Fund Governance

A. Composition of the Board—The Independent Director

1) Desirability of Independent Directors Generally

The 1940 Act contemplates independent oversight and monitoring of investment company operations. The interests of the investment company and its shareholders are of undivided concern only to the independent directors. Their status as other than “interested persons” is intended to permit them to act with genuine independence in addressing conflict-of-interest situations.

Mistakes made by a fund’s adviser or other service providers, including violations of fund policies or applicable laws and trading and processing errors occur from time to time. Given the nature of fund operations, the consequences of violations or errors may be significant. The independent directors should receive reports concerning these matters and be satisfied with the corrective actions taken in response, which will often be pursuant to the fund’s or service provider’s compliance policies and procedures previously approved by the board. In appropriate cases the independent directors may determine to involve independent experts and negotiate a resolution with management or the relevant service providers. In all cases the independent directors must exercise independent judgment in seeking a resolution that is appropriate and in the best interests of the fund in light of the relevant facts and circumstances.
2) 1940 Act Independence Requirements

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

In 2004, the SEC adopted amendments to the SEC Governance Standards that would have required an investment company board to have at least 75% independent directors (66% in the case of a three-member board) and for the board’s chair to be an independent director. The U.S. Chamber of Commerce initiated a number of legal challenges to these requirements, and a federal appeals court ultimately invalidated them. In 2006, the SEC sought additional comment on the requirements, but has not taken further action. Thus, there is no legal requirement for 75% independent director membership on a fund board.

The term “interested person” is defined in Section 2(a)(19) of the 1940 Act. This important definition is highly technical in nature and must be approached with great care. It includes (i) certain categories of persons with interests potentially in conflict with the investment company, (ii) persons with any beneficial or legal interest in securities issued by the investment adviser or principal underwriter or their control persons, (iii) brokers or dealers that effect portfolio transactions on behalf of or with the investment company or certain related entities within the last
six months, (iv) persons loaning money or other property to the investment company or certain related entities, and (v) a person or partner or employee of a person who within the last two years has served as legal counsel for the investment company or its investment adviser or principal underwriter. The term “interested person” also encompasses persons with close familial, substantial financial, or certain professional relationships with an “affiliated person” of the investment company, including its investment adviser. A person who has been convicted of certain securities laws violations, enjoined from engaging in certain securities-related activities or prohibited by the SEC or by court order from serving as a director because of willful violations of the securities laws is ineligible to serve as a fund director.

Boards sometimes are faced with the question of whether a former officer or director of a fund’s investment adviser or principal underwriter can serve as an independent director of a fund. Section 2(a)(19) provides that the SEC by order may determine a person is an “interested person” by reason of having had a material business or professional relationship with the fund’s adviser or underwriter or with the principal executive officer or any controlling person of the adviser or underwriter of the fund within the last two fiscal years. As a result, boards that want to consider a former officer or director of the adviser or underwriter for an independent director position often choose to deem such individual “interested” for at least two full fiscal years and may re-consider the question at the end of that period. The ICI best practices report goes even further and recommends that former officers or directors of an investment company’s investment adviser, principal underwriter or related entities not serve as independent directors. The MFDF best practices report recommends that such persons not serve as independent directors if they have been affiliated with the fund’s adviser or its affiliates within the last five years. In addition, SEC rules require public disclosures about independent directors, including information that could potentially raise conflict-of-interest concerns. Consequently, it is important that the status and relationships of a potential director be considered carefully by counsel prior to his joining the board.

Generally, fund shareholders elect directors in accordance with state law and the SEC’s proxy solicitation rules. Many open-end funds, ETFs, and unlisted closed-end funds are not required under applicable state law to hold annual meetings of shareholders. In Maryland, where many open-end funds are incorporated, a fund’s charter or bylaws may
eliminate the need for an annual meeting of shareholders in any year in which election of directors is not required under the 1940 Act. Funds organized as trusts, which are governed by their declarations of trust, also are generally not required to hold annual shareholder meetings. Closed-end funds with securities listed on an exchange are required to have annual shareholder meetings (see Section 13.A(3)). Under the 1940 Act, vacancies on a board generally may be filled by the directors (without a shareholder vote) if, after the new director takes office, at least two-thirds of the board has been elected by shareholders. If the number of shareholder-elected board members decreases to less than half of the board, a fund must hold a shareholder meeting for the purpose of electing directors within 60 days.

3) Independent Chair

As noted above, in 2001 the SEC amended the SEC Governance Standards to require that chairs of fund boards be independent, but this requirement was invalidated after a court challenge. Thus, there is no legal requirement for fund boards to have an independent chair.

Where there is no board chair or the role of chair is filled by a “management” director, the independent directors may consider designating one of their members to act as a lead independent director. This director can serve as the focal point for governance and operational practices enhancing the role of the independent directors, including other matters related to the requirements of the Sarbanes-Oxley Act and the SEC Governance Standards. The SEC requires a fund to disclose whether the board chair is independent, and where such person is not independent, the fund must disclose whether it has a lead independent director and what specific role the lead independent director plays in the leadership of the fund.

4) Importance of Maintaining Independence

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

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

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

It has long been industry practice for fund boards to include directors who serve on more than one board in a fund complex. For complexes with a large number of funds, this is a practical necessity. Although there are areas of common interest among the funds, the directors must exercise their specific board responsibilities on a fund-by-fund basis. Broadened exposure to the operations of a complex can be valuable to a board member and provide a better context for carrying out board functions, such as serving the independent directors’ “watchdog” role. Service on multiple boards also facilitates administrative convenience.

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

The SEC Governance Standards require that the board of directors evaluate, at least annually, the performance of the board. This annual self-assessment must include a consideration of, among other things, the number of funds on whose boards each director serves. (For a more in-depth discussion of the self-assessment requirement, see Section 4.C(7)).

B. Board Committees

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

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

1) Audit Committees

The Sarbanes-Oxley Act and exchange rules adopted pursuant thereto impose requirements for the audit committees of listed closed-end funds and ETFs in terms of its composition and its role and authority. The Sarbanes-Oxley Act requirements do not, however, supplant or lessen the importance of the 1940 Act requirements as to director independence and the extensive role of independent directors in the regulatory regime of the 1940 Act.

(a) Composition of the Audit Committee

The listing requirements of national securities exchanges provide that each member of the fund’s audit committee must be independent according to specified criteria that are different from those under the 1940 Act (see Section 13.G(1)). The listing requirements are directly applicable only to closed-end funds with listed securities and to ETFs, but may serve as a “best practices” guide for open-end funds.

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

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

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

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

(b) Role and Authority of the Audit Committee

An audit committee generally oversees a fund’s relationship with its auditors and acts as a liaison between the independent auditors and the full board. The audit committee oversees the accounting and financial reporting processes of the fund, the quality and integrity of the fund’s financial statements and the independent audit of the fund’s financial statements. The audit committee also oversees the fund’s compliance with the legal and regulatory requirements that relate to the fund’s internal control over financial reporting.

The Sarbanes-Oxley Act and SEC exchange rules adopted pursuant thereto impose various requirements for audit committees in terms of their role and authority. The listing requirements provide that the audit
committee is directly responsible for the appointment, compensation, retention and oversight of the auditors. The audit committee is authorized to evaluate and, if necessary, terminate the auditors. In addition, Section 32(a) of the 1940 Act provides that independent auditors of registered investment companies must be selected for each fiscal year by a majority vote of the independent directors (see Section 7.C(3)). In connection with the annual approval of the audit engagement, the audit committee must receive information from the auditors to enable the committee to evaluate the auditors’ independence.

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

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

Because of concern that management consulting services offered by accounting firms created substantial conflicts that eroded the independence of auditors, the Sarbanes-Oxley Act and the SEC’s auditor independence rules mandated thereby specify a number of non-audit services that auditors cannot provide to their clients, such as financial information systems design and implementation, bookkeeping, and other services related to the accounting records or financial statements. The auditors also may not provide a variety of other non-audit services, such as internal audit outsourcing, legal services, and investment advisory services.

Auditors may perform non-audit services (including certain types of tax services) that are not on the prohibited list for an audit client only if the audit committee approves the activity in advance. Preapproval by
the audit committee is also required for permissible non-audit services provided to the fund’s investment adviser, and any entity controlling, controlled by, or under common control with the investment adviser that provides ongoing services to the fund, if the engagement relates directly to the operations and financial reporting of the fund. The audit committee is not required to preapprove audit or non-audit services provided to an unaffiliated sub-adviser that primarily provides portfolio management services to the fund. The audit committee may delegate the authority to preapprove non-audit services to one or more members of the audit committee. Audit committee approval of non-audit services must be disclosed in the periodic reports filed with the SEC.

The SEC auditor independence and audit committee pre-approval rules include provisions that treat services by auditors to other members of a fund’s investment company complex the same as services to the fund in many cases.

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

Fund directors should be aware that business or consulting relationships a director has with a fund’s auditors or the auditors’ affiliates may compromise the auditors’ independence. In 2015, the SEC brought an enforcement action against an audit firm based on the SEC’s finding that the audit firm had violated auditor independence rules when its consulting affiliate maintained a business relationship with a director serving on the boards and audit committees of funds it audited. The SEC also charged the independent director on the basis that he had caused related reporting violations by the funds, and charged the funds’ administrator with causing related compliance violations.

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

It is unlawful for a fund to retaliate against an employee or “agent” who has provided information about possible fraud or violations of federal law to enforcement authorities and others (so-called whistleblower protection). The listing requirements provide that the audit committee must establish procedures for handling complaints and for confidential, anonymous submissions by employees regarding accounting/auditing matters and such procedures are a best practice for all funds (see Section 7.C(11)).

Fund auditors also typically report to the audit committee on whether the audit firm has been reviewed by the Public Company Accounting Oversight Board (“PCAOB”) and the results of that review, including whether the fund audits were specifically reviewed by the PCAOB or whether other issues were raised by the PCAOB regarding the audit firm’s controls that are relevant to a fund’s audit.

2) Nominating Committees

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

The investment adviser may play an appropriate role in the selection and recommendation of candidates for election to the fund’s board. The adviser has a legitimate interest in ensuring, for example, that the independent directors are qualified and are not unduly associated with competitors. On the other hand, the adviser should not be permitted to participate in the process in a manner that limits the independent directors’ discretion.
3) Other Committees

Other standing committees are sometimes created by fund boards to focus on specific areas. Thus, a board may have, for example, pricing or valuation, contracts, regulatory compliance, brokerage, and governance committees. In each case, the purpose is to designate an appropriate number of directors as a committee to devote time to the particular matter under review and make recommendations to the board. For example, a pricing committee may review the criteria used by a fund to determine when to use fair value pricing and review the methodology used in valuing portfolio securities for which market quotations are not readily available (see Section 8). A governance committee might be charged with responsibility for developing, recommending, and evaluating a set of corporate governance principles applicable to the fund and procedures for conducting performance evaluations of the board.

C. Board Operations

1) Operating Style

Boards of directors should conduct their proceedings in a manner calculated to encourage, reinforce, and demonstrate the board’s role in providing independent oversight of the fund’s affairs and the performance of its investment adviser. Board practice will, over time, significantly affect the extent to which a board of directors is likely to discharge its obligations in a manner that effectively protects and advances the interests of the fund’s shareholders. No single operational style fits all situations, and there is considerable diversity of practice among fund complexes. A board’s operational style may be influenced by many factors, such as the number of funds in the complex, the amount of assets under management, and the fund’s distribution methods. Each fund or fund group should develop a style appropriate to its nature and circumstances. Fund directors may find it useful to compare the practices of other fund groups as well as evolving practices in the corporate world. The best practices reports of the ICI and MFDF identify a number of practices followed by fund groups in their governance activities, which may or may not be suitable for every fund board depending upon its individual circumstances.
Independent directors should consider having periodic separate meetings to review the corporate governance policies and standards relating to the manner in which the board conducts its operations. Topics to be considered may include the size of the board and its overall composition, the frequency and length of the meetings, the adequacy of the agendas, the time allotted for the discussion of particular agenda items, the quality of the information being received, the adequacy of access to the personnel of the adviser and others, the adequacy of access to qualified legal counsel sufficiently independent from the adviser and its affiliates, and the adequacy of continuing education as to board members’ duties and responsibilities (see Section 4.C(7), which discusses the annual board self-assessment).

2) Size of Board of Directors

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

3) Director’s Time Commitment

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

4) Meetings

It is generally regarded as a “best practice” for directors to be physically present at regular board meetings. Under the 1940 Act, the independent directors are required to meet in person to approve investment advisory and distribution arrangements and the selection of independent auditors. Telephonic and video meetings are generally permissible under applicable state law and may be useful and appropriate for special or emergency meetings. In addition some fund boards and committees find it convenient to schedule regular telephonic meetings of the board or key committees between regularly scheduled in-person board and committee meetings.

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

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

5) Meeting Agendas

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

6) Independent Counsel and Other Resources

Independent directors may decide to retain independent legal counsel and other experts, or in some instances to employ their own separate staff, at the fund’s expense to assist them in properly performing their responsibilities under the 1940 Act. The SEC Governance Standards require the independent directors to be authorized to hire employees and to retain advisers and experts necessary to carry out their duties. The Sarbanes-Oxley Act listing requirements provide that the audit committee has the authority to engage independent legal counsel and to consult with the fund’s independent auditors or other experts, as appropriate, in carrying out its duties and that the issuer must provide appropriate funding for the audit committee as determined by that committee.

The ICI and MFDF best practices reports recommend that independent directors have qualified investment company counsel who is independent from the investment adviser and the fund’s other service providers. Whether to retain independent counsel for the independent directors is dependent upon a number of factors. The SEC Governance Standards require that, if counsel is engaged to advise the independent directors, such counsel must be “independent legal counsel” which involves, among other things, a determination by the independent directors at least annually that any representation by such counsel of the fund’s investment adviser, principal underwriter, administrator, or any of their control persons, since the beginning of the fund’s last two fiscal years, is or was sufficiently limited that it is unlikely to adversely affect the professional judgment of the person in providing legal representation to the independent directors. Counsel that qualifies as “independent legal counsel” often acts both as fund counsel and counsel for the independent directors. In other cases, the relationship of fund counsel to management warrants having the directors consider retaining independent counsel. The size and complexity of a fund group may also warrant retaining independent counsel who can focus upon the needs of the independent directors. In lieu of regular independent counsel, the board might consider engaging independent counsel on an ad hoc basis with respect to specific matters.
7) **Annual Self-assessments**

The SEC Governance Standards require and exchange listing standards may require that fund directors evaluate, at least once annually, the performance of the fund board and its committees. The evaluation is required to include a consideration of the effectiveness of the committee structure of the fund board and the number of funds on whose boards each director serves. The SEC states that this practice is intended to strengthen directors’ understanding of their role, foster better communications and greater cohesiveness and help directors identify potential weaknesses and deficiencies in the board’s performance. The self-assessment does not have to be in writing, but the SEC expects the board minutes to reflect “the substance of the matters discussed” during an annual self-assessment. Boards use different approaches to conduct the self-assessment, which may include interviews by counsel or completion of a questionnaire by the directors with responses summarized by counsel.

8) **Independent Director Compensation**

Neither the 1940 Act nor state law sets forth specific requirements or limitations regarding the establishment of directors’ compensation. State law generally recognizes that directors are entitled to “reasonable” compensation. The independent directors of a fund, not the adviser, are responsible for setting their own compensation. Because directors have an inherent conflict of interest in determining their compensation, they should seek appropriate data necessary to reach a fair conclusion, including data on comparable funds, together with analysis of any special factors that may relate to the fund or fund group. Independent directors’ compensation may take a number of different forms, including annual retainers and attendance fees for board and committee meetings. Deferred compensation plans, retirement programs, and similar benefits are sometimes provided. Independent chairs, lead independent directors, and committee chairs may also receive additional fees and frequently do. The compensation paid to each director by the fund and by the fund complex as a whole must be publicly disclosed in the fund’s Statement of Additional Information and proxy statements. Directors who are technically deemed to be “interested persons” but who are not employed by the fund’s adviser (or its related entities) also typically receive the same level of compensation as the independent directors.
9) **Procedural Standards Set by the Courts**

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

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

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

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

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

Directors should review, and may also ask counsel to review, draft minutes of board and committee meetings before approving them. This task is important as the SEC staff considers the minutes to be evidence of how the directors and the adviser have fulfilled their duties. Board meeting minutes are often requested by the SEC staff and reviewed during SEC inspections and examinations and may also be subject to review in private litigation.

11) Disagreement

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

Directors who have a personal interest in a matter being voted on should consider abstaining and, in all events, should disclose their interest. Directors should request that their disclosure and, where relevant, their abstention or withdrawal from the meeting when the relevant matter was discussed, be noted in the board meeting minutes.

12) Term of Service

Neither the 1940 Act nor state law sets forth specific requirements on retirement policies or term limits. The ICI best practices report recommends that fund boards adopt policies on retirement of directors. Many boards have adopted a mandatory retirement age policy, typically at ages ranging from 72 to 75. Some boards set a retirement age but allow the board to make an exception for directors with special skills or who make exceptional contributions to the board. Other boards have policies setting term limits that allow directors to serve for a maximum number of years (e.g., 15 years). Some other boards have determined that setting a mandatory retirement age or term limit is not appropriate for their fund or complex.