

# A Summary of the Report of the Advisory Group on Best Practices for Fund Directors

## Enhancing a Culture of Independence and Effectiveness

### Making a Strong System Even Stronger

The fund industry's corporate governance system has succeeded in keeping the industry free from major scandals. Nevertheless, this system, like any other, must periodically be reexamined to ensure its continuing effectiveness.

Such an examination is appropriate now because the investment company industry has grown and changed dramatically in recent years, offering new types of funds, entering new distribution channels and appealing to new segments of investors. These business changes have required investment company boards to change as well, developing new areas of expertise, posing new questions to management, and adjusting their practices and procedures to remain efficient and effective as board workloads have increased and become more complex.

In February 1999, the Securities and Exchange Commission held a [Roundtable](#) on the Role of Independent Investment Company Directors to focus on the appropriate role of independent directors and their specific responsibilities. SEC Chairman Arthur Levitt announced one month later that the SEC would consider making regulatory proposals to enhance the role of independent fund directors. He also called on the fund industry to work with the SEC to further enhance the effectiveness of fund directors. The Investment Company Institute responded with the creation of the [Advisory Group](#) on Best Practices for Fund Directors.

## Enhancing the Role of Independent Directors and the Effectiveness of All Fund Boards

The [members](#) of the Advisory Group include: John J. Brennan, Chairman of the Investment Company Institute and Chairman and CEO of The Vanguard Group, Inc.; Dawn-Marie Driscoll, independent director of the Scudder Funds; Paul Haaga, Executive Vice President of Capital Research and Management Company; Dr. Manuel H. Johnson, independent director of the Morgan Stanley Dean

Witter Family of Funds; William M. Lyons, President and COO of American Century Funds; and Gerald C. McDonough, independent trustee of The Fidelity Funds.

The group's mission was to identify the best practices used by fund boards to enhance the independence and effectiveness of investment company directors, and to recommend practices that should be considered for adoption by all fund boards. The Advisory Group consulted a variety of experts, including former SEC officials, representatives of the accounting and legal communities, prominent academics and others with expertise in the areas of mutual fund and corporate governance.

The Advisory Group's [report](#) recommends a series of policies and practices that go beyond what is required by law and regulation and are designed to enhance the role of independent investment company directors and the effectiveness of fund boards in general.

These practices, the Advisory Group concluded, will help ensure that fund directors continue to effectively represent the interests of fund shareholders. The recommendations are focused on practices that enhance the structure and operations of fund boards. The Advisory Group concluded that the adoption of practices that enhance the overall independence and effectiveness of fund boards will help assure that individual issues are addressed and resolved in the best interests of America's 77 million mutual fund investors.

## Recommendations

Listed below are the practices that the Advisory Group is recommending to investment company boards of directors.

The Advisory Group recommends that:

- At least two-thirds of the directors of all investment companies be independent directors.
- Former officers or directors of a fund's investment adviser, principal underwriter or certain of their affiliates not serve as independent directors of the fund.
- Independent directors be selected and nominated by the incumbent independent directors.
- Independent directors establish the appropriate compensation for serving on fund boards.
- Fund directors invest in funds on whose boards they serve.
- Independent directors have qualified investment company counsel who is independent from the investment adviser and the fund's other service providers; and that independent directors have express authority to consult with the fund's independent auditors or other experts, as appropriate, when faced with issues that they believe require special expertise.
- Independent directors 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.
- Investment company boards establish Audit Committees composed entirely of independent directors; that the committee meet with the fund's independent auditors at least once a year outside the presence of management representatives; that the committee secure from the auditor an annual representation of its independence from management; and that the committee have a written

charter spelling out its duties and powers.

- Independent directors meet separately from management in connection with their consideration of the fund's advisory and underwriting contracts and otherwise as they deem appropriate.
- Independent directors designate one or more "lead" independent directors.
- Fund boards obtain directors' and officers'/errors and omissions insurance coverage and/or indemnification from the fund that is adequate to ensure the independence and effectiveness of independent directors.
- 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.
- Fund boards adopt policies on retirement of directors.
- Fund directors evaluate periodically the board's effectiveness.
- New fund directors receive appropriate orientation and all fund directors keep abreast of industry and regulatory developments.

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