranges from quarterly meetings—generally thought to be the minimum number of meetings necessary for fund directors to discharge their responsibilities properly—to monthly meetings in the case of some larger complexes. Some complexes have quarterly meetings that last two days or more. With the increasing emphasis upon the role of the independent directors and the audit committee, the trend is toward more frequent and longer meetings.

Time at board and committee meetings should be budgeted carefully. There are occasions when the independent directors may wish to—or should—meet without management. The participation of counsel may be desirable to help the independent directors address the issues at hand. In addition, the independent directors may wish to meet informally from time to time to discuss fund matters and generally compare views. The SEC governance standards require the independent directors to meet at least once a quarter in executive session and at least once a year in executive session with the fund CCO. Whether a meeting without management is structured as a special committee meeting or as part of a regular board meeting, holding such a meeting is an appropriate exercise of independent directors’ discretion.

## **5) Meeting Agendas**

Independent directors should take an active role in determining matters to be discussed and acted upon at board meetings and influencing the priority and amount of time allocation to various matters. In this regard, an independent chairman or lead independent director, in consultation with counsel, can play a useful role in coordinating with management. Matters to be discussed and acted upon by the board typically are determined initially by the investment adviser frequently in consultation with a lead independent director or independent counsel to the fund or the independent directors. In any event, independent directors should have an opportunity to place items on the agenda and to influence the priority and amount of time allocated to various matters. A balance should be sought between the investment adviser’s presentations and discussion among directors and representatives of the adviser. Directors should be satisfied that there is an overall annual or more frequent agenda of matters that require recurring and focused attention by the board or a committee thereof, such as review of investment performance, required continuance of contract arrangements, required regulatory approvals, review of other services provided by the adviser and other service providers and meeting with the independent accountants of the fund.

## **6) Independent Counsel and Other Resources**

Independent directors may decide to retain independent legal counsel and other experts, or in some instances to employ their own separate staff, at the fund's expense to assist them in properly performing their responsibilities under the 1940 Act. The 2004 amendments to the SEC governance standards make explicit the authority of the independent directors to hire employees and to retain advisers and experts necessary to carry out their duties. The S-O Act listing requirements provide that the audit committee has the authority to engage independent legal counsel and to consult with the fund's independent auditors or other experts, as appropriate, in carrying out its duties and that the issuer must provide appropriate funding for the audit committee as determined by that committee.

The ICI and MFDF best practices reports recommend that independent directors have qualified investment company counsel who is independent from the investment adviser and the fund's other service providers. Whether to retain independent counsel for the independent directors is dependent upon a number of factors. The SEC governance standards require that, if counsel is engaged to advise the independent directors, the independent directors must determine at least annually that such counsel is "independent legal counsel" free of significant conflicts of interest that might affect their legal advice. Counsel with no material relationship with the investment adviser or its affiliates frequently acts both as fund counsel and counsel for the independent directors. In other cases, the relationship of fund counsel to management warrants having the directors consider retaining independent counsel. The size and complexity of a fund group may also warrant retaining independent counsel who can focus upon the needs of the independent directors. In lieu of regular independent counsel, the board might consider engaging independent counsel on an ad hoc basis with respect to specific matters. There is no "bright line" test, but generally it is important that the independent directors have ready access to counsel who views the board (and, where appropriate, the fund), rather than the adviser, as the client.

Independent counsel and other experts can contribute to the quality of the deliberative process and the validity and adequacy of the independent directors' decision-making process and can keep directors informed of their responsibilities. Directors' decisions to retain experts must balance the costs to the fund against the value provided to investors. The presence of independent counsel has been taken into account by courts in analyzing the degree of independence of the directors and in considering whether independent directors have carried out their responsibilities. Sometimes the SEC requires independent counsel and/or other experts for the independent directors as a condition to granting exemptive relief or as a condition in a regulatory settlement.

## **7) Annual Self-Assessments**

The 2004 amendments to the SEC governance standards, effective January 16, 2006, require that fund directors must evaluate, at least once annually, the performance of the fund board and its committees. The evaluation must include a consideration of the effectiveness of the committee structure of the fund board and the number of funds on whose boards each director serves. The SEC states that this requirement is intended to strengthen directors' understanding of their role, foster better communications and greater cohesiveness and help directors identify potential weaknesses and deficiencies in the board's performance. The self-

assessment does not have to be in writing, but the SEC expects the board minutes to reflect “the substance of the matters discussed” during the annual self-assessment.

## **8) Board Compensation**

Neither the 1940 Act nor state law sets forth specific requirements or limitations regarding the establishment of directors’ compensation. State law generally recognizes that directors are entitled to “reasonable” compensation. The directors of a fund, not the adviser, are responsible for setting their own compensation. Because directors have an inherent conflict of interest, they should seek appropriate data necessary to reach a fair conclusion, including data on comparable funds, together with analysis of any special factors that may relate to the fund or fund group. Directors’ compensation may take a number of different forms, including annual retainers and attendance fees for board and committee meetings. Deferred compensation plans, retirement programs and similar benefits are sometimes provided. The compensation paid to each director by the fund and by the fund complex as a whole must be publicly disclosed.

## **9) Procedural Standards Set by the Courts**

Courts have examined the actions of the independent fund directors to determine whether the directors’ actions should be upheld in situations involving a conflict of interest between the investment company and the adviser and its affiliates. If proper procedures have been followed, and there has been a valid decision-making process, the courts are more likely to allow the decision to stand.

Various factors that the courts have cited in assessing the quality of the deliberative process (and, therefore, the weight to be given to director determinations and approvals) include, in no particular order: (i) the relative number of independent directors; (ii) the backgrounds, experience and expertise of the directors; (iii) the methods utilized in selecting and nominating directors; (iv) the extent to which the directors understand the nature of their statutory duties and responsibilities and are free of domination or undue influence; (v) the extent and quality of the information supplied to the directors by the adviser and the manner in which such information is presented; (vi) the nature of directors’ deliberations and whether those deliberations are substantive in nature; (vii) the responsiveness of the adviser to director initiatives seeking additional information or suggesting alternatives to management proposals; and (viii) whether the independent directors have their own independent counsel and have utilized counsel or other qualified experts in reviewing information or considering matters that require special expertise. This is not to say that every factor need be present or has been present in the favorable court decisions.

Independent directors must assure themselves that they have received sufficient information and independent advice to enable them to engage in the requisite deliberations and to support any findings that they are called upon to make. In this regard, both Section 15(c) of the 1940 Act, with respect to investment advisory approvals, and Rule 12b-1, with respect to distribution plan approvals, explicitly impose upon directors the duty to request and evaluate, and make it the duty of the investment adviser or distributor (as the case may be) to furnish, such information as may be necessary for the directors to fulfill their duties.

## **10) Quality of Information**

The quality of information made available to directors significantly impacts their ability to perform their role effectively. To the extent feasible, information submitted to the directors should be relevant, concise, timely, well-organized, supported by any background or historical data necessary or useful to place the information in context and designed to inform directors of material aspects of a fund's operations, its performance and prospects and the nature, quality and cost of the various services provided to the fund by the investment adviser, its affiliates and other third parties.

Whenever possible, information should be provided in written form sufficiently in advance of the meeting to provide time for thoughtful reflection and meaningful participation by the directors. Many advisers and legal counsel provide directors with annual guidance manuals as to their duties and responsibilities or annual contract review books and regularly apprise directors of recent relevant legal or regulatory developments. The ICI and MFDF best practices reports recommend that new fund directors also receive appropriate orientation and that all fund directors keep abreast of industry and regulatory developments. The ICI and MFDF best practices reports recommend that fund directors, where possible, invest in funds upon whose boards they serve or establish policies in this regard.

Directors should review, and may also ask counsel to review, draft minutes of the board meetings before approving them. This task is important as the SEC staff considers the minutes to be evidence of how the directors and the adviser have fulfilled their duties.

## **11) Disagreement**

If a director disagrees with any significant action to be taken by the board, the director may vote against the proposal and may request that the dissent be recorded in the minutes. Under state law, a director is generally presumed to agree unless his or her dissent is so noted. Except in unusual circumstances, a dissenting vote should not cause a director to consider resigning. If a director believes, however, that information being disclosed by the fund is inadequate, incomplete or incorrect or that the adviser is not dealing with the directors, the shareholders or the public in good faith, the director should seek corrective action and consult with legal counsel (who has no material relationship with the adviser) for purposes of determining an appropriate course of action.

Directors who have a personal interest in a matter being voted on should consider abstaining and, in all events, should disclose their interest. Directors should request that their disclosure be noted in the fund's minutes.

## **12) Term of Service**

Neither the 1940 Act nor state law sets forth specific requirements on retirement policies. The ICI best practices report recommends that fund boards adopt policies on retirement of directors, and many boards have adopted a mandatory retirement age policy, typically at ages ranging from seventy to seventy-five.

