

OVERVIEW OF

# Fund Governance Practices, 1994–2012



# Overview of Fund Governance Practices, 1994–2012

## Key Findings

- » **Fund boards, as a group, follow strong governance practices to best serve the interests of shareholders.** Studies of board practices indicate that over the past 18 years, fund boards have adopted such practices in advance of, or in the absence of, any regulatory mandate to do so.
- » **As of year-end 2012, independent directors made up three-quarters of boards in 85 percent of fund complexes.** Between 1996 and 2012, the number of complexes reporting that independent directors hold 75 percent or more of board seats rose from 46 percent to 85 percent. Current SEC rules require only that funds relying on common exemptive rules have boards with a majority of independent directors.
- » **Nearly two-thirds of fund complexes report having an independent board chair.** Sixty-two percent of complexes reported having boards with independent chairs at year-end 2012. When complexes that have boards with independent lead directors also are considered, 88 percent of participating complexes reported having an independent director in board leadership at year-end 2012.
- » **More than nine in 10 fund complexes report that separate legal counsel serve their independent directors.** The total percentage of complexes reporting that independent directors are represented either by dedicated counsel or counsel separate from the adviser's has increased over the past decade, from 64 percent in 1998 to 93 percent at year-end 2012. More than half of complexes say their independent directors retain their own counsel—separate from both fund counsel and the adviser's counsel.
- » **A vast majority of fund complexes have an audit committee financial expert.** While current rules require only that funds disclose whether the audit committee includes a financial expert, 95 percent of participating complexes report having a financial expert on the audit committee.

## Background

Fund boards perform an important role in the oversight of the fund industry. The Investment Company Act of 1940 (1940 Act) and its related rules impose significant responsibilities on fund boards and dictate elements of board structures and practices. Fund governance practices have evolved, and in 1995, the Investment Company Institute (ICI) began to document those practices by collecting data from fund complexes biennially.<sup>1</sup> The Independent Directors Council (IDC) was formed in 2004, and since then, the studies have been conducted jointly by ICI and IDC.

Board practices have been influenced by changing attitudes toward governance and by regulatory actions (see “Fund Governance Developments” below). In 1999, for example, a panel of interested and independent fund directors convened by ICI identified 15 practices to enhance the independence and effectiveness of fund directors. Their recommendations were published as the *Report of the Advisory Group on Best Practices for Fund Directors: Enhancing a Culture of Independence and Effectiveness (Best Practices Report)*.<sup>2</sup> Studies since 1999 document the effect of the *Best Practices Report* and other developments on board practices industrywide. IDC has issued a number of white papers, each of which provides practical guidance to boards. The papers are listed in the back of this overview.

This overview provides common fund governance practices covering the period from 1994 through 2012, and is an update to the overview published two years ago.<sup>3</sup> While the complexes participating in each biennial study have varied over the years—and some fluctuations in the data may be attributable to those variances—an examination of the data reveals certain trends. To put these data in context, this overview includes information on fund assets managed by complexes that participated in each of the biennial studies, the average fund assets served per director, the average number of funds served, and selected independent director characteristics.

### Fund Governance Developments

<b>1999</b>	SEC hosts roundtable discussion on fund governance.
<b>1999</b>	ICI publishes advisory group report on best practices for fund directors ( <i>Best Practices Report</i> ).
<b>2001</b>	SEC adopts rule amendments focused on board governance requirements (2001 SEC Rules). <sup>4</sup>
<b>2004</b>	SEC adopts rule amendments focused on board governance, including requirements that fund boards be composed of at least 75 percent independent directors and chaired by an independent director (2004 SEC Rules). <sup>5</sup>
<b>2006</b>	Federal appeals court invalidates requirements in the 2004 SEC Rules that fund boards be composed of at least 75 percent independent directors and chaired by an independent director. <sup>6</sup>
<b>2006</b>	SEC seeks additional comment on 75 percent independent director composition and independent chair requirements. <sup>7</sup>

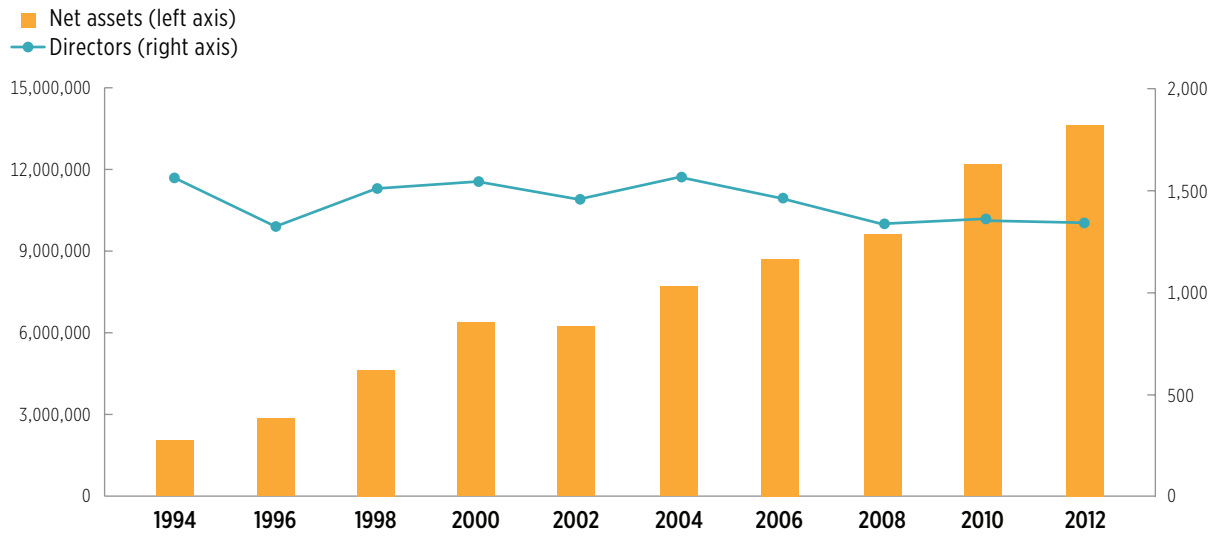
## Fund Net Assets and Independent Directors at Participating Complexes

To put the analysis in context, this overview presents data on the aggregate fund net assets of complexes participating in each of the biennial studies. Further, this overview presents the aggregate number of independent directors at these complexes. It should be noted that the number and identity of complexes participating in the studies change over time (Figure 1).

FIGURE 1

### Total Net Assets and Total Independent Directors at Participating Complexes

Millions of dollars, 1994–2012



## Fund Net Assets and Funds Served by Independent Directors

Fund net assets served by independent directors, on average, have increased in each of the studies conducted over the 18-year period (Figure 2). The average number of funds served has increased over the past decade, but the rate of the increase has slowed in recent years (Figure 3).

FIGURE 2

### Net Assets Served by Independent Directors

Millions of dollars, 1994–2012

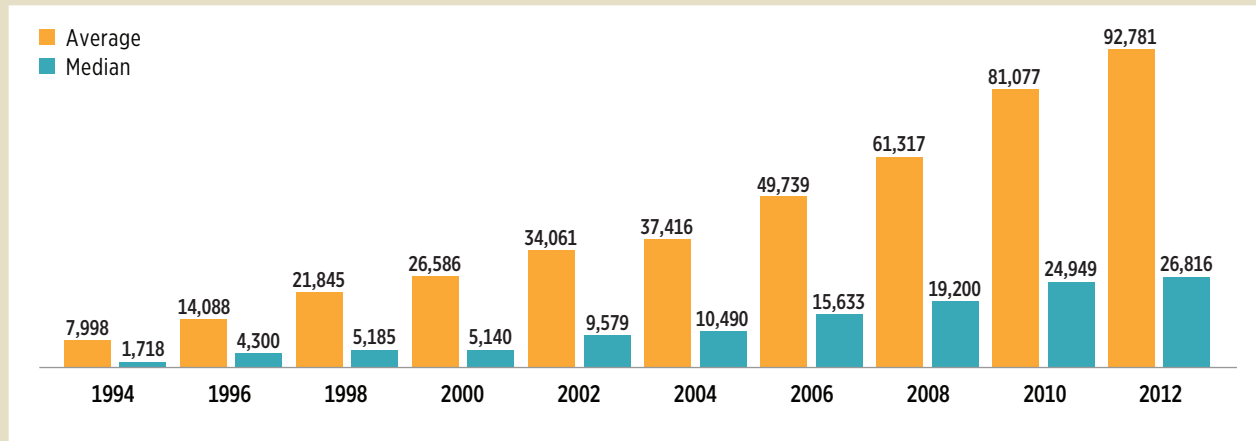
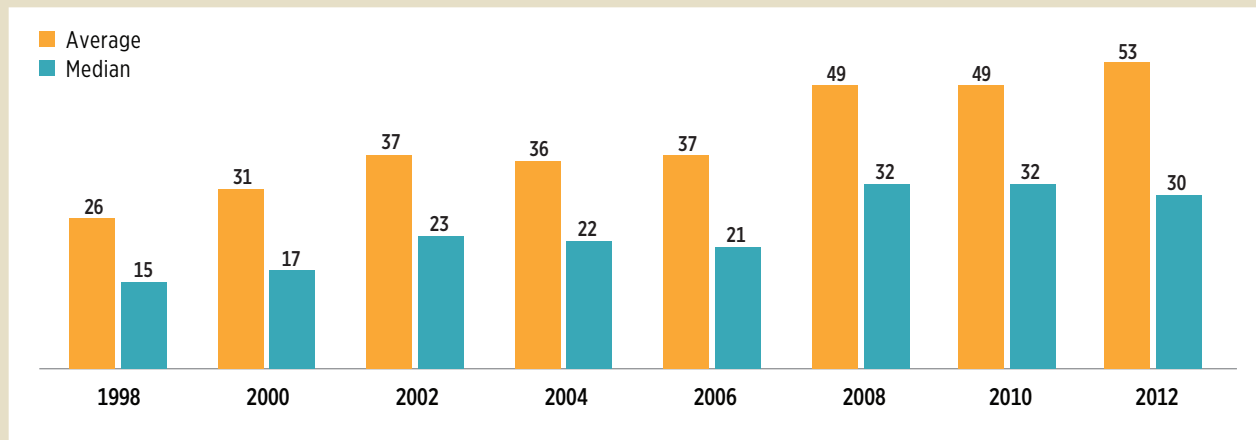


FIGURE 3

### Funds Served by Independent Directors

Number of funds, 1998–2012



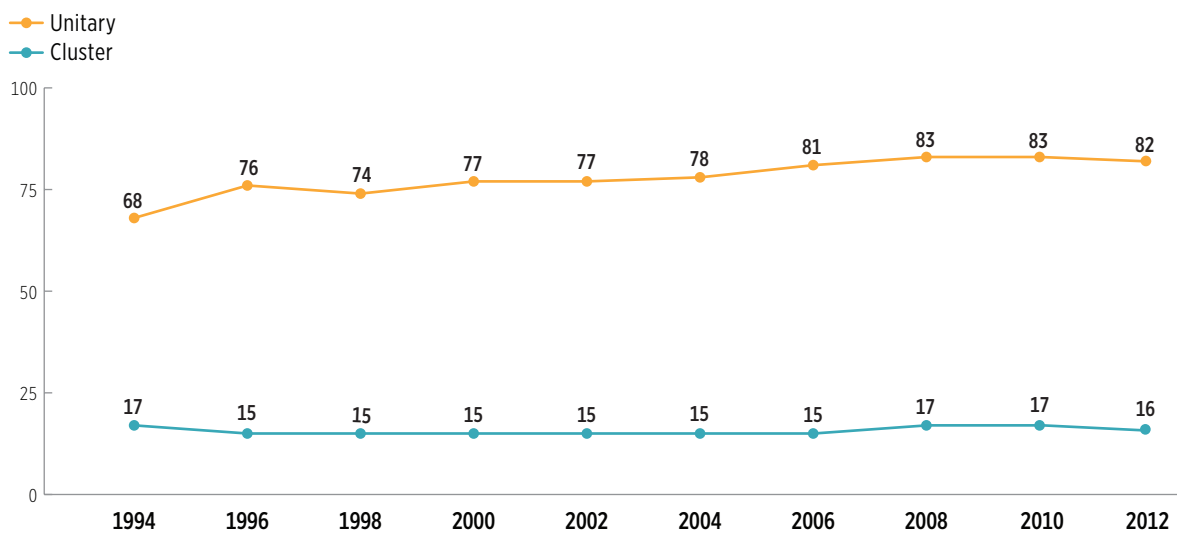
## Board Structure: Unitary or Cluster Boards

Since 1994, most complexes have employed a unitary board structure, meaning that a single board oversees all funds in the complex. As of 2012, 82 percent of participating complexes have a unitary board structure (Figure 4). Some complexes, particularly large ones, have adopted a cluster structure, where there are several boards within the complex, each overseeing a designated group of funds. The number and makeup of the clusters may be determined by several factors, including the type of funds (e.g., money market, institutional) or whether the funds in a particular cluster were acquired by the complex as a group. The percentage of participating fund complexes using the cluster structure over the last 18 years has remained relatively stable at around 15 to 17 percent (Figure 4).

FIGURE 4

### Board Structure

Percentage of fund complexes, 1994–2012

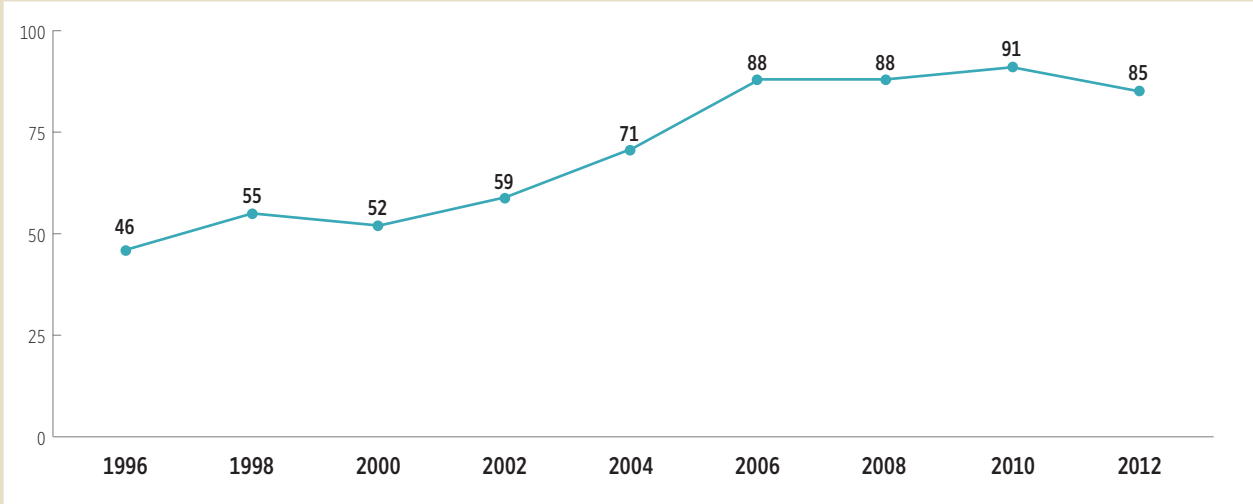


## Complexes in Which 75 Percent or More of Board Seats Are Held by Independent Directors

Over the years, these studies have collected information on the number of independent directors relative to the total number of directors at a fund complex. Under the 1940 Act, independent directors—directors who are not “interested persons” of the fund under the Act—must constitute at least 40 percent of each board unless special circumstances (e.g., following a merger) dictate a higher percentage. ICI’s *Best Practices Report* recommends that each board have a two-thirds majority of independent directors. The 2001 SEC Rules mandated a majority of independent directors for funds relying on certain exemptive rules, and the 2004 SEC Rules increased the required percentage to 75 percent independent directors on each board.<sup>8</sup> In 2006, a federal appeals court invalidated the 75 percent independent director requirement.<sup>9</sup> The SEC subsequently sought additional comment on that component of the fund governance rules, but has not taken further action. In 2004, the number of complexes with 75 percent of board seats held by independent directors increased to 71 percent, likely in response to the 75 percent mandate that was pending at that time. By 2006, the vast majority (88 percent) of complexes reported that 75 percent or more of the board seats at the complex were held by independent directors. In recent years, the number of complexes with a board composition of at least 75 percent independent directors has remained relatively stable (Figure 5).

FIGURE 5

### Complexes Where 75 Percent or More of Board Seats Are Held by Independent Directors Percentage of complexes, 1996–2012



## Number of Independent Directors per Complex and per Board

The number of independent directors in a given complex is influenced by the total number of directors on the board and the number of fund boards at the complex. The average number of independent directors per complex has remained unchanged over the course of the 18-year period (Figure 6). The median number has remained relatively stable over the same time period. In 2008, the study began reporting the number of independent directors per board (in addition to the number per complex). Since that time, the median and average number of independent directors per board generally has been six (Figure 7). The study will continue to report the number of independent directors per board going forward.

FIGURE 6

### Independent Directors per Complex

1994–2012

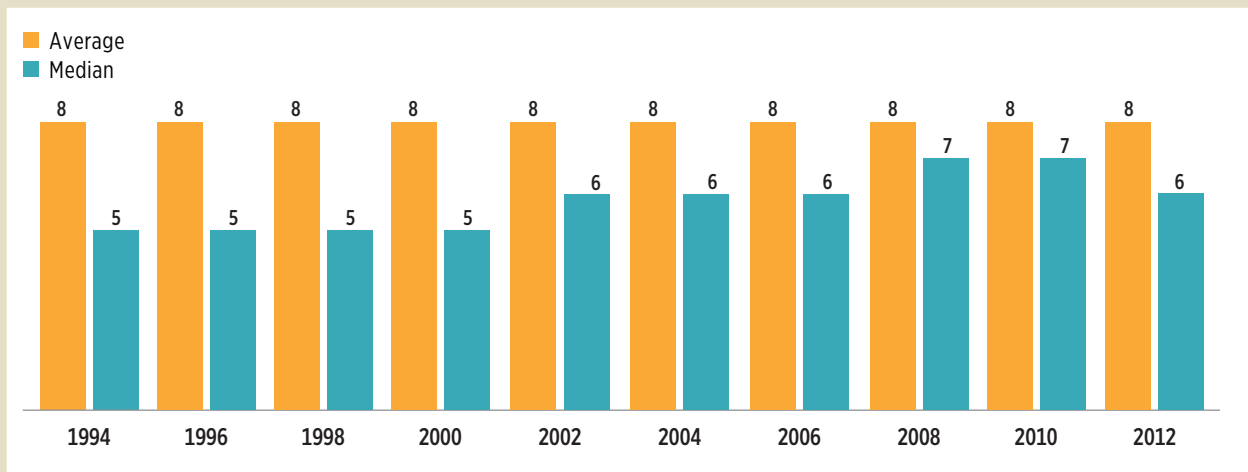
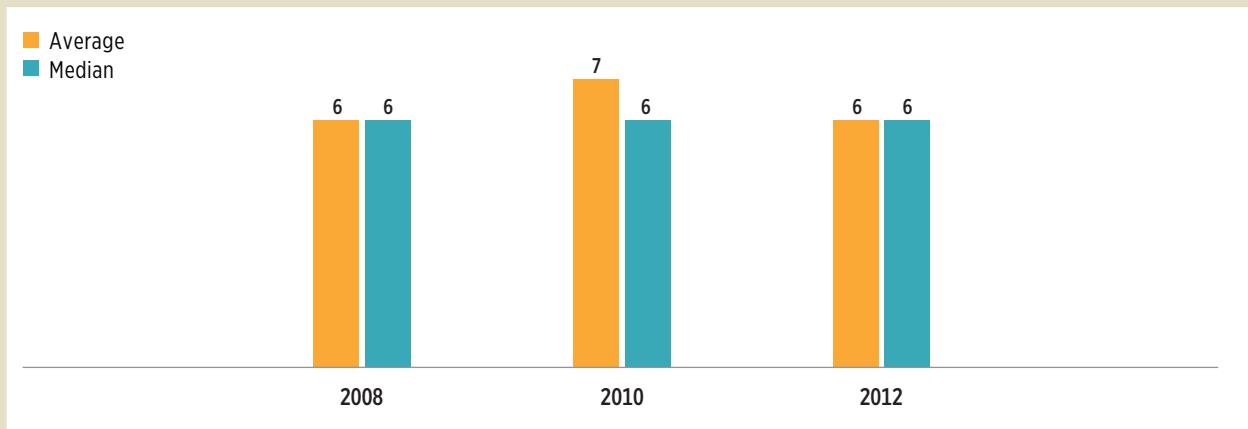


FIGURE 7

### Independent Directors per Board

2008–2012





## Frequency of Board Meetings

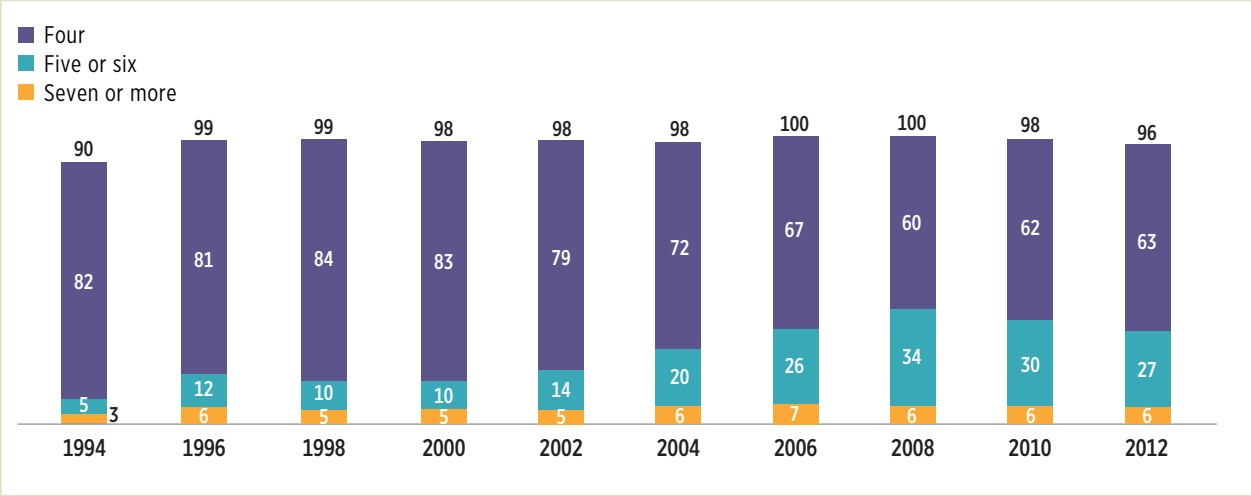
The frequency of regularly scheduled board meetings is not dictated by statute or rule. Approval of the advisory contract, among other duties, must occur annually at an in-person meeting, but the timing, length, and nature (e.g., in person, telephonic) of the other meetings are matters to be determined by each board.<sup>10</sup> The decision on the frequency of meetings may be influenced by several factors, including the size of the board and the number of funds the board oversees. A board also may elect to meet less frequently but for more days each time. One-third of participating complexes indicate that they held five or more regularly scheduled in-person board meetings in 2012 (Figure 8).

In actuality, fund directors often meet more frequently than called for by their regular schedule. Additional in-person or telephonic meetings are held, if necessary, to address specific issues.

**FIGURE 8**

### Regularly Scheduled In-Person Board Meetings per Year

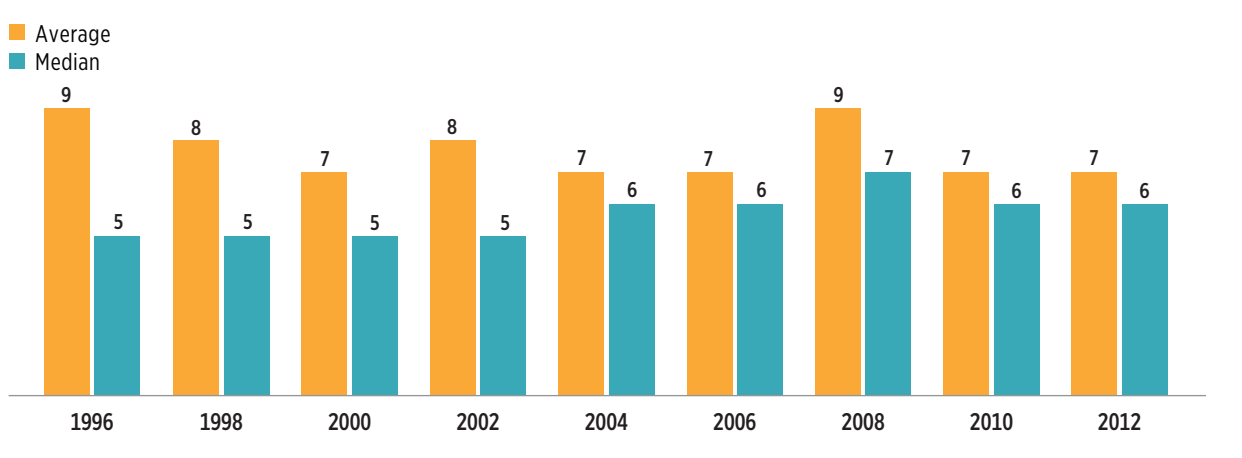
*Percentage of complexes, 1994–2012*



# Board Meetings and Committee Meetings in Which Independent Directors Participated

As noted, a board’s regularly scheduled meetings may be augmented by nonscheduled or impromptu meetings. For that reason, since 1998, the studies have included information on the number of board meetings in which independent directors actually participated, either by phone or in person. Between 1998 and 2006, the number of board meetings averaged between seven and eight per year, increased to nine in 2008, and returned to seven in 2010 and 2012 (Figure 9). The turbulent market environment in late 2008 may have prompted an increase in the number of impromptu board meetings in 2008. Additionally, some independent directors serving at cluster complexes may serve on more than one board. Such directors would normally attend four or more board meetings for each cluster they serve, and this practice likely would increase the reported average number of board meetings in which independent directors participated.

**FIGURE 9**  
**Board Meetings in Which Independent Directors Participated**  
*1996–2012*

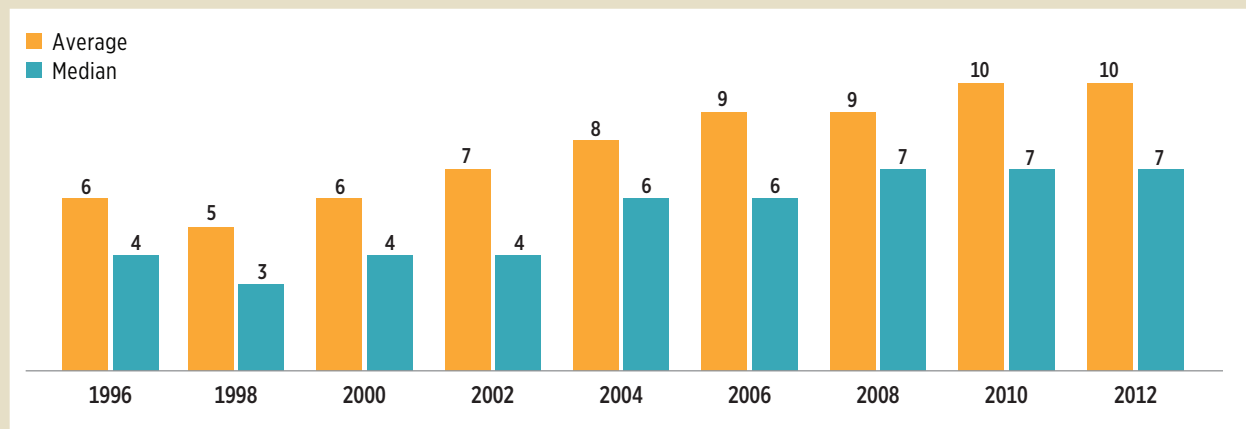


Quite often, committee meetings are held in conjunction with regularly scheduled board meetings. If necessary to accomplish their respective missions, committees may hold additional meetings. In addition, independent directors may serve on multiple committees. The average number of committee meetings in which independent directors participated has increased steadily from six in 2000 to 10 in 2012 (Figure 10).

**FIGURE 10**

**Committee Meetings in Which Independent Directors Participated**

1996–2012



## Independent Board Chair or Lead Director

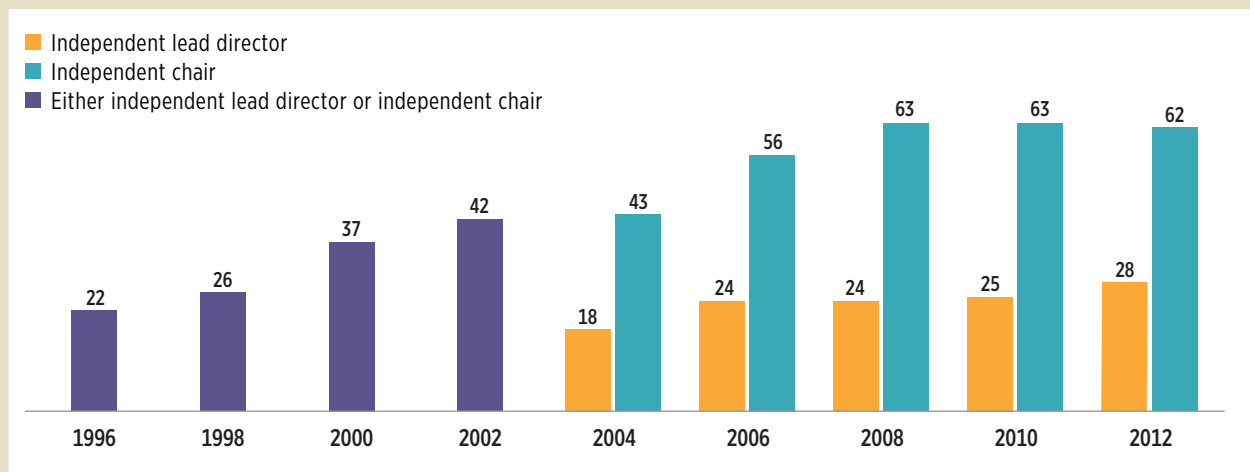
Board practices relating to independent directors serving as the board chair vary greatly. Prior to the repeal of the Glass-Steagall Act in 1999, independent board chairs were required for bank-sponsored funds. Some nonbank sponsored funds adopted the practice, but it was not widespread. Although no longer mandated after the enactment of the Gramm-Leach-Bliley Act in 1999, the independent chair practice was retained by most bank-sponsored funds. Other boards designated an independent director to serve as the primary liaison between independent directors and the adviser. This practice of designating an independent “lead director” was identified in ICI’s *Best Practices Report* as an effective governance tool. The 2004 SEC Rules mandated an independent chair for all boards, but that requirement was invalidated by a federal appeals court.<sup>11</sup> In 2006, the SEC sought additional comment on that component of the fund governance rules, but has not taken further action.

Beginning in 1996, survey participants were asked if they had either an independent board chair or an independent lead director, but they were not asked to distinguish between the two. The 2004 study, for the first time in the series, collected data separately on the incidence of independent board chairs and independent lead directors. The adoption of the 2004 SEC Rules and the board deliberations surrounding it resulted in a marked increase that year in the number of boards with independent board chairs. In 2012, nearly two-thirds (62 percent) of the participating complexes reported that they have an independent board chair. As of year-end 2012, 88 percent of participating complexes reported having an independent board chair or an independent lead director (Figure 11).<sup>12</sup>

FIGURE 11

### Complexes with an Independent Board Chair or Independent Lead Director

Percentage of complexes, 1996–2012



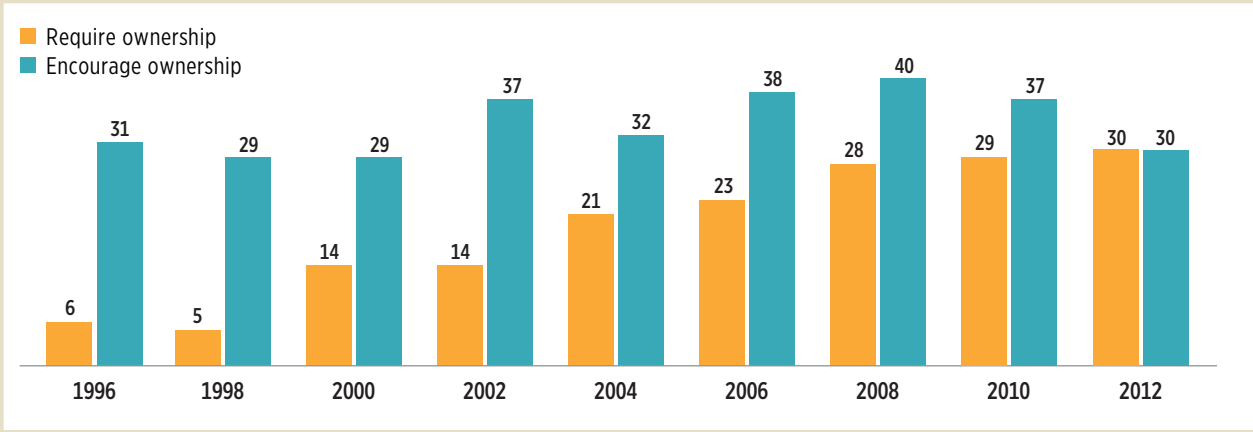
## Independent Director Fund Share Ownership

While many independent directors choose to own shares of the funds they oversee, the practice is not routinely required. This issue attracts some attention because SEC rules require disclosure of fund share ownership by directors. The data indicate that the number of complexes formally requiring fund share ownership by independent directors has increased steadily since 1996 (Figure 12). As of year-end 2012, 30 percent of participating complexes reported that they have a formal policy requiring such fund share ownership. The segment of complexes encouraging, as opposed to requiring, ownership of fund shares was approximately 30 percent in 2012. ICI's *Best Practices Report* recommends that directors invest in the funds of the boards on which they serve.

FIGURE 12

### Share Ownership by Independent Directors

Percentage of complexes, 1996–2012



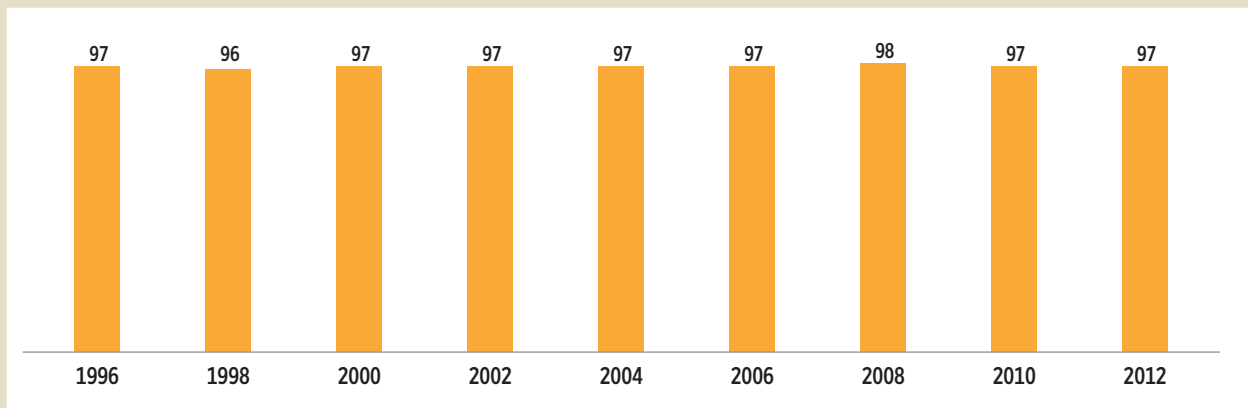
## Independent Directors' Prior Affiliation with Complex

The 1940 Act provides that an individual is an “interested person” if he or she has certain personal, financial, or professional relationships with the fund, investment adviser, or principal underwriter. The SEC also may issue an order finding that a director who has had a material business or professional relationship with the fund, adviser, or principal underwriter within the past two fiscal years is an interested person.<sup>13</sup> ICI’s *Best Practices Report* recommends always treating former officers or directors of the adviser, underwriter, or certain affiliates as interested persons in order to avoid any possible perception that such a director might not act in the best interests of shareholders. The studies reflect an appreciation for the letter and spirit of the law and industry best practices, as 97 percent of independent directors surveyed report never having been previously employed by the complex (Figure 13).

FIGURE 13

### Independent Directors Never Previously Employed by Complex

*Percentage of directors, 1996–2012*



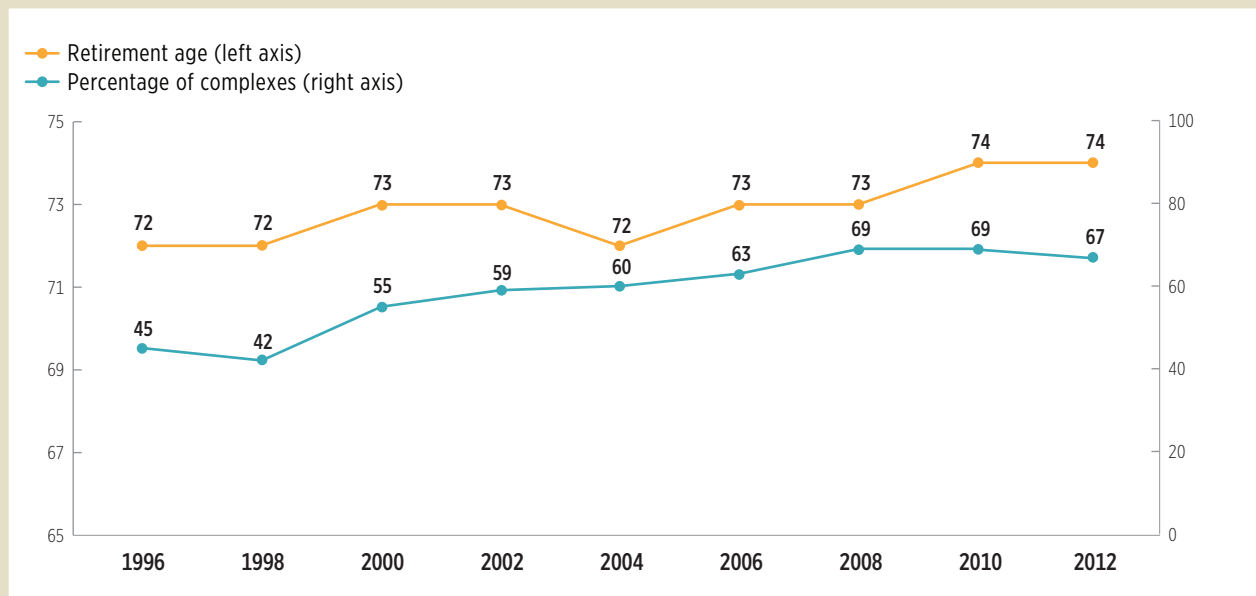
## Mandatory Retirement Policy

No regulatory requirement relating to retirement policies exists for fund directors, but the topic may be addressed in a board's annual self-assessment. The studies began collecting data regarding mandatory retirement policies in 1996. Since then, the percentage of complexes that have formally adopted such policies has increased gradually, and stood at 67 percent in 2012 (Figure 14). ICI's *Best Practices Report* recommends that fund boards adopt policies on the retirement of directors, but declined to specify the type of policy (e.g., retirement age, term limits) or a recommended retirement age. For those complexes with a mandatory retirement policy, the average mandatory retirement age has increased slowly from 72 in 1996 to 74 in 2012.

FIGURE 14

### Mandatory Retirement Policy

1996–2012

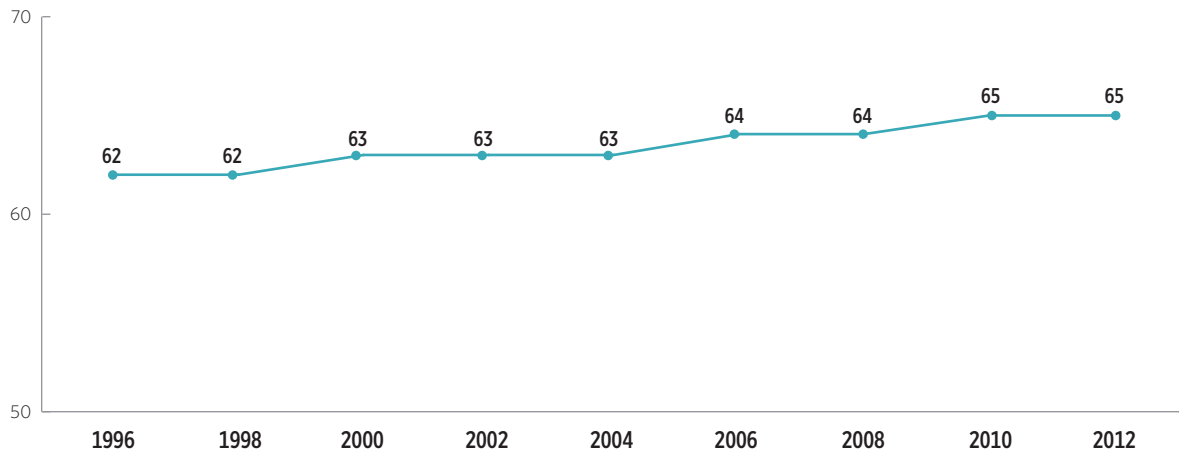


To help put a director's average retirement age in context, previous studies included the age of all independent directors participating in each biennial study and the number of years they had served their complexes as directors. Since 1996, the average age has edged up from 62 to 65 (Figure 15), and the average number of years of service has increased from nine to 12 years (Figure 16).

**FIGURE 15**

**Average Age of Independent Directors**

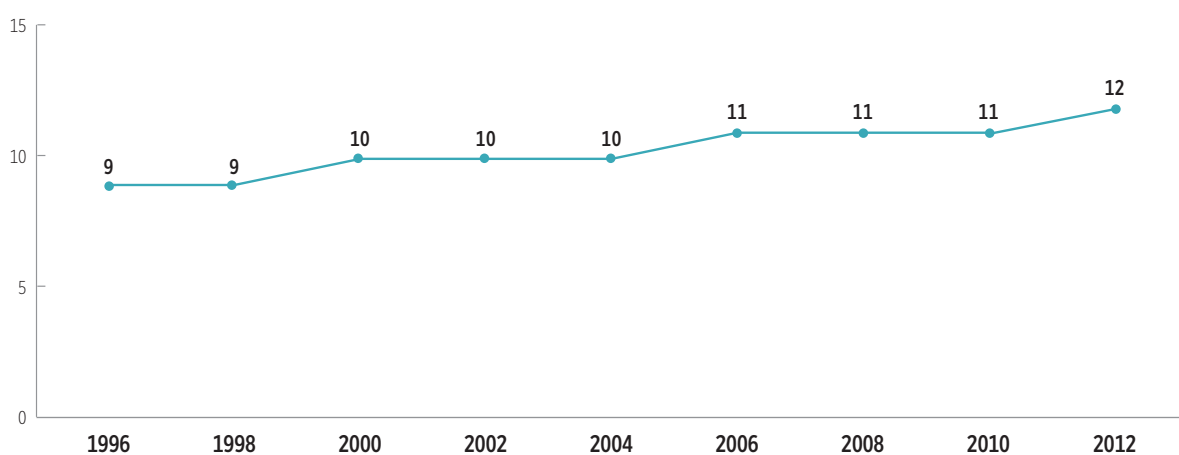
*1996–2012*



**FIGURE 16**

**Length of Service at Complex by Independent Directors**

*Number of years, 1996–2012*





## Independent Counsel

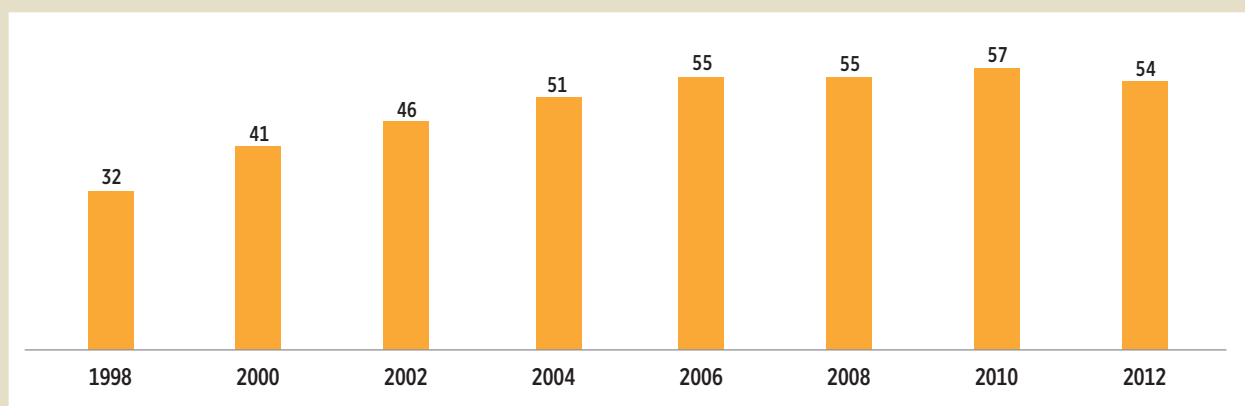
Fund boards employ a variety of arrangements in retaining counsel. Some independent directors have their own dedicated counsel, others formally retain counsel with the fund, and still others have no dedicated counsel but instead rely on counsel to the fund (or retain other counsel) on an as-needed basis. ICI's *Best Practices Report* recommends that independent directors have qualified investment company counsel who is independent from the investment adviser and the fund's other service providers. The report acknowledges that independent directors may elect to have their own counsel or rely on counsel to the fund and, as the data demonstrate, independent directors increasingly recognize this practice as a key component of effective fund governance. The 2001 SEC Rules further provide that, if the independent directors were to have counsel, it must be "independent legal counsel" as defined, but they decline to mandate representation.

The studies have collected data concerning director retention of counsel and, though the form of the query in the survey questionnaire has varied over time, certain trends emerge. The data show that instances in which independent directors retain their own counsel—separate from fund counsel and the adviser's counsel—have increased markedly, from 32 percent of participating complexes in 1998 to 54 percent in 2012 (Figure 17). These instances include arrangements in which the fund, adviser, and directors are served by different counsel, as well as arrangements in which the fund and adviser share counsel, but the independent directors have separate, dedicated counsel.

FIGURE 17

### Independent Directors Have Dedicated Counsel

*Percentage of complexes, 1998–2012*

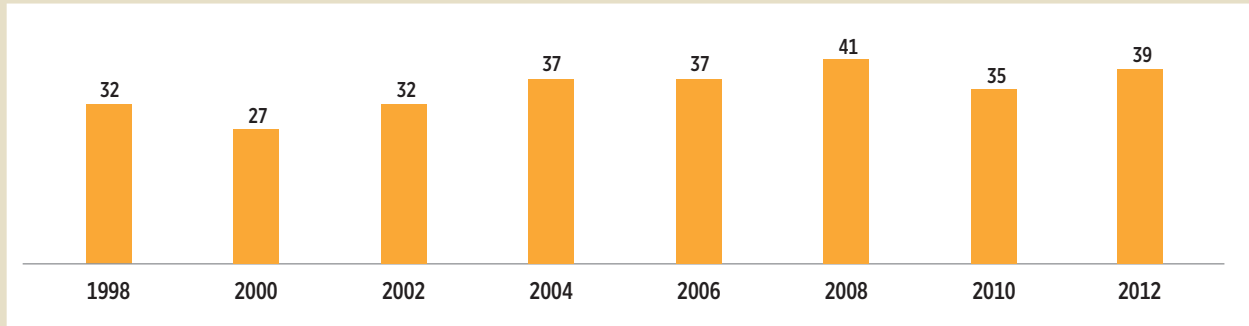


In instances where independent directors formally or informally rely on counsel to the fund, while the adviser is served by different counsel, the fund counsel would constitute independent legal counsel. In 2012, 39 percent of the complexes reported that independent directors rely on fund counsel (Figure 18).

FIGURE 18

**Independent Directors Rely on Fund Counsel (Different from Adviser’s Counsel)**

*Percentage of complexes, 1998–2012*

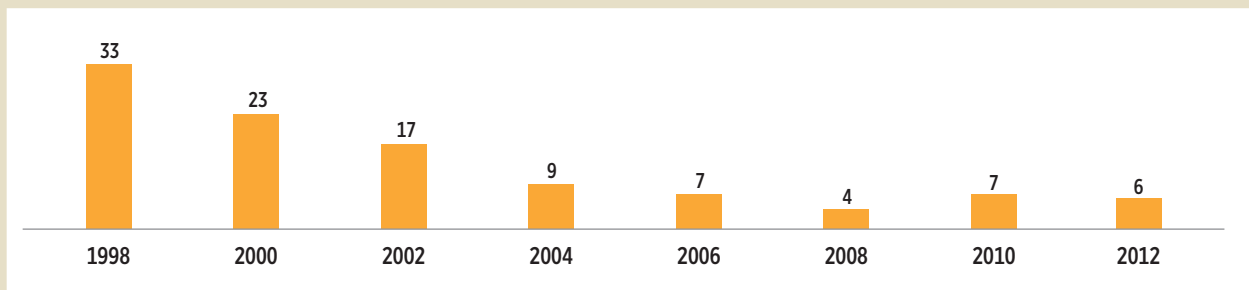


The percentage of complexes indicating that independent directors are not represented by counsel—and are not formally or informally relying on counsel to the fund—has declined sharply since 1998 (Figure 19). This decline was likely influenced by a number of factors, including ICI’s *Best Practices Report*, the 2001 SEC Rules relating to independent counsel, and, most recently, the focus on director independence following the 2004 SEC Rules and litigation involving funds.

FIGURE 19

**Same Counsel Represents Fund and Adviser: Independent Directors Have No Separate Counsel**

*Percentage of complexes, 1998–2012*



The data permit us to conclude that an increasing number of independent directors are represented by independent legal counsel. In fact, the total percentage of complexes indicating that independent directors either are represented by dedicated counsel or counsel separate from the adviser's has increased steadily since the release of ICI's *Best Practices Report*, from 68 percent in 2000 to 93 percent in 2012 (Figures 17 and 18). Given the increased amount of regulatory compliance matters being addressed by fund boards, such representation is beneficial to both the independent directors and the shareholders they represent.

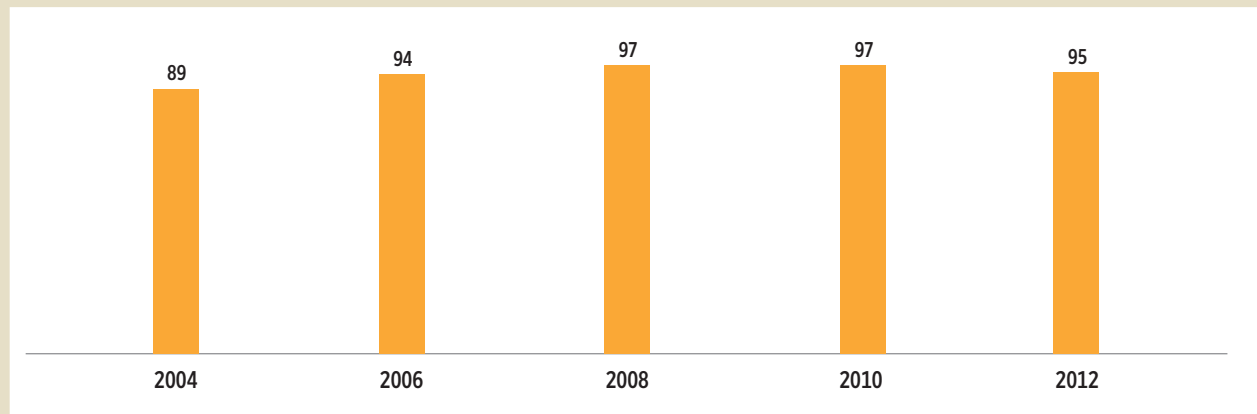
### Audit Committee Financial Expert

In 2003, the SEC adopted rules that require funds to disclose whether they have at least one financial expert serving on the audit committee of the board and, if so, the name of the expert and whether the expert is independent of management. Funds that do not have an audit committee financial expert must disclose the reasons why.<sup>14</sup> Based on the new requirement, beginning in 2004, the studies include data on whether complexes have an audit committee financial expert. The vast majority (95 percent) of complexes have a financial expert serving on an audit committee, notwithstanding that they are not required to do so (Figure 20).

FIGURE 20

#### Complexes with Audit Committee Financial Expert

*Percentage of complexes, 2004–2012*



### Conclusion

Fund governance practices have continued to evolve in response to emerging industry standards and often well in advance of, or in the absence of, explicit regulatory requirements. ICI and IDC will continue to document these and other trends in fund governance practices through their studies and will publish updated overviews every two years in conjunction with the biennial collection of data.

## Additional Reading

IDC has issued the following white papers, each of which provides practical guidance to boards. The papers are available on IDC's website at [http://www.idc.org/idc/pubs/white\\_papers](http://www.idc.org/idc/pubs/white_papers).

- » *Considerations for Board Composition: From Recruitment Through Retirement* (To come)
- » *Investment Performance Oversight by Fund Boards* (To come)
- » *Board Oversight of Exchange-Traded Funds* (October 2012)
- » *Fund Board Oversight of Risk Management* (September 2011)
- » *Board Oversight of Target Retirement Date Funds* (April 2010)
- » *Board Oversight of Subadvisers* (January 2010)
- » *Board Oversight of Fund Compliance* (September 2009)
- » *Navigating Intermediary Relationships* (September 2009)
- » *Board Oversight of Derivatives* (July 2008)
- » *Oversight of Fund Proxy Voting* (July 2008)
- » *Board Oversight of Certain Service Providers* (June 2007)
- » *Board Consideration of Fund Mergers* (June 2006)
- » *Fair Valuation Series: The Role of the Board* (January 2006)
- » *Fair Valuation Series: An Introduction to Fair Valuation* (June 2005)
- » *Director Oversight of Multiple Funds* (May 2005)
- » *Board Self-Assessments: Seeking to Improve Mutual Fund Board Effectiveness* (February 2005)
- » *Implementing the Independent Chairperson Requirement* (January 2005)

## Notes

- <sup>1</sup> ICI and IDC collect data on board practices from participating fund complexes through the *Directors Practices Study: Practices and Compensation*. The first such study, conducted in 1995, collected data covering the year ended December 31, 1994, and 4,048 funds were represented. Subsequent studies covered 1996 (5,191 funds), 1998 (6,452 funds), 2000 (7,740 funds), 2002 (8,073 funds), 2004 (7,549 funds), 2006 (7,764 funds), 2008 (7,690 funds), 2010 (7,756 funds), and 2012 (8,235 funds). This overview will use the term “studies” to refer to all of the biennial studies collectively; results that are unique to a particular study will be identified by year.
- <sup>2</sup> Investment Company Institute, *Report of the Advisory Group on Best Practices for Fund Directors: Enhancing a Culture of Independence and Effectiveness* (June 24, 1999).
- <sup>3</sup> ICI and IDC, *Overview of Fund Governance Practices, 1994–2010*.
- <sup>4</sup> Securities and Exchange Commission, Investment Company Act Release No. 24816 (January 2, 2001).
- <sup>5</sup> Securities and Exchange Commission, Investment Company Act Release No. 26520 (July 27, 2004). The 2001 and 2004 SEC Rules imposed conditions on fund boards that rely on any one of 10 popular exemptive rules. Most funds rely on at least one of these rules. Accordingly, this overview will discuss the conditions as generally applying to all funds. Because the 2004 SEC Rules now mandate certain fund governance practices that previously were optional (i.e., that boards conduct self-assessments and that independent directors meet in separate sessions), we have discontinued collecting data regarding those mandated practices and do not include such data in this overview.
- <sup>6</sup> *Chamber of Commerce v. Securities and Exchange Commission*, 443 F.3d 890 (DC Cir. 2006). In 2005, the court stayed the effectiveness of the rule amendments requiring boards to be composed of 75 percent independent directors and have an independent chair until the litigation was concluded. See *Chamber of Commerce v. Securities and Exchange Commission*, No. 05-1240 (DC Cir. August 10, 2005).
- <sup>7</sup> Securities and Exchange Commission, Investment Company Act Release No. 27395 (June 13, 2006) and Investment Company Act Release No. 27600 (December 15, 2006).
- <sup>8</sup> See 2001 SEC Rules, note 4, *supra*, and 2004 SEC Rules, note 5, *supra*.
- <sup>9</sup> See *Chamber of Commerce v. Securities and Exchange Commission*, note 6, *supra*.
- <sup>10</sup> The frequency of board meetings is a topic that may be evaluated as part of the annual board self-assessment mandated by the 2004 SEC Rules. See also IDC Task Force Report, *Board Self-Assessments: Seeking to Improve Mutual Fund Board Effectiveness* (February 2005).
- <sup>11</sup> See *Chamber of Commerce v. Securities and Exchange Commission*, note 6, *supra*.
- <sup>12</sup> Certain complexes with cluster boards have an independent board chair and an independent lead director, and are included in both measures in Figure 11. Accordingly, the percentage of complexes having either an independent board chair or an independent lead director is less than the sum of these two measures.
- <sup>13</sup> Under Section 2(a)(19) of the 1940 Act, the SEC also may issue an order finding a person who had a material or professional relationship with the principal executive officer of the fund, investment adviser, or principal underwriter; with any other fund having the same investment adviser, principal underwriter, or the principal executive officer of such fund; or with any controlling person of the investment adviser or principal underwriter, within the past two fiscal years, to be an interested person.
- <sup>14</sup> Securities and Exchange Commission, Investment Company Act Release No. 25914 (January 27, 2003).



*The Investment Company Institute (ICI) is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs). ICI seeks to encourage adherence to high ethical standards by all industry participants; advance the interests of funds, their shareholders, directors, and advisers; and promote public understanding of mutual funds and other investment companies.*



*The Independent Directors Council (IDC) serves the fund independent director community by advancing the education, communication, and policy positions of fund independent directors, and promoting public understanding of their role.*

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