

# Fundamentals for Newer Directors

February 2014

Information about the role and responsibilities of fund directors, and the framework within which they operate

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# Introduction

The Independent Directors Council (IDC) created this material as an information resource for newer fund directors. This material is designed to help newer directors understand the legal and regulatory framework within which investment company directors operate, and their role and responsibilities within that framework.

## The Fund Industry

Mutual funds and other U.S.-registered investment companies play a significant role in the U.S. economy and world financial markets. These funds held more than \$16 trillion in assets for more than 90 million U.S. investors as of December 31, 2013. Funds supply investment capital in securities markets around the world and are among the largest group of investors in the U.S. stock, commercial paper, and municipal securities markets. Firms providing fund services employed 166,177 U.S. workers as of spring 2013.



In 2012 there were 776 financial firms from around the world that competed in the U.S. market as sponsors of investment companies, providing investment management services to fund investors. Banks, insurance companies, securities broker-dealers, and non-U.S. fund advisers may sponsor investment companies in the U.S. marketplace. Approximately 76 percent of U.S. fund sponsors, though, are independent fund advisers, and they manage close to two-thirds of investment company assets.

## Types of Funds

In the United States, fund sponsors offer four types of registered investment companies: open-end funds (commonly called mutual funds), closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs).

### Mutual Funds

Mutual funds can have actively or passively managed portfolios. For actively managed portfolios, the adviser creates a unique mix of investments to meet a particular investment objective. For passively managed portfolios, the adviser seeks to track the performance of a selected benchmark or index.

#### KEY TERM

**Forward pricing.** The concept describing the price at which mutual fund shareholders buy or redeem fund shares. Shareholders must receive the next computed share price following the fund's receipt of a shareholder transaction order.

One hallmark of mutual funds is that they issue “redeemable securities,” meaning that the fund stands ready, every day, to buy back its shares at their current net asset value, or NAV. The NAV is calculated when the markets close by dividing the total market value of the fund’s assets, minus its liabilities, by the number of mutual fund shares outstanding. As of December 31, 2013, there were 8,977 mutual funds with total assets of more than \$15 trillion.

## Closed-End Funds

Unlike a mutual fund, a closed-end fund does not issue redeemable shares. Instead, it issues a fixed number of shares that trades intraday on a stock exchange. As a result, the share price of a closed-end fund is determined by the market, unlike that of a mutual fund. This market-determined price may differ from the fund’s NAV. Investors in a closed-end fund buy or sell shares through a broker or via a brokerage account, just as they would the shares of any publicly traded company. As of September 30, 2013, there were 604 closed-end funds with total assets of \$277 billion.

## Exchange-Traded Funds

ETFs are, practically speaking, hybrid investment companies in that they are structured, in part, like an open-end fund and, in part, like a closed-end fund. They are structured and legally classified as mutual funds or UITs (discussed below), but trade intraday on stock exchanges like closed-end funds.

ETFs only buy and sell fund shares directly to certain third-party “authorized participants” (typically broker-dealers) in large blocks known as creation units, which often are 50,000 shares or more. The third parties who purchase the creation units then sell the shares on an exchange so that, to the ultimate investor, the purchase and sale of ETF shares is much like the purchase and sale of closed-end fund shares. The price at which ETF shares trade is determined by the market. As of December 31, 2013, there were 1,332 ETFs with total assets of \$1,675 billion.

### KEY TERM

#### Intraday indicative value (IIV).

A real-time estimate of an ETF’s intraday value. Third-party providers calculate and disseminate this measure every 15 to 60 seconds during securities markets trading hours.

## Unit Investment Trusts

UITs are also a hybrid, with some characteristics of mutual funds and some of closed-end funds. Like mutual funds, UITs issue redeemable shares. Like closed-end funds, however, UITs typically issue only a specific, fixed number of shares. A UIT does not actively trade its investment portfolio, instead it buys and holds a set of particular investments until a set termination date, at which time the trust is dissolved and proceeds are paid to shareholders. Unlike other investment companies, a UIT is not required to have a board of directors, corporate officers, or an investment adviser. As of December 31, 2012, there were 5,787 UITs with assets of \$72 billion.

## Legal Framework

The remainder of this material will focus primarily on mutual funds because the vast majority of investment companies, both in terms of number of funds and assets under management, are mutual funds. Even so, many of the concepts are common to all types of registered investment companies.

Mutual funds are complex, stringently regulated financial institutions that must comply with a variety of federal laws and regulations. Funds must be registered under the Investment Company Act of 1940 (the 1940 Act) and their shares typically are registered under the Securities Act of 1933. The fund industry's principal regulator is the U.S. Securities and Exchange Commission (SEC).

Mutual funds offer investors many benefits, principally the chance to own liquid, diversified, professionally managed portfolios at a relatively low cost. Mutual fund shareholders are also protected by an array of securities laws that set funds apart from many other types of financial products. The 1940 Act goes far beyond the disclosure and antifraud requirements characteristic of the other federal securities laws and imposes substantive requirements and prohibitions on the structure and day-to-day operations of mutual funds. The core objectives of the 1940 Act are to:



- » require a high degree of independent oversight and accountability;
- » guard against conflicts of interest;
- » protect the physical integrity of the fund's assets;
- » guard against potentially problematic affiliated transactions and prohibit other forms of self-dealing;
- » protect against potentially unfair and unsound capital structures (by, for example, placing constraints on the use of leverage);
- » pursue transparency and accuracy of the liquidity and valuation of fund shares (by, for example, requiring mutual fund navs to be calculated and marked-to-market daily); and
- » ensure that investors receive appropriate information about the mutual funds in which they invest and that the information is accurate and not misleading.

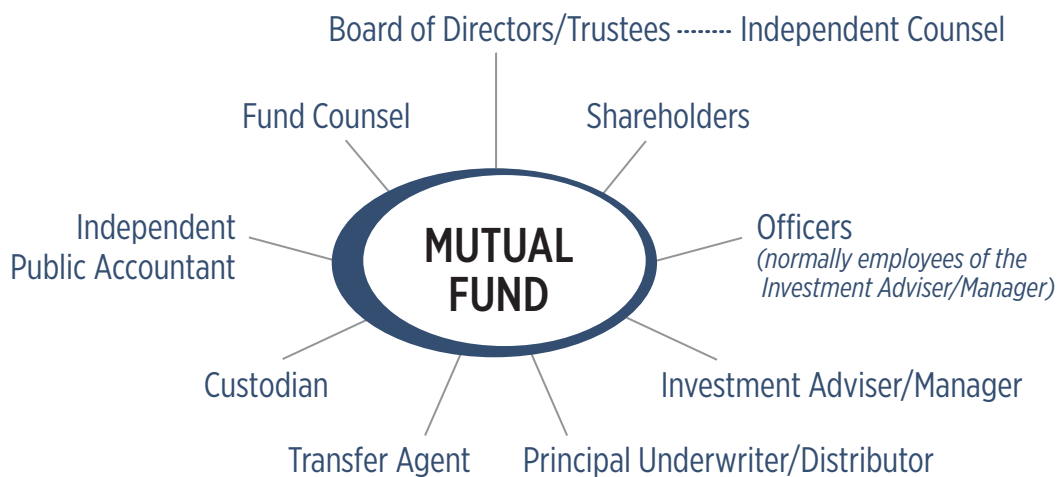
In addition, those who sell fund shares to the public are subject to regulation as broker-dealers under the Securities Exchange Act of 1934 (1934 Act). The sales practices of broker-dealers are, in turn, regulated by the Financial Industry Regulatory Authority (FINRA). It is important to note that the offer and sale of mutual fund shares also may be subject to notice filing requirements and antifraud prohibitions under state law. Investment advisers to funds must register with the SEC under the Investment Advisers Act of 1940 (Advisers Act). In addition, investment advisers and subadvisers to funds that invest in derivatives may be required to register with the Commodity Futures Trading Commission (CFTC) as commodity pool operators and commodity trading advisors under the Commodity Exchange Act and become members of the National Futures Association. Finally, the Internal Revenue Code of 1986 grants pass-through tax treatment to mutual funds, which means that mutual funds are not subject to taxation on their income and capital gains at the entity level, so long as they meet certain gross income, asset, and distribution requirements.

# Overview of a Mutual Fund

## Structure

A mutual fund is a pool of stocks, bonds, and other investments (or cash). Each investor (also called a shareholder) owns a proportionate interest in, or share of, the pool. A mutual fund is organized under state law either as a corporation or as a business or statutory trust. Mutual funds have officers and boards of directors (if organized as a corporation) or trustees (if organized as a business or statutory trust). In this way, mutual funds are similar to other types of operating companies. Unlike other companies, however, a fund is typically externally managed. It is not an operating company; it generally has no employees; and, usually, a fund has no assets other than its investments and cash. As a result, a fund relies on third-party service providers that are either affiliate organizations of the entity that launched the fund (such as the fund's investment adviser) or independent contractors (such as the fund's auditors and attorneys) to operate the fund and carry out its day-to-day affairs.

The diagram below shows a typical fund complex, including its principal service providers. Following the diagram is a description for each principal service provider.





## Investment Adviser/Manager

A fund's investment adviser (also called investment manager) is the entity that has overall responsibility for directing the fund's investments and handling its day-to-day operations. The investment adviser has its own employees, including investment professionals who make investment decisions for the fund. The investment adviser also typically provides all operational and office support for the fund, maintains its books and records, and provides legal and compliance services. All of the investment adviser's services to the fund are rendered pursuant to an advisory agreement between the adviser and the fund (see *Advisory Contract Renewal*). The advisory agreement includes the terms of the investment adviser's compensation. An adviser is usually compensated based on the assets of the fund (or sometimes on fund performance). A fund's investment adviser is often the fund's initial sponsor and shareholder through the "seed money" it invests to create the fund.

## Subadvisers

A fund's investment adviser may contract with one or more subadvisers to manage all or part of the fund's portfolio. In arrangements referred to as "manager-of-managers" or "multi-manager," an adviser hires one or more subadvisers to manage the fund's assets. If the fund has more than one subadviser, the portion of the assets managed by each subadviser is referred to as a "sleeve." The fund's portfolio decisions may be delegated entirely to subadvisers or the investment adviser may manage a portion of the portfolio.

To protect investors and guard against potential conflicts of interest and self-dealing, a fund's investment adviser, any subadvisers, their affiliates, and their employees are subject to many standards and legal restrictions, including those under the Advisers Act. An investment adviser, and any subadviser, must have a compliance program in place to ensure compliance with all applicable laws. The compliance program should include detailed policies and procedures, and the program must be overseen by a chief compliance officer (CCO).

### **DID YOU KNOW?**

Regardless of how a subadviser is used, the fund's board, under the 1940 Act, has essentially the same oversight responsibilities relating to the subadviser as it does for the investment adviser.

### **TO LEARN MORE**

Read the IDC task force paper *Board Oversight of Subadvisers*.

## Principal Underwriter/Distributor

The principal underwriter, also known as the fund's distributor, is the entity in charge of selling (also called distributing) fund shares and often is an affiliate of the fund's adviser. Distributors are registered under the 1934 Act as broker-dealers, and are subject to strict rules governing how they offer and sell securities directly to investors or indirectly through other intermediaries, such as brokers or financial advisers. The distributor's services are provided pursuant to a contract with the fund, and the distributor's compensation is typically tied, in part, to the assets of the fund. The reason that funds have different classes of shares is that each class reflects different distribution arrangements applicable to each class. Nondistribution expenses tend to be the same for all classes of shares.



## Transfer Agent

The transfer agent, which may be an affiliate of the fund's adviser, is the entity that serves as a liaison between a fund and its investors. The transfer agent's responsibilities typically include executing shareholder transactions, maintaining records of shareholder accounts (which reflect daily investor purchases, redemptions, and account balances), responding to shareholder inquiries, and sending account statements and other documents to shareholders. Transfer agents must register with the SEC and are regulated under the 1934 Act.

## Custodian

A fund's custodian holds the fund's assets, maintaining them separately to protect shareholder interests. Nearly all funds use a bank custodian for domestic securities because the SEC imposes strict requirements on broker-dealers acting as custodians, funds that self-custody their assets, and affiliated custodians. In addition to the SEC, the Federal Reserve Board, the Comptroller of the Currency, the Federal Deposit Insurance Corporation, and/or various state banking commissions also regulate custodians. A fund's custody agreement with a bank is typically far more elaborate than that used for other bank clients. The custodian's services generally include safekeeping and accounting for the fund's assets, settling securities transactions, receiving dividends and interest, providing foreign exchange capabilities, paying fund expenses, reporting failed trades, reporting cash transactions, monitoring corporate actions, and tracing loaned securities. Foreign securities are required to be held in the custody of a foreign bank or securities depository.

## Independent Public Accountant

A fund's independent public accountant is the entity that reviews and certifies the fund's financial statements. The independent public accountant typically works closely with the board's audit committee, and is actively involved in reviewing many matters related to the fund's financial integrity. For example, as part of its annual audit, the accountant reviews the fund's valuation of securities and certain transactions with affiliates. The accountant also is often called on to provide specialized tax, consulting, or compliance services. The independent public accountant's ability to provide non-audit services is limited by certain laws and regulations.

## Fund Counsel

Virtually all funds use outside legal representation and the law firm (or attorney) who provides those services often is referred to as fund counsel. Fund counsel typically represents the fund in connection with all legal aspects of its operations, including preparing or reviewing SEC and other regulatory filings, preparing or reviewing minutes of board meetings, reviewing the adviser's proposals involving matters that affect fund operations, and attending board meetings. Just like the independent public accountants, fund counsel is often called on to undertake special reviews or research on legal matters that arise in the course of the fund's day-to-day operations.

## Independent Counsel

Independent directors are not required to have their own legal counsel, but, if they do, that counsel must be independent under SEC rules. Generally, the law firm representing the independent directors is itself “independent” if neither the law firm nor the individuals representing the independent directors have a significant relationship with the fund’s adviser or its affiliates. If fund counsel does not do significant work for the adviser or its affiliates, fund counsel may (and often does) act as counsel to the independent directors. Independent counsel’s role is to work closely with the independent directors, advising them in the context of most decisions in view of their unique role as independent fiduciaries who ensure that the fund is run solely for the benefit of its shareholders.

### **DID YOU KNOW?**

More than 90 percent of fund complexes report that separate legal counsel serve their independent directors.

## Other Service Providers

In addition to the principal service providers described above, some funds retain one or more of the following service providers.

### Administrator

Not all funds have an administrator, as many of the responsibilities of an administrator are typically assumed by the fund’s manager (the investment adviser). Still, some funds—for historical, business, or practical reasons—do have one. The responsibilities of an administrator will vary, but often include: keeping books and records; registering the fund and its public offering of shares and keeping the registration statement current; providing corporate administrative services, including logistical support for the board of directors; preparing board reports and minutes of meetings; providing legal and regulatory compliance support, including preparing annual and semiannual reports to shareholders and quarterly schedules of investments; and overseeing other service providers to the fund.

### Fund Accounting Agent

Funds are subject to unique accounting and financial reporting requirements. In order to assist funds in fulfilling these requirements, a fund accounting agent can perform a variety of services, including valuing all portfolio securities daily, calculating the fund’s NAV and NAV per share, recording all security trades and corporate actions, calculating daily expenses, calculating dividend and distribution rates, and maintaining the fund’s general ledger. Some or all of these services also may be provided by one of the fund’s other services providers, such as the custodian or administrator.

## Pricing Vendor

The integrity of a fund's NAV and the accurate valuation of portfolio holdings are of central importance under the 1940 Act and, of course, to the fund's shareholders. As securities have become more complicated and markets more volatile, it has become common for funds to hire an external pricing vendor to help price portfolio holdings. According to the SEC staff, funds should implement appropriate measures to determine whether prices provided by vendors reflect what the funds might reasonably expect to receive upon a "current" sale of the securities.

## Proxy Voting Service

A fund's investment adviser may rely on a third-party proxy voting service to provide administrative efficiencies. A fund complex may engage a proxy voting service when, for example, there are many funds in the complex and perhaps thousands of individual portfolio securities to vote, as well as the obligation to report those votes. There may be cost savings associated with the hiring of a service to vote proxies, as well as to research the individual proposals. Administrative efficiencies also may be achieved for smaller advisers or fund complexes that have limited resources to handle proxy voting functions in-house. A third-party proxy voting service also may offer protection against potential conflicts between the interests of the adviser and those of fund shareholders.

## Securities Lending Agent

Funds may enter into securities lending programs in order to generate extra income, thus increasing the fund's total return. Funds that engage in securities lending often do so through a securities lending agent, which may be the fund's custodian, an affiliate, or a third party. In most cases, 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.

## Class Action Administrator

Some funds may retain a third-party vendor, known as a class action administrator, to help identify, monitor, and evaluate whether to participate in class action lawsuits involving the securities held in the fund's portfolio. The class action administrator also may help a fund complex with notice of a class action settlement ascertain whether any of the funds held the particular security during the specified "class period" and then submit proofs of claim to collect the settlement proceeds to which the fund may be entitled.

# Fund Directors/Trustees

## Fund Boards and Corporate Boards

The duties of mutual fund directors are somewhat different from corporate directors because of the unique structure of mutual funds. Like the directors of a corporate board, mutual fund directors oversee the management and operations of a company (the fund) and have a fiduciary duty to represent the interests of shareholders. Because a fund has no employees and the board relies on the adviser and other service providers to run the fund's day-to-day operations, the board focuses on the performance and fees of these entities under their respective contracts and monitors potential conflicts of interest.

It is important to note that the mutual fund board is not the board of the fund adviser. In fact, in some cases, the adviser may itself be a public company with its own board of directors and shareholders. Thus, while the fund board oversees the services the adviser provides to the mutual fund, it does not oversee the management and operations of the adviser.

## Oversight Responsibilities

A director's fundamental role is to provide oversight for the fund and its shareholders—not to be involved in the fund's day-to-day management. In broad terms, the board oversees the management and operations of the fund on behalf of the fund's shareholders. Directors also have significant and specific responsibilities under the federal securities laws. Among other things, directors oversee the performance of the fund, approve the agreement and fees paid to the investment adviser for its services, and oversee conflicts of interest as well as the fund's compliance program (the section *Specific Regulatory Responsibilities* covers specific responsibilities directors must fulfill).

## Director Independence

The 1940 Act requires that at least 40 percent of directors be “independent” and strictly defines independence. An independent director cannot own any stock of the investment adviser (or any subadviser) or certain related entities, such as parent companies or subsidiaries of the investment adviser (or any subadviser). In general, under the 1940 Act, an independent director also cannot have, or at any time during the previous two years have had, a significant business relationship with the fund's adviser (including any subadvisers), principal underwriter (distributor), or their affiliates. The 1940 Act also sets standards for when a person will be disqualified from being an independent director. A director who is not independent is considered an “interested person” under the 1940 Act. It is important that all directors consult periodically with fund or independent counsel to be sure they understand the thresholds that may lead an otherwise independent director to become “interested.”

### DID YOU KNOW?

Independent directors make up three-quarters of boards in more than 85 percent of fund complexes.

The issues related to director independence are not limited to those under the 1940 Act. Directors should be mindful of any relationships or situations that might call into question the director's ability to independently discharge his or her fiduciary duties to the fund and its shareholders. Every independent director should carefully review business or financial relationships that he or she (or any immediate family member) has with the fund's adviser (including any subadvisers), principal underwriter (distributor), or their affiliates. To help facilitate this review, fund counsel typically provides directors with a detailed questionnaire annually.

Because a number of the actions taken by a fund board, such as approval of the investment advisory contract, must be taken by a majority of independent directors, the potential ramifications in the event that an independent director is deemed to not be independent can be significant. Independent directors, therefore, should be vigilant of relationships that could jeopardize their independence as a matter of law or perception and inform the fund's adviser and counsel of any contemplated changes in occupation or employment.

Whether independent or interested, all fund directors are subject to the same fiduciary standards. While the number of interested directors on a board is limited by law, and some boards do not have any interested directors, most boards have at least one interested director who is employed by or otherwise affiliated with the fund's adviser. One or more interested directors on a board may enhance a board's effectiveness if they have specific knowledge about the adviser's operations. They also may help to maintain open communication with the adviser and more direct accountability on the adviser's part.

## Selection of Directors

New independent directors are nominated by existing independent directors and then elected by the full board. Sometimes, based on requirements of the 1940 Act, new directors also must be elected by shareholders. The 1940 Act generally requires that, before adding a new director, at least two-thirds of the then-serving board members be elected by the fund's shareholders.

When a new fund complex is launched, the fund sponsor (often the fund's investment adviser) typically is the initial and sole shareholder of the new funds and elects the initial slate of directors.

### TO LEARN MORE

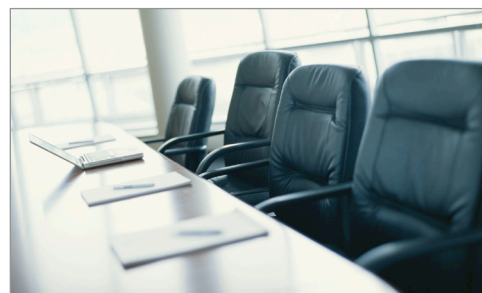
Read the IDC paper *Considerations for Board Composition: From Recruitment Through Retirement*.

## Fiduciary Duty

Directors have a fiduciary duty to represent the interests of the fund's shareholders and are subject to state law duties of loyalty and care.

The duty of loyalty requires that directors use their positions of trust and confidence to further the interests of the fund and its shareholders ahead of their private interests. Fundamental to the duty of loyalty is the avoidance of self-dealing and of conflicts of interest that are detrimental to the fund.

The duty of care requires directors to perform their duties in good faith, in a manner reasonably believed to be in the best interests of the fund, and with the degree of care that an ordinarily prudent person in a like position would exercise under



similar circumstances. The duty of care also requires that directors be informed, apply their business judgment, and reach reasonable decisions.

When facing claims for breaches of fiduciary duties under state law, directors often rely on the “business judgment rule.” This rule provides considerable deference by courts to decisions of directors that have acted on an informed basis, in good faith, and in the honest belief that their decisions were made in the best interests of the fund and its shareholders.

Directors can also face liability under federal laws (including civil liability for material omissions or misstatements in a fund prospectus), and the 1940 Act authorizes the SEC to bring an action against any director who, through personal misconduct, breaches his or her fiduciary duty.

## Indemnification and Insurance

From time to time, independent directors are individually named as defendants in fund industry lawsuits. At other times, independent directors, while not named, are the target of discovery efforts and depositions. Independent directors may also become involved in regulatory investigations or regulatory proceedings. Attempts to reduce the direct financial impact of such fund-related actions commonly focus on arranging for appropriate indemnification of independent directors and adequate professional liability insurance coverage for any financial exposure.

### Indemnification

Indemnification allows independent directors to be reimbursed from fund assets for liabilities (including legal expenses) incurred by them as defendants or witnesses in fund-related actions. Indemnification also allows independent directors to receive “advances” to cover their legal and associated expenses, as those expenses are incurred during the course of an action. Because funds typically have minimal risk of insolvency, indemnification generally affords strong protection to fund independent directors.

### Insurance

Directors and Officers (D&O) insurance affords a second line of protection against the direct financial impact of fund-related actions. While there is no legal requirement that they do so, most funds arrange to purchase such insurance. D&O insurance typically provides coverage for liabilities, including legal expenses, resulting from negligence or breach of duty by fund directors or officers in performance of their duties (though not for liabilities resulting from their fraud, dishonesty, or similar misconduct). As with indemnification, D&O insurance typically allows independent directors to receive “advances” to cover their legal and associated expenses, as those expenses are incurred by them during the course of a fund-related action. Unlike indemnification, liabilities and advancements covered by D&O insurance are paid by the insurer, rather than directly out of the fund’s assets.

#### TO LEARN MORE

Read the ICI Mutual papers *Mutual Fund D&O/E&O Insurance and Independent Directors Liability (IDL) Insurance*.

Some funds purchase a third line of protection, commonly referred to as independent directors liability (IDL) insurance. IDL insurance mitigates the exposure of fund independent directors to various risks associated with indemnification and D&O insurance.

# Board Structure and Operations

## Unitary or Cluster

The boards of most funds are organized according to one of two models—a unitary board consisting of one group of directors who serve on the board of every fund in the complex, or a cluster board, consisting of two or more separate boards of directors within the complex, each of which oversees a different group of funds. There may be overlapping directors in cluster board models. Some of the many advantages of the unitary and cluster board models (as opposed to a model in which every fund in a complex has its own board) follow.

## Common Regulatory Structure

The detailed regulatory scheme under the 1940 Act creates a common set of issues for fund directors to consider and duties to discharge for all the funds they oversee. For example, fund directors are required to establish standards for valuation of portfolio securities; oversee fund brokerage, soft-dollar, and trade allocation procedures; review and approve codes of ethics; review and approve plans for allocating common expenses among funds in the same complex; review and approve fidelity bonds and joint liability insurance policies; monitor certain types of custody arrangements; review and approve anti-money laundering procedures; and approve procedures governing certain types of affiliated transactions. The standards that govern directors' determinations in these areas apply to all funds in a complex.

## Common Personnel and Service Providers

All funds within the same complex generally are served by common personnel and service providers, enter into consistent contractual arrangements, and adopt fairly uniform policies and practices. It is efficient to have a single board, or a few cluster boards, review these common policies and procedures and oversee common arrangements. It also is easier to implement any changes on a complex-wide basis.

## Complex-Wide Oversight Mechanisms

The mechanisms that boards use to assist in their oversight of funds and fund service providers generally apply on a complex-wide basis. These include board oversight of compliance, risk, and the audit function.



## Enhanced Board Influence

The practice of having a single board oversee all the funds within a complex—or within a cluster of funds in the complex—enhances the board’s knowledge and expertise, as well as its authority and influence in the fund complex. As a result, the board’s effectiveness in serving the interests of fund shareholders is enhanced.

## Committees

Many boards establish committees to focus on specific subject matters (e.g., audit, governance, investments). The time and effort required of mutual fund directors, especially independent directors, have grown exponentially as the industry has increased in size and complexity and as new regulations have expanded directors’ duties. In this environment, boards frequently use both standing and ad hoc committees to help manage their workloads and to enable greater in-depth review and oversight of particular topics or aspects of the fund’s operations.

## Audit Committees

A mutual fund board audit committee is responsible, among other things, for overseeing the accounting and financial reporting processes of the fund and its internal controls over financial reporting. In this context, the audit committee recommends to the full board (and shareholders, where a shareholder vote is sought) the selection of independent auditors for the investment company and meets periodically with the auditors.

Meetings with the auditors help the committee:

- » review the arrangements for and the scope of the annual audit of the fund’s financial statements, and
- » consider any comments the auditors have in connection with their audit and their audit opinion.

An audit committee also often monitors management’s accounting and internal control systems for the funds.

## The Sarbanes-Oxley Act

The Sarbanes-Oxley Act of 2002 places a number of requirements on fund board audit committees. For example, to minimize potential conflicts of interest, audit committees must preapprove any audit or permitted non-audit services provided to the fund, as well as any permitted non-audit services provided to the fund’s investment adviser and certain affiliates of the adviser where the nature of the services provided relates directly to the operations and financial reporting of the fund. The Sarbanes-Oxley Act also requires the timely reporting of specific information by auditors to audit committees.

### DID YOU KNOW?

As of 2012, 82 percent of fund complexes participating in IDC/ICI’s *Directors Practices Study* have a unitary board structure. Generally about 16 percent of fund complexes participating in IDC/ICI’s *Directors Practices Study* have cluster boards.

### DID YOU KNOW?

Virtually every mutual fund’s audit committee is composed entirely of independent directors. This has been adopted as a best practice even though funds are not required to do so unless relying on certain SEC rules.

## Audit Committee Financial Experts

Each fund board is required to determine whether any member(s) of the audit committee are “audit committee financial experts” as defined by SEC rule. Although a fund board is not required to have an audit committee financial expert, it is required to disclose whether it has one, and if so, the name of the expert and whether the expert is independent of management. A fund that does not have an audit committee financial expert must disclose this fact and explain why it has no such expert.

The SEC has tried to clarify that the designation of a person as an audit committee financial expert does not impose on that person any duties, obligations, or liabilities under the federal securities laws that are greater than those imposed on the person as a member of the audit committee and board. This clarification, however, does not have the force of law and whether the fund audit committee financial expert designation does, in fact, invite greater scrutiny remains an open question.

## Board Leadership

The SEC requires disclosure about a fund’s leadership structure—specifically, whether the board chair is an independent director and, if not, whether the board has a lead independent director (and what specific role the lead independent director plays in the leadership of the fund).

## Self-Assessments

SEC rules require virtually all fund boards to conduct an annual self-assessment. The requirement does not specify how a board should conduct the self-assessment or document it. The SEC has stated that the minutes of the board meeting at which the self-assessment is discussed should reflect the substance of the matters covered. In addition, the requirement does not prescribe the specific aspects of a board’s operations that must be considered, except in the following two areas:

- » The effectiveness of the board’s committee structure; and
- » The number of funds overseen by directors.

### DID YOU KNOW?

Ninety-five percent of fund complexes participating in IDC/ICI’s *Directors Practices Study* report having a financial expert on the audit committee.

### DID YOU KNOW?

In 2004, the SEC adopted rule amendments focused on board governance, including requirements that fund boards be composed of at least 75 percent independent directors and chaired by an independent director. These requirements have not gone into effect pending further study as a result of the decision of the United States Court of Appeals for the District of Columbia circuit in *U.S. Chamber of Commerce v. SEC*. IDC/ICI studies show that 85 percent of boards are composed of at least 75 percent independent directors and nearly two-thirds of fund complexes have an independent board chair.

Given that the SEC's requirement largely defers to boards on what the self-assessment should cover and how it is conducted and documented, practices in this regard vary widely. Many boards rely on independent counsel to help administer and coordinate the self-assessment process so as to try and preserve the attorney-client privilege over the results of the self-assessment.

#### **TO LEARN MORE**

Read the IDC task force paper *Board Self-Assessments: Seeking to Improve Mutual Fund Board Effectiveness*.

## **Compensation**

Independent directors of mutual funds are compensated for their time and service by the funds they oversee. The adviser typically pays the compensation of interested directors who also are officers or employees of the adviser. Compensation varies within the industry and may depend on a number of factors. The following factors may play a role in determining compensation:

- » differences in the complexity and size of funds and fund groups overseen by a director,
- » the time commitment required for meetings and other duties,
- » the number of meetings, and
- » the compensation levels necessary to attract highly qualified people.

Director compensation may be structured in different ways and can include an annual retainer, board and committee meeting attendance fees, a deferred compensation plan, a retirement program, or other benefits. Independent chairs, lead independent directors, and committee chairs may receive additional compensation for their added responsibilities. Unlike corporate directors, fund independent directors do not receive shares or options in the fund (although many directors do invest in some of the funds they oversee).

# Oversight of Fund Performance and Fees

## Portfolio Management and Performance

Independent directors evaluate a fund's investment performance on an ongoing basis. This does not mean that directors second-guess the portfolio manager's decisions to buy or sell particular securities. Rather, the directors look at a fund's performance as a whole and over time, taking into consideration its investment objectives, strategies, and risks to evaluate whether the fund is meeting its stated objectives. An important element of a board's ability to do this is to receive periodic presentations and detailed written material from portfolio managers. While review of fund performance is an integral part of the advisory contract renewal process, boards generally do not limit their review of fund performance to contract renewal time. Instead, review of fund performance typically happens, in some fashion, at every meeting.

The following questions may help new directors initially familiarize themselves with fund portfolio management and performance:

- » What is the fund's objective and strategy?
- » What are the benchmarks and peer groups against which performance is compared?
- » What is the portfolio manager's investment and risk management process?
- » What is the investment selection process?
- » What are the sources of returns and risks, relative to the fund's benchmark?
- » What kind of volatility is associated with the fund?
- » What are the fund's concentration and diversification policies?
- » What are the fund's investment guidelines and restrictions?
- » Does the fund use derivatives? If so, what types? How are they monitored?

### TO LEARN MORE

Read the IDC paper *Investment Performance Oversight by Fund Boards*.

Directors also will want to understand the structure of the adviser's organization as it relates to the oversight of fund performance. Some of the questions directors may wish to ask include the following:

- » What groups or individuals within the advisory firm are responsible for portfolio manager selection and ongoing monitoring and evaluation?

- » If the fund complex uses portfolio managers employed by the adviser and a subadviser, is the same group within the adviser's organization responsible for selection and evaluation of both? Are the same criteria used for both? How are subadvisory fees determined?
- » What are the reporting lines for portfolio management?
- » How is portfolio manager compensation structured? What incentives do portfolio managers have to seek superior performance?
- » Are portfolio managers required to invest in the funds they manage?
- » Is there a performance "watch list"? If so, what are the criteria for placing a fund on it and taking remedial action, if necessary?
- » Does the adviser devote adequate resources to the management of the fund?

In evaluating whether the fund is being managed consistently with its mandate as well as whether the fund's investment performance has been satisfactory, the board's primary considerations may include the following elements:

- » Relative performance. How did the fund perform relative to its benchmarks and peers?
- » Risk-adjusted performance. Did the active management add sufficient value to justify the added risk relative to the benchmarks (or passive investment alternatives)?
- » Market experience. Did the fund perform as expected in the actual market and economic environment?
- » Reasons for over- or underperformance. What were the primary reasons for the fund's performance relative to its benchmark and peer group, and were these consistent with the expectations discussed by the adviser with the board?
- » Portfolio structure and risk. Was the fund's portfolio structure consistent with disclosures and guidelines in terms of exposures, concentration, and risk relative to the benchmark?
- » Investment process. Did the portfolio managers follow their stated investment process, including selection and allocation of fund holdings?
- » Implementation. Did the portfolio managers efficiently implement their investment strategy, including prompt investment of cash, use of derivatives as appropriate, and control of turnover and transaction costs?
- » Lessons learned/changes. In light of market experience, are the portfolio managers or senior management considering any changes to the investment process or portfolio structure?

## Fund Fees and Expenses

Mutual fund investing involves two primary kinds of fees and expenses: fees that are charged directly to shareholders and fees that are charged to the fund and reflected in the fund's total expenses (which shareholders bear indirectly by virtue of owning shares of the fund).

Fees that are charged directly to shareholders may include the following (please note: not every fund charges every type of fee):

- » **Upfront Sales Charge (Front-End Load).** The maximum sales charge that a shareholder may pay when purchasing fund shares. This charge usually compensates a financial professional for investment advice and other services provided to the shareholder.
- » **Deferred Sales Charge (Back-End Load).** The maximum sales charge that a shareholder may pay if shares are redeemed or sold within a certain number of years after purchase. This charge serves as an alternative way to compensate a financial professional for services provided to a shareholder.
- » **Redemption Fee.** The amount a shareholder may pay into the fund when redeeming fund shares within a specified period of time. This fee is to cover the costs associated with the redemption or to deter market timing activity.
- » **Exchange Fee.** The amount a shareholder may pay to exchange fund shares for shares of another fund within the same fund family. This fee is to cover the costs associated with the exchange or to deter market timing activity.
- » **Account Maintenance Fee.** The fee that a shareholder with a low account balance may pay to reduce the cost of maintaining the account.

The fund's annual fund operating expenses, which are deducted from the fund's assets, may include the following (again, not every fund charges every type of fee):

- » **Management Fee.** The amount paid to the investment adviser for managing the fund's portfolio.
- » **Distribution and Service (12b-1) Fees.** The amount paid to the distributor and other intermediaries for providing services to fund shareholders in connection with the purchase and sale of shares or the maintenance of accounts, and to pay fund marketing and advertising expenses.  
(See *Director Responsibilities Under Rule 12b-1.*)
- » **Other Expenses.** The amount paid in connection with operating expenses of the fund, such as directors' fees, legal and accounting costs, custodial expenses, and transfer agency fees.

### KEY TERM

**12b-1 fee.** A mutual fund fee, named for the SEC rule that permits it, used to pay distribution costs, such as compensation to financial advisers for initial and ongoing assistance.

Both types of fees and expenses are required to be clearly disclosed in a table at the front of every fund prospectus and in more detail in the fund's financial statements. Also included is the total annual fund operating expenses, expressed as a percentage of average net assets (known as the fund's "expense ratio"), which investors use to compare funds.

In addition, a mutual fund may issue more than one class of shares that represent interests in the same portfolio of securities with each class, among other things, having a different arrangement for shareholder services or the distribution of securities, or both. The distinct fee structure of each class reflects these different arrangements and is shown in the fund's fee table. Multiclass structures offer investors the ability to select a fee and expense structure that is most appropriate for their investment goals, including the time that they expect to remain invested in the fund.

Director oversight of a fund's fees and expenses is subject to the directors' general fiduciary duties. While directors are not required to negotiate the lowest rates with any of the fund's service providers they should satisfy themselves that the fees charged are appropriate in light of the services rendered. (Note that there are very specific legal standards that apply to the review and approval of a fund's management fee as part of the investment advisory contract renewal process; see *Advisory Contract Renewal*.)

## Advisory Contract Renewal

One of the most important responsibilities of the independent directors is to annually review and approve the advisory contract, including the advisory fees. This process is known as the 15(c) process, after the section of the 1940 Act that requires a majority of a fund's independent directors to annually approve the fund's advisory contract at an in-person meeting called for that purpose. Section 15(c) requires the board to "request and evaluate," and the adviser to furnish, "such information as may reasonably be necessary" for the board "to evaluate the terms" of the advisory contract.

While the statute requires one annual meeting for the purpose of approving the contract, the process of preparing for that meeting takes several months, and often the entire year. Independent directors spend a significant amount of time preparing for, and participating in, numerous other meetings at which they develop questions for the adviser probing the appropriateness of the fee, review the answers provided by the adviser, and solicit additional information when the information provided by the adviser is deemed insufficient. In the process, independent directors consider and review hundreds if not thousands of pages of detailed information, some of which is provided by third-party consultants.

Boards consider a number of factors when reviewing an advisory contract, including those considered by federal courts in "excessive fee" cases (also known as 36(b) cases after the section of the 1940 Act that allows the SEC or a shareholder to sue a fund's adviser for breach of fiduciary duty with respect to the receipt of compensation). The factors, which, for many years, have been referred to as the "Gartenberg factors" after the court decision that first articulated them, have been incorporated into an SEC disclosure rule requiring funds to discuss the basis for the board's approval of the advisory contract. Thus, at a minimum, boards typically consider:

- » the nature, extent, and quality of the services to be provided by the investment adviser;
- » the investment performance of the fund and the investment adviser;



- » the costs of the services to be provided and profits to be realized by the investment adviser and its affiliates;
- » the extent to which economies of scale would be realized as the fund grows; and
- » whether fee levels reflect these economies of scale for the benefit of fund investors.

Boards also often consider comparative fees and services information, such as those under contracts between another fund and its adviser or the same adviser and other types of clients (e.g., pension funds and other institutional clients). The SEC requires funds to disclose whether the board relied upon such comparisons.

In the *Jones v. Harris Associates* case, the Supreme Court in 2010 endorsed the *Gartenberg* court's approach to reviewing excessive fee claims against an adviser, but provided a few cautionary notes about fee comparisons. First, the Court noted that courts may give comparisons of the fees charged by different types of clients "the weight they merit in light of the similarities and differences between the services that the clients in question require" and that "there may be significant differences between the services provided by an investment adviser to a mutual fund and those it provides to a pension fund." The Court also cautioned that undue reliance should not be given to comparisons with fees charged to funds by other advisers. In discussing the advisory contract renewal process, the *Jones* Court recognized the critical role of fund boards and made clear that the standard for court review does not call for "judicial second-guessing of informed board decisions."

The adviser's fees are part of the advisory contract that directors review and approve every year. Directors are not required to negotiate for the absolute lowest rate with the adviser. Instead, regulators and the courts recognize that directors must balance a number of considerations, including the factors noted above. In the fee approval process, of course, directors may work with the adviser to take steps to bring fees down, such as instituting breakpoints at specified asset levels, waiving fees, reducing fees outright, or enhancing services.

#### KEY TERM

**Breakpoints.** The dollar amounts at which many mutual funds offer reduced fees to investors. There are two kinds of breakpoints. One kind is a reduction in sales charges (load fees) to investors when they initially purchase fund shares. The amount of the discount varies, depending upon the amount of the investment: the more invested, the greater the likelihood of surpassing a breakpoint and thus receiving a discount. The other kind of breakpoint is a reduction in management fees that fund advisers may charge their associated funds as fund assets surpass a given level.

## Service Provider Contracts

As noted, a fund's board annually approves the fund's investment advisory agreement (see *Advisory Contract Renewal*). The 1940 Act also requires that the board annually approve the contract with the fund's principal underwriter and select the fund's independent public accountant. For the remainder of the fund's service providers, though, there are no regulatory requirements for the contracts to be reviewed and/or approved by the fund's board at any set interval, or at all. Directors oversee these service provider contracts as part of their overall fiduciary responsibilities. In the absence of prescribed regulatory requirements regarding the approval and/or renewal of these contracts, their terms 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.

### TO LEARN MORE

Read the IDC task force paper *Board Oversight of Certain Service Providers*.

# Oversight of Distribution

Most funds use intermediaries to distribute their shares. Intermediaries may include:

- » broker-dealers,
- » banks,
- » fund supermarkets,
- » insurance companies,
- » registered investment advisers, and
- » retirement plan service providers.

## KEY TERM

**Fund supermarket.** A brokerage platform that provides access to funds from a wide range of fund families.

Among other things, intermediaries:

- » may provide financial advice and counseling to shareholders;
- » maintain the financial records and account information of shareholders;
- » disburse dividend and capital gains distributions;
- » mail trade confirmations, shareholder reports, and prospectus updates; and
- » complete year-end tax reporting.

Because intermediaries often are an important liaison between a fund and its shareholders, intermediaries can perform a range of vital compliance functions for funds, such as:

- » enforcing fund policies;
- » providing disclosures, confirmations, and account statements to fund shareholders;
- » collecting redemption fees;
- » calculating shareholder breakpoint discounts; and
- » monitoring for frequent trading.

## Intermediary Compensation

Intermediaries are compensated for the distribution of fund shares and shareholder servicing through a variety of arrangements. Generally, fees for these activities are billed by intermediaries to the fund, the fund's transfer agent, or an affiliate of the fund. Some forms of compensation are paid directly by investors. Each fund complex tailors the structure of intermediary arrangements and related compensation to its unique business model and the competitive forces within the industry. As a result, compensation structures may vary from one fund complex to another, and most fund complexes employ a combination of fee structures to compensate their intermediary business partners. Intermediaries are compensated for performing services that would otherwise need to be provided by the fund complex. For example, "subaccounting" fees are paid to intermediaries for maintaining the financial records of the individual investor, providing investor statements, and producing tax reporting to the investors. Often, these fees are evaluated in the context of the fund's cost of providing the same services to an account directly held and serviced by the fund's transfer agent.

Some fund investors pay a front-end sales charge to compensate intermediaries for activities conducted in connection with an investment. As an alternative, many funds use Rule 12b-1 under the 1940 Act. This rule permits funds to compensate brokers and other financial intermediaries out of fund assets, subject to specific conditions (including board approvals) for services they provide shareholders related to the distribution of fund shares.

### **DID YOU KNOW?**

12b-1 fees are an alternative to sales loads that pay for services provided by financial intermediaries to fund shareholders.

## Director Responsibilities Under Rule 12b-1

Fund directors have several obligations in connection with payments made under Rule 12b-1. In general, the board is expected to determine that these payments are reasonably likely to produce benefits for the fund and its shareholders, set the level of 12b-1 fees, and monitor the arrangement once it is established.

Any payments that a fund makes for distribution must be in accordance with a written plan that must be approved by a majority of the independent directors. Both the full board and the independent directors must vote at least annually to renew the plan. Also, independent directors may terminate the 12b-1 plan at any time without penalty.

## Other Intermediary Compensation

There are also other types of payments that may be made to intermediaries. Some fund distributors may have incentive programs for some of their distribution partners to compensate them for providing additional education to registered representatives and additional marketing to potential investors. These payments are made from the revenue of the distributor or adviser and are commonly known as "revenue sharing."

### **TO LEARN MORE**

Read ICI/IDC's paper *Navigating Intermediary Relationships*.

Another type of compensation that may be paid to intermediaries to incentivize them to include mutual funds as part of the array of offerings they carry for their customers are referred to as "shelf space" or "access" fees. The arrangements are generally established between fund affiliates and their more significant business partners.

# General Oversight Responsibilities

## Conflicts of Interest

### Affiliated Transactions

An important responsibility of a fund's board is to oversee potential conflicts of interest. Because conflicts may arise in arrangements or transactions between a fund and its "affiliates" (very broadly, the fund's investment adviser, other entities or people or businesses with whom it has close relationships, and other funds managed by the same adviser), some transactions with affiliates are prohibited. In other cases, the transactions are permitted only in accordance with SEC rules and orders, which impose conditions designed to protect investors and require fund directors to adopt and review procedures designed to ensure compliance with those conditions.

For example, the fund's board of directors, including a majority of the independent directors, must adopt procedures before a fund may engage in:

- » Transactions in which the fund purchases a security from an underwriting syndicate of which the fund's adviser (or its affiliate) is a member;
- » Purchases and sales of securities between the fund and other funds in the same complex; and
- » Purchases and sales of securities for which a broker affiliated with the fund receives commissions.

In each of these examples, the board must approve changes to the procedures when necessary, and determine at least quarterly that any transactions subject to the procedures that were made during the preceding quarter complied with those procedures. The SEC staff has expressed its belief that fund boards may make the required quarterly determinations about the transactions effected under the rules without reviewing each transaction, but may not delegate the required quarterly determinations. Instead, directors may rely on summary quarterly reports, which may be prepared by the fund's chief compliance officer or other designated persons.

## Risk

All companies, including funds and their advisers, incur risk as a part of doing business. The primary business of a fund is investment management, and in order to achieve investment returns, a fund must incur investment risks. Boards have a general oversight responsibility to oversee both a fund's investment risks and its business operational risks.

## Derivatives

One specific type of investment risk that has drawn the attention of many, including the SEC and CFTC staffs, is the risk associated with a fund's use of derivatives. Board oversight of derivatives is generally the same as it is for other portfolio investments and directors are not expected to be experts in this area or to micromanage a fund's use of derivatives. Rather, board oversight of the use of derivatives includes working with the adviser to be sure that the board receives meaningful, understandable, and organized risk-related information. Further, a board typically engages in discussions with the adviser about the following:

- » types of derivative instruments in which the fund may invest, the investment rationale for using these instruments, and the potential benefits and risks associated with their use;
- » expertise and experience of the adviser and relevant service providers with respect to derivatives investments as well as their operational resources, internal controls, and organizational structures; and
- » policies and procedures designed to identify and control risks associated with derivatives investments, including protocols for routine and event-related reporting to the board.

### TO LEARN MORE

Read the IDC task force paper *Board Oversight of Derivatives*.

## Operations Risk

Another category of risk that funds face is business operations risk, which arises from the business of running a fund. It captures the risk of loss arising from an external event or internal failure of people, processes, or systems, and includes compliance, information technology, and human capital risks.

## Fiduciary Duty to Oversee Risk

A fund board oversees the management of all of these and other risks as part of its general fiduciary duties and oversight responsibilities. Neither the 1940 Act nor any SEC rules contain specific provisions that require a fund board to engage in risk oversight. The SEC requires, however, that funds disclose in their registration statements “the extent of the board’s role in the risk oversight of the fund, such as how the board administers its oversight function and the effect that this has on the board’s leadership structure.”

### TO LEARN MORE

Read the IDC paper *Fund Board Oversight of Risk Management*.

## Portfolio Trading

Directors have a duty to oversee fund trading practices and the use of brokerage commissions, including the manner in which the fund's adviser fulfills its obligation to seek "best execution" when trading portfolio securities. Nevertheless, directors are not required or expected to monitor each trade the fund makes. Over the years, many regulatory developments and technological innovations in trading and market structure have resulted in board oversight of fund trades becoming a potentially complex task.

## Brokerage Commissions

Boards oversee the adviser's use of fund brokerage commissions and the overall transaction costs that the fund incurs when the fund buys or sells portfolio securities. This is an important function of boards for two reasons. First, transaction costs have an impact on a fund's net performance (because the costs are reflected in the fund's total expenses). Second, fund advisers are subject to a number of potential conflicts of interest in conducting portfolio transactions on behalf of clients, including funds. Fund brokerage commissions, which are paid out of fund assets, may, for example, be used to obtain brokerage and research services that might otherwise be paid for directly by the fund's investment adviser. This practice is known as using "soft dollars." In addition, an adviser may use a commission recapture arrangement, whereby the fund receives a portion, or rebate, of the brokerage commission (or spread) charged by the broker-dealer handling the trade. Additionally, an investment adviser may use fund brokerage to pay certain providers for services utilized by the fund through an expense reimbursement arrangement with a broker-dealer and/or its affiliates.

## Best Execution

A fund adviser generally must seek to execute securities transactions for its clients in the most favorable manner under the circumstances. In seeking to achieve best execution, the determinative factor is not the lowest possible commission cost but whether the transaction represents the best qualitative execution for the account. Accordingly, an adviser may take into account the full range and quality of a broker's services in selecting broker-dealers including, among other things, the value of research provided as well as execution capability, commission rate, market impact, financial responsibility, and responsiveness to the adviser. It is common for boards to receive periodic certifications from the fund's adviser confirming that the adviser has executed all portfolio transactions pursuant to its obligation to seek best execution.

## Soft Dollars

Some fund advisers may use brokerage commissions generated by the fund's securities transactions to obtain research and related services from broker-dealers. This practice, known as using "soft dollars," is regularly reviewed by directors. Also, because soft-dollar services benefit the adviser as well as the fund, directors may review the adviser's soft-dollar practices to evaluate whether they result in a "fall-out benefit" to the adviser under its contract with the fund. Soft-dollar reports provided to the board by the adviser typically identify the top broker-dealers that are providing soft-dollar services and the average commissions per share that those brokers are charging on soft-dollar-generating trades. While boards, as overseers, won't usually second-guess an adviser's selection of broker-dealers, it is important for boards to be comfortable with the process used by advisers for selecting broker-dealers and to satisfy themselves that any potential conflicts of interest are addressed by that process.



# Specific Regulatory Responsibilities

## Pricing and Valuation

Mutual funds are required to determine the price of their shares at least once each business day. Share price (or NAV) is the value of the securities in the fund's portfolio, minus liabilities, divided by the number of shares outstanding. Some securities are easy to value because market quotations are readily available. For other securities, there may be no readily available market price. In these cases, the fund's board is required by statute to "fair value" the securities. To help them do this, boards typically delegate the day-to-day fair valuation determinations, while receiving periodic reports and actively overseeing the process.

Under SEC rules, all funds must adopt written policies and procedures that address the circumstances under which securities may be fair valued, and establish criteria for determining how to assign fair values in particular instances. These policies and procedures should be presented in an understandable way, address conflicts of interest, make clear to whom (advisory personnel, pricing services, portfolio managers) responsibility has been delegated, and establish an appropriate oversight role for the board. In addition, the valuation procedures should address, and boards should understand, methodologies for pricing portfolio securities, testing stale prices, use of broker quotes, and overrides of prices supplied by pricing services. There also needs to be flexibility in the policies and procedures to accommodate changes in various economic climates or new and unusual circumstances. Boards should review the policies and procedures at least annually, or more frequently, as needed.

## Illiquid Securities

Boards oversee the adviser's categorization of securities as "liquid" or "illiquid." The SEC limits the amount of a fund's assets that may be illiquid and, as a result, directors typically review and approve a fund's guidelines for illiquid securities. The topic of illiquid securities is closely tied to the issue of valuation because, as noted above, securities without a readily available market price (and illiquid securities often fall into this category) must be "fair valued."

## Compliance

There are many ways in which fund complexes pursue the development and implementation of effective compliance programs, and there is no one "right" approach to compliance. Nevertheless, the characteristics of a strong fund compliance program include an ethical, compliance-focused "tone at the top"; a collaborative approach by the fund's chief compliance officer (CCO) and fund management; a risk-based program tailored to the fund and the adviser's business; transparency and candor among the CCO, fund board, and adviser; and knowledgeable staff armed with appropriate resources.

## Regulatory Responsibilities

The 1940 Act has a fund compliance program rule, which provides fund boards with tools for overseeing compliance, along with specific responsibilities relating to the compliance function. In particular, the rule requires that:

### TO LEARN MORE

Read the IDC task force paper *Board Oversight of Fund Compliance*.

- (i) the board approve the fund’s policies and procedures, as well as those of each investment adviser, principal underwriter, administrator, and transfer agent of the fund; and
- (ii) the board approve the designation, compensation, and removal of a fund CCO.

In addition, the CCO, at least annually, must:

- (i) provide a written report to the board that, at a minimum, addresses the operation of the fund’s policies and procedures and each material compliance matter that occurred since the date of the last report, and
- (ii) meet in executive session with the fund’s independent directors.

Beyond these specific requirements, the rule offers little guidance on its implementation. As a result, each fund complex has developed its own compliance framework based on its own facts and circumstances.

## Fund Chief Compliance Officer (CCO)

Though the compliance program rule requires the CCO to provide a written report to the board and to meet separately with the independent directors “no less frequently than annually,” it is common for a CCO to attend every board meeting—in many cases, for the full length of the meeting. In addition, many independent directors meet with their fund CCO in executive session at every regularly scheduled board meeting. Items that may be addressed in board meetings with the CCO include: compliance matters, the CCO’s staffing and support, the CCO’s relationship with the adviser’s management, and confirmation that the CCO has not been subject to undue influence. In addition, many boards, sometimes through a specifically designated liaison such as the independent chair, communicate with the CCO between board meetings.

Under the fund compliance program rule, the board must approve the CCO’s compensation. The appropriate level of compensation will likely depend on a number of factors, including his or her experience, the responsibilities associated with the position, and the nature of the fund complex. The form and source of the compensation will vary across fund complexes. For example, some CCOs may receive a bonus in the form of stock options or restricted stock, which raises the issue of whether a fund CCO can have a financial interest in the adviser or its parent and still retain his or her independence.

Another decision faced by fund boards is whether any or all of the CCO’s compensation should be paid by the fund, reasoning that one way to ensure the CCO’s allegiance and a clearly delineated reporting relationship is for the fund to pay at least a portion of the CCO’s compensation. Boards may reasonably differ on their approaches to these issues, and should make a reasoned and informed decision based on the relevant facts and circumstances.

## Codes of Ethics

Funds, their advisers, distributors, and subadvisers are required to have a written code of ethics that contains provisions reasonably necessary to prevent fraudulent, deceptive, or manipulative acts and requires reporting of personal securities transactions. A fund's board must approve the code of ethics, as well as any material change to the code within six months of the change. In addition, the board must review, at least annually, a written report describing any issues that arose since the last report and certifying that processes are in place to prevent future violations. Key reporting requirements of a code of ethics include an annual holdings report, quarterly reporting of transactions, and certifications relating to adherence to the code of ethics.

## Securities Lending

Securities lending is a practice where a fund temporarily lends out, on a collateralized basis, some of its portfolio securities. Funds often engage in securities lending through a lending agent, which may be the fund's custodian, an affiliate, or a third party. Typically, a board approves securities lending policies that establish the parameters for the fund's lending program—approved borrowers, restrictions on the portion of a fund's portfolio that may be loaned, required collateral levels, how the lending agent is compensated, and similar matters.

After the securities lending program is in place, it is common for the board, in conjunction with fund management, to periodically review the appropriateness of those policies. The board, in conjunction with fund management, also may periodically evaluate the program performance and costs. Performance can be compared with projections and, using available data sources, usually can be measured against the performance of other comparable portfolios.

Relief from the 1940 Act (known as “exemptive relief”) is usually necessary if loans are made to affiliated borrowers or through an affiliated lending agent. The relief often requires directors, particularly independent directors, to have special monitoring responsibilities.

## Proxy Voting

A fund's board of directors, acting on the fund's behalf, is responsible for overseeing the voting of proxies for portfolio securities. As a practical matter, fund boards typically delegate proxy voting to the fund's investment adviser. The nature and extent of this delegation may vary. While broad delegation of proxy voting responsibilities is very common, boards may follow other approaches, such as relying on the adviser to implement a fund's proxy voting policy but not vesting the adviser with voting discretion.

### TO LEARN MORE

Read the IDC/ICI paper *Oversight of Fund Proxy Voting*.

A fund's board can adopt a separate fund policy or may adopt or rely on the investment adviser's policy. A board also may elect to adopt the policy recommended by a proxy voting service. A proxy voting policy is part of a fund's compliance program, and subject to the board approval and review requirements of the SEC's fund compliance rule.

## Disclosure

The SEC requires that extensive disclosures be made to investors about a fund, including the fund's board. These disclosures are contained in a fund's registration statement, shareholder reports, and proxy statements. As signatories of a fund's registration statement, directors may be liable under the federal securities laws for material misstatements or omissions in the registration statement, including the prospectus. For this reason, directors should be familiar with fund disclosures and satisfy themselves that the disclosures are accurate and complete. Further, prudence suggests that directors be comfortable with the process by which fund disclosures are prepared and updated.

### TO LEARN MORE

Read the ICI Mutual paper *Mutual Fund Prospectus Liability: Understanding and Managing the Risk*.

Some of the disclosures that must be made about individual directors include the following:

- » Director's principal occupation during the past five years;
- » Other directorships held by the director during the past five years;
- » The compensation paid to the director by the fund and the fund complex;
- » The number of funds overseen by the director;
- » The director's ownership in each fund overseen (using specified dollar ranges rather than an exact dollar amount);
- » The qualifications of the director; and
- » The reasons why that person should serve as a director of the fund.

The disclosures that must be made about the board include:

- » Information about the responsibilities of the board and its standing committees;
- » Its leadership structure;
- » Its role in risk management oversight; and
- » The consideration of diversity in the process by which candidates for director are considered for nomination by the fund's nominating committee.

# Oversight of Specific Types of Funds

## Money Market Funds

Money market funds provide a low-cost, efficient cash management tool with a high degree of liquidity, stability in principal value, and a market-based yield. One defining feature of money market funds is that they seek to maintain a stable NAV, typically \$1.00 per share. Money market funds usually do this by using the amortized cost method of valuing their portfolio securities. In addition to requiring boards to make the initial determination that the use of the amortized cost method is appropriate, Rule 2a-7 (the SEC rule governing money market funds), imposes on money market fund boards a number of specific responsibilities relating to oversight of the fund.

For example, the board must monitor deviations between the amortized cost price and the market-based price (also called the “shadow price”) of fund shares, and can suspend redemptions and liquidate the fund if the deviation could result in material dilution or other unfair results to investors. The board also must adopt procedures that provide for periodic stress testing of the fund’s ability to maintain a stable NAV based on certain hypothetical events. The rule requires a money market fund board to establish the frequency for shadow pricing a fund’s securities and to determine stress testing intervals based on its view as to what is appropriate and reasonable in light of current market conditions.

In 2013, the SEC proposed amendments which would impose additional responsibilities on money market fund boards. To date, the SEC has not taken action on these proposals.

## Insurance-Dedicated Funds

Some mutual funds may be used as a funding vehicle for variable life insurance and variable annuity contracts. Primarily for tax reasons, these insurance-dedicated funds do not offer their shares to the public. The owners of the fund shares are the insurance company separate accounts rather than the underlying contract owner.

Boards of directors of insurance-dedicated funds have the same duties as directors of mutual funds that offer their shares to the general public, with notable distinctions in two areas—Rule 12b-1 plans and monitoring for potential conflicts.

## Rule 12b-1 Plans

Like all directors considering a 12b-1 plan (see *Director Responsibilities Under Rule 12b-1*), directors of an insurance-dedicated fund must assure themselves that legitimate services will be rendered in return for 12b-1 payments. This analysis may be affected by the unique offering structure of insurance products. Also, when considering the benefits of the 12b-1 plan to the shareholders, the directors must consider the likelihood of a benefit to the individual contract owners, not the insurance company separate account, even though the insurance company separate account is the technical owner of the fund's shares.

## Monitoring for Potential Conflicts

A second area of specific focus for directors overseeing insurance-dedicated funds involves monitoring for potential conflicts. Specifically, directors of an insurance-dedicated fund that sells its shares to both variable life separate accounts and variable annuity separate accounts (also known as “mixed funding”) must monitor for material irreconcilable conflicts between the interests in the two types of contract owners and determine what action, if any, should be taken in the event of a conflict. In practice, this type of conflict seems to be rare, but might arise, for example, by virtue of a change in the tax code.

## Commodity Funds

Mutual funds that invest in derivatives (e.g., futures contracts, options on futures contracts, and swaps) generally are considered to be “commodity pools” under the Commodity Exchange Act. CFTC regulations provide an exclusion from regulation under the Commodity Exchange Act where investment advisers comply with certain trading and other limits with respect to a fund's investments in derivatives. Investment advisers and subadvisers to funds that invest in derivatives above these limits, however, are required to register with the CFTC as commodity pool operators and/or commodity trading advisors, and therefore are subject to dual regulation by the SEC and the CFTC.

Although CFTC regulations apply primarily to investment advisers and subadvisers, these regulations may impact the manner in which mutual funds that invest in derivatives are managed and operated. Accordingly, boards overseeing funds that invest in derivatives should be comfortable that the funds have appropriate policies and procedures in place to address CFTC regulations. For example, boards overseeing funds that seek to comply with the CFTC's trading limits on investments in derivatives may want to consider adopting appropriate compliance policies and procedures to ensure that the funds comply with such limits. Similarly, directors overseeing funds that invest in derivatives above these limits may want to consider implementing policies and procedures to ensure the accuracy and completeness of any additional disclosures or regulatory filings that may be necessary.

# Joining a Fund Board

## Prior to Joining a Fund Board

Candidates for membership on a fund board should realize that joining a fund board is not a responsibility to be taken lightly. The structure of an investment company is complex and at times quite technical. For those who do not have fund industry experience, the learning curve is steep and long. There are a number of factors that fund board candidates may wish to consider when making the decision of whether to join a fund board. Once a candidate decides to join a fund board, he or she may then wish to consider the timing of becoming a board member. Both of these topics are discussed in more detail below.

*Board Opportunity Due Diligence Considerations.* While joining a fund board is likely to be an interesting and fulfilling experience, that experience carries with it legal responsibilities and attendant liabilities. As a result, director candidates should be mindful to “kick the tires” of the fund complex they are thinking of joining. No two complexes are the same and it is important for candidates to satisfy themselves that the complex in question is right for them. Among the questions that candidates may wish to consider asking before joining a board are:

- » Who are the individuals currently on the board? Is there a mix of backgrounds and expertise on the board and how do I fit in both professionally and personally?
- » Who is the adviser? What is their reputation in the industry? Has the adviser been the subject of significant compliance or legal concerns?
- » Why am I being considered and what expectations would the board have of me?
- » How is the relationship between the adviser and the board?
- » How is the board structured? What committees exist? How often do they meet? Does the board size seem appropriate in light of the number of funds overseen?
- » Does the board have an independent chair or a lead director?
- » What is the amount of D&O insurance coverage provided and who is the insurance carrier?
- » What is the compensation of the directors?
- » Do the independent directors have independent counsel? If not, why not? If so, is it a reputable firm that is knowledgeable in the field?
- » How much time is involved in preparing for board meetings?

*The “Right” Time to Join a Fund Board.* There is no right or wrong time to join a board. A new director, however, should consider carefully which board meeting will be his or her first. For example, a board’s contract renewal meeting (the meeting at which the board considers renewing the fund’s contract with the investment adviser) typically entails lengthier, more-complicated meeting materials than any of the other board meetings held during the year. The contract renewal meeting also can be marked by difficult conversations between the board and the adviser if there are concerns with the performance or fees of the fund. For these reasons, a new director’s transition into the board is likely to be an easier one if his or her inaugural board meeting is not a contract renewal meeting.

## New Director Orientation

While the board’s existing independent directors (or a group of them) are likely to play a prominent role in the orientation of new independent directors, it is also important for the investment adviser or management to be involved. In part, this is because the adviser is in charge of the fund’s day-to-day affairs and, as such, has the most thorough and detailed understanding of the business. Further, the adviser and the fund board presumably have developed a collaborative relationship over the years (even though that relationship is conducted at arm’s length) and one way to underscore that early on for a new director is to coordinate at least part of the orientation with the adviser. Finally, the investment adviser is likely to want to be a part of a new director’s orientation. Participating in that orientation enables the investment adviser to: introduce its key personnel to the new director outside the formality and time constraints of a board meeting; establish a working relationship with the new director from the very beginning; and help shape the new director’s impressions about the fund complex.

As part of a new director’s orientation, the director should understand how the funds that he or she will oversee are structured (e.g., internally advised, subadvised); who the principal service providers are for the funds, and how the funds are distributed (the types of intermediaries that sell the fund’s shares and service the fund’s shareholders; and the compensation structure associated with those distribution and servicing activities). In addition to becoming familiar with the funds and fund complex, new directors may wish to meet, or receive biographical information about, representatives of the fund’s management company and principal service providers that regularly attend fund board meetings.

New directors may find it helpful to get together with representatives of the fund’s management company prior to a board meeting and review sample board books. This may provide new directors with insight into the types of reports regularly given to directors, the reasons the reports are provided to directors, the key issues to be spotted in the reports, and the next steps to be taken as a result of the information in the reports.



## Familiarizing Yourself with a Particular Board and Fund Complex

Once a candidate for membership on a fund board has made the decision to join the board, he or she may want to ask the following questions in order to become more familiar with the board and fund complex.

### What is the investment advisory firm that will manage the funds?

Of fundamental importance to any new director will be the company managing the fund. Some of the questions to be considered are listed below.

- » What types of funds are being offered and who manages them?
- » What are the mission, culture, and reputation of the management company?
- » Who are the management company's key personnel?
- » What are the other lines of business of the management company?
- » How do the funds fit into the management company's overall product line?

### Who are the other directors on the board?

It may be helpful to have biographies for the directors on the board, as well as for the directors on any other boards in the fund complex.

### What is the leadership structure of the board?

Does the board have an independent chair? Lead independent director? If so, what is the lead independent director's role? The SEC has noted that "different leadership structures may be suitable for different companies depending on factors such as the size of a company, the nature of a company's business, or internal control considerations, among other things."

### What is the committee structure of the board?

Many boards establish committees to focus on specific subject matters (e.g., audit, governance, investments). The time and effort required of mutual fund directors, especially independent directors, have grown exponentially as the industry has increased in size and complexity and as new regulations have expanded directors' duties. In this environment, boards frequently use both standing and ad hoc committees to help manage their workloads and to enable greater in-depth review and oversight of particular topics or aspects of the fund's operations.

## What is the overall structure of the board?

Most funds are part of complexes comprising multiple funds managed by the same investment adviser. Boards of these funds generally are organized according to one of two models—a unitary board consisting of one group of directors who serve on the board of every fund in the complex, or cluster boards consisting of two or more separate boards of directors for groups of funds within the complex. Clusters typically are organized according to investment objective, investment sector, or distribution channel—or result from a merger of complexes that were initially organized under separate management.

## How frequently does the board meet?

The frequency of regularly scheduled board meetings is not dictated by statute or rule. Approval of the advisory contract, among other duties, must occur annually at an in-person meeting, but the timing, length, and nature (e.g., in-person, telephonic) of the other meetings are matters to be determined by each board. The frequency of board meetings may be influenced by several factors, including the size of the board and the number of funds the board oversees. A board also may elect to meet less frequently but for more days each time. In actuality, fund boards quite often meet more frequently than called for by a regular schedule because additional in-person or telephonic meetings are held to address specific issues.

## What are the board's compensation practices?

Independent directors of mutual funds are compensated for their time and service by the funds they oversee. The adviser typically pays the compensation of directors who also are officers or employees of the adviser. Compensation varies within the industry and may depend on a number of factors. Some factors include: differences in the complexity and size of funds and fund groups overseen by a director, the time commitment required for meetings and other duties, the number of meetings, and the compensation levels necessary to attract highly qualified people.

Director compensation may be structured in different ways and can include an annual retainer, meeting attendance fees, a deferred compensation plan, a retirement program, or other benefits. Independent chairs, lead independent directors, and committee chairs may receive additional compensation for their added responsibilities. Unlike corporate directors, fund independent directors do not receive shares or options in the fund.

## Does the board have a policy requiring or encouraging directors to invest in the funds they oversee?

While many directors choose to own shares of the funds they oversee, not all boards have adopted formal policies requiring or encouraging them to do so. The issue attracts some attention because SEC rules require disclosure of fund share

ownership by directors and some investors and industry reporting services consider it to be a noteworthy topic. In 1999, ICI published a *Report of the Advisory Group on Best Practices for Fund Directors*, which recommended that directors invest in the funds of the boards they serve.

### **To what extent do the independent directors have directors' and officers'/errors and omissions (D&O/E&O) insurance coverage and/or indemnification from the fund that is adequate to ensure their independence and effectiveness?**

In determining whether the coverage is adequate, there are a variety of factors you may wish to consider. One factor is the exact nature of what constitutes a claim that can be made on the policy and what events may be excluded from coverage. Other factors include whether the fund insurance policies and/or indemnification provisions in fund charters or bylaws provide continuing coverage for claims arising in connection with your service as a director after you cease to serve on the board, and whether the insurance policy provides coverage if the fund's independent directors and its investment adviser are opposing parties in litigation.

### **Does the board have legal counsel independent from the fund and/or the fund's investment adviser?**

Fund boards employ a variety of arrangements in retaining counsel. Some independent directors have their own dedicated counsel, others formally retain counsel with the fund, and still others have no dedicated counsel but instead rely on counsel to the fund (or retain other counsel) as needed (see *Independent Counsel*).

### **How is the board's annual assessment administered? Who is involved? How is it formulated?**

Virtually all fund boards are required by SEC rule to conduct self-assessments annually. In the self-assessment, the board must consider the effectiveness of its committee structure, and the number of funds overseen by directors. Beyond those requirements, a board's self-assessment does not need to follow any specific process or contain any specific content. Self-assessments may vary from board to board.

### **Does the board require or encourage directors to seek out continuing education?**

The fund industry is extremely complex and, as such, directors may need to seek opportunities to keep abreast of industry and regulatory developments. This can be done in many ways, including by regularly reviewing written materials that address industry and regulatory topics (such as reports prepared by fund counsel), holding special sessions of the board that focus on particular topics, or attendance at conferences and educational seminars.

### **Does the board have a mandatory retirement policy?**

No regulatory requirement relating to retirement policies exists for fund directors, but the topic may be addressed in a board's annual self-assessment. ICI's *Report of the Advisory Group on Best Practices for Fund Directors* recommends that fund boards adopt policies on the retirement of directors, but does not specify the type of policy (e.g., retirement age, term limits) or a recommended retirement age.

## What other policies and/or practices does the board follow?

Boards may encourage practices or adopt formal or informal policies on a number of subjects other than those required by law or regulation. Examples include media policies that indicate whether board members may speak with the press and conference attendance policies (e.g., whether directors must get prior approval for attending a conference, whether directors are limited in the number of conferences that they can attend each year).

# Additional Resources

## Statutory and Regulatory Responsibilities of Fund Boards Under the Investment Company Act of 1940

This section provides a brief overview of the legal responsibilities commonly encountered by fund directors under the 1940 Act and its rules. Because this overview is expansive, it may highlight rules or requirements that are not applicable to every board.

### Fund Governance

To comply with **Rule 0-1(a)(7)**, a fund's board or its independent directors must:

- » Determine the independence of any counsel for the independent directors;
- » Conduct an annual self-assessment of board performance;
- » Be authorized to hire employees and to retain advisers and experts necessary to carry out their duties;
- » Meet at least once quarterly in executive session; and
- » Select and nominate other independent directors.

### Fair Valuation of Portfolio Securities

**Section 2(a)(41)** and **Rule 2a-4** assign to boards the responsibility for valuing portfolio securities.

- » Securities with an ascertainable market value are priced using the market value.
- » Other securities must be valued "as determined in good faith by the board of directors."
- » Directors may delegate the pricing of portfolio securities to a fund's investment adviser so long as that delegation is overseen by the board in a prudent and conscientious manner.

## Money Market Funds

In 2013, the SEC proposed amendments which would impose additional responsibilities on money market fund boards. To date, the SEC has not taken action on these proposals. To comply with **Rule 2a-7**, the board of a money market fund must do the following things.

- » Find that it is in the best interests of the fund and its shareholders to maintain a stable NAV per share or stable price per share.
- » If the fund uses the amortized cost method of valuation:
  - » Determine that the Amortized Cost Method fairly reflects the funds' market-based net asset value per share ("shadow price");
  - » Establish and periodically review procedures designed to stabilize the fund's NAV at \$1.00;
  - » Establish and periodically review procedures for calculating the fund's shadow price at appropriate intervals (in light of market conditions) and reviewing the deviation between the shadow price and the fund's amortized cost NAV;
  - » If the deviation exceeds  $\frac{1}{2}$  of 1 percent, promptly consider what action, if any, should be initiated by the board; and
  - » If the board believes the extent of the deviation could result in material dilution or other unfair results to investors, determine what action is appropriate to eliminate or reduce the deviation (this could include suspending redemptions and liquidating the fund).
- » If the fund uses the penny-rounding method of valuation, assure that the fund's price per share will not deviate from the single price established by the board.
- » Adopt procedures that provide for periodic stress testing of the fund's ability to maintain a stable NAV based on hypothetical events. The board must review reports on the results of the stress testing.
- » Determine whether it is in the interest of the fund not to dispose of a security that no longer presents minimal credit risk or that is no longer an eligible security.
- » Adopt procedures requiring periodic review of whether certain floating and variable rate securities can be expected to have a market value that approximates their amortized cost.
- » Delegate to the fund's adviser or officers, subject to written guidelines and procedures and continued oversight by the board, responsibility for:
  - » Determining that securities acquired and held by the fund present minimal credit risks and, if the security is subject to a conditional demand feature, the risk that the demand feature will terminate is minimal;
  - » Determining whether unrated securities are of comparable quality to first- or second-tier securities;
  - » Reassessing a security's credit quality or disposing of the security after it is downgraded;

- » Determining whether any other money market fund in which the fund invests meets diversification requirements;
- » Evaluating the creditworthiness of the seller of a repurchase agreement;
- » Determining that the fund should not rely on a demand feature or guarantee;
- » Determining that it would not be in the fund’s interest to exercise demand features that have been downgraded to second tier; and
- » Determining whether asset-backed securities have any 10 percent obligors.
- » Adopt and periodically review **Rule 38a-1** procedures for compliance with Rule 2a-7’s conditions:
  - » Limiting investments to U.S. dollar-denominated securities;
  - » Limiting the fund’s dollar-weighted average maturity (determine with and without regard for interest rate adjustments);
  - » Limiting investment to eligible securities;
  - » Requiring diversification of issuers and the providers of demand features and guarantees; and
  - » Requiring the fund to maintain sufficient liquid assets to meet anticipated redemptions (including procedures to assess anticipated redemptions of certain shareholders) and satisfy other liquid asset standards.

## Subclassification of Funds

**Rule 5b-3** allows an investment company to “look through” repurchase agreements and pre-refunded bonds to the underlying collateral to determine the issuer in connection with the diversification criteria of Section 5(b)(1). Under the rule, the board (or its delegate) must evaluate the creditworthiness of the repurchase agreement counterparty.

## Exemptions

Under **Rule 6c-6**, for purposes of maintaining an exemption under Section 6 for certain separate accounts, the board must determine that a transfer of securities from an existing portfolio to a new portfolio is fair and reasonable to all shareholders.

Under **Rule 6e-3T**, directors of an insurance-dedicated fund that sells its shares to both variable life separate accounts and variable annuity separate accounts must monitor for material irreconcilable conflicts between the interests in the two types of contract owners and determine what action, if any, should be taken in the event of a conflict.

Directors, particularly independent directors, also often have significant responsibilities under any exemptive orders a fund may have received from the SEC.

## Affiliate Transactions

**Rule 10f-1** requires that in the case of a purchase by a fund acting as an underwriter of an issuer that is not an investment company, the board must approve the underwriting agreement.

**Rule 10f-3** requires that the board: (i) approve procedures reasonably designed to provide that purchases of securities otherwise prohibited by Section 10(f) comply with the rule's conditions; (ii) approve changes to the procedures as necessary; and (iii) determine at least quarterly that the purchases complied with the procedures.

## Distribution Plans

**Rule 12b-1** requires the board to approve and monitor distribution-related fee payments under a 12b-1 plan, including revenue-sharing arrangements. This includes a quarterly review of the amounts expended under the plan and the purposes for which such expenditures were made. The board also must reevaluate and reapprove distribution agreements annually.

The board must approve policies and procedures to prevent: (i) persons selecting executing broker-dealers from taking into account the broker-dealers' distribution efforts on behalf of the fund; and (ii) any directed brokerage agreement.

## Investment Advisory Arrangements

**Sections 15(a), 15(c), and Section 36(b)** require that a majority of the board's independent directors approve a fund's advisory contracts (including subadvisory contracts), and that the board (or shareholders) annually approve any advisory contract that continues more than two years. Directors also must request and evaluate information reasonably necessary for them to evaluate the terms of an advisory contract and advisers must furnish this information.

The board must review and approve disclosure describing the factors that it considered in evaluating the advisory contracts.

**Section 15(c)** requires the board to review principal underwriting contracts, including fees. The board must review and approve multiyear contracts annually (also can be done with a majority shareholder vote).

**Rule 15a-4** requires board approval for an interim advisory contract after termination of the previous contract through assignment or nonrenewal.

## Independent Director Vacancies

**Section 16(b)** requires independent directors to select and nominate individuals to fill independent director vacancies that occur in connection with compliance with Section 15(f)(1)(A).

## Affiliated Transactions

**Section 17** requires independent directors to oversee certain securities transactions involving affiliates to the extent they are permitted by the rules.

**Rule 17a-6** allows a fund to engage in certain transactions with portfolio affiliates, including those in which the board, including a majority of the independent directors, has determined that the interests of certain persons are not material. The board must record the basis for its findings in the minutes of its meeting.



**Rule 17a-7** allows certain affiliated transactions if the board: (i) adopts procedures by which transactions may be effected in compliance with this rule; (ii) makes and approves changes to the procedures as necessary; and (iii) determines at least quarterly that the purchases or sales made during the preceding quarter were effected in compliance with the procedures.

**Rule 17a-8** requires that directors evaluate and approve potential mergers.

**Rule 17d-1** requires that directors make annual determinations concerning joint liability insurance.

**Rule 17e-1** requires that directors adopt procedures concerning the commissions paid to affiliated brokers and determine at least quarterly that all transactions effected with affiliated brokers were done so in compliance with the procedures.

**Rules 17f-1, 17f-4, 17f-5, and 17f-7** require that directors annually review custody contracts and oversee custody arrangements with specific obligations with respect to self-custody, affiliated custody, or foreign custody.

**Rule 17g-1** requires that directors review and approve fidelity bonds and the allocation of the premium for a joint bond.

**Rule 17j-1** requires that directors approve the fund's code of ethics and receive and review annual reports of any significant violations of the code.

## Multiclass Arrangements

**Rule 18f-3** requires directors to evaluate any plan proposed under this rule to ensure fairness to all shareholders and the fund as a whole.

## Distribution, Redemption, and Repurchase of Securities

**Rule 22c-1** requires the board to determine when NAV is calculated.

**Rule 22c-2** requires the board to decide whether to impose a redemption fee.

**Rule 23c-3** requires the board to make various determinations with respect to the repurchase of interval fund shares.

## Selection of Accountants

**Section 32(a)(1)** requires a majority of the independent directors select the fund's independent public accountants.

**Rule 32a-1** allows an exemption from the requirement that a majority of the independent directors select the fund's independent public accountants, so long as the fund meets certain conditions and the accountants are selected by a majority of all of the members of the board.

**Rule 32a-4** allows an exemption from the requirement that the fund's selection of an independent accountant be subject to a shareholder vote, if the board establishes a committee of independent directors to oversee the fund's accounting and auditing processes and has adopted a charter setting forth the audit committee's structure, duties, powers, and methods of operation.

The board must also review the accountant's annual written report to the audit committee.

## Compliance

**Rule 38a-1** requires the board to:

- » Approve the policies and procedures of the fund and each of its principal service providers. The approval must be based on a board finding that the policies and procedures are reasonably designed to prevent securities law violations by the fund and its service providers—boards typically receive this certification from the fund's CCO before approving the policies and procedures;
- » Approve the designation and compensation of a CCO and the removal of the CCO;
- » Review the Annual Report provided by the CCO addressing compliance policies and procedures and material compliance matters; and
- » Have an executive session of only the independent directors to meet with the CCO at least once per year.

Directors either must adopt policies and procedures with respect to frequent purchases and redemptions by shareholders, or the fund must include a statement of the specific basis for the view of the board as to why it is not appropriate to have such policies and procedures.

## Disclosure

Directors have a statutory responsibility for the accuracy of registration statements and should engage in reasonable investigation to ensure that fund management followed procedures to ensure registration statement accuracy.

Directors must provide necessary information to fund management to allow accurate registration statements, proxy statements, and other disclosures concerning directors and to determine on a continuous basis a director's status as an independent director or interested person.

Directors must determine whether any member of the audit committee qualifies as an audit committee financial expert.

## Special Types of Investment Practices

The board must make certain determinations when the fund engages in repurchase agreements and reverse repurchase agreements, forward commitments and similar arrangements, and options, futures, and other derivative transactions.

The board must make determinations of credit quality with respect to investments in debt securities of issuers deriving more than 15 percent of their revenues from securities-related activities.

The fund must adopt certain policies and procedures with respect to investments in money market funds permitted by **Rule 12d1-1**.

## Publications

### IDC White Papers

- » *Investment Performance Oversight by Fund Boards* (October 2013)  
[www.idc.org/pdf/pub\\_13\\_performance\\_oversight.pdf](http://www.idc.org/pdf/pub_13_performance_oversight.pdf)
- » *Considerations for Board Composition: From Recruitment Through Retirement* (October 2013)  
[www.idc.org/pdf/pub\\_13\\_considerations\\_board\\_comp.pdf](http://www.idc.org/pdf/pub_13_considerations_board_comp.pdf)
- » *Overview of Fund Governance Practices, 1994–2012*  
[www.idc.org/pdf/pub\\_13\\_fund\\_governance.pdf](http://www.idc.org/pdf/pub_13_fund_governance.pdf)
- » *Board Oversight of Exchange-Traded Funds* (October 2012)  
[www.idc.org/idc/pubs/white\\_papers/ci.idc\\_12\\_etfs.idc](http://www.idc.org/idc/pubs/white_papers/ci.idc_12_etfs.idc)
- » *Audit Committee Annual Evaluation of the External Auditor* (October 2012)  
[www.idc.org/pdf/pub\\_12\\_audit\\_eval.pdf](http://www.idc.org/pdf/pub_12_audit_eval.pdf)
- » *Fund Board Oversight of Risk Management* (September 2011)  
[www.idc.org/pdf/pub\\_12\\_audit\\_eval.pdf](http://www.idc.org/pdf/pub_12_audit_eval.pdf)
- » *Board Oversight of Subadvisers* (January 2010)  
[www.idc.org/pdf/idc\\_10\\_subadvisers.pdf](http://www.idc.org/pdf/idc_10_subadvisers.pdf)
- » *Board Oversight of Fund Compliance* (September 2009)  
[www.idc.org/pdf/idc\\_09\\_compliance.pdf](http://www.idc.org/pdf/idc_09_compliance.pdf)
- » *Board Oversight of Derivatives* (July 2008)  
[www.idc.org/pdf/ppr\\_08\\_derivatives.pdf](http://www.idc.org/pdf/ppr_08_derivatives.pdf)
- » *Board Oversight of Certain Service Providers* (June 2007)  
[www.idc.org/pdf/21229.pdf](http://www.idc.org/pdf/21229.pdf)
- » *Board Consideration of Fund Mergers* (June 2006)  
[www.idc.org/pdf/ppr\\_idc\\_fund\\_mergers.pdf](http://www.idc.org/pdf/ppr_idc_fund_mergers.pdf)
- » *Director Oversight of Multiple Funds* (May 2005)  
[www.idc.org/pdf/ppr\\_idc\\_multiple\\_funds.pdf](http://www.idc.org/pdf/ppr_idc_multiple_funds.pdf)
- » *Board Self-Assessments: Seeking to Improve Mutual Fund Board Effectiveness* (February 2005)  
[www.idc.org/pdf/ppr\\_idc\\_self-assessments.pdf](http://www.idc.org/pdf/ppr_idc_self-assessments.pdf)
- » *Implementing the Independent Chairperson Requirement* (January 2005)  
[www.idc.org/pdf/ppr\\_idc\\_chair\\_requirements.pdf](http://www.idc.org/pdf/ppr_idc_chair_requirements.pdf)
- » *Overview of Mutual Fund Governance*  
[www.idc.org/idc/issues/governance/overview\\_fund\\_gov\\_idc](http://www.idc.org/idc/issues/governance/overview_fund_gov_idc)

- » Frequently Asked Questions about Mutual Fund Directors  
[www.idc.org/pubs/faqs/faq\\_fund\\_gov\\_idc](http://www.idc.org/pubs/faqs/faq_fund_gov_idc)
- » “Board Oversight of Target Date Funds”  
[www.idc.org/idc/pubs/white\\_papers/ci.10\\_idc\\_trdf.idc](http://www.idc.org/idc/pubs/white_papers/ci.10_idc_trdf.idc)

## IDC/ICI White Papers

- » *Disclosure of the Role of the Board in Risk Oversight: Samples of Fund SAI Disclosure* (October 2010)  
[www.idc.org/pdf/ppr\\_10\\_risk\\_disclosure.pdf](http://www.idc.org/pdf/ppr_10_risk_disclosure.pdf)
- » *Navigating Intermediary Relationships* (September 2009)  
[www.idc.org/pdf/ppr\\_09\\_nav\\_relationships.pdf](http://www.idc.org/pdf/ppr_09_nav_relationships.pdf)
- » *Oversight of Fund Proxy Voting* (July 2008)  
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- » *Fair Valuation Series: The Role of the Board* (January 2006)  
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