

Report of the Advisory Group on Best Practices for Fund Directors

ENHANCING A CULTURE OF INDEPENDENCE AND EFFECTIVENESS

JUNE 24, 1999

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of Governors, Investment Company
Institute and Chairman and CEO,
The Vanguard Group, Inc.

Dawn-Marie Driscoll, Independent
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ENHANCING A CULTURE OF INDEPENDENCE AND EFFECTIVENESS —
REPORT OF THE ADVISORY GROUP ON
BEST PRACTICES FOR FUND DIRECTORS

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EXECUTIVE SUMMARY

FORMATION OF THE ADVISORY GROUP

The regulatory requirements governing investment company boards of directors are unique in the world of American business. Independent directors of investment companies in particular play a critical role in overseeing fund operations and policing conflicts of interest between the fund and its investment adviser or other service providers. In fulfilling this role, independent directors act as “watchdogs,” protecting the interests of fund shareholders.

There is broad consensus that this governance system has worked well for investment companies and their shareholders. Nevertheless, this system, like any other, must periodically be reexamined to ensure its continuing effectiveness.

Toward that end, in February 1999, the Securities and Exchange Commission held a Roundtable on the Role of Independent Investment Company Directors in order to focus on the appropriate role of independent directors and their specific responsibilities. Shortly thereafter, SEC Chairman Arthur Levitt announced that the SEC would consider certain regulatory proposals to enhance the role of independent fund directors and called on the fund industry to work with the SEC to further enhance the effectiveness of fund directors.

At the same time, the Investment Company Institute* announced the creation of an Advisory Group on Best Practices for Fund Directors. The Advisory Group’s mission was to

* The Investment Company Institute is the national association of the American investment company industry. Its membership includes 7,576 open-end investment companies (“mutual funds”), 479 closed-end investment companies and 8 sponsors of unit investment trusts. Its mutual fund members have assets of about \$5.86 trillion, accounting for approximately 95 percent of total industry assets, and have over 73 million individual shareholders.

identify the best practices used by fund boards to enhance the independence and effectiveness of investment company directors, and to recommend those practices that should be considered for adoption by all fund boards. This Report carries out that mission. In preparing this Report, the Advisory Group considered various practices currently utilized by fund boards and other suggested practices. The Advisory Group consulted a variety of experts, including independent directors of investment companies, fund management representatives, former SEC officials, representatives of the accounting and legal communities, prominent academics, and representatives of consumer organizations.

THE ROLE OF FUND DIRECTORS

Meaningful recommendations to enhance the independence and effectiveness of fund directors require an understanding of their unique role. The Investment Company Act of 1940 specifically requires investment companies to have on their boards at least a certain percentage of independent directors, and strictly defines independence for this purpose.

The Act also assigns investment company directors a series of specific responsibilities, including approval of the fund's contract with its investment adviser. In addition, fund directors must monitor and protect against various conflicts of interest in order to ensure that the fund is operated in the best interests of shareholders. The fundamental responsibility of fund directors, in the opinion of the Advisory Group, is to ensure that the fund's shareholders receive the benefits and services to which they are fairly entitled, both as a matter of law and in accordance with the fund's prospectus and other disclosure documents.

RECOMMENDATIONS

This Report recommends a series of policies and practices that go beyond what is required by law and regulation and that are designed to enhance the role of investment company directors.

Many of these recommendations are already in use by many fund boards. The recommendations are designed to ensure that the outside directors are independent from the fund's investment adviser, principal underwriter and their affiliates, and to enhance the effectiveness of all fund directors in fulfilling their oversight responsibilities.

The specific recommendations of the Advisory Group are set forth below:

1. Super-Majority of Independent Directors

The Advisory Group recommends that at least two-thirds of the directors of all investment companies be independent directors.

2. Persons Formerly Affiliated with the Adviser, Principal Underwriter and Certain Affiliates

The Advisory Group recommends that former officers or directors of a fund's investment adviser, principal underwriter or certain of their affiliates not serve as independent directors of the fund.

3. Control of the Nominating Process by Independent Directors

The Advisory Group recommends that independent directors be selected and nominated by the incumbent independent directors.

4. Compensating Independent Directors

The Advisory Group recommends that independent directors establish the appropriate compensation for serving on fund boards.

5. Fund Ownership Policy

The Advisory Group recommends that fund directors invest in funds on whose boards they serve.

6. Qualified Independent Counsel and Other Experts

The Advisory Group recommends that independent directors have qualified investment company counsel who is independent from the investment adviser and the fund's other service providers. The Advisory Group also recommends that independent directors have express authority to consult with the fund's independent auditors or other experts, as appropriate, when faced with issues that they believe require special expertise.

7. Annual Questionnaire on Relationships with the Adviser and Other Service Providers

The Advisory Group recommends that independent directors complete on an annual basis a questionnaire on business, financial and family relationships, if any, with the adviser, principal underwriter, other service providers and their affiliates.

8. Organization and Operation of the Audit Committee

The Advisory Group recommends (1) that investment company boards establish Audit Committees composed entirely of independent directors; (2) that the Audit Committee meet with the fund's independent auditors at least once a year outside the presence of management representatives; (3) that the Audit Committee secure from the auditor an annual representation of its independence from management; and (4) that the Audit Committee have a written charter that spells out its duties and powers.

9. Separate Meetings of Independent Directors

The Advisory Group recommends that independent directors meet separately from management in connection with their consideration of the fund's advisory and underwriting contracts and otherwise as they deem appropriate.

10. Lead Independent Director or Directors

The Advisory Group recommends that independent directors designate one or more "lead" independent directors.

11. Insurance Coverage and Indemnification

The Advisory Group recommends that fund boards obtain directors' and officers' errors and omissions insurance coverage and/or indemnification from the fund that is adequate to ensure the independence and effectiveness of independent directors.

12. Unitary or Cluster Boards

The Advisory Group recommends that investment company boards of directors generally be organized either as a unitary board for all the funds in a complex or as cluster boards for groups of funds within a complex, rather than as separate boards for each individual fund.

13. Retirement Policy

The Advisory Group recommends that fund boards adopt policies on retirement of directors.

14. Evaluation of Board Performance

The Advisory Group recommends that fund directors evaluate periodically the board's effectiveness.

15. Orientation and Education

The Advisory Group recommends that new fund directors receive appropriate orientation and that all fund directors keep abreast of industry and regulatory developments.

ENHANCING A CULTURE OF INDEPENDENCE AND EFFECTIVENESS —
REPORT OF THE ADVISORY GROUP ON
BEST PRACTICES FOR FUND DIRECTORS

I. INTRODUCTION AND BACKGROUND

The regulatory requirements governing investment company boards of directors are unique in the world of American business. Unlike any other type of business entity, investment companies are required to have on their boards at least a certain percentage of directors who are independent of fund management.¹ The Investment Company Act of 1940 (the “Act”) assigns to the independent directors specific obligations to oversee the fund’s relationship with management. These directors serve a “watchdog” function, providing independent oversight of the management of investment companies to ensure that the companies are being operated in the interests of shareholders.²

There is a broad consensus that this governance system has worked well for investment companies and their shareholders. In its 1992 report on investment company regulation, the Division of Investment Management of the Securities and Exchange Commission (“SEC”) concluded: “The oversight function performed by investment company boards of directors,

¹ The terms “fund management,” “investment adviser,” “investment manager,” “management company,” and like terms are used interchangeably throughout this Report.

² As the Supreme Court observed in Burks v. Lasker, 441 U.S. 471, 486 (1979): “[T]he structure and purpose of the Investment Company Act indicate that Congress entrusted to the independent directors of investment companies . . . the primary responsibility for looking after the interests of the funds’ shareholders.” In recognition of such responsibility, court decisions often refer to the independent directors as “independent watchdogs” for the funds and their shareholders. See, e.g., Tannenbaum v. Zeller, 552 F.2d 402, 406 (2d Cir.), cert. denied, 434 U.S. 934 (1977).

especially the ‘watchdog’ function performed by the independent directors, has served investors well at minimal cost.”³

Nevertheless, the system of director oversight, like any other, must periodically be reexamined to ensure its continuing effectiveness. Reexamination is especially appropriate now, as the investment company industry has grown and changed dramatically in recent years, offering new types of funds, entering new distribution channels, and appealing to new segments of the investing public. These changes have required investment company boards to change as well, developing new areas of expertise, posing new questions to management, and adjusting their practices and procedures to remain effective as board workloads have increased and become more complex.

The responsibilities of fund directors were recently explored in depth at the SEC Roundtable on the Role of Independent Investment Company Directors held on February 23-24, 1999, in Washington, D.C. At the Roundtable, SEC Chairman Arthur Levitt hosted panels of experts from a variety of disciplines to evaluate how independent directors are meeting the challenges posed by the growth and increased complexity of the mutual fund industry and its growing importance to American investors. Significantly, the Roundtable’s deliberations did not reveal a need for wholesale restructuring of the system of mutual fund governance and the role of independent fund directors. As Chairman Levitt subsequently noted, however, there was “broad agreement” that the existing “mutual fund governance structure could and should be improved so that the directors are better able to serve shareholders.”⁴

³ SEC Division of Investment Management, Protecting Investors: A Half Century of Investment Company Regulation (May 1992) at 253.

⁴ Remarks of SEC Chairman Arthur Levitt at the Mutual Funds and Investment Management Conference, Palm Springs, CA (March 22, 1999) (“Remarks of SEC Chairman Arthur Levitt”).

Following the Roundtable, Chairman Levitt announced a “major Commission initiative to improve mutual fund governance,” including specific regulatory proposals that the SEC would consider. At the same time, the Chairman called upon the mutual fund industry “to undertake a similar effort in enhancing the role of independent directors.”⁵

In response, Matthew P. Fink, President of the Investment Company Institute, announced the formation of an Advisory Group on Best Practices for Fund Directors. The Advisory Group was given the mission to identify the best practices used by investment company boards and to recommend those practices that should be considered for adoption by all fund boards. The membership of the Advisory Group consists of three experienced independent fund directors and three senior executives of major fund management organizations who serve as affiliated directors of the funds managed by their organizations.⁶

In addition to drawing upon the experience of its members, the Advisory Group sought the views of other independent directors of investment companies, fund management representatives, former senior SEC officials, representatives of accounting and law firms with expertise in investment company matters, academicians knowledgeable in the fields of investment company regulation and corporate governance, representatives of consumer and investor organizations, and other individuals with expertise in investment company, fund director and corporate governance matters.⁷

In developing this Report and the recommendations herein, the Advisory Group sought to identify those practices that act to maintain and enhance a culture of independence and

⁵ Id.

⁶ See Appendix A for the biographies of the members of the Advisory Group.

⁷ See Appendix B for a list of the persons with whom the Advisory Group consulted.

effectiveness on the part of fund boards. The Advisory Group concluded that such practices would help ensure that fund directors can effectively represent the interests of fund shareholders. In varying degrees, these practices, which go beyond statutory and regulatory requirements, have already been adopted by many investment company boards and tested by actual experience. Adoption of the recommended practices by other fund boards would bolster the effectiveness of the current system in safeguarding the interests of fund shareholders, particularly in guarding against potential conflicts of interest between the fund and the fund's investment adviser.

The Advisory Group determined to focus its recommendations on practices that enhance the structure and operations of fund boards, rather than seek to develop guidelines that would govern how fund boards should address specific issues (e.g., brokerage allocation or portfolio valuation). The latter issues are apt to involve different considerations for different fund boards, and the Advisory Group did not believe it was necessary or appropriate to attempt to guide the exercise of directors' judgments in these areas. Instead, the Advisory Group concluded that the adoption of practices that enhance the overall independence and effectiveness of fund boards will help assure that individual issues are addressed and resolved in a manner consistent with the best interests of America's more than 70 million mutual fund investors.

II. THE ROLE OF FUND DIRECTORS

Meaningful recommendations to enhance the independence and effectiveness of fund directors require an understanding of the unique role these directors play. Like other corporate directors, directors of investment companies must discharge fiduciary duties defined by state law.⁸

⁸ Most funds are established in corporate form under Maryland or Delaware law or in business trust form under Massachusetts or Delaware law. (With a few exceptions, the Act does not distinguish between the directors of a corporation and the trustees of a business trust. In this paper, the term "director" is used to include both.) State law requires that directors adhere to the fiduciary duties of loyalty and care in carrying out their responsibilities. The duty of loyalty
(continued)

These duties apply to all fund directors – both independent directors and affiliated directors. Unlike other corporate boards, however, investment company boards are subject to structural requirements and to specific obligations imposed by the Act and SEC regulations to oversee fund operations and, in the case of independent directors serving on fund boards, to protect against conflicts of interest between funds and their service providers. The most important of these requirements and obligations are discussed below.

Federal law mandates that investment company boards include at least a specified percentage of independent directors. Section 10(a) of the Act generally requires that at least forty percent of the directors of an investment company not be “interested persons” (as defined in the Act) of such company, its investment adviser or principal underwriter. In the case of open-end funds offering shares through an affiliate of the adviser, which is quite common, the Act effectively requires a majority of the fund board to be independent of the adviser/underwriter.⁹ The vast majority of fund boards today consist of a majority of independent directors.

generally mandates that directors perform their duties in good faith and in a manner reasonably believed to be in the company’s best interests. Fundamental to the duty of loyalty is the avoidance of self-dealing. The duty of care generally obligates directors to perform their functions with the degree of care that an ordinarily prudent person in a like position would exercise under similar circumstances.

⁹ See Section 10(b) of the Act. In addition, Section 10(c) of the Act requires bank-sponsored funds to have a majority of independent directors. Moreover, Section 32 of the Glass-Steagall Act generally provides that there may be no overlap between officers and directors of an open-end fund and officers and directors of a member bank of the Federal Reserve System (which includes all national banks and most large state-chartered banks). As a result, most, if not all, of the directors of open-end funds sponsored by a bank or a bank affiliate are not employed by the banking institution or its affiliate. Funds whose sponsors are undergoing a change of control, and who are relying on the safe harbor in Section 15(f) of the Act, are required to have a board that is composed of directors at least 75% of whom are not “interested persons” of the selling or purchasing adviser for a period of three years after the reorganization.

The Act imposes strict standards for measuring the independence of investment company directors. For example, the Act excludes from independent director status any person affiliated with the investment adviser, principal underwriter or the investment company (except, of course, as a director of the investment company), as well as any person in a control relationship with any such affiliate.¹⁰ The term “affiliated person” is broadly defined to include any officer, employee or 5% shareholder of the investment company, its investment adviser or principal underwriter.¹¹ In addition, any person affiliated with a brokerage firm is not considered independent.¹² Finally, the Act empowers the SEC, by order, to exclude from independent status any director who has, or within the prior two years has had, a material business or professional relationship with the fund, its investment adviser or principal underwriter.¹³ In fact, it is common industry practice to ensure that no director who appears to have, or have had, such a business or professional relationship is counted as an independent director, even in the absence of an SEC order.¹⁴

Investment company directors also differ from directors of operating companies because they are assigned a series of specific responsibilities under the Act and various SEC rules, orders and interpretations. These include, for example, annual approval of the fund’s investment advisory contract, annual approval of the contract with the fund’s principal underwriter, valuation

¹⁰ See Section 2(a)(19) of the Act (defining “interested person”) in Appendix C.

¹¹ See Section 2(a)(3) of the Act (defining “affiliated person”). Any member of an affiliated person’s immediate family, as well as legal counsel for the investment company, its adviser or underwriter is likewise an “interested person.”

¹² The SEC has made an exception by rule for brokers who do not transact any business with the fund. See Rule 2a19-1 under the Act.

¹³ See Section 2(a)(19)(A)(vi) and (B)(vi) of the Act in Appendix C.

¹⁴ Nevertheless, the Advisory Group strongly believes that the standard in the Act, which establishes a “bright line” test for ascertaining whether a person qualifies as an independent director, is the correct one for statutory and regulatory purposes.

of certain securities held by the fund, and approval of any distribution plan under Rule 12b-1.¹⁵ Several matters require the approval of both a majority of the whole board and a majority of the independent directors voting separately, because of potential conflicts inherent in the position of the affiliated directors.

Approval of the fund's contract with its investment adviser, including the advisory fee, is one of the more important responsibilities of fund directors. The Act provides that an advisory contract can run initially for a term of no more than two years, and continue in effect thereafter only if the board annually approves it. The standards guiding this process are complex. In cases challenging the fairness of advisory fees, courts have viewed the Act as assigning to the independent directors the primary responsibility for considering those fees. In these cases, courts consistently have found that the independent directors discharged this responsibility diligently and in good faith, and accordingly have not second-guessed their judgment.¹⁶

Independent directors are not required to engage in a competitive bidding process or to award the advisory contract to the adviser offering the lowest rates. As a practical matter, they must take account of the fact that the fund's shareholders have chosen the adviser in the context of the disclosures in the fund's prospectus and other documents that set forth the material facts concerning the adviser, the fund's investment objectives, strategy and risks, and the management

¹⁵ A list of responsibilities imposed on fund directors by the Act and the regulations thereunder is set forth in Appendix D. This list necessarily must be considered in light of each fund's specific activities, and is not intended to serve as a checklist of board responsibilities.

¹⁶ See, e.g., Gartenberg v. Merrill Lynch Asset Management, Inc., 694 F.2d 923 (2d Cir. 1982), cert. denied, 461 U.S. 906 (1983); Krinsk v. Fund Asset Management, Inc., 715 F. Supp. 472 (S.D.N.Y. 1988), aff'd, 875 F.2d 404 (2d Cir.), cert. denied, 110 S. Ct. 281 (1989). Similarly, in some cases, the informed approval of the advisory contract by independent directors has been a substantial factor in the court's rejection of charges that the investment adviser committed a breach of fiduciary duty involving misconduct in violation of Section 36(a) of the Act. See Tannenbaum v. Zeller, 552 F.2d at 427.

fee structure and other expenses of investing in the fund. As one of the Act's draftsmen, Alfred Jaretzki, noted in 1964, "[T]he board of directors does not act in a vacuum . . . [The] stockholders either have chosen the existing management or they have bought their shares in probable reliance on such management. Presumably, they have confidence in the management and would not expect the directors to take action to change it except in unusual circumstances."¹⁷ Consequently, while it is uncommon for fund boards to terminate the investment adviser, the Advisory Group does not agree with those critics who have suggested that this represents a failing on the part of fund directors or, more generally, the mutual fund corporate governance system.

Nonetheless, within this framework, directors have a responsibility under the Act to make certain that management fees are reasonable in light of all relevant facts and circumstances. In this regard, directors consider, among other things, the impact of any economies of scale that may result as the fund grows. SEC Chairman Levitt succinctly summed up the duty of directors with respect to management fees as follows: "Directors don't have to guarantee that a fund pays the lowest rates. But they do have to make sure that fees fall within a reasonable band."¹⁸

Approval of advisory contracts, however, is just one of the responsibilities of fund directors. As noted above, fund directors must monitor and protect against conflicts of interest. While the Act contains broad prohibitions against various types of self-dealing transactions,¹⁹ funds can be faced with other, perhaps more subtle, conflicts. These potential conflicts may

¹⁷ Jaretzki, Jr., Alfred, "Duties and Responsibilities of Directors of Mutual Funds," 29 *Law and Contemporary Problems* 777, 786 (1964).

¹⁸ Remarks by Chairman Arthur Levitt, U.S. Securities and Exchange Commission, Investment Company Institute, Washington, D.C. (May 15, 1998).

¹⁹ See Section 17 of the Act which, among other things, prohibits, in the absence of an SEC exemption, purchases and sales of securities between a registered investment company and any of its affiliated persons, as well as joint transactions involving the investment company and an affiliated person.

involve such diverse matters as the allocation of brokerage commissions, the use of fund assets for distribution, the allocation of expenses between a fund and its adviser and among funds, responsibility for any pricing errors or violations of investment restrictions, and personal investing by officers and employees of the fund's adviser. In these and many other areas, independent oversight of fund operations by fund directors helps to ensure that funds will be operated in the best interests of shareholders.

The independent fund directors' job becomes most difficult on those rare occasions when they suspect that the manager may have engaged in illegal or improper conduct. In those instances, directors require the active involvement of the SEC. SEC Chairman Levitt recently acknowledged this need, stating, "Some [have] made the point that the Commission, in allocating key governance responsibilities to independent directors, needs to be actively involved and pursue charges of illegal conduct by fund managers whenever they occur. I couldn't agree more."²⁰

Ultimately, the Advisory Group believes that the fundamental responsibility of fund directors is to ensure that the fund's shareholders receive the benefits and services to which they are fairly entitled, both as a matter of law (e.g., resulting from the investment adviser's fiduciary duties to the fund and specific requirements under the Act) and in accordance with investor expectations reasonably created by the fund's prospectus and other disclosure documents. Within this context, it is the responsibility of the fund's board to evaluate the performance of the fund's investment adviser and that of its other service providers on the basis of what is best for shareholders and to apply that same standard in evaluating any proposals for change in fund operations or expenses. On those occasions where the interests of the adviser and fund shareholders diverge, the fund's directors and, in particular, the independent directors, must

²⁰ Remarks of SEC Chairman Arthur Levitt, supra note 4.

effectively represent the interests of the fund and its shareholders. The Advisory Group has drafted the recommendations in this Report with the foregoing in mind.

III. RECOMMENDATIONS

The Advisory Group considered a variety of practices, beyond those required by law or regulation, that are used by many independent investment company directors to help ensure their independence from the fund's investment adviser and other service providers and by both independent and affiliated investment company directors to enhance their effectiveness in carrying out their oversight responsibilities. Set forth below are those practices that the Advisory Group has decided to recommend for consideration by all investment company boards of directors.

The Advisory Group recognizes that every recommendation may not be suitable for every board. Depending on individual circumstances, other practices may be equally or more effective in achieving the objectives of the recommendations.

1. SUPER-MAJORITY OF INDEPENDENT DIRECTORS

The Advisory Group recommends that at least two-thirds of the directors of all investment companies be independent directors.

The Advisory Group recommends that independent directors constitute at least two-thirds of the directors of every investment company board.²¹ This will help assure that independent directors control the voting process, particularly on matters involving potential conflicts of interest with the fund's investment adviser or other service providers. The Act requires that

²¹ Except where indicated otherwise, as used in this section of the paper, the term "independent director" refers to a director that meets the standards contemplated herein (see, e.g., Recommendation 2 below), as opposed to a director that qualifies as an independent director under the Act.

certain important decisions, including those with a clear potential for conflict of interest between the fund and its investment adviser or other service providers, be made by the independent directors voting separately.²² Nevertheless, a multitude of other issues that require separate consideration of the interests of fund shareholders from those of the adviser may arise in the course of fund operations. The Act does not require a separate vote of independent directors on these matters, nor could it, since they cannot all be foreseen.

The Advisory Group believes that a two-thirds standard will be more effective than a simple majority in enhancing the authority of the independent directors. The Advisory Group notes that while investment company boards meeting this standard are not uncommon, they are far from universal. In order to comply with a two-thirds standard, many fund boards will have to either remove affiliated directors, or add independent directors. Such actions are not without cost. Nonetheless, the Advisory Group believes that the benefits of a two-thirds standard justify recommending it as an industry best practice.

Suggestions have been made that fund boards should be composed exclusively of independent directors. While the Advisory Group recognizes that some funds may find a board consisting of only independent directors to be most suitable under their particular circumstances, as a general matter, the Advisory Group believes that fund boards can benefit from having affiliated directors on the board. Board membership by representatives of the adviser allows for

²² For example, a majority of the independent directors voting separately must approve the fund's investment advisory and underwriting agreements, and any plan to use fund assets to support share distribution under Rule 12b-1, as well as the purchase of joint liability insurance and the selection of the independent auditors. The SEC, by rule, also has relied on the independent directors to oversee a number of other areas where conflicts may arise. See, e.g., Rule 10f-3, regarding purchases of underwritten securities by a fund during the existence of the underwriting syndicate of which an affiliate is a member; Rule 17a-7, governing cross-trades with affiliates; Rule 17a-8, covering mergers of affiliated investment companies; and Rule 17e-1, governing portfolio brokerage transactions through affiliated brokers.

more direct accountability on the adviser's part and a better exchange of information with the adviser. In addition, representatives of the adviser may have greater expertise in many aspects of the operations of the fund. Thus, their participation may enhance the board's effectiveness. Finally, as noted above, affiliated directors are subject to the same fiduciary standards as independent directors.

2. PERSONS FORMERLY AFFILIATED WITH THE ADVISER, PRINCIPAL UNDERWRITER AND CERTAIN AFFILIATES

The Advisory Group recommends that former officers or directors of a fund's investment adviser, principal underwriter or certain of their affiliates not serve as independent directors of the fund.

Former officers and directors of the fund's investment adviser or principal underwriter often may be highly desirable candidates for board membership because of their extensive knowledge of the industry, the fund complex and the operations of the adviser and/or underwriter. Nevertheless, prior service as an officer or director of the adviser or principal underwriter may affect the director's independence, both in fact and in appearance. In particular, it may call into question whether the former officer or director would be able to effectively "switch hats."

The Advisory Group therefore recommends that former officers or directors of a fund's investment adviser or principal underwriter not serve on that fund's board as independent directors. The Group further recommends that former officers and directors of certain affiliates of the fund's adviser and principal underwriter – in particular, parent companies that own a majority interest, and majority-owned subsidiaries – likewise not serve as independent directors, as the same potential conflicts can arise in these situations. The Group considered applying this standard to former directors and officers of all affiliates of the fund's adviser and underwriter, but decided against doing so in light of the strength of the prohibition and the fact that the prior relationship to

a significant service provider to the fund may be much more remote in those cases. Nevertheless, the Advisory Group recommends that the board's nominating committee (or other body charged with nominating independent directors), as part of the selection process, carefully consider any such relationships and their potential effect on a candidate's de facto independence.²³

The Advisory Group recognizes that its recommendation goes far beyond current law.²⁴ It is not meant in any way to call into question the character and integrity of current independent directors that do not meet this standard, nor the propriety of any actions taken by the boards on which they serve. The Group believes, however, that this standard should be adopted because it provides more meaningful assurance of directors' independence and enhances the overall credibility of the system of independent directors.

The Advisory Group does not believe that its recommendation need deprive a fund board of the experience of a former officer or director of the adviser, underwriter or their affiliates. A board that would benefit from the knowledge and experience of such a person may choose to retain the individual as an affiliated director. Alternatively, the individual could serve as a member of an "advisory board." Under these approaches, the fund would benefit from the expertise and

²³ For similar reasons, the Advisory Group decided not to recommend applying this standard to all former employees of the fund's adviser and underwriter. Such a prohibition could lead to absurd results (e.g., disqualifying an individual who worked for the adviser for a summer while in college) and could be very difficult to administer. The nominating committee, however, should carefully scrutinize the appropriateness of any such individual serving as an independent director. The Advisory Group believes that former employees of the investment adviser or principal underwriter who had significant responsibilities should be treated similarly to former officers and directors.

²⁴ As noted above, the definition of "interested person" under the Act provides that any person not having a current affiliation with the adviser or principal underwriter, but who had a "material business relationship" with the adviser or the principal underwriter within the last two years, may be deemed "interested" if the SEC issues an order to that effect. See Section 2(a)(19)(A)(vi) and (B)(vi) in Appendix C.

experience stemming from a person's former associations, without that person being counted as an independent director.

The Advisory Group considered an alternative proposal to impose a period of time (e.g., five years) between a board member's serving as an officer or director of the fund's adviser or underwriter and as an independent director, but decided against recommending it. The Advisory Group believes that such a period would not eliminate questions as to the continuing identification of the former officer or director with the adviser or underwriter. Because of this, as well as the importance of maintaining the public's confidence in the independence of outside fund directors, the Advisory Group has concluded that a permanent prohibition is preferable.

3. CONTROL OF THE NOMINATING PROCESS BY INDEPENDENT DIRECTORS

The Advisory Group recommends that independent directors be selected and nominated by the incumbent independent directors.

In order to enhance the independence of independent directors, the Advisory Group recommends that independent directors be selected and nominated by vote of a majority of the incumbent independent directors. The Advisory Group's recommendation recognizes that the independent directors are uniquely qualified to evaluate whether a present or prospective director is likely to contribute to the continuing independence and effectiveness of the independent directors as a group. Moreover, control of the nominating process by the independent directors helps dispel any notion that the directors are "hand picked" by the adviser and therefore not in a position to function in a true spirit of independence.²⁵

²⁵ The initial independent directors of funds in a new fund complex are, by necessity, named by management. These directors are subject to the same fiduciary duties and responsibilities to the funds and their shareholders as are all other fund directors. Moreover, the standards and (continued)

Independent directors' control of the selection and nomination process for independent directors is already commonplace within the fund industry. Funds that adopt distribution plans pursuant to Rule 12b-1 under the Act are required to provide that independent directors select and nominate their own successors; such funds constitute a majority of the industry. Many funds without Rule 12b-1 plans follow this practice as well.

Frequently, fund boards form a nominating, governance or other committee composed exclusively of independent directors to manage the selection and nomination process.²⁶ Independent directors' control of the nominating process, however, does not preclude input from persons associated with the fund's investment adviser and its affiliates. Many nominating committees give consideration to suggestions from fund management of persons qualified to serve as independent directors, and nominating committees may give fund management an opportunity to meet with a prospective new independent director prior to a final decision by the committee. The Advisory Group believes that the nature and extent of fund management's input into the nomination process is best left to a fund's independent directors to decide, provided that control of the process rests exclusively with the independent directors.

The election of a nominee to the board is accomplished either by a vote of the board or by a shareholder vote.²⁷ In either case, the affiliated directors may have an opportunity to vote

requirements under the Act relating to independence serve to ensure the de facto independence of the initial directors. Adoption of the best practices set forth in this Report would further enhance that independence.

²⁶ A sample Nominating and Administration Committee charter is set forth in Appendix E.

²⁷ Section 16(a) of the Act requires, as a general matter, that investment company directors be elected by shareholders. Section 16(a) further provides, however, that directors may be appointed by the board so long as, following such appointment, at least two-thirds of the board has been elected by shareholders. The articles of incorporation or trust instruments of virtually all investment companies provide for the appointment of directors under such circumstances.

on the nominee. Where state corporation or trust law and the fund's charter permit delegation to a subset of the full board, the Advisory Group believes that the board should delegate to the independent directors the authority to elect, or recommend that shareholders elect, the nominee. In other cases,²⁸ the Advisory Group believes that the affiliated directors should adopt a policy of generally deferring to the choice of the independent directors.

4. COMPENSATING INDEPENDENT DIRECTORS

The Advisory Group recommends that independent directors establish the appropriate compensation for serving on fund boards.

Independent directors of mutual funds, like directors of other types of companies, are compensated by the entities on whose boards they serve. Compensation varies within the industry, because of differences in the complexity and size of funds and fund groups served by a director, the time commitment required for meetings and other duties, the number of meetings, the compensation levels necessary to attract highly qualified members, and other factors.²⁹

The Advisory Group believes that the appropriate level of compensation for serving as a director should be set by the independent directors, acting either as a body or through a

²⁸ For example, under Maryland corporate law, the board cannot delegate to a committee the power to recommend to shareholders any action that requires shareholder approval. See Annotated Code of Maryland, "Corporations and Associations," Sec. 2-411(a)(2) (Michie 1993 Replacement Volume). Thus, where a fund organized as a Maryland corporation intends to recommend board candidates for election by shareholders, both the affiliated and independent directors may have to vote on the nominees.

²⁹ The time commitment can be affected not only by the number and size of the funds served by the director and the number and length of board meetings per year, but also by, among other things, the nature of the funds (e.g., whether retail, institutional, or insurance product; equity, bond or money market; domestic or foreign), the structure of the board (e.g., whether a director serves on board committees or takes on additional responsibilities by acting as a lead director), the frequency of board consideration of changes in fund operations and expenses, and whether these changes constitute "cutting edge" proposals.

committee. Although setting appropriate director compensation is a function that state law generally assigns to the board as a whole, the Advisory Group believes that the affiliated directors generally should defer to the independent directors on this matter.³⁰ Placing control over compensation in the hands of the independent directors and not with fund management helps to ensure the independence and effectiveness of the board.

5. FUND OWNERSHIP POLICY

The Advisory Group recommends that fund directors invest in funds on whose boards they serve.

The Advisory Group believes that fund directors can better serve the interests of shareholders if they have a personal investment stake in one or more funds that they serve. Share ownership by fund directors helps to align their interests with those of fund shareholders. In particular, directors can learn more about the quality of the shareholder services provided by a fund group if they personally experience those services from a shareholder's perspective. Accordingly, the Advisory Group recommends that investment company boards in each complex adopt a policy requiring fund directors to invest in one or more (though not necessarily all) funds on whose boards they serve. The policy can make exceptions in those cases where the directors only serve on the boards of funds for which they are not eligible investors, such as institutional or private label funds, or where the funds are not suitable investments for the director.³¹

³⁰ As with the nominating process, such deference should not preclude input from fund management.

³¹ Fund groups that may want to compensate their directors in shares should note that the Act prohibits the issuance of shares in return for services without an SEC exemptive order. See Section 22(g) of the Act. As an alternative, fund directors might be paid in cash, but leave standing instructions with the fund's administrator to invest certain percentages of their compensation in specified funds.

6. QUALIFIED INDEPENDENT COUNSEL AND OTHER EXPERTS

The Advisory Group recommends that independent directors have qualified investment company counsel who is independent from the investment adviser and the fund's other service providers. The Advisory Group also recommends that independent directors have express authority to consult with the fund's independent auditors or other experts, as appropriate, when faced with issues that they believe require special expertise.

The Advisory Group believes that it is important for independent directors to have counsel with expertise in the regulation of investment companies who can advise them as to their responsibilities under both state and federal law. Experienced counsel can help to ensure that the directors understand their responsibilities, ask the pertinent questions, and receive the information necessary to carry out those responsibilities.

Counsel to the independent directors must be independent from the adviser and other fund service providers in order to render objective advice on areas of potential conflict between the fund and its service providers. Courts frequently consider whether the directors have used independent counsel in evaluating whether the directors acted independently of the fund manager in fulfilling their responsibilities to fund shareholders.³² The Advisory Group believes that counsel

³² For example, the court in Gartenberg noted that the independent trustees received advice from counsel independent of the investment adviser in determining to dismiss the shareholders' derivative suit for excessive management fees. 694 F.2d at 927. See also Schuyt v. Rowe Price Prime Reserve Fund, Inc., 663 F. Supp. 962 (S.D.N.Y.), aff'd, 835 F.2d 45 (2d Cir. 1987), cert. denied, 485 U.S. 1034 (1988) (court dismissed a derivative suit against the adviser for breach of fiduciary duty in part because of the independent directors' regular meetings with outside counsel and counsel's detailed advice regarding the independent directors' legal responsibilities).

for the independent directors also may serve as fund counsel because, in virtually every situation except possibly litigation, the interests of the fund and its directors are aligned.³³

The Advisory Group recognizes that there are situations where it may be most efficient for the counsel for the fund and independent directors also to provide some legal services to the investment adviser or other service provider. The Advisory Group believes that the rendering of such services by counsel for the independent directors is not inconsistent with its recommendation as long as (a) counsel has made clear that, in the event of a conflict with the fund, counsel will represent the fund and its independent directors and (b) the adviser or other service provider waives any objection and understands that any disclosures that it makes to such counsel are not privileged against disclosure to the independent directors. Counsel should disclose to the independent directors the nature and type of services it performs for the investment adviser or other fund service providers and the amount of fees earned from such services so that the independent directors can evaluate whether the nature and volume of work might have the potential to affect counsel's independence.³⁴

The Advisory Group believes that, as a general matter, it is advisable for counsel to the independent directors to attend meetings of the board, appropriate committee meetings and separate meetings of the independent directors. The Advisory Group is sensitive to the cost that this can impose. The Group believes, however, that attendance at these meetings can help to

³³ Counsel for a new fund often will have been retained by the manager on behalf of the fund. The Advisory Group believes that such retention is not inconsistent with counsel's representation of the independent directors, as long as the independent directors have the power to replace that counsel.

³⁴ In some situations, legal services are provided to the fund but paid for by the adviser – e.g., preparation of a fund proxy statement to approve a new advisory contract that is necessitated by a merger involving the investment adviser. The Advisory Group believes that this practice is not inconsistent with its recommendation because counsel's obligation remains with the fund.

ensure that counsel is able to meaningfully fulfill its role. Otherwise, counsel likely would be limited to responding to questions raised by the independent directors, and would not be in a position to effectively identify and respond to the legal issues raised by discussions at the various meetings referred to above. At the very least, counsel to the independent directors should attend any meetings where the advisory contract is considered or where there is a matter on the agenda involving an apparent conflict of interest between the fund and the adviser.

Independent directors also should be able to obtain expert advice from independent accountants and other third parties whenever particular problems or initiatives may call for special expertise. Use of independent consultants may be necessary if the directors are to be effective on matters that are beyond their experience and the expertise of their counsel. Consultants also may give the directors a sense of common practices in the industry.

Accordingly, fund bylaws or committee charters should make clear the authority of the independent directors, or a committee of independent directors, to use fund assets to retain experts when they deem it necessary to further shareholder interests. The Advisory Group recognizes that, in considering whether to retain outside consultants in particular instances, directors will need to take matters of cost into account. As with counsel, the independent directors also must satisfy themselves that any experts they consult are sufficiently independent from the fund's investment adviser and other service providers to provide objective advice.

7. ANNUAL QUESTIONNAIRE ON RELATIONSHIPS WITH THE ADVISER AND OTHER SERVICE PROVIDERS

The Advisory Group recommends that independent directors complete on an annual basis a questionnaire on business, financial and family relationships, if any, with the adviser, principal underwriter, other service providers and their affiliates.

Assuring the continuing independence of the outside directors is of primary importance to the Act's regulatory scheme and the integrity of the fund corporate governance system. Accordingly, fund boards should regularly review changes in the affiliations of the independent directors to ensure that a director does not assume relationships that might impair his or her independence. To this end, the Advisory Group recommends that independent directors complete on an annual basis a questionnaire that solicits information on business, financial and family relationships with the fund's investment adviser, other service providers and their affiliates, as well as other relationships that could affect their status as independent directors (e.g., affiliations with registered broker-dealers).³⁵ The questionnaire should be reviewed by the nominating committee of independent directors (if any), a lead independent director and/or counsel, as appropriate. Such questionnaires may be available to the SEC staff during examinations.

³⁵ A recent SEC enforcement action underscored the need for monitoring business and financial relationships between the independent directors of a fund and the fund's investment adviser or its affiliates. In the Matter of Monetta Financial Services, Inc., Investment Advisers Act Release No. 1702 (February 26, 1998) (the SEC alleged a failure to disclose that independent directors of the fund who were also clients of the investment adviser received preferred IPO allocations).

8. ORGANIZATION AND OPERATION OF THE AUDIT COMMITTEE³⁶

The Advisory Group recommends (1) that investment company boards establish Audit Committees composed entirely of independent directors; (2) that the Audit Committee meet with the fund's independent auditors at least once a year outside the presence of management representatives; (3) that the Audit Committee secure from the auditor an annual representation of its independence from management; and (4) that the Audit Committee have a written charter that spells out its duties and powers.

Independent auditors play a key role in assuring the integrity of mutual fund operations. They audit a fund's financial statements annually; as a part of that audit, among other things, they verify security ownership positions, test portfolio valuations as of the end of the fiscal year, and confirm that the fund is entitled to pass-through treatment under the federal income tax laws. They also evaluate the internal control environment of the management company and satisfy themselves as to the integrity of operations at the fund's custodian and transfer agent.

Like many other business organizations, the boards of many funds have Audit Committees that recommend the selection of auditors, review the financial statements and results of the audit, and oversee the fund's internal control system. The Advisory Group recommends that all investment company boards have Audit Committees and that such committees be composed

³⁶ In preparing this section of its report, the Advisory Group considered, among other things, the recent report of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees. That Committee was established in 1998 by the New York Stock Exchange and the National Association of Securities Dealers, Inc. in response to a call by SEC Chairman Arthur Levitt for improved board oversight of the financial reporting process of public companies. Several of the Committee's most important recommendations – for example, specifying that the auditors are accountable to the board – have long been applicable to investment companies under the Act.

entirely of independent directors. This arrangement is entirely consistent with the Act, which places the selection of auditors in the hands of the independent directors.³⁷

The Advisory Group also recommends that the Audit Committee meet with the fund's independent auditors at least once a year outside the presence of management representatives. Such meetings provide additional assurance that the Committee can candidly discuss with the auditors any questions they may have regarding accounting practices or internal controls. The Audit Committee also may want to meet separately with management, to learn its assessment of the auditors and the appropriateness of the audit fees.

The Advisory Group also recommends that the Audit Committee request an annual representation from the auditor of its independence from management. Many audit firms today also engage in management consulting and other functions, which may result in a non-audit relationship with the fund's manager or its affiliates. The Audit Committee should ask the auditor to describe all such relationships. If they exist, the Audit Committee should consider whether the relationships or the fees involved raise questions about the auditor's independence, and whether the auditor, in its evaluation of management's internal control structure, may be in the position of evaluating a control system recommended by the auditor's own consulting group.

The Advisory Group recommends that the Audit Committee have a written charter spelling out its duties and powers. A written charter helps ensure that both the Audit Committee and the full board understand the Committee's role, and contributes to the Committee's independence of action when difficult issues arise.³⁸

³⁷ Indeed, the audit function is considered so important that the selection of auditors is one of the few functions that the Act consigns exclusively to the independent directors.

³⁸ Appendix F to this Report contains a sample of such a charter.

9. SEPARATE MEETINGS OF THE INDEPENDENT DIRECTORS

The Advisory Group recommends that independent directors meet separately from management in connection with their consideration of the fund's advisory and underwriting contracts and otherwise as they deem appropriate.

The Advisory Group believes that separate meetings of the independent directors, outside the presence of management representatives, can enhance independence and effectiveness. A separate meeting of the independent directors is especially important in connection with the annual review of the advisory and underwriting contracts required by the Act. Such meetings allow the independent directors to discuss the adviser's performance outside the presence of its personnel, consider what areas may call for improvement and critically analyze the reasonableness of the proposed contracts. A separate meeting also is especially important on such matters as a management proposal for a fee increase or other significant change in the terms of the arrangement between the fund and its affiliated service providers, or questions involving claims against the adviser or its affiliates.³⁹

The Advisory Group believes that separate meetings of the independent directors can be beneficial in other circumstances as well. Accordingly, the Advisory Group recommends that the independent directors also meet separately on such other occasions as they consider appropriate. At these separate meetings, which can be held in conjunction with regularly scheduled board meetings, the independent board members can, for example, review upcoming agendas and determine what items, if any, should be emphasized when the full board meets or discuss other issues that warrant special attention or study during the year. Counsel to the independent directors or, if appropriate, counsel to the fund, also should attend these separate meetings.

³⁹ See Schuyt, 663 F. Supp. at 966.

10. LEAD INDEPENDENT DIRECTOR OR DIRECTORS

The Advisory Group recommends that independent directors designate one or more “lead” independent directors.

The Advisory Group believes that the effectiveness of independent directors is enhanced if one or more of them serves in the capacity of a “lead” independent director. A lead director can help to coordinate activities of the independent directors, such as by chairing separate meetings of the independent directors (see Recommendation 9 above) and by raising and discussing issues with counsel. A lead director also may act as a spokesperson for the independent directors in between meetings of the board. From fund management’s perspective, it can be useful to have a point of contact among the independent directors with whom management can discuss ideas informally.

While many fund boards may find it optimal to have a single director act in the capacity of lead independent director, others may prefer to divide these responsibilities among two or more independent directors. For example, one independent director (e.g., the Chair of the Audit Committee) could act as the independent directors’ spokesperson on matters related to financial reporting, while another could perform a similar role with respect to issues involving contracts with service providers. The Advisory Group also notes that in the case of smaller boards (e.g., with only three independent directors), there may be less need to designate one of them to act in this role. Finally, the Advisory Group wishes to emphasize that the designation of one or more persons as lead director should in no way imply that the obligations or commitment of the other directors are diminished.

11. INSURANCE COVERAGE AND INDEMNIFICATION

The Advisory Group recommends that fund boards obtain directors’ and officers’/errors and omissions insurance coverage and/or indemnification

from the fund that is adequate to ensure the independence and effectiveness of independent directors.

The relationship between independent directors and fund management rarely results in litigation. There have been two recent cases, however, where fund management sought to resolve serious differences with the independent directors through litigation. Such instances have emphasized to the Advisory Group the importance of ensuring that independent directors be able to take whatever action they believe in good faith to be necessary for the protection of shareholders without concern over personal liability from litigation, particularly litigation with fund management. Such litigation can be extremely expensive and may even carry with it a potential for personal financial ruin. Consequently, the absence of adequate insurance coverage or indemnification can discourage independent directors from acting aggressively in the interests of fund shareholders and even discourage qualified individuals from serving as independent directors.

For these reasons, the Advisory Group recommends that independent directors obtain directors' and officers'/errors and omissions ("D&O/E&O") insurance coverage and/or indemnification from the fund that is adequate to ensure their independence and effectiveness. In determining whether such coverage is adequate, directors should consider a variety of factors. One factor to be considered is whether any such insurance policy would provide coverage in instances in which a fund's independent directors and its investment adviser are opposing parties in litigation. D&O/E&O policies generally have broad exclusions for suits between "co-insureds" and thus may not provide coverage in these circumstances.⁴⁰ Directors also may wish to consider whether their fund insurance policies and/or indemnification provisions in fund charters or bylaws

⁴⁰ Chairman Levitt recently suggested that independent directors check their insurance policies to make certain that their policies do not exclude suits between "co-insureds." See Remarks of SEC Chairman Arthur Levitt, supra note 4.

provide continuing coverage for claims arising in connection with their service as directors after the directors cease to serve on the board. Otherwise, directors could be deterred from acting independently out of concern that they would lose coverage after leaving the board for actions taken while serving as directors. Similar issues may arise if the policy is terminated or modified after directors leave the board. For this reason, directors may wish to ensure that they would have adequate coverage even if the policy subsequently is terminated or modified and to ascertain who would pay for such extended coverage.

12. UNITARY OR CLUSTER BOARDS

The Advisory Group recommends that investment company boards of directors generally be organized either as a unitary board for all the funds in a complex or as cluster boards for groups of funds within a complex, rather than as separate boards for each individual fund.

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

Questions have recently been raised whether service on more than one board within the same complex somehow compromises the independence of directors.⁴¹ The Advisory Group has

⁴¹ See Strougo v. Scudder, Stevens & Clark, Inc., 964 F. Supp. 783 (S.D.N.Y. 1997) (service on boards of multiple funds within a complex held to render directors not sufficiently independent under Maryland corporate law to evaluate a demand that fund sue management (continued))

found no evidence that this is the case, and sees no reason why it should be the case, especially where independent directors control the nominating process and set their own compensation.⁴² Instead, the Advisory Group believes that service on multiple boards can provide the independent directors of those boards with an opportunity to obtain better familiarity with the many aspects of fund operations that are complex-wide in nature.⁴³ It also can give the independent directors greater access to the fund's adviser and greater influence with the adviser than they would have if there were a separate board for each fund in the complex. Moreover, it would be much more difficult to attract highly qualified directors if they were limited to service on the board of only one fund in a complex. There also would be additional costs, administrative complexities and redundancies. Some fund complexes would be forced to have scores of independent directors.

For these reasons, the Advisory Group recommends that all fund complexes with any substantial number of funds generally adopt either a unitary or a cluster board structure.⁴⁴ This should not preclude funds in a complex from having additional directors or separate boards where appropriate. For example, a country-specific fund may find it helpful to have a director or directors with special knowledge of that country. In general, however, the Advisory Group believes that fund complexes should not have a separate board for each fund in the complex.

company). Maryland and Massachusetts have since adopted legislation stating that investment company directors who are independent under the Act are considered independent under state law. To date, similar claims under the Act have been uniformly rejected by the courts. See, e.g., Strougo v. BEA Associates, 98 Civ. 3725 (S.D.N.Y. Mar. 11, 1999); T. Robert Verkouteren v. Blackrock Financial Management, Inc., 98 Civ. 4673 (S.D.N.Y. Feb. 4, 1999).

⁴² SEC Chairman Levitt recently stated, "There have been questions raised in the press and in the courts about whether simply serving on multiple boards or portfolios compromises a director's independence. Recent court decisions say it doesn't. And I'm inclined to agree." Remarks of SEC Chairman Arthur Levitt, supra note 4.

⁴³ These aspects include, for example, the nature and quality of compliance, administrative, transfer agency and custodial services, as well as the distribution channels used by the complex.

⁴⁴ It should be noted that where funds are organized as series of a corporation or trust, all of such series necessarily have the same board of directors.

Because each has certain advantages, the Advisory Group believes that the choice between a unitary board and cluster boards is best left to individual fund organizations.

13. RETIREMENT POLICY

The Advisory Group recommends that fund boards adopt policies on retirement of directors.

The Advisory Group recommends that investment company boards adopt policies governing retirement of directors. Boards should provide for administration of these policies by the independent directors or a committee of independent directors in order to prevent fund management from having control over their implementation.

In adopting a retirement policy, the board should consider whether setting a specific mandatory retirement age would enhance the board's effectiveness. In doing so, the board should balance the need for fresh perspectives against the benefits that the experience and institutional memory of existing directors can provide. Some boards of directors have opted to institute retirement policies that call for board members to step down upon reaching a designated age. As an alternative, boards may wish to consider setting specific term limits on the service of fund directors.

14. EVALUATION OF BOARD PERFORMANCE

The Advisory Group recommends that fund directors evaluate periodically the board's effectiveness.

Several of the recommendations set forth above suggest important steps that boards can take to improve their operating effectiveness. It also can be helpful, however, for boards to step back periodically and review their overall performance. The Advisory Group recommends that

all boards periodically conduct such an evaluation, which should focus on both substantive and procedural aspects of the board's operations. The evaluation need not be done in written form.

The Advisory Group does not believe it is feasible to list specific criteria against which a board should measure its effectiveness. Given the widely varying nature of different fund complexes, board composition and operating needs, it is impossible to specify criteria that would apply to all. Examples of issues that directors may want to consider during the course of their evaluation include:

- (1) Whether the board meets with the right frequency.
- (2) Whether the materials provided to the board are useful, sufficient, and properly focused. Boards also may want to consider whether materials are received far enough in advance of the meeting to allow for a thorough review.
- (3) Whether the board focuses on the most important matters and whether an appropriate amount of meeting time is devoted to issues that the independent directors consider to be most important. The independent directors also may want to consider how the agenda is established, what matters must be covered by reason of regulatory requirements, and whether there is enough time reserved to discuss the issues they consider important.
- (4) Whether there is sufficient opportunity for the independent directors to meet separately from management to consider agenda and other issues.

- (5) Whether board members participate actively, ask pertinent questions and contribute meaningfully to the board's deliberations.
- (6) Whether the board's ability to handle its workload efficiently and effectively would be enhanced by a different form of organization, such as use (or greater use) of committees.
- (7) Whether the board has the right mix of backgrounds, skills and experience. Diversification of experience and professional backgrounds can contribute to the board's effectiveness.
- (8) Whether the board understands and is in agreement with fund management's objectives and criteria for evaluating whether those objectives have been achieved. For example, the independent directors may want to ensure that they are made aware of, and are satisfied with, any benchmarks or other standards utilized by the fund's adviser in areas such as investment performance and shareholder services.

15. ORIENTATION AND EDUCATION

The Advisory Group recommends that new fund directors receive appropriate orientation and that all fund directors keep abreast of industry and regulatory developments.

In recognition of the detailed regulation to which investment companies are subject and the extensive duties imposed on fund directors, the Advisory Group believes it is important that new fund directors receive appropriate orientation. Such orientation can be conducted by fund management or fund counsel, for example at a special meeting. New directors, in particular, also

may find it helpful to attend conferences or educational seminars geared towards the work of investment company directors. The Advisory Group further recommends that all fund directors keep abreast of industry and regulatory developments. This can be done in many ways, including by regularly reviewing written materials that address industry and regulatory topics (such as reports prepared by fund counsel), by holding special sessions of the board that focus on particular topics or by attendance at conferences and educational seminars.

MEMBERS OF THE ADVISORY GROUP
ON BEST PRACTICES FOR FUND DIRECTORS

Biographies

JOHN J. BRENNAN

John J. Brennan is chairman and chief executive officer and a member of the board of directors of each of the mutual funds in The Vanguard Group. Mr. Brennan also serves as the Chairman of the Board of Governors of the Investment Company Institute.

The Vanguard Group is the second largest mutual fund organization in the world. Headquartered in Malvern, Pennsylvania, Vanguard comprises more than 100 separate investment portfolios, with current assets of more than \$480 billion.

Mr. Brennan joined Vanguard in July 1982. He was elected President in 1989, Chief Executive Officer in 1996 and Chairman of the Board in 1998.

Mr. Brennan graduated from Dartmouth College in 1976 with an AB degree, and received a Master's in Business Administration from the Harvard Business School in 1980. Prior to his career at Vanguard, Mr. Brennan had been employed at S.C. Johnson and Son, Racine, Wisconsin, and the New York Bank for Savings in New York City.

DAWN-MARIE DRISCOLL

Dawn-Marie Driscoll is an Executive Fellow and Advisory Board member of the Center for Business Ethics at Bentley College, one of the nation's leading institutes devoted to the study and practice of business ethics. She is also president of Driscoll Associates, a consulting firm. Ms. Driscoll has co-authored (with Drs. W. Michael Hoffman and Edward S. Petry) *The Ethical Edge: Tales of Organizations That Have Faced Moral Crises* and her articles on business ethics have appeared in such publications as Workforce, Business Ethics, Directors' Monthly, The Chicago Tribune, The Christian Science Monitor, The Boston Globe and The New York Times. She is a member of the Board of Editors of the Business and Society Review.

Ms. Driscoll is an independent trustee of several Scudder Kemper mutual funds, and a director of several private companies. She has been a director, trustee and overseer of many civic and business institutions, including WGBH-TV, The Massachusetts Bay United Way, and Regis College. Ms. Driscoll was formerly a law partner at Palmer & Dodge in Boston and served for over a decade as Vice President of Corporate Affairs and General Counsel of Filene's, the Boston-based department store chain.

Among Ms. Driscoll's awards and honors are an honorary Doctor of Humane Letters degree from Suffolk University, an honorary Doctor of Commercial Science degree from Bentley College Graduate School of Business, and appointment as a Visitor-in-Residence at The Bunting Institute at Radcliffe College, as a visiting scholar at the University of Montana School of Business and as visiting Aram Professor of Business Ethics at Gonzaga University.

PAUL G. HAAGA, JR.

Paul Haaga is Executive Vice President and Director of Capital Research and Management Company, as well as Chairman of CRMC's Executive Committee. He is Chairman of the Board of Capital Income Builder and of the 12 fixed-income funds in The American Funds Group. He is also an officer and/or director of a number of other CRMC-managed mutual funds and CGC companies.

Prior to joining Capital in 1985, Mr. Haaga was a partner in the law firm of Dechert Price & Rhoads in Washington, D.C. From 1974 to 1977, he was a senior attorney for the U.S. Securities and Exchange Commission.

Mr. Haaga earned a bachelor's degree from Princeton University, an M.B.A. from the Wharton School and a J.D. from University of Pennsylvania Law School. He is Chairman of the Investment Companies Committee of NASD Regulation (the primary self-regulatory organization of the U.S. broker-dealer industry). Mr. Haaga has lectured on mutual fund regulation at Stanford University Law School. He is President of the Board of Trustees of the Polytechnic School in Pasadena; Trustee, Vice President and Chairman of the Budget Committee of the Los Angeles County Museum of Natural History; member of the Board of Overseers of the Huntington Library, Museum and Gardens in San Marino; and Trustee of the Salzburg Seminar in Salzburg, Austria.

MANUEL H. JOHNSON

Manuel H. Johnson became co-chairman and senior partner in the consulting firm of Smick Medley International in September 1990. At that time the name was changed to Johnson Smick International, Inc. (JSI). JSI provides information services on important economic and political policy changes in major countries that impact global financial markets.

Prior to assuming his current duties, Dr. Johnson was Vice Chairman of the Board of Governors of the Federal Reserve System where he served for four and a half years beginning in February 1986. Dr. Johnson served as Assistant Secretary of the Treasury between 1982 and 1986, and as Deputy Assistant Secretary between 1981 and 1982.

Dr. Johnson received a B.S. in Economics (Cum Laude) from Troy State University at Troy, Alabama in 1973, a M.S. in Economics from Florida State University at Tallahassee in 1974, and a Ph.D. in Economics from Florida State University in 1977. From 1977 to 1994, Dr. Johnson was a professor of economics at George Mason University where he held the Koch Chair in International Economics.

Dr. Johnson's academic research and writing have been concentrated in the area of political economy and public policy. He is the author and co-author of five books and has published over 50 articles in academic journals and other publications. In addition to his writings, Dr. Johnson has edited a professional journal, and served on three presidential and congressional commissions. He also currently serves on the board of directors of the Morgan Stanley Dean Witter Family of Funds, Greenwich Capital Holdings, NVR, Inc., Independent Standards Board, and is currently Chairman of the Financial Accounting Foundation.

WILLIAM M. LYONS

William M. Lyons is president and chief operating officer of American Century Companies, Inc., the investment manager of a diversified family of mutual funds and institutional accounts. The company manages approximately \$90 billion, has over 2,500 employees and is headquartered in Kansas City, Missouri.

Mr. Lyons serves on the company's Board of Directors and chairs its Executive Committee. He previously served as the company's general counsel.

Prior to joining American Century in 1987, Mr. Lyons served as an attorney with McCutchen, Doyle, Brown & Enersen, a law firm located in San Francisco, California. Before that, he served as a law clerk to Judge Mary M. Schroeder of the United States Court of Appeals for the Ninth Circuit.

Mr. Lyons holds a bachelor's degree in history from Yale University and a Doctorate in Law from Northwestern University School of Law. He is a member of the American, Missouri and California Bar Associations.

GERALD C. MCDONOUGH

Gerald C. McDonough has served as an independent trustee of The Fidelity Funds since 1989. He also is a member of the boards of directors of Associated Estates Realty Corporation, Commercial Intertech Corporation, CUNO, Inc., and York International Corporation. Mr. McDonough retired in 1988 as Chairman and CEO of Leaseway Transportation Corporation. He has also been a certified public accountant since 1963 and has served on the boards of directors of numerous charitable, professional, religious, medical and educational institutions. Mr. McDonough attended John Carroll University and graduated from Case-Western Reserve University in 1954.

**Persons Consulted by the
Advisory Group on Best Practices for Fund Directors**

The work of the Advisory Group was assisted by the staff of the Investment Company Institute, in particular by Craig S. Tyle, General Counsel of the Institute, Frances M. Stadler, Deputy Senior Counsel, and Marguerite C. Bateman, Associate Counsel, and by the law firm of Kirkpatrick & Lockhart LLP.

In developing its findings and recommendations, the Advisory Group consulted with a broad array of experts. Listed below are persons with whom the Advisory Group consulted. The Advisory Group also consulted with members of the Institute's Director Services Committee, including nine independent directors and three management directors. While the findings and recommendations contained in the Report are solely those of the Advisory Group, the valuable time and assistance provided by each of these persons is most gratefully acknowledged.

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Section 2(a)(19) of the Investment Company Act of 1940

“Interested person” of another person means —

- (A) when used with respect to an investment company —
 - (i) any affiliated person of such company,
 - (ii) any member of the immediate family of any natural person who is an affiliated person of such company,
 - (iii) any interested person of any investment adviser of or principal underwriter for such company,
 - (iv) any person or partner or employee of any person who at any time since the beginning of the last two completed fiscal years of such company has acted as legal counsel for such company,
 - (v) any broker or dealer registered under the Securities Exchange Act of 1934 or any affiliated person of such a broker or dealer, and
 - (vi) any natural person whom the Commission by order shall have determined to be an interested person by reason of having had, at any time since the beginning of the last two completed fiscal years of such company, a material business or professional relationship with such company or with the principal executive officer of such company or with any other investment company having the same investment adviser or principal underwriter or with the principal executive officer of such other investment company:

Provided, That no person shall be deemed to be an interested person of an investment company solely by reason of (aa) his being a member of its board of directors or advisory board or an owner of its securities, or (bb) his membership in the immediate family of any person specified in clause (aa) of this proviso; and

- (B) when used with respect to an investment adviser of or principal underwriter for any investment company —
 - (i) any affiliated person of such investment adviser or principal underwriter,
 - (ii) any member of the immediate family of any natural person who is an affiliated person of such investment adviser or principal underwriter,
 - (iii) any person who knowingly has any direct or indirect beneficial interest in, or who is designated as trustee, executor, or guardian of any legal interest in, any security issued either by

such investment adviser or principal underwriter or by a controlling person of such investment adviser or principal underwriter,

(iv) any person or partner or employee of any person who at any time since the beginning of the last two completed fiscal years of such investment company has acted as legal counsel for such investment adviser or principal underwriter,

(v) any broker or dealer registered under the Securities Exchange Act of 1934 or any affiliated person of such a broker or dealer, and

(vi) any natural person whom the Commission by order shall have determined to be an interested person by reason of having had at any time since the beginning of the last two completed fiscal years of such investment company a material business or professional relationship with such investment adviser or principal underwriter or with the principal executive officer or any controlling person of such investment adviser or principal underwriter.

For the purposes of this paragraph (19), “member of the immediate family” means any parent, spouse of a parent, child, spouse of a child, spouse, brother or sister, and includes step and adoptive relationships. The Commission may modify or revoke any order issued under clause (vi) of subparagraph (A) or (B) of this paragraph whenever it finds that such order is no longer consistent with the facts. No order issued pursuant to clause (vi) of subparagraph (A) or (B) of this paragraph shall become effective until at least sixty days after the entry thereof, and no such order shall affect the status of any person for the purposes of this title or for any other purpose for any period prior to the effective date of such order.

MEMORANDUM

TO: The Advisory Group on Best Practices for Fund Directors
FROM: Kirkpatrick & Lockhart LLP
DATE: June 17, 1999
SUBJECT: Obligations Imposed on Investment Company Boards by the 1940 Act, the Rules Thereunder, and SEC Releases and No-Action Letters

Set forth on the following pages is a list of specific obligations imposed on the boards of directors of registered investment companies by the Investment Company Act of 1940, the rules thereunder, and SEC releases and no-action letters. Since many board obligations derive from an interpretation of the directors' fiduciary duties under specific circumstances, this list is necessarily incomplete. It is not intended to be used as a checklist.

I. 1940 Act Sections Specifically Imposing Responsibilities on the Directors or Trustees of Registered Investment Companies

Section 2(a)(41) — Determination of Fair Value of Portfolio Securities

Defines "value" of securities for which market quotations are not readily available and other assets as "fair value as determined in good faith by the board of directors."

Section 15(a) — Continuation and Termination of Investment Advisory Contract

Makes it unlawful for any person to serve or act as investment adviser to a registered investment company except pursuant to a written contract which, among other things:

- (1) shall continue in effect for a period of more than two years from the date of its execution, only so long as such continuance is specifically approved at least annually by the investment company's board of directors or by a vote of shareholders.
- (2) provides that it may be terminated at any time, without penalty, by a vote of the board of directors or the shareholders, on not more than 60 days' written notice to the adviser.

Section 15(b) — Continuation of Underwriting Contracts

Makes it unlawful for any principal underwriter for a registered open-end investment company to offer for sale, sell or deliver after sale any security issued by that investment company except pursuant to a written contract which, among other things:

- (1) shall continue in effect for more than two years from the date of its execution, only so long as such continuance is specifically approved at least annually by the company's board of directors or by a vote of shareholders.

Section 15(c) — Continuation of Investment Advisory and Underwriting Contracts: Special Duties of Independent Directors

Makes it unlawful for any registered investment company having a board of directors to enter into, renew or perform any investment advisory or principal underwriting contract unless the terms of such contract and any renewal thereof are approved by a vote of the majority of directors who are neither parties to the contract nor interested persons of any such party, such vote to be cast in person at a meeting called for the purpose of voting on such approval.

Makes it the duty of the directors to request and evaluate such information as may reasonably be necessary to evaluate the terms of any such contract.

Makes it unlawful for the directors, in determining whether to continue an investment advisory contract, to take into account the purchase price or other consideration any person may have paid in connection with a transaction of the type referred to in Sections 15(f)(1), (3) or (4).¹

Section 16(a) — Changes in the Board of Directors

Requires the board of directors of a registered investment company (or a proper officer) forthwith and in any event within sixty days to hold a meeting of shareholders to fill vacancies on the board in the event that less than a majority of the directors then holding office were elected by shareholders.

Section 16(b) — Changes in the Board of Directors of an Investment Company Subject to Section 15(f)(1)(A)

Requires that a vacancy among the independent directors of a registered investment company subject to Section 15(f)(1)(A)² must be filled by a vote of the shareholders, the nominee to have

¹ Section 15(f) allows an investment adviser to an investment company to receive any amount or benefit in connection with the sale of an interest in the advisory firm, which results in an assignment of the advisory contract with that investment company, provided certain conditions are met.

² Section 15(f)(1)(A) requires that, for a period of at least three years following the transaction, at least 75 percent of the directors of the investment company must be neither interested persons of the new adviser nor interested persons of the predecessor adviser.

been selected by a majority of the directors who are not interested persons of either party to the sale of interest in the advisory firm. Special provisions apply if a person so selected dies, becomes disqualified or resigns.

Section 16(c) — Special Provisions Applicable to Common Law Trusts³

Requires the trustees of a common law trust promptly to call a meeting of shareholders to vote on removal of one or more trustees when requested in writing to do so by the record holders of 10 percent or more of the outstanding shares.

Requires that when the trustees receive a written request for a meeting for the purpose of removing one or more trustees, from ten or more shareholders of record who have been such for at least six months and who hold in the aggregate shares having a net asset value equal to at least \$25,000 or one percent of the outstanding shares, whichever is less, the trustees must provide access to a list of shareholders or offer to mail materials on behalf of, and at the expense of, the requesting group.

Provides a mechanism by which a majority of the trustees can file an application with the Commission objecting that material they are asked to send to shareholders pursuant to the above provision contains materially false or misleading statements or omits to state material information necessary to make the statements contained therein not misleading.

Section 32(a) — Selection of Accountants and Auditors

Makes it unlawful for any registered management company or registered face-amount certificate company to file with the Commission any financial statement signed or certified by an independent public accountant unless, among other things:

- (1) Such accountant has been selected by the vote, cast in person, of a majority of the independent directors of the investment company at a meeting held within 30 days before or after the beginning of the fiscal year or before the annual meeting of stockholders in that year.
- (2) Such selection has been submitted for ratification or rejection at the next annual meeting of shareholders, provided that, any vacancy occurring due to the death or resignation of the accountant may be filled by a majority vote of the independent directors, cast in person at a meeting called for that purpose.

Provides that a common law trust need not secure shareholder ratification of the choice of accountant; however, if a request is made for a shareholder meeting to consider the matter, Section 16(c) (above), which governs the convening of a meeting of shareholders of a common law trust for the purpose of removing a trustee, shall apply.

³ Although this section by its terms applies only to common law trusts, the Commission staff requires new corporate registrants to agree to meet the terms of this section as a condition of accelerated effectiveness if their corporate documents do not require annual shareholder meetings.

Section 32(b) — Selection of Principal Accounting Officer

Provides that no registered management company or face-amount certificate company shall file with the Commission a financial statement in the preparation of which its controller or other principal accounting officer or employee participated, unless such person was selected either by the shareholders at the last annual meeting or by the board of directors.

II. Regulations under the 1940 Act Specifically Imposing Responsibilities on the Directors of a Registered Investment Company⁴

Rule 2a-4(a)(1) — Definition of “Current Net Asset Value” for Use in Computing Periodically the Current Price of Redeemable Security

Provides that in the determination of current net asset value of any redeemable security issued by a registered investment company, securities for which market quotations are not readily available and other assets shall be valued at fair value as determined in good faith by the board of directors.

Rule 2a-7 — Money Market Funds (Capitalized terms used herein shall have those meanings set forth in the Rule)

Provides that a money market fund may use the Amortized Cost Method or Penny-Rounding Method to determine price per share, provided that: the board of directors determines, in good faith based upon a full consideration of all material factors, that it is in the best interest of the fund and its shareholders to maintain a stable net asset value or a stable price per share by such method, and that the fund will continue to use such method only so long as the board believes that it fairly reflects the market-based net asset value per share.

In the case of a fund using the Amortized Cost Method:

In supervising the fund’s operations and delegating special responsibilities involving portfolio management to the investment adviser, the board, as a particular responsibility within its overall duty of care owed to its shareholders, shall establish procedures reasonably designed, taking into account current market conditions and the fund’s investment objectives, to stabilize the fund’s net asset value per share, as computed for the purpose of distribution, redemption and repurchase, at a single value.

Procedures adopted by the board must include, among other things, the following:

written procedures whereby the extent of deviation, if any, between the current net asset value per share using market quotations (or an appropriate substitute) and amortized cost price per share is determined at such intervals as the board determines appropriate and reasonable in light of current market conditions;

periodic review by the board of the extent of deviation and the methods used to calculate it; and

the maintenance of records of the determination of and the board’s review of the deviation.

⁴ Omits regulations applicable only to investment companies organized under Canadian law.

If the extent of deviation exceeds one-half of one percent, the board shall promptly consider what action, if any, it should initiate. Where the board believes the extent of deviation may result in material dilution or other unfair results to investors or existing shareholders, the board will take such action as it deems appropriate to reduce or eliminate to the extent reasonably practicable such dilution or unfair results.

In the case of a fund using the Penny-Rounding Method:

In supervising the fund's operations and delegating special responsibilities involving portfolio management to the fund's investment adviser, the fund's board of directors undertakes, as a particular responsibility within the overall duty of care owed to its shareholders, to assure to the extent reasonably practicable, taking into account current market conditions affecting the fund's investment objectives, that the fund's price per share as computed for the purpose of distribution, redemption and repurchase, rounded to the nearest one percent, will not deviate from the single price established by the board of directors.

All Money Market Funds:

The fund must buy only those dollar-denominated instruments which the board determines present minimal credit risks and which are either (A) of high quality as determined by the requisite number of nationally recognized statistical rating organizations not affiliated with the issuer ("Requisite NRSROs"), or (B) in the case of a security that is not rated by such an organization, is of comparable quality as determined by the board of directors, with limited exceptions.

Securities Subject to a Conditional Demand Feature. A security that is subject to a Conditional Demand Feature ("Underlying Security") may be determined to be an Eligible Security or a First Tier Security if, among other things, at the time of Acquisition of the Underlying Security, the money market fund's board of directors has determined that there is minimal risk that circumstances that would result in the Conditional Demand Feature not being exercisable will occur.

The Underlying Security or any Guarantee of such security (or the debt securities of the issuer of the Underlying Security or Guarantee that are comparable in priority and security with the Underlying Security or Guarantee) has received either a short-term or long-term rating, as the case may be, from the Requisite NRSROs within the NRSROs' two highest short-term or long-term rating categories or, if unrated, is determined to be of comparable quality by the fund's board of directors to a security that has received a rating from the Requisite NRSROs within the NRSROs' two highest short-term or long-term rating categories, as the case may be.

Shares of Other Money Market Funds. A money market fund that Acquires shares issued by another money market fund in an amount that would otherwise be prohibited by the Rule shall nonetheless be deemed in compliance with the Rule if the board of directors of the Acquiring money market fund reasonably believes that the fund in which it has invested is in compliance with the Rule.

Demand Features and Guarantees Not Relied Upon. If the fund's board of directors has determined that the fund is not relying on a Demand Feature or Guarantee to determine the quality, maturity or liquidity of a portfolio security, and maintains a record of this determination, then the fund may disregard such Demand Feature or Guarantee for all purposes of the Rule.

Downgrades. In the event that (i) a portfolio security of a money market fund ceases to be a First Tier Security or (ii) the investment adviser becomes aware that any Unrated Security or a Second Tier Security held by the fund has, since the security was Acquired, been given a rating by any NRSRO below the NRSRO's second highest short-term rating category, the board of directors of the fund shall reassess promptly whether such security continues to present minimal credit risks and shall cause the fund to take such action as the board of directors determines is in the best interests of the fund and its shareholders.

The reassessments required by the previous paragraph shall not be required if, in accordance with the procedures adopted by the board of directors, the security is disposed of (or matures) within five Business Days of the specified event and in the case of events specified in (ii) in the previous paragraph, the board is subsequently notified of the adviser's actions.

In the event that after giving effect to a rating downgrade, more than five percent of the fund's Total Assets are invested in securities issued by or subject to Demand Features from a single institution that are Second Tier Securities, the fund shall reduce its investment in securities issued by or subject to Demand Features from that institution to no more than five percent of its Total Assets by exercising the Demand Features at the next succeeding exercise date(s), absent a finding by the board of directors that disposal of the portfolio security would not be in the best interests of the fund.

Defaults and Other Events. In the event (a) of a default with respect to a portfolio security; (b) a portfolio security ceases to be an Eligible Security; (c) a portfolio security has been determined to no longer present minimal credit risks; or (d) an Event of Insolvency occurs with respect to the issuer of a portfolio security or the provider of any Demand Feature or Guarantee, the fund shall dispose of such security as soon as practicable consistent with achieving an orderly disposition of the security, by sale, exercise of any Demand Feature or otherwise, absent a finding by the board of directors that disposal of the portfolio security would not be in the best interests of the fund.

Delegation. The fund's board of directors may delegate to the fund's investment adviser or officers the responsibility to make any determination required to be made by the board of directors under the Rule, except the determinations required by paragraphs (c)(1) (board findings); (c)(6)(i)(C) (rule for certain securities subject to second tier Demand Features); (c)(6)(ii) (defaults and other events); (c)(7)(i) (general required procedures: Amortized Cost Method); (c)(7)(ii)(A) (shadow pricing), (B) (prompt consideration of deviation), and (C) (material dilution or unfair results); and (c)(8) (required procedures: Penny-Rounding Method) of the Rule, provided:

the board establishes and periodically reviews written guidelines (including guidelines for determining whether securities present minimal credit risks as required by the Rule) and other procedures under which the delegate makes such determinations; and

the board takes any measures reasonably necessary (through periodic reviews of fund investments and the delegate's procedures in connection with investment decisions and

prompt review of the adviser's actions in the event of a default of a security or Event of Insolvency with respect to the issuer of the security or any Guarantee to which it is subject that requires notification of the Commission under the Rule) to assure that the guidelines and procedures are being followed.

Rule 2a19-1 — Certain Investment Company Directors Not Considered Interested Persons

Provides that a director will not be considered an “interested person” of a registered investment company or of any investment adviser or principal underwriter for such investment company, as defined in Section 2(a)(19) of the 1940 Act, solely because that director is a registered broker or dealer or an affiliated person of a registered broker or dealer, provided that, among other things, the board of directors of the investment company determines that the company and its shareholders will not be adversely affected if the broker or dealer does not execute any portfolio transactions for the company, engage in any principal transactions with the company or distribute any shares of the company.

Rule 6e-2(b)(9) — Exemption of Certain Variable Life Insurance Separate Accounts from the Requirements of Section 17(f) of the 1940 Act

Exempts from the requirements of Section 17(f) of the 1940 Act (relating to custody of assets) a variable life insurance separate account to the extent that the assets of the separate account are maintained in the custody of the life insurer or an insurance company that is an affiliate of the life insurer, provided that, among other things:

- (iii) access is limited to, among others, a group of no more than 20 persons authorized by a resolution of the board of directors of the separate account, who must be chosen from categories specified by the rule;
- (iv) assets need not be maintained in the vault of a qualified insurance company (as required by subsection (b)(9)(i)) if, among other things, they are hypothecated, pledged or placed in escrow for the account of such separate account in connection with a loan or other transaction authorized by specific resolution of the board of directors of the separate account;
- (v) the board of directors of the separate account (or of the insurer) shall have designated a person to receive a notation of each deposit to or withdrawal from such depository.

Rule 6e-3(T) — Temporary Exemptions for Flexible Premium Variable Life Insurance Separate Accounts

Subsections (b)(9)(iii), (iv) and (v) are similar to the corresponding subsections of Rule 6e-2, above.

Subsection (b)(15) provides a variety of exemptions to a separate account organized as a unit investment trust, all the assets of which consist of the shares of one or more registered management investment companies which offer their shares exclusively to separate accounts of the life insurer or its affiliated life insurance companies, offering either scheduled contracts or flexible contracts or both; or which also offer their shares to variable annuity separate accounts of the life insurer or of any affiliated life insurance company, or which offer their shares to any such

life insurance company in consideration solely for advances made by the life insurer in connection with the operation of the separate account, provided that, among other things:

the board of directors of each investment company, constituted with a majority of independent directors, will monitor such company for the existence of any material irreconcilable conflict between the interests of variable annuity contractholders and scheduled or flexible contractholders investing in such company.

Rule 10f-1 — Conditional Exemption of Certain Underwriting Transactions

Provides an exemption from Section 10(f) of the 1940 Act⁵ for a registered investment company purchasing as underwriter the securities of an issuer which is not a registered investment company, provided that, among other things, the investment company is acting pursuant to a written agreement and:

- (e) The agreement is authorized by a resolution adopted by a vote of not less than a majority of the board of directors, none of which majority is an affiliated person of the principal underwriter, of the issuer, or of any person primarily engaged in the securities business.

Rule 10f-3 — Exemption for the Acquisition of Securities During the Existence of an Underwriting or Selling Syndicate

Provides an exemption from Section 10(f) of the 1940 Act for the purchase of a security during the existence of an underwriting or selling syndicate in which an affiliate of the investment company is participating, provided, among other things:

- (b)(10) the board of directors, including a majority of the directors who are not interested persons of the fund, (i) has approved procedures pursuant to which such purchases may be effected for the company that are reasonably designed to provide that the purchases comply with all conditions of the rule; (ii) approves such changes to the procedures as the board deems necessary; and (iii) determines no less frequently than quarterly that all purchases made during the preceding quarter were effected in compliance with the procedures.

Rule 12b-1 — Distribution of Shares by Registered Open-End Management Investment Company

Makes it unlawful for any registered open-end management investment company to finance, directly or indirectly, any activity primarily intended to result in the sale of its shares, unless certain conditions are met, including the following:

⁵ Section 10(f) provides that no registered investment company shall knowingly purchase or otherwise acquire, during the existence of any underwriting or selling syndicate, any security a principal underwriter of which is affiliated with the investment company in specified ways.

- (b) Such payments are made only pursuant to a written plan, describing all material aspects of the proposed financing, and all agreements relating to implementation of the plan are in writing, and further provided that:
 - (2) Such plan and any related agreements have been approved by the board of directors, and the directors who are not interested persons of the company and have no direct or indirect financial interest in the operation of the plan or any related agreements (“12b-1 directors”), cast in person at a meeting called for the purpose of voting thereon;
 - (3) Such plan or agreement provides in substance:
 - (ii) that any person authorized to direct the disposition of monies paid or payable by the company pursuant to the plan or any related agreement shall provide to the board of directors, and the directors shall review, at least quarterly, a written report of the amounts so expended and the purposes for which such expenditures were made;
 - (iii) that the plan may be terminated at any time by a vote of a majority of the 12b-1 directors;
 - (iv) that any related agreement may be terminated at any time, without payment of a penalty, by a vote of a majority of the 12b-1 directors on not more than sixty days’ written notice to any other party to the agreement.
- (c) The selection and nomination of independent directors of the company are committed to the discretion of the independent directors.
- (d) The directors who vote to approve initially or continue such a plan conclude, in the exercise of reasonable business judgment and in light of their fiduciary duties under both state law and Sections 36(a) and 36(b) of the 1940 Act, that there is a reasonable likelihood that the plan will benefit the company and its shareholders.

Subsection (d) also provides that, in considering whether a registered open-end management investment company should implement or continue a plan, the directors shall have a duty to request and evaluate such information as may reasonably be necessary to an informed determination of whether such plan should be implemented and continued. The section further provides that, in fulfilling this duty, the directors should consider and give appropriate weight to all pertinent factors.

Subsection (g) provides that any action taken with respect to a plan that covers more than one series or class of shares pursuant to this section must be taken separately for each series or class affected by the matter.

Rule 15a-4 — Temporary Exemption for Certain Investment Advisers

Provides that a person may act as investment adviser to a registered investment company pursuant to a contract that has not been approved by shareholders during the 120-day period following termination of an investment advisory contract by an event (other than assignment by an investment adviser in connection with which such investment adviser, or a controlling person

thereof, directly or indirectly receives money or other benefit) described in paragraphs (3) or (4) of Section 15(a) or by failure to renew such contract, provided that, among other things:

- (a) The contract has been approved by the investment company's board of directors, including a majority of the directors who are not interested persons of the investment company.

Rule 17a-7 — Exemption of Certain Purchase and Sale Transactions Between an Investment Company and Certain Affiliated Persons Thereof

Provides that a registered investment company or separate series thereof may purchase a security from, or sell a security to, certain affiliated persons, provided that, among other things:

- (e) The board of directors, including a majority of those directors who are not interested persons of the investment company, (1) adopts procedures pursuant to which such purchase or sale transactions may be effected for the company, which are reasonably designed to provide that all conditions of the rule are complied with; (2) makes and approves such changes to the procedures as the board deems necessary; and (3) determines no less frequently than quarterly that all such purchases and sales made during the preceding quarter were effected in compliance with such procedures.

Rule 17a-8 — Mergers of Certain Affiliated Investment Companies

Allows a merger, consolidation or purchase or sale of substantially all the assets of certain registered investment companies which are affiliated persons of one another, provided that, among other things:

- (a) The board of directors of each company participating in the transaction, including a majority of the directors who are not interested persons of any investment company participating in the transaction, determine:
 - (1) that participation in the transaction is in the best interests of that company; and
 - (2) that the interests of shareholders of that company will not be diluted as a result of effecting the transaction.

Rule 17d-1(d)(7) — Exemption for Joint Enterprise or Arrangement Involving Liability Insurance

Exempts from Section 17(d) of the 1940 Act and Rule 17d-1 thereunder⁶ any arrangement regarding liability insurance policies (other than a bond pursuant to Rule 17g-1) provided that,

⁶ These provisions prohibit any affiliated person of or principal underwriter for any registered investment company, or any affiliated person of such affiliated person or principal underwriter, acting as principal, from participating in or effecting any transaction in connection with any joint transaction or arrangement with the investment company, except pursuant to an exemptive order.

among other things: These provisions prohibit any affiliated person of or principal underwriter for any registered investment company, or any affiliated person of such affiliated person or principal underwriter, acting as principal, from participating in or effecting any transaction in connection with any joint transaction or arrangement with the investment company, except pursuant to an exemptive order.

- (iii) The board of directors, including a majority of directors who are not interested persons of the investment company, determines no less frequently than annually that:
 - (a) the company's participation in the joint liability insurance policy is in its best interests; and
 - (b) the proposed premium allocated to the company, based upon its proportionate share of the sum of the premiums that would have been paid if such insurance coverage were purchased separately by the insured parties, is fair and reasonable to the company.

Rule 17e-1 — Brokerage Transactions on a Securities Exchange

Declares that for purposes of Section 17(e)(2)(A) of the 1940 Act⁷ a commission, fee or other remuneration shall be deemed as not exceeding the usual and customary broker's commission if, among other things:

- (b) the board of directors, including a majority of the directors who are not interested persons of the investment company: (1) has adopted procedures which are reasonably designed to provide that such commission, fee or other remuneration is reasonable and fair compared to the commission, fee or other remuneration received by other brokers in connection with comparable transactions involving similar securities being purchased or sold on a securities exchange during a comparable period of time; (2) makes and approves such changes in those procedures as the board deems necessary; and (3) determines no less frequently than quarterly that all such transactions effected during the preceding quarter were effected in compliance with such procedures.

Rule 17f-1 — Custody of Securities with Members of National Securities Exchanges

Provides that no registered management investment company shall place or maintain any of its securities or similar investments in the custody of a company which is a member of a national securities exchange except pursuant to a written contract which, among other things, has been

⁷ This section makes it unlawful for any affiliated person of an investment company, or any affiliated person of such person, acting as broker, in connection with the sale of securities to or by such investment company or any controlled company thereof, to receive from any source a commission, fee or other remuneration which exceeds the usual and customary broker's commission if the sale is effected on a securities exchange, or certain other limits for non-exchange transactions.

approved by a majority of the board of directors, and is ratified by the board of directors at least annually thereafter.

Rule 17f-2 — Custody of Investments by Registered Management Investment Company (Self-Custody)

Subsection (b) provides that the securities and similar investments of a registered management investment company that maintains custody of its own assets must be deposited in the safekeeping of, or in a vault or similar depository maintained by, a bank or similar institution. Subsection (c) provides, however, that this requirement does not apply to securities on loan which are collateralized to the extent of their full market value, or to securities hypothecated, pledged or placed in escrow for the account of such investment company in connection with a loan or other transaction authorized by specific resolution of its board of directors.

Subsection (d) provides that no person shall be authorized or permitted to have access to securities and similar investments deposited as provided in subsection (b), except pursuant to a resolution of the board of directors designating persons to have access and the circumstances under which they may have access.

Subsection (e) provides that each person depositing investments in or withdrawing investments from such a depository shall sign a notation of such deposit or withdrawal, which shall be delivered to an officer or director of the investment company designated by its board of directors.

Rule 17f-3 — Free Cash Accounts for Investment Companies with Bank Custodians

Provides that no registered investment company having a bank custodian shall hold free cash except, upon resolution of the board of directors, a petty cash account may be maintained in an amount not to exceed \$500, provided, among other things, it is maintained subject to adequate controls approved by the board of directors over disbursements and reimbursements.

Rule 17f-4 — Deposits of Securities in Securities Depositories

Subsection (c) provides that a registered management investment company may place securities in a registered clearing agency which acts as a securities depository, provided that, among other things, the board of directors initially approved the arrangement, and any subsequent changes thereto; and has authorized one or more persons to give necessary instructions to the clearing agency.

Subsection (d) provides that the custodian for a registered management investment company may deposit securities in a registered clearing agency which acts as a securities depository or the book-entry system (*i.e.*, in the Treasury book-entry system or similar system of other federal agencies), or both, provided that, among other things, the board of directors of the investment company initially approved the arrangement and any subsequent changes thereto. Through no-action

letters, the SEC staff has extended these requirements to the use of depositories operated by banks that are not registered clearing agencies.⁸

Rule 17f-5 — Custody of Investment Company Assets Outside the United States⁹

Provides that a registered management investment company incorporated or organized under the laws of the United States or any state may place and maintain in the care of an Eligible Foreign Custodian (as defined in the Rule) any investments (including foreign currencies) for which the primary market is outside the United States, and such cash and cash equivalents in amounts reasonably necessary to effect the fund's transactions in such investments, provided that:

- (c) (1) The Foreign Custody Manager (*i.e.*, the fund's board of directors or the board's delegate under certain provisions of the Rule) determines that the fund's assets will be subject to reasonable care, based on the standards applicable to custodians in the relevant market, if maintained with the custodian, after considering all factors relevant to the safekeeping of such assets, including, without limitation:
 - (i) the custodian's practices, procedures and internal controls, including, but not limited to, the physical protections available for certificated securities (if applicable), the method of keeping custodial records, and the security and data protection practices;
 - (ii) whether the custodian has the requisite financial strength to provide reasonable care for fund assets;
 - (iii) the custodian's general reputation and standing and, in the case of a Securities Depository (as defined in the Rule), the depository's operating history and number of participants; and
 - (iv) whether the fund will have jurisdiction over and be able to enforce judgments against the custodian, such as by virtue of the existence of any offices of the custodian in the United States or the custodian's consent to service of process in the United States.
- (2) The Foreign Custody Manager has determined that the written contract governing the fund's foreign custody arrangements will provide reasonable care for the fund's assets based on the standards set forth in paragraph (c) (1). Such contract shall include provisions specified in the Rule or such other provisions that the Foreign Custody Manager determines will provide, in their entirety, the same or a greater level of care and protection for fund assets as the provisions specified in the Rule, in their entirety.

⁸ See Investment Company Institute, SEC No-Action Letter (pub. avail. June 15, 1999). See also Morgan Guaranty Trust Co. of N.Y., SEC No-Action Letter (pub. avail. Aug. 14, 1985), and Salomon Brothers Inc., SEC No-Action Letter (pub. avail. April 8, 1985).

⁹ Rule 17f-5 is currently proposed to be amended. Release IC-23814 and IC-23815 (April 29, 1999).

- (3) The board of directors establishes a system to monitor the appropriateness of maintaining the fund's assets with a particular custodian and the contract governing the fund's arrangements.
- (4) A fund's board of directors may delegate to the fund's investment adviser or officers or to a U.S. Bank or to a Qualified Foreign Bank (each as defined in the Rule) the responsibilities set forth above, provided that, among other things:
 - (i) the board determines that it is reasonable to rely on the delegate to perform the delegated responsibilities; and
 - (ii) the board requires the delegate to provide written reports notifying the board of the placement of the fund's assets with a particular custodian and of any material change in the fund's arrangements, with the reports to be provided to the board at such times as the board deems reasonable and appropriate based on the circumstances of the fund's foreign custody arrangements.

Rule 17g-1 — Bonding of Officers and Employees of Registered Management Investment Companies

Provides that each registered management investment company shall provide and maintain a bond against larceny and embezzlement.

Subsection (d) provides that the bond shall be in such reasonable form and amount as a majority of the independent directors of the investment company shall approve as often as their fiduciary duties require, but not less often than annually, with due consideration to all relevant factors, including those specified in the rule.

Subsection (e) provides that no premium may be paid for any joint bond or amendment thereto unless a majority of the independent directors of each management investment company named therein approve the portion of the premium to be paid by such company, taking into account all relevant factors, including those specified by the rule.

Rule 17j-1 — Certain Unlawful Acts, Practices or Courses of Business and Requirements Relating to Codes of Ethics with Respect to Registered Investment Companies

- (c) (1) Except as provided in paragraph (c)(3) below, every director of a registered investment company, among others, shall report to the investment company the information required by the rule with respect to transactions in any security in which such director has, or by reason of such transaction acquires, any direct or indirect beneficial ownership in the security.
 - (3) Independent directors must report only where they knew or, in the ordinary course of fulfilling their official duties as directors of the registered investment company, should have known that during the 15-day period immediately preceding or after the date of their transaction in a security, such security is or was purchased or sold by the investment company, or a purchase or sale by the investment company is or was considered by the investment company or its investment adviser.

Rule 18f-3 — Multiple Class Companies

Subsection (c)(1) provides that income, realized gains and losses, unrealized appreciation and depreciation, and fundwide expenses (*i.e.*, expenses of the company not specific to a particular class) shall be allocated based on one of the methods specified in the Rule. After enumerating several possible methods, the Rule states that income and expenses also may be allocated to each class based on any other appropriate method, provided that a majority of the directors of the company, and a majority of the independent directors of the company, determine that the method is fair to the shareholders of each class and that the annualized rate of return of each class will generally differ from that of the other classes only by the expense differentials among the classes.

Subsection (d) provides that any expenses paid by each class in connection with the class' arrangement for shareholder services or the distribution of securities or both, under subsection (a) of the Rule, shall be made pursuant to a written plan setting forth the separate arrangement and expense allocation of the class, and any related conversion features or exchange privileges. Before the first issuance of a share of any class in reliance upon this section, and before any material amendment of a plan, a majority of the directors of the company, and a majority of the independent directors of the company, shall find that the plan as proposed to be adopted or amended, including the expense allocation, is in the best interests of each class individually and the company as a whole.¹⁰ Before any vote on the plan, the directors shall request and evaluate, and any agreement relating to a class arrangement shall require the parties thereto to furnish, such information as may be reasonably necessary to evaluate the plan.

Rule 22c-1 — Pricing of Redeemable Securities for Distribution, Redemption and Repurchase

Subsection (d) requires the board of directors of a registered investment company to establish the specific time or times during the day at which the company will determine the net asset value of its shares and to make and approve such later changes as the board deems necessary.

Rule 23c-3 — Repurchase Offers by Closed-End Companies

Subsection (a)(3) provides that before each repurchase offer, the repurchase offer amount (as defined in the Rule) for that repurchase offer shall be determined by the directors of the company.

Subsection (b)(2)(i) requires that a registered closed-end company shall repurchase securities pursuant to a fundamental policy, changeable only by a majority vote of the outstanding voting securities of the fund, stating specific matters enumerated in the subsection. Subsection (b)(2)(iii) states that a fund shall be deemed to be making repurchase offers pursuant to this required fundamental policy if, among other things, the fund's board of directors adopts a policy specifying the matters required under paragraph (b)(2)(i), and the periodic interval specified therein conforms generally to the frequency of the fund's prior repurchase offers.

¹⁰ Initial board approval under this paragraph is not required, however, if the plan does not make any change in the arrangements and expense allocations previously approved by the board under an existing order of exemption.

Subsection (b)(3)(i) provides that a registered closed-end company shall not suspend or postpone a repurchase offer except pursuant to a vote of a majority of the directors, including a majority of the fund's independent directors, among other things.

Subsection (b)(7) provides that (i) the current net asset value of a registered closed-end company's common stock shall be computed no less frequently than weekly on such day and at such specific time or times during the day that the board of directors of the fund shall set; (ii) the current net asset value of the fund's common stock shall be computed daily on the five business days preceding a repurchase request deadline at such specific time or times during the day that the board of directors of the fund shall set; (iii) for purposes of Section 23(b) of the 1940 Act,¹¹ the current net asset value applicable to a sale of common stock by the fund shall be the net asset value next determined after receipt of an order to purchase such stock. During any period when the fund is offering its common stock, the current net asset value of the common stock shall be computed no less frequently than once daily, Monday through Friday, at the specific time or times during the day that the board of directors of the fund shall set, with certain exceptions.

Subsection (b)(8) requires a majority of the directors of the registered closed-end company to be directors who are not interested persons of the fund, and the selection and nomination of independent director candidates must be committed to the discretion of the incumbent independent directors.

Subsection (b)(10)(ii) provides that in the event that the registered closed-end company's assets fail to comply with the liquidity requirements set forth in the Rule, the board of directors shall cause the fund to take such action as it deems appropriate to ensure compliance. Subsection (b)(10)(iii) further provides that in supervising the fund's operations and portfolio management by the investment adviser, the board of directors shall adopt written procedures reasonably designed, taking into account current market conditions and the fund's investment objectives, to ensure that the fund's portfolio assets are sufficiently liquid so that the fund can comply with its fundamental policy on repurchases, and comply with the liquidity requirements of the Rule. The board of directors shall review the overall composition of the portfolio and make and approve such changes to the procedures as the board deems necessary.

Subsection (c) permits a registered closed-end company to repurchase common stock of which it is the issuer from the holders of the stock pursuant to a repurchase offer that is not made pursuant to a fundamental policy and that is made to all holders of the stock not earlier than two years after another offer pursuant to this paragraph if the company complies with the requirements of subparagraphs (3), (7)(ii), (8) and (10)(ii) of paragraph (b) set forth above, among others.

¹¹ Section 23(b) prohibits a registered closed-end company from selling any common stock of which it is the issuer at a price below the current net asset value of such stock, exclusive of any distribution commission or discount, except in limited circumstances.

Rule 32a-1 — Exemption of Certain Companies from Affiliation Provisions of Section 32(a)(1)

Provides that a registered investment company shall be exempt from Section 32(a)(1) of the 1940 Act¹² if the company meets the conditions of Section 10(d) of the Act¹³ and the accountants are selected by a majority of all members of the board.

III. Commission Releases and No-Action Letters Imposing Special Responsibilities on the Board of Directors of a Registered Investment Company

Approval of Service Contracts

The SEC staff has taken the position that service contracts between a registered investment company and its affiliates or principal underwriter may be subject to Section 17(d) of the 1940 Act and Rule 17d-1 thereunder.¹⁴ Working from this position, the staff has informally established a set of criteria for fund directors to apply when reviewing the terms of service contracts with affiliates.

The staff has said that such contracts should be approved annually by the board of directors and by a majority of the independent directors, considering such information as may reasonably be necessary to evaluate the terms of the service contract. The independent directors should determine that:

1. the service contract is in the best interests of the fund and its shareholders;
2. the services to be performed pursuant to the contract are required for the operation of the fund;
3. the services provided are of a nature and quality at least equal to the same or similar services provided by independent third parties; and
4. the fees for such services are fair and reasonable in light of the usual and customary charges made by others for services of the same nature and quality.¹⁵

¹² Section 32(a)(1) of the Act requires that a majority of the independent directors of an investment company select its accountant at a meeting held within 30 days before or after the beginning of the fiscal year or before the annual meeting of shareholders in that year.

¹³ Section 10(d) sets forth conditions under which an investment company may have a board of directors all the members of which except one are interested persons of the adviser or officers or employees of the investment company.

¹⁴ See supra note 6.

¹⁵ These provisions prohibit any affiliated person of or principal underwriter for any registered investment company, or any affiliated person of such affiliated person or principal underwriter, acting as principal, from participating in or effecting any transaction in connection
(continued)

The SEC staff has noted that administration contracts are not specifically subject to Sections 15(c) or 36(b) of the Act. Not surprisingly, however, the factors outlined by the SEC staff under Section 17(d) and Rule 17d-1 are not dissimilar to those outlined by the courts under Section 36(b).¹⁶

Fund Supermarket Fees

In October of 1998, the Chief Counsel of the SEC's Division of Investment Management sent a letter to the ICI, noting that the services provided by many fund supermarket sponsors may include those related to distribution and others that are not distribution-related. The letter reiterated that mutual funds can pay expenses primarily intended to result in share distribution only pursuant to a plan under Rule 12b-1. If a fund has a sufficient 12b-1 fee to cover the entire amount of any supermarket fee, it may use the 12b-1 fee to pay the supermarket fee whether the services are distribution-related or not. If a fund has no 12b-1 plan, the fund can pay the non-distribution portion of the supermarket fee, but any distribution-related portions of the supermarket fee would have to be paid by the distributor or another party out of its own assets. The letter stated that if a fund has no 12b-1 plan, the entire amount of the fee can be paid out of fund assets only if the board determines that none of the supermarket fee is for distribution services.

The letter sets forth the following criteria for boards to support a determination that the entire amount of the supermarket fee is for non-distribution services:

with any joint transaction or arrangement with the investment company, except pursuant to an exemptive order.

¹⁶ Indeed, in proposing to amend Rule 17d-1 expressly to exempt such contracts, the SEC described the expected analysis in terms strikingly reminiscent of a Section 15(c) analysis:

When considering a service agreement involving affiliates, the directors should examine in particular not only the factors contained in the amendment proposed herein but also the extent to which the fee structure of any such agreement provides for a reduction in payments resulting from economies of scale as well as whether it provides a reasonable rate of return on the capital invested by the persons performing the services. The directors should be furnished information adequate to make judgments on these and other relevant issues by the contracting party.

These considerations are not intended to preclude affiliates who perform services for investment companies from realizing reasonable profits necessary to afford economic incentives. They are intended, however, to assure that those who derive economic benefits from their fiduciary relationship with investment companies do not abuse that relationship. In light of this intent, a standard of reasonableness should be applied not only to the profits to be gained from the specific services, but those from the affiliated relationship viewed as a whole.

Release IC-8245, supra note 15.

If a fund's board determines that none of the supermarket fee was for distribution services, and the fund paid the entire fee out of its own assets, the Division believes that the board would need to be able to satisfy itself that its determination was supported by all factors relevant to its characterization of the purpose of the services. These factors would include, among others, the nature of the services provided; whether the services provide non-distribution related benefits and are typically provided by fund service providers; the costs that the fund could reasonably be expected to incur for comparable services if provided by another party, relative to the total amount of the supermarket fee; and the characterization of the services by the fund supermarket sponsor.

The SEC staff letter outlines the process that it expects boards to follow in making this determination. Boards should review both the distribution and non-distribution services provided by the supermarket sponsor. The board should then determine whether the portion of the fund supermarket fee that is paid by the fund for non-distribution services is reasonable in relation to (a) the value of those services and the benefits received by the fund and its shareholders and (b) the payments that the fund would be required to make to another entity to perform the same services. If the amount paid to the supermarket sponsor exceeds the amount the board believes is reasonable for the non-distribution services, the remainder should be attributed to distribution services.

Approval of Combined Line of Credit

Related investment companies that enter into a single line of credit agreement with a bank must consider whether the arrangement constitutes a joint transaction under Section 17(d) of the 1940 Act and Rule 17d-1 thereunder. The SEC staff has permitted such single lines of credit, subject to certain conditions. By no-action letter, the SEC staff has indicated that it would not recommend any enforcement action under Section 17(d) or Rule 17d-1 if funds enter into a committed line of credit arrangement and pay the commitment fee.⁶⁰

The SEC staff's position in these no-action letters was based on the facts outlined in those letter and the funds' representation that the board of directors for each of the participating funds, including a majority of the independent directors, would, prior to any fund's entering into the loan agreement and annually thereafter: (i) approve the loan agreement as fair and equitable and in the best interest of the participating fund; (ii) establish and oversee the application of procedures for allocating loans among each participating fund on a first come, first served basis, and (iii) approve any change in the apportionment methodology for payment of the commitment fee.¹⁷

In approving the loan agreement as fair and equitable and in the best interests of the participating fund on an annual basis, the fund group represented that the board would consider the following factors: (i) the expected benefits and costs to each fund; (ii) the experience of each fund under the loan agreement; (iii) the availability of other sources of liquidity for each fund; and (iv) the expected continuing need by the fund for the loan arrangement.

¹⁷ See T. Rowe Price Funds, SEC No-Action Letter (pub. avail. July 31, 1995); Alliance Capital Management, L.P., SEC No-Action Letter (pub. avail. April 25, 1997).

In addition, in establishing the exact method of allocation, the board of directors would consider such matters as (i) the amount available under the agreement; (ii) the amount requested by each fund and the funds in the aggregate; (iii) the availability of other sources of cash to meet the needs of each fund; (iv) the history of each requesting fund's request for loans; (v) the expected duration of each requested loan; and (vi) the expected need for loans in the immediate future.

Repurchase Agreements

The SEC staff has taken the position that repurchase agreements between registered investment companies and brokers or dealers may violate Section 12(d)(3) of the 1940 Act;¹⁸ however, in a policy statement endorsed by the Commission, the staff has said that it will not recommend enforcement action under Section 12(d)(3) provided that:

1. the repurchase agreement is structured in a manner reasonably designed to ensure that the investment company's position (including any accrued interest) is fully collateralized; and
2. the investment company's board of directors has evaluated the creditworthiness of the broker or dealer issuing the repurchase agreement.¹⁹

In a subsequent letter, the SEC staff indicated that a fund's investment adviser, rather than the fund's board of directors, may assume primary responsibility for monitoring and evaluating the fund's use of repurchase agreements.²⁰ The staff said that it would not recommend enforcement action under Section 12(d)(3) of the 1940 Act if a fund enters into repurchase agreements with broker-dealer and bank counterparties that are engaged in a securities-related business, provided that:

¹⁸ Section 12(d)(3) prohibits registered investment companies, with certain exceptions, from investing in the securities of issuers engaged in the securities business.

¹⁹ In taking this position, the staff recognized that it would not normally be feasible for the directors themselves to evaluate the creditworthiness of each issuer. Rather, the staff anticipated that fund directors would discharge their responsibilities primarily by setting guidelines and standards of review for the adviser and monitoring the adviser's actions. SEC Release IC-13005 (February 2, 1983).

In an earlier release, the staff said that investment company directors should review the adequacy of the company's methods of accounting for repurchase agreements. It also said directors should review the company's policies under Section 8(b) of the 1940 Act regarding, in particular, the obligation to ensure compliance with Sections 8 and 21. SEC Release IC-10666 (April 18, 1979). Section 21 makes it unlawful for any registered management investment company to lend money or property to any person if, among other things, the investment policies of the company, as recited in its registration statement and reports filed with the Commission, do not permit such a loan.

²⁰ Investment Company Institute, supra note 8.

1. the fund's board *or* investment adviser evaluates the creditworthiness of the repurchase agreement counterparties; and
2. the fund's board *or* investment adviser takes steps that are reasonably designed to ensure that the fund's repurchase agreements are fully collateralized.

The fund need not adopt repurchase agreement procedures and the fund's board need not review the form of repo agreement if the fund's adviser evaluates the creditworthiness of the fund's counterparties, and takes steps reasonably designed to ensure that the fund's repurchase agreements are fully collateralized. If a fund's board continues to assume those responsibilities, however, the fund should adopt procedures and the board should review those procedures and the form of repo agreement initially, and any subsequent changes thereto.

Reverse Repurchase Agreements, Standby Commitment Agreements and Firm Commitment Agreements

The SEC has stated that the directors of an investment company engaged in any of the above activities should:

1. consider whether such practices are consistent with the company's investment objectives and policies;
2. review the company's portfolio and custodial accounts to determine if any segregated accounts with the company's custodian should be created;
3. consider the potential loss of flexibility in portfolio management resulting from the need to segregate liquid assets; and
4. review valuation procedures, accounting systems and systems of internal accounting control to determine whether any inadequacies exist with regard to the valuation and accounting treatment of such agreements.

SEC Release No. IC-10666 (April 18, 1979).

Securities Lending

The SEC staff has indicated through the no-action process that investment company boards of directors have certain responsibilities related to loans of an investment company's portfolio securities.²¹ Fund boards of directors have the responsibility to approve the identity of borrowers and the general terms of the lending agreement. The directors must determine that the fee is reasonable and based solely on the services rendered and that the fund's return after making such payment is reasonable. These responsibilities may be delegated to the investment adviser, provided that such a delegation would be consistent with the terms of the advisory contract.

²¹ See, e.g., SIFE Trust Fund, SEC No-Action Letter (pub. avail. Feb. 17, 1982); Salomon Brothers, SEC No-Action Letter (pub. avail. May 4, 1975); Standard Shares Inc., SEC No-Action Letter (pub. avail. Aug. 28, 1974); State Street Bank & Trust Company, SEC No-Action Letter (pub. avail. Sep. 29, 1972).

However, the board must approve guidelines for any such delegation. Delegation does not relieve fund directors from their fiduciary responsibilities, including their fiduciary duty to vote proxies with respect to the loaned securities. The directors are obligated to call loans of securities to vote proxies if a material event affecting the investment is to occur.

Liquidity of Rule 144A Securities

In adopting Rule 144A,²² the SEC modified its long-standing position that registered investment companies should generally regard a restricted security as an illiquid security. The SEC said that determination of the liquidity of Rule 144A securities in the portfolio of an open-end investment company is “a question of fact for the board of directors to determine, based upon the trading markets for the specific security.” The SEC set out a non-exclusive list of factors that a board reasonably could consider in making a liquidity determination, including: (i) the frequency of trades and quotes; (ii) the number of dealers willing to purchase or sell the security; and (iii) the market place trades.²³

The SEC stated that the board could delegate the day-to-day function of determining liquidity to the investment adviser, provided that the board maintains sufficient oversight. The SEC also said that the board or its delegate should continue to monitor the liquidity of Rule 144A securities held by the company. “If, as a result of changed conditions, it is determined that a Rule 144A security is no longer liquid, the fund’s holdings of illiquid securities should be reviewed and the board should determine if any steps are required to assure that the ten percent test²⁴ continues to be satisfied.” The SEC staff further explained that the board is not required to specifically approve and review each Rule 144A security selected by the investment adviser. The board is responsible, however, for developing and establishing guidelines and procedures for determining the liquidity

²² See SEC Release 33-6862 (April 23, 1990) (“Release 6862”). Rule 144A provides a safe harbor exemption from the registration requirements of the Securities Act of 1933 for resales of restricted securities to “qualified institutional buyers,” a term that includes many registered investment companies.

²³ The SEC also recognized in Release 6862 at n. 60 that foreign securities would not necessarily be illiquid for purposes of the 15% limitation, despite their restricted nature, if the board determines that the foreign security can be freely traded in a foreign securities market and all the facts and circumstances support a finding of liquidity. Similarly, the SEC staff, in reliance on the SEC’s position in Release 6862, has stated that a fund’s board of directors may determine that certain mortgage-backed securities and municipal lease obligations are liquid using the same analysis set forth above for Rule 144A securities. See Letter to Registrants (Jan. 17, 1992) and Letter to Catherine L. Heron, Vice President — Tax and Pension, Investment Company Institute, from Carolyn B. Lewis, Assistant Director, Division of Investment Management (June 21, 1991).

²⁴ At the time this policy was adopted, the SEC took the position that no more than 10 percent of the net assets of a registered open-end fund could be invested in illiquid securities. This position was based on the need of such funds to stand ready to redeem their shares on demand. The SEC subsequently raised the limit to 15 percent for all except money market funds.

of Rule 144A securities and monitoring the adviser's implementation of the guidelines and procedures.²⁵

Liquidity of Section 4(2) Paper

In Merrill Lynch Money Markets Inc., SEC No-Action Letter (Jan. 19, 1994), the SEC staff concurred that a fund's board of directors may conditionally determine for purposes of the 15% illiquidity limitation that certain commercial paper issued in reliance on the exemption from registration in Section 4(2) of the Securities Act of 1933 ("4(2) Paper") is liquid, whether or not it may be resold under Rule 144A. To make that determination, the following conditions must be met: (i) the 4(2) Paper must not be traded flat or in default as to principal or interest; (ii) the 4(2) Paper must be rated in one of the two highest rating categories by at least two NRSROs, or if only one NRSRO rates the security, by that NRSRO (if the security is unrated, the board must determine that the security is of equivalent quality); and (iii) the board must consider the trading market for the specific security taking into account all relevant factors.

The board of directors may delegate to the fund's investment adviser the responsibility for determining and monitoring the liquidity of 4(2) Paper in a fund's portfolio, provided the board retains sufficient oversight. The board or adviser must continue to monitor the liquidity of any 4(2) Paper purchased. If the board or the adviser determines that an issue of 4(2) Paper no longer is liquid, it must review the fund's portfolio to determine whether the fund must take any action to ensure that its portfolio complies with the 15% illiquidity limitation. Even if the board delegates determinations to the investment adviser, the board remains ultimately responsible for liquidity determinations.

Liquidity of Money Market Funds

In adopting Rule 2a-7, the SEC set forth three responsibilities of the board of directors of a money market fund regarding liquidity of the portfolio:

1. The board may have "a fiduciary obligation" to limit the acquisition of illiquid portfolio investments beyond the [10] percent of net assets normally applied to registered open-end investment companies.²⁶
2. The board has "a particular responsibility" to ensure that when a money market fund purchases or acquires illiquid investments, such instruments will not impair the proper management of the fund. The SEC suggested that such impairment might come about because a money market fund holding illiquid instruments, in seeking to satisfy shareholder redemptions, could be forced to sell instruments it would otherwise wish to retain.

²⁵ Letter to Registrants (Dec. 2, 1992).

²⁶ See also SEC Release IC-18612 (March 12, 1992) and Letter to Matthew P. Fink, President, Investment Company Institute, dated Dec. 9, 1992.

3. The board has “a fiduciary duty” to ascertain that a fund purchasing illiquid securities is operated in such a manner that the purchase of such instruments does not materially affect the valuation of its shares.

SEC Release IC-13380 (July 11, 1983).

Derivatives

Consistent with its general oversight responsibility, a fund’s board has a particular responsibility to ask questions concerning why and how the fund uses derivative instruments, the risks of using such instruments and the effectiveness of internal controls designed to monitor risk and ensure compliance with investment policies regarding derivatives.²⁷

²⁷ See SEC Release IC-22389 (Dec. 11, 1996) (adopting Rule 17f-6 under the 1940 Act).

[The sample charter below is not intended to serve as legal advice. Each investment company board should tailor the charter to fit its particular circumstances.]

**XYZ FUNDS
NOMINATING AND ADMINISTRATION COMMITTEE CHARTER**

Nominating and Administration Committee Membership

The Nominating and Administration Committee shall be composed entirely of independent directors.

Board Nominations and Functions

1. The Committee shall make nominations for independent director membership on the Board of Directors. The Committee shall evaluate candidates' qualifications for Board membership and their independence from the Funds' manager and other principal service providers. Persons selected must be independent in terms of both the letter and the spirit of the Investment Company Act of 1940. The Committee shall also consider the effect of any relationships beyond those delineated in the 1940 Act that might impair independence, e.g., business, financial or family relationships with managers or service providers.
2. The Committee shall periodically review Board governance procedures and shall recommend any appropriate changes to the full Board of Directors.
3. The Committee shall periodically review the composition of the Board of Directors to determine whether it may be appropriate to add individuals with different backgrounds or skill sets from those already on the Board.
4. The Committee shall periodically review director compensation and shall recommend any appropriate changes to the independent directors as a group.

Committee Nominations and Functions

1. The Committee shall make nominations for membership on all committees and shall review committee assignments at least annually.
2. The Committee shall review as necessary the responsibilities of any committees of the Board, whether there is a continuing need for each committee, whether there is a need for additional committees of the Board, and whether committees should be combined or

reorganized. The Committee shall make recommendations for any such action to the full Board.

Other Powers and Responsibilities

1. The Committee shall monitor the performance of legal counsel employed by the Funds and the independent directors, and shall be responsible for the supervision of counsel for the independent directors.
2. The Committee shall have the resources and authority appropriate to discharge its responsibilities, including authority to retain special counsel and other experts or consultants at the expense of the appropriate Fund(s).
3. The Committee shall review this Charter at least annually and recommend any changes to the full Board of Directors.

[The sample charter below is not intended to serve as legal advice. Each investment company board should tailor the charter to fit its particular circumstances.]

XYZ FUNDS
AUDIT COMMITTEE CHARTER

1. The Audit Committee shall be composed entirely of independent directors.
2. The purposes of the Audit Committee are:
 - (a) to oversee the Funds' accounting and financial reporting policies and practices, its internal controls and, as appropriate, the internal controls of certain service providers;
 - (b) to oversee the quality and objectivity of the Funds' financial statements and the independent audit thereof; and
 - (c) to act as a liaison between the Funds' independent auditors and the full Board of Directors.

The function of the Audit Committee is oversight; it is management's responsibility to maintain appropriate systems for accounting and internal control, and the auditor's responsibility to plan and carry out a proper audit.

3. To carry out its purposes, the Audit Committee shall have the following duties and powers:
 - (a) to recommend the selection, retention or termination of auditors and, in connection therewith, to evaluate the independence of the auditors, including whether the auditors provide any consulting services to the manager, and to receive the auditors' specific representations as to their independence;
 - (b) to meet with the Funds' independent auditors, including private meetings, as necessary (i) to review the arrangements for and scope of the annual audit and any special audits; (ii) to discuss any matters of concern relating to the Funds' financial statements, including any adjustments to such statements recommended by the auditors, or other results of said audit(s); (iii) to consider the auditors' comments with respect to the Funds' financial policies, procedures and internal accounting

controls and management's responses thereto; and (iv) to review the form of opinion the auditors propose to render to the Board and shareholders;

- (c) to consider the effect upon the Funds of any changes in accounting principles or practices proposed by management or the auditors;
 - (d) to review the fees charged by the auditors for audit and non-audit services;
 - (e) to investigate improprieties or suspected improprieties in fund operations; and
 - (f) to report its activities to the full Board on a regular basis and to make such recommendations with respect to the above and other matters as the Committee may deem necessary or appropriate.
4. The Committee shall meet on a regular basis and is empowered to hold special meetings as circumstances require.
 5. The Committee shall regularly meet with the Treasurer of the Funds and with internal auditors, if any, for the management company.
 6. The Committee shall have the resources and authority appropriate to discharge its responsibilities, including the authority to retain special counsel and other experts or consultants at the expense of the appropriate Fund(s).
 7. The Committee shall review this Charter at least annually and recommend any changes to the full Board of Directors.