INDEPENDENT DIRECTORS COUNCIL

The voice of fund directors at the Investment Company Institute

Board Oversight of Certain Service Providers

Independent Directors Council
Task Force Report
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1401 H Street, NW
Suite 1200
Washington, DC 20005

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I. Introduction

A fund's board of directors may oversee various service providers as part of its overall responsibilities. Service providers play a significant role in the day-to-day operations of a fund, and funds may incur considerable expenses for their services. For these reasons, the Independent Directors Council formed a Task Force of fund directors to offer practical guidance to boards in fulfilling their oversight responsibilities with particular reference to the following kinds of service providers: the administrator, custodian, fund accounting agent, transfer agent, and securities lending agent (collectively, "service providers").[1] A list of Task Force members is attached to the report as Appendix A.

This report discusses board oversight of the selection of these service providers, including potential board considerations in evaluating: (i) service provider agreements, (ii) the qualifications and capabilities of service providers, (iii) fees, and (iv) potential conflicts of interest. In addition, the report discusses ongoing oversight of service providers by boards. Appendices B–F contain descriptions of the typical services that may be provided by each of the service providers covered in this report and some additional factors a board may wish to consider when evaluating the merits of a particular service provider.

The nature and extent of board involvement in the oversight of the service providers covered in this report varies across the fund industry. Many boards are involved to some degree in the selection of service providers and engaged in ongoing oversight of the quality of services received by the fund from its providers. Invariably, a fund's adviser and/or administrator ("fund management") also is involved in both the selection or recommendation of service providers and their management on a day-to-day basis. Directors should be cognizant of the distinction between board oversight, on the one hand, and day-to-day management, which is the responsibility of fund management, on the other hand. The extent of a board's involvement, including the specifics of its role in relation to fund management's role, is a decision best left to each board based on its fund's particular circumstances.

[1] While securities lending is not typically considered to be one of a fund's core services, it is included in this report because of recent attention paid to it, and because, in many instances, one of a fund's core service providers, such as the custodian, may act as the fund's lending agent. *See, e.g.,* B. Wilcox, *SEC Securities Lending Sweep Yields Deficiency Letters,* BoardIQ, Feb. 6, 2007; and T. Lauricella, Fund Track, *SEC Discovers Breaches In Lending of Securities,* Wall St. J., Jan. 29, 2007, at C3.

II. Standard of Care for Board Actions

State laws, and cases interpreting these laws, define the standard by which courts view board actions, including those relating to oversight of service providers. Under the "business judgment rule," board actions, including the approval, ratification, or renewal of a contract, are protected from judicial inquiry so long as the directors acted on an informed basis, in good faith, and in the honest belief that the action taken was in the best interests of the fund. In order to be afforded the protection of the business judgment rule, a board must act on an informed basis, making it of great importance that the board obtain sufficient information to, for example, evaluate a service provider contract.

III. Selection of Service Providers

The Investment Company Act of 1940 ("1940 Act") by its terms only requires that certain contracts be approved by a fund's board, and generally does not require board approval of contracts with the service providers covered in this report.[2] In the absence of a particular federal provision, state laws govern the board's role with respect to service provider contracts, and, in general, state laws do not specifically require board consideration of these contracts. Many boards, nevertheless, are involved to some degree in the selection and approval process. Some boards may decide to be actively involved in the identification of potential new service providers or a particular provider, while others may leave this responsibility to fund management, subject to the board's oversight. In many cases, fund management evaluates potential service providers and recommends one to the board for its approval. Once a new service provider is identified, many boards are involved in the final approval of the agreement, including the fees to be paid for the services, and evaluation of any potential conflicts of interest. A board may wish to make clear the role that the board will take and the role that fund management will take in the overall selection process.

A. Evaluating Service Provider Agreements

Regulators, including the Securities and Exchange Commission ("SEC"), have not formally prescribed any regulatory standard by which boards should evaluate service provider agreements. Because of the potential conflicts of interest involved in arrangements with affiliates, however, some boards may evaluate an agreement with an affiliated service provider with greater scrutiny than a similar agreement with a third-party service provider.[3] In

[2] For example, the 1940 Act specifically requires boards to approve advisory agreements (Section 15(a)) and principal underwriting agreements (Section 15(b)). Although Rule 17f-1 under the 1940 Act also requires board approval of custodial agreements with broker-dealers, such arrangements are rare.

[3] When used in this report, an "affiliated service provider" refers to an entity that controls, is controlled by, or is under common control with, the fund's adviser. *See* definition of "affiliated person," Section 2(a)(3) of the 1940 Act.

this context, some boards consider the following factors when evaluating agreements with affiliated service providers: (i) whether the agreement is in the best interest of the fund and its shareholders; (ii) whether the services to be performed under the agreement are required for the operation of the fund; (iii) whether the services provided are of a nature and quality at least equal to the same or similar services provided by independent third parties; and (iv) whether the fees for the services are fair and reasonable in light of the usual and customary charges made by others for services of the same nature and quality.[4] Factors (iii) and (iv) above relate to the use of affiliated service providers; the other aspects of this test also may be of relevance to the evaluation of contracts with third parties.

B. EVALUATING SERVICE PROVIDERS

1. New Service Providers

A board typically relies on fund management to provide it with information it needs to understand the fund's service provider arrangements generally and to evaluate a potential service provider. Fund management frequently provides directors in advance with a copy of the proposed contract, often with a memorandum highlighting the key terms and, to the extent relevant under the circumstances, explaining the process used by fund management in determining to recommend the particular provider for approval. The proposed service provider may be invited to meet with the board to discuss its capabilities and fee arrangements, and answer any questions directors may have.

The selection of a fund's service provider will depend, in large part, on the services needed by the fund and the service provider's ability to fulfill those needs. The fund will have various service providers, and directors generally should understand the division of responsibilities among those providers. Each service provider agreement should clearly outline the scope of the provider's responsibilities. The board may wish to inquire about the standard of care prescribed by the contract to be entered into with the service provider.

In evaluating a service provider, directors may consider how the service provider will support and interact with the fund's Chief Compliance Officer ("CCO").[5] For example, the board may want to determine whether a service provider's staff will be available to the fund's CCO, such as when the CCO decides to conduct due diligence or visit the service

[4] The factors are based on an SEC proposal, advanced many years ago but never adopted, under which contracts with affiliated service providers would be subject to heightened scrutiny, and subsequent SEC staff guidance. *See, e.g.*, Norwest Bank Minnesota, N.A, SEC No-Action Letter (May 25, 1995); Washington Square Cash Fund, SEC No-Action Letter (July 9, 1990).

[5] The fund compliance program rule under the 1940 Act (Rule 38a-1) requires board approval of the policies and procedures of, among others, the fund's administrator and transfer agent. The rule also requires each fund to designate a CCO to, among other things, report to the board about such policies and procedures.

provider or during an SEC examination of the fund. Because the fund's CCO and the service provider will work together on some level, the CCO's views regarding the service provider may be an important factor in selecting the service provider. A board also may wish to inquire whether the service provider's CCO support services are included as part of its standard service offering.

When evaluating a service provider for the first time, the board typically will rely on the reports of management, counsel, the fund's CCO, and possibly consultants regarding the resources, capabilities, and reputation of the service provider under consideration. Depending on the facts and circumstances of the fund and service provider, these reports may include information about:

- the service provider's history and reputation in the industry, including the experiences of similar funds serviced by this provider and the provider's history of client retention;
- the service provider's financial condition and ability to devote resources to the fund;
- recent corporate transactions (such as mergers and acquisitions) that involve the service provider;
- the service provider's regulatory and disciplinary history;
- the level of service that will be provided to the fund;
- the nature and quality of the services to be provided;
- the experience and quality of the staff providing services to the fund and the stability of the workforce;
- the service provider's internal controls and compliance policies and procedures;
- the service provider's operational resiliency, including its disaster recovery and business continuity plans;
- the technology and process it uses to maintain information security, including the privacy of customer data;
- the reporting mechanism for a board to stay apprised of the performance of the service provider;
- the service provider's communications technology;

- the service provider's insurance coverage; and
- the service provider's willingness to provide information to the fund, including, for example, third-party assessments of and/or certifications regarding the provider's implementation of its compliance policies and procedures.[6]

In describing the process it used to select a particular service provider, fund management may identify the companies it eliminated from consideration and explain why they were eliminated. Often it is helpful for directors to know whether fund management viewed certain functions, such as reliable and advanced technological capabilities, to be of paramount importance. Fund management also should clearly describe the compensation to be paid under the proposed arrangement and whether it expects to receive any ancillary benefits from the selection of the proposed provider.

2. Existing Service Providers

A board also may at times be involved in evaluating whether to renew an existing service provider contract. Absent regulatory requirements for contracts with service providers to be reviewed at any set interval, or at all, the terms of the contracts may vary greatly. Some contracts are renewed each year or every few years, while others may run indefinitely until a contractual termination provision is invoked. Whatever the formal term of the contract, boards may seek to determine that the frequency with which they review the arrangement is sufficient to detect and correct any problems in a timely manner, and that the services performed and the fees charged under the contract continue to be reasonable in light of the fund's possibly changing needs.

When a board is evaluating whether to renew an existing service provider contract, its focus may appropriately shift from indicative information (including others' views) about the service provider's ability to deliver quality services to the fund, to an evaluation of the provider's actual performance over the prior contract period. In this case, the board may have received information and compliance reports throughout the period relating to the provider's performance. The board may evaluate whether the provider's history with the fund merits renewal on similar terms or whether a different fee arrangement is appropriate.

[6] One report prepared by accounting firms that may be used by the board and/or the fund CCO in understanding the internal controls of certain service providers relevant to a fund's financial statements is known as a SAS 70. In addition, some service providers have engaged accounting firms to issue other types of reports. The CCO Task Force of the American Institute of Certified Public Accountants Auditing Standards Board also is developing guidance for accountants, expected to be issued this summer, which will provide additional and specific information about compliance-related engagement and reporting procedures for use with service providers. These reports generally are available only to current clients of the service provider.

If the performance of the provider was less than expected, the board may evaluate whether the provider improves its quality of service after receiving critical feedback about its performance or whether fund management should be asked to consider other arrangements with the provider or to consider changing providers.

There are practical difficulties associated with making a change in service providers. The conversion process from one service provider to another may be expensive and may be complicated by a period of adjustment, technical difficulties, or even a temporary lapse in service. If a fund undertakes a change in service providers, directors may wish to inquire whether fund management has carefully planned the transition to ensure it operates smoothly.

C. EVALUATING FEES

A key component of every service provider agreement with a fund is the fee to be paid by the fund. In assessing the level of the fee, boards should be aware of the nature and extent of the services that will be provided in return for the fee, including any indirect benefit or compensation to the provider that may arise from its relationship with the fund. While the fees charged for the services are an important consideration in the selection of a service provider, they are just one factor to consider, and hiring the lowest-priced service provider may not necessarily be in the best interest of the fund's shareholders.

The general standard for assessing fees is whether they are reasonable in light of the services to be provided. In considering whether a service provider's proposed fee meets this standard initially and remains so over the course of the relationship, boards may rely upon a variety of resources. In the case of transfer agents, one such resource may be the *Mutual Fund Transfer Agents Trends and Billing Practices Report,* which is published bi-annually by the Investment Company Institute.[7] Boards also may consider comparative data provided by third-party vendors or consultants. Boards may consider the expenses associated with obtaining these resources in determining whether and how to use the resources. Depending on a fund's individual circumstances, boards may use the resources on an as-needed basis rather than each year. During interim periods, boards may ask fund management to compare the elements of a fund's expenses paid to certain service providers with those of its peers receiving similar services, as disclosed in the funds' financial statements, as a less expensive validation that

[7] This report is based on findings of a survey of Investment Company Institute members. The report provides data regarding transfer agent industry trends and cost information on a continuing basis and provides a means for fund directors to compare their funds' transfer agency fees with those of similar funds. The survey is participant funded, and the resulting report is available only to those member funds of the Investment Company Institute who participate in the survey.

the expenses associated with the fund's service provider are reasonable. Some boards also periodically may ask each service provider to provide information regarding the fees, or range of fees, charged to clients receiving similar services to understand where their fund's fees fall in relation to others.

Depending on the type of arrangement under consideration, boards may consider more specific factors relating to the fees. For example, some funds may pay fees related to a fund's participation in platforms that provide for purchases and redemptions of fund shares on an omnibus basis, such as mutual fund supermarkets. These fees may be characterized appropriately as sub-transfer agent or shareholder servicing fees, and may not be covered (nor have to be) under a Rule 12b-1 plan. In such cases, the board may seek to evaluate whether the fees are reasonable in light of the cost of comparable services rendered by the fund's primary transfer agent or others in the marketplace. To the extent these fees may exceed the reasonable compensation for the services to be rendered, a board may wish to inquire whether a portion of the fees should be covered by a Rule 12b-1 plan or paid by the adviser. As another example, if a fund's sub-transfer agent fees exceed the per account charge for the fund's transfer agent, the board may wish to examine whether the services for such fees are demonstrably different and justifiable.

If directors feel that fees charged by a service provider are not fair and reasonable in light of the services being rendered, or that the services provided fail to meet their expectations, the directors may consult with fund management about their concerns and ways to improve the service provider relationship. After consulting with fund management, directors may consider asking fund management to solicit bids from other service providers. Directors also may consider asking fund management to solicit bids periodically for a service provider contract to add an element of competition to the process and to evaluate the services and fees potentially available to the fund from different service providers. Because soliciting bids can be a complex and time-consuming process, this alternative may not be optimal unless the fund is seriously considering changing service providers.

D. EVALUATING POTENTIAL CONFLICTS OF INTEREST

Some arrangements between fund management and service providers could present potential conflicts of interest. In evaluating service provider arrangements, the board should be alert for any arrangements that could unfairly benefit the adviser or others to the detriment of the fund and its shareholders. Fund management should fully disclose to the fund's directors potential conflicts, as well as any circumstances in which one fund may benefit to the disadvantage of, or disproportionately to, another fund (or type of fund) in the complex. For example, if a service

provider waives part of its fee for a fund, such as for a limited period of time immediately following the fund's inception, the directors should satisfy themselves that no other funds in the complex are bearing a higher expense as a result.

In general, directors reviewing arrangements involving funds, management, and service providers should seek to assure themselves, after consultation with counsel, the fund's CCO, and/or independent consultants, that (i) they are satisfied with the information they receive, (ii) they have been informed about the extent of the relationship between the parties, and (iii) any required disclosure to shareholders has been or will be made.

1. Affiliated Service Providers

Directors should be especially attuned to the potential conflicts of interest that may arise between the fund and a service provider that is affiliated with the fund's adviser. In certain instances, such as in the use of an affiliated securities lending agent, the board also may be required to make specific findings or approvals.

When evaluating an arrangement with an affiliated service provider that in turn subcontracts to an unaffiliated service provider, boards may wish to inquire about the respective roles of the two entities and whether fund management or the affiliated service provider receives any benefit, directly or indirectly, other than the fees payable under the contract. Examples of such benefits could include payments by a service provider to fund management, the reduction or waiver of other payments owed to the service provider by fund management, or the support of other business arrangements involving the service provider and fund management. Boards also may wish to evaluate the fees paid to the affiliated service provider and the unaffiliated service provider, relative to the services each will perform.[8]

When an adviser receives a material benefit as a result of an arrangement with a fund's service provider, boards should include a review of the arrangement as part of the fund's annual advisory contract review. The fiduciary duty of a fund's adviser with respect to the fees it receives from the fund extends to the fees received by any affiliates of the adviser for services provided to the fund.

[8] *See In the Matter of Smith Barney Fund Management LLC and Citigroup Global Markets, Inc.*, SEC Release Nos. 34-51761 and IA-2390, Admin. Proc. File No. 3-11935 (May 31, 2005) (in a settled administrative proceeding, finding that the funds' boards were misled when the funds changed from a third-party transfer agent to an affiliate even though the third-party transfer agent continued to perform almost all of the same services it had performed previously, but at deeply discounted rates, while the affiliated transfer agent kept most of the discount for itself and made a high profit for performing limited work).

2. Unaffiliated Service Providers

Conflicts of interest also may arise in arrangements with unaffiliated service providers. For example, boards may wish to inquire about the existence of any revenue or expense sharing, related business arrangements, or other "side" compensation or fee waiver arrangements between fund management and the service provider or their respective affiliates.[9] Fund management may receive compensation for overseeing the provider, in which case directors may wish to inquire as to the process and monitoring criteria employed by fund management in its oversight function. Directors also may wish to inquire whether the service provider uses any part of the fee it receives from the fund for distribution or any other purposes not contemplated in the agreement detailing the fund's arrangement with that service provider. For boards overseeing funds subject to an expense cap, the board may wish to inquire whether the service provider is allocating charges differently than it does for funds in the complex not subject to an expense cap. Boards also may wish to inquire about other business relationships between affiliates of the adviser and the service provider or any of the service provider's affiliates.

IV. Ongoing Oversight of Service Providers

Regardless of whether the board is directly involved with the selection of a service provider, the board typically is engaged in ongoing oversight of the quality of the services received by the fund from its providers. The way in which it conducts such oversight will depend on the facts and circumstances of each fund.

When a service provider is an affiliate of the fund's adviser, the board's oversight role may be more substantial due to the greater potential for conflicts of interest inherent in these arrangements. Boards may seek more detailed reports concerning the level and quality of the services provided. If a sub-service provider is used, the board may monitor the respective duties of each, particularly in light of the fees each receives.

[9] *See In the Matter of BISYS Fund Services, Inc.,* SEC Release Nos. IA-2554 and IC-27500, Admin. Proc. File No. 3-12432 (Sept. 26, 2006) (in a settled administrative proceeding, finding that side arrangements undisclosed to the directors between certain fund advisers and an administrator obligated the administrator to rebate a portion of its fee to the advisers in exchange for the advisers' recommendations that the administrator's contract be renewed. The rebated monies were then used to pay for marketing and other expenses incurred by the advisers to promote the funds, which expenses should have been paid for by the advisers out of their own assets).

A fund should have in place a system to monitor the quality of the services provided. At least annually, the fund's CCO will provide a written report to the board regarding the operation of the compliance procedures of at least those service providers covered by the fund compliance program rule. In addition, fund management and/or the fund's CCO may report to the board on a periodic basis as to whether the service providers meet expectations and the existence of any material compliance issues.

The board may wish to inquire as to the standards that fund management will use in its assessment of the quality of services to be rendered. Many boards receive periodic reports at regular board meetings from fund management regarding the provider's delivery of its services and level of performance. These reports may be written or oral, and typically are reflected in the meeting's minutes. The frequency and timing of these reports will vary from fund to fund.

There likely will be some periodic reports from the service provider that fund management will use to assess the ongoing quality of the service provider's performance. The board may receive summaries of these reports on a regular basis. Directors also may wish to request periodic presentations by representatives of the service provider, during which time they may ask questions to supplement the information they receive from management. In addition, an occasional on-site visit to a service provider's facilities may provide the board with an educational opportunity for valuable insights regarding the operations, technology, and personnel of the service provider.

Other information that a board may wish to receive from fund management and/or the CCO about a service provider may include updates on technological enhancements or lapses, whether key personnel at the service provider (such as the primary contact person for the fund) have left, and whether the departure has had, or is expected to have, an effect on the quality of services rendered. The board also might inquire whether fund management has received adequate cooperation and support from the service provider, including in the resolution of any errors and in response to inquiries from the CCO.

V. Conclusion

A fund's board of directors may oversee various service providers as part of its overall responsibilities. The nature and extent of board involvement in the selection of fund service providers and ongoing oversight of their performance varies across the fund industry. Regardless of the extent of that involvement, directors should be aware of the potential for conflicts of interest that may arise under certain circumstances and the protections in place to address any such conflicts. Once a service provider is selected, the board typically is involved in the ongoing oversight of that service provider. The extent of this involvement, as well as the type of information and detail that boards receive in reports concerning service providers, will vary from fund to fund. Directors should determine for themselves the approach that is most appropriate for the funds and the service providers they oversee.

Appendix A

Task Force Members

Geoff Bobroff	*Independent Director* Matthews International Funds
Lynne M. Cannon	*Interested Director* Stratton Mutual Funds
Darlene T. DeRemer	*Independent Director* Nicholas-Applegate Institutional Funds AIG Strategic Hedge Fund of Funds
Peter S. Drotch	*Former Independent Director* BlackRock Funds
Sam Freedman	*Independent Director* OppenheimerFunds Board II
Steven J. Paggioli *(Task Force Chair)*	*Independent Director* Professionally Managed Portfolios Managers Funds Managers AMG Funds
George J. Sullivan, Jr.	*Independent Director* SEI Funds State Street Navigator Securities Lending Trust

Appendix B

ADMINISTRATOR

An "administrator" is defined in Rule 0-1(a)(5) under the 1940 Act as "any person who provides significant administrative or business affairs management services to an investment company." Administrative services may be provided to a fund by an affiliate of the fund, typically the investment adviser, or by an unaffiliated third party. The range of these services will vary depending on a number of factors, including whether the administrator is affiliated or unaffiliated. Some of the services provided may include:

- registering the fund and its public offering of shares and keeping the registration statement current;
- providing corporate administration services, including logistical support for the board of directors;
- preparing board reports and minutes of meetings;
- providing legal and regulatory compliance, such as for SEC and Blue Sky filings; tax, shareholder, and other reporting, including preparing annual and semi-annual reports to shareholders and quarterly schedules of investments; and coordinating the Sarbanes-Oxley certification process;
- monitoring compliance with portfolio restrictions and limitations;
- performance monitoring of the custodian, transfer agent, and fund accounting agent;
- providing expense budgeting and analysis;
- coordinating financial audits and regulatory examinations; and
- providing various CCO support services.

In addition to the general factors mentioned in the body of the report, some of the factors that a board may wish to consider when analyzing the merits of a particular administrator and the quality of its services include:

- the number, sizes, and types of funds it administers; and
- its experience in interacting with other vendors and providers.

Appendix C

CUSTODIAN

The 1940 Act requires each investment company to maintain its securities and similar assets in the custody of either one or more banks, a broker or dealer, or the fund itself. Almost all funds use banks as custodians because the SEC imposes special requirements, including physical segregation of fund assets, on a broker-dealer acting as a custodian that makes using broker-dealer custody impractical. If any funds undertake custody of their securities and investments themselves, strict guidelines also must be followed. The SEC staff has imposed similar requirements when a fund uses an affiliated custodian, such as a bank. The SEC, the Federal Reserve Board, the Comptroller of the Currency, the Federal Deposit Insurance Corporation, and/or various state banking commissions regulate custodians.

The custodian may provide the following services:

- safekeeping of securities, cash, and other assets of the fund;
- settlement of portfolio purchases and sales;
- identifying and collecting portfolio income (interest on bonds and dividends on stock);
- reporting of failed trades;
- performing cash and position reconciliations;
- monitoring of corporate actions (*e.g.,* stock splits, rights offerings, tender offers, and calls) and other capital changes of portfolio companies;
- conducting and overseeing securities lending programs;
- providing foreign exchange capabilities;
- providing cash management "sweep" services (such as automatic overnight cash investments);
- overseeing sub-custodians, including the hiring, firing, and performance review of foreign sub-custodians; and
- providing portfolio compliance reports on transactions, positions, income, performance, and risk measurement in order to assist management in complying with investment guidelines and restrictions.

In addition to the general factors mentioned in the body of the report, some of the factors that a board may wish to consider when analyzing the merits of a particular custodian and the quality of its services include:

- the custodian's experience in the fund business and its anticipated commitment to continuing in the fund business, particularly if its line of business extends beyond the fund business, as may be the case with bank custodians;
- the availability and cost of a line of credit and overdraft protection from the custodian, if applicable;
- the custodian's procedures with regard to corporate actions;
- whether trades would be communicated by the adviser to the custodian electronically;
- how corporate actions would be communicated by the custodian to the fund accounting agent or how quickly a fund's trades would be reflected in the portfolio manager's information system;
- its overall costs, including arrangements for cash balances and any resulting credits against service fees; and
- if a fund holds foreign securities, its quality of foreign custody services (offered directly or through its sub-custodian network).

Appendix D

Fund Accounting Agent

Some or all fund accounting services may be provided by one of the other service providers, such as the fund's administrator or the custodian. This appendix addresses the services of the fund accounting agent and not those of the independent accountant, its audit of the fund's financial statements, or the preparation of any work papers and gathering of evidence to support the auditors' opinion. Fund accounting functions may include:

- valuing all portfolio securities daily;
- calculating the net asset value (NAV) and NAV per share;
- recording all security trades and corporate actions;
- calculating daily expenses, including adviser fees and fee waivers;
- calculating dividend and distribution rates;
- maintaining the fund's general ledger;
- calculating 30-day SEC yields and total returns;
- performing cash and position reconciliations;
- calculating and recording interest and dividend income, unrealized appreciation and depreciation, and capital gains and losses;
- responding to inquiries made by any audit committee financial experts;
- accumulating financial information for management, regulatory, shareholder, and tax reporting; and
- preparing periodic audit and financial information for the fund's independent auditors.

In addition to the general factors mentioned in the body of the report, some of the factors that a board may wish to consider when analyzing the merits of a particular fund accounting agent and the quality of its services include:

- the auditor's opinion of the quality of the fund accounting agent's services;
- the fund accounting agent's historical NAV accuracy rate (overall and by type of fund);
- whether a fund accounting agent is fully conversant with the way the fund values its securities; and
- the fund accounting agent's policies and procedures, including those relating to error corrections and stale pricing.

Appendix E

TRANSFER AGENT

Fund transfer agents maintain records of shareholder accounts, which reflect daily investor purchases, redemptions, and account balances. Transfer agents must register with the SEC and are regulated under the Securities Exchange Act of 1934. Some of the responsibilities a transfer agent may perform, depending upon its contractual obligations with the fund, include:

- maintaining all shareholder account information, including name, address, and tax I.D. number, and current and historical ownership of shares;
- processing purchases and redemptions of fund shares and paying dividends and capital gains distributions;
- withholding taxes, where required, and sending the IRS and shareholders Form 1099 information at year-end;
- preparing and mailing to shareholders transaction confirmations and periodic account statements confirming transactions and reflecting share balances, as well as other shareholder notices;
- providing call center representatives or a voice response system to answer shareholder and broker calls and, where permitted, to accept transactions via telephone;
- providing custodial and tax reporting account services for retirement accounts;
- providing anti-money laundering and customer information program services to assist funds in combating fraud and the funding of terrorism and other criminal activity;
- providing daily reconciliation of shares and cash;
- providing reports of daily share transactions to the fund accounting agent as well as periodic reports to the fund's adviser, as requested; and
- providing daily compliance monitoring for fund policies with regard to market timing and excessive trading.

In deciding which transfer agent to use, a board may consider certain characteristics of the fund or fund complex, including:

- the size of the fund complex;
- the nature of the funds to be serviced;
- the primary method of distribution used for the fund;
- number of accounts to be serviced;
- type of accounts to be serviced (*e.g.,* omnibus, institutional, retirement, networked);
- average account size;
- transaction frequency;
- need for shareholder/intermediary interaction; and
- technology requirements.

In addition to the general factors mentioned in the body of the report, some of the factors that a board may wish to consider when analyzing the merits of a particular transfer agent and the quality of its services include:

- the transfer agent's promptness of responses by phone or mail or quality of phone experience;
- the existence and nature of complaint files for the fund and the reporting mechanism for a board to stay apprised of such complaints;
- the flexibility, functionality, and stability of the technology platform on which the transfer agent maintains shareholder accounts;
- the transfer agent's technological capabilities, including whether the transfer agent digitizes documents (such as account applications) that can then be accessed electronically and provides a website or voice response system for shareholder communications; and
- who receives the interest or credits earned on deposit accounts of the transfer agent.

Appendix F

Securities Lending Agent

Funds that engage in securities lending frequently do so through a securities lending agent. Many funds utilize their custodians to perform this function as an adjunct to their custodial services. The documentation and primary activities involved with lending a fund's portfolio securities are distinct from pure custodial functions, however, and many banks, broker-dealers, or their affiliates act as securities lending agents for funds for which they do not also act as custodians. In most cases, both custodial and third-party lending agents are compensated for their services based upon a percentage or "split" of the net revenue generated by the fund's securities lending activity.

Through a series of no-action positions, the SEC staff has provided interpretive advice and guidance regarding securities lending that, among other things, require that funds establish certain parameters (*e.g.,* limitations on the securities available to be loaned, eligible borrowers, collateralization requirements, and approved investments for cash collateral) for their securities lending programs. At least when the lending agent is affiliated with the fund, the guidance also requires that the fund's adviser or compliance personnel monitor the lending agent's performance, including its compliance with those parameters. Use of an affiliated securities lending agent normally requires SEC exemptive relief.

Securities lending agents generally provide the following services:

- identifying eligible borrowers interested in borrowing specific securities that are available for loan within the fund's portfolio;
- negotiating specific loan terms within the parameters established by the fund, including the loan fees or the rebates to be paid on cash collateral;
- delivering, or arranging for the delivery of, loaned securities to the borrowers, and receiving, or arranging for the receipt of, the cash or other collateral required to be provided by the borrowers;
- investing cash collateral in investments of the types specified by the fund;
- daily marking to market of the value of loaned securities and of any securities collateral, and requiring delivery of additional collateral (or effecting or arranging for the return of any excess collateral) in accordance with loan terms;
- obtaining the payment by borrowers of amounts equivalent to dividends or other distributions paid on loaned securities;

- arranging for the return of loaned securities and collateral upon the termination of the loan;
- monitoring for borrower defaults, including any failure to return loaned securities in a timely manner, and liquidating collateral and enforcing other fund remedies in the event a default occurs;
- recordkeeping, accounting, and reporting services needed in connection with securities lending activities; and
- in the case of third-party lending agents, establishing the necessary operational links with the fund's custodian.

In addition to the general factors mentioned in the body of the report, some of the factors that a board may wish to consider when analyzing the merits of a particular securities lending agent and the quality of its services include:

- access to borrowers and markets appropriate to the fund's portfolio and lending objectives;
- additional custody and fund accounting costs to accommodate securities lending (*e.g.,* costs associated with increased recordkeeping);
- lending approach—*i.e.,* focus on loan volume or on "special" securities for which there is high demand—and the appropriateness of that approach to the fund's portfolio and lending objectives;
- fairness and competitiveness of the proposed "split" of net lending revenues;
- approach to reinvestment of cash collateral and availability of low-cost reinvestment funds and vehicles;
- projections of net lending income to the fund and depth and quality of data and analysis supporting those projections;
- in the case of third-party lenders, ability to interact with the fund's custodian on operational matters; and
- flexibility in accommodating the fund's lending needs, including loan recall policies relating to proxy voting and corporate actions.