Independent Directors Council

COMPENDIUM OF IDC PUBLICATIONS
MAY 2009

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Introduction

When the Independent Directors Council was established in May 2004, we had in mind a venue to promote the voice of investment company independent directors and to assist them in fulfilling their responsibilities on behalf of millions of fund investors. From that vision emerged the three missions of IDC: advancing director education, promoting interaction and communication among fund directors, and assisting in the formulation of policy positions on issues that impact fund boards.

Since its founding five years ago, IDC has fulfilled its missions and produced a wealth of educational resources for fund directors. In addition to the many conferences, workshops, and educational conference calls IDC has sponsored, we also have developed the Directors Reference Center, and issued nine papers on topics of importance to directors and the industry.

In our papers, we seek to assist fund directors in fulfilling their duties by providing information and practical guidance on important issues. Topics have included guidance about the structure and organization of a board (e.g., implementation of an independent chair, board self-assessments) and board oversight of the fund's operations and investments (e.g., fund mergers, derivatives). Six of the papers were written by IDC task forces of independent directors and others; the other papers were collaborative efforts by IDC, ICI, and, in the case of the fair valuation papers, ICI Mutual Insurance Company. In the aggregate, we believe this collection provides an important resource for independent directors.

Our papers also have proven helpful in educating regulators, the media, and others about the appropriate role and operation of fund boards. In this regard, the papers address two important themes that are critical to the understanding of the role of independent directors. First, a board's role is one of oversight; the board should not be directly involved in the day-to-day management or operations of the fund. Second, there is no "one size fits all" approach for fund practices or fund governance. Each board must take into consideration the particular facts and circumstances of the fund or funds it oversees when exercising its duties. This holds true with respect to the structure and operation of the board itself as well as the board's oversight function.

Finally, as we have developed these resources and worked with many of you to enhance resources available to directors, we have come to recognize all the more the importance of well-educated directors to the fund industry and its shareholders. We thank all of you who have given so generously your time and shared your unique insights with us. We hope all directors will find this collection useful.

James H. Bodurtha
Chair, Independent Directors Council, 2004–2006
May 2009

Implementing the Independent Chairperson Requirement

JANUARY 2005

Preface—May 2009

In 2004, a host of new regulations were implemented by the U.S. Securities and Exchange Commission (SEC) as a response to the market timing and late trading cases that came to light in the fall of 2003. The SEC's fund governance rule—which requires that funds relying on any one of 10 common exemptive rules comply with a set of fund governance practices—directly impacted fund boards.

One of the most significant (and controversial) of the fund governance requirements was that boards be led by an independent chair. IDC formed its first task force to write a report that would assist fund boards in implementing this part of the fund governance rule. The report, *Implementing the Independent Chairperson Requirement,* was issued in January 2005. Since then, the independent chair requirement, as well as the requirement that independent directors hold at least 75 percent of the seats on each board, has been invalidated by an appellate court. Thus, as of May 2009, boards are not required to have an independent chair.

Despite the appellate ruling, many boards opted to have an independent chair. By year-end 2007, slightly more than half (58 percent) of the complexes participating in the ICI/IDC Directors Practices Study had an independent board chair, and 26 percent had an independent lead director, whose responsibilities, in some respects, may be similar to those of an independent chair. This report continues to be relevant to boards with an independent director in a board leadership role as well as those considering moving to the independent chair model. In addition to discussing a board's transition to an independent chair, the report discusses a chairman's duties and responsibilities, including managing the board meeting, setting the agenda, and coordinating communication with management. The report provides thoughts regarding the qualifications of a chair that should be considered in the selection process and factors relevant to the chairman's compensation.

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Introduction

The U.S. Securities and Exchange Commission (SEC) recently adopted rule amendments that would require, among other things, that boards of registered investment companies appoint an independent director as the chairman of the board.[1] The SEC believes that "a fund board is in a better position to protect the interests of the fund and to fulfill the board's obligations under the [Investment Company] Act and the Exemptive Rules, when its chairman does not have the conflicts of interest inherent in the role of an executive of the fund adviser."[2] The task force agrees that an independent chairperson (hereinafter referred to as the "chair" or "he" regardless of gender) can play an important role "in establishing a boardroom culture that can foster the type of meaningful dialogue between fund management and independent directors that is crucial for healthy fund governance."[3]

For some investment companies the requirement for a chair does not represent a departure from current practice. In particular, boards that are affiliated with banks have had independent chairpersons for some time because of historical reasons.[4] Others have been required to do so as a consequence of regulatory settlements. For many boards, however, the appointment of a chair will require a change from the way they currently conduct business.

The Independent Directors Council convened a task force of 17 independent directors to study the new requirement for a chair and to identify issues that implementation of the rule amendment may raise.[5] A list of the task force members is attached as Appendix A. The task force prepared this report, which presents considerations and recommendations for boards implementing the new requirement for a chair. While the task force is aware of the pending lawsuit by the Chamber of Commerce challenging the requirement of a chair[6] and a Congressional mandate that the SEC study the issue,[7] it is the belief of its members that many fund groups are not waiting for the outcome of these initiatives and are currently preparing to implement the new requirement. The task force intends the guidance offered in this report to provide assistance in this effort.

While the task force is confident that all boards are united in their efforts to implement the chair requirement in a manner that advances the interests of shareholders, the task force recognizes that board practices vary greatly. As a result, a single set of practices is not appropriate for all boards nor will all boards respond alike to the considerations presented here. Much depends on current board culture and the relationship each board shares with the management company that serves as the investment adviser to the funds that the board oversees. Responses to the chair requirement also may depend upon the size and structure of a particular fund complex. To the extent practices are in place that already accomplish the objectives of the task force recommendations, modifications may not be necessary or desirable.

I. An Independent Director as Chair

The task force considered the real-world implications of designating an independent member of the board as the chair. This requirement is intended to strengthen the board so that it will be in a position to better serve shareholders.[8] The SEC has not, however, specifically indicated those activities the chair is expected to engage in, nor has it delineated those activities that should be reserved to an executive at the management company.[9] The wording of the regulation simply specifies that a disinterested director who serves as chair " . . . presides over meetings of the board of directors and has substantially the same responsibilities as would a chairman of a board of directors."[10]

The task force began its work by examining the role of the chair. The task force concurred with statements by the staff of the SEC that the chair position contemplated is a non-executive position; it does not involve managerial responsibility.[11] The role of the chair is one of leadership and, like that of all directors, is one of oversight. That being said, the position must have a sufficient amount of authority to accomplish its responsibilities. Thus, implementation efforts should be undertaken with an eye to imbuing the chair with the authority needed to perform all responsibilities assigned to him. Any job description of the chair should reflect the overriding principle of director independence and acknowledge that the chair's responsibilities are not operational in nature. Furthermore, any effort to describe the position of chair should not diminish the responsibilities of the other independent directors. The directors each retain equal voting power and responsibility to the fund and its shareholders.

As part of its analysis, the task force evaluated the chair position as compared to the existing "lead director" position employed by many funds.[12] It then assessed the duties and responsibilities of a chair and considered how a chair might perform them to advance the interests of shareholders. The members agreed that it would be advantageous to have all board members concur on these duties and responsibilities at the time the chair is named or, in the case of a current chair, as part of the annual self-assessment process. It also may be advisable to include a general description of the chair's role in the fund's by-laws, while reserving any more detailed discussion of specific duties and responsibilities to an internal board charter, if there is one, or to the minutes or a document attached to the minutes.[13]

It is worth noting that the task force considered the duties of chairs of fund boards of various sizes and determined that the functions served by the chair are approximately the same for all, but that the time commitment required to perform the chair responsibilities may differ depending on the complexity of the particular fund(s) involved. Similarly, the complexity of the fund group may dictate the need for auxiliary resources for the chair, such as the assistance of staff (either of the adviser or of the board) or independent counsel. As all boards gain experience with the chair position, it is possible that the list of responsibilities undertaken by the chair, as well as any practical considerations relating to how those responsibilities are performed, will need to be revisited. Appendix B to this report contains a summary of the considerations in implementing the independent chairperson requirement, which may assist in this effort.

A. Transition from a Lead Independent Director Model

Some industry participants have questioned the impact the requirement for a chair will have on fund boards that currently have a lead independent director. As a preliminary matter, while a board could conceivably retain the position of a lead independent director in addition to the chair, the consensus of the task force was that the lead director position will disappear once a chair is appointed. Other models have been proposed that are consistent with the appointment of a chair, for example, the naming of a vice chair (who is also independent) or the development of a succession plan that would allow an independent successor to share in the responsibilities of the chair. The SEC has indicated informally that both of these models may be acceptable under the new governance rule amendments.

The task force agreed that the power of a chair is, in fact, distinct from that of a lead director. It identified several differences between the two positions. First, from a perception standpoint, the use of the term "chair" conveys to shareholders a clear message that their interests are being represented. It also eliminates the perception

of diminished influence as compared to that of a member of the management company who holds the chair position, and may, as chair, have the final authority in setting the agenda, controlling debate, and responding to information requests.

This structural change, in turn, may affect the dynamics of the meeting. The SEC has said that the ". . . chairman is in a unique position to set the tone of meetings, and to encourage open dialogue and healthy skepticism."[14]

The chair will typically have the power to control the meeting, including the number of meetings and their length. In the view of some, if prior board meetings had "show and tell" presentations, now they are more likely to have agendas that are more aligned with directors' and investors' concerns. The extent to which this change in board leadership will require altering the operations of the board will depend in large part on the comfort level of the board with the effectiveness of existing practices. It may also depend on the extent to which an independent director, as the lead director or otherwise, has been previously actively engaged with the management company in setting the agenda for meetings and serving as a point person for information flowing to and from the other independent directors.

B. Duties and Responsibilities of an Independent Chair

The naming of an independent director as chair does not generate a host of new responsibilities to be performed by that person. Rather, the fact of a chair is intended to further empower independent directors to perform the role of oversight in the best interests of shareholders. By mandating that the chair be an independent director, the SEC seeks to encourage independent directors to bring to the boardroom "a high degree of rigor and skeptical objectivity to the evaluation of management and its plans and proposals," particularly when evaluating conflicts of interest.[15]

1. Manage the Meeting and Set the Agenda

One of the chair's primary responsibilities is to provide leadership to the board and to advance the principle that all decisions made by directors are in the best interests of shareholders. He will lead both the full board meetings and, in most cases, executive sessions of the board.

The SEC suggests that a chair typically will play an important role in setting the agenda of the board and determining the information provided to the board.[16] The task force interpreted this to include not only a review of the specific agenda items for each meeting, but also the process of advancing the agenda in a manner that ensures that the independent directors are equipped to make informed decisions. As part of this process, the chair should help establish or critically review an existing regulatory calendar, which includes items requiring quarterly and annual review/approval, with an eye to ensuring that regulatory requirements are spread among the scheduled meetings and that sufficient time is provided to review these and all other agenda items. This may be done with the assistance of counsel to ensure that all required approvals are obtained in a timely manner.

In this regard, the chair should consider the time allotted to each agenda item, the materials provided to directors and any planned presentations to facilitate discussion and critical examination by the directors. The way in which the chair goes about these tasks may vary among fund complexes and, to the extent the existing process is effective, changes may not be necessary or desirable. The SEC has acknowledged that the chair may consult with management in carrying out these functions, as well as leading the board through its various tasks.[17] But the

task force agreed that the goal of the new requirement is to ensure that the final decision in setting the agenda, and the process by which the work of the board will be accomplished at the meeting, will be made by someone independent of management.

The task force identified several actions by the chair, listed below, that will positively contribute to the agenda process and, coincidentally, the efficiency of board meetings:

- Seek the input of fellow independent directors and members of the management company as to agenda items that go beyond the regulatory calendar and address emerging trends, issues, and concerns.
- Estimate the amount of time that will be devoted to issues on the agenda, ensuring that adequate time is devoted to issues of significance.
- Reserve adequate time at each meeting to address unanticipated matters and current industry developments of importance to the board.
- Preview the materials for the meeting sufficiently in advance to allow for meaningful input to ensure that they contribute to the decision-making and oversight process of the board.
- Encourage open dialogue and healthy skepticism at every meeting.
- Ensure that there is a process in place and a person chosen (independent counsel or management staff) to identify open issues at the conclusion of each meeting so that the proper follow-up can be conducted.

2. Coordinate Communication with Management and Others

The task force members anticipated that the chair would serve as the primary contact for management executives or other members of the adviser's staff wishing to communicate with the board and/or for the board to communicate with third parties, unless such responsibility has been delegated to another independent committee or board member. The chair, as a result, ordinarily will become responsible for ensuring that all members of the board are kept informed of relevant developments and that messages delivered to management and others on behalf of the board are consistent and representative of the views of the independent directors. This could include informal communications between meetings or formal requests for information, such as during the contract renewal process.

To the extent a board does not have an effective process in place for identifying and communicating with other providers of services to the board, the task force's view was that the chair is the logical person to communicate with these parties.[18] The task force identified several categories of persons with whom the chair might interact—chief compliance officer (CCO), independent counsel, consultants, and third party administrators, as appropriate. The chair may take on this responsibility personally or delegate it to another director, a committee of the board, or the CCO. In the event the need arises for communication between the board and regulators, it is likely that the chair, with the assistance of counsel, would take the lead to facilitate this.

3. Manage Board Operations

An important role of the chair, in consultation with the full board, is to determine how best to accomplish the work of the board. The chair may assign certain tasks to individual board members. To the extent a decision is made by the board to conduct its business through use of committees,[19] the chair should communicate regularly with the committee chairmen to ensure that the work of the committee is progressing at a pace consistent with the expectations of the rest of the board. In some cases, the chair will delegate certain tasks or projects identified by the chair to these committees. The chair may be involved in the selection or rotation of committee chairmen. He also may be responsible for recommending board members for the various committees or this role may already exist in the nominating or governance committee charters.

Some boards may wish the chair to play a leadership role in developing an effective board. This may be accomplished through actions such as encouraging continuing education for existing board members and leading board self-assessments.

4. Guide Contract Renewal Process

The advisory contract must be approved annually by a majority of the independent directors on the board.[20] In connection with this approval and the negotiation of the advisory fee, the Investment Company Act provides that it is the duty of the directors to request and evaluate and the duty of the adviser to furnish information that may be reasonably necessary to evaluate the terms of the advisory contract.[21] The task force agrees with the SEC position that the chair "can play an important role in providing a check on the adviser, in negotiating the best deal for shareholders when considering the advisory contract, and in providing leadership to the board that focuses on the long term interests of investors."[22] As the person who is in contact with the management company most frequently, the chair may be in a position to coordinate formal or informal requests for information relating to the review or approval of the advisory contract after consultation with counsel and management representatives.

If a contracts committee or other board committee has responsibility for coordinating the contract renewal effort, the involvement of the chair in the day-to-day aspects of the process may be more limited. However, the chair may make more subtle contributions to the process. For example, the fact that the chair is conducting the board meeting may change the dynamics of the fee negotiations to one that is focused more on the interests of shareholders.

5. Manage Board Self-Assessment Process

The new governance rule amendments include a requirement that boards conduct an annual assessment of their effectiveness.[23] Some boards have been performing evaluations for some time and have developed a process that is successful for their particular circumstance.[24] To the extent a board is embarking on this exercise for the first time, the task force believes that the leadership of the chair is important to its success. The chair should encourage participation of his fellow directors in the development of the evaluation tool. He also should embrace the value of evaluations to the effective working of the board and, by doing so, promote serious and candid responses to the questions presented. The chair may be the person designated to present a cumulative report of the evaluation results to the board or this may be reserved to another person, such as counsel. If the board has a governance committee, it may be that this committee and its chairman will have responsibility for managing the assessment process.

II. Considerations Important in the Selection Process—Qualifications of the Chair

Serving as chair will necessarily require an additional time commitment. Before naming a chair, the task force encourages each board to spell out the scope of the chair's responsibilities and to then identify the characteristics that it views important for a person in this position to have. In order to function effectively, it is important that the chair and the board are clear as to the assignments. Some of the qualifications of a chair identified by the task force as generally required include:

A. Time Commitment

An individual selected to serve as chair should be willing and able to devote the time and energy that this job will entail. The number and complexity of funds the board oversees (e.g., those using multiple managers, covering a range of asset classes or investing in complex financial instruments) could impact this consideration, depending upon the board's structure and practices.[25] The task force noted that persons with business and/or professional experience are desirable as directors; however, their obligations as chair may conflict with time commitments to other activities or professional obligations. Care should be taken to evaluate these relationships before a final selection is made. In some cases it may be necessary for the chair to step down from other boards on which he serves.

Another factor that is relevant to the selection of the chair is how long the individual may be available to serve in this capacity. While there is no set term for a chair, the task force believes that it is desirable to have the same chair for a number of years, so an individual who is nearing the retirement age adopted by the particular board may not be the best choice for this position. A final consideration that may be relevant to the time commitment expected of the chair is his willingness to be readily available for fund business. The task force does not believe that the chair must necessarily live in close proximity to the management company. Rather, the chair should be available by phone or otherwise on short notice.

B. Leadership Skills

An individual being considered as the chair should be able to work well with others and have exhibited the ability to act in a leadership capacity. Experience as a board or committee chairman or lead director would be a plus. The ultimate responsibility of the chair is not to do all of the work personally but to exercise his leadership to see that it gets done in the best interest of shareholders, so the chair must be a good manager. He must have a good working relationship with all members of the board. He must also work well with management company executives and staff to ensure that tasks important to the fund are being done. Both good communication and organizational skills are desirable attributes in a chair.

The board may ask the chair to exercise his leadership in an effort to strengthen the board, such as assessing the competencies of current board members and working with the nominating committee to identify candidates who may fill a need, e.g., financial expertise or relevant industry knowledge. The chair also may be in a position to encourage more gender and age diversity on the board. The task force recognized age diversity as a way to facilitate succession planning on the board.

C. Knowledge of the Industry

The task force concluded that a working knowledge of the investment management industry would be helpful to a person serving as a chair so that he can effectively communicate with the management company and other industry participants. For this reason, persons with significant industry experience often are considered desirable as directors and, more specifically, as chairs.[26] Persons from outside the industry may gain such knowledge by seniority as a fund director, active participation in fund director activities or industry continuing education. To the extent no one on the board currently has this background, the task force believed this may be a relevant consideration when evaluating future candidates for board seats and preparing a succession plan for the chair.

D. Communications Proficiency

The task force considered communication among board members to be essential. The chair should promote communication through various means and encourage directors to stay abreast of industry developments. Access to industry news services, many of which are free, will increase the effectiveness of the board. Furthermore, to the extent the board is able to communicate electronically between meetings concerning key issues or concerns, the board will be more productive and focused, and its work likely will be completed in a timely manner.

III. Relevant Factors in Evaluating Compensation for a Chairman

The task force considered the appropriate factors to evaluate in setting additional compensation, if any, for a chair. As with other independent directors' compensation, any premium to the chair's compensation should be set by the independent directors and each board must make this determination individually. The task force agreed that, in most cases, the increased time commitment and responsibility demanded by the position warranted a compensation premium over and above the retainer received by the independent directors on the board.[27] The task force also noted that it is likely that any preliminary estimates of the time required to perform the chair role will be refined over time based on actual experience. For this reason, a board should revisit the subject of the chair's compensation annually.

Factors a board may consider in setting compensation include:

A. Time Commitment

If the individual selected as the chair is devoting a considerable number of hours annually to his or her position as the chair, additional compensation may be appropriate.

B. Opportunity Cost

If, because of his activities as the chair, the individual is not able to pursue business or professional opportunities, these foregone activities may justify additional compensation.

C. Involvement with One or More Local or National Directors' Organizations, Associations, or Initiatives

To the extent the chair is involved in organizations or activities that enhance his ability to serve as the chair, this may be taken into account by the board in setting compensation. Not only do those activities take additional time, they demonstrate leadership and benefit the board and fund shareholders.

IV. Removal of the Chair

As noted above, the task force believes that it is desirable for a chair to serve in the position for several years. This argues against establishing term limits for the chair. However, there may be a circumstance that warrants the removal of the chair. The task force identified several ways in which a board may address this contingency. First, any removal approach adopted could be included in the fund's bylaws along with the selection criteria or set forth in a separate document and attached to the minutes of the meeting at which the removal procedure and selection criteria of the chair are adopted. Second, the bylaws could provide for the annual election of all officers, including officers of the fund and the board. The chair would be appointed with the understanding that he will be reelected for several years, but the annual election process could provide for a tactful manner to replace a chair who is not meeting expectations. Third, boards could decide to include a provision in the annual self-assessment specifically addressing the performance of the chair. To the extent the chair has lost the confidence of the board, this exercise should bring that fact to light.

V. D&O Insurance Notification

The task force considered whether there was any need to notify a board's D&O insurance carrier of the appointment of a chair and whether this raises any insurance issues, such as the need for additional coverage (including separate policies or reserved limits within existing joint policies). None of the members of the task force reported this as an issue with their particular insurance provider but recommended that directors be alert to this possibility and to inquire at the time of renewal.[28]

VI. Review and Amendment of Bylaws

The task force suggests that all boards or their governance committees take the appointment of a chair as an opportunity to review bylaw provisions relating to the role of all officers.[29] To the extent that existing bylaws assign to the chair responsibilities that are inconsistent with this position being filled by an independent director, i.e., executive or managerial responsibilities, amendments may be necessary. It may be preferable to limit the express duties of the chair to procedural matters, such as those the SEC set forth in the new rule requirement, i.e., to serve as chairman of the board and to preside over meetings.[30] Additional responsibilities, which will vary from fund group to fund group, could be spelled out in a board charter or a board resolution that becomes a part of the minutes. This would permit the board and the chair to revisit exactly what the chair will do from time to time and to easily make adjustments with respect to a particular chair and experience with this new process.

As noted earlier in this report, fund bylaws also may need to be reviewed for considerations relevant to the appointment and removal of the chair, or to provide for the annual election of all officers.[31] Also, the chair should be described as an officer of the board and not of the fund; to do otherwise would be inconsistent with his status as "independent."[32] Finally, the bylaws may be amended to clarify that the vote of the chair on any given issue is no more significant that that of other board members—it is still one person, one vote. A sample set of bylaw provisions is attached to this report as Appendix C.

VII. Other Issues

A. Staffing

The task force felt that chairs would not necessarily require their own staff. The CCO and independent counsel were viewed as the logical persons to interface regularly with the chair and their involvement may alleviate the need for permanent staff to the board or chair. The management company typically provides the bulk of secretarial and clerical support for most boards. To determine if staffing is needed, the task force recommended that each board evaluate the responsibilities that are being assigned to the chair, the resources currently available to the chair and the board, and the cost to shareholders of securing staff.

B. Industry Activism

The task force recommended that boards consider the extent to which they want the chair to be involved in public activities or broader industry issues (e.g., visits to Capitol Hill or participation in industry programs). This also would include the extent to which there is an expectation that the chair may comment to the media on behalf of the board. A determination early on this issue will avoid confusion later. Any board policies with respect to communications should be reviewed with independent counsel.

Appendix A: Implementing the Independent Chairperson Requirement Task Force

William Altman	FPA Funds
John Benning	Liberty All-Star Funds
Kathy Cuocolo	Select Sector SPDR Trust
Dawn-Marie Driscoll	Scudder Funds
William Foulk	AllianceBernstein Funds
Gary Gerst	Harris Insight Funds
Rainer Greeven	Smith Barney Funds
Cynthia Hargadon, Chairperson	Wilshire Funds Allmerica Securities Trust
Sidney Koch	ING Funds
John Murphy	Smith Barney Funds
Frank Nesvet	StreetTRACKS Series Trust
Jock Patton	ING Funds
Michael Scofield	Evergreen Funds
Ed Smeds	Thrivent Funds
Robert Smith	Guardian Group of Funds
Susan Sterne	Sentinel Funds
Frederick Vogel	Waddell & Reed Funds

The Independent Directors Council and the Independent Chairperson task force would like to thank Margaret Bancroft, Partner, Dechert LLP, for her assistance and counsel in connection with this project.

Appendix B: Summary of Considerations for Transition to Independent Chairperson

- **Existing lead independent director**
  - Logical candidate for chair?
  - Required leadership and communications skills?
  - Commands trust and respect of other board members?
- **Duties and responsibilities—manage the meeting and set the agenda**
  - Ensure all activities of board promote interests of shareholders
  - Lead board meetings and executive sessions
  - Compile, with counsel, the regulatory calendar and schedule those requirements across the periodic board meeting agendas
  - Set meeting agendas
    - Solicit input from other directors, management, and counsel
    - Review materials in advance to ensure productive discussion and content appropriate for decision-making
    - Allow adequate time for unanticipated matters, and current industry developments
  - Conduct and manage meetings
    - Allocate time to each agenda item
    - Assure sufficient time for significant issues
    - Encourage and solicit participation from all board members, management, and counsel
  - Keep close track of open issues from meeting to meeting to assure appropriate follow-up and resolution
- **Coordinate communications with management and others**
  - Serve as primary contact for communications among directors and with management executives and other staff members
  - Ensure all board members are informed of relevant developments
  - Assure directives to management and other service providers are consistent and representative of the views of the independent directors
  - Serve as lead communicant with additional providers of services to the board—independent counsel, consultants, Chief Compliance Officer, and third party service providers, as appropriate
  - Delegate duties to standing committees or board members as deemed by committee charter or as appropriate
- **Manage board operations**
  - Oversee the delegation of duties and projects to standing committees or other board members as appropriate and efficient
  - Lead the building and maintenance of a strong and effective board
  - Lead board self-assessment process, if determined by the board
    - Involve other board members
    - Stress importance of process and need for candor

- **Guide contract renewal process**
  - Coordinate communication with management company as appropriate
  - Ensure negotiations focus on best interests of shareholders

- **Self assessment process**
  - Encourage candid and serious responses

- **Qualifications of the chair**
  - Time commitment
    - Ability to devote the time requirements and perform the agreed upon responsibilities
    - Commitment and ability to serve for a certain time period
    - Willingness to forego other board, professional or charitable commitments to devote the required time and energy to this position
  - Leadership skills
    - Prior positions in leadership positions considered a plus
    - Good working relationship with management and other directors
    - Develop a coalition among the board members to gain consensus on important issues and elicit dissenting viewpoints to foster important discussion among the independent board members
    - Work with nominating committee to strengthen board
  - Knowledge of the industry
    - Working knowledge of the mutual fund or investment industry is a plus
    - Continuing education through participation in a variety of industry and association activities is encouraged
  - Communications proficiency
    - Promote effective and efficient communications among board members through written, electronic and telephonic means

- **Considerations for compensation for the chair**
  - Estimated time commitment
    - Additional hours to perform the communication, coordination and board agenda development duties
  - Opportunity cost
    - Other activities, both paid and unpaid, relating to business or charitable organizations that are abdicated or foregone due to fulfillment of chair duties
  - Continued educational efforts
    - Involvement with director organizations, associations and initiatives

- **D&O Insurance**
  - No indications that appointment of a chair affects insurance coverage provisions or premium rates

- **Review and amendment of bylaws**
  - Changes should emphasize the communications, coordination and procedural aspects of the duties of the chair
  - Emphasis on the chair being an officer of the board, not the fund(s)
  - Strengthen text relative to one-person-one-vote, which includes the chair

Appendix C: Sample Bylaw Provisions

Article [ ]
Officers of the Board

Section 1

Chairman of the Board

The Board of Directors shall elect from among its members a Chairman of the Board who shall at all times be a director who is not an interested person of the fund as that term is defined by the Investment Company Act of 1940. The Chairman of the Board shall be an officer of the board but not of the Fund and as such shall preside over all meetings of the Board of Directors and shall have such other responsibilities in furthering the Board's functions as may be prescribed from time to time by resolution of the Board. It shall be understood that each director, including the Chairman of the Board, shall have equal responsibility to act in good faith, in a manner which he reasonably believes to be in the interest of the fund and with the care that an ordinarily prudent person in a like position as a director would use under similar circumstances.[33] The Chairman shall be elected by the Board of Directors annually to hold office until his successor shall have been duly elected and shall have qualified, or until his death, or until he shall have resigned, or have been removed, as herein provided in these bylaws. Each director, including the Chairman of the Board, shall have one vote.

Section 2

Resignation

The Chairman of the Board may resign at any time by giving written notice of resignation to the Board of Directors. Any such resignation shall take effect at the time specified therein or, if the time when it shall become effective shall not be specified therein, immediately upon its receipt; and, unless otherwise specified therein, the acceptance of such resignation shall not be necessary to make it effective.

Section 3

Removal of the Chairman

The Chairman of the Board may be removed by the Board of Directors with or without cause at any time.

Section 4

Vacancy

A vacancy in the office of Chairman of the Board, either arising from death, resignation, removal or any other cause, may be filled for the unexpired portion of the term of the office which shall be vacant, by the vote of the Board of Directors.

Note: The sample language above is not intended to serve as legal advice. Each fund board should tailor the language to fit its particular circumstances and should consult with counsel before adopting or amending fund bylaws.

Notes

[1] Investment Company Governance, 69 Fed. Reg. 46,378 (Aug. 2, 2004) (Adopting Release), available at http://www.sec.gov/rules/final/ic-26520.pdf. The SEC adopted this and other rule amendments with the intention of enhancing the independence and effectiveness of fund boards. The rule amendments require funds to adhere to heightened fund governance standards if they are relying on certain exemptive rules under the Investment Company Act of 1940 (Investment Company Act), including Rules 10f-3, 12b-1, 15a-4(b)(2), 17a-7, 17a-8, 17d-1(d)(7), 17e-1, 17g-1(j), 18f-3, and 23c-3 (Exemptive Rules). Because most funds rely on at least one of these rules, the governance standards apply to almost all boards.

[2] See Adopting Release at p. 7.

[3] Id.

[4] The Glass–Steagall Act, which was repealed in relevant part by the Gramm-Leach-Bliley Act of 1999, required that funds sponsored by banks have independent board chairmen.

[5] For purposes of this report, the term "director" includes "trustee" and the term "independent director" refers to directors who are not "interested persons" of the fund as that term is defined in Section 2(a)(19) of the Investment Company Act.

[6] *Chamber of Commerce v. U.S. Securities and Exchange Commission,* No. 04-1300 (DC Cir.).

[7] Consolidated Appropriations Act, 2005, Pub. L. No. §108-447 (H.R. 4818); at p. 102.

[8] See Adopting Release at p. 4.

[9] In this report, the terms "adviser," "investment adviser," and "management company" are used interchangeably. In all instances, the term shall include the management company where the portfolio management is performed internally, and any affiliated or unaffiliated advisory firms providing external portfolio management to the fund.

[10] Rule 0-1(a)(7)(iv) under the Investment Company Act.

[11] See "The Role of Independent Fund Directors," remarks of Paul F. Roye, Director, Division of Investment Management, U.S. Securities and Exchange Commission, before the Fund Governance Program presented by the Mutual Fund Directors Forum and Fund Directions (Dec. 9, 2004).

[12] An Investment Company Institute Advisory Group (Advisory Group) report entitled, "Enhancing a Culture of Independence and Effectiveness: Report of the Advisory Group on Best Practices for Fund Directors" (Jun. 24, 1999), defined the role of a lead independent director as one that would coordinate the activities of the independent directors, such as by chairing separate meetings of the independent directors and by raising and discussing issues with counsel. The lead director also would act as a spokesperson for the independent directors between meetings of the board. This person would be the point of contact among the independent directors with whom management could discuss ideas informally. Since the release of the Advisory Group report, fund boards that have appointed a lead director have assigned him a variety of responsibilities based upon the particular needs of each board.

[13] Any description of the chair in these documents, including, of course, the bylaws, must make clear that he serves as an officer of the board and not as an officer of the fund. References to "all officers" without this clarification may suggest that he serves as an officer of the fund and, as the SEC pointed out in the Adopting Release, a fund officer is, by the terms of the Investment Company Act, an interested person of the fund. See footnote 58 to the Adopting Release.

[14] Adopting Release at p. 8.

[15] Id. at p. 4.

[16] Id. at p. 8.

[17] Id.

[18] Directors seeking to identify companies and/or individuals providing services to fund boards should reference the Investment Company Service Directory, available through the Independent Directors Council website at www.idc1.org.

[19] Some boards actively employ committees to facilitate the work of the board. Others choose to have all of the independent directors act as a committee of the whole. While most boards have audit and nominating committees, the task force did not take a position with respect to whether the use of committees is the most effective management structure.

[20] Section 15(c) of the Investment Company Act.

[21] Id.

[22] Adopting Release at p. 7.

[23] Rule 0-1(a)(7)(v) under the Investment Company Act.

[24] Another Independent Directors Council task force is preparing a report on self-assessments and expects to release its findings in the next few months.

[25] A third Independent Directors Council task force is preparing a report on board oversight of multiple funds and expects to release its findings in the next few months.

[26] See Adopting Release, Dissent of Commissioners Cynthia A. Glassman and Paul S. Atkins, at fn. 35.

[27] A small number of boards have reported that additional compensation will not be paid because the chair position will rotate among the independent directors with each serving, for example, a three-year term. Over time, each will devote the additional time and assume the additional responsibilities required by the job.

[28] There is nothing to suggest that designation as chair will result in increased liability for a director who serves as such. If an event, such as a court case or enforcement proceeding were to suggest that such liability exists, the insurance industry would likely evaluate the need for additional coverage.

[29] It is very common for bylaws to establish the titles and roles of officers. Most funds are created as corporations or trusts under the laws of Maryland, Delaware, or Massachusetts. Boards should seek the advice of counsel to ensure that bylaws are amended in accordance with the relevant state law of incorporation.

[30] Rule 0-1(a)(7)(iv) under the Investment Company Act.

[31] See discussion at Section B-4.

[32] See note 13, supra.

[33] This is the Maryland General Corporation Law standard governing the responsibilities of a director. The language should be appropriately modified to conform to the similar articulations of a director's duties to the entity under the laws of other jurisdictions.

Board Self-Assessments: Seeking to Improve Mutual Fund Board Effectiveness

FEBRUARY 2005

Preface—May 2009

The U.S. Securities and Exchange Commission's fund governance rule (adopted in 2004) requires that funds relying on any one of 10 common exemptive rules comply with a set of fund governance practices. One of the required practices is that boards conduct self-assessments annually. While some fund boards voluntarily conducted self-assessments prior to the adoption of the rule, and ICI's Advisory Group on Best Practices for Fund Directors had recommended that practice in 1999, the adoption of the rule meant that some fund boards would undertake self-assessments for the first time. IDC convened a task force to consider the requirement and offer practical guidance to boards implementing or reexamining the self-assessment process in light of the new rule.

The report, *Board Self-Assessments: Seeking to Improve Mutual Fund Board Effectiveness,* was published in February 2005 and provides helpful insights for boards regarding possible questions to ask and the process to follow in administering the self-assessment. While most fund boards have now developed their own process, the rule requirement and board practices in this area are still relatively new, and boards continue to consider whether to change their processes or the topics covered in the self-assessment. This report provides a useful framework for boards to reevaluate their processes and identifies issues for boards to consider.

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Introduction

Self-assessment by investment company boards is not a new concept. It is a tool successfully employed by some boards to gauge the performance of the board and its members and to evaluate other aspects of board operations. In its 1999 report, *Enhancing a Culture of Independence and Effectiveness,* the Advisory Group on Best Practices for Fund Directors recommended that fund directors:

> ". . . step back periodically and review their overall performance . . . conduct . . . an evaluation, which should focus on both substantive and procedural aspects of the board's operations."[1]

While board self-assessments to date have been voluntary, under new governance rules adopted by the U.S. Securities and Exchange Commission (SEC), after January 16, 2006, virtually all investment company boards will be required to conduct self-assessments annually.[2] The Independent Directors Council convened a task force of 11 mutual fund directors to consider this requirement and to offer practical guidance to boards that will be undertaking self-assessments for the first time or that are reexamining their existing self-appraisal practices. A list of task force members and their fund affiliations is attached to this report at Appendix A. For purposes of this report, the term "director" includes "trustee," and the term "independent director" refers to a director who is not an "interested person" of the fund as that term is defined in Section 2(a)(19) of the Investment Company Act.

Through the end of 2002, board self-assessments were not prevalent in the mutual fund industry. An Investment Company Institute study representing approximately 94 percent of industry assets under management reported that 61.7 percent of the participating complexes had no formal or informal policies or procedures for self-evaluations.[3] While the number of boards assessing their effectiveness may be higher today, a mandatory annual evaluation program will represent a new experience for many directors.

In its Adopting Release on the Governance Amendments, the SEC stated:

> "The annual self-assessment requirement is intended to . . . [strengthen] directors' understanding of their role and [foster] better communications and greater cohesiveness."[4]

Importantly, the Governance Amendments do not proscribe the specific aspects of a board's operations that must be considered in a self-assessment, except in two areas: (i) the effectiveness of the board's committee structure, and (ii) the number of funds overseen by directors. Also, while the board's self-assessment does not need to be in writing, the SEC has stated that the minutes of the board meeting at which the self-assessment was discussed should reflect the substance of the matters covered.[5]

The annual self-assessment requirement differs from each of the other governance standards addressed by the Governance Amendments because it specifically requires the "board of directors" to perform the annual evaluation (each of the other provisions applies only to "disinterested directors"). The task force believes this was not an oversight by the SEC and would expect "interested directors" to participate in the undertaking. The task force notes, however, that there may be certain issues (e.g., nominations, director compensation) that are, by rule or practice, primarily within the purview of independent directors, and thus participation by interested directors in these areas of the self-assessment may not be appropriate.

Because mutual fund directors' history and experience with self-assessments is limited, and due to the recent pace of change in the mutual fund industry, the task force believes it is premature to offer "best practices" for the conduct of board self-evaluations. Furthermore, although every mutual fund board shares a fundamental commitment to overseeing and protecting the interests of fund shareholders, the actual structure, composition, and operating needs of boards of directors vary widely among different fund complexes. Because of this, the task force determined that it is not practicable to suggest a single methodology or to enumerate universally applicable criteria. That being said, the directors participating on the task force have pooled their experiences and reviewed examples of self-assessments shared by independent directors. This report identifies what the task force regards as key considerations for a board embarking on the self-assessment exercise.

The report begins with a discussion of various ways a board might consider conducting its self-assessment. Next, the task force identifies those aspects of its operations a board might decide to evaluate and offers specific guidance on several areas the task force regards as important. The report then reviews the considerations involved in individual self-evaluations by directors and peer reviews. The final section of the report comments on the importance of developing an action plan to ensure that any identified areas of weakness are addressed and recommended improvements are implemented.

The task force encourages boards to take ownership of their self-assessments and agree in advance on issues such as:

- methodology and coordination of the process;
- areas of focus;
- extent of the record to be maintained; and
- any appropriate follow-up to the findings of the self-assessment.

In offering this guidance, the task force wants to underscore the inherent benefits of self-assessments. Fully realizing these benefits requires a positive attitude on the part of directors as they proceed through the self-assessment process. Indeed, the task force believes that forthright, thoughtful, and constructive consideration by a board as to whether it is operating effectively in the best interests of the fund and its shareholders is invaluable in strengthening the board's ability to fulfill its important responsibilities. The open communication encouraged by the self-evaluation program can sharpen the board's focus as a unit and, at the same time, optimize contributions by individual board members. Improving the overall effectiveness of a board and its members benefits shareholders and therefore is the overarching goal of any self-assessment program.

I. Conducting a Self-Assessment

The task force concluded that, based upon its own experiences as well as informal discussions with industry representatives and other directors who have been through the process, there is no single best method for conducting self-assessments. It appears that some boards have successfully conducted evaluations informally with little documentation other than a discussion outline. Others have chosen instead to use detailed questionnaires with a summary compilation of responses, typically without attribution to any director.[6] Documentation practices vary, and it is worth repeating that the Governance Amendments do not require board self-assessments to be in writing, although the SEC has stated that it expects the board's minutes to " . . . reflect the substance of matters discussed . . . "[7]

Among the threshold issues facing a board conducting a self-assessment is determining how the process should be administered and who the coordinator should be. For example, the process could be administered and coordinated by the chair of the board, the chair of the nominating committee, an outside third party consultant, or counsel. It is important to recognize that these decisions will now be made in a context where board self-assessments are no longer merely a recommended "best practice" for investment companies but are, for most funds, required by regulation. As a result, the assessment may be subject to scrutiny by regulators or litigators. In such an environment, the task force acknowledges that any perceived threat to the confidentiality of directors' self-assessments can have a chilling effect on the entire process. In fact, by requiring only that board minutes reflect the substance of the matters discussed in board self-assessments, the SEC seems to have implicitly recognized the need to conduct self-assessments in an environment that fosters full and frank communication by directors.

Accordingly, in order to promote optimal constructive and open dialogue and to preserve any attorney-client privilege and/or other relevant privileges, the task force suggests that counsel be actively involved in all aspects of the self-assessment process.[8] In engaging counsel for this purpose, it should be understood that counsel's involvement is to provide legal guidance and to assist the board in meeting the self-assessment requirement of the Governance Amendments.[9] While the task force accepts that there is always a possibility that a court or regulator may choose not to recognize the privilege in connection with a self-assessment, it believes counsel's involvement in the process is the most prudent course of action.

A board may wish to consider all of these factors in determining the best way to conduct its self-evaluation. If the board elects to conduct the self-assessment orally, the task force believes that providing board members with a discussion guide or an agenda of topics in advance of the meeting will promote a more focused discussion at the meeting. Alternatively, if the board prefers to utilize a written questionnaire and to review response compilations, the task force believes the board, in consultation with counsel, should adopt a procedure for the disposition of the documentation. In each case, minutes of the meeting should document the process and record key board considerations and conclusions.

II. Topics of Board Self-Assessments

The task force believes that the self-assessment process will be a more positive and constructive undertaking if, at the outset, directors agree specifically on which aspects of the board's operations are to be evaluated. This may be especially important for a board that has never engaged in a formal, or even an informal, review of its effectiveness. To achieve this "buy-in" and consensus, counsel or the individual identified as the coordinator of the process might share with directors in advance a draft of the discussion guide or questionnaire, if either is to be used. The task force identified the following topics that may be appropriate subjects for a board self-assessment.

A. Composition of the Board

Each board is unique in its character and dynamics. And, though it seems obvious to say, the effectiveness of any board depends ultimately upon the directors themselves and how each understands and approaches his or her role and responsibilities. For existing boards, the composition of the board is determined by the board itself. Indeed, board nominating committees must be composed entirely of independent directors who retain sole responsibility

for selecting fellow independent board members.[10] Beyond legal requirements for determining independence, a board may set its own criteria for filling board vacancies or for adding new directors.

In evaluating its composition or determining criteria for filling vacancies, a board's directors might ask themselves the following questions:

Is the size of the board appropriate? The task force observes that the number of funds in a complex will likely be a key determinant of a board's size. Boards will most likely seek to have enough members to manage its workload effectively, as well as to have a breadth of perspective as it discharges its duties.

Is the makeup of the board appropriate? For most funds, this question must be answered in the context of the Governance Amendments, which provide that on or after January 16, 2006, at least 75 percent of a board be comprised of independent directors and the board be led by an independent chair.[11] Noting that these new requirements were adopted by the SEC to strengthen a board's independence and that some boards successfully function with independent directors exclusively, the task force suggests evaluations weigh the relative advantages and disadvantages of having interested directors serve on the board. For example, some commentators have observed that boards can benefit from having a member who is affiliated with management.[12] Such an "inside" director may offer a level of industry expertise and perspective that is useful in the board's decision-making process and, at the same time, by serving on the board the inside director may gain an enhanced understanding of what fellow directors view as being in the best interests of the fund and its shareholders. While a senior representative (or representatives) of the adviser who attends board meetings (as opposed to actually sitting on the board) also can provide this insight to the board, directors may conclude that a management representative who is a member of the board, with a duty to look out for the best interests of the fund and its shareholders, is in a better position to provide such insight.

Should the board consider standards of independence that exceed statutory requirements? In view of the unique organizational structure of investment companies and the potential conflicts of interest inherent in that structure, the Investment Company Act imposes strict standards of independence applicable to boards and individual board members.[13] Commentators on industry best practices have urged that the background of individuals eligible to serve as independent directors be more closely examined to ensure their undivided loyalty to shareholders. Specifically, the Advisory Group report recommended that former officers or directors of a fund's investment adviser, principal underwriter, or certain of their affiliates never serve as independent directors of that fund.[14] In addition, the Investment Company Institute board of governors has recommended that boards prohibit "close family members" of employees of a fund, its adviser, or principal underwriter from serving as independent directors.[15] Although these considerations go beyond minimum statutory requirements, the task force encourages boards to take these and other personal and business relationships into account when evaluating standards of independence for their directors.

Does the board possess the right professional/educational experience and skills to address current issues it faces? There are no express qualifications for service on the board of an investment company. Some boards have adopted nominating committee charters and policies that specify personal attributes sought in board candidates, including having such characteristics as "unquestioned personal integrity" and "sound business judgment gained through broad experience in significant positions." The task force agrees that personal integrity and

sound business judgment should be baseline attributes for all independent directors. A board also may wish to assess the experience of its current directors to determine if adding a director with specific expertise will enhance the board's oversight capabilities. In today's environment, given regulatory attention to matters of compliance and financial statement integrity, board candidates having investment, finance, legal, or accounting backgrounds—and even investment company experience—are likely to be in greater demand.[16]

Other possible considerations. A self-assessment also might consider such issues as whether the board should have a retirement policy, whether there should be term limits on directors' tenure, whether the board's age distribution and diversity is appropriate, and whether the board's nominating process effectively produces the best candidates.

B. Board Committees

One of the items the Governance Amendments specifically require each board to determine is the effectiveness of the board's committee structure.[17]

It is undeniable that the time and effort required of 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 have frequently turned to standing committees as a technique to manage their workloads. Committees may be established for a variety of purposes. Some representative standing committees include:

» Audit

» Brokerage

» Compliance[18]

» Contracts

» Governance

» Investment Oversight

» Nomination

» Operations

» Valuation

The task force does not want to give the impression that it is a "best practice" for funds to have every one of the committees listed above. Larger fund complexes with sizeable boards may establish more committees than smaller boards or boards overseeing fewer funds. In addition, boards may establish special purpose committees to address individual events, such as accounting or valuation issues, litigation or regulatory investigations, fund mergers or liquidations, or changes of control of the adviser.

Generally, committees of the board are comprised of fewer directors than sit on the full board. However, small boards and boards that oversee a single fund may have "committees of the whole" where all the independent board members serve on certain board committees.

Many of the same types of questions used to assess the operations of the full board are also relevant for committees. Listed below are some suggested areas of inquiry specifically applicable to committee evaluations.

Should there be more/fewer committees? The task force believes that appropriately structured and effectively operating standing committees can have a significant impact on how a board manages its workload. Broadly speaking, in establishing standing committees, the board is seeking greater in-depth review and oversight of a particular aspect of the fund's operations than it is able to accomplish practically as a full board. There is no optimum number of committees that should be established. While a board's size and the complexity and number of funds it oversees are basic considerations, the directors' perspective on workload management and their comfort in "delegating" elements of their role to a committee are important factors to probe as well.

In assessing the use and effectiveness of a board's standing committees, a board may wish to expand the scope of its inquiry to include consideration of whether additional committees should be formed to focus attention on specific aspects of the fund's operations. These might include the annual consideration of its relationship with its investment adviser and affiliated service providers, the fund's investment performance, best execution and related brokerage issues, valuation of the fund's portfolio securities, overall compliance matters, the fund's disclosure documents, matters relating to pricing and distribution of the fund's shares, and the fund's relationships with its non-affiliated service providers.[19] Each of these specific areas also might be evaluated separately in a self-assessment.

Is the composition of each committee appropriate? Although regulations provide that under certain circumstances committees be comprised solely of independent directors, the size of these committees is left up to the board.[20] The task force observes that as a matter of practice, standing committees typically are comprised of independent directors only, although in some cases (e.g., valuation committee) an interested director may be included because regular input from management is a part of the committee's basic function. Committee memberships may be allocated among board members to divide the workload and minimize overlaps. Additionally, some boards may find it effective to rotate committee memberships periodically to broaden directors' exposure and to gain fresh perspective, although such an approach should be weighed against the loss of continuity and expertise that may result from such a practice.

Is the scope of each committee's activities appropriate? The scope of a committee's activities is determined by the board's initial delegation of authority, typically reflected in a committee charter. In periodically assessing the effectiveness of a committee, questions should elicit board members' views concerning the need to adjust the scope of a committee's original delegation. For example, a nominating committee may be asked to expand its responsibilities to include board governance matters, including making recommendations to the full board regarding the annual self-assessment process. Also, since committee charters tend to be broad and non-specific, a committee may itself decide to elaborate on the board's delegation by adopting its own policies and procedures or working agenda for the year.

Is the information flow and communication from the committee to the full board adequate to enable the board to make informed decisions and otherwise fulfill its responsibilities? A committee rarely takes action on its own. A committee of the board typically is charged with making recommendations to the full board based upon a comprehensive review and in-depth analysis. Committees do not take the place of the board, and committee

actions remain subject to consideration and approval by the full board. Consequently, board members who do not sit on a particular committee depend upon full and accurate reports supporting the committee's recommendations.[21] Boards may receive written summaries (e.g., committee minutes) and/or an oral report from the committee chair before acting upon the committee's recommendation. The adequacy and frequency of these communications are important matters to be evaluated.

C. Board Meetings

The key decisions and oversight relating to a fund are made at regular or special meetings of directors. Consequently, the board meeting reflects the manner in which a board discharges its fiduciary responsibilities. Fundamental to a board's self-assessment and improvement is an in-depth analysis of how its meetings are conducted. In light of the increasing responsibilities being placed upon directors, especially independent directors, the task force recommends frequent evaluation of board meeting effectiveness and the process by which decisions are made on behalf of shareholders.

Here are some suggested areas of inquiry to assist a board in evaluating the effectiveness of its meetings.

Are more frequent and/or longer meetings necessary to properly deal with expanding agendas? The increasing workload of directors stemming from the mandates in new statutory and regulatory requirements, together with demands relating to such matters as the number and/or type of funds overseen by the board, the funds' increasing complexity, and the variety of distribution platforms through which the funds are offered, may give rise to questions about whether the board should meet more frequently and/or for longer sessions. As recently as 2002, it was the prevailing practice for investment company boards to meet quarterly, possibly with a fifth meeting to consider annual contract renewals.[22] Many boards are now reevaluating not only the number of meetings, but also the number of hours/days each meeting will last. The task force observes that the examination of the frequency and length of meetings may be closely correlated with considerations regarding agenda management and the board's committee structure.

Is the location and format for board meetings appropriate? Often for convenience and access to fund officers and portfolio management staff, board meetings are held at the adviser's offices. If directors prefer, meetings may be held at an off-site location, such as the offices of counsel or the funds' non-affiliated service provider(s). A board might evaluate the effectiveness of in-person meetings for board deliberations (other than meetings for consideration of the advisory agreement, for consideration of 12b-1 plans, and for selection of the fund's independent auditors, which are required to be in-person meetings), and their impact on interaction among directors. Similarly, if a board meeting is held by teleconference or videoconference (which is not a legal substitute for an in-person meeting), directors may wish to assess such considerations as the frequency of these meetings, the length of agendas or the complexity of issues that can effectively be addressed at these meetings.

Are board members satisfied with the process used for setting agendas? Are agenda items appropriate? Determining what matters are to be addressed at each board meeting and prioritizing agenda items are critical to meeting efficiency and effectiveness. The importance of agenda-setting and the chair's involvement in formulating the agenda was underscored by the SEC in the Governance Amendments in connection with the requirement that the chair of the board be an independent director.[23]

In practice, matters to be discussed and acted upon at board meetings can be determined jointly by management, the chair, and counsel. Input from fellow directors also may be solicited. Often, an annual calendar of recurring matters requiring board consideration provides the core agenda for regular board meetings. The task force encourages directors to evaluate this process routinely to ensure that they are satisfied with their ability to add issues to the agenda.

Is board meeting time properly allocated among agenda items and between board discussion and management presentations? Are issues resolved in a timely and effective manner? To promote effective decision-making, board members should have an adequate opportunity to evaluate and discuss relevant aspects of each agenda item. At the same time, as necessary, time should be set aside for management to discuss items requiring board consideration. Managing this process and encouraging appropriate and meaningful dialogue—while simultaneously ensuring that sufficient attention is devoted to each agenda item to enable the board to reach a conclusion it is comfortable with—are among the most important and challenging responsibilities facing the chair and board and should be evaluated.

Are open communication and meaningful participation by board members and management encouraged at meetings? A boardroom atmosphere enabling and encouraging open communication among board members as well as between independent directors and management is fundamental to directors' effectively fulfilling their role as shareholder representatives. The conduct of each meeting should promote this atmosphere and directors should confirm, through the assessment process, that they, as the shareholders' "watchdogs," are in a position to exercise independent judgment. A boardroom environment that supports constructive skepticism, diligent inquiry, and engaged participation on the part of all directors is an essential ingredient to produce this result.

Do the independent directors have sufficient opportunity to meet and deliberate separately from management? The Governance Amendments require that, on or after January 16, 2006, independent directors meet at least quarterly in a session at which no directors who are interested persons of the fund are present.[24] While some boards have conducted executive sessions without management present as a best practice,[25] now all boards will be required to do so. Among matters to be evaluated in terms of board effectiveness are whether the board should employ the executive session tool more frequently and whether the executive sessions to date have been useful and productive.

Do the minutes of board meetings adequately reflect the considerations of and determinations by the board? While the task force recognizes that there are different approaches to the level of detail found in board minutes, directors should consider carefully whether the minutes form a record sufficient to support the discussions held and conclusions reached by the board. The board minutes form the official record of meetings and may be open to inspection by third parties, including regulators. In addition, in applying the "business judgment" rule, courts have relied on board minutes when showing substantial deference to decisions made by appropriately informed directors.

Is there a reliable process in place to follow up on issues raised and not resolved at board meetings? Often, during the course of a board meeting, matters arise that need to be pursued by management, counsel, the chair, a committee, or the auditor after the meeting. In evaluating its effectiveness, a board should consider whether there is an affirmative and effective follow-up process in place or whether improvements in an existing

process may be warranted. For example, rather than waiting for the minutes of the meeting to be drafted and circulated (typically with materials for the next quarterly meeting) where such issues would presumably be restated, before the meeting is adjourned, the board might consider requesting that counsel or management prepare a list of follow-up items and the agreed-upon person(s) responsible for addressing those items.

Do board members have sufficient access to counsel, management, and/or each other between board meetings? Matters often arise between meetings that require the attention of independent directors' counsel, board or committee chairs, or the full board. The accessibility of counsel, management, and board members merits consideration in a self-assessment. Questions to consider might be their availability, their responsiveness, and their proficiency in effectively communicating with others.

D. Meeting Materials

The efficacy of discussions held and decisions made at board meetings is influenced significantly by the quality of the background information directors consider in connection with their deliberations. For the most part, board materials received by directors in advance of their meetings, as well as written and oral presentations delivered at meetings, are provided by management. Certain issues may be addressed by information prepared and presented by independent third parties or by counsel. It is also not uncommon for board materials to be reviewed by counsel, the independent chair or lead independent director, or committee chairs, before distribution to board members. The self-assessment process provides an opportunity for a board to identify and implement improvements or refinements in connection with the form and/or content of meeting materials.

The task force believes the following questions about meeting materials may be appropriate to evaluate:

Does the board receive sufficient information to permit directors to understand and evaluate agenda items? Are board materials presented in a form and with accompanying explanations that make the information clear and understandable? As meeting agenda and the volume of board materials continue to expand, ensuring that directors can reasonably digest the information and make informed decisions on behalf of shareholders is an increasing challenge. Task force members agree that the quality of board materials received by directors in advance of their meetings can have a positive effect on meeting efficiency, deliberations, and decision-making. Transmittal memoranda that summarize more detailed presentations and that identify and focus the key issues before the board can provide critical support to directors as they consider increasingly complicated and sensitive subject matter. Board members' views on sufficiency and the optimal form and content of board materials will undoubtedly vary, and this is a matter the task force suggests may warrant ongoing attention. Even reports where no action is called for may be subject to scrutiny for improvements (e.g., board members may request that portfolio management and performance reports contain more charts and tables and that narrative be more focused on performance attribution).

Are board materials received sufficiently in advance to allow directors adequate time to prepare for board meetings? In order to ensure that directors feel they have adequate preparation time for meetings, the task force recommends that board evaluations include questions regarding the timing and manner of distribution of material prior to board meetings. Directors may prefer to establish a minimum time period before the board meeting for delivery of materials or request to receive material in a staggered time frame so they can read through each agenda item as it becomes available. Perhaps directors would like to receive more web-based

material or material on CD-ROM in advance of the meetings. When a board meeting involves proposals for the annual consideration of contract renewal pursuant to Section 15(c) of the Investment Company Act, the addition of new funds to the complex, fund reorganizations, changes in key service providers to the fund(s) or similar non-routine matters, directors may need additional time to review background materials, consider the proposals and, when appropriate, hold executive sessions for preliminary deliberations with counsel or outside advisors.

E. Oversight of Multiple Funds

The other area that boards are expressly required by the Governance Amendments to consider when conducting board self-assessments is the number of funds overseen by each director.[26] The task force believes that the SEC intends for boards as a whole, and directors individually, to consider their ability to represent effectively the interests of a single fund and its shareholders while simultaneously overseeing additional funds in the same family or in a different fund complex.[27] Although the SEC has offered little guidance on the nature or scope of this consideration,[28] the task force believes workload management is fundamental to the issue of director oversight of multiple funds. How a board and its individual members manage the board's workload is affected by a variety of factors, and boards will likely reflect wide differences in how they address the issues.

Some of the questions that may be useful in evaluating the issue of directors' overseeing multiple funds include the following:

Are directors able to devote sufficient time and attention to matters specific to each fund and matters common to all funds in the complex? Do the directors have sufficient experience and knowledge to effectively serve all of the funds over which they have oversight? Because mutual fund directors have a duty to act in the best interests of each fund they oversee and that fund's shareholders, it is important to confirm their ability to devote sufficient time and attention to issues both specific to each fund and common to all funds in the complex, as well as their expertise and ability to understand and address multiple investment products. The task force recognizes the increasing time commitment and personal dedication involved in serving as a director for multiple funds within a complex.[29] Nevertheless, the task force believes it is important to recognize that a director's overall workload is not measured simply by mechanically counting the number of funds he or she oversees. This is because, for funds that are part of a fund family, a significant portion of the directors' workload involves governance issues common to all of the funds. Even fund-specific matters—such as portfolio management, performance, fund expenses and valuation of portfolio securities—often involve aspects common to all funds or groups of funds (e.g., equity, fixed-income, international).[30]

Is the structure of the fund complex effective in enabling director oversight of multiple funds? The task force suggests that one potential factor affecting a director's ability to oversee multiple funds is how the fund complex is structured. Within a family of funds, a single board may oversee all of the funds in the complex (often called a "unitary" or "pooled" board) or several boards may oversee distinct groups, but not all, of funds within the complex (often called "cluster" boards). Occasionally, within a complex consisting of cluster boards, there may be directors who overlap one or more of the clusters. Directors' access to management and management's interaction with and responsiveness to board members may be affected by the number of different boards overseeing funds in a complex. The number of separately registered investment companies that comprise

a fund complex and whether a series or a master-feeder structure is utilized by the complex can also affect workload levels. Directors may wish to consider whether the structure in place is appropriate for the protection of shareholders of each fund overseen.

Are there techniques that could be employed or adjustments to existing procedures that might enhance the board's management of its workload? Many of the factors affecting the effectiveness and efficiency of board operations that have been covered in earlier sections of this report, such as the size and make-up of the board, the use of board committees, the management of board meetings, and the quality of board materials, are directly pertinent to workload management and a director's ability to protect a fund's shareholders' interests while overseeing other funds. Factors associated with the structure of a fund complex mentioned above also are relevant. For example, fund families with cluster boards may find that joint sessions of boards or board committees may be more effective and efficient for considering relationships with common service providers or for considering other matters common to the funds (e.g., joint insurance arrangements).

Should the board adopt a policy limiting its members' ability to serve on other boards? The task force recognizes that while some boards have formal or informal policies regarding their members' ability to serve on other boards, others have not adopted such policies. Nevertheless, in view of increasing workloads for directors of investment companies and greater focus on fiduciary responsibilities of serving on corporate boards generally, boards may wish to address this subject in the context of a self-assessment.

F. Director Compensation

Compensation levels and structure can be important in attracting and retaining highly qualified board members. Assessing compensation in the context of a board self-evaluation is appropriate and customary. A board might ask:

Is the level and structure of director compensation fair and adequate? Is the board comfortable with its process for establishing compensation? Although there are different approaches to board compensation, a key goal is to develop a compensation system that produces a fair level of compensation and that is able to attract and retain qualified directors.[31] Commentators on fund governance practices recommend that independent directors determine their own compensation (level, structure, and form) and that, in doing so, they seek data necessary to reach a fair conclusion.[32] Such data would likely include compensation paid by comparable boards (number and complexity of funds and overall assets in the funds are typical comparative measures) together with any special factors that may relate to the funds they oversee (e.g., complexity of funds, use of sub-advisers, etc.). The board may wish to engage third party consultants to facilitate in the data-gathering and analysis.

Related questions a board might consider are: ***Should the board adopt a policy encouraging or requiring directors to invest in one or more of the funds? If so, should a minimum amount of investment be established and should an allocation among funds be considered?***

Commentators on board practices have suggested that fund directors might be more effective in serving the interests of fund shareholders if they have ". . . a personal investment stake in one or more of the funds that they serve. Share ownership by fund directors helps to align their interests with those of fund shareholders." The task force believes this is a subject many boards may want to discuss during their self-assessments.

Considerations relating to deferred compensation and retirement benefits may also fall within the scope of these questions.[34]

G. Overall Effectiveness of the Board

Beyond the more specific aspects of board operations addressed above, in conducting a self-assessment, the task force suggests that the board step back and gauge its overall effectiveness from a broader perspective. The questions offered below are intended to provide directors with an opportunity to evaluate the board's performance applying broader, more qualitative measures.

Fundamental Role and Responsibilities:

Does the board approach each issue with a perspective independent from the adviser?

Is the board given adequate time and opportunity to evaluate and comment upon the adviser's goals, strategies, and long-term plans for the funds?

Does the board consistently ensure that all decisions are, first and foremost, to the benefit of the fund and its shareholders?

Is the board's process to identify and review conflicts of interest effective?

Do board members understand and respect the differences between the board's policymaking and oversight roles and the adviser's operating role?

Do new board members receive adequate training regarding their role and responsibilities?

Does the board provide, or do directors attend and participate in, ongoing educational and informational programs to strengthen directors' knowledge of issues relating to best practices and fund oversight?

Oversight Role:

Is the board generally well prepared for its meetings?

Does the board have a workable process to keep abreast of current regulatory developments and their potential impact on the fund?

Does the board receive the required information and assistance from counsel, fund accounting, fund compliance, and fund outside auditors?

Do board members effectively raise issues and concerns with service providers?

Is the interface with the chief compliance officer appropriate?

Leadership:

Do board and committee chairs set a tone that encourages full participation, independent thinking, open communication, and a healthy airing of all of the issues prior to their resolution?

Is the board effective in setting a "tone at the top" for legal and ethical expectations?

Has the board adopted and communicated policies and procedures that are adequate to guide and support the fund?

Board Participation:

Does the board get the full benefit of the experience and skills of all of its members as applied to the issues that come before it?

Does the board work well as a team?

Does the board effectively deal with disagreements among its members?

III. Assessing Individual Board Members

Some directors believe a thorough and complete self-assessment by a board should extend beyond an evaluation of the board as a whole, and boards may want to consider whether to assess individual members as part of the self-assessment process. Self-appraisal (in which directors assess their own performance) and peer reviews (in which directors review each other) can be effective techniques for both self improvement and team building, although neither is required expressly by the Governance Amendments. The task force observes that carefully constructed individual self-evaluations can ultimately strengthen the entire board by making each board member more effective. Further, a discussion of the process may stimulate a director to look more closely at the level of his or her own participation and his or her ability to make the commitment required to effectively contribute to the board's work.[35]

Task force members recognize that director self-appraisals can be sensitive undertakings. It will be important for directors at the outset of the self-assessment process to know the evaluation criteria that will be used and how confidentiality will be maintained. Importantly, directors must feel secure that the collegiality and spirit of cooperation enjoyed by the board will not be jeopardized in the process.

Individual director self-evaluations might include such questions as:

Do I attend board meetings on a regular basis?

Am I well prepared for board meetings?

Do I participate in board meetings in a constructive and effective manner?

Am I sufficiently aware of and do I have a good understanding of the issues affecting the fund and shareholders so that I am able to provide critical oversight?

Do I approach board deliberations with a perspective independent of management?

Am I accessible to address matters that may need attention between board meetings?

Do I work well and cooperatively with the other directors, always treating each with respect?

Do I keep abreast of industry developments affecting the fund?

Am I proactive in taking advantage of opportunities to strengthen my understanding of my role as an independent director?

Most of the questions listed above also could be adapted for a peer review.[36] Introducing peer reviews into the evaluation process may be awkward for board members, and there is considerably less industry precedent for conducting peer evaluations. A board may prefer to develop experience with board and individual self-assessments before determining whether the process should evolve to include peer reviews as well. In deciding whether to incorporate a peer review into the self-assessment process, directors should understand that the purpose is not to focus on, or single out, shortcomings of any individual directors, but to identify where additional support may be beneficial to directors. The goal, as with all evaluations, is to energize the entire board across the spectrum of its responsibilities to improve its overall effectiveness in serving fund shareholders.

IV. Action Plan

A primary goal of the annual self-assessment process is to improve board effectiveness. With a comprehensive and positively approached process, directors will walk away with an in-depth understanding of the boards' collective views of its operations, if not also ideas regarding specific areas of potential improvement.

At the conclusion of the self-assessment board members should discuss the results and, as required by the Governance Amendments, minutes should reflect the substance of the matters evaluated. The task force encourages boards to develop an action plan for any matters to be pursued, including a timeline and follow-through program. At subsequent meetings there should be a discussion regarding the status of implementation and minutes of these meetings should record progress on and completion of the action plan.

Appendix: Board Self-Assessments: Seeking to Improve Mutual Fund Board Effectiveness Task Force

Paul Ades	Certain Smith Barney Funds
Herbert Eggerding	Thrivent Funds
David Gunning	MFS Funds
Debra McGinty-Poteet	Brandes Investment Funds
Peter Meenan, Task Force Chair	MainStay Funds Vantagepoint Funds
Anne Mills	Aquila Group of Funds
James Peterson	American Funds
Donald Romans	Burnham Investors Trust The Phoenix Funds
Patrick Simpson	Columbia Funds
Marcia Wallace	North Track Funds
Jon Zeschin	ICON Funds

The task force wishes to extend its sincere gratitude to David A. Sturms, Shareholder, Vedder, Price, Kaufman & Kammholz, P.C., for his invaluable contribution to this report.

Notes

[1] See Investment Company Institute, *Enhancing a Culture of Independence and Effectiveness, Report of the Advisory Group on Best Practices for Fund Directors* (June 24, 1999) 29–30 (Advisory Group Report), available at http://www.idc1.org/getPublicPDF.do?file=11070.

[2] Investment Company Act Release No. 26520 (July 27, 2004) (Adopting Release), available at http://www.sec.gov/rules/final/ic-26520.pdf; see also Investment Company Act Release No. 26323 (January 15, 2004) (Proposing Release), available at http://www.sec.gov/rules/proposed/ic-26323.htm. The SEC adopted amendments to rules (Governance Amendments) under the Investment Company Act of 1940 (Investment Company Act) intended to enhance the independence and effectiveness of fund boards. The Governance Amendments require funds to adhere to certain fund governance standards if they rely on certain exemptive rules under the Investment Company Act. These rules include Rules 10f-3, 12b-1, 15a-4(b)(2), 17a-7, 17a-8, 17d-1(d)(7), 17e-1, 17g-1(j), 18f-3, and 23c-3 (collectively, the "Exemptive Rules"). For purposes of this report, it is assumed that all funds rely on the Exemptive Rules.

With respect to the timing of the board self-assessments, IDC confirmed with SEC staff that the first self-assessment must be accomplished no later than January 16, 2007. Conversation between C. Hunter Jones, Assistant Director, Office of Regulatory Policy, Division of Investment Management, Securities and Exchange Commission, and Lisa C. Hamman, Assistant Counsel, Independent Directors Council (January 14, 2005).

[3] Data compiled from the Investment Company Institute *Directors' Practices Study* (July 25, 2003) (Directors' Practices Study).

[4] See Adopting Release, supra note 2, at pp. 24–25.

[5] Id. at p. 25.

[6] Where boards have used questionnaires to conduct directors' evaluations, the most prevalent practice the task force has seen has been a form of questionnaire that presents declarative statements about aspects of the board's operations and requests a graded response to each. For example, "The minutes of board meetings adequately reflect the considerations of and determinations by the board." The form might ask for a "satisfactory/unsatisfactory" response or an indication ranging from "outstanding" to "needs significant improvement." Explanatory comments or examples typically are encouraged.

[7] Adopting Release, supra note 2, at p. 25.

[8] Courts have long recognized the attorney-client privilege and the work product doctrine to protect and promote free and open communications between attorney and client, and to protect attorney work-product from normal discovery processes. See 8 J. WIGMORE, EVIDENCE, § 2290: 542–43 (McNaughton rev. ed. 1961) (discussing attorney-client privilege); Edna A. Epstein, *The Attorney-Client Privilege and the Work-Product Doctrine:* 479 (4th ed., A.B.A. 2001) (discussing work-product doctrine). The task force understands that some courts also have recognized the "self-critical analysis" or "self-evaluation" privilege to further strong public interests in critical self-evaluations that might otherwise be curtailed if subject to normal discovery processes. See, e.g., *Clark v. Pa. Power and Light Co.,* No. 98-3017, 1999 U.S. Dist. LEXIS 5119 (E.D. Pa. 1999) (protecting disclosure of a confidential self-evaluation process under the self-critical analysis privilege); *Flynn v. Goldman, Sachs & Co.,* 1993 WL 362380, 1–2 (S.D.N.Y. 1993) (recognizing privilege where "an intrusion into the self-evaluative analyses of an institution would have an adverse affect on the [evaluative] process, with a net detriment to a cognizable public interest"). Each of these legal principles may have application to communications, reports, and work product in connection with board self-assessments.

The task force recognizes that while the prevalent industry practice is for independent directors to retain counsel separate and independent from management, not all fund boards operate this way. In circumstances where "interested" directors will participate in the self-assessment, directors should seek counsel's advice regarding the applicability of the attorney-client privilege.

[9] Both counsel and the directors should consider taking appropriate steps to designate communications with counsel as privileged and to preserve the confidential nature of these attorney-client communications.

Matters that arise in a self-assessment also may encompass conduct or events that are the subject of pending or threatened claims, litigation, or government investigations and enforcement actions. Counsel should exercise care to recognize and preserve the confidentiality of attorney work product with respect to such matters.

[10] Rule 0-1(a)(7)(ii) under the Investment Company Act requires disinterested directors of a fund to select and nominate any other disinterested directors of the fund.

[11] See Adopting Release, supra note 2. See also Independent Directors Council, *Implementing the Independent Chairperson Requirement, IDC Task Force Report* (January 2004). A fund's board must continue to satisfy the Investment Company Act prerequisites for board composition and the task force reminds directors of Rule 31a-2(a)(4) under the Investment Company Act, which requires funds to maintain any documentation, including questionnaires, used to determine that a director is not an interested person of the fund.

[12] See *Advisory Group Report,* supra note 1, at pp. 11–12; see also *Best Practices and Practical Guidance for Mutual Fund Directors, Report of the Mutual Fund Directors Forum* (July, 2004), at p. 7 (MFDF Report).

[13] See Rule 2(a)-19 under the Investment Company Act (defining the term "interested person") and Section 10(a) of the Investment Company Act (mandating at least 40 percent of directors on fund boards not be "interested persons" of the fund). See also Governance Amendments, supra note 2 (mandating at least 75 percent of directors on fund boards not be "interested persons" of the fund).

[14] See *Advisory Group Report,* supra note 1, at p. 13.

[15] See Investment Company Institute, *Resolution of the Board of Governors of the Investment Company Institute* (Oct. 3, 2003).

[16] See Adopting Release, supra note 2, Dissent of Commissioners Cynthia A. Glassman and Paul S. Atkins, at fn. 35. Form N-CSR, adopted by the SEC pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 and implemented by amendment to Rule 30b2-1 under the Investment Company Act, requires an investment company to disclose whether it has at least one "audit committee financial expert" serving on its audit committee (See Item 3 of Form N-CSR).

[17] Adopting Release, supra note 2, at p. 25.

[18] Recently, in response to expanded board compliance oversight responsibilities generated by new Rule 38a-1, some boards have established compliance committees responsible for (i) overseeing the chief compliance officer's implementation and administration of the funds' compliance policies and procedures and monitoring the chief compliance officer's oversight of the compliance policies and procedures of the funds' service providers; (ii) recommending to the full board the appointment, compensation, and/or removal of the chief compliance officer; and (iii) receiving all reports delivered by the chief compliance officer between board meetings.

[19] For example, recent commentators have recommended that fund boards designate a committee, comprised of some or all of the board's independent directors, to ". . . oversee . . . the review process . . ." in connection with the board's annual consideration of the renewal of the fund's agreement with its investment adviser. See MFDF Report, supra note 12, at p. 28. A board might consider whether its review of this critical relationship could be materially enhanced by establishing such a "contracts" committee.

[20] Rule 32a-4 under the Investment Company Act exempts investment companies from the requirement that the selection of a fund's independent public accountant be submitted for ratification or rejection at the next annual shareholders' meeting if the board has established an audit committee composed ". . . solely of directors who are not interested persons of . . ." the fund. See also Rule 10A-3(b)(1)(iii) under the Securities Exchange Act of 1934, which requires a listed closed-end fund's audit committee to be comprised solely of independent directors and has been viewed by commentators as a "best practice" for open-end funds. See American Bar Association Section of Business Law, *Fund Director's Guidebook* (2d ed. 2003) at p. 12 (Director's Guidebook). See also supra note 10.

[21] The Maryland Corporation Code provides that a director is entitled to rely on information prepared or presented by a committee of the board on which the director does not serve if the director reasonably believes the committee merits confidence. Maryland General Corporation Law §2-405.1(b)(1)(iii).

[22] See *Directors' Practices Study,* supra note 3, at 3.2.

[23] See Adopting Release, supra note 2, at pp. 18–19.

[24] Rule 0-1(a)(7)(vi) under the Investment Company Act. See also *Advisory Group Report,* supra note 1, at p. 24.

[25] See *Directors' Practices Study,* supra note 3, at 3.5.

[26] See Adopting Release, supra note 2.

[27] The Independent Directors Council has formed a task force, consisting of 14 independent directors, to study and issue a report on issues relating to director oversight of multiple funds. For purposes of this report, the task force considers each investment portfolio that reports performance separately as a single "fund."

[28] See Proposing Release, supra note 2.

[29] See "Depending on Independent Directors," *Wall Street Journal,* October 18, 2004 (quoting one director as saying ". . . workload is up a minimum of 50 percent from two years ago, but it's probably more than that.").

[30] See C. Meyrick Payne and Jock Patton, *Governing Many Funds with a Single Board*, Mutual Fund Governance, available at http://www.mfgovern.com.

[31] The task force acknowledges that the adequacy of directors' and officers' liability insurance coverage and indemnification also is critical to attracting and retaining qualified directors and, in that context, is a subject closely related to compensation. While the Task Force recognizes that the adequacy of the directors' protection from personal liability could be included in a self-assessment program, D&O/E&O insurance otherwise is subject to in-depth consideration and analysis by a board on an annual basis.

[32] See, e.g., Advisory Group Report, supra note 1, at pp. 16–17; MFDF Report, supra note 12, at p. 10; and Director's Guidebook, supra note 20, at p. 26.

[33] See Advisory Group Report, supra note 1, at p. 17.

[34] The task force notes that disclosure of these items is required in a fund's statement of additional information. See Item 12 of Form N-1A.

[35] A fund's organizational documents often include provisions for the resignation and removal of board members.

[36] Beginning each of the above questions with "Do all of the directors . . . " or "Are all of the directors . . . " (versus "Do I . . . " or "Am I . . . ") could be an alternative way to address these subjects. If responses to the alternative questions suggest some shortcomings, directors may wish to follow-up with additional questions regarding individual director performance.

Director Oversight of Multiple Funds

MAY 2005

Preface—May 2009

Corporate and fund governance received much attention from regulators and the media during the early part of the decade, and director oversight of multiple funds within a fund complex was among the fund governance issues raised. Although Congress and the U.S. Securities and Exchange Commission (SEC) increased regulation in a number of areas, neither attempted to impose an arbitrary limit on the number of funds directors may oversee. Rather, the SEC identified oversight of multiple funds as a matter that should be addressed in the self-assessment process.

IDC's task force paper on *Director Oversight of Multiple Funds* (issued in May 2005) was written to promote better public understanding of why fund boards oversee multiple funds as well as to assist fund boards in evaluating this issue in their self-assessment process. The report describes the prevalent fund and board structures and explains the efficiencies associated with oversight of multiple funds, including common regulatory structure, common personnel and service providers, and complex-wide oversight mechanisms. The report also discusses strategies to facilitate oversight of multiple funds, including board organization and composition, frequency of meetings, and use of committees. The report is a useful resource for boards who, as part of the annual self-assessment, periodically evaluate their fund and board structures and their oversight of multiple funds.

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Executive Summary

- » The unitary or cluster board structure, in which directors oversee all or many of the funds in a complex, is prevalent in the industry and is consistent with good governance.
- » Neither Congress nor the Securities and Exchange Commission have found that imposing an arbitrary limit on the number of funds a director may oversee would be in the best interests of shareholders. Rather, the SEC has required that boards evaluate their performance in this regard as part of an annual self-assessment.
- » Mutual funds within a fund family share the same investment adviser and other key service providers and, as a result, significant efficiencies are realized when a single or limited number of boards oversees all of the funds.
- » Independent directors control who serves as an independent director and the amount of compensation for each director. Control of these processes by independent directors is a critical factor in assuring director independence.
- » Oversight of significant assets enhances a board's knowledge and expertise and its ability to influence fund management and key service providers and, as a result, enhances the board's effectiveness in serving the interests of shareholders.
- » The tasks of a fund director involve a common regulatory structure, common personnel and service providers, and oversight mechanisms that are complex-wide. These tasks contrast significantly with the role of a corporate director that, in many cases, involves oversight of multiple product lines, several business units, numerous business plans and management teams, and diverse regulatory structures and compliance issues.
- » Mutual fund boards have developed a number of techniques and strategies that address the challenges inherent in the oversight of multiple funds and that enable directors to meet their responsibilities to shareholders.
- » Limiting the number of funds a director may oversee is not only inefficient, it would result in significant additional management, service provider, and director costs to shareholders.
- » Board annual assessments provide an opportunity for boards to periodically evaluate their ability to continue to provide appropriate oversight to the number of funds for which they are responsible. A board can take into account a number of relevant factors, including the types of funds involved, the support the board receives and the strategies the board uses to manage its workload.

Introduction

Today, corporate governance—and mutual fund governance in particular—are topics receiving much attention. Fund governance is important in achieving shareholder goals because good governance by its nature puts the interests of shareholders first. The public discussion of governance issues has included an examination of the issue of director oversight of multiple funds within a fund complex. However, wisely in our view, neither the Congress nor the Securities and Exchange Commission has attempted to impose an arbitrary limit on the number of funds a director may oversee. The SEC has identified this as a matter that should be specifically included in the annual board self-assessment.[1]

The Independent Directors Council[2] formed a task force of independent directors to study fund oversight, and to examine the specific issue of director oversight of multiple funds.[3] This report, which reflects the directors' collective views of this issue, is intended to promote better public understanding of this aspect of fund governance and to assist fund boards as they undertake the self-assessment process.

This report will first outline the fund and board structures that are prevalent in the mutual fund industry today. It then will analyze the efficiencies and other advantages that these structures provide to fund directors in fulfilling their oversight responsibilities, and discuss the governance arrangements and strategies that mutual fund boards and their independent directors commonly rely upon to facilitate oversight of multiple funds. Finally, the implications of arbitrarily limiting the number of funds overseen by an individual director will be presented.[4]

I. Prevalent Fund and Board Structures

There are unique structural aspects of mutual funds that must be understood to assess whether any group of directors has undertaken oversight of "too many funds." The industry's structure differs substantially from that of public operating companies, making the implications of a director's oversight of multiple funds quite different from the implications of oversight of multiple operating companies.

What is commonly referred to as a mutual fund is an investment company—an entity that is organized under state law (as a corporation or business trust), that is registered with the SEC, and that is required to have a board of directors or trustees. An investment company may have one or more portfolios.[5] A mutual fund family or complex is comprised of a number of investment companies and the portfolios they include. In most cases, different investment companies within the complex are overseen by one or only a few groups of directors. When a single board of directors oversees all of the investment companies (and associated portfolios), this is known in the industry as a unitary board structure. In a cluster board structure, a complex will have several separate boards overseeing different groups or clusters of investment companies. The cluster or grouping of investment companies under a given board may be deliberate—dictated by investment or distribution considerations, for example. It also may be a result of the history of a fund complex—for example, the merger of fund families that were sponsored initially by different fund management firms and whose investment companies therefore had different boards prior to the merger. Surveys conducted over the years by the Investment Company Institute indicate that, while unitary boards are by far the most prevalent structure, cluster boards are not uncommon.[6]

There are sound practical and economic reasons that unitary or cluster board structures predominate in the industry. Most of the investment companies (and their portfolios) within the same family or complex are created by the same fund management firm and have a common investment adviser, principal underwriter, and administrator. They commonly receive necessary services (including, for example, portfolio management, shareholder recordkeeping, custody of fund securities, distribution of fund shares, legal counsel, and auditing) from the same entities. Investment company complexes are organized around these common operating features and are designed to take advantage of the efficiencies inherent in single service providers, as described in more detail below. It is unnecessary (and undesirable in terms of cost and administrative burdens) to require each investment company to have a separate board performing similar if not identical functions.

The task force recognizes that some of the commentators suggesting a limit to the number of funds a director can oversee have sought to equate the task of the mutual fund director with that of a corporate director. They have suggested that recommended limits on board memberships for corporate board members might be appropriate for fund directors. In the view of the task force, this analysis is overly simplistic and is not instructive for those seeking to evaluate how fund directors are able to effectively manage their workload. An independent director of a major corporation typically oversees many separate business units in numerous diverse industries, involving different business plans, management teams, workforces and locations, and regulatory and compliance concerns. These companies frequently engage in acquisitions and dispositions that require substantial attention from their boards. In addition, the tax and accounting issues facing these companies are numerous, complex, and specific to different business lines. Directors of these companies are expected to be familiar with all these matters.

The responsibilities of mutual fund directors, on the other hand, are more focused. Fund directors are charged with having a basic knowledge of the Investment Company Act of 1940 (1940 Act) and those portions of the other securities laws that relate to mutual funds. These laws are applicable across all funds that the director serves and relate to parties and relationships that are often common across an entire fund complex. Mutual fund accounting is quite straightforward and is similar, if not identical, across all funds in the complex. Because the major public company and the mutual fund are not comparable, the task force concluded that it is not appropriate to draw conclusions about the ability of a mutual fund director to serve multiple funds by looking at whether it would be feasible for the same individuals to serve effectively on the boards of numerous operating companies.

An essential component of fund structure is how and by whom fund directors are selected and compensated. Some commentators have suggested that directors who oversee multiple funds become captive to management; however, this assertion ignores the fact that independent directors nominate and elect independent directors[7] and determine the amount and method of their compensation, compensation that is paid by the funds, not by the management company. The fact that management companies do not control who serves as an independent director on a fund board or how much fund directors are paid is a critical factors in assuring director independence.

II. Efficiencies of Board Oversight of Multiple Funds

The practice of having a board oversee multiple funds or portfolios that is prevalent within the mutual fund industry is not a historical accident. Rather, it is a logical approach to corporate governance, derived from the unique features of mutual funds.

There are several reasons for this. First, due to the detailed regulatory scheme established under the 1940 Act, which governs all mutual funds, the issues faced by fund directors generally apply to all of the funds that they oversee. Second, because all funds within the same complex generally are served by common personnel and utilize common service providers, the manner in which these issues are addressed tends not to vary much, fund-by-fund. Third, the mechanisms that boards use to assist in their oversight of funds and fund service providers generally apply on a complex-wide basis. Fourth, the practice of having a single board oversee all of 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.

A. Common Regulatory Structure

In addition to the duties under state law of care and loyalty that are common to all directors, mutual fund directors are subject to a series of specific obligations imposed under the 1940 Act and under various SEC rules and interpretations. Most of the duties—and the standards by which fund directors discharge them—apply in the case of all funds.

For example, fund directors are required to, among other things: establish standards for the valuation of portfolio securities; review the liquidity of certain types 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 the same complex.

In addition, all funds are subject to the same disclosure standards, and many specific disclosures are similar for funds in the same complex, which can facilitate director review of documents such as registration statements and shareholder reports. Fund accounting issues are similar across the entire complex and fund-specific issues such as pricing of portfolio securities are easily identified.

Certain director obligations require analysis on a more fund-specific basis. Perhaps the best examples of this are the board's annual review of the advisory contract and the board's evaluation of fund performance. Obviously, a board must evaluate each fund's fees and expenses and investment results. But, even in this case, many factors the directors must consider will be common to all of the funds within a complex, such as the nature and quality of shareholder services, the adviser's compliance record and systems relating to portfolio trading practices. In addition, in order to assess profitability and economies of scale, a fund board must understand the methodologies used by the adviser to allocate costs and profits among all funds in a complex.

Other issues can arise that involve a particular portfolio, or group of portfolios. For example, international equity and high yield bond funds may be more susceptible to market timing and may present more substantial issues of fair valuation. Still, boards benefit from being able to apply their expertise when a similar issue arises in the cases of other portfolios (e.g., market timing and valuation issues for small-cap equity funds).

B. Common Personnel and Service Providers

Business operations for mutual funds within a complex tend to be quite similar, as all funds generally are served by the same executive management team and external service providers. Almost all funds are externally managed; the funds' investment adviser, which is responsible for portfolio management and often numerous other services, performs these services pursuant to a written contract with the funds. (The adviser is most often the sponsor that formed the funds in the first instance.) In the case of complexes of funds that are internally managed, the same personnel typically service all of the funds in the complex.

Similarly, funds within the same complex generally have a common principal underwriter, transfer agent, and administrator (if the fund has a separate administrator). Funds within a single complex often have the same custodian as well, although it is not uncommon for there to be more than one custodian assigned to certain funds

in a complex with particular safekeeping issues. Funds within a single complex also generally have common professional service providers, such as fund counsel and fund auditors. (Occasionally, a fund complex may use two or more audit firms, each of which audits different funds in the complex.) Other entities that provide services to funds—such as insurance carriers and pricing services—also generally provide these services to all of the funds within a complex.

Because all portfolios within a fund family tend to have common management and external service providers, policies and practices within a fund family, as well as contractual arrangements, are fairly uniform. Examples of these include shareholder services (e.g., exchange privileges, on-line services); compliance monitoring procedures (including funds' codes of ethics); proxy voting policies and procedures; anti-money laundering procedures; Regulation S-P (privacy) policies and procedures; brokerage allocation and soft dollar policies; fair valuation policies and procedures; and arrangements with dealers and other intermediaries. The task force believes that it is generally far more efficient to have a single board review these common policies and procedures, and oversee common arrangements, than to have multiple boards do so. In addition, in cases where a board concludes that changes in fund policies, procedures, or arrangements are warranted, it will invariably be far easier to implement such changes on a complex-wide basis than in a piecemeal fashion (which could easily occur if different boards were to come to different conclusions).

C. Complex-Wide Oversight Mechanisms

The mechanisms that directors employ to facilitate their oversight of funds tend to be uniform across a fund complex. Perhaps the best example is implementing the SEC's new rule[8] requiring that each fund have a chief compliance officer ("CCO"). All funds within a complex generally have a common CCO. Under Rule 38a-1, the CCO is required to report directly to the fund board and meet at least annually with the independent directors in executive session. As the SEC stated in the release adopting Rule 38a-1, "The rule provides the board with a powerful tool to exercise its oversight responsibilities over fund compliance matters . . . Under the new rule, the chief compliance officer will be responsible for keeping the board apprised of significant compliance events at the fund or its service providers and for advising the board of needed changes in the fund's compliance program."[9] The Commission noted as well that the appointment of a chief compliance officer was intended to replace practices that "balkanize responsibility for fund compliance."[10] Thus, the compliance rule clearly envisions a unified compliance program under the overall supervision of a single or limited group of fund directors.

Directors also employ other service providers, such as contract analysis consultants. These entities typically provide services with respect to all funds within a complex. Finally, directors rely heavily on fund auditors. The relationship between fund auditors and fund directors is especially important; the task force believes that it is critical that directors maintain a strong and ongoing relationship with senior members of the fund audit team. Doing so promotes better monitoring of the audit function and of auditor independence.[11] This is much easier if the auditors report to a single board, or a few cluster boards, than to many different fund boards.

D. Enhanced Board Influence

The fourth, and perhaps most important, reason why multiple fund oversight is an effective structure is that it enhances a board's ability to oversee and influence fund management and key service providers and, as a result, enhances the board's effectiveness in serving the interests of fund shareholders. The members of the task force

strongly believe that a board's influence with management is greatest when the board oversees a significant portion of the firm's fund assets under management. Dividing fund boards into smaller groups would diffuse influence by spreading it among a number of boards, no one of which may have the authority to influence the management of a major asset pool or a large number of funds. Single fund boards lose one of the board's key bargaining issues—economies of scale. The task force also believes that a unitary board has a greater ability to negotiate with management over matters such as fund fees and expenses; the level of resources devoted to technology, compliance and audit functions; and contingency planning. Management is also more readily able to respond to a request for a change in policy or for additional information when it comes from a single board or limited number of boards rather than many boards, thus minimizing the delay or inaction caused by the need to coordinate multiple and possibly inconsistent requests.

A board that oversees multiple funds also is more likely to have extensive contact with senior management, and to develop an ongoing and productive dialogue with them. If management must attend to a large number of fund boards, it most likely would delegate the responsibility of dealing with directors to a team of less senior and perhaps more specialized staff members. This team would sit between the board and management, impairing significantly the ability of board members to influence senior management. Direct contact makes it easier for the board to gain a thorough understanding of the integrity and overall attitude of the management team. As past scandals demonstrate, this type of oversight may ultimately prove to be the most important to the general welfare of fund shareholders.

For all of the foregoing reasons, the task force believes that the practice of director oversight of multiple funds within a single fund family is optimal and serves fund shareholders well.

III. Strategies to Facilitate Oversight of Multiple Funds

Notwithstanding the benefits of overseeing a large number of funds, the task is demanding and time-consuming. It necessarily generates more work for the directors on the board and requires a greater time commitment from each.[12] As the number of funds increases, boards have developed a number of strategies and techniques that address the challenges inherent in the oversight of multiple funds and that enable directors to meet their responsibilities to shareholders. Boards should consider whether these strategies might contribute to the effectiveness of their operations.

A. Organization and Composition of the Board

The board should organize itself in a way to facilitate oversight of multiple funds. This may include consideration of a unitary or cluster board structure and the use of committees discussed in this report. The board should regularly evaluate its structure, as well as its composition to ensure that it is adequate to undertake the responsibilities assigned to it. The size of the board and the competence and experience of the directors also are relevant areas of inquiry. It may be necessary for the board to add members so that it is of sufficient size and includes directors with requisite expertise (e.g., financial expert) to perform its oversight role most effectively.

B. Frequency of Meetings

The number of funds a board oversees may dictate a need to increase the number of meetings the board holds each year. This may be accomplished by increasing the number of times the board meets and/or by extending the

meetings to more days. In either case, the board should ensure that it has reserved adequate time for a thorough review of complex-wide—as well as fund specific—matters. This determination is directly related to the structure of the meetings and the development of other good governance practices.

C. Good Governance Practices

Directors should examine the structure of board meetings to ensure that the meetings are productive and efficient and that materials are easily understood and accessed. In addition, each board should develop, with the assistance of counsel and the CCO, an annual calendar of required actions so that it can assess the full scope of these requirements and plan accordingly.

Faced with mounting obligations, boards have developed a number of strategies to manage the workload. These include: (1) chair development of board agendas and coordination of materials well in advance of meetings to assure that the independent directors have necessary data in a useful format and that they meet with the personnel they wish and need to see;[13] (2) determining, organizing, and managing the nature and length of all board presentations;[14] (3) staggering contract renewals so that a discrete number of contracts are reviewed at each meeting;[15] and (4) grouping contract renewals by fund type to enable board members to more easily consider renewal data such as expenses and fees charged by comparable funds.

D. Use of Committees

Boards that oversee many funds often make extensive use of committees to manage the workload. Committees can be tasked with performing some of the background or detail-oriented work, thus preserving the board time for reports and discussion.[16] It may be logical to divide responsibilities among committees for particular fund types or distribution channels. Use of committees may be particularly effective in connection with the processes for contract renewal and portfolio performance review. Some fund complexes divide the in-depth review of contracts among various board committees, for example; one for equity funds, one for municipal bond funds, one for taxable, fixed income funds, etc. Others delegate the more detailed work to a contract committee.[17]

E. Professional Assistance for the Board

Each board should consider the professional assistance that may be required for the board to oversee multiple funds effectively. This may consist of assistance from fund management, independent counsel, outside consultants and service providers, or staff hired by the board. Many boards are able to call upon personnel of the management company on an ongoing or as-needed basis to assist the board. Areas where this may be particularly helpful include addressing individual fund performance and conducting risk assessments of investing in new types of instruments.

Boards should have access to the assistance of independent counsel. Independent counsel's expertise is critical to ensuring that all regulatory requirements are met. In addition, his or her familiarity with practices of a number of boards may result in new ideas for workload management. Boards also may elect to take advantage of other professionals to assist in various aspects of their work. Many boards employ third party consultants to assist with contract renewal. Boards use these third party consultants to assemble and present data, and work with these consultants to assure that the presentation format and content are focused and easy to use.[18] For example, data on fees and expenses of comparable funds can be presented in bar graph, pie chart, or scatter graph format, which

permits a director to see instantly where any fund stands in relationship to comparable funds. Much of the data used draws upon databases with which directors become very familiar over time.

F. Transferring Information Outside of Meetings

Technological advances belie the arguments of some who contend that directors overseeing multiple funds are not capable of reviewing information necessary to approve contracts. Many fund complexes have sophisticated methods for transferring information.[19] Under these systems, directors receive data throughout each year and substantially in advance of each meeting. By the time a director attends a committee or board meeting at which contract approval is to be considered, a massive information transfer already has occurred and the director has done a significant amount of homework. These innovations have made it even easier for board members to ensure that board meetings are productive.

In fact, some director tasks that are unique to each fund occur outside the boardroom. So, even if a director oversees a large number of funds, the detail work is performed in advance of meetings and need not be discussed at the actual meeting. For example, the review of registration statements, proxy statements, and of semi-annual and annual reports may be board homework, accomplished whenever the fund director chooses to devote attention to these matters.

IV. Impact of Limiting the Number of Funds Overseen by Fund Directors

The number of funds within a complex that a director oversees is not a determinative factor in analyzing his or her ability to effectively serve shareholders. While there may be circumstances where a limit on the number of funds would be appropriate, the task force believes that this would, in the vast majority of cases, not be in the best interests of shareholders, as those shareholders would lose the benefits of oversight of multiple funds. As noted above, limiting oversight to some arbitrarily established number of funds would not, for example, improve the contract renewal process. Instead, it could reduce the ease of access to key personnel and service providers. In fact, many independent directors believe that they better serve each fund in their group because of the experience they have gained from oversight of a wide variety of funds: they are familiar with complex-wide data and their knowledge of the data content across the entire complex facilitates critical analysis. Similarly, limiting the number of funds a director may serve would not improve the ability of boards to oversee fund compliance and risk management or to deal with pricing issues because these issues are, for the most part, not sensitive to the number of funds the director is overseeing.

A. Further Inefficiencies and Increased Costs

Thus report has outlined some of the large scale efficiencies that are realized through oversight of multiple funds. Limiting the number of funds overseen by directors could create a number of inefficiencies on a smaller scale, the impact of which could be significant additional cost. By way of illustration, if there were 10 separate boards overseeing 14 separate funds each, as opposed to one board overseeing 140 funds, and management representatives and service providers were required to meet with each separate board, costs would increase exponentially, and the time commitment of all persons who interact with the board regularly would increase several-fold. This would result in considerable duplication of board expense and efforts by all service providers. It also would deploy resources away from other matters important to shareholders interests.

There are several specific areas where the inefficiencies presented by such a proposed structure are readily apparent. First, additional staffing would certainly be required to attend to the additional boards on an ongoing basis.[20] Second, the time and personnel needed to prepare for meetings would increase. Additional time allowances would be needed to collect and organize the materials for each meeting, review the agenda and materials in advance with each independent chair,[21] and to consult with the CCO, general counsel, board counsel, and independent auditors.

Meeting time also would increase. There would be duplication of service provider presentations, approvals, and documentation, notwithstanding the fact that these would be substantially identical for each fund.[22] Individual boards also could develop policies and procedures that differ from one another without substantive effect and that require different reports from the management company and external service providers.

Communication among boards and between multiple boards and the management company would require time and coordination, significantly reducing the prospect of a speedy resolution of issues. It also significantly reduces prospects for harmonizing matters within a fund family, including policy positions, regulatory procedures, board compensation, and committee structure. Consider, for example, if a consensus has to be reached regarding a complex-wide issue (e.g., the performance and pay of the CCO). Collecting information from all of the boards, reconciling differences, and reaching a final conclusion would require substantial time and energy. This process would detract from the energy and resources that directors should be devoting to more substantive issues and would be contrary to the best interests of shareholders.

Expenses would unquestionably increase as a result of these inefficiencies. This increased cost would either be passed on to fund shareholders, result in increased management resistance to fee reductions, or a combination of both. The attention of the management company also would be deflected from managing the funds toward managing relationships with multiple boards. In addition, travel and attendance fees of independent directors, which are a fund expense, would increase.

B. Other Possible Negative Consequences

Beyond the specific adverse consequences described above, the task force believes that there may be additional, less obvious, negative consequences to limiting the number of funds a director may oversee. It is quite conceivable that, faced with significantly increased costs and time commitments in dealing with multiple boards, management companies may be less willing to introduce or maintain niche funds targeted to a smaller investor audience. This would not only deny investors in those target audiences the opportunity to invest in new types of funds, it also might impede industry innovation. Many funds popular today, including money market funds, managed municipal bond funds, and sector funds, began as niche products.

Serving on a board that oversees multiple funds is a time-consuming and challenging job, and requires, as funds under management increase, a very significant commitment from board members. A fund group that employs a structure comprised of many boards may find it more difficult to attract directors of the highest caliber.

Conclusion

The members of the task force are of the unanimous view that a unitary or cluster board structure is the most efficient structure for a mutual fund family, and that any arbitrary limit on the number of funds within a complex that could be overseen by a director would be counter-productive and harmful to fund shareholders. As a general matter, the task force believes that the burdens on fund directors do not increase significantly as the number of funds they oversee increases. In fact, significant benefits arise when a director oversees all, or a significant portion of, funds in a single family, both in terms of efficiencies and in terms of effectiveness of the directors in protecting the interests of fund shareholders. At the same time, the task force recognizes that directors face additional challenges as the number of funds that a board oversees increases. A director's capacity to address these challenges successfully and undertake oversight of multiple funds depends on many factors, including the types of funds involved, the support the board receives, and the strategies the board uses to manage its workload. The task force believes that all boards must assess, as part of the annual assessment process, their own unique circumstances and the board structure, and the optimal number of funds monitored by each director that is most effective and best serves their shareholders.

Appendix: Direct Oversight of Multiple Funds Task Force

James H. Bodurtha	Merrill Lynch Funds (38 Funds with 55 portfolios)
Peter Brown	TT International Funds and Capital Growth Management Group (6 Funds)
Dawn-Marie Driscoll	Scudder Funds (48 Funds)
William H. Foulk, Jr.	AllianceBernstein Funds (47 Funds)
Sam Freedman	OppenheimerFunds (38 Funds)
Armon Kamesar	Smith Barney Funds (30 Funds)
Robert E. LaBlanc	Prudential Funds (91 Funds)
Marvin L. Mann	Fidelity Funds (300 Funds)
Robert D. Neary	Armada Funds (32 Funds)
Ruth H. Quigley	AIM Funds (113 Funds)
Patricia L. Sawyer	Diversified Investment Advisors (64 Funds)
Robert Straniere	Reich & Tang Funds (9 Funds)
Roger B. Vincent	ING Funds (142 Funds)

Notes

[1] See Investment Company Act Release No. 26520 (July 27, 2004) (Adopting Release), available at http://www.sec.gov/rules/final/ic-26520.pdf. The SEC noted in the release proposing the rule requiring self-assessments that the self-assessment should involve a careful evaluation of whether directors “have taken on the responsibility of overseeing too many funds.” Investment Company Act Release No. 26323 (January 15, 2004), available at http://www.sec.gov/rules/final/ic-26323.pdf.

[2] The Independent Directors Council serves the mutual fund independent director community and provides a venue to advance the education, communication, and policy positions of mutual fund independent directors.

[3] The task force members, who individually oversee as many as 300 funds and as few as 6 funds, are listed at Appendix A.

[4] This paper covers service on both open-end and closed-end fund boards, although the term “mutual fund” technically does not include closed-end funds.

[5] A single investment company may have numerous portfolios that differ from each other principally with respect to their investment objectives and strategies, and their fees. This type of investment company, frequently called a series fund, may include—and its board would oversee—a variety of different stock, bond, balanced, or money market portfolios. Each of these portfolios is not a distinct corporate entity under state law (although each is regarded for certain federal securities laws purposes as an individual fund).

[6] As of year-end 2002, 77 percent of the fund complexes participating in an ICI study reported that they had a unitary or pooled board structure; 15 percent had a cluster board structure. Data compiled from the Investment Company Institute Directors' Practices Study (July 25, 2003).

[7] Funds relying on certain popular exemptive rules currently are required to have a majority of the directors as independent directors. In January 2006, the percentage of the board that must be independent directors increased to 75 percent. With this distinct majority, they can elect independent directors of their choosing to the board. See Rule 0-1(a)(7) of the 1940 Act [Editor's note: The 75 percent independent director requirement was later invalidated, in April 2006, by an appellate court. See *Chamber of Commerce v. Securities and Exchange Commission,* 443 F.3d 890 (DC Cir. 2006). Nevertheless, the vast majority (88 percent) of fund complexes participating in the ICI/IDC Directors Practices Study reported that, as of year-end 2007, 75 percent or more of the board seats are held by independent directors]. Obviously, management directors are elected by the entire board. Board processes as to the selection of management directors vary.

[8] Rule 38a-1 under the 1940 Act.

[9] *Compliance Programs of Investment Companies and Investment Advisers*, Investment Company Act Rel. No. IC-26299 (December 17, 2003).

[10] Id. at p. 12.

[11] There also are efficiencies in terms of cost and time. Auditors are required to make nearly identical presentations to each board. Because the scope of the audit doesn't change, considerable time is saved by making a single presentation to a single board. Furthermore, audit system improvements can be easily implemented. Audit committee review of annual reports, which currently can be managed in groups of similar funds whose audit issues such as pricing of portfolio securities are similar, are streamlined.

[12] Individual directors who are being recruited by fund groups should understand the time commitment involved before they join a board. This commitment should extend beyond attending board meetings to cover extensive time preparing for board meetings, the initial education effort to familiarize the director with the activities of the fund complex, and a commitment to ongoing education through attendance at industry conferences and seminars. In some cases, it may be necessary for the director to agree to limit other outside commitments, such as service on other fund, corporate, or nonprofit boards.

[13] See Adopting Release, supra note 1, at p. 8.

[14] For example, some boards have taken the step of limiting PowerPoint presentations.

[15] While contract renewal is an annual requirement, boards report that it is in fact an ongoing process. As a practical matter, management performance and shareholder services are reviewed at every board meeting, not just at contract renewal times. Directors and management personnel will be aware of those funds with performance issues or those funds with issues related to fees and/or expenses or service problems and these issues can be subject to an ongoing dialogue between management and the fund board. When the calendar date for contract renewal arrives, valuable meeting time can be devoted to deliberations and making the findings necessary to renew the contract. Some fund groups stagger the delivery of contract renewal presentations and conduct fund renewals at one meeting.

[16] The number and nature of committees vary among boards depending upon such factors as the types and size of funds overseen by the board.

[17] To ensure that delegation to a committee does not impair the ability of a director to raise concerns, boards often employ processes that permit any director to call for a full board review of the details of any particular contract.

[18] Although the process is complex, directors are proactive and aggressive in developing systems and procedures to manage data flow and maximize director efficiency. Directors benefit by participating in the task of formatting the data for efficient consumption because designing the format requires an in-depth understanding of the raw data and its sources. Data formatting and analysis are under constant review and changes or enhancements to contract data analysis are frequent.

[19] Some boards are now using web-based systems through which fund directors can access board materials from anywhere in the world. Emails are sent advising directors of the availability of new data. Other boards send directors information on CD-ROM.

[20] Many boards establish a management company contact person to work directly with their chairs. Managing information flow to one board is virtually a full time job. Increasing the number of boards could likely require additional personnel, with the increased risk of inconsistent communication and information.

[21] The inefficiencies would be exacerbated because independent chairs would need to spend time coordinating presentations for their respective boards.

[22] Inefficiencies also would arise in the case of issues such as pricing and fair value analytical reports, securities lending, anti-money laundering policies, privacy, accountant independence, broker-dealer marketing practices, portfolio compliance monitoring, counsel independence, compliance monitoring systems, proxy voting, insurance, human resource concerns (adequacy and competence of service provider staff), succession planning, and disaster contingency planning.

Board Consideration of Fund Mergers

JUNE 2006

Preface—May 2009

Fund mergers occur for a variety of reasons, and the number of fund mergers in any given year will vary. When IDC published the task force paper, *Board Considerations of Fund Mergers*, in June 2006, the pace of fund mergers was increasing, with more than 200 fund mergers occurring in 2005. Many analysts believe the market environment of early 2009 may lead to a large number of fund mergers.

Fund boards periodically may be called upon to act on a proposed merger. Generally speaking, directors have a responsibility to evaluate a proposed merger of funds they oversee to determine whether the proposed merger is in the best interests of those funds and their shareholders. Directors considering a proposed merger may refer to this report for practical guidance in considering issues such as comparison of the investment objectives, policies, strategies, restrictions, and risks of funds being merged; repositioning of fund securities; allocation of costs; and impact of a merger on board composition. The report also provides a list of potential questions boards may consider asking in connection with a proposed merger.

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Introduction

The pace of investment company mergers[1] has increased recently, with more than 200 fund mergers occurring in 2005.[2] In light of this activity, the Independent Directors Council convened a task force of investment company directors to review legal standards and business considerations relating to fund mergers and to offer practical guidance to boards that consider mergers of funds, particularly those boards that consider fund mergers for the first time.[3]

Directors called upon to act on a proposed merger may find it helpful to review the questions and considerations outlined in this report.[4] In analyzing the merger and its anticipated benefits to shareholders, the factors that are relevant and the weight given to each will vary depending on the facts of the merger.

Fund mergers occur for a variety of reasons. In some cases, two investment advisory organizations merge, which may result in more than one fund with substantially similar investment objectives (i.e., overlapping funds). The overlapping funds may then merge, resulting in a larger fund. In other instances, a fund may merge with another fund because it may not be economically viable on its own. This may occur, for example, when a particular market sector in which a fund invests has fallen out of favor or a fund has failed to garner sufficient assets. In still other instances, two funds that are "clones" may merge to increase economies of scale.

Other times, a fund with an attractive performance history but relatively little distribution capacity may merge into a newly created shell fund that is part of a fund complex with greater distribution capabilities. The fund's adviser may continue to manage the fund following the merger as subadviser to the fund. This type of a merger is commonly referred to as a "fund adoption" or "shell reorganization." Mergers can benefit fund shareholders by, for example, lowering expenses, creating efficiencies due to economies of scale by spreading fixed costs over a larger asset base, or providing shareholders with enhanced services.

Fund boards evaluate the proposed merger of any fund they oversee. Fund directors[5] may approve a proposed merger with a view toward reducing the number of funds or reorganizing fund product lines. This may result in more efficient portfolio management and eliminate the duplication of resources and costs associated with marketing and servicing similar funds as separate entities. A board may approve the "adoption" of a fund to provide an investment product for which the adviser does not already have the requisite investment expertise or resources. Boards may choose to merge, rather than liquidate, a fund that is not economically viable, particularly because most fund mergers are tax-free events for funds and their shareholders.[6]

Directors may receive information from counsel and the investment adviser(s) to the funds to assist them in their consideration of fund mergers. Directors typically explain the reasons for their decision to recommend that shareholders approve a merger in the fund's proxy statement. Either they, or more often, the fund's investment adviser also may send a letter to shareholders containing such an explanation.[7]

Directors overseeing fund mergers should take into account relevant state law requirements and, if applicable, Rule 17a-8 under the Investment Company Act. Generally speaking, directors have a responsibility under state law to evaluate the proposed merger of any funds they oversee to determine whether, in their business judgment, the proposed merger is in the best interests of those funds.

Rule 17a-8 regulates mergers of affiliated funds.[8] It requires a board, including a majority of the independent directors, to consider the relevant facts and circumstances with respect to a merger of affiliated funds and determine that the merger is in the best interests of each of the merging funds and that the interests of the shareholders of both the fund being acquired and the acquiring fund are not being diluted. Directors must request and evaluate any information reasonably necessary to their determinations, and consider and give appropriate weight to all pertinent factors in making their findings under Rule 17a-8. Significantly, there is no one set of factors that are relevant for every merger.[9] State law or Rule 17a-8 may require the acquired fund's shareholders to approve the merger after directors have approved the merger.[10]

I. Consideration by One or More Boards

Under state law, both the board of the acquiring fund and the board of the acquired fund consider whether to approve a merger. In some cases, the funds may have a common board. In other cases, they may not, even when the funds are affiliated.

» ***How does one board that oversees both the acquired and acquiring funds evaluate the merger?*** Where one board oversees both funds, it will consider the merger from the perspective of the acquiring fund and the fund to be acquired.

» ***How does the evaluation differ when two boards oversee the merger?*** Each board may meet on its own to consider the merger from the perspective of the fund they oversee. If the funds are affiliated, the boards already are familiar with the attributes of the advisory organization, including the adviser's senior management, infrastructure, and compliance systems. They may meet jointly to consider certain information, such as performance and expense information.

II. Comparison of Investment Objectives, Policies, Strategies, Restrictions, and Risks

Directors considering a merger typically begin by comparing the investment objectives, policies, strategies, restrictions, and risks of the funds being merged. In the case of a merger with a shell fund, such a comparison will be more limited. For example, the acquired fund's board may review the acquiring fund's investment restrictions if they will replace the acquired fund's existing restrictions.

» ***How do the merging funds' investment objectives, policies, strategies, restrictions, and risks compare?*** Fund management may provide information to the board that compares these attributes in a format that facilitates comparison of the material differences, and, in doing so, may discuss the advantages and disadvantages of making such changes. For example, directors may consider the extent to which each fund may invest in a particular industry or enter into borrowing arrangements.

» ***Which fund will survive the merger?*** In a shell reorganization, the surviving shell fund assumes the financial and performance history of the acquired fund. In a merger of two or more existing funds, only one fund survives the merger for accounting purposes. That fund assumes the financial and performance history of the fund it most closely resembles (i.e., the accounting survivor).[11] Because only one fund survives, the other merging funds' performance history will no longer be used in advertisements or other publications.[12]

- ***Which of the funds' portfolio managers will manage the combined fund?*** This may be determined by the acquiring fund's adviser. Directors may consider whether the adviser's proposed arrangement is reasonable and consistent with shareholder interests. In the case of a shell reorganization, the acquired fund's adviser may become the subadviser of the new fund. In this circumstance, directors may inquire about the extent of the adviser's oversight of the subadviser and the resources that the adviser will make available to the subadviser.
- ***Will the adviser have the investment personnel and other resources to manage the combined fund?*** Directors may request fund management to provide the relevant information to help them consider this factor.

Will the combined fund be too large to achieve its investment objectives? This factor may be relevant for funds investing in constrained asset classes, such as those focusing on smaller capitalization companies. Directors may receive pro forma financial information for the combined fund and rely on the representations of fund management in assessing whether the combined fund will be too large to achieve its investment objectives.

III. Repositioning of Fund Securities

A merger of funds may necessitate the selling of certain portfolio securities and purchase of other securities, commonly referred to as portfolio repositioning. Repositioning is common when two existing funds are merged. It may occur because the same securities are held by each fund (i.e., overlapping securities) or because the acquired fund owns securities that are not consistent with the investment policies or strategies of the acquiring fund. Repositioning generally does not occur in a shell reorganization.

- ***To what extent will the merged fund reposition its securities?*** What costs are associated with the planned repositioning? The acquiring fund's portfolio manager may provide the acquiring fund's board with a description of the anticipated repositioning, an estimate of the expected costs, and alternative approaches to minimize these costs.[13] Boards may consider not only the transaction costs of buying and selling securities, but also any potential adverse tax consequences associated with the transactions. For example, directors may consider that repositioning may result in the recognition of capital gains. The extent of repositioning may be limited by tax rules to maintain the tax-free status of the reorganization. In evaluating this information, directors may balance the costs of the transaction with the benefits and use their business judgment to determine its reasonableness.
- ***How will the costs associated with portfolio repositioning be allocated?*** The allocation of costs associated with repositioning of securities varies from merger to merger. In considering the allocation of costs, directors may consider the impact of these costs against the benefits expected from the merger.
- ***How long will it take to sell the securities?*** Are there special considerations for large positions? The acquiring fund's portfolio manager may provide an estimate of how long it will take to reposition the securities of the combined fund. The sale of a large position in particular securities, especially securities of smaller capitalization issuers or securities that are thinly traded, may have a negative impact on the market price of the security. In some instances, the adviser may recommend using the services of a "transition manager" that specializes in minimizing market impact and transaction costs to assist in any large-scale repositioning.

- ***Do the securities of the acquired fund that will be retained after the merger have unrealized gains or losses?*** What positive or negative effect will this have on shareholders? Capital losses generally are carried over to the acquiring fund as a result of the tax-free reorganization. However, under certain circumstances, the acquired fund's ability to carry forward capital losses may be limited because of tax law requirements. Directors of both the acquired and acquiring funds may consider that, to the extent these capital losses cannot be carried forward, their potential benefit may be lost as a result of the merger. In addition, directors of the acquiring fund may consider whether there are any unrealized capital gains associated with the acquired fund's securities because the eventual sale of a security acquired through the merger could result in capital gains to the acquiring fund even if the security performs poorly after the merger. Directors may balance this with other costs and benefits of the merger.

IV. Direct Costs

In addition to costs associated with repositioning, mergers include proxy solicitation costs and legal and accounting fees.

- ***Who will pay the costs of the merger?*** How expenses associated with the merger are allocated may be negotiated. In some cases, the investment adviser to the acquiring and/or acquired fund bears the proxy solicitation expenses, legal fees, and accounting fees. In other cases, the acquired fund or the acquiring fund bears some or all of this expense. For example, if the acquired fund would not be economically viable on its own, or if the acquired fund would pay lower advisory fees as a result of the merger, it may bear some or all of the expenses. If the acquiring fund will achieve economies of scale, it may bear some or all of the expenses. In other cases, expenses may be split proportionately between the two funds and/or the funds' investment advisers. Directors may look at both the amount of expected savings and the time period over which the savings will be realized.
- ***Will the combined fund pay any of these costs?*** In cases where shareholders are asked to bear a portion of the merger costs, directors may attempt to quantify the expected benefits associated with the merger and weigh these benefits against the expected costs. For example, directors may consider that the combined fund will have a lower expense ratio, or achieve breakpoints in an advisory contract as a result of the merger. It will be more difficult to quantify more intangible benefits like enhanced shareholder services or potential economies of scale.

V. Fund Performance

Boards of merging funds may consider the performance history of the acquired and acquiring funds.

- ***How have the funds performed for the past three to five years?*** The boards may consider the performance history of the funds along with the relative historic volatility of the funds. The boards may look at how the performance of the funds compare to their relative benchmarks over recent and longer-term time periods. This information may be provided by the investment adviser.

VI. Distribution and Other Fund Services

The acquired fund and the acquiring fund may have different distribution arrangements and other fund services.

- ***How do the nature and quality of distribution and other shareholder services provided to the acquiring fund compare to those provided currently to the acquired fund?*** If the funds being merged are affiliated, there may be few or no material differences in the distribution of, and services provided to, each. Differences in distribution and other fund services are more likely to occur in connection with fund adoptions and other mergers of unaffiliated funds. For example, in a fund adoption, the acquired fund may benefit from the greater distribution capacity of the acquiring fund.
- ***How does the acquiring fund's class structure differ from the acquired fund's class structure?*** To the extent the funds being merged are affiliated, there may be few or no material differences in the class structure of each. Differences in class structure are more likely to occur in connection with fund adoptions, mergers with unaffiliated funds, or mergers of institutional and retail funds. For example, an institutional fund with one share class that has no 12b-1 fees or sales charges may merge with a fund with retail share classes with varying fee structures (e.g., Class A, B, and C shares). In such an instance, the institutional fund may be given a new class of shares for its shareholders. In other instances, these fund shareholders may be given load-waived Class A shares. With respect to Class B shareholders in an acquired fund, they may be considered to have held their shares from the date of their original purchase of the acquired fund's shares.

VII. Fund Fees and Expenses

The ability to achieve operational efficiencies as a result of the fund combination may be a benefit of the increased asset pool. Examples include realizing the benefit of fee breakpoints in advisory or other service provider contracts, and the ability to trade portfolio securities in larger blocks with lower transaction costs.

- ***What effect will the merger have on the acquiring fund's fees and expenses?*** Fund management may provide information to the board that compares the fund's fees and expenses in a format that facilitates comparison of the material differences. They also may provide a pro forma report of the combined funds' fees and expenses.
- ***Will shareholders of the acquired fund pay lower fees and expenses overall as a result of the merger?*** In many instances, the two merging funds have differing expense structures. Not all mergers result in lower fees for the acquired fund's shareholders. For example, in fund mergers between two fund families where multiple funds are involved in a series of mergers, fund expenses may be lower for some funds, and the same or higher for others. Directors may consider to what extent expenses are higher, whether the acquired fund's shareholders will be receiving additional services or some other benefit in exchange for paying higher expenses, whether the use of fee waivers is appropriate, whether there is the potential for lower fees in the future due to economies of scale, and whether the overall benefits of the merger justify higher expenses.

VIII. Board Composition

How will the merger affect the composition of the acquiring fund's board? Will all members of the acquiring fund's board remain on the board? Will any members of the acquired fund's board join the acquiring fund's board? The issue of board composition following a merger may be considered by both the acquired and acquiring fund's board. All, some, or none of the acquired fund's directors may become members of the combined fund's board. Combining the boards may result in a larger-sized board than desired. In addition, the acquiring fund's ability to add directors to its board may be limited, in that new directors may need to be elected by the acquiring fund's shareholders.

IX. Insurance and Indemnification

What is available to the acquired fund's board to protect it from future claims? Fund boards typically are protected against specified claims of wrongdoing by indemnification provisions and "directors and officers/errors and omissions" liability insurance. The insurance coverage for a particular board may cease when the fund it oversees is merged out of existence. If it does, the acquired fund's board may consider purchasing "tail" or "run off" insurance to protect it from claims that may arise after the merger for activities that occurred before the merger. In addition, or as an alternative, the acquiring fund's adviser may indemnify the acquired fund's board for any such claims.[14]

X. Alternatives to the Merger

The board of a fund that is considering being acquired may consider alternatives to the proposed merger at the same time that it considers merging with another fund. The board may revisit these considerations in the event that shareholders do not approve the merger.

- ***Why is the adviser recommending the merger and what alternatives did the adviser consider?*** The various reasons that may prompt an adviser to recommend a merger were discussed at the beginning of this paper. Alternatives to the merger include not merging and continuing operation of the acquired fund, or liquidating that fund. Liquidation may be viewed as an alternative of last resort due to the adverse tax consequences for fund shareholders (i.e., recognition of capital gains).
- ***Why is the adviser recommending this acquiring fund?*** The acquiring fund may be recommended because its investment strategy approximates that of the acquired fund or the expense structures are compatible. In addition, the acquiring fund may have greater distribution resources, such as a network of selling broker-dealers.

XI. Consideration of Benefits to the Adviser

Depending on the structure of the transaction, and particularly in the case of mergers of unaffiliated funds, the board of the acquired fund may evaluate whether any aspect of the transaction could impose an "unfair burden" on the combined funds.

» ***Will any aspect of the transaction impose an "unfair burden" on the combined funds?*** Section 15(f) of the Investment Company Act addresses circumstances under which an adviser may receive compensation or other benefits in connection with the sale of an advisory agreement, which may include the sale in connection with a merger. Section 15(f) explicitly permits the adviser of an acquired fund to benefit from the sale of its advisory agreement provided that the fund maintains a prescribed level of independence and does not place an unfair burden on shareholders.[15] The board of an acquired fund may receive assurances from the acquiring fund's adviser that the reorganization will be structured in the manner contemplated by Section 15(f).[16]

Appendix A: Board Consideration of Fund Mergers Task Force

Peter Gordon	Wells Fargo Advantage Funds
Susan Kerley	Legg Mason/Citi Funds Mainstay Funds
Ruth Quigley	AIM Funds
Richard Redeker	Prudential Funds
Gary Schpero	EQ Advisors Trust
Thomas Theobald	Columbia Funds

The Independent Directors Council and the task force would like to thank John M. Ford, Partner, Morgan, Lewis & Bockius LLP, for his assistance and counsel in connection with this project. In addition, the Council would like to thank Dorothy M. Donohue, Associate Counsel – Securities Regulation, Investment Company Institute, for her work with the task force in preparing this report.

Appendix B: Shareholder Letter

XYZ FUND

c/o XYZ Corporation
123 Main Street
City, State Zip

Dear Shareholder:

As a shareholder of XYZ Fund (the "Fund") you are being asked to vote on an Agreement and Plan of Reorganization for the Fund to transfer all of the Fund's assets attributable to its Class A, Class B, and Class C shares in a tax-free reorganization to ABC Fund (the "Acquiring Fund"), in exchange for Class A, Class B, and Class C shares, respectively, of the Acquiring Fund. If the Agreement and Plan of Reorganization is approved and consummated for the Fund, you would no longer be a shareholder of the Fund, but would become a shareholder of the Acquiring Fund, which has management policies similar to those of the Fund.

After careful review, the Board of Directors has unanimously approved the proposed reorganization. We are recommending the proposed reorganization because it will permit Fund shareholders to participate in a larger fund that has similar investment policies and a lower expense ratio. The Directors believe that the proposal set forth in the notice of the meeting for the Fund is important and recommend that you read the enclosed materials carefully and then vote for the proposal.

If you have any questions after considering the enclosed materials, please call 800/555-1666.

Sincerely,

[XYZ Fund Directors] or
[XYZ Fund President]

Appendix C: Checklist

Comparison of Investment Objectives, Policies, Strategies, Restrictions, and Risks

- How do the merging funds' investment objectives, policies, strategies, restrictions, and risks compare?
- Which fund will survive the merger?
- Which of the funds' portfolio managers will manage the combined fund?
- Will the adviser have the investment personnel and other resources to manage the combined fund?
- Will the combined fund be too large to achieve its investment objectives?

Repositioning of Fund Securities

- To what extent will the merged fund reposition its securities? What costs are associated with the planned repositioning?
- How will the costs associated with portfolio repositioning be allocated?
- How long will it take to sell the securities? Are there special considerations for large positions?
- Do the securities of the acquired fund that will be retained after the merger have unrealized gains or losses? What positive or negative effect will this have on shareholders?

Direct Costs

- Who will pay the costs of the merger?
- Will the combined fund pay any of these costs?

Fund Performance

- How have the funds performed for the past three to five years?

Distribution and Other Fund Services

- How do the nature and quality of distribution and other shareholder services provided to the acquiring fund compare to those provided currently to the acquired fund?
- How does the acquiring fund's class structure differ from the acquired fund's class structure?

Fund Fees and Expenses

- What effect will the merger have on the acquiring fund's fees and expenses?
- Will shareholders of the acquired fund pay lower fees and expenses overall as a result of the merger?

Board Composition

- How will the merger affect the composition of the acquiring fund's board? Will all members of the acquiring fund's board remain on the board? Will any members of the acquired fund's board join the acquiring fund's board?

Insurance and Indemnification

- What is available to the acquired fund's board to protect it from future claims?

Alternatives to the Merger

- Why is the adviser recommending the merger and what alternatives did the adviser consider?
- Why is the adviser recommending this acquiring fund?

Consideration of Benefits to the Adviser

- Will any aspect of the transaction impose an "unfair burden" on the combined funds?

Appendix D: Other Fund Merger Resources

WHERE CAN I FIND MORE INFORMATION?	
Regulatory Framework:	» Investment Company Act Section 17(a) » Investment Company Act Rule 17a-8 » Investment Company Act Section 15(f) *Available through links at the SEC's Division of Investment Management website at www.sec.gov/divisions/investment.shtml.*
	» Form N-14 *Available through a link at the SEC's website at http://www.sec.gov/about/forms/secforms.htm.*
	» Investment Company Act Release No. 25666 (July 18, 2002) (most recent amendments to Rule 17a-8). » Investment Company Act Release No. 25259 (November 8, 2001) (release proposing most recent amendments to Rule 17a-8). *Available through links on the SEC's website at http://www.sec.gov/rules.shtml.*
SEC Guidance:	» SEC letter to North American Security Trust (August 5, 1994)
Judicial Decisions:	» *Meyer v. Oppenheimer Management Corp.*, 764 F.2d 76 (2d Cir. 1985). » *Olesh v. Dreyfus Corp*, Fed. Sec. L. Rep. (CCH) ¶ 98, 907 (E.D.N.Y. 1995).
Industry Guidance:	» ICI's white paper: "*Fund Mergers*" (March 1, 2004) (addressing accounting, tax, and operational issues).

Notes

[1] The term “merger” is used in this report to include a merger, consolidation, reorganization, or purchase or sale of substantially all of an entity’s assets. A fund merger typically is structured so that the acquiring fund purchases the assets and assumes the liabilities of the acquired fund in exchange for shares of the acquiring fund. The acquired fund then makes a liquidating distribution of acquiring fund shares to its shareholders.

[2] See, e.g., Eleanor Laise, “Mutual Fund Mergers Jump Sharply—Combinations Can Cut Costs for Investors, But May Create Investment-Mix, Tax Problems,” *Wall Street Journal*, March 9, 2006, (stating that a growing number of mutual funds are merging for a variety of reasons, including the exit of some financial service firms from the mutual fund business).

[3] The Independent Directors Council serves the mutual fund independent director community and provides a venue to advance the education, communication, and policy positions of mutual fund independent directors. A list of task force members and their fund affiliations is in Appendix A.

[4] A list of the questions provided in this paper is attached as a checklist in Appendix C.

[5] For purposes of this report, the term “director” includes “trustee,” and the term “independent director” refers to a director who is not an “interested person” of the fund as that term is defined in Section 2(a)(19) of the Investment Company Act of 1940.

[6] Funds customarily receive opinions of counsel regarding the tax-free nature of the reorganization.

[7] Appendix B includes an example of a letter to shareholders.

[8] Section 2(a)(3) of the Investment Company Act technically defines the circumstances under which two funds are “affiliated persons” of each other. The fund industry historically has questioned whether funds with a common investment adviser, common directors, and/or common officers are in fact affiliated persons of each other based on the Investment Company Act’s definition of “control” in Section 2(a)(9) of the Act. Solely for ease of discussion in this paper, however, we assume that funds within a complex are affiliated. In most cases, all or a few groups of directors oversee the funds within a fund complex. See *Director Oversight of Multiple Funds* (Independent Directors Council, May 2005), a task force report describing and analyzing board structures prevalent in the mutual fund industry.

[9] See Investment Company Act Release No. 25666 (July 18, 2002) at note 15.

[10] State law or a fund’s governing documents also may require an acquiring fund’s shareholders to approve the merger.

[11] See, e.g., North American Security Trust, SEC No-Action Letter (pub. avail. August 5, 1994) (the factors used to determine which fund will be the accounting survivor of a merger include a comparison of the funds’ investment advisers, investment objectives, policies, and restrictions, expense structures and expense ratios, asset size, and portfolio composition).

[12] While which fund survives a merger is an accounting determination, directors may consider which fund has been determined to be the accounting survivor as part of its overall consideration of the merger.

[13] For example, the portfolio manager may use cross trades, spread sales over time, and/or trade a “basket” of some agreed-upon grouping of securities to a counterparty at a reduced commission to reduce costs.

[14] The acquired fund’s board may consult with fund, or its own, counsel as to whether such an arrangement raises issues under Section (2)(a)(19) and/or Section 17 under the Investment Company Act.

[15] Section 15(f) provides that: (1) for a period of three years after the time of the merger, at least 75 percent of the board of the combined funds must be composed of persons who are not “interested persons” of either the acquired fund’s investment adviser or the acquiring fund’s investment adviser, and (2) an “unfair burden” must not be imposed on the combined funds as a result of the sale or any express or implied terms, conditions, or understandings applicable to the transaction. Two federal courts have considered Section 15(f). See *Meyer v. Oppenheimer Management Corp.*, 764 F.2d 76 (2d Cir. 1985) and *Olesh v. Dreyfus Corp*, Fed. Sec. L. Rep. (CCH) ¶ p. 98, 907 (E.D.N.Y. 1995).

[16] Section 15(f)(2)(b) of the Investment Company Act generally defines an “unfair burden” to include any arrangement during the two-year period after the date of the merger whereby either the predecessor or successor adviser or any interested person of such adviser receives any compensation: (1) from any person in connection with the purchase or sale of securities or other property to, from, or on behalf of the fund, other than *bona fide* ordinary compensation as principal underwriter for the fund, or (2) from such fund or its shareholders for other than *bona fide* investment advisory or other services.

Board Oversight of Certain
Service Providers

JUNE 2007

Preface—May 2009

Unlike some IDC papers, *Board Oversight of Certain Service Providers,* published in June 2007, was not prompted by specific regulatory action or change in the industry. Two enforcement actions brought by the U.S. Securities and Exchange Commission in 2005 and 2006, however, focused attention on service provider contracts and issues that fund boards may want to consider.

Fund boards oversee service providers as part of their general oversight responsibilities, and the report provides practical guidance to boards in this regard. Boards may look back to the report for guidance on replacing an existing service provider as well as for thoughts relating to ongoing oversight of service providers. The report discusses the evaluation of service providers, their fees, and potential conflicts of interest. The report also provides overviews of each of the principal service providers (administrator, custodian, fund accounting agent, and transfer agent) and factors a board may consider when reviewing the merits of a particular service provider and the quality of its services.

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Introduction

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

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

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

I. Standard of Care for Board Actions

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

II. Selection of Service Providers

The Investment Company Act of 1940 (1940 Act) by its terms only requires that certain contracts be approved by a fund's board, and generally does not require board approval of contracts with the service providers covered in this report.[2] In the absence of a particular federal provision, state laws govern the board's role with respect to service provider contracts, and, in general, state laws do not specifically require board consideration of these contracts. Many boards, nevertheless, are involved to some degree in the selection and approval process. Some boards may decide to be actively involved in the identification of potential new service providers or a particular provider, while others may leave this responsibility to fund management, subject to the board's oversight. In many cases, fund

management evaluates potential service providers and recommends one to the board for its approval. Once a new service provider is identified, many boards are involved in the final approval of the agreement, including the fees to be paid for the services, and evaluation of any potential conflicts of interest. A board may wish to make clear the role that the board will take and the role that fund management will take in the overall selection process.

A. Evaluating Service Provider Agreements

Regulators, including the Securities and Exchange Commission (SEC), have not formally prescribed any regulatory standard by which boards should evaluate service provider agreements. Because of the potential conflicts of interest involved in arrangements with affiliates, however, some boards may evaluate an agreement with an affiliated service provider with greater scrutiny than a similar agreement with a third-party service provider.[3] In this context, some boards consider the following factors when evaluating agreements with affiliated service providers: (i) whether the agreement is in the best interest of the fund and its shareholders; (ii) whether the services to be performed under the agreement are required for the operation of the fund; (iii) whether the services provided are of a nature and quality at least equal to the same or similar services provided by independent third parties; and (iv) whether the fees for the services are fair and reasonable in light of the usual and customary charges made by others for services of the same nature and quality.[4] Factors (iii) and (iv) above relate to the use of affiliated service providers; the other aspects of this test also may be of relevance to the evaluation of contracts with third parties.

B. Evaluating Service Providers

1. New Service Providers

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

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

In evaluating a service provider, directors may consider how the service provider will support and interact with the fund's Chief Compliance Officer (CCO).[5] For example, the board may want to determine whether a service provider's staff will be available to the fund's CCO, such as when the CCO decides to conduct due diligence or visit the service provider or during an SEC examination of the fund. Because the fund's CCO and the service provider will work together on some level, the CCO's views regarding the service provider may be an important factor in selecting the service provider. A board also may wish to inquire whether the service provider's CCO support services are included as part of its standard service offering.

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

- the service provider's history and reputation in the industry, including the experiences of similar funds serviced by this provider and the provider's history of client retention;
- the service provider's financial condition and ability to devote resources to the fund;
- recent corporate transactions (such as mergers and acquisitions) that involve the service provider;
- the service provider's regulatory and disciplinary history;
- the level of service that will be provided to the fund;
- the nature and quality of the services to be provided;
- the experience and quality of the staff providing services to the fund and the stability of the workforce;
- the service provider's internal controls and compliance policies and procedures;
- the service provider's operational resiliency, including its disaster recovery and business continuity plans;
- the technology and process it uses to maintain information security, including the privacy of customer data;
- the reporting mechanism for a board to stay apprised of the performance of the service provider;
- the service provider's communications technology;
- the service provider's insurance coverage; and
- the service provider's willingness to provide information to the fund, including, for example, third-party assessments of and/or certifications regarding the provider's implementation of its compliance policies and procedures.[6]

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

2. Existing Service Providers

A board also may at times be involved in evaluating whether to renew an existing service provider contract. Absent regulatory requirements for contracts with service providers to be reviewed at any set interval, or at all, the terms of the contracts may vary greatly. Some contracts are renewed each year or every few years, while others may run indefinitely until a contractual termination provision is invoked. Whatever the formal term of the contract, boards may seek to determine that the frequency with which they review the arrangement is sufficient to

detect and correct any problems in a timely manner, and that the services performed and the fees charged under the contract continue to be reasonable in light of the fund's possibly changing needs.

When a board is evaluating whether to renew an existing service provider contract, its focus may appropriately shift from indicative information (including others' views) about the service provider's ability to deliver quality services to the fund, to an evaluation of the provider's actual performance over the prior contract period. In this case, the board may have received information and compliance reports throughout the period relating to the provider's performance. The board may evaluate whether the provider's history with the fund merits renewal on similar terms or whether a different fee arrangement is appropriate. If the performance of the provider was less than expected, the board may evaluate whether the provider improves its quality of service after receiving critical feedback about its performance or whether fund management should be asked to consider other arrangements with the provider or to consider changing providers.

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

C. Evaluating Fees

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

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

Depending on the type of arrangement under consideration, boards may consider more specific factors relating to the fees. For example, some funds may pay fees related to a fund's participation in platforms that provide for purchases and redemptions of fund shares on an omnibus basis, such as mutual fund supermarkets. These fees

may be characterized appropriately as sub-transfer agent or shareholder servicing fees, and may not be covered (nor have to be) under a Rule 12b-1 plan. In such cases, the board may seek to evaluate whether the fees are reasonable in light of the cost of comparable services rendered by the fund's primary transfer agent or others in the marketplace. To the extent these fees may exceed the reasonable compensation for the services to be rendered, a board may wish to inquire whether a portion of the fees should be covered by a Rule12b-1 plan or paid by the adviser. As another example, if a fund's sub-transfer agent fees exceed the per account charge for the fund's transfer agent, the board may wish to examine whether the services for such fees are demonstrably different and justifiable.

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

D. Evaluating Potential Conflicts of Interest

Some arrangements between fund management and service providers could present potential conflicts of interest. In evaluating service provider arrangements, the board should be alert for any arrangements that could unfairly benefit the adviser or others to the detriment of the fund and its shareholders. Fund management should fully disclose to the fund's directors potential conflicts, as well as any circumstances in which one fund may benefit to the disadvantage of, or disproportionately to, another fund (or type of fund) in the complex. For example, if a service provider waives part of its fee for a fund, such as for a limited period of time immediately following the fund's inception, the directors should satisfy themselves that no other funds in the complex are bearing a higher expense as a result.

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

1. Affiliated Service Providers

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

When evaluating an arrangement with an affiliated service provider that in turn subcontracts to an unaffiliated service provider, boards may wish to inquire about the respective roles of the two entities and whether fund management or the affiliated service provider receives any benefit, directly or indirectly, other than the fees payable under the contract. Examples of such benefits could include payments by a service provider to fund management, the reduction or waiver of other payments owed to the service provider by fund management,

or the support of other business arrangements involving the service provider and fund management. Boards also may wish to evaluate the fees paid to the affiliated service provider and the unaffiliated service provider, relative to the services each will perform.[8]

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

2. Unaffiliated Service Providers

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

III. Ongoing Oversight of Service Providers

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

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

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

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

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

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

Conclusion

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

Appendix A: Board Oversight of Certain Service Providers Task Force

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

Appendix B: Administrator

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

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

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

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

Appendix C: Custodian

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

The custodian may provide the following services:

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

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

- the custodian’s experience in the fund business and its anticipated commitment to continuing in the fund business, particularly if its line of business extends beyond the fund business, as may be the case with bank custodians;
- the availability and cost of a line of credit and overdraft protection from the custodian, if applicable;
- the custodian’s procedures with regard to corporate actions;
- whether trades would be communicated by the adviser to the custodian electronically;
- how corporate actions would be communicated by the custodian to the fund accounting agent or how quickly a fund’s trades would be reflected in the portfolio manager’s information system;

- its overall costs, including arrangements for cash balances and any resulting credits against service fees; and
- if a fund holds foreign securities, its quality of foreign custody services (offered directly or through its sub-custodian network).

Appendix D: Fund Accounting Agent

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

» valuing all portfolio securities daily;

» calculating the net asset value (NAV) and NAV per share;

» recording all security trades and corporate actions;

» calculating daily expenses, including adviser fees and fee waivers;

» calculating dividend and distribution rates;

» maintaining the fund's general ledger;

» calculating 30-day SEC yields and total returns;

» performing cash and position reconciliations;

» calculating and recording interest and dividend income, unrealized appreciation and depreciation, and capital gains and losses;

» responding to inquiries made by any audit committee financial experts;

» accumulating financial information for management, regulatory, shareholder, and tax reporting; and

» preparing periodic audit and financial information for the fund's independent auditors.

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

» the auditor's opinion of the quality of the fund accounting agent's services;

» the fund accounting agent's historical NAV accuracy rate (overall and by type of fund);

» whether a fund accounting agent is fully conversant with the way the fund values its securities; and

» the fund accounting agent's policies and procedures, including those relating to error corrections and stale pricing.

Appendix E: Transfer Agent

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

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

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

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

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

» the transfer agent's promptness of responses by phone or mail or quality of phone experience;

» the existence and nature of complaint files for the fund and the reporting mechanism for a board to stay apprised of such complaints;

» the flexibility, functionality, and stability of the technology platform on which the transfer agent maintains shareholder accounts;

» the transfer agent's technological capabilities, including whether the transfer agent digitizes documents (such as account applications) that can then be accessed electronically and provides a website or voice response system for shareholder communications; and

» who receives the interest or credits earned on deposit accounts of the transfer agent.

Appendix F: Securities Lending Agent

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

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

Securities lending agents generally provide the following services:

- identifying eligible borrowers interested in borrowing specific securities that are available for loan within the fund's portfolio;
- negotiating specific loan terms within the parameters established by the fund, including the loan fees or the rebates to be paid on cash collateral;
- delivering, or arranging for the delivery of, loaned securities to the borrowers, and receiving, or arranging for the receipt of, the cash or other collateral required to be provided by the borrowers;
- investing cash collateral in investments of the types specified by the fund;
- daily marking to market of the value of loaned securities and of any securities collateral, and requiring delivery of additional collateral (or effecting or arranging for the return of any excess collateral) in accordance with loan terms;
- obtaining the payment by borrowers of amounts equivalent to dividends or other distributions paid on loaned securities;
- arranging for the return of loaned securities and collateral upon the termination of the loan;
- monitoring for borrower defaults, including any failure to return loaned securities in a timely manner, and liquidating collateral and enforcing other fund remedies in the event a default occurs;
- recordkeeping, accounting, and reporting services needed in connection with securities lending activities; and
- in the case of third-party lending agents, establishing the necessary operational links with the fund's custodian.

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

» access to borrowers and markets appropriate to the fund's portfolio and lending objectives;

» additional custody and fund accounting costs to accommodate securities lending (e.g., costs associated with increased recordkeeping);

» lending approach—i.e., focus on loan volume or on "special" securities for which there is high demand—and the appropriateness of that approach to the fund's portfolio and lending objectives;

» fairness and competitiveness of the proposed "split" of net lending revenues;

» approach to reinvestment of cash collateral and availability of low-cost reinvestment funds and vehicles;

» projections of net lending income to the fund and depth and quality of data and analysis supporting those projections;

» in the case of third-party lenders, ability to interact with the fund's custodian on operational matters; and

» flexibility in accommodating the fund's lending needs, including loan recall policies relating to proxy voting and corporate actions.

Notes

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

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

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

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

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

[6] One report prepared by accounting firms that may be used by the board and/or the fund CCO in understanding the internal controls of certain service providers relevant to a fund's financial statements is known as a SAS 70. In addition, some service providers have engaged accounting firms to issue other types of reports. The CCO Task Force of the American Institute of Certified Public Accountants Auditing Standards Board also is developing guidance for accountants, expected to be issued this summer, which will provide additional and specific information about compliance-related engagement and reporting procedures for use with service providers [Editor's note: AICPA Auditing Standard Board's Statement of Position 07-2 was released in October 2007]. These reports generally are available only to current clients of the service provider.

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

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

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

Board Oversight of Derivatives

JULY 2008

Preface—May 2009

Throughout 2007, at IDC chapter meetings and other venues, fund directors repeatedly expressed interest in receiving education regarding derivatives. In addition, the media and regulators focused attention on derivatives, which continues today.

In this task force report, *Board Oversight of Derivatives,* released in July 2008, IDC provides a resource for directors that explains, in plain English, the fundamentals of derivatives and their uses by funds. It provides an overview of operational, regulatory, and reporting considerations associated with fund investments in derivatives. While there are a number of texts written about derivatives in portfolio management and articles examining related legal and regulatory issues, no report had been written specifically for fund boards. The task force integrated information from a wide variety of industry and academic resources to tailor this report for fund boards. The report's description of portfolio management applications focuses on how funds may use derivatives and includes specific examples to help directors better understand the purpose and impact of derivative investments. The report highlights the primary operational and regulatory considerations to assist boards in their discussions with the adviser about these issues, and includes suggested topics for board-adviser discussions.

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Introduction

Derivatives—broadly defined as financial instruments whose value is derived from a separate asset or metric—have become an integral tool in modern financial management. Many institutions, such as corporations, insurance companies, banks, and governments, use derivatives to facilitate the efficient transfer of risk between parties with different financial objectives, risk tolerances, and/or forecasts.

Many investment advisers, including those who previously have used derivatives in managing institutional separate accounts (such as pension or endowment funds), are increasingly integrating derivatives into their management of fund portfolios. Derivatives may offer opportunities to improve a fund's risk-adjusted returns. They also may introduce investment, regulatory, and operational complexities, particularly for open-end funds, which redeem their shares daily at net asset value (NAV).

Fund boards oversee investments in derivatives as part of their general oversight of all portfolio investments. While many of the uses and risks of derivatives parallel those of other portfolio holdings, their particular features, benefits, risks, and resource requirements may warrant boards' additional attention.

To support fund boards in fulfilling their responsibilities for overseeing derivatives investments, the Independent Directors Council established a task force (see Appendix A) to write this report, which provides an overview of derivatives, with practical guidance for fund directors. The task force evaluated and integrated materials from a wide variety of industry and academic resources to tailor the report for fund boards.

This report discusses:

- board oversight responsibilities;
- definitions and primary categories of derivatives;
- portfolio management applications, risks, and controls;
- operational and regulatory considerations; and
- board practices and resources.

Appendix B presents topics for possible board-adviser discussion. Funds vary considerably in their uses of derivatives, so specific topics and their depth and detail will depend on the particular circumstances of a fund, including the types of derivatives in which the fund may invest, the fund's investment strategy and derivatives applications, and the adviser's organizational structure. Appendices C, D, and E provide in-depth information about derivatives, including a glossary of terms, examples of derivatives applications, and references to additional educational resources.

The task force's objective in structuring the report was to provide fund directors with an overview of derivatives and the respective responsibilities of the board and adviser that will be relevant over different market environments. This report is being released during a time of special focus on developments in the fixed income markets. During periods of market stress, fund boards may choose to engage in more frequent dialogue with the adviser about the fund's holdings, including its derivatives investments, and the adviser's controls and resources, as they may be impacted by specific market conditions.

I. Board Oversight Responsibilities

A fund board's oversight responsibilities with respect to derivatives are generally the same as for other portfolio investments. The board reviews and, where applicable, approves policies developed by the adviser and other service providers with respect to fund investments, including derivatives, and oversees those entities' performance of their duties. Under the "business judgment rule," board actions are protected from judicial inquiry so long as the board acted on an informed basis, in good faith, and in the honest belief that the action taken was in the best interests of the fund.

Fund boards are not expected to be technical experts regarding derivatives, nor to micromanage the details of individual derivatives investments undertaken by the fund's adviser.[1] The Securities and Exchange Commission (SEC) has stated (in connection with the adoption of a custody rule relating to futures contracts) that the board's general oversight includes the "particular responsibility to ask questions concerning why and how the fund uses futures and other derivative instruments, the risks of using such instruments, and the effectiveness of internal controls designed to monitor risk and assure compliance with investment guidelines regarding the use of such instruments."[2] Board oversight may entail discussions with the adviser about the:

» 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.

II. Derivatives Overview

While there is no universal definition of "derivative," it may be broadly defined as an instrument that derives its value from some other asset or metric (the underlying or **reference asset**). (Highlighted terms are defined in the glossary, Appendix C.) Derivatives span a wide range of complexity based on a number of factors, including the liquidity and structure of the instrument and the transparency of reference assets.

A. Evolution of Derivatives

Derivatives were originally commodity based (e.g., agricultural) and were designed to enable farmers and merchants to transfer business risk stemming from uncertainty of future commodity prices. Market participants eventually established organized futures exchanges to provide a central marketplace with standardized contract terms, open price discovery, and, importantly, mechanisms to ensure adherence to contract terms. The exchanges also created **clearing houses** that act as buyer for every contract seller and as seller to every contract buyer, thereby limiting **counterparty risk** for exchange participants.

To protect itself from credit risk, the clearing house requires participants to maintain deposits, called margin. Like collateral on loans, the **margin** for transactions is set at levels designed to protect the clearing house from defaults by the participants due to changes in the value of the underlying commodity.

Market participants are able to acquire exposure (either long or short) to a large dollar amount of an asset (the **notional value**) with only a small down payment, enabling parties to shift risk more efficiently and with lower costs. The **leverage** inherent in these transactions magnifies the effect of changes in the value of the underlying asset on the initial amount of capital invested. For example, an initial 5 percent collateral deposit on the total value of the commodity would result in 20:1 leverage, with a potential 80 percent loss (or gain) of the collateral in response to a 4 percent movement in the market price of the underlying commodity.

In the 1970s and 1980s, exchanges such as the Chicago Mercantile Exchange, New York Mercantile Exchange, and Chicago Board of Trade expanded beyond their commodity-based instruments to trade derivatives designed for the financial markets, including futures and options on securities indices and foreign currencies. S&P 500 futures started trading on the Chicago Mercantile Exchange in 1982 and, within a decade, their trading volume exceeded that of listed equities.

Exchange-traded derivatives are now offered globally. In most countries, government regulatory authorities or quasi-public industry organizations oversee them. They have standardized contract terms, and their liquidity is facilitated through an open market and the role of arbitrageurs who will buy and sell in the event that prices of the derivative and underlying cash instruments (e.g., stocks and bonds) are not aligned. Exchange-traded derivatives include **futures**, **options**, and options on futures.

Advances in technology and ever-growing market interest and ingenuity have facilitated rapid expansion of **over-the-counter (OTC)** derivative products that are more precisely structured and customized to meet the needs of individual market participants. Banks and broker-dealers facilitate transactions in the OTC market by developing OTC products and serving as the counterparty to OTC transactions. Frequently, these organizations will act as market makers during the early stages of the adoption of a new derivative instrument. For instance, when interest rate swaps were first introduced in the early 1980s, broker-dealers played an important role in their growth through their willingness to take offsetting positions to those desired by their customers. As the market for an instrument grows and, most importantly, becomes more liquid, the need for market makers to risk their own capital diminishes.

OTC derivatives are negotiated between the parties, without an exchange as the intermediary. While OTC contracts are customized, most are based on industry-developed standardized agreements (e.g., the **International Swaps and Derivatives Association, Inc. (ISDA) Master Agreement**), with addenda and individual trade confirmations that provide the customized specifics to the agreement. Unlike exchange-traded derivatives, OTC contracts are not guaranteed by a clearing organization and, as discussed in Section III, involve greater counterparty risk. In addition, OTC instruments can be more complicated to liquidate, and may require approval from the counterparty in the event of a proposed sale or transfer (a **novation**).

COMPARISON OF EXCHANGE-TRADED AND OVER-THE-COUNTER DERIVATIVES	
Exchange-traded derivatives	**Over-the-counter derivatives**
» Exchange stands between buyer and seller	» Contract between two parties (not over an exchange)
» Standardized contracts and terms	» Customized contracts and terms
» Minimal counterparty risk	» Counterparty risk
» Exiting or offsetting position can be readily achieved	» Exiting position may require agreement of counterparty
» Examples: Futures, Options, Options on Futures	» Examples: Forwards, OTC Options (e.g., swaptions), Swaps

B. Primary Categories

The primary categories of financial derivatives include **futures**, **forwards**, **options**, and **swaps**. Underlying or reference assets generally include stocks, bonds, commodities, currencies, interest rates, and market indices.

1. Futures and Forwards

Futures and forwards are contracts for the future purchase or sale of an asset at a specified price on a specified date. Futures are exchange-traded, while forwards are transacted in the OTC market. Reference assets include major U.S. and international equity market indices, U.S. Treasuries, other major government bond markets, and currencies. They are structured to closely replicate the returns and risks of the reference asset, and fund advisers may use them to gain or hedge broad market, interest rate, or currency exposure, among other applications.

2. Options

For the purchaser, an option represents the right, but not the obligation, to buy or sell the reference, or underlying, asset (e.g., an individual security, broad market index, or currency) within a specified time period (i.e., up to or at the expiration date of the option) for a specified price (the **strike price**). The party that writes (i.e., sells) a **call** option is obligated to sell the underlying asset to the call purchaser for the strike price if the purchaser exercises the option on or before the expiration date; the **put** writer is obligated to buy the asset for the strike price should the purchaser exercise the put option on or before the expiration date. Some options, such as options on equity securities or futures, are exchange-traded, while others, such as **swaptions** (options on swaps), are OTC instruments.

The option seller receives a **premium** from the purchaser seeking participation in the asset price increase above a certain level (through a call) or protection below a certain level of asset decline (through a put). While the option purchaser's potential loss is limited to the option premium, the put seller's loss may be substantial, and the call seller's loss is potentially unlimited. (See the glossary, Appendix C, for payoff diagrams illustrating return patterns for writing or purchasing calls or puts.)

Options provide buyers and sellers a mechanism to target upside or limit downside risk exposure to, for example, a market index or individual security. Option prices reflect multiple factors, including the expected price volatility of the underlying asset. Accordingly, investors also may use options to reflect their forecasts of future market or security price volatility. Funds generally use options in conjunction with cash (to gain exposure) or securities (to hedge exposure).

3. Swaps

Swaps are OTC transactions between two parties who exchange a series of cash flows at specified intervals based on an agreed-upon principal amount (the notional value) over a specified time period (the maturity of the swap). Payments generally are made on a net, rather than a gross, basis. The party with the larger obligation pays the difference to the other party as the swap is marked-to-market. Primary swap categories include:

- ***Interest rate swap:*** Agreement to exchange interest rate based flows (e.g., one party agrees to pay a fixed rate and the other party agrees to pay a floating rate, such as one based on LIBOR [London Interbank Offered Rate]), on a specified series of payment dates based on a specified principal amount (notional value)
- ***Total return swap:*** Agreement in which one party receives the total return (interest or dividend payments and any capital gains or losses) from a specified reference asset and the other party receives a specified fixed or floating rate
- ***Currency swap:*** Agreement for the exchange of one currency (e.g., U.S. dollars) for another (e.g., Japanese yen) on a specified schedule
- ***Credit default swap:*** Agreement in which the protection seller agrees to make a payment to the protection buyer in the event of a specified credit event (such as a default on an interest or principal payment of a reference entity) in exchange for a fixed payment or series of fixed payments

Investment managers employ swaps to tailor the fund's risk exposures, benefiting from customized contract terms and time frames. Swaps may be used to gain or hedge exposures.

C. Other Complex Instruments

There are numerous types of derivatives (including combinations of the primary categories of derivatives, such as swaptions and forward swaps) as well as other types of financial instruments with derivatives-like characteristics, such as complex structures whose value is linked to the value of other assets. Examples include **structured notes**, **asset-backed securities**, and **mortgage-backed securities**.

As noted above, there is no universal agreement as to whether a particular instrument may be characterized as a "derivative," but, regardless of their characterization, such other instruments also may be part of a fund's portfolio. While those instruments are not specifically described in this report, they may raise similar investment, operational, and regulatory issues. The following discussions, including those relating to possible board-adviser discussion topics, may be relevant to fund investments in them as well.

III. Derivatives in Fund Management

The derivatives and **cash securities** (i.e., traditional securities) markets are becoming increasingly integrated, with movement in one market quickly reflected in the other. Fund managers may use derivatives as an alternative to, or in combination with, cash securities. This section discusses derivatives' primary portfolio management applications and the related investment risks. Appendix B, Sections 1–2, presents possible board-adviser discussion topics, which may be tailored to the specific details of the derivatives used by a fund, their role in the fund's investment strategy, and the adviser's investment risk management controls, procedures, and organizational structure.

A. Portfolio Management Applications

Derivatives offer fund managers and traders an expanded set of choices, beyond the cash securities markets, through which to implement the manager's investment strategy and manage risk (targeting an improved risk-adjusted return), consistent with the fund's stated investment objective and mandate. Derivatives may permit a fund to increase, decrease, or change the level and types of portfolio exposure in much the same way as through investments in related cash securities.

Relative to comparable cash securities, derivatives' potential benefits include the ability to:

- gain or reduce exposure to a market, sector, security, or other target exposure more quickly and/or with lower transaction costs and portfolio disruption;
- precisely target risk exposures;
- benefit from price differences between cash securities and related derivatives;
- gain access to markets in which transacting in cash securities is difficult, costly, or not possible; and
- gain exposure to commodities as an asset class (subject to certain tax tests).

Consistent with the fund's investment mandate and guidelines, portfolio managers may invest in derivatives to target or hedge portfolio exposures, with numerous possible combinations depending upon the manager's investment strategy and current market conditions. Long-only indexed and actively managed equity and fixed-income funds may use derivatives to gain or reduce exposure to a market, sector, security, or currency. Fixed-income funds frequently use derivatives to structure and control duration, yield curve, sector, and/or credit exposures.

Asset allocation funds seeking to move efficiently across asset classes while minimizing disruption of underlying securities holdings make extensive use of derivatives to control (i.e., maintain, hedge, or shift) their broad asset class exposures. Funds incorporating long-short (e.g., **130/30, market-neutral**, or **portable alpha**) strategies also employ derivatives to maintain their respective target market exposure.

Primary fund applications are described below, with certain examples and market scenarios amplified in Appendix D.

1. Gain Broad Market Exposure (e.g., U.S. or non-U.S. equity or fixed income markets)

A fund may use derivatives to gain or maintain broad exposure to a market (or, for asset allocation funds, to shift among market exposures), enabling the fund manager to minimize individual security turnover so as to limit the negative impact of transaction costs, tracking error relative to the fund benchmark, and realization of short-term capital gains.

- ***Futures to gain equivalent market exposure.*** A fund may invest in futures to help manage daily cash flows. Holding cash, rather than investments in the target market, may cause dilution for current shareholders. Attempting to quickly invest inflows of cash in a select list of securities may incur transaction costs and market impact, negatively affecting fund performance. By purchasing futures on a stock or bond index most closely comparable to the fund's investment universe, the fund can gain full exposure to the market return, potentially minimizing the dilution and relative performance risk introduced by cash. (See Equitize Cash Example 1, Appendix D.)

- ***Total return swaps to gain foreign market exposure.*** Fund managers seeking exposure to non-U.S. markets for which there is no appropriate or liquid futures contract or where local settlement of securities transactions may be difficult and costly (e.g., emerging markets) may use total return swaps. The fund would "pay" a fixed or floating rate and "receive" the total return of the target market (as specified in the OTC contract).
- ***Call options to participate in market increases.*** A fund also may participate in market increases above a certain level through purchase of market index call options. The fund would pay an option premium in exchange for upside participation in the return of the market index. The fund's downside exposure would be limited to the option premium.

2. Target Sector Exposure (e.g., industry, credit grouping, or currency)

A fund's manager may seek to target and tailor exposures to specific sectors within the U.S. and non-U.S. markets. Derivatives may represent a less expensive way than the cash securities markets to gain the desired exposure. The manager also may prefer to precisely target a sector through derivatives rather than cash securities, which entail market, interest rate, or currency risks that then may need to be hedged or accepted for their impact on the portfolio's risk and return.

- ***Futures to target sector exposure.*** A fund may replicate the returns and risks of a sector with investment in futures that target the sector, such as U.S. Treasury futures. Institutions such as banks and mortgage lenders often use the Treasury futures market to adjust the duration, or price sensitivity to interest rate changes, of their mortgage portfolios. (When interest rates rise, for example, the durations of mortgage assets lengthen.) Financial institutions may reduce the duration of their portfolios by selling Treasury futures. A fund manager purchasing Treasury futures in an environment when a number of market participants seek to sell may be able to target exposure to the U.S. Treasury market at a more advantageous price in the futures market than the cash bond market.

  A fund manager also could use U.S. Treasury futures to specifically target portfolio risks. For example, a manager of a fund holding a position in 10-year U.S. Treasury bonds who becomes concerned that short-term interest rates will rise, flattening the yield curve, could sell 2-year U.S. Treasury futures to partially hedge the portfolio's duration position and reduce exposure to the specific portion of the yield curve (i.e., short-term rates) that the manager wishes to avoid.
- ***Credit default swaps to target credit exposure.*** A fund manager may use credit default swaps to target exposure to credit markets, such as the investment grade or high yield credit markets. Specifically, a manager may gain exposure to a credit market by selling protection against an index composed of individual credit default swap contracts for a basket of corporate issuers.

3. Replicate Security Exposure (e.g., individual stocks or bonds)

Depending upon market conditions, the pricing and liquidity of derivatives on individual securities may be more attractive than the related cash market security. Such applications may play a role in actively managed equity and bond funds.

- ***Credit default swaps to target corporate or sovereign issuer exposure.*** A fund manager may use a single-name credit default swap to gain or reduce exposure equivalent to a corporate or sovereign issuer. The manager may gain exposure by selling protection on a specific credit. (See Gain Corporate Exposure Example 2, Appendix D.) Alternatively, a manager could hedge an existing credit exposure by purchasing protection, taking the other side of the swap.
- ***Call options to participate in individual security return.*** A manager may purchase an individual security call option to gain upside participation in the security's price increase in exchange for payment of the call premium.

4. Hedge Current Portfolio Exposures (e.g., market, sector, and/or security)

When the fund portfolio is structured to reflect the manager's long-term investment strategy and forecasts, interim events may cause the manager to seek to temporarily hedge a portion of the portfolio's broad market, sector and/or security exposures. Relative to the alternative of selling individual securities, derivatives may provide a more efficient hedging tool, offering greater liquidity, lower round-trip transaction costs, lower taxes, and reduced disruption to the portfolio's longer-term positioning. Generally, the derivatives' uses described above for gaining market, sector, or security exposures may be reversed, on the short side, to hedge a portion of the portfolio's existing holdings.

- ***Futures or forwards to hedge market, sector, or currency exposures.*** A fund may sell futures or forwards to hedge exposures to markets, sectors or currencies. (See Hedge Currency Exposure Example 3, Appendix D.) If the market rises, the long positions' gains will be partially offset by the short position's loss in the derivative instrument, while the short position will gain value if the market (and the long position) declines. In combination, the return on the long securities positions, including the market and individual security returns, will be offset by the short derivatives' return.
- ***Put options to limit downside exposure.*** By purchasing put options on a market index or individual security, in exchange for the option premium, the fund manager may establish a floor return below which the value of the position will not fall. (See Hedge Against Potential Price Declines, Example 4, Appendix D.)

B. Investment Risks and Controls

All fund investments, to varying degrees, incur market and credit risks as well as potential volatility or illiquidity if market conditions change. Effective investment management, especially for actively managed funds, entails ongoing measurement and evaluation of all types of identified risks in a portfolio (including, if applicable, market, country, currency, interest rate, sector, and individual issuer exposures), which, as noted in the preceding section, may be obtained through derivatives and/or their related cash securities. The adviser may analyze and evaluate

the relevant risks to support selection of individual investments, including derivatives, and their incorporation in the composite fund portfolio. Depending upon their specific structure, derivatives may warrant analysis of several layers of exposures, including reference assets, collateral, and counterparties.

The adviser may quantify risks at the individual security and composite portfolio levels, initially and on an ongoing basis, to measure and control exposures so that they are within the fund's investment mandate and guidelines as well as active management targets set by the portfolio management team. Risk models, such as Value at Risk (VaR), utilize various volatility and correlation measures, historical and/or prospective, to estimate potential sensitivity to market moves.

The adviser also may simulate (stress test) performance of individual investments and the composite portfolio, including derivatives with complex return patterns, over a range of market events, capturing the potential impact of extreme low-probability, but potentially damaging, events, which could have a significant adverse effect on fund performance. Unexpected differences from projected correlations among assets, including derivatives and related cash securities, may disrupt the fund portfolio's targeted diversification and hedges (if, for example, long-short combinations do not offset one another as expected).

The adviser may have a separate risk management or analytical group that monitors risks and performs modeling and testing to identify risk concentrations and other significant risk factors. The adviser's senior management may be involved as well, particularly to address significant issues relating to individual investments or portfolio exposure and concentrations identified through the analytical tests.

Derivatives raise additional investment risk management issues, some of which also may relate to operational and regulatory considerations discussed in Section IV, including:

» ***Leverage.*** Unlike cash securities, derivatives enable investors to purchase or sell exposure without committing cash in an amount equal to the economic exposure (the notional value) of the position. This ability could result in leverage, or magnification, of the risk position, on the long or short side. As discussed in Section IV, the SEC requires funds to cover or segregate liquid assets equal to the potential exposure created by certain derivatives. Aggregate portfolio statistical reports may be used to evaluate the leveraged exposures (long or short, market, sector, or security) of the portfolio compared to any limits on leverage set by the fund's disclosure documents, investment guidelines, or portfolio management targets.

» ***Illiquidity.*** Some derivatives, particularly complex OTC instruments, may be illiquid and some previously-liquid derivatives (as well as cash securities) may become illiquid during periods of market stress. A shift in the fund's portfolio to a higher concentration of illiquid investments may raise concerns about meeting daily redemptions in open-end funds and potentially forcing the sale of more liquid investments. For portfolio management and compliance purposes,[3] the fund's adviser should have procedures reasonably designed to control the fund's exposure to illiquid assets. Illiquid holdings also present valuation challenges (discussed in Section IV).

- ***Counterparty risk.*** Because the satisfaction of an OTC contract depends on the creditworthiness of the counterparty, OTC derivatives entail counterparty risk. The adviser's credit analysts may evaluate the banks and brokers serving as the fund's counterparties and establish lists of approved counterparties satisfying the credit standards. Counterparty risk may be reduced through careful review and negotiation of contractual protections, well-designed collateral exchange agreements, and clear termination provisions. Funds may use multiple counterparties to limit exposure to any particular institution, but use of multiple counterparties may entail negotiation of multiple agreements with potentially different terms. The adviser's legal department or outside counsel may negotiate the terms of master agreements with counterparties.

IV. Operational and Regulatory Considerations

Board oversight may entail discussions with the adviser about the operational resources, internal controls, and organizational structures of the adviser and service providers, and the policies and procedures designed to identify, assess, document, and control risks associated with derivatives investments. To assist fund boards in these discussions, this section highlights:

- key derivatives-related operational and regulatory considerations that are specific to registered funds;
- examples of organizational responsibilities and structures; and
- related policies and procedures.

Appendix B, Sections 3–5, suggests discussion topics concerning operational issues, controls, and resources.

Operational and regulatory issues will vary across funds, depending upon such factors as the types of derivatives in which a fund may invest and the volume of derivatives transactions. Certain issues discussed below may be implicated primarily with respect to OTC derivatives.

A. Primary Areas of Potential Impact

1. Fund Operations

OTC derivatives may require customized, manual processing and documentation of transactions by portfolio management, accounting, and back office staff, as well as the fund custodian. Some transactions may not fit within existing automated systems for confirmations, reconciliations, and other operational processes used for "traditional" securities, requiring staff to devise "work-arounds"—such as separate spreadsheets—to track and record derivatives transactions and holdings. In addition, trade confirmations and reconciliations may require ongoing communications between back office personnel and the counterparties.

Operational challenges include hiring and retaining staff with derivatives-related knowledge, as well as retraining them as derivatives evolve and become more complex. Additional challenges include devoting sufficient staff and system resources to designing and executing manual processes and controlling these processes. To evaluate the infrastructure's ability to handle the processing of trades or settlements, some advisers monitor certain parameters associated with OTC derivatives processing, such as average number of days to complete documentation for a trade and average time required for settlement.

Although major industry players are developing standardized systems and procedures to automate, as far as possible, many of these processes, such automated systems are not yet prevalent.

2. Custody and Collateral

The 1940 Act requires that fund assets, which would generally include margin or other collateral posted in connection with a transaction, be maintained in the custody of one or more qualified banks or, subject to SEC rules, a broker or dealer, or the fund itself.[4] SEC rules permit funds to post futures margin directly with futures commission merchants registered with the Commodity Futures Trading Commission, subject to certain conditions.[5] Swaps and other OTC derivatives transactions present additional custody issues. For example, neither the SEC nor its staff has provided guidance as to how a swap should be custodied, given the contractual nature of the arrangement. Some funds provide a copy of the ISDA agreement and/or relevant confirmations to their custodian banks. In addition, although the SEC has not specifically addressed the treatment of collateral in these contexts, some funds establish tri-party custody arrangements for collateral posted by the fund to secure its swap or other OTC derivatives obligations, using a special collateral account at the fund's custodian bank.

3. Senior Security and Asset Segregation

The 1940 Act restricts a fund's ability to issue "senior securities," which the SEC construes as a restriction against the use of leverage.[6] The SEC views certain derivatives transactions as entailing leverage and, thus, presenting "senior security" concerns, to the extent that they represent contractual obligations under which the fund could owe more money in the future than the amount of its initial investment.[7] Provided that a fund takes specified steps to limit the potential for loss generated by derivative instruments, the SEC has stated it will not treat such transactions as "senior securities."[8] Accordingly, funds can invest in these types of instruments if they segregate liquid assets equal to the potential exposure to the fund created by the transaction or if the fund holds an offsetting position that effectively eliminates the fund's exposure on the derivatives transaction.

Among the key issues to be evaluated and resolved are the amount (e.g., notional or mark-to-market value) and type of assets required to be segregated, and the nature of permissible offsetting positions. (The adviser's calculation of the economic leverage of the fund's portfolio for purposes of investment risk measurement and control may differ from the leverage calculated to comply with SEC requirements for asset segregation and coverage.) The SEC has noted that, as asset segregation reaches certain levels, a fund may impair its ability to meet current obligations, honor requests for redemption, and manage the investment portfolio in a manner consistent with its stated investment objectives.[9]

4. Issuer Exposure

Applying a fund's diversification and concentration policies to derivatives requires determining the "issuer" and value of the instrument for purposes of the relevant regulatory requirements and fund compliance controls.[10] This requires determining whether to calculate the derivative's contribution to the exposure based on its mark-to-market value or the notional value and whether it is appropriate to net exposures. Similar determinations must be made regarding compliance with the rule limiting fund purchases of securities issued by financial services firms, as well as whether a derivative is a "security" and, if so, whether it is debt or equity, because the relevant limitations are different.[11]

5. Valuation

Depending on their structure, some categories of derivatives may present special valuation challenges. Exchange-traded futures and options may be priced based on readily available market quotations, and prices for certain broadly-used types of OTC derivatives, such as some credit default swaps, may be obtained from pricing vendors or dealer quotations. Customized OTC derivatives may be valued based on a model (a formula based on weighted variables), and, in some cases, the model may be maintained by the counterparty to the derivatives transaction, which can raise potential conflict of interest concerns. In addition, as noted above, valuation and liquidity considerations intersect, and during periods of market stress or disruption, pricing vendors and dealers may not quote prices for certain OTC derivatives and other securities for which there no longer is a liquid market.

The board ultimately is responsible for the fair valuation process, although it can adopt procedures pursuant to which the day-to-day responsibility to price the fund's investments, including those for which market quotations are unavailable (i.e., investments that must be priced at "fair value"), is delegated to the adviser or other service provider (such as an accounting agent).[12] Because open-end funds redeem their shares daily at net asset value (NAV), there may be more operational pressure on management to establish a robust and effective valuation process than for other types of investment accounts, which are not required to price their holdings as frequently. As with all fair valuations, fund boards should periodically evaluate the fair valuation procedures and the quality of the prices obtained through the application of the fund's procedures. Boards also should receive periodic reports from management discussing the valuation process and the nature and resolution of any valuation issues or problems.

6. Accounting and Financial Reporting

The accounting treatment of derivative instruments, including their initial recording, income recognition, and valuation, may require detailed analysis of relevant accounting guidance as it applies to the specific instrument structure. Accounting and financial reporting guidance may be found in pronouncements, such as FAS 133 and FAS 140, and in the AICPA's Investment Company Audit Guide.[13]

In addition, recently-adopted FAS 157 and FAS 161 apply to fund financial statement disclosures. FAS 157 requires, for each major category of assets and liabilities, disclosure of the level within the fair value hierarchy in which the fair value measurements in their entirety fall: quoted prices in active markets for identical assets (Level 1); significant other observable inputs (Level 2); and significant unobservable inputs (Level 3).[14] FAS 161 requires disclosure regarding (i) how and why a fund uses derivatives; (ii) how derivatives are accounted for; and (iii) how derivative instruments affect a fund's results of operations and financial position.[15] FAS 161 also requires tabular note disclosure of gains/losses and fair values by derivative type.

The fund's accounting staff (either internal to the adviser or its affiliate or an external service provider) should have sufficient expertise, or access to such expertise, in the accounting treatment of derivatives, as well as access to all relevant documentation for the instrument to support analysis of its structure and accounting treatment.

7. Tax

Derivatives raise issues under Subchapter M of the Internal Revenue Code requirements for qualification as a regulated investment company. A fund must meet gross income and asset diversification tests, which require determining (i) whether income generated by a holding qualifies as "good" income for this purpose, (ii) the issuer of each holding, and (iii) the value of each holding.[16]

While derivatives-generated income may qualify as "good" income, this is not always the case. For instance, the IRS recently ruled that income from swaps based on commodity indices did not qualify as good income because the swaps were not clearly "securities" for Subchapter M purposes and the income was not otherwise derived with respect to the fund's investment business.[17] In addition, it is not always clear who the "issuer" of a derivative is for purposes of the Subchapter M asset diversification test.[18]

Other important considerations include the timing of income from a derivative, which may determine whether the fund has over- or under-distributed its income for the year, and the character of the derivative income (ordinary versus capital). The character of derivative income for tax purposes may differ from the character for financial accounting purposes. In addition, under recently adopted accounting standard FIN 48, any uncertain tax positions need to satisfy a "more likely than not" standard for a fund to avoid potential income tax accruals with respect to such positions.[19]

8. Disclosure

The fund's registration statement must provide disclosure about the fund's investment objectives, policies, strategies, and associated risks, including those relating to investments (or potential investments) in derivatives. A fund's investments must be consistent with its registration statement disclosure, including its fundamental policies relating to diversification, concentration, the issuance of senior securities, and borrowing, as well as with the fund's name.[20]

In their annual shareholder reports, funds using derivatives to an extent that materially affects performance should consider the need to include appropriate disclosure concerning the use and impact of derivatives during the period in the management discussion of fund performance.

B. Organizational Responsibilities and Coordination

Several teams or individuals within the adviser's organization and relevant service providers have important responsibilities for a fund's derivatives investments. Fund complexes are organized differently: some functions may be performed internally by the adviser or an affiliate or externally by a service provider; a particular department or a single person might be responsible for multiple functions; or multiple departments and people may share responsibility for certain functions (e.g., legal and compliance functions may be combined at some complexes).

The following table highlights primary functions related to derivatives investing that may be performed within the adviser's or service provider's organizations. Because the organizational structures and allocation of responsibilities among personnel vary across fund complexes, the descriptions below may not apply or be relevant to a particular fund complex.

KEY FUNCTIONS RELATED TO FUND DERIVATIVES INVESTING	
Functions	**Potential participants**
Implement investment strategy, including: » select derivatives for investment; » test composite portfolio for compliance with investment strategy and various controls, including concentration and leverage; » evaluate counterparty risk; and » assist, when applicable, in fair value pricing	Portfolio Management Traders Credit Analysts Risk Management and/or Compliance Personnel
Oversee compliance with fund disclosures and policies and procedures, including those relating to: » valuation; » asset segregation; » liquidity; » diversification, concentration, and financial services firm investment limits; and » counterparties	Fund CCO and Compliance Personnel Legal Personnel Administrator Fund Accountant Treasurer
Negotiate OTC derivatives contracts, such as swaps	Portfolio Management Legal Personnel
Process and document derivatives transactions, including confirmations, settlements, and reconciliations	Back Office Personnel (of Administrator and/or Adviser)
Maintain custody of portfolio assets, including collateral	Custodian
Provide prices for portfolio holdings, including matrix-based prices and model-based OTC derivatives	Pricing Service Broker-dealers Counterparties Portfolio Management (may provide input)
Calculate daily NAV	Fund Accountant
Determine accounting policies for derivatives' initial recording, income recognition, and valuation; and prepare financial statements	Treasurer Fund Accountant Fund Auditor (to audit financial statements at year end)
Determine appropriate tax treatment	Treasurer Tax Personnel

Advisory staff and, where applicable, service provider personnel, should regularly communicate and coordinate regarding a fund's derivatives transactions.[21] Some advisers have established committees, with representatives from the departments responsible for oversight of some aspect of the fund's derivative investments (e.g., portfolio management, operations, credit, risk management, legal, compliance, accounting, and tax). These committees may evaluate issues relating to a fund's investment (or consideration of an investment) in a type of derivative, including the portfolio manager's investment rationale, the potential benefits and risks to the fund, and regulatory and operational considerations.

In some cases, the committee may approve (or the fund's policies and procedures may establish) guidelines for fund investments in derivatives or other complex instruments, including a list of approved types of investments. The committee may be required to evaluate and approve any new type of investment product that is not covered by the guidelines prior to the fund's investment in the product. The adviser's committee also may work closely with relevant external service providers or other resources, such as fund counsel and the custodian, accounting agent, and auditor.

C. Policies and Procedures

A fund's policies and procedures may be written broadly enough to encompass the types of derivatives the fund may use. In other cases, policies and procedures may include provisions tailored specifically for derivatives investments. For example:

- valuation policies may specify pricing procedures for specific types of derivatives, such as swaps;
- liquidity policies may include criteria for deeming certain types of derivatives to be liquid or illiquid;
- asset segregation policies may specify the amount and type of assets required to be segregated for categories of derivatives as well as procedures for ongoing monitoring of the adequacy of segregated assets;
- custody policies may specifically address the custody of derivatives documentation and collateral;
- counterparty policies may set criteria for evaluating and approving counterparties, limit counterparty exposure for individual fund portfolios or for all advisory clients, and assign responsibilities for initial screening and ongoing monitoring of counterparty credit adequacy; and
- diversification and concentration policies may identify the issuer of types of derivatives (i.e., the counterparty, issuer of the reference asset, or both) and monitor combined exposure to entities that are both counterparties to derivatives transactions and issuers of other portfolio securities.

In addition to integrating derivatives into the fund's existing policies and procedures, a fund may add policies specifying, for example, categories of derivatives in which the fund may invest, the use of derivatives (e.g., hedging only), limits on derivatives exposure by percentage of fund assets or derivatives category, or required authorizations and procedures for the initial set-up and ongoing monitoring of derivatives investments. The fund's primary service providers, such as the adviser, subadvisers, and custodian, also may have policies and procedures that cover derivatives investments.

V. Board Practices and Resources

Oversight of derivatives is part of the board's overall responsibility for overseeing portfolio investments and the adviser's relevant expertise, resources and controls. The level of board involvement with respect to derivatives oversight varies across the industry and may depend on the extent and type of derivatives investing conducted by the fund. For example, the board of an index fund that uses futures solely to efficiently invest (equitize) cash may not find it necessary to devote as much time and attention to the fund's derivatives investments as might the board of an actively-managed fund with complex OTC derivatives holdings and strategies.

Some boards may oversee derivatives investments within the broader context of oversight of all portfolio investments and rely on the adviser to implement the fund's investment strategies consistent with the fund's mandate and guidelines; some may establish parameters within which the adviser may invest in derivatives; and some may review new categories of derivatives before the fund invests in them. Fund board practices, including delegation to board committees to focus on different aspects of derivatives investments, continue to evolve.

A. Board Education

Fund directors may seek education about derivatives from a variety of sources, such as educational papers, books, and conferences. (See Appendix E for educational resources for boards.) The fund's adviser may play a significant role in board education, assisting the board in understanding and evaluating the impact of derivatives on portfolio structure, risk, and performance.

While individual directors may bring significant knowledge of derivatives from their professional backgrounds, exceeding the depth required for board oversight, educational presentations and materials for the board should be designed to assist all directors in understanding the key features, benefits, and risks of derivatives investments and applications.

In addition to a basic overview of derivatives, presentations to the board might include discussion of:

» specific derivatives proposed for the fund;

» examples of their application to implement the manager's investment strategy;

» their benefits and risks;

» the adviser's key systems, personnel and/or committees with derivatives responsibility; and

» relevant policies and procedures.

B. Board Reporting

A fund's derivatives investments should be captured in compliance and portfolio performance reports to the board. In some cases, information about derivatives investments may be highlighted within existing reports and/or presented in separate reports.

In its reports to the board, the adviser may present the contributions of derivatives and any related securities, explaining derivatives' role within the fund's investment strategy, portfolio structure, and performance. The adviser's written commentary and reports might discuss:

» investment decisions and portfolio structure—the manager's primary investment decisions relative to the fund benchmark, including portfolio beta and overall risk, and sector or security under- and over-weightings;

» performance attribution—which of the manager's investment decisions added or subtracted value relative to the benchmark return; and

» derivatives contribution—how derivatives, in conjunction with cash securities, were used to implement the portfolio decisions, including their effect on the market risk, relative to the appropriate equity or bond benchmark as well as the target industry credit, and security exposures.

The adviser also might report on derivatives-related controls, including risk management measures to avoid inadvertent portfolio leverage or concentration, or compliance reviews to determine if specific derivatives and their applications are appropriate within any guidelines specified in fund disclosure documents, by the board, and in the adviser's internal guidelines.

As with all aspects of board reporting, the adviser and board should agree on procedures for timely alerts about material problems or issues encountered with the fund's derivatives investments.

C. Board Resources

In preparing for and evaluating discussions with the adviser, the board may seek input from a number of resources to provide perspective on the specific details of the fund's derivatives use and the adviser's capabilities, as well as a broader overview of fund industry developments concerning derivatives use, controls, and issues. Resources available to the board may include the fund auditor, board and fund counsel, as well as industry or academic publications and conferences (see Appendix E).

Conclusion

As the derivatives markets rapidly evolve in volume, type, and complexity, industry practices and fund uses of derivatives will evolve as well. Fund boards should continue to work with their advisers to stay informed about derivatives used by the funds they oversee, their potential benefits in achieving the fund's investment objectives, and the potential added risks, controls, and resource requirements.

Appendix A: Board Oversight of Derivatives Task Force

Kelley J. Brennan	Independent Director Allegiant Funds
Jerome S. Contro	Independent Director Janus Funds
Brent R. Harris	Chairman of the Board and Interested Director PIMCO Funds
Susan B. Kerley, Task Force Chair	Independent Chair MainStay Funds Independent Director Legg Mason Partners Funds
Alan R. Latshaw	Independent Director MainStay Funds State Farm Funds
Edward L. Pittman	Independent Chair Van Wagoner Funds
Walter S. Pollard, Jr.	Senior Legal Counsel Fidelity Management & Research Company
Thomas Schneeweis	Independent Director Managers Funds

Appendix B: Potential Topics for Board-Adviser Discussion

This report is intended to facilitate dialogue between a fund's board and adviser (with input from counsel and other resources) regarding the fund's derivatives investments. Listed below are potential topics that may be addressed, including as part of educational sessions for fund directors. The content and extent of individual board-adviser discussions will depend on the particular circumstances of the fund, including the approved types and applications of derivatives, the adviser's organizational structure, and market conditions. Some of the topics may not be relevant to a fund. In addition, depending on the circumstances, a board may determine to focus in a greater level of detail on some issues than others.

1. Portfolio Management Applications

- Types of derivatives used (or to be used) in the fund
  - Criteria for defining and identifying derivatives
  - Other fund holdings with characteristics similar to derivatives
  - Limitations, if any, on the fund's derivatives investments based on criteria such as types of derivatives or percentage of portfolio value
- Use of derivatives (current or prospective) to implement the fund's investment strategies, for example:
  - Gain target risk exposures (market, sector, currency, security)
  - Replicate target holdings
  - Hedge portfolio positions
  - Invest in markets which may be difficult or costly to access directly
- The criteria and analyses for deciding whether to use derivatives to implement the investment strategies
- The benefits and risks of using derivatives, relative to the alternative of holding cash securities only

2. Investment Risks and Controls

- Processes and/or analyses for initial selection and structuring of derivatives holdings, including evaluation of credit exposure at the issuer, counterparty, and/or collateral levels
- Processes for ongoing measurement and analyses of portfolio risks, including leverage, counterparty and credit exposure, illiquidity, and the potential impact of worst-case scenarios
  - For all portfolio holdings, including derivatives, and their impact on the composite portfolio
  - Specifically developed for and applied to derivatives holdings

3. Regulatory and Operational Considerations

- Any customized or manual processes for derivatives transactions, including for confirmations, settlements and reconciliations
- Key processes and responsibilities for:
  - Custody and collateral flows
  - Asset segregation

    - Tracking counterparty exposure
    - Valuation, which may include pricing sources and processes for validating prices
    - Determining appropriate accounting and tax treatments
    - Review of disclosure in registration statements, shareholder reports, and financial statements

4. Organizational Structure and Processes

- Organizational structure and process for evaluating investment, operational, and regulatory considerations relating to derivatives investments prior to investment and/or on an ongoing basis, including whether there is a committee or other mechanism to facilitate communication among, and/or approval by, personnel involved in evaluating and supporting derivatives investments
- Process and responsibility for elevating issues of concern relating to derivatives investments to senior management, legal or compliance personnel, fund counsel, the fund auditor, and/or the board

5. Policies and Procedures

- Description of how derivatives fit within existing policies and procedures
- Recommended modifications or additions, if any, to incorporate derivatives' features
- Testing and monitoring by compliance or other personnel

6. Experience of Adviser and Service Providers

- Experience of the adviser, service providers, and relevant personnel with respect to derivatives
- Adviser's experience in using derivatives to implement the particular investment strategies followed for the fund
- Any significant, additional derivatives-related regulatory or operational requirements for registered funds
- Issues that may be pertinent to the fund's uses of derivatives that the adviser has previously encountered or discovered in audits, regulatory examinations or other types of reviews, and their resolution
- Training of relevant personnel

7. Board Practices

- Review and/or approval of the fund's derivatives uses (or delegation to adviser)
    - Full board
    - Committees
- Reporting to the board
    - Significant issues or violations of policies
    - Ongoing reporting
        - Investment applications and results
        - Compliance tests and results

Appendix C: Glossary

Note: Some of the definitions provided below can be found on the website of the Commodity Futures Trading Commission at http://www.cftc.gov/educationcenter/glossary/index.htm.

asset-backed securities (ABS): Securities backed by a discrete pool of self-liquidating assets, such as credit card receivables, home-equity loans, and automobile loans. Asset-backed securitization is a financing technique in which financial assets are pooled and converted into instruments that may be offered and sold in the capital markets. (See also **mortgage-backed securities**.)

cash securities: Physical (non derivative) assets, such as bonds or equity securities.

clearing house: An entity, commonly affiliated with a major exchange, such as the Chicago Mercantile Exchange, New York Mercantile Exchange or Chicago Board Options Exchange, through which futures and other exchange-traded derivatives are cleared and settled. (See also **exchange-traded derivatives**.)

counterparty: The opposite party in a bilateral agreement, contract, or transaction, such as a swap.

> **counterparty risk:** The risk associated with the financial stability of the opposite party of a contract.

credit event: An event such as a debt default or bankruptcy that will affect the payoff on a credit derivative, such as a credit default swap, as defined in the derivative agreement.

exchange-traded derivatives: Standardized contracts traded on recognized exchanges, such as the Chicago Mercantile Exchange, New York Mercantile Exchange, and Chicago Board Options Exchange. Transactions in exchange-traded derivatives generally are guaranteed by a clearing house that imposes a system of margin requirements designed to minimize credit risks: trades settle the business day following trade date, contracts are marked-to-market daily, and collateral (margin) is exchanged daily. Exchange-traded derivatives include futures, options, and options on futures.

forward: A contract that obligates each party to the contract to trade an underlying asset (commonly, foreign currency) at a specified price at a specified date in the future. Forward contracts are traded in the over-the-counter markets and their terms are customized, unlike futures contracts.

futures: A standardized contract to purchase or sell an underlying asset in the future at a specified price and date. Futures are exchange-traded derivatives.

International Swaps and Derivatives Association (ISDA): A New York-based group of major international swap dealers that publishes standard master interest rate, credit, and currency swap terms and definitions for use in connection with the creation and trading of swaps.

> **ISDA master agreements:** Standard master interest rate, credit, and currency swap agreements and definitions for use in connection with the creation and trading of swaps, published by the International Swaps and Derivatives Association (ISDA). These standard agreements must be supplemented by the swap parties based upon individual negotiations.

leverage: The ability to control large dollar amounts of an asset with a comparatively small amount of capital.

long-short strategies: Strategies combining long positions, in holdings identified by the fund's portfolio manager as offering favorable return-risk prospects, offset by short positions in holdings with unfavorable prospects. Such strategies may include long-short positions in individual securities and/or broader market sectors. By allowing the manager to short unfavorable securities, the fund is seeking additional potential value-added (alpha) from the manager's active management strategies.

130/30 funds: Primarily managed against a broad equity (e.g., S&P 500) or fixed income (e.g., CSFB High Yield) benchmark. The fund manager may short securities, up to 30 percent of the portfolio value, and go long up to 130 percent in favorably positioned securities. (While 130/30 currently represents the most common long-short percentages for registered funds, funds could employ other portfolio combinations of long-short percentages.) The fund seeks to maintain overall market exposure equivalent to the fund benchmark (with a beta close to one). Depending upon the aggregate portfolio beta resulting from the combination of long and short securities (which will vary on a daily basis), this may require purchasing derivatives (generally futures) to increase market exposure or selling to reduce market exposure.

market-neutral funds: Seek only the alpha of the combined long-short positions, with no market exposure. Therefore, the fund seeks a return equal to the return on a short-term fixed income holding plus the alpha. Because the long and short positions may not precisely offset each other, the fund manager may need to use derivatives, generally to hedge any remaining market risk exposure.

portable alpha funds: Combine (or overlay) long-short alpha opportunities from one broad asset class (e.g., U.S. equities) with the market return (beta) of another asset class (e.g., U.S. bonds). In this case, the market neutral approach described above would be used to eliminate any market risk in the "alpha market" and derivatives would be used to gain the target exposure to the "beta market."

margin: The amount of money or collateral to be deposited by a derivatives purchaser or seller. For exchange-traded derivatives, the collateral will be held by the broker or clearing house. For OTC derivatives, the terms of the collateral requirements will be specified in the contract between the two parties to the transaction.

initial margin: The amount of margin required to be deposited when the position is opened.

variation margin: Payment made daily (or with frequency specified in the OTC contract) based on adverse price movements in the derivative's reference asset.

mortgage-backed securities: Instruments whose cash flow depends on the cash flow of an underlying pool of mortgages.

notional value: The economic value imputed to a derivatives transaction to calculate periodic payment obligations, based on, for example, price movement in an interest rate, currency, specified issuer, or index.

novation: Agreement to replace one party to a contract with a new party. The novation transfers both rights and duties and requires the consent of both the original and new party. Also refers to replacement of an older debt or obligation with a newer one. ISDA published the Novation Protocol in 2005 to enable parties to confirm their understanding and intentions regarding the transfer by novation of the transactions covered by their agreement.

option: A contract that gives the buyer the right, but not the obligation, to buy or sell a specified quantity of a security, commodity, or other asset at a specific price within a specified period of time. (See **put** and **call** and payoff diagrams below.)

option buyer: The party which buys calls, puts, or any combination of calls and puts.

option writer: The party which originates an option contract by promising to perform a certain obligation in return for the price or premium of the option. Also known as option seller.

call: An option contract giving the buyer the right, but not the obligation, to purchase a specified quantity of a security, commodity or other asset at a given price (the strike price) prior to or on a specified future date.

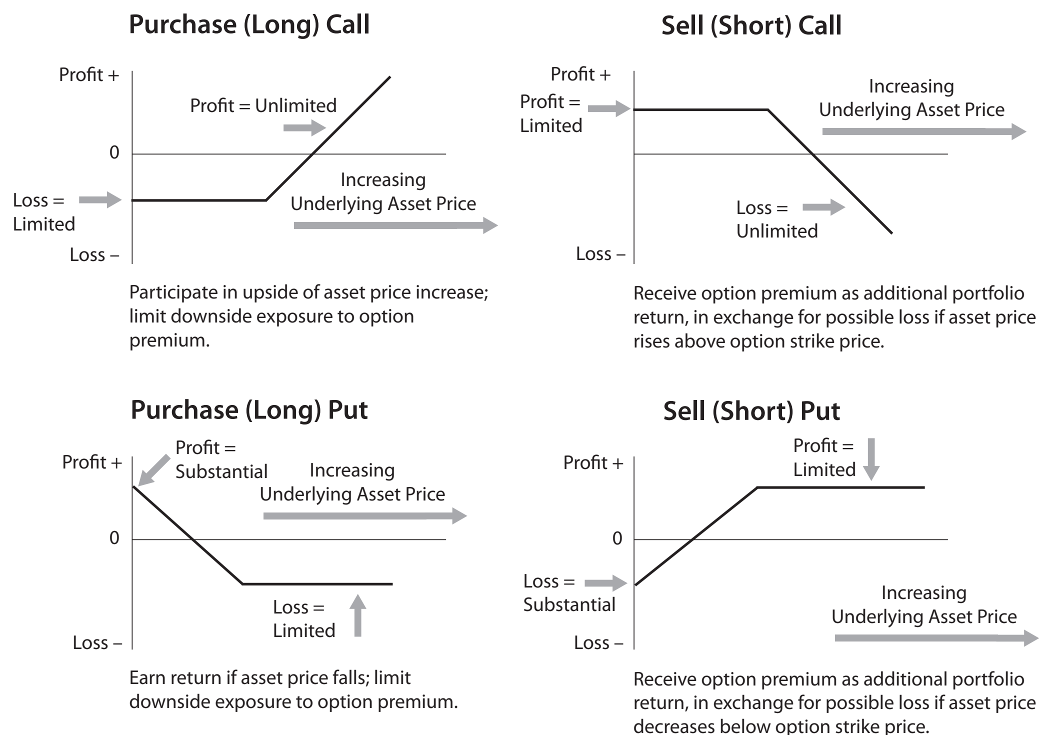
premium: The payment an option buyer makes to the option writer for granting an option contract.

put: An option contract that gives the holder the right, but not the obligation, to sell a specified quantity of a security, commodity, or other asset at a given price (the strike price) prior to or on a future date.

strike price (exercise price): The price, specified in the option contract, at which the underlying asset (e.g., the futures contract, security, or commodity) will move from the option seller to the option buyer.

swaptions: An option to enter into a swap– i.e., the right, but not the obligation, to enter into a specified type of swap at a specified future date.

Option Payoff Diagrams



Source: Chicago Board Options Exchange

over-the-counter (OTC) derivatives: Derivative transactions that are entered into on a bilateral contractual basis outside an organized exchange. OTC derivatives include forwards, swaps, and options that are not exchange-traded.

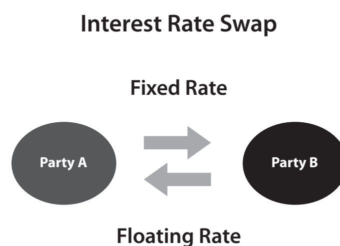
reference asset: The asset or metric, such as a securities index or corporate bond, that underlies or is referenced by a derivative. For example, the reference asset of an S&P 500 futures contract is the S&P 500 index.

structured notes: Instruments which pay interest rates that are indexed to an unrelated indicator (e.g., the S&P 500 Index). The two may be inversely related (for example, with "inverse floaters," as the index goes up, the coupon rate goes down).

swap: The exchange of one asset or liability for another asset or liability. Swaps are structured and transacted over-the-counter. Common types of swaps include:

> **credit default swap:** Agreement in which the seller agrees to make a payment to the buyer in the event of a specified credit event (such as a default on an interest or principal payment of a reference entity) in exchange for a fixed payment or series of fixed payments.
>
> **currency swap:** Agreement for the exchange of one currency (e.g., U.S. dollars) for another (e.g., Japanese yen) on a specified schedule.
>
> **interest rate swap:** Agreement to exchange interest rate based flows (e.g., one party agrees to pay a fixed rate and the other party agrees to pay a floating rate, such as one based on LIBOR [London Interbank Offered Rate]), on a specified series of payment dates based on a specified principal amount (i.e., notional value).

Interest Rate Swap



> **total return swap:** Agreement in which one party receives the total return (interest or dividend payments and any capital gains or losses) from a specified reference asset and the other party receives a specified fixed or floating rate.

Appendix D: Portfolio Management Examples

EXAMPLE 1: **EQUITIZE CASH: PURCHASE S&P 500 FUTURES TO GAIN MARKET EXPOSURE**	
Scenario Overview:	Portfolio manager of $500 million equity mutual fund benchmarked to the S&P 500 Index learns of $100 million cash flow to the fund on relatively short notice (3 days).
Concerns/Challenges:	Fund's stated objective is to outperform the S&P 500 Index. The portfolio manager would like to minimize the performance impact of a large uninvested cash position in the fund.
Derivatives Transaction Overview:	Purchase (long) S&P 500 Futures Contracts traded on the Chicago Mercantile Exchange (will require modest amount of initial margin with remaining funds available to invest in cash or cash equivalent securities). Having gained exposure to the broad equity market return, the portfolio manager will have the time to invest in individual stocks reflecting the investment management strategy, selling the futures as stock purchases are made.
Governing Framework:	Futures contracts are governed by the terms established by the exchange.
Current Market Data:	**Date**: 31 March 20XX **S&P 500 Index Level (current)**: 1,000 **LIBOR Rate**: 4% (annualized)
Contract Specifications:	Initial margin requirement: 5% Contract multiplier: $250
Transaction Mechanics:	To generate equity exposure equivalent to $100 million, purchase approximately 400 S&P Futures Contracts » $100 million = $250 (contract multiplier) x 1,000 (S&P 500 Index Level) x 400 contracts Open long (purchase) 400 S&P 500 Futures Contracts as follows: » Deposit $5 million in initial margin required by exchange (5% of $100 million) » Invest remaining $95 million in cash equivalent securities yielding LIBOR At termination of transaction, the fund has the following position: » Long 400 S&P 500 Futures Contracts » $5 million initial margin posted with the exchange (earning LIBOR) » $95 million in cash equivalent securities (earning LIBOR)

EXAMPLE 1 (CONTINUED) **EQUITIZE CASH: PURCHASE S&P 500 FUTURES TO GAIN MARKET EXPOSURE**	
Future Cash Flows:	S&P 500 Futures Contracts are cash settled on a daily basis. Assume that on the following day, the S&P 500 Index Level increases by 100 (from 1,000 to 1,100). The exchange would send the fund the following proceeds: » Change in index level: 100 (1,100 – 1,000) » Dollar value of increase per contract: $25,000 (100 [index level change] x $250 [contract multiplier]) » Total proceeds: $10,000,000 = $25,000 per contract x 400 contracts Assume that on the next day, the index level decreases by 200 (from 1,100 to 900). The fund would forward cash (variation margin) in the following amount: » Change in index level: -200 (900 – 1,100) » Dollar value of increase: -$50,000 (-200 [index level change] x $250 [contract multiplier]) » Total proceeds: -$20,000,000 = - $50,000 per contract x 400 contracts
Risk Considerations:	**Counterparty risk:** There is minimal counterparty risk since the exchange (technically, the exchange's clearing house) ensures that both buyer and seller execute the terms of the agreement. **Market risk:** The fund has assumed $100 million of market risk, which is consistent with the fund's objectives. **Basis risk:** Depending upon market conditions, futures and cash securities may trade at slightly different prices, leading to a small differential in return (but significantly less than the difference between the equity and cash returns). **Leverage risk:** The portfolio manager must be sure to balance the purchase of individual securities with the sale of the equivalent amount of futures to ensure the overall portfolio's market exposure is maintained. **Other risk considerations:** If the $95 million invested in cash and cash equivalent securities earns a rate of return substantially different than the money market rate, this position will generate returns different from that of the index. For this reason, the manager must carefully oversee the management of cash backing the futures position.

EXAMPLE 2:

CREDIT DEFAULT SWAPS TO GAIN EXPOSURE TO A CORPORATE DEBT ISSUER

Scenario Overview:	Fund portfolio manager seeks to gain $10 million of exposure to a corporate issuer for the next three years.
Concerns/Challenges:	Portfolio manager could purchase $10 million par of a floating rate bond issued by the reference corporation: » Fund would receive a regular coupon payment from the issuer. » If the reference entity defaults, the fund would hold a credit-impaired bond. The loss on this position would be $10 million minus the recovery value of the bond. Alternatively, for various reasons, including a limited supply of the reference entity's securities trading in the market, the fund could sell $10 million of "credit protection" to a counterparty in the event of default (or another credit event) by the reference corporate entity. The fund could then invest $10 million in cash and/or cash equivalent securities to back the contingent liability of the credit protection it has sold.
Derivatives Transaction Overview:	The fund sells protection to a counterparty in the credit default swap market against default of the reference corporate issuer.
Governing Framework:	Credit default swaps are traded OTC. The majority of credit default swap contracts have been standardized according to terms developed by the International Swaps and Derivatives Association (ISDA).
Current Market Data:	**Date:** 31 March 20XX **Reference issuer floating rate bond yield:** 5 percent (500 basis points)
Contract Specifications:	» Notional Value (amount protected against default/credit event): $10 million » Annual premium (cost) for providing default protection paid by buyer of credit protection: $500,000 (5 percent of $10 million) » Credit event (including default) by the reference entity requires protection seller to deliver $10 million in exchange for a bond of the reference entity with a specific maturity » Maturity of the credit default swap: 3 years
Transaction Mechanics:	» Fund (as protection seller) agrees to terms with protection buyer (counterparty); assume no cash is initially exchanged. » Fund invests $10 million in cash and cash equivalent securities.

EXAMPLE 2 (CONTINUED) **CREDIT DEFAULT SWAPS TO GAIN EXPOSURE TO A CORPORATE DEBT ISSUER**	
Future Cash Flows:	If no credit event by the reference entity occurs, fund (as protection seller) would earn a total of $900,000 annually: » $500,000 annual premium from the protection buyer (likely in quarterly payments); and » $400,000 from $10 million investment in cash equivalent securities (assume earning 4 percent annualized rate) If a credit event specified in the agreement occurs, the fund (as protection seller) would deliver $10 million in cash to the protection buyer and receive in exchange a bond (of an agreed upon maturity). The fund's $10 million loss would be reduced by any recovery amount associated with the impaired bond.
Risk Considerations:	**Counterparty risk:** Prior to a credit event, the protection seller has counterparty risk exposure to the protection buyer since the protection buyer may default on its obligation for annual payments over the life of the swap. In the event of a credit event, the protection buyer will incur counterparty risk exposure to the protection seller for the notional amount of the swap (in this case, $10 million). **Credit risk:** The fund has gained exposure to default (or a similar credit event) by the reference entity. In exchange for this, the portfolio manager has increased the income (yield) of the fund. **Other risk considerations:** As with the futures example, the management of the $10 million invested in cash and cash equivalent securities backing the agreement could materially alter the risk profile of the portfolio. For instance, if the portfolio manager invests the $10 million in securities that have a high likelihood of default, the portfolio manager has materially increased the credit risk of the fund.

EXAMPLE 3: FORWARD CURRENCY CONTRACTS TO HEDGE CURRENCY EXPOSURE	
Scenario Overview:	An international bond fund, which is fully hedged to the U.S. Dollar (USD), has a $1 million position in a corporate bond denominated in Swiss Francs (Sf). While the portfolio manager believes that the credit metrics of the company issuing the security will improve over the next year, the portfolio manager is not willing to assume the currency risk of the Swiss Franc.
Concerns/Challenges:	The fund is effectively long Swiss Francs through owning a bond denominated in that currency. The portfolio manager wishes to implement an efficient and effective transaction to remove the currency risk of the position. To reduce this exposure, the portfolio manager can take an off-setting (i.e. short) position in the forward market.
Derivatives Transaction Overview:	Sell (go short) Swiss Francs in the forward market.
Governing Framework:	Forward contracts are transacted in the OTC market, and the terms are negotiated by the parties.
Current Market Data:	**Date:** 31 March 20XX **Current (spot) exchange rate:** 1.35 USD to 1 Sf **Current one year forward exchange rate on 31** **March 20XY:** 1.32 USD to 1 Sf
Contract Specifications:	Contract maturity: 1 year
Transaction Mechanics:	Current value of 1,000,000 Sf position in USD is 1,350,000 USD: 1,350,000 USD = 1,000,000 Sf x (1.35 USD / 1 Sf) Transacting in the OTC market, the fund would sell to a counterparty 1,000,000 Sf for 1,320,000 USD with the transaction settling in 1 year: 1,320,000 USD = 1,000,000 Sf x (1.32 USD / 1 Sf)

EXAMPLE 3 (CONTINUED)

FORWARD CURRENCY CONTRACTS TO HEDGE CURRENCY EXPOSURE

Future Cash Flows:	Assume in 1 month, the current (spot) rate for 1 Sf has fallen to 1.31 USD and the 11 month forward exchange rate for 1 Sf falls to 1.28 USD The fund's position is now worth: 1,310,000 USD = 1,310,000 USD = 1,000,000 Sf x (1.31 USD / 1 Sf) The fund's loss (in dollar terms) for the position is 40,000 USD: 40,000 USD = 1,350,000 USD - 1,310,000 USD However, the forward position gains in value: 40,000 USD » Previous value of forward position: 1,320,000 USD = 1,000,000 Sf x (1.32 USD / 1 Sf) » Current value of forward position: 1,280,000 USD = 1,000,000 Sf x (1.28 USD / 1 Sf) » Gain on forward position: 40,000 USD = (1,320,000 USD - 1,280,000 USD) Thus, the gain on the forward position offsets the currency loss from the original exposure
Risk Considerations:	**Counterparty risk:** In this case, the fund is "owed" $40,000 by the counterparty since this is the amount by which the forward position has gained. Therefore, the fund has $40,000 of counterparty risk exposure. This risk would be mitigated according to the terms of the forward agreement. **Market risk:** While the portfolio manager has removed currency risk from this position, the fund maintains exposure to other risks associated with the bond, such as credit and/or interest rate risks. **Other risk considerations:** If the agreement with the counterparty requires the exchange of collateral prior to contract termination, the portfolio manager would need to carefully manage liquidity in the fund to support potential collateral exchanges. For instance, a worst-case scenario would be a dramatic rise in the Swiss Franc, which could generate a requirement for a collateral payment. If the fund lacked liquidity, the portfolio manager would be required to sell assets that were intended to be held in order to meet collateral requirements.

EXAMPLE 4:
OPTIONS TO HEDGE AGAINST POTENTIAL PRICE DECLINES IN AN EQUITY SECURITY

Scenario Overview:	A fund had purchased 10,000 shares of XYZ at $5 per share. The XYZ shares have increased in value to $15 per share and, as a result, XYZ is now a significant portion of the fund's portfolio holdings. The portfolio manager seeks to reduce the fund's exposure to a potential short-term price decline in XYZ.
Concerns/Challenges:	While the portfolio manager could sell all or part of the position in XYZ, the portfolio manager is reluctant to do so for a variety of reasons: the portfolio manager expects that XYZ will outperform cash; the manager continues to believe that XYZ is fairly priced relative to other comparable securities; and, for the purpose of tax efficiency, the manager would like to defer the realization of a gain until a period that offers more advantageous tax treatment for fund shareholders (i.e., short- vs. long-term capital gains).
Derivatives Transaction Overview:	Purchase exchange-traded put options on XYZ. The fund will pay a premium for the right to sell XYZ at a specific price by (or on) a specific future date.
Governing Framework:	Exchange-traded option contracts are governed by the terms established by the exchange (e.g., Chicago Board of Options Exchange, American Stock Exchange)
Current Market Data:	**Date:** 31 March 20XX **Current price of XYZ:** $15 per share
Contract Specifications:	Current price (premium) of 1 put contract (for 100 shares) on XYZ with strike price of $15: $5
Transaction Mechanics:	Total current gain on portfolio: $100,000 $100,000 = $10 price gain per share x 10,000 shares The fund purchases 100 put contracts for $50,000 $50,000 = 100 put contracts x 100 shares per put contract x $5 per share option premium Effectively, the portfolio manager has foregone $50,000 in profit in order "lock in" a $50,000 gain.

EXAMPLE 4 (CONTINUED)

OPTIONS TO HEDGE AGAINST POTENTIAL PRICE DECLINES IN AN EQUITY SECURITY

Future Cash Flows:	Assume in 1 month, the price of XYZ drops to $7 per share: » Loss on stock position: $80,000 Loss = $150,000 (previous value of position) - $70,000 (current value of position) » Net gain on put option: $30,000 Gain on put option: $80,000 = $15 (strike price) – $7 (current price) x 10,000 (number of shares) Less premium paid: $50,000 = $5 x 10,000 shares » Total "loss" on stock position = $50,000 $80,000 (loss on stock position) - $30,000 (net gain on put option) Regardless of how far the stock price falls from $15 per share, the portfolio manager has ensured that he can "sell" or "put" the fund's shares for $10 per share.
Risk Considerations:	**Counterparty risk:** Counterparty risk is minimal since contract execution is guaranteed by the exchange, or, more precisely, the exchange's clearing house. **Market risk:** The portfolio manager has paid a fee (sacrificed yield or income in the portfolio) in order to reduce the fund's exposure to XYZ. **Other risk considerations:** A variety of factors influence the price of a given option, including the strike price of the option, time to option expiration, and the price volatility of the underlying security. A portfolio manager must balance the benefits of buying and selling options with the costs of the option transaction, including changes in the option prices.

Appendix E: Additional Resources for Boards

The following websites and publications contain additional information about derivatives. They are merely a sample of a large number of available sources. Except for the Investment Company Institute (ICI) and IDC websites and publications, the websites and publications listed below are created, maintained, and published by other organizations. ICI and IDC do not control, cannot guarantee, and are not responsible for the accuracy, timeliness, or even the continued availability or existence of this outside information.

Regulatory Agencies

- U.S. Securities and Exchange Commission: www.sec.gov
  - *See also speeches of SEC staff:*
    - Keynote Address at Mutual Fund Directors Forum Program by Gene Gohlke, Associate Director, Office of Compliance Inspections and Examinations (Nov. 8, 2007) ("If I Were a Director of a Fund Investing in Derivatives — Key Areas of Risk on Which I Would Focus"): www.sec.gov/news/speech/2007/spch110807gg.htm
    - Remarks Before the Investment Company Institute 2007 Operations and Technology Conference by Andrew J. Donohue, Director, Division of Investment Management, U.S. Securities and Exchange Commission (October 18, 2007): www.sec.gov/news/speech/2007/spch101807ajd.htm
    - Keynote Address at Practicing Law Institute, Investment Management Institute 2007 by Andrew J. Donohue, Director, Division of Investment Management, U.S. Securities and Exchange Commission
(April 12, 2007): www.sec.gov/news/speech/2007/spch041207ajd.htm
    - Keynote Address at 2007 Mutual Funds and Investment Management Conference by Andrew J. Donohue, Director, Division of Investment Management, U.S. Securities and Exchange Commission (March 26, 2007): www.sec.gov/news/speech/2007/spch032607ajd.htm

- See also Senior Supervisors Group, *Observations on Risk Management Practices during the Recent Market Turbulence* (March 2008): www.sec.gov/news/press/2008/report030608.pdf
- Commodity Futures Trading Commission: www.cftc.gov
  - See glossary: www.cftc.gov/educationcenter/glossary/index.htm

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  - Directors Reference Center: www.idc.org
  - *Fair Valuation: The Role of the Board* (January 2006): www.ici.org/pdf/06_fair_valuation_board.pdf
  - *An Introduction to Fair Valuation* (Spring 2005): www.ici.org/pdf/05_fair_valuation_intro.pdf

- International Swaps and Derivatives Association, Inc. (ISDA): www.isda.org
  - Includes ISDA Master Agreement Protocols and market statistics.
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  - Includes conferences, articles and journals such as the *Financial Analysts Journal*.
- Global Association of Risk Professionals: www.garp.com
  - Includes courses and publications.

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- CFTC Glossary: www.cftc.gov/educationcenter/glossary/index.htm
- John Downes and Jordan Elliot Goodman, *Barron's Dictionary of Finance and Investment Terms* (7th ed. 2006)

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Notes

[1] See letter from Arthur Levitt, Chairman, Securities and Exchange Commission, to Matthew P. Fink, President, Investment Company Institute (June 17, 1994) (directors "need not micromanage the minutiae of individual derivatives transactions," but should "exercise knowledgeable and meaningful oversight").

[2] Custody of Investment Company Assets with Futures Commission Merchants and Commodity Clearing Organizations, Investment Company Act Release No. 22389 (Dec. 11, 1996) (adopting Rule 17f-6 under the Investment Company Act of 1940 [1940 Act]); see also Keynote Address at Mutual Fund Directors Forum Program by Gene Gohlke, Associate Director, Office of Compliance Inspections and Examinations (Nov. 8, 2007). Available at www.sec.gov/news/speech/2007/spch110807gg.htm).

[3] Fund registration statements may include policies limiting the fund's investments in illiquid securities. For example, many open-end funds have policies limiting investments in illiquid securities to no more than 15 percent of net assets. See Statement Regarding "Restricted Securities," Investment Company Act Release No. 5847 (Oct. 21, 1969); Revisions of Guidelines to Form N-1A, Investment Company Act Release No. 18612 (Mar. 12, 1992).

[4] Section 17(f) of the 1940 Act and Rules 17f-1 and 17f-2 under the 1940 Act.

[5] See Rule 17f-6 under the 1940 Act.

[6] See Section 18 of the 1940 Act and Securities Trading Practices of Registered Investment Companies, Investment Company Act Release No. 10666 (April 18, 1979) (Release No. 10666).

[7] See Release No. 10666, supra n.6.

[8] Id.

[9] Id.

[10] A fund must state in its registration statement its policy as to concentration in a particular industry or group of industries, and a fund classified as "diversified" must comply with certain investment limits. See Sections 5(b) and 8(b) of the 1940 Act.

[11] See Section 12(d)(3) of the 1940 Act and Rule 12d3-1 under the 1940 Act.

[12] See Section 2(a)(41) of the 1940 Act and Rule 2a-4 under the 1940 Act.

[13] Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 133, Accounting for Derivative Instruments and Hedging Activities (Jun. 1998); FASB Statement of Financial Accounting Standards No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities (Sep. 2000); American Institute of Certified Public Accountants (AICPA), Investment Companies – AICPA Accounting and Audit Guide (May 1, 2007).

[14] FASB Statement of Financial Accounting Standards No. 157, Fair Value Measurements (Sept. 2006). FAS 157 requires funds to disclose in their financial statements the aggregate dollar value of securities by hierarchy level.

[15] FASB Statement of Financial Accounting Standards No. 161, Disclosures about Derivative Instruments and Hedging Activities (Mar. 2008). FAS 161 is effective for fiscal years and interim periods beginning after November 15, 2008.

[16] Section 851 of the Internal Revenue Code.

[17] IRS Rev. Rul. 2006-1.

[18] Under federal securities laws, an investment company classified as a "diversified company" must limit holdings in securities of any one issuer, and the "issuer" of the derivative must be determined for purposes of this test as well. See Section 5(b) of the 1940 Act. The analysis and outcome may differ under tax and securities laws.

[19] FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes (Jun. 2006).

[20] See Section 8 of the 1940 Act. In addition, a rule adopted pursuant to Section 35(d) of the 1940 Act requires that an investment company with a name suggesting that the fund focuses on a particular type of investment invest at least 80 percent of its assets in that investment. Derivative products providing synthetic exposure of the nature suggested by a fund's name frequently are considered part of the qualifying 80 percent of assets but questions may arise about whether a particular derivative product is a qualifying asset for this purpose.

[21] See keynote address at Investment Company Institute 2007 Mutual Funds and Investment Management Conference of Andrew J. Donohue, Director, SEC Division of Investment Management (March 26, 2007).

Oversight of Fund Proxy Voting

JULY 2008

As fiduciaries, advisers to mutual funds and other investment companies must vote proxies in a way that best serves the interests of fund shareholders. Funds also must disclose every vote they cast, as well the policies that guide their voting and the procedures they use to avoid potential conflicts of interest. Because funds hold almost 30 percent of the shares of U.S. companies on behalf of more than 90 million shareholders, how they vote corporate proxies is a matter of no small interest and public commentary.

The IDC/ICI paper, *Oversight of Proxy Voting*, was released in July 2008 in conjunction with an ICI research study, *Proxy Voting by Registered Investment Companies: Promoting the Interests of Fund Shareholders*.

ICI's research examines the proxy votes cast by the largest fund families during a 12-month period ending June 30, 2007. While the study found that funds tend to vote in favor of management proposals much of the time, most of those proposals involved noncontroversial issues such as uncontested elections of corporate directors and ratification of audit firms. The research countered the notion that funds "rubber stamp" management decisions when voting proxies and showed how funds use their proxy votes to promote the interests of shareholders.

The IDC/ICI paper focuses on board oversight of proxy voting and:

» discusses the responsibilities of fund boards in overseeing fund proxy voting;

» considers various arrangements that funds and their advisers use to vote proxies;

» attempts to identify the major issues that boards are likely to face in establishing and overseeing a fund's proxy voting policy; and

» offers suggestions for board consideration in evaluating and resolving proxy voting issues.

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Introduction

Directors of registered management investment companies (funds) that invest in equity securities of publicly traded companies have certain responsibilities related to voting proxies for those companies.[1] A fund's board of directors typically delegates decisions about the voting of portfolio company proxies to the fund's investment adviser, in recognition that proxy voting is part of the investment advisory process. This delegation is subject to the board's continuing oversight. When fund investment advisers vote proxies on behalf of a fund, they must do so in a manner consistent with their fiduciary duty to manage the fund in the best interests of the fund and its shareholders. Pursuant to SEC rules, a fund and/or its adviser adopts policies and procedures designed to ensure that proxies for portfolio securities are voted in the best interests of the fund and its shareholders and to address conflicts that may arise between the interests of the adviser and those of fund shareholders with respect to proxy voting decisions.[2] Unlike other shareholders, funds must publicly disclose the votes they cast each year by filing Form N-PX with the SEC.

This paper:

- Discusses the responsibilities of fund boards of directors in overseeing proxy voting of fund portfolio securities;[3]
- Considers various arrangements that funds and their advisers use to vote proxies, as well as other proxy voting issues that can arise for specific categories of funds or particular investment practices;
- Attempts to identify the major issues that boards are likely to face in establishing and overseeing a fund's proxy voting policy; and
- Offers suggestions for board consideration in evaluating and resolving proxy voting issues.

As with other aspects of fund operations, there is no "one-size-fits-all" approach to fund proxy voting or board oversight of the voting process. As a result, funds and their advisers and boards seek to establish practices that are effective and workable in their particular circumstances.

I. Board Oversight of Proxy Voting

A fund's board of directors, acting on the fund's behalf, is responsible for 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. The investment adviser, in turn, may rely on a third-party proxy voting service to perform one or more elements of the functions delegated by the board.

When the proxy voting function has been delegated, a fund's board has the responsibility to continue to oversee that function. This oversight responsibility is an aspect of the board's general fiduciary duties of care, loyalty, and good faith. A board's oversight of a fund's proxy voting should be subject to the "business judgment rule," which provides that courts will not find a board liable or second-guess its decisions so long as the board has exercised reasonable judgment in carrying out its duties and has not placed its interests above the interests of the fund and its shareholders.[4] There are various ways boards can fulfill their oversight responsibility with respect to proxy voting, and the approach taken by a board will depend heavily on the unique facts and circumstances of the fund(s) that it oversees.

A. Proxy Voting Policies

Perhaps the most tangible board oversight responsibility with respect to proxy voting is the establishment and review of a fund's proxy voting policy. 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.[5] That rule requires a board to approve a fund's compliance policies—including its proxy voting policy—based on the board's determination that the policies are "reasonably designed to prevent violation of the Federal Securities Laws."[6] The compliance rule also requires a fund's board to review the adequacy of the fund's compliance policies, including its proxy voting policy, at least annually. This is typically accomplished through the annual review of fund compliance policies conducted by a fund's chief compliance officer (CCO), who is required by the compliance rule to report to the board at least annually on the operation of the funds' compliance policies and any material changes, violations, or weaknesses of the policies.

1. Factors for the Board to Consider

The factors a board may wish to consider in assessing a proxy voting policy include:

» ***Consistency of the policy with the fund's investment objectives.*** Is the policy's treatment of various kinds of proposals supportive of, and not inconsistent with, the fund's investment objectives and strategies?

» ***Treatment of potential conflicts of interest.*** Does the policy contain effective mechanisms to address potential conflicts of interest? As discussed below and in Appendix A, there are a number of ways a proxy voting policy may address the potential conflicts of interest that may arise in connection with proxy voting.

» ***Treatment of specific categories of proposals.*** Does the policy describe how the fund will vote on specific categories of proposals, or indicate whether the fund will instead consider some or all proposals on a case-by-case basis? There may be instances in which the board will determine that it would be prudent to routinely vote for proposals made by portfolio companies. For example, the fund may have a policy of routinely voting for portfolio company nominees in uncontested elections of directors. Other categories of proposals that proxy voting policies may cover include those relating to anti-takeover provisions and shareholder rights, board structure and election process, and compensation-related issues. A board may want to consider whether and how a fund's policy should address these types of proposals. For example, for stock option proposals, the board may consider whether the policy should establish the degree of dilution of existing shareholders that will be acceptable or the expense of the options to be granted in proportion to earnings; for board structure and election process proposals, the board may consider whether to address how a fund will vote on measures such as a separate non-executive chairperson, a majority of independent directors, and/or staggered board seats.

» ***Treatment of social issues.*** Should the policy address the criteria used to evaluate and vote on environmental, social, and governance issues? These issues may be particularly important for "socially responsible funds," which typically vote proxies according to both socially responsible and financial criteria. These funds often support and may even sponsor proposals requesting that portfolio companies adopt socially responsible policies and practices. The boards and advisers of socially responsible funds are subject to the same fundamental fiduciary duties with respect to proxy voting as the boards and advisers of other funds.

» ***Policy exceptions.*** Does the policy establish an appropriate process for making determinations that exceptions from the proxy voting policy are warranted, and for periodically reviewing exceptions? It also may be desirable for the policy to address how these exceptions will be reported to the board.

2. Reports to the Board

A fund's board should identify what kinds of proxy voting reports it wants to receive as well as the frequency of those reports. The board should work with the fund's adviser to determine whether these reports will be provided by the fund's adviser, its CCO, or a third-party proxy voting service. The nature and frequency of reports to be provided to the board may be specified in a fund's proxy voting policy, or the board may request this information separately.

A report on all proxy votes may be too voluminous, particularly for large funds or large fund complexes. Consequently, a board may wish to request reports only on certain proxy votes—for example, on an exception basis, with respect to votes that departed from the proxy voting policy, were contrary to the portfolio company management's recommendation, or involved potential conflicts of interest for the adviser, other fund affiliates or any voting service to which voting was delegated. In an effort to discern whether potential conflicts had a material impact on votes cast, a board may wish to request a report that compares the voting pattern for proposals of portfolio companies that have business relationships with the adviser to the voting pattern for proposals of companies that do not.

Absent unusual circumstances, the board typically receives "exception reports" retroactively. If there have been no exceptions in the prior period, the report can so note.

B. Proxy Voting by Investment Advisers

1. The Role of Investment Advisers in Proxy Voting

Where proxy voting authority has been delegated to an investment adviser, voting proxies becomes part of the adviser's investment management function and is subject to the adviser's fiduciary duties.[7] These fiduciary duties generally require an investment adviser to cast proxy votes in a manner consistent with the best interests of the fund and its shareholders, to disclose and address actual or potential conflicts of interest, and not to elevate its own interests over those of the fund and its shareholders. An adviser need not vote every proxy, however, and there may be occasions when voting a proxy is not in the best interests of a fund and its shareholders. For example, as discussed further below, the benefits of casting a vote for a proxy solicited by a foreign issuer may be outweighed by the burdens associated with voting foreign proxies. The SEC has cautioned, however, that an adviser that has assumed the responsibility of voting fund proxies may not simply adopt a "policy" of not voting any proxies at all.[8]

In addition, investment advisers are subject to their own proxy voting rule.[9] This rule requires that an investment adviser adopt and implement policies and procedures reasonably designed to ensure that the adviser votes proxies in the best interests of its clients (including any funds for which it acts as investment adviser), and that the procedures address material conflicts that may arise between the adviser's interests and those of its clients. Consequently, where an investment adviser has been delegated proxy voting authority by a fund's board, both its general fiduciary duties and the SEC's regulations require the adviser to vote proxies in the best interests of the fund and its shareholders.[10]

Investment advisers use a number of approaches in voting a fund's proxies, based on the adviser's and the fund's particular circumstances. Some investment advisers vest proxy voting authority in the same individuals responsible for making investment decisions for a particular fund—that is, the portfolio managers. Others may use non-portfolio management personnel to vote proxies. Still others may use a proxy voting committee comprised of officers or employees of the adviser, including, in some cases, the CCO. Another approach adopted by some investment advisers is the use of unaffiliated third-party proxy voting services.[11] Many investment advisers use a combination of these approaches.

Regardless of the approach used, not all investment advisers or portfolio managers will have the same view of the effect of a particular proposal, or which vote will be in the best interests of a fund and its shareholders. For example, there are differences of opinion on the benefits of various corporate governance measures, such as requiring cumulative voting. Also, factors such as an individual fund's investment objectives and strategies may lead to different judgments and conclusions by different advisers or portfolio managers about the expected impact of proxy proposals (e.g., a merger proposal). Similarly, a particular adviser or portfolio manager might reach different judgments or conclusions with respect to different funds (e.g., a socially responsible fund and a non-socially responsible fund). As a result, proxy votes on a given portfolio company proposal might vary even within a single investment adviser or fund complex.

2. Board Delegation and Oversight of Adviser Proxy Voting

As discussed above, fund boards often delegate proxy voting to a fund's investment adviser as part of the adviser's general management of fund assets, subject to the board's continuing oversight. In connection with this delegation and continuing oversight, there are several questions a board may consider to satisfy itself that the fund's portfolio company proxies will be voted in a manner that is timely and consistent with the fund's proxy voting policy.[12] For example:

» ***What processes does the adviser have to timely review and vote proxies?*** The board might request a description of how an adviser processes proxy votes from notification and receipt through actual voting and return of the proxy, including:

   » ***How does the adviser monitor portfolio company proxy statements?*** The board might inquire whether the adviser has procedures in place to monitor whether the fund's service providers forward all portfolio company proxies in time for the adviser to vote them. One mechanism to monitor the receipt of proxies is to compare the proxies received to the fund's portfolio holdings.

  - ***How does the adviser promote timely voting of proxies?*** The board might ask the adviser to describe the procedures used to return the proxies it receives in time for votes to be counted at the portfolio company's shareholder meeting.

- ***Does the adviser have the time and/or resources to monitor and execute a fund's portfolio company proxies?***
  - ***Does the adviser have adequate staffing to handle the fund's proxy voting requirements?*** In order to assess the adequacy of staffing, the board might request that the adviser describe the personnel responsible for reviewing, researching, and executing the proxies, including their experience and training. The adviser may determine that it would be more efficient to outsource these functions to a third-party proxy voting service, which is discussed in more detail below.
  - ***Does the adviser have sufficient physical infrastructure to handle the fund's proxy voting requirements?*** The board might request assurance, for example, that the adviser has adequate software, hardware, or other equipment.

- ***Does the adviser consistently meet proxy voting deadlines?*** If there is a pattern or excessive number of missed proxy voting deadlines, the board might question whether the adviser's procedures are effective or whether the adviser has devoted sufficient resources to proxy voting.
- ***Does the adviser have a process for the timely filing of the fund's Form N-PX?*** The board might request information about the resources that the adviser has devoted to compiling a fund's voting record, such as personnel responsible for compiling the record, and for preparing and filing the fund's Form N-PX.

3. Board Oversight of Potential Adviser Conflicts of Interest

From time to time, a fund's investment adviser may face a potential conflict of interest in connection with a fund proxy vote. Appendix A discusses various mechanisms that advisers use to identify and resolve conflicts of interest. A board that has delegated voting discretion to the adviser should have an understanding of the process the adviser will follow to identify and resolve potential conflicts of interest in the best interests of the fund and its shareholders. There are a number of questions that a board may consider, such as:

- ***What procedures does the adviser have to highlight votes raising potential conflicts?*** The board might request a description of the procedures that the adviser uses when it receives a portfolio company proxy statement to identify whether the adviser may have a potential conflict.
- ***What is the adviser's process for resolving conflicts?*** The board might inquire whether the adviser has specified personnel or committees responsible for resolving conflicts. In the event a board is retroactively reviewing an adviser's resolution of a conflict, the board might consider whether the adviser properly followed its own procedures for conflict resolution. If the vote was an exception to the adviser's proxy voting policy, the board might determine whether the proper exception procedures were followed. In addition to confirming that procedures were properly followed, a board may request and evaluate the adviser's explanation of how and why its resolution of the conflict was in the best interests of the fund and its shareholders.

- ***Should the board review conflicts before a proxy vote is cast?*** In most instances, it may be impractical for an adviser to seek prior specific direction from a fund's board. In general, advisers should be able to resolve potential conflicts by following pre-established conflict resolution policies, if practicable. In unusual circumstances, where the standing policy does not adequately address a potential conflict, it may be appropriate for an adviser to consult with or notify a fund's board, board committee, or other designated directors about the adviser's proposed resolution. In these circumstances, the board also may retroactively review the potentially conflicted proxy vote and consider amending the proxy voting policy in an effort to prevent similar occurrences in the future.
- ***How will the adviser disclose potential conflicts and their resolution to the board?*** The board may request periodic reports regarding proxy votes of portfolio companies that raised potential conflicts for the adviser, together with a description of how the conflicts were resolved.

Consideration of whether a conflict has been appropriately resolved in the best interests of the fund and its shareholders is subject to the board's reasonable business judgment. This requires that the board be free of conflicts, prudently consider the information it deems relevant to its analysis, and consult with legal counsel or other experts as needed. Directors who may have a potential conflict also must take appropriate action—including disclosing the conflict to the board and potentially recusing themselves from participation in the matter.

C. Third-Party Proxy Voting Services

1. The Role of Third-Party Proxy Voting Services

A fund or its adviser may avail itself of third-party proxy voting services. These proxy voting services typically offer a number of different services to funds and advisers, including:

- Formulating proxy voting policies, typically using the service's default policies as a starting point and offering the ability for customization to meet a fund's or adviser's particular needs and specifications
- Researching a portfolio company's proxy proposals, which may include assessment of director nominees, background information on the company (such as its adherence to corporate governance "best practices"), and analysis of shareholder proposals or competing director nominees
- Providing notification and reminders of upcoming proxy votes
- Providing coverage and translation services with respect to foreign issuers
- Communicating voting recommendations and rationales
- Executing voting instructions
- Recording and reporting proxy voting records
- Preparing and/or filing Form N-PX for funds.

A fund or adviser may use all or some of these services. For example, an adviser may receive recommendations and accompanying analysis, but still reserve voting authority in its own discretion. Or, an adviser may establish default voting policies with the service and authorize the service to automatically vote according to those policies, with the adviser retaining discretion to override those voting policies and vote the proxies itself when it deems

it appropriate to do so. Similarly, an adviser may arrange for the service to cast fund proxy votes, but have a fund administrator file the fund's Form N-PX based on data feeds from the service.

Funds may choose to use a third-party proxy voting service for a variety of reasons. These services may provide administrative efficiencies where, for example, a fund complex has many funds and perhaps thousands of individual portfolio securities to vote, as well as the obligation to report those votes on Form N-PX. In this situation, delegating proxy voting functions to a third-party proxy voting service may be more cost-effective than establishing a large staff to handle these tasks.[13] There may be cost savings not only in the mechanical voting of proxies, but also in researching all of 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 may also offer protection against potential conflicts between the interests of the adviser and those of fund shareholders. For example, the SEC has stated that an adviser could demonstrate that a proxy vote was not the product of a conflict of interest if it voted the fund's portfolio securities in accordance with a predetermined policy based upon the recommendations of an independent third party.[14]

Even where a third-party proxy voting service is primarily responsible for voting proxies of a fund's portfolio securities, a fund or adviser may wish to establish procedures allowing the adviser to override the proxy voting service and direct a fund's vote where the adviser believes it is particularly important to do so. In these circumstances, the adviser might provide a board with periodic reports on the circumstances surrounding any proxy votes that the adviser decided to override.

As the discussion above suggests, it may be appropriate for fund boards and advisers to weigh the costs against the benefits to determine whether and to what extent to use a third-party proxy voting service.

2. Board Oversight of Third-Party Proxy Voting Services

A fund's board may choose to be involved to varying degrees in the selection and approval of third-party proxy voting services.[15] For example, the board might base its approval on the recommendations of the fund's adviser or delegate the selection to the fund's adviser, subject to board oversight. In considering the use of a third-party proxy voting service, the fund's board may wish to take into account matters such as:

- The service's reputation in the marketplace
- Any recent material events affecting the service's business organization (e.g., a buyout)
- The service's philosophy regarding corporate governance issues and shareholder activism, as reflected in the service's default voting policies
- The service's ability to implement customized voting policies that are specific to the fund or its adviser
- The extent to which the service would permit the fund or its adviser to vote on specific proposals directly, if desired
- The process the service uses to identify and address any conflicts of interest it may have.

A board may delegate to a fund's adviser the day-to-day oversight of a third-party proxy voting service. This oversight of third-party proxy voting services often focuses on, among other things, the "mechanical" ability of the service to timely vote the fund's proxies consistent with the fund's or the service's established policies and maintain an accurate record of the proxy votes cast, as well as the service's ability to timely and correctly prepare and file the fund's Form N-PX. A board or adviser might therefore wish to receive periodic reports from the third-party proxy voting service to monitor performance on such quality issues as the service's adherence to customized policies, proportion of missed votes, and accuracy and timeliness in the preparation and filing of the fund's Form N-PX. A board or adviser may want to request that a service identify and disclose any conflicts that may arise for the service in voting a fund's proxies.

D. Board Voting of Fund Proxies

As discussed above, it is unusual for fund boards to directly engage in voting proxies. As with other fund management functions, boards typically serve in an oversight role. A small number of boards have decided, however, that rather than delegate proxy voting responsibility, the board will vote proxies itself. As in the case where the adviser has voting authority, a board need not vote every proxy, as there may be occasions when voting a proxy is not in the best interests of a fund and its shareholders.

In considering this approach, a board should first determine whether one or more of its members have the expertise necessary to analyze portfolio company proxy statements, or have access to staff or consultants that possess such expertise. It is also important to conclude that the time and resources devoted to proxy voting will not detract from performance of board duties that cannot be delegated or from other important responsibilities entrusted to the board. In many cases, the cost of retaining proxy voting authority, in terms of time and resources, may be prohibitive compared to delegating authority to the fund's adviser or a third-party proxy voting service.

A board that has decided to retain proxy voting authority, whether on a regular or occasional basis, can vote proxies in any number of ways. It may divide up responsibility among the various directors, or establish a committee of directors devoted to analyzing and voting proxies. Presumably, a board could also hire its own staff to analyze and vote proxies. Although this might reduce the demands on directors, it likely would entail significant costs and would not eliminate but only shift the focus of the board's oversight responsibilities.

While retaining voting authority has the advantage of eliminating any potential conflicts of interest vis-à-vis the fund's adviser, it would remain necessary to have a process for identifying and addressing any potential conflicts of interest that individual directors themselves might have.

II. Other Proxy Voting Issues

Certain kinds of funds or certain investment practices raise particular proxy voting issues, described below, that fund boards may have to address from time to time.

A. Subadvisers/Managers of Managers

Funds often employ subadvisers, whose duties may range from managing a designated "sleeve" of a fund's portfolio to managing the entire fund portfolio. Some fund complexes use a manager of managers approach, where the primary responsibility of the investment adviser of the funds is to select, monitor and, as needed, replace subadvisers.

Boards of funds using subadvisers should consider whether the subadviser will be responsible for voting a fund's proxies and, if so, whether to adopt the proxy voting policy of the subadviser. Where funds or fund complexes use multiple subadvisers, boards may consider the desirability of adopting a single proxy voting policy to promote consistency and uniformity in votes cast. In addition, an adviser who is responsible for overseeing the activities of multiple subadvisers may find it administratively challenging to track and monitor multiple subadvisers' proxy voting policies. On the other hand, it may be equally challenging for a subadviser that manages multiple fund portfolios to tailor its operations to comply with different proxy voting policies of the funds for which it serves as subadviser. Accordingly, some subadvisers may be reluctant to accept the responsibility of voting proxies for a fund that has a policy that differs from the subadviser's policy.

If a fund determines that it is appropriate to adopt a subadviser's policy, the policy would still be subject to the board approval and review requirements of the SEC's fund compliance rule, discussed above. Regardless of who has voting responsibility and which policy is used, the most important considerations are that portfolio company proxies be voted in the best interests of the fund and its shareholders, the board receive satisfactory reports enabling it to effectively oversee the policy, and the fund's Form N-PX be accurately and timely filed.

B. Affiliated Funds of Funds

Another fund structure that raises unique proxy voting issues is an affiliated fund of funds. In such an arrangement, the adviser for the fund of funds is also the adviser for an underlying fund in which the fund of funds invests. A potential conflict may arise if the underlying fund issues a proxy soliciting votes on a proposal that would directly benefit the adviser. For example, if the proposal involves approval of an advisory contract arising from a sale of the adviser or an advisory fee increase, then the adviser could have a potential conflict in voting the underlying fund shares held by the fund of funds in favor of the proposal.

There are several possible ways to resolve such potential conflicts. First, the adviser could follow its standing conflict resolution procedures. Second, the adviser could vote in accordance with the recommendation of the underlying fund's board. This would be particularly appropriate if the underlying fund's board also oversees the fund of funds because, in making its recommendation, the board can weigh the benefits to the shareholders at both the underlying fund and fund of funds level. In most cases, the interests of the shareholders at both levels should be aligned. By voting consistently with the underlying fund board's recommendation, the adviser is effectively following the recommendation of the fund of funds' board too.

A third alternative is for the fund of funds to vote its shares of the underlying fund in the same proportion as the votes of the other beneficial shareholders of the underlying fund. Under this "echo voting" approach, the fund of funds would merely amplify the votes already received from the other underlying fund shareholders. The adviser's potential conflict is therefore extinguished by replicating the voting preferences expressed by the underlying fund's other shareholders.

C. Foreign Securities

Voting proxies of foreign issuers, as compared to those of domestic companies, can entail significant costs. These costs may include the cost of translating proxy statements or travel to attend shareholder meetings. Administrative obstacles also may arise. For example, funds often do not receive timely notice of, or adequate information related to, proxy votes for foreign securities they own. In addition, in certain countries, shares that

will be voted must be held by a designated depositary during a period of time commencing shortly before the date of the shareholder meeting and lasting until the meeting has taken place and the shares are returned to the fund's custodian bank ("share blocking") resulting in the inability to sell the shares during that time. The SEC has acknowledged that funds and advisers may determine that refraining from voting is in a fund's best interest in some circumstances, such as where the costs involved in voting exceed any anticipated benefit to the fund.[16]

D. Securities Lending

Funds frequently enter into securities lending programs in order to generate extra income, thus increasing the fund's total return. Securities lending programs are subject to certain conditions set forth in no-action letters issued by the SEC staff many years ago.[17] One of these conditions is that a loan must be terminated and the security recalled to vote proxies for loaned securities if fund management has knowledge that "a material event will occur affecting an investment on loan."[18] The SEC staff has not explicitly addressed this matter since it issued those letters. Many fund advisers employ a cost-benefit analysis to determine whether the cost of voting a proxy for a security on loan exceeds the expected benefit to the fund of voting the proxy. In performing this analysis, advisers may take into account practical considerations, such as the administrative burden of retrieving the securities. Advisers also may consider the size of a fund's holding in the security on loan and the likelihood that the vote will have a significant impact on the value of the holding. Advisers weigh these types of factors against the financial benefits they expect the fund to derive by keeping the security on loan.

Conclusion

Funds, their boards, and their advisers must take the responsibility to vote portfolio security proxies very seriously. Fund boards typically delegate this responsibility to the fund's adviser, in recognition that proxy voting is part of the investment process. Fund directors play an important oversight role to ensure that proxy voting is carried out in the best interests of funds and their shareholders. The manner in which boards fulfill their oversight responsibility appropriately varies among funds depending on the facts and circumstances.

Appendix A: Identifying and Resolving Investment Adviser Conflicts of Interest

Investment advisers have developed a number of techniques for identifying and resolving potential conflicts of interest that can arise in connection with voting fund proxies. An adviser may be able to determine in advance which funds and other significant business relationships are likely to give rise to proxy voting conflicts. For example, an investment adviser may have a potential conflict of interest when faced with a proxy solicited by an issuer whose retirement plan the adviser or an affiliate manages, or for which it serves as administrator, or an issuer that distributes the adviser's funds. An adviser also may have a potential conflict of interest when deciding how to vote on a proposal sponsored or supported by a shareholder group that is a client of the adviser. Identifying these and other potential conflicts of interest may be a more formidable task for investment advisers that are part of large financial organizations with numerous affiliates—each with its own client base and business relationships. Some advisers have designated personnel responsible for determining whether the portfolio company appears on a list of companies with which the adviser or an affiliate has a material business relationship. In many situations, potential voting conflicts may only be identifiable on a case-by-case basis, requiring an adviser's compliance and investment personnel to be sensitive and vigilant in monitoring proxy solicitations.

Advisers utilize a variety of techniques to limit the possibility that conflicts of interest might improperly influence voting decisions. One common approach is to adhere to the adviser's predetermined voting policy in voting proxies. This effectively results in an adviser limiting its own voting discretion on individual votes, thus limiting its susceptibility to influence by considerations outside the proxy voting process. A potential advantage of this approach is that, as long as it adheres to its policy, the adviser can resolve potential conflicts by voting consistently with its policy, regardless of whether the vote also was consistent with the adviser's interests. (This assumes, of course, that the predetermined policy was originally designed—as it should be—to further the interests of the fund and its shareholders.)

From time to time the adviser may have good cause to deviate from the predetermined policy. In addition, it may not be possible to anticipate every voting situation, and the adviser may encounter proxy proposals that are not covered by its pre-determined policy (e.g., mergers) and which may involve a potential conflict. An adviser could develop special procedures to handle these situations—for example, by requiring that exceptions or new situations be referred to a committee and reported to the fund's board.

An adviser also could avoid potential conflicts of interest by voting in accordance with the recommendations of a third-party proxy voting service. Even where an adviser has delegated proxy voting to a third-party voting service, the adviser must still adopt policies to address potential conflicts of interest if the adviser retains any discretion to override the service's recommendation and vote differently. An adviser could address potential conflicts arising from vote overrides by establishing a procedure to obtain approval for overrides from a committee and report vote overrides to the fund's board.

Another mechanism advisers may employ to protect against the possibility that conflicts of interest will improperly affect proxy votes is the establishment of "firewalls" or "ethical walls." Using this technique, advisers screen off personnel responsible for proxy voting from personnel who may be susceptible to potential conflicts, such as an adviser's marketing or client relations personnel, or investment banking or other affiliates of the adviser that may have business relationships with the portfolio company.[19] The firewalls would not necessarily

require physical separation so long as the adviser's or its affiliate's personnel understand that it is a violation of the adviser's policy to discuss proxy proposals with voting personnel who are "behind the wall."

In the event a conflict does arise, there are a number of ways that an adviser might address it. One way is to obtain voting instructions or consent from the fund's board, a board committee, or other designated directors. This approach is not without its drawbacks: it eliminates the benefit of the adviser's investment expertise; and it imposes demands on the directors, whom it may be difficult to assemble—even by telephone—when there are tight proxy voting deadlines. Another potential drawback is that an adviser or subadviser may need to seek feedback from more than one fund board, committee, or group of directors. For an adviser or subadviser that manages numerous funds with different boards of directors, this approach may simply not be feasible.

Another way to address potential conflicts of interest with director involvement could be to establish a proxy voting committee that is comprised of both adviser personnel and one or more fund directors. An advantage of this approach is that it allows for board representation in resolving conflicts while retaining access to the adviser's insight and expertise. On the other hand, time constraints may make even limited director involvement impractical. This structure may also prove difficult where an adviser advises funds in separate complexes—as a subadviser, for example—because it may not be feasible to arrange for board representation from each fund complex.

Another approach to address potential conflicts of interest is to notify the fund's board, a board committee, or designated directors of the potential conflict and the proposed resolution of that conflict, if practicable. The advantage of this approach is that it gives directors a potential opportunity to impact the resolution before the vote is cast.

Yet another alternative that an adviser may use is a proxy voting committee comprised of senior officers and/or portfolio managers of the adviser—without fund board representation. Although this approach lacks the advantage of involving the board in the resolution of potential conflicts, it often represents a more viable option, particularly for an adviser or subadviser that advises numerous funds with different boards of directors. An advantage of this approach is that it does not impose an absolute constraint on the adviser's ability to exercise its judgment and discretion in determining how a proxy should be voted. If the adviser's proxy committee employs sufficient safeguards for addressing potential conflicts—for example, by including representatives of the CCO or chief legal officer in discussions of potential proxy voting conflicts—then there may be reasonable assurance that potential conflicts will be properly analyzed and resolved in the best interests of the fund and its shareholders.

Notes

[1] At the end of 2007, mutual funds and other registered investment companies held approximately 27 percent of U.S. corporate equity securities. Investment Company Institute, *2008 Investment Company Fact Book*, at p. 11. Proxy voting is primarily an issue for equity funds because equity securities typically entitle the owner to vote at shareholder meetings (such securities are sometimes referred to as "voting securities"). Funds that primarily hold fixed-income securities are affected to a much lesser extent because fixed-income securities generally have limited or no voting rights.

[2] The SEC adopted proxy voting rules for funds in 2003. See Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management Investment Companies, SEC Release No. IC-25922 (Jan. 31, 2003) (Investment Company Proxy Voting Release). The rules generally require a fund to: (i) describe the policies and procedures that govern the voting of proxies for fund portfolio securities (proxy voting policy) in certain SEC filings; and (ii) disclose annually how the fund cast its proxy votes by filing Form N-PX with the SEC. The SEC provided examples of general issues that would be appropriate for a proxy voting policy to address, including: (i) the extent to which a fund delegates its proxy voting decisions to its investment adviser or another third party, or relies on the recommendations of a third party; (ii) how a fund votes on matters that may affect substantially the rights or privileges of the holders of the securities to be voted; and (iii) the extent to which a fund will support or give weight to the views of management of a portfolio company. The SEC has indicated that a fund's board may design its own proxy voting policy or may adopt the adviser's policy. A board also may elect to adopt the policy recommended by a proxy voting service. In all cases, the fund must disclose how the policy addresses situations where a vote presents a conflict between the interests of a fund's shareholders, on the one hand, and those of its investment adviser, principal underwriter, or their affiliates, on the other.

[3] For an analysis of the proxy voting records of funds in 160 of the largest fund families in the 12 months ending June 30, 2007, see Investment Company Institute Research Perspective, Vol. 14, No. 1 (July 2008).

[4] See Fed. Regulation of Securities Comm., Am. Bar Ass'n Section of Bus. Law, Fund Director's Guidebook § 10 (3d ed. 2006).

[5] Rule 38a-1 under the Investment Company Act of 1940 (1940 Act). The board's approval and review requirements also apply where a fund is relying on the proxy voting policy of its adviser or subadviser.

[6] Rule 38a-1(a)(1) and (2). For these purposes, the applicable "Federal Securities Laws" would include a fund's requirement to disclose its proxy voting policy and file Form N-PX, as well as an adviser's requirement to maintain proxy voting procedures and related records under Rules 206(4)-6 and 204-2, respectively, under the Investment Advisers Act of 1940 (Advisers Act).

[7] Investment Company Proxy Voting Release at p. 3.

[8] Proxy Voting by Investment Advisers, SEC Release No. IA-2106 (Jan. 31, 2003) (Adviser Proxy Voting Release), n.23.

[9] Advisers Act Rule 206(4)-6.

[10] The SEC has stated, however, that "[a]n adviser's fiduciary duties to a client do not necessarily require the adviser to become a 'shareholder activist' by, for example, actively engaging in soliciting proxies or supporting or opposing matters before shareholders. As a practical matter, advisers will determine whether to engage in such activism based on its costs and expected benefits to clients." Adviser Proxy Voting Release, n.19. Cf. Department of Labor, Advisory Opinion 2007-07A (Dec. 21, 2007).

[11] As discussed in more detail in Section I-C, these services will vote proxies on behalf of a fund or adviser, either according to the service's internal voting policies or according to policies provided by the fund or adviser.

[12] This discussion would be equally applicable where proxy voting authority has been delegated to one or more fund subadvisers.

[13] In some cases, the costs of third-party proxy voting services are borne by the funds in a fund complex. In other cases, these costs are assumed by the adviser or shared between funds and their adviser. The specific payment arrangements are typically the result of negotiations between a fund's board and its adviser.

[14] Adviser Proxy Voting Release at p. 5.

[15] For a discussion of board oversight of certain other service providers, see *Board Oversight of Certain Service Providers*, Independent Directors Council Task Force Report (June 2007).

[16] Adviser Proxy Voting Release, n.18 and accompanying text.

[17] See, e.g., State Street Bank & Trust Company, SEC No-Action Letter (Sept. 29, 1972).

[18] Id.

[19] See, e.g., In re Deutsche Asset Management, Advisers Act Release No. 2160 (Aug. 19, 2003) (alleged failure of an adviser to disclose a material conflict of interest to its clients prior to voting client proxies in a contested merger, where an affiliate of the adviser was an investment bank that was retained by a party to the proxy contest).

Fair Valuation Series: An Introduction to Valuation

APRIL 2005

Valuation of a fund's portfolio securities—and, in particular, the fair valuation process—is a constant topic of interest for fund boards. The Investment Company Act of 1940 imposes specific responsibilities on fund boards relating to fair valuation. In general, securities for which market quotations are "readily available" must be valued at market value, and all other securities and other assets must be valued at "fair value" as determined in good faith by the fund board. Although the legal framework is simple, the valuation process has many subjective elements and can be complex.

The U.S. Securities and Exchange Commission (SEC) has provided piecemeal guidance on the subject over the years in various rules and no-action letters. In March 2009, the SEC's Division of Investment Management published a bibliography listing select provisions of the Investment Company Act of 1940 and related rules and SEC guidance addressing valuation, with the intent to assist funds in understanding and applying the Act's valuation requirements. The SEC staff has periodically stated plans to propose additional valuation guidance, but as of May 2009, such guidance has not been proposed.

In 2005, IDC, the Investment Company Institute (ICI), and ICI Mutual Insurance Company published *An Introduction to Fair Valuation*—the first of a series of papers on fair valuation that draws upon the vast guidance on the subject and provides a narrative discussion intended to assist funds and their boards in addressing securities valuation. The paper offers a useful framework for thinking about the valuation process and includes discussions of key issues to consider in defining the roles and responsibilities of the fund board, valuation committees, and others involved in the valuation process. The paper also discusses monitoring for circumstances that may require fair valuation; outlining specific valuation techniques and methodologies; and reviewing and testing valuations.

The second installment (also included in this compendium) addresses the role of the board.

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Introduction

Mutual funds are in the business of investing in securities, and the value they place on those securities has a direct impact on their shareholders. Every business day, a fund must determine the value of each portfolio security it holds to calculate its net asset value per share (NAV). The fund's NAV then is used to process purchases, redemptions, and exchanges by shareholders.

The Investment Company Act sets forth the legal framework for valuation: securities for which market quotations are "readily available" must be valued at market value, and all other securities and other assets must be valued at "fair value" as determined in good faith by the fund's board of directors or trustees. Although the legal framework is simple, the valuation process has many subjective elements and can be complex.

The Investment Company Institute, ICI Mutual Insurance Company, and the Independent Directors Council are publishing the *Fair Valuation Series* to assist funds (other than money market funds) and their boards in addressing securities valuation. This installment of the series provides an overview of issues to consider in developing and administering valuation policies and procedures. Subsequent installments will explore specific valuation topics in detail, such as the valuation of particular types of securities, the role of a fund's board of directors in the fair valuation process, and the correction of pricing errors.

The *Fair Valuation Series* is not a set of best practices. Each fund's approach to the valuation of securities will depend on many factors particular to that fund. Ultimately, each fund's board and management, acting in good faith and exercising their reasonable business judgment, will have to consider a broad array of factors to devise an appropriate approach to fund valuation.

KEY DEVELOPMENTS ON FAIR VALUATION	
1940	The Investment Company Act of 1940 is enacted, requiring fund boards to determine fair value prices in good faith when market quotations are not readily available.
1969	The SEC issues Accounting Series Release 113 providing guidance on valuing restricted securities.
1970	The SEC issues Accounting Series Release 118 providing general guidance on fair valuation and the board's related responsibilities.
1981	The SEC staff issues a "no action" letter to Putnam funds stating that funds may use closing market prices for foreign securities "except when an event has occurred . . . that is likely to have resulted in a change in [their] value."
1984	The SEC affirms the staff position in the Putnam letter in a release proposing amendments to Rule 22c-1.
1997	ICI publishes a white paper on valuation and liquidity issues for mutual funds. In response to extreme volatility in U.S. and Asian markets, a few funds fair value price Asian securities. Some investors challenge this action, and the SEC initiates a review of fair value pricing.
1998	Following its 1997 review of fair value practices, the SEC takes steps to enhance fair value disclosure in fund prospectuses. In the release, the SEC states that in response to the 1997 market volatility, "funds appear to have relied on a long-standing position of the Commission's staff that a fund may (but is not required to) value portfolio securities traded on a foreign exchange using fair value . . . when an event occurs after the close of the exchange that is likely to have changed the value of the securities."
1999	The SEC staff issues a letter to ICI providing guidance on valuation responsibilities during unusual or emergency situations.

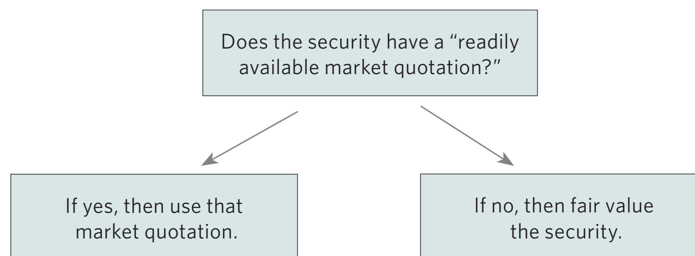
KEY DEVELOPMENTS ON FAIR VALUATION CONTINUED	
2001	The SEC staff issues a second letter to ICI explaining the concept of "significant events" in the context of fair valuing foreign securities. The letter states that market fluctuations may constitute significant events.
2002	ICI publishes a supplement to its valuation and liquidity white paper. The supplement focuses on "significant events" and the valuation of foreign securities.
2003	The SEC release adopting Rule 38a-1 outlines four obligations relating to fair valuation.
2004	The SEC amends its disclosure rules to require disclosure of the circumstances under which funds will use fair value pricing and the effects of using fair value pricing. The SEC states in the adopting release that "funds are required to use fair value prices any time that market quotations for their portfolio securities are not . . . reliable."

I. What Are a Fund's Valuation Obligations?

A. Statutory Framework

The definition of "value" in the Investment Company Act has two elements: securities for which market quotations are readily available are to be valued at market value, and all other securities and other assets are to be valued at **fair value**, as determined in good faith by the fund's board of directors. This sets up a simple decision tree for valuation:

TERMINOLOGY: FAIR VALUE
*The **fair value** of a security is the price that the fund might reasonably expect to receive upon a current sale.*



The SEC has provided guidance over the years on the meaning of "readily available market quotation" and "fair value." As discussed below, this guidance addresses when a market price for a security should be disregarded because it is unreliable or otherwise not "readily available."

B. Valuation Obligations

The SEC has outlined four obligations relating to fair valuation. When it adopted the compliance program rule (Rule 38a-1 under the Investment Company Act), the SEC stated that a fund must:

1. Adopt written policies and procedures that require the fund to monitor for circumstances that may necessitate the use of fair value pricing;
2. Establish criteria for determining when market quotations are not reliable for a particular security;
3. Establish a methodology or methodologies to determine the current fair value of a security; and
4. Regularly review the appropriateness and accuracy of the methods used in valuing securities.

This installment of the *Fair Valuation Series* focuses on issues funds may wish to consider in fulfilling these obligations and developing fair valuation disclosure.

"There is no uniform method or single standard for fair value pricing because it necessarily requires some measure of judgment and flexibility."

Paul F. Roye
Director of the SEC's Division of Investment Management
February 25, 2004

II. Establishing Valuation Policies and Procedures: What Are the Key Issues to Consider?

Valuation policies generally serve to: 1) define the roles of various parties involved in the valuation process; 2) describe the ways that the fund will monitor for situations that might require fair valuation; 3) describe valuation methodologies that a fund's board has approved for particular types of securities; and 4) describe the methods by which the fund will review and test fair valuations to evaluate whether its valuation procedures are working as intended.

FAIR VALUATION SERIES
*A subsequent installment in the **Fair Valuation Series** will discuss in more detail the role of the board in the valuation process.*

A. Defining Roles and Responsibilities

In defining the roles of the parties involved, funds should consider the role of the board, the role and composition of valuation committees, the role of others in the valuation process, and the need for escalation procedures. Each of these is discussed below.

1. The Role of the Board

Directors' involvement in the fair valuation process typically consists of approving fund valuation policies and procedures, monitoring their implementation, and periodically reviewing the fair valuation decisions and changes to valuation policies made by pricing personnel or valuation committees. Typically, the board and individual board members are not involved in day-to-day valuation decisions.

KEY POINT
The Investment Company Act places ultimate responsibility for fair valuation on fund boards. SEC and staff guidance enables boards to delegate day-to-day fair value decisions.

2. The Role and Composition of Valuation Committees

Most funds have valuation committees, but practices vary widely as to their precise role and composition and the frequency with which they meet, often reflecting the nature of valuation issues faced by a fund. If a fund invests significantly in securities that may be difficult to value, it may have more experienced or senior committee members, and the committee may meet more frequently. On the other hand, if a fund invests exclusively in actively traded domestic securities, it may have no need for a valuation committee or may have one that meets infrequently.

If a fund uses a valuation committee, it should define the committee's membership, scope of delegated authority, and reporting obligations to the board. This often is done either in a written charter or in the fund's valuation policies and procedures.

There are special considerations in having board members or lawyers serve on a valuation committee:

- ***Board members.*** Independent directors of some funds serve as members of valuation committees. While this may enhance board oversight of the valuation process, it also may require a substantial commitment of a director's time. Directors may wish to consider the differences in the role they would assume by virtue of being an active participant in valuation committee decisions, on the one hand, and a reviewer of those decisions, on the other.

KEY POINT
Board members and lawyers have special considerations in deciding whether to serve on valuation committees.

- ***Lawyers.*** General counsel or other attorneys of the fund's adviser often serve on valuation committees because of their knowledge of fund valuation obligations. Attorneys, however, may wish to consider attending valuation committee meetings in their capacity as counsel to the committee, rather than as a member of the committee per se. This approach may help maintain the counsel's objectivity in case a review of the committee's activities or the fund's valuation practices is necessary. It also may enable the fund to assert the attorney-client privilege for communications with counsel arising from the committee's activities.

3. Others Involved in the Valuation Process

The valuation process often involves these personnel:

- ***Accounting personnel.*** Accounting personnel typically have day-to-day pricing responsibility, including monitoring for events that might require the use of fair value prices. Funds that have established valuation committees often ask senior accounting personnel, including the treasurer or chief financial officer, to serve on those committees.

- ***Investment professionals.*** Investment professionals, such as portfolio managers and analysts, often are included in the valuation process because they are important sources of information about the value of securities. At the same time, investment professionals may have potential conflicts of interest if the valuations used by the fund affect a fund's performance and their own compensation.

  The extent of the conflicts that might arise varies from fund to fund depending on the precise role the investment professionals are expected to play in the valuation process and their compensation structure. When investment professionals are used in the valuation process, funds should take steps to enhance their valuation procedures to minimize any potential conflicts of interest. For example, funds may require a senior member of management to sign off on valuation decisions made by investment professionals.

KEY POINT
Investment professionals can be important sources of information about the value of securities, but funds should recognize that there may be potential conflicts of interest that should be addressed.

- ***Chief Compliance Officers (CCOs) and other compliance personnel.*** CCOs and other compliance personnel have an important role in ensuring that a fund's valuation procedures are reasonably designed to prevent the fund from violating the federal securities laws and are being followed.

4. Escalation Procedures

A fund's procedures should include a process for addressing any difficulties or problems that may arise in the valuation process, including clear instructions on the timely escalation of valuation issues. That clarity can

help every person involved understand when a valuation matter needs to be escalated to someone higher in the organization, and to whose attention it should be brought, including that of the fund's board.

B. Monitoring for Circumstances That May Require Fair Value Pricing

The SEC requires funds "to monitor for circumstances that may necessitate the use of fair value prices." This means monitoring for circumstances in which market quotations for portfolio securities may not be readily available. Whether a particular market quotation, is or is not "readily available" is highly fact-specific.

The SEC staff has described various events that ordinarily would cause a fund to consider fair valuing a portfolio security. Broadly summarized, these are events that occur after the last market price was established but before the time set for the calculation of the fund's NAV, and that suggest that the market price no longer represents the security's value. There are two concepts here: 1) the lack of a current market quotation, and 2) the occurrence of a "significant event."

1. The Lack of a Current Market Quotation

Funds may wish to monitor for the following types of circumstances where there may not be a current market quotation:

EXAMPLE
Closing prices for securities trading on the Tokyo Stock Exchange, for example, are established either 14 or 15 hours before 4 pm eastern time, depending on daylight savings time.

- ***Markets closing before 4:00 p.m. eastern time.*** Many foreign markets are closed at 4:00 p.m. Eastern time when most funds cut off orders and begin to calculate their NAVs. As a result, market quotations for securities principally traded on these exchanges may no longer be current at that time.
- ***Trading halts.*** The last market quotation for a security that was subject to a trading halt may not be current if the halt remains in place at the end of the trading day.
- ***Events that unexpectedly close entire markets.*** Natural disasters, power blackouts, public disturbances, or similar major events could force a market to close unexpectedly.
- ***Scheduled market holidays.*** A scheduled holiday in a market (other than the NYSE) could call into question whether securities that principally trade on that market have current market quotations.
- ***The absence of trading.*** The absence of trading in an individual security could raise the issue of whether that security has a current market quotation. This may be a common occurrence with respect to some small capitalization stocks and many fixed income securities.

2. Significant Events

If a security lacks a current market quotation, funds should have procedures to monitor whether some **significant event** happened that suggests that the value of the security has changed. Significant events could be: 1) events relating to a single issuer, such as an after-hours earning announcement; 2) events relating to an entire market sector, such as a significant governmental action like raising interest rates; 3) natural disasters that affect securities values, such as an earthquake; or 4) a significant fluctuation in domestic or foreign markets.

TERMINOLOGY: SIGNIFICANT EVENT
*The term **significant event** is defined as an event that will affect the value of a fund's securities that has occurred after closing prices were established for those securities, but before the specific time set for the fund's NAV calculation. The term was defined in the SEC staff's April 2001 letter to ICI on valuation issues.*

Market fluctuations as significant events. The SEC staff, in a 2001 interpretive letter to ICI, stated that a significant fluctuation in domestic or foreign markets may constitute a significant event. This concept appears to be based on a finding of historical correlations between market movements and the subsequent prices of particular securities.

Since the SEC staff issued its letter in 2001, pricing methodologies have been developed that allow funds to take market movements into account in the fair valuation process. Many of these methodologies are based on changes in the value of **market-based proxies** such as:

- The U.S. market, to the extent that the U.S. market may bear a correlation to the particular foreign market;
- Baskets of American Depository Receipts (ADRs) relating to securities in the foreign market;
- Futures contracts or other derivative securities based on indexes representative of the foreign market; and/or
- Baskets of securities from the foreign market or funds that are comprised of those securities, such as exchange-traded funds (ETFs) or closed-end country funds.

TERMINOLOGY: MARKET-BASED PROXIES

In this context, the term ***market-based proxies*** *refers to securities, baskets of securities (such as ETFs), or market indexes that might be actively trading when the individual security being valued by the fund is not.*

Funds may find market-based proxies useful singularly or in combination with each other.

EXAMPLE: THE USE OF MARKET-BASED PROXIES

Assume a fund owns Japan Manufacturing Corporation, Ltd. (JMC), a stock listed on the Tokyo Stock Exchange (TSE) that tends to trade in line with the Nikkei 225 Index. At 1:00 a.m. eastern time Monday, JMC closes on the TSE at $10 a share. By 4:00 p.m. eastern time (the time the fund values its portfolio securities), futures on the Nikkei 225 Index that trade on the Chicago Mercantile Exchange are up 10 percent.

The facts that JMC tends to trade in line with the Nikkei 225 Index and that Nikkei futures trading in the U.S. are up 10 percent, taken together, suggest that the current value of JMC might have increased to $11 as of 4:00 p.m. Eastern time. In other words, there is an indication that a reasonable buyer and reasonable seller of JMC at 4:00 p.m. might conduct their transaction at $11, rather than the $10 closing price on the TSE established earlier in the day.

In the absence of actual trading in the security, trading in the Nikkei futures in this example could provide a reasonable "market-based proxy" of what might be expected from trading in the Japanese equity security being valued.

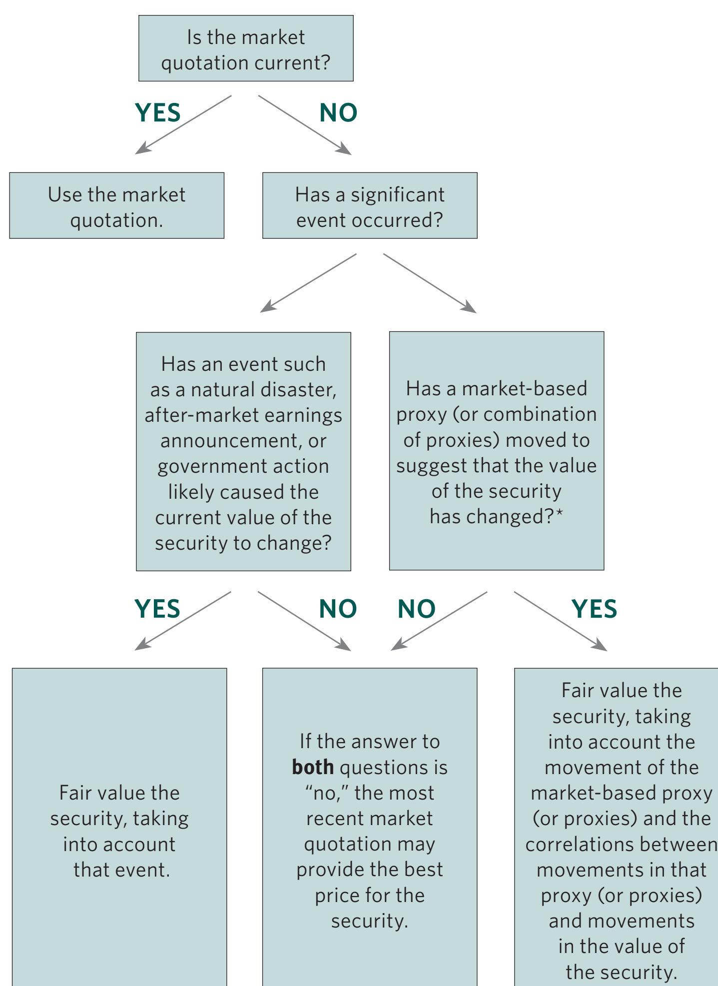
Monitoring correlations. Identifying correlations between portfolio securities and various market-based proxies—and conducting fair valuation thereon—can be very complex. As a result of the number of securities potentially involved and the narrow time window in which funds must value their portfolios daily, many funds have found it necessary to consult third-party vendors that offer pricing products and services based on such correlations, particularly with respect to foreign equities. These vendors use extensive historical data to perform correlation studies that make it possible for funds to determine fair values based on the movement of market-based proxies.

A fund that uses a pricing vendor in the fair valuation process must consider when and how it will use the information provided by the vendor. Some funds establish a threshold **trigger.** These funds may take into account the vendor's data only on days when the trigger has been exceeded. On other days, these funds may conclude that closing market prices reflect the security's current value. Other funds may conclude that it is reasonable to use the vendor's data more frequently—or even every day, a "no trigger" or "zero trigger" approach.

Each fund should determine the appropriate level and benchmark for any trigger based on its own due diligence and understanding of the correlations relevant to its portfolio.

TERMINOLOGY: TRIGGER
A movement in some index or security above a certain stated amount. For example, funds could set a 75 basis-point trigger pegged to movements in the S&P 500 index. This would mean that the fund would use the information provided by a vendor only if the S&P 500 index closed more than 0.75 percent up or down from its previous close.

3. Questions to Ask in Deciding Whether to Use a Market Quotation



**Market-based proxies could be based on market indexes, ETFs, ADRs, closed-end funds, or other securities that actively trade in the absence of trading in the security being valued.*

C. Outlining Specific Valuation Techniques and Methodologies

Increasingly, fund valuation procedures describe specific valuation techniques and methodologies that will be used by the fund, including methodologies for particular types of securities. The SEC staff has stated that if a fund board has approved comprehensive fair valuation policies that provide methodologies for how fund management should fair value securities, a board can have comparatively little involvement in the day-to-day valuation process. A fund also may be able to automate certain fair valuation processes involving techniques based on objective criteria (e.g., quantitative models to fair value foreign equity securities) if fund procedures clearly identify the techniques, describe how and when they will be used, and provide a process for periodic board review of the resulting valuations.

TREND
Funds are developing detailed valuation procedures for specific types of securities.

When drafting valuation procedures, funds may find it useful to start by considering the types of securities that they typically will hold. Funds may also take into account their investment approach in crafting valuation procedures. A fixed income fund that invests primarily in fixed income securities using a quantitatively oriented investment approach might describe, in specific quantitative terms, the formulas used for fair value in certain situations. An equity fund managed primarily using fundamental research, on the other hand, might use procedures that consider fundamental factors and input from analysts.

FAIR VALUATION SERIES
Common valuation techniques used for various types of securities will be discussed in more detail in a subsequent installment in the ***Fair Valuation Series.***

D. Reviewing and Testing Valuations

1. Why Back-Test?

The SEC requires funds to review regularly the appropriateness and accuracy of the methods used in fair valuing securities. Back-testing fair valuations can assist funds in fulfilling this requirement.

The purpose of back-testing is to identify any significant bias in the fair value procedures and evaluate the reasonableness of using data provided by vendors. In other words, the testing permits the fund to assess the operation of particular valuation methodologies in specific situations and over time, so that those methodologies can be adjusted going forward as needed in light of changing conditions or experience. It is important to understand that the primary goal of testing is not to assess the accuracy of the valuation. By definition, fair value prices are good faith estimates of a security's value. For this reason, funds have, consistent with SEC guidance, focused their attention on developing appropriate processes for making informed valuation decisions and on following those processes consistently and in good faith.

KEY POINT
Funds should focus on developing appropriate ***processes*** *for making informed valuation decisions and on following those processes consistently and in good faith.*

2. How To Back-Test

Fair valuations can be back-tested in a variety of ways. Two common methods are comparing actual trades against fair values and comparing fair values against the next available market price.

» ***Testing actual trades.*** This procedure compares the prices used in any actual trades of a security against the fair value that the fund used for that security. If the actual trade occurred at a price that is significantly different than the fair value price, the trade typically is brought to the attention of

valuation personnel or the valuation committee. If this occurs in a meaningful number of instances, the fund may wish to consider reviewing and modifying the procedures by which fair value prices are set.

» ***Testing fair values against subsequent market prices.*** This procedure compares fair values against the last market prices and next available market prices, such as the next-day opening price for foreign securities. This type of test can show whether the fair values used by a fund were generally closer to the subsequent market prices, both in terms of the direction and magnitude of the change from the previous market price. Funds that use this type of procedure should recognize that in most cases a security's next market price will not represent its earlier fair value. Nevertheless, that market price may be the most contemporaneous price available, and as such may provide some help as a fund reviews the appropriateness and accuracy of its valuation methodologies.

3. Back-Testing by Vendors

Funds that use an external pricing vendor in the fair valuation process should consider the extent of the vendor's own back-testing in determining how the fund should test its valuation methodologies. As part of its due diligence prior to the engagement of a particular vendor, the fund should take steps to understand the nature and frequency of the back-testing that the vendor will perform and the modifications that the vendor may make as a result of that testing. In addition, the fund may wish to consider periodically performing its own back-testing.

4. The Role of Fund Auditors

Auditors seek to independently verify values for the fund's portfolio securities. This is not possible for fair valued securities, where there are no observable market prices that would enable independent verification. Instead, for fair valued securities, auditors consider whether the fund's valuation method was appropriate in the circumstances and applied consistently. As a result, auditors do not substantively verify fair value prices: they do not make an independent determination as to what the fair value of a security should have been or whether the fund, if it sold a security, would realize the price at which a security is being valued.

The frequency with which a fund uses fair valuation should not impact the fund's ability to get an unqualified audit opinion on the fund's financial statements, as long as the fund's valuation procedures were appropriate in the circumstances and applied consistently.

"Fair valuation procedures must continuously be back-tested, critiqued, and refined in order to maximize their effectiveness for the benefit of shareholders. Fair valuation, therefore, must be a dynamic process."

Paul F. Roye
Director of the SEC's Division of Investment Management
April 2, 2004

III. Disclosure: How Are Valuation Policies and Procedures Disclosed?

The SEC requires funds to explain in their prospectuses both the circumstances under which they will use fair value pricing and the effects of using fair value pricing. SEC instructions state that the disclosure should be brief and that funds are not required to provide detailed information about their fair value pricing methodologies and formulas.

In practice, striking an appropriate balance with respect to disclosure can be challenging. Overly specific disclosure could provide abusive traders with information that they could use to harm a fund. On the other hand, inadequate or incomplete disclosure could subject the fund to SEC enforcement action or private litigation.

Appendix A: Other Valuation Resources

WHERE CAN I FIND MORE INFORMATION?	
Regulatory Framework:	» Investment Company Act, Sections 2(a)(41), 22(c), and 22(e) » Investment Company Act, Rules 2a-4, 22c-1, and 38a-1 *Available through links at the SEC's Division of Investment Management website at www.sec.gov/divisions/investment.shtml.*
Industry Guidance:	» ICI's white papers: "*Valuation and Liquidity Issues for Mutual Funds*" (February 1997 and March 2002)
Notable SEC Enforcement Actions:	» Parnassus Investments (September 3, 1998) » Piper Capital Management (August 6, 2003) » The Heartland Funds: – FT Interactive Data (December 11, 2003) – Jon D. Hammes, et al (December 11, 2003) » Van Wagoner Capital Management (August 26, 2004)
SEC Guidance:	» April 30, 2001 and December 8, 1999 SEC staff letters to ICI » ASR 113 (October 21, 1969) and ASR 118 (December 23, 1970)

Fair Valuation Series: The Role of the Board

JANUARY 2006

Preface—May 2009

The Role of the Board is the second in a series of fair valuation papers that IDC, the Investment Company Institute (ICI), and ICI Mutual Insurance Company began to publish in 2005. This paper, published in 2006, focuses on the board's role and responsibilities, while the first paper in the series, *An Introduction to Fair Valuation* (also in this compendium), provides an overview of issues to consider in developing and administering valuation policies and procedures.

Valuation of a fund's portfolio securities—and, in particular, the fair valuation process—is a constant topic of interest for fund boards. The Investment Company Act of 1940 imposes specific responsibilities on fund boards relating to fair valuation. According to guidance from the U.S. Securities and Exchange Commission, a board may direct members of fund management or others to make the actual fair value determinations, as long as the board reviews and approves the methodologies by which fair value determinations are made, regularly reviews the appropriateness and accuracy of the valuation methodologies, and makes any necessary adjustments.

This report provides a helpful overview regarding the board's responsibilities and offers practical guidance in connection with that oversight. It includes questions useful for boards to consider and suggested "Dos and Don'ts" relating to board oversight of fair valuation.

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Introduction

Mutual fund boards of directors have a fundamental responsibility under the Investment Company Act of 1940 to fair value a fund's securities. Specifically, the Act provides that securities for which market quotations are readily available must be valued at market value, and all other securities and other assets must be valued at fair value as determined in good faith by a fund's board of directors. Unlike other responsibilities specifically given by the Act to independent directors, the responsibility for fair value determinations is assigned to the board as a whole.

FAIR VALUATION SERIES
*The first installment of the **Fair Valuation Series**, which provides an overview of fair valuation issues, describes various events, such as markets closing before 4:00 p.m. and trading halts, that ordinarily would cause a fund to consider fair valuing a portfolio.*

The valuation of fund securities determines a fund's per share net asset value (NAV). Every business day, a fund must determine the value of each portfolio security it holds to calculate its NAV. The fund's NAV then is used to process purchases, redemptions, and exchanges by shareholders. Proper valuation of fund securities ensures that all transacting fund shareholders pay or receive a price that represents their proportionate share of the fund's portfolio. Improperly determined securities valuations, on the other hand, may cause adverse consequences such as **dilution** for fund investors. Fair value pricing can protect long-term investors from dilution and other harm caused by short-term investors or arbitrageurs seeking to profit from the mispricing of a fund's securities. By the same token, eliminating arbitrage or dilution is not an appropriate reason, in and of itself, to fair value fund portfolio securities. As noted above, the Investment Company Act does not permit funds to use fair valuations unless market quotations are not "readily available."

Directors play an important role in the fair valuation process, which may include approving fund valuation policies and procedures, monitoring their implementation, and periodically reviewing the fair valuation decisions made by pricing personnel or valuation committees. While the board is ultimately responsible for the fair valuation process, that responsibility does not necessarily mean that the board itself must make fair value determinations. The specific actions that a board must take with respect to the fair valuation of securities will vary depending on, among other things, the nature of the particular fund, the context in which fair value determinations are made, and the pricing procedures adopted by the board.

TERMINOLOGY: DILUTION
If a fund's assets are undervalued, purchasing shareholders will receive more shares than they are entitled to upon entering the fund, diminishing the interests of the other fund investors. If a fund's assets are overvalued, redeeming shareholders will take away more than they should receive, at the expense of the remaining fund investors.

According to guidance from the SEC, a board may direct members of fund management (who may or may not sit on the board) or others to make the actual fair value determinations so long as the board reviews and approves the methodology or methodologies by which fair value determinations are made, regularly reviews the appropriateness and accuracy of the valuation methodologies, and makes any necessary adjustments.

The level of director involvement in fair valuation matters varies from fund to fund and board to board. Regardless of individual levels of involvement and expertise in fair valuation issues, directors may find the following questions useful to consider in their oversight of fair valuation determinations:

- ***Are the fund's fair valuation policies and procedures appropriate in light of the fund's anticipated investments?*** The SEC has indicated that, in directing fund management to make fair valuation determinations, a board of directors must approve the fund's fair valuation policies and procedures that form the basis for fair valuation determinations. Depending on the types of securities held by the fund, valuation procedures may describe specific valuation techniques and methodologies that will be used to fair value particular types of securities. For example, the valuation procedures of funds that hold foreign securities typically will address whether a **significant event** has occurred after the close of the foreign exchange or market on which the securities trade, but before the fund's NAV calculation. Policies and procedures may also include procedures for escalating difficulties or problems that may arise in the valuation process. A board's consideration of these types of issues may be important at the time the board establishes a new fund and approves the fund's fair valuation procedures.

TERMINOLOGY: SIGNFICANT EVENT

Depending on the facts and circumstances involved, a ***significant event*** *may include: events relating to a single issuer, such as corporate announcements on earnings; events relating to an entire market sector, such as significant governmental actions (e.g., raising interest rates); natural disasters that affect securities values, such as an earthquake; or significant fluctuations in domestic or foreign markets.*

- ***Are any modifications to the policies and procedures necessary?*** The SEC has stated that boards should review the methods used to fair value portfolio securities and the prices obtained through these procedures. The SEC has indicated that boards should make changes to policies and procedures when appropriate.
- ***Do external pricing vendors engaged by the fund provide helpful information?*** For certain types of securities, such as foreign equities and derivatives, some funds use external pricing vendors that offer fair valuation products or services based on quantitative models or other factors. 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. As part of their oversight role, directors may ask management to prepare reports that compare the prices provided by the vendors to the prices received on the sale of the securities or the securities' next available market price.
- ***Is the fund's fair valuation process working effectively?*** In addition to approving policies and procedures, directors play an important role in periodically monitoring the fund's fair valuation process. Monitoring can help to ensure that the fair valuation process results in the valuation of securities at prices that the fund could reasonably expect to receive upon the current sale of the securities. The SEC staff has stated that funds should regularly test their fair value prices by comparing them with values that are available from other sources (if there are any), such as actual trade prices and next-day opening prices, as well as any available quotations from external vendors.

The remainder of this installment of the Fair Valuation Series suggests a number of practical "dos and don'ts" intended to help directors answer these four questions and oversee an effective process for the valuation of securities.

I. Fair Valuation Dos and Don'ts

A. Policies and Procedures

Do focus on the fair valuation process and its implementation in practice.

Don't expect directors to determine fair values for specific portfolio securities.

As a general principle, a security's fair value is the price that the fund might reasonably expect to receive upon its current sale. To determine this price, directors, fund management, and others involved in the valuation process are required to make a good faith estimate of a security's value based on information available at the time. Estimations necessarily will vary and those involved in the valuation process are not expected to be omniscient. Nor are they expected to have chosen what, in hindsight, may appear theoretically to have been the "right" or "correct" price for a fair valued security. In fact, as the SEC has consistently pointed out, there is no single "right" or "correct" price for a fair valued security.

For these reasons, boards, their counsel, and fund management have, consistent with SEC guidance, focused their attention on developing and following a reasoned process for making informed valuation decisions.

The Investment Company Act states that fair values must be determined in good faith by the fund's board of directors. The SEC has stated that to comply with this responsibility, directors are not required to determine the specific fair values used by a fund. Rather, directors may entrust fair valuation decisions to individuals with suitable knowledge and expertise, subject to the board's oversight. Thus, boards typically establish a process for making informed valuation decisions and take steps to oversee that process consistently and in good faith.

Do approve valuation policies and procedures that are tailored to the funds you oversee.

Don't expect that fair valuation policies and procedures will contemplate every possible fair valuation situation.

The SEC has stated that all funds must adopt written policies and procedures governing the fair valuation of securities. These policies and procedures typically address the circumstances under which securities may be fair valued and may establish criteria for determining how to assign fair values in particular instances.

In considering valuation policies and procedures, directors, with the assistance of fund management (and counsel, if desired), may take into account the specific valuation issues that are likely to arise by virtue of the types of funds they oversee and the kinds of securities that these funds will reasonably be expected to hold. These considerations also may be a particularly important responsibility of directors when they approve the establishment of a new fund. For example, an emerging markets fund is likely to hold securities that may need to be fair valued because of the effect of threshold **triggers** on closing prices. Such a fund also is likely to hold securities that may need to be fair valued because of the effect of significant events that may occur between the time that market prices are established for those securities in their local (i.e., foreign) markets and the time the fund's NAV is calculated. Fair valuation policies and procedures that contemplate the occurrence

TERMINOLOGY: TRIGGERS

Triggers *signal movements in an index or security above a stated amount. For example, a fund might set a 75 basis-point trigger related to movements in the S&P 500 index. This would mean that the fund would consider fair valuing securities if the S&P 500 index closed more than 0.75 percent up or down from its previous close.*

of significant events would be appropriate for an emerging markets fund, although a significant event can also affect securities held by other types of funds.

As another example, a fund that holds illiquid or thinly traded securities (such as micro-capitalization stocks and certain fixed-income securities) may have procedures relating to identifying and updating stale prices. By contrast, specific policies and procedures to identify and update stale prices may not be necessary for other funds, such as ones that hold securities that trade in deep, liquid markets and are listed on the New York Stock Exchange.

Fair valuation issues that are not addressed in valuation policies and procedures invariably will arise. To accommodate these situations, policies might include procedures, often called "escalation procedures," that alert management officials not typically involved in the valuation process or certain members of the fund's board to specific valuation issues. The need for escalation may depend on the nature of the event requiring fair valuation, the size of the position being fair valued, and the valuation's potential effect on the fund's NAV. As it may not always be possible to contact a specific person in a time-sensitive situation, escalation procedures often designate more than one individual from fund management or the board, who, if needed, can act on fair valuation matters.

B. Allocating Specific Duties

Do consider the use of one or more valuation or pricing committees.

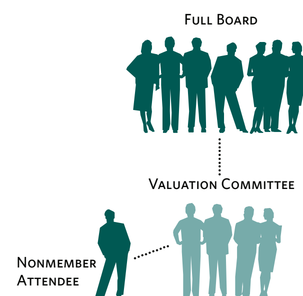
Don't expect there to be a single committee structure that will be appropriate for every board.

Depending on the number, size, and type of funds a board oversees, the board may choose to establish a committee or group, often called a "valuation committee" or "pricing committee," which has day-to-day responsibility for fair valuation. The SEC staff has recognized that funds may use valuation committees, but has noted that the board must oversee the committee(s) and retains ultimate responsibility for valuation matters.

Practices vary widely as to the precise role and composition of valuation or pricing committees, and boards should select a committee structure based on the particular circumstances of the boards and the funds they oversee.

One common structure employs a committee made up entirely of management personnel, such as legal, compliance, fund accounting, treasury, and/or investment professionals. In selecting this structure, the board may have determined that the process of fair valuation works effectively when the full board oversees the management personnel who are knowledgeable about the fair valuation process and the securities being fair valued. Investment professionals, for example, can be important sources of information about the value of securities. At the same time, conflict of interest concerns may be raised when investment professionals assign fair valuations that dramatically boost a fund's performance. These concerns may be heightened when the compensation of the investment professionals is based on the fund's performance. To address these potential concerns, boards may want to consider whether investment professionals responsible for managing a particular fund should have sole or primary authority for determining securities valuations for that fund.

Another structure includes a director on the valuation committee. In selecting this approach, the board may have concluded that committee participation by a director with a particular interest or experience in valuation matters may enhance board oversight of the valuation process. Directors who are contemplating this type of structure may wish to consider the differences between the roles a director would assume by virtue of being an active participant in committee decisions, on the one hand, and a reviewer of those decisions, on the other. Active participation could demand a greater time commitment and may be more likely to result in a director being named as a party in potential legal challenges relating to fair valuation.



Directors also may choose to participate in valuation committee meetings as nonmember attendees. This permits a director to oversee the process firsthand, but leaves the actual valuation determinations to others.

Another committee structure is multi-tiered, with a management pricing committee that handles daily fair valuation issues but that presents unusual or emergency fair valuation decisions to a committee made up entirely of directors. Each director on this committee may be empowered to act on behalf of the committee. This structure can facilitate board participation when time-sensitive valuation issues arise.

Regardless of the structure used, it is important that a valuation committee's membership, scope of delegated authority, and reporting obligations to the board be clearly defined. These matters often are reflected in a written charter or in the fund's valuation policies and procedures.

Do consider the use of external pricing vendors.

Don't expect that a vendor will always provide the price ultimately assigned to a security.

To assist them in meeting their fair valuation obligations, some boards, particularly those that oversee funds that invest significantly in foreign markets, have found it useful to consult external pricing vendors that offer fair valuation products and services. There is no requirement that boards use external pricing vendors, however, and the decision to use them may depend on, among other things, the particular types of securities the funds are expected to hold. Before engaging an external pricing vendor, directors may find it helpful to review background information on the vendor. This information includes, for example, consideration of the vendor's operations and internal testing procedures, emergency business continuity plans, and methodologies and information used to form its recommended valuations. Boards may request periodic presentations by the vendor, particularly if the information provided by the vendor will be an important part of the fund's fair valuation process. Boards also may request management to conduct an on-site visit of the external

TERMINOLOGY: BACK-TESTING

Back-testing *involves taking a sample of the prices provided by the vendor and reviewing them in light of other indicia of the value of the relevant securities, including prices received on the sale of the securities or the securities' next available market prices. Back-testing may assist in evaluating the reasonableness of using data provided by vendors.*

vendor. In addition, boards may request that management **back-test** a sample of the prices provided by the vendor. Boards can review and rely on management's due diligence of the pricing vendor as long as management's due diligence appears reasonably complete and thorough.

Vendors can play an important role in the fair valuation process by providing information that would be difficult for funds to develop on their own. There have been instances, however, when pricing vendors have provided improperly determined prices and, in some cases, have deviated from their stated procedures. A fund's valuation policies may include provisions for back-testing, reviewing, and, when appropriate, using different prices from those provided by external pricing vendors.

C. Ongoing Oversight

Do review reports from management on fair valuation.

Don't stop there—follow up on any fair valuation issues that the board has raised with management.

In exercising its ongoing oversight responsibility for fair valuations, the board typically reviews, on a periodic basis, information regarding fair value determinations.

Board reports relating to fair valuation may include different types of information depending on whether the fair valuations are routine or based on specific unusual circumstances. Routine fair valuations include those determined from the frequent application of quantitative models, such as foreign equity securities that are fair valued based on information provided by an external pricing vendor. The types of general information provided to the board may include summary back-testing data, including the **directional correctness** of security-level values and the degree to which the resulting valuations, taken as a whole, were c**loser to the open**. The general information may also include an analysis of the impact fair valuations had on the fund's NAV.

TERMINOLOGY: DIRECTIONAL CORRECTNESS
Directional correctness *refers to whether a fair value price moved in the same direction (relative to the prior market price) as the security's next actual market price.*

More specific information may be included in board reports for securities that are fair valued on a less routine basis. This information may include, for example, the fair value assigned to each security, the size of the holding, the effect of the fair value price on the fund's NAV, and the rationale for the decision to fair value. The results of back-testing analyses of securities that were fair valued also may be included in board reports to assist directors in assessing the operation of particular valuation methodologies in specific situations and over time.

TERMINOLOGY: CLOSER TO THE OPEN
Closer to the open *refers to whether a fair value price was closer to the security's next actual market price than the prior market price, regardless of the direction.*

Board reports also may include security-specific information for instances where management, pursuant to the fund's policies and procedures, used a price other than the one provided by the external vendor because management reasonably believed that it did not reflect the security's value. Such action on the part of management is a normal and necessary part of the valuation process, but also is an example of the type of action that, depending on its frequency, may warrant board consideration of the extent to which revisions to the fair valuation policies and procedures may be appropriate. For example, frequent use of prices other than those

provided by an external vendor that increase the value of portfolio securities might indicate that a vendor's prices are not reliable. It may also be a red flag, suggesting potential conflict of interest concerns and the need for greater board scrutiny.

Some funds also include in board reports the minutes of, or summary memoranda and other written documentation from, valuation committee meetings held during the prior period.

A board's responsibilities do not end with the review of a fair valuation report from management. SEC enforcement actions have highlighted the need for a board to follow up on fair valuation issues raised during board meetings so that fund management addresses questions or concerns expressed by directors.

Do periodically review fair valuation policies and procedures to make sure that they are working as intended.

Don't assume regulatory expectations in this area will remain static.

Fair valuation is an area in which regulatory expectations and external vendor products and services can rapidly evolve. Part of a board's responsibility is to keep abreast of these developments with the assistance of management, outside counsel, and other experts, and to decide whether any developments require modifications to a fund's fair valuation policies and procedures.

The SEC requires funds to regularly review the appropriateness and accuracy of the methods used in valuing securities. Given the board's oversight responsibility for valuation, the SEC staff has stated that boards should receive periodic reports from fund management that discuss the functioning of the valuation process and any issues and valuation problems that may have arisen. Directors also may confirm with management that the fund's fair valuation prospectus disclosure is consistent with the fund's fair valuation practices.

II. Overview of Enforcement Actions

From time to time, the SEC has brought enforcement actions against fund directors relating to their role in fair valuing portfolio securities. These cases may provide some guidance to directors in connection with their oversight of a fund's fair valuation process. Enforcement actions involving fund directors and the valuation process have focused on, among other things:

- **Directors overlooking information indicating that prices were no longer reliable.**
  - In one action, the SEC found that a board did not follow up on pricing issues when presented with specific information about deteriorating credit quality and questions concerning the liquidity of high-yield bonds held in a fund's portfolio.
- **Directors approving securities' prices based on valuation methodologies that were inconsistent with SEC guidance.**
  - For example, in one case, an administrative law judge found that a thinly traded security was fair valued based on the price expected to be received in a subsequent active market, rather than the price that would be received in the current market.

- **Directors failing to consider or ignoring specific information made available to them concerning an issuer's current financial condition and future prospects.**
  - In one case, an administrative law judge found that directors, in determining fair value, did not adequately consider the security's delisting from a stock exchange, the issuer's bankruptcy proceedings, and the issuer's consistent failure to meet management's income projections.
- **Directors continuing to rely on prices provided by a pricing service when they were given information indicating that these prices did not reflect the fair value of the securities.**
  - For example, in one case, the SEC found that directors should have instructed the fund's pricing committee to stop using a vendor's prices after the directors were advised by the fund's portfolio manager that the vendor's prices were inaccurate.
- **Directors approving fair valuation policies and procedures and considering their jobs done, rather than being alert for circumstances indicating that the procedures were not being followed.**
  - In one enforcement action, the SEC found that directors failed to follow up on their requests for information from the adviser, when the directors were on notice of problems with the prices of the fund's securities.

Conclusion

Given the differences among funds and boards, there is no one specific path for directors to take in the fair valuation process. Valuation is an important process, but one that has been widely recognized as "more of an art than a science." Through effective allocation of duties and oversight, all boards can exercise good faith and protect the interests of fund shareholders in connection with fair value determinations.

Appendix A: Other Valuation Resources

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Regulatory Framework:	» Investment Company Act, Sections 2(a)(41), 22(c), and 22(e) » Investment Company Act, Rules 2a-4, 22c-1, and 38a-1 *Available through links at the SEC's Division of Investment Management website at www.sec.gov/divisions/investment.shtml.*
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1401 H Street, NW, Suite 1200
Washington, DC 20005-2148
202/326-8300