Considerations for Board Composition:

From Recruitment Through Retirement

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IDC
INDEPENDENT DIRECTORS COUNCIL

Nothing contained in this report is intended to serve as legal advice. Each investment company board should seek the advice of counsel for issues relating to its individual circumstances.

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Introduction

Over time, every fund board, regardless of its size or structure, will naturally confront certain central issues relating to its composition. After all, a board is not static; it changes as directors depart and new members join. The composition of a fund board—in terms of total size, the proportion of independent directors to interested directors, and the backgrounds of the individual directors, among other variables—is heavily influenced by the facts and circumstances of the specific fund complex. Board composition also may be affected by efforts to establish or maintain a good "group dynamic" among board members.

A fund board should reassess its composition periodically to ensure that it continues to be properly constituted to perform its oversight role. As part of this process, a board may address issues relating to: its members' mix of skills, experience, and expertise; the board's processes and criteria for recruiting and selecting new directors; and its processes for integrating or "onboarding" new directors. Other practices that may contribute to maintaining effective board operations include continuing education, working to ensure a robust self-assessment process, limiting a director's length of service or establishing a mandatory retirement age, and developing succession plans.

Over 85 percent of fund boards have at least 75 percent independent directors. Some boards—almost 12 percent—are composed solely of independent directors.

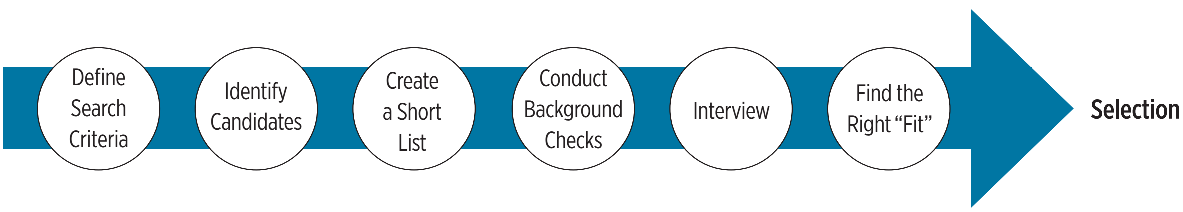
The Independent Directors Council (IDC) prepared this paper to assist directors when considering these and related governance topics.[1] This paper is not intended to prescribe a set of best practices; rather, each board should take into account its own unique facts and circumstances when determining whether and how to address the topics raised in this paper. Whether and how a specific board addresses and resolves these issues is best left to each board's discretion.

Recruitment and Director Selection

Independent directors, as a practical matter, are required to select and nominate other independent directors.[2] Accordingly, a fund board's independent directors typically have primary responsibility for identifying and recruiting new independent directors for the board. They have broad discretion in doing so inasmuch as the Investment Company Act of 1940 (the 1940 Act) and its rules do not prescribe specific qualifications for a fund independent director, other than the independence standards thereunder.[3] U.S. Securities and Exchange Commission (SEC) rules do require though that a fund disclose for each director the specific experience, qualifications, attributes, or skills that led to the conclusion that the person should serve as a director for the fund.[4]

Some boards consider identifying and recruiting new members to be an ongoing function. The process of identifying and evaluating appropriate candidates can be somewhat lengthy, and boards may find it helpful to develop a timeline for the process. In many cases, the timing of a board opening is predictable, such as when the board is going to replace a retiring director. In other cases, the board may decide to expand to fill a specific need or because of a change in the fund complex's business model or strategic needs, such as the introduction of a new line of funds. Ideally, a board should continually be mindful of its future needs for new directors and the potential timing of those needs, including whether a shareholder meeting will be necessary for the election of one or more directors.[5]

Many fund boards have a nominating and/or governance committee—composed solely of independent directors—that focuses on, among other governance topics, the recruitment and selection of independent directors. Some boards might establish an ad hoc committee for this purpose only when a position on the board needs to be filled. Whether recruitment and selection is handled by a committee or all of the independent directors,[6] the process that a board follows to identify and evaluate candidates generally will include the following steps, each of which is discussed more fully in this paper.



Involvement of Fund Management and the Interested Director(s)

The timing and extent of management's input and involvement in the process will vary from board to board. Some boards may wait until they have identified a candidate before a management company representative meets with the person, with the thought that this preserves the independent directors' integral role in the process. Others might invite management to provide input regarding the desired board composition and search criteria early in the process, and they also may invite management to suggest potential candidates or provide its views on the short list of candidates or both. The role of the interested directors also might vary from board to board. For some boards, the interested director(s) may participate in interviewing the short list candidates. For other boards, the interested director(s) may meet with each candidate separately from the independent directors or sometimes with other representatives of the management company. In any case, at some point in the process, the independent directors as a group may wish to meet with each candidate without any interested directors or other representatives of the management company present. This allows for a candid discussion about how the board works with the management company and affords the independent directors a chance to gauge the candidate's perspective on the subject.

Define Search Criteria

When selecting a new board member, the board should take time to determine the type of candidate it is seeking, recognizing that its criteria may evolve during the process. The board might analyze the types of expertise and qualifications it needs by assessing the skills of its current members, thereby identifying the board's existing strengths and weaknesses. For example, the board might seek candidates who qualify as audit committee financial experts or have other relevant experience. When determining the type of experience and background it is seeking in candidates, a board may consider and, depending on its own circumstances, place varying levels of emphasis on the following:

» *Independence.* Of course, any independent director candidate must meet the statutory definition of independence before he or she can serve. Detailed director questionnaires typically are used to help assess the statutory independence of the candidates. This analysis can be challenging for multi-manager funds and funds that use many subadvisers because the independent directors must be independent from each manager and each of its affiliates as well as from each subadviser and each of its affiliates. Many fund boards extend their analysis beyond the 1940 Act and its rules when determining independence and take a more holistic approach by considering any relationships or situations that might call into question an individual's ability to independently discharge his or her fiduciary duties to the fund and its shareholders.[7] When speaking with candidates during the interview process, the board and counsel to the fund or the independent directors should engage in a broad and in-depth discussion about personal, business, and professional relationships that exist or potentially could exist between the candidate (and his or her family members) and the fund's principal service providers and their affiliates and related individuals. On an ongoing basis, independence and potential conflicts of interest remain important issues for a fund's directors. See Appendix A for a discussion about this topic and for sample self-reporting guidelines relating to changes in circumstances that may impact a director's independence. In addition, there are changes in circumstances, such as bringing on a new subadviser, that could jeopardize a director's independence.

- *General experience.* Boards typically consider the general types of experience, qualifications, attributes, or skills that would be desirable in a candidate. These might include financial industry experience, prior service on boards (discussed below), or expertise focused in areas that may help the board understand the needs of a particular shareholder base (e.g., a fund that has section 403(b) or other government plans as shareholders may target a candidate who had a career in public service). A board also may focus on having at least one member with experience in each of the following areas: investment management, risk management, and governance. In addition, a board might want a least one member with experience as an audit committee expert. If the board is lacking in any one of these areas, it may try to find a candidate who could fill that gap.

Independent Director Profiles

- 97 percent were not employed by the complex prior to becoming an independent director.
- 52 percent are currently serving on corporate, major charitable, or major nonprofit boards.
- 46 percent are active full-time employees.
- 32 percent are retired.
- 27 percent previously served as an officer of a company in the asset management industry.

- *Fund industry experience.* Prior fund industry experience often is a desired attribute given the unique nature of mutual funds and other registered investment companies. Directors with experience in fund operations, distribution, regulatory compliance, and other aspects of the fund industry can contribute valuable insights on matters before a fund board. Many independent directors were previously employed in the fund industry or by law firms, accounting firms, and custodian banks that serve the fund industry, although most were not employed by the adviser or other affiliates of the funds they oversee.[8]

- *Fund board experience.* Candidates who currently serve, or have previously served, on another fund board can bring applicable and valuable experience to the board, particularly if the size of the fund complex is comparable. In addition, these candidates can provide the board with knowledge about how others in the industry may have addressed various topics. Still, boards considering candidates with other fund board experience should be mindful of any potential conflicts with the business of the funds or confidentiality issues. Boards have different views about whether current service on another fund board is desirable, and whether a board allows its members to serve on another fund board or limits them in doing so is an issue best resolved within each boardroom.

Fund complexes may limit or require pre-approval of board service outside the complex

- 87 percent of complexes have no specific limits (other than those that represent a conflict of interest).
- 13 percent have specific limits or requirements.

Types and frequency of specific limits or requirements

- 35 percent require pre-approval of service on boards outside the complex.
- 30 percent prohibit service on fund boards outside the complex.
- 13 percent prohibit service on boards of companies in the financial services industry.
- 13 percent set a maximum number of boards outside the complex on which directors can serve.
- 30 percent have other types of limits.

- *Other board experience.* Service on a corporate or nonprofit board may be considered an asset for a potential fund board candidate, as he or she likely will know how to be a part of a consensus-building team, and have experience asking challenging questions as well as making difficult decisions in a boardroom. Service on other boards though may take a significant amount of an individual's time and attention, thereby detracting from the time and attention he or she can devote to the board's work. Recognizing this, some fund complexes limit or require pre-approval of board service outside of the complex. In addition, candidates should be aware that service on a corporate or nonprofit board is different than service on a fund board. This is because a fund board has specific oversight duties set forth by the 1940 Act and its rules. A fund board's focus is on the funds, which may constitute one of a number of the adviser's product lines, and on the performance of the fund's service providers. The board does not exercise direct authority regarding the management, operations, or strategy of those service providers, including the fund's adviser.

» *Employment status.* Some boards may prefer candidates who are currently employed, perhaps because the candidates may be more up-to-date with technology or corporate practices. Others may prefer candidates who are retired because they might have more flexible schedules, allowing them to attend board meetings and devote more time and attention to the position. A board considering a currently employed candidate should take steps to ensure that the candidate has the bandwidth to prepare for board meetings as well as to perform the board's work, and that his or her employment does not pose any conflicts of interest.

» *Age.* Some boards may want to strike a balance between candidates with sufficient background and experience and younger candidates who might have the ability to serve on the board for a number of years before reaching a mandatory retirement age, if applicable. Younger candidates may offer a fresh perspective on items such as technology, social media, and derivatives or customized investment products. In addition, having a younger director on the board may help the board as a whole better reflect the fund's shareholder base. The board should recognize, though, that a relatively young director serving on a board without term limits may hold the position for a long time.

» *Geography.* A board may take into consideration the potential advantages, such as lower travel costs and the ease of convening special in-person meetings, of a candidate who is based relatively close to board meeting locations. On the other hand, geographic diversity may offer certain potential advantages. For example, a board overseeing a fund heavily invested in international securities might benefit from a director living outside of the United States.

» *Diversity.* SEC rules require disclosure in certain shareholder documents regarding whether and how a nominating committee considers diversity in identifying director nominees.[9] In adopting the rules, the SEC declined to define diversity and recognized that boards may define diversity in various ways, reflecting different perspectives.[10] Many boards disclose that they take an expansive view of diversity and seek to construct a "well-rounded" board with members representing a mix of viewpoints, education, skills, and experiences. In so doing, boards may take note of attributes such as gender and race, but typically do not set quotas or establish minimal numerical requirements regarding the gender or racial makeup of the board. With increased attention devoted to this topic, it seems—anecdotally—that boards are working to foster gender and racial diversity in the boardroom.

Identify Candidates

After the board defines the search criteria, the board will determine the method it will use to identify possible candidates, including whether to engage a search firm. Boards identify director candidates in various ways, including any combination of the following: personal relationships, introductions at professional conferences, word-of-mouth, references from outside counsel or the fund's independent auditor, and the use of executive search firms. As noted above, the board also may ask management for names of potential candidates (and would be required to disclose the source of the candidate in any proxy statement seeking election of the director[11]). The board should be aware of the possible limitations in its ability to identify diverse candidates if it relies solely on its members' personal networks.

Fund Complexes Use Multiple Sources to Suggest Independent Director Candidates	
Board committee	85%
All current independent directors	70%
Entire board	56%
Management of the advisory company	53%
Shareholders	35%
Outside counsel	26%
Executive search or recruiting firm	21%
Independent auditor	9%

The source(s) of candidates used by a board will depend on a variety of factors, including its size and the immediacy of its need. For example, a board that is part of a large fund complex might have more resources at its disposal to engage an executive search firm, which may be especially useful if a board is seeking candidates with specialized expertise. In addition, depending upon the scope of the search, boards might wish to hire a third party to screen candidates in order to avoid the inefficiencies and other problems associated with the board screening too many candidates, including some who may have personal relationships with board members.

Boards also should consider when candidates need to fill out questionnaires confirming the requisite independence under the 1940 Act; boards should strike a balance between the need to determine if someone is eligible before they get too far along in the interview process with the inconvenience of having to review and analyze a large number of questionnaires. One strategy to consider is bifurcating the questionnaire; that is, at the outset of the process, only providing potential candidates with the list of any entities in which an independent director may not have an interest, including through ownership of securities. This enables the candidate and the board to quickly determine if any potential independence issues exist. Later in the process, the candidate can complete the remainder of the lengthy questionnaire, which addresses in extensive detail any business, financial, or family relationships with the fund's adviser, principal underwriter, other service providers, and their affiliates.

Create a Short List

The board will then need to decide how it wishes to screen candidates. For example, the entire board may want to review candidate resumes. Alternatively, the nominating committee chair or a subset of the board might wish to conduct the initial review. The goal at this stage is to identify a short list of potential qualified candidates. Mindful of the need to maintain its independence, some boards develop a short list without the involvement of management or any interested directors.

Conduct Background Checks

Once a short list is developed, background checks may be conducted on the candidates. If the board has engaged a search firm, the search firm might conduct the background checks. Otherwise, the board may use independent counsel or seek management's assistance. A board might also decide, because of cost or another reason, to conduct background checks on the candidates after the interview process.

Interview

The board will then typically meet with each candidate. These meetings provide an opportunity for the board to delve deeply into many different areas. Certainly the board will want to gain an in-depth understanding of each candidate's qualifications and prior business experience. In addition, the board will want to understand each candidate's view of—or willingness to learn—the role and responsibilities of the fund board, the candidate's commitment to act for the benefit of shareholders, and whether the candidate will be able to devote the appropriate time and energy to the job.

The interview also presents an opportunity for the board to explain its policies and the expectations of its members. This might include stressing the importance of preparing for meetings and attending the meetings in person, both to meet 1940 Act requirements and to contribute to the board's overall effectiveness. The board also might communicate its policy or expectations about matters such as continuing education and whether its members are required to invest in the funds they oversee.

Fund counsel and/or the independent directors' counsel may attend these meetings, in part to assist in explaining legal responsibilities of fund directors to the candidate. In addition, they might explore the independence of the individual, the existence of any potential conflicts of interest, or any other issues that may affect the individual's candidacy.

Find the Right "Fit"

Critical to the effective operation of any board is finding a group of individuals who complement one another and can work cooperatively together in the interests of the fund and its shareholders. Determining "fit" can be challenging because this essential and subjective element of the selection process is an art, not a science. Boards may use a number of different techniques to try to assess a candidate's compatibility. These might include formal or social one-on-one meetings between board members and the candidate or references from prior employers and business colleagues. In addition, if the candidate previously served on other boards, a board representative may contact directors on those other boards to ask about the candidate. Once the board has made its decision about which candidate(s) will be selected and nominated, it should communicate its decision to the other candidates who were not chosen to join the board.

Integrating New Board Members

Boards employ a number of approaches to integrate a new director, and the approaches should be tailored to an individual director's specific needs. The proper integration of a new director contributes to the effectiveness of both the new director and the board as a whole. Some considerations are discussed below.

Orientation

Every new director, including those with a background in the fund industry, should be oriented to his or her new position. The new director may attend briefings or presentations on various topics, including the board and its governance practices, the funds and their investment strategies, the fund complex and fund operations, and the role and legal responsibilities of board members under the 1940 Act and state law. If it has not already been discussed, the orientation also may provide a useful opportunity to educate new directors about potential liability and related insurance and indemnification arrangements, as well as historical or pending legal and regulatory matters impacting the funds. Typically, management and counsel play a significant role in new director orientation. The director also might have an orientation about the fund industry in general; this broader orientation may be particularly helpful to directors who are new to the fund industry.

These orientation sessions may or may not be open to other experienced members of the board. Because experienced directors can benefit from continuing education, the board might schedule the session so that all directors can attend with the new directors. Other boards may decide to limit the orientation to new directors for a variety of reasons. For example, one of those reasons could be so that the presence of others does not inhibit a new director from asking more fundamental questions.

A new director also might look to other resources for educational opportunities, including counsel, accounting firms, and trade associations. For example, *Fundamentals for Newer Directors,* an online IDC tool, contains information about the role and responsibilities of fund directors and the regulatory framework within which they operate. This tool can provide a useful orientation to any new fund director.

Transitioning onto the Board

Some boards might establish a process to ease a new director's transition onto the board. Approaches include:

- *Overlapping service.* In situations where a new board member is replacing a retiring director, the board might time the appointment or election of the new director to occur prior to the retirement so that both directors can attend one or more meetings together. The overlapping directors' compensation might be reduced during the transition phase. Overlapping service may be particularly complicated for open-end funds, which do not typically hold annual shareholder meetings, because of requirements in the 1940 Act—and perhaps in a fund's governing documents—that a certain percentage of directors be elected by shareholders at all times.[12]

- *Advisory board member position.* A new director also might become an advisory board member before he or she becomes a board member. An advisory board member typically would not have voting rights and may or may not be compensated for his or her service.

- *Short initial terms.* Another possible approach is a short initial term for a new member to serve, such as one year, before he or she is eligible for reelection under the usual terms applicable to board members. This might help ensure that the director is a good fit for the board before both the board and the director make a long-term commitment to each other.

Timing of the New Service

The board might wish to consider the timing of a new director's service. Some boards may determine that the first meeting should be a meeting other than the annual meeting to consider and renew the fund's investment advisory contract. In some cases, an incoming director might attend a meeting—after signing a confidentiality agreement—before he or she formally joins the board, in order to become familiar with how the board operates. In most cases, though, the board is eager for a new member to begin service once that person is selected.

Mentoring

A new director may benefit from having an experienced board member and/or counsel call or meet with him or her prior to the first few board meetings to help review the materials and answer any preliminary questions the new director might have. Some boards assign a peer mentor, who, during a new director's first year, will meet one-on-one with the new director and be available to answer questions. In addition, a new director may be matched up with a representative of the management company whose expertise is in line with that of the director (e.g., the chief financial officer with the board's audit committee financial expert) to help familiarize the director with that aspect of the fund's business and the personnel responsible for it.

Continuing Education

Recognizing that regulatory developments frequently affect fund board oversight and that the fund industry continuously evolves on numerous levels, including types of products, distribution channels, and investment strategies, most boards encourage directors to participate in continuing education. Fund directors can stay abreast of regulatory and industry developments in a number of ways. For example, board members may receive briefings and reports from the adviser, outside counsel, and/or other service providers. A board also might periodically arrange for special education sessions before, after, or as part of its meetings. Many fund directors attend industry conferences, webinars, educational seminars, and regional or local meetings of directors. Some boards require directors attending these events to report back to the rest of the board about what they learned. In addition, there are many online resources offered by industry trade groups, commercial publications, and others.

Board Mergers and Consolidations

Many of the topics discussed in this paper will need to be considered if a fund board changes its composition because of a fund acquisition, a merger of investment advisers, or a consolidation within the fund complex (e.g., from cluster boards to a unitary board). Board mergers and consolidations trigger the need to consider how large the surviving/new board should be and which directors should continue to serve. For example, in the case of a fund acquisition, all, some, or none of the directors of the acquired funds might become members of the surviving board. Which directors drive this process and the role that the respective management companies play will inevitably vary depending upon the specific circumstances. One potential mechanism to sort through the various issues is to establish a joint committee of members of both boards to develop recommendations in appropriate circumstances.

Relevant questions for consideration may include the following:

- What is the desired size of the surviving/new board?
- Is the surviving/new board able to add directors without triggering a shareholder vote under the 1940 Act?
- Who will serve as chair of the board and committees following the consolidation?
- How do the ages of the directors that may be joining the surviving/new board comport with that board's retirement policy, succession planning needs, or desire for a range of ages on the board?
- What is the asset size and type of funds overseen by each board?
- What mix of skills and qualifications should the surviving/new board have?
- What, if any, historical knowledge about the funds to be acquired is important to carry forward?
- What diversity considerations should be taken into account when populating the surviving/new board?
- What economic considerations, including total director compensation levels, should be taken into account when determining the size of the surviving/new board and the locations of its meetings?
- What are management's views about the preceding questions, as relevant to the board's situation?

Resolving these issues is challenging even when just two boards are involved. When multiple boards are involved in a consolidation or merger, the number of directors and the unique attributes of each board complicate the considerations even more. While these issues may be especially sensitive, it is critical that the resolution, like every board decision, be guided at all times by the directors' fiduciary duties to the funds they serve.

If a director is not going to be included in the surviving/new board, the fund or the management company may determine to pay additional compensation to the departing director. This additional compensation might be in recognition of the director's past services and/or to partially compensate the director for the loss of expected future compensation if he or she had remained in good standing on the board to normal retirement age.

Another important consideration is to ensure that going forward an outgoing director has adequate indemnification under the fund's governing documents and adequate liability insurance coverage, either through the fund group's ongoing insurance coverage or through special tail coverage, or both.

Payments to outgoing directors and payments for insurance coverage for outgoing directors can raise sensitive issues and they deserve careful attention, including the issue of whether the fund and/or the adviser is the appropriate party to make the payments. While a board must determine that payments by the fund are in the best interests of shareholders, payments by the adviser may give the appearance that the adviser might be unduly influencing the board composition process. Nonetheless, it may be appropriate for either the fund or the adviser to pay these costs depending upon, among other factors, the impetus for the board reorganization and the relative efficiencies the fund and its adviser may realize. In cases where the board reorganization is being pursued because of the adviser's recommendation, such as in connection with the sale of an adviser's fund business, it is more typical for the adviser to bear these types of expenses.[13] If the consolidation is taking place at the board's recommendation or is focused principally on producing efficiencies for the fund, the board may determine that the fund should bear some or all of the expenses. The departing director also might agree to provide future services through a consultancy arrangement.

Self-Assessments

Self-assessments play an integral role in maintaining effective board composition, because the assessment presents a prime opportunity to consider the makeup of the board and whether any changes may be appropriate. The SEC's fund governance standards—which, as noted above, apply to the vast majority of funds—require fund boards relying on certain exemptive rules to conduct an annual self-assessment. The self-assessment requirement does not specify how a board should conduct the assessment or document it. In addition, the requirement does not prescribe the specific aspects of a board's operations that must be considered, except in two areas: the effectiveness of the board's committee structure and the number of funds overseen by directors. The SEC has stated though that the minutes of the board meeting at which the self-assessment is discussed should reflect the substance of the matters covered.[14] Given that the SEC's requirement largely defers to boards regarding the topics covered by the self-assessment and how it is conducted and documented, there is no single particular "best practice" in this area and the approaches boards use can reasonably vary based on the circumstances. Boards should consider periodically whether to vary their self-assessment practices to keep the process fresh and not perfunctory. Some considerations with regard to designing self-assessments follow.

Topics

Most boards have a list of topics they suggest the assessment should cover, such as quality of written board materials, level of engagement by board members, level of preparation by board members, attendance, and appropriateness of board composition. In some instances, boards may have an open discussion in which the directors discuss any topic of interest to them, even if it is not covered in a preestablished list of topics. When considering how to conduct a self-assessment, boards may find it useful to refer to *Board Self-Assessments: Seeking to Improve Mutual Fund Board Effectiveness,* a paper that IDC published shortly after the SEC adopted the requirement. In addition, a template for potential discussion items is included in Appendix B of this paper. Regardless of the topics for the self-assessment, directors should critically examine them, identify any shortcomings in current processes and procedures, and suggest any areas for improvement.

Process

Boards often conduct a self-assessment session with only the independent directors, followed by a session of all directors. Many boards look to someone to serve as the facilitator of the self-assessment process. Common facilitators include the board chair, the chair of the governance committee or a similar committee, or outside counsel (see "Documentation" on page 16 for a discussion about applying the attorney-client privilege to board self-assessments). Some boards may engage a professional facilitator or an outside governance consultant to help with the process.

Some boards prefer to have each director complete a written questionnaire, then have the facilitator consolidate or summarize the various responses. The questionnaire may ask directors to rate how effectively the board is doing in each area, elicit open-ended responses, or a combination of both. Other boards might wish to engage in an informal discussion about the topics at an in-person meeting with all of the board members. Still other boards may prefer that the facilitator engage each board member in a one-on-one conversation or interview, and then consolidate and summarize the findings. Boards taking this approach might ask the facilitator to distribute a questionnaire prior to the conversation or interview so that the board members have time to consider the discussion items before the interview. Deciding which process to use depends on a number of factors, including:

- The extent to which the directors will be candid in their responses. This may be more likely with the anonymity of a written questionnaire or in one-on-one interviews than in an open meeting with a large number of participants.
- The time and resources available to the board and facilitator. An informal discussion can occur at a board meeting, while compiling responses through interviews or questions will take more time and resources.
- The desire for an interactive dialogue between the board and facilitator.

- Sensitivity to creating a written record of the evaluation results. A written questionnaire might raise concern about how the record may appear to, or be misinterpreted by, third parties and whether the record may be used against the board in regulatory or civil litigation. This is discussed in “Documentation” on page 16.

Peer Reviews

In addition to conducting a self-assessment of the board as a whole, some boards also evaluate committee chairs, board chairs, and/or individual board members. A board might wish to conduct peer reviews in an anonymous setting, such as through a third-party service that elicits and summarizes anonymous input from individual directors. Conducting peer reviews and/or individual self-assessments as part of the annual board self-assessment may enable individual board members to get constructive feedback and understand his or her strengths and weaknesses as perceived by other board members. Still, a board should not wait for the self-assessment to address a situation in which one of its members is not contributing to the board’s effectiveness.

Formal Policies and General Practices for Peer Reviews	
Fund complexes with no formal policies or general practices for peer reviews	77%
Peer reviews occur, but there is no formal policy	16%
Fund complexes with a formal policy for peer review	7%

In circumstances where a board is faced with an underperforming director, the feedback given to the director should be as specific as possible to give the director a practical sense of how to improve his or her performance (e.g., the director is failing to provide meaningful input to board discussions, the director often distracts from the discussion by asking off-topic questions) and the time in which improvement is expected before other remedial action will be taken. The board also should familiarize itself with the fund’s charter and bylaws to see if, and under what circumstances, the board may remove an underperforming member, including whether removal can take place with or without cause.

Additional Input

In addition to the assessment performed by the entire board, some boards may choose to conduct self-assessments at the committee level.[15] Boards also might find it helpful to gather input from key personnel of the fund’s adviser or from other principal service providers to contribute to the discussion and offer suggestions for improving the board’s effectiveness. For example, the board may solicit feedback from the fund’s chief compliance officer about the compliance committee’s performance. The board also might ask the fund’s audit firm whether it is satisfied that the audit committee collectively has the financial expertise it needs to be effective.

Documentation

If a board elects to conduct the self-assessment using written materials, those writings, and any other documentation resulting from a self-assessment, raise the issue of what, if any, self-assessment documentation the board should retain.

As noted above, many boards use counsel to facilitate the self-assessment process. A potential advantage of this practice is that the attorney-client privilege may protect certain communications relating to the self-assessment from discovery in the event of litigation or an SEC examination. Whether the privilege applies is fact-dependent, however, and boards should understand that there is no practical way to fully guarantee that these materials will be shielded from discovery. The attorney-client privilege applies only to confidential communications reflecting requests for, or the provision of, legal advice. Thus, to the extent that the self-assessment materials reflect counsel's guidance regarding compliance with fiduciary and other legal duties, such communications should be deemed by a court to fall within the protection of the attorney-client privilege. By contrast, the privilege will typically be held not to apply where communications with counsel were for purely *business* purposes or where counsel was simply carrying out a ministerial task that a nonlawyer could just as easily have completed.

In other words, simply including an attorney among the recipients of an email, or involving an attorney in the creation of a document, does not in and of itself ensure that the privilege attaches to that communication or document. And counsel's mere presence at self-assessment board meetings will not by itself cloak the meetings or resulting minutes with a privilege protection. Rather, the privilege is most likely to apply to those communications where the attorney's advice relates to a board's adherence to legal standards. In addition, in instances where the privilege does apply, it can easily be waived by disclosure of the privileged communication to third parties. For example, minutes about the self-assessment or other board meeting materials typically available to management and other service providers would generally be considered outside the scope of attorney-client privilege.

Finally, it is worth noting that the SEC staff has occasionally taken the position that any and all fund documents are subject to examination at any time, with no privilege available vis-à-vis the staff. Given that self-assessments are essentially mandated by the SEC exemptive rules, the staff might be expected to take this position regarding assessment materials they are interested in reviewing. Whatever the merits of the counterargument, it can be difficult as a practical matter to resist a regulator's demands to turn over documents.

Length of Service

For open-end funds, there are no legal or regulatory requirements relating to the maximum age or length of service for a fund director.[16] Many boards have mandatory age–based retirement policies and fewer have term or maximum length of service limits to dictate the maximum length of a director's service.[17] Some boards have a combination of both. For example, a director may serve until he or she reaches the age of 74 or has served for 20 years, whichever comes first.

A mandatory retirement policy or term limit helps establish a degree of predictability in turnover and thus facilitates succession planning (discussed below). These policies also establish consistent, objective criteria for the completion of a director's service. In addition, either type of policy aids the orderly introduction of new directors who can bring fresh perspectives to the boardroom. As noted in the call out box, there has been a trend in recent years to increase the mandatory retirement age of fund boards. This is partly due to improvements in health care and longevity among the adult population, which allow directors to perform effectively at more advanced ages.

Mandatory retirement policies and term limits

- An increasing number of fund complexes have adopted mandatory retirement policies, from 45 percent in 1996 to 67 percent in 2012.
- The average mandatory retirement age is 74.
- In recent years, a number of fund boards have increased the mandatory retirement age from 72 to 75.
- Some boards specify terms for board service, but this practice is still uncommon.
- Term limits may be more relevant for fund boards with younger directors who might be able to serve for a number of years (e.g., 20 years) before reaching a mandatory retirement age.

A potential downside of mandatory retirement policies and term limits is that they might require high-performing directors to retire when their institutional knowledge, experience, and productivity remain valuable to the board. For this and other reasons, some fund boards do not have mandatory retirement policies or term limits. Instead they elect to address director retirement on an ad hoc or less formal basis. Others may have retirement policies, but allow for exceptions or annual renewals of a director's term under particular circumstances. For example, a board might determine that an unexpected event in the financial markets, an impending merger or acquisition of the fund's adviser, or taking the lead to oversee a particular project warrants retaining an experienced and knowledgeable director beyond a mandatory retirement age or term limit. Whenever an exception is made to a policy, other directors may assume that the exception should apply to them as well. Therefore, boards should take care not to establish expectations for regular exceptions if that is not the board's intention.

If a board determines to adopt or modify a mandatory retirement policy or term limit, it should consider the following:

- » What is the ideal mandatory retirement age or term limit?
- » Should the policy apply to existing board members? Or should certain or all current members be grandfathered in under the prior policy?
- » What is the most appropriate timing for the policy to take effect?
- » Should the policy require a director's term to end immediately when the director reaches the retirement age or serves the specified term? Or at the end of the calendar year or quarter when the director reaches the specified age or term end?
- » Does the board foresee making exceptions to the policy? If so, under what circumstances? What process will be applied to determine whether an exception will be granted? What is an appropriate length of time for any exceptions?

Boards without mandatory retirement policies or term limits rely on less specific means for determining when a director's service should end, including a board member's decision to retire based on his or her own circumstances. Boards also may use the annual self-assessment process to assess an individual director's performance and to consider whether it is time for a director to resign or retire.

Boards with retiring directors should remind those individuals to maintain confidentiality to the funds they oversaw; likewise retiring directors should realize that they have a continuing duty of confidentiality to those funds. In addition, a retiring director should be aware that he or she may have ongoing obligations or liability exposures. For example, a retired director might be called to testify regarding acts or omissions that occurred during his or her service on the board or may face potential claims for such acts or omissions.

Succession Planning

Succession planning can help a board effectively manage many of the topics raised in this paper. Boards take various approaches in this regard. Boards often assign the responsibility of succession planning and identifying replacement candidates to the board's nominating committee, and they may work with counsel to develop a timeline to help the planning process. Boards also might identify the key attributes of an outgoing director in order to anticipate the necessary skills, expertise, leadership style, and personal characteristics that will be most needed in a replacement.

When faced with a pending director vacancy, a board may consider other circumstances that might warrant identifying and appointing additional directors at the same time. For example, if other members of the board are close to a mandatory retirement age, then the board may wish to recruit one or more directors in addition to filling the expected vacancy.

To maintain continuity and avoid losing the benefit of valuable experience, a board might grant an outgoing director emeritus status, although this practice is rare. Typically this means that the director will be a nonvoting board member for a certain period of time, such as one year, and may receive reduced compensation for that service.

Boards also should plan for the succession of board chairs and committee chairs. One strategy is to rotate these positions (i.e., each member of the board or committee serves as chair for a certain amount of time). Another strategy is for the board or committee to elect a vice chair who will become chair at the appropriate time. In the case of a committee chair, a new chair will likely be chosen from the committee. This also is true of the board chair—most boards will choose a director who has been on the board for a number of years and is well versed in the history of the board and the funds it oversees. In some cases, however, the board may recruit a new director with proven leadership skills to become chair or lead independent trustee.

Conclusion

The composition of a fund board will vary over time. Every board should periodically assess its composition to ensure that it continues to be properly constituted to effectively perform its oversight role on behalf of its funds and their shareholders. Boards should be mindful of the topics raised in this paper and, where appropriate, adopt policies to address them.

Appendix A: Independence Considerations

It is important for a fund board to ensure the continued independence of its independent directors and to stay apprised of any potential conflicts of interest. This is often done through an annual director questionnaire that solicits information about, among other things, business, financial, and family relationships with the fund's adviser and affiliates as well as other major service providers. In addition, fund boards should consider adopting a policy requiring each independent director to inform the board promptly of changes in his or her business, professional, or personal situation that may impact his or her objectivity, continued board service, or ability to devote sufficient time and attention to board matters. Below are sample self-reporting guidelines.

It is possible that a director may continue to be independent for purposes of the 1940 Act, but his or her objectivity may be compromised by a business, financial, or family relationship. In this case, the board might consider a number of different approaches to address the matter, including the following:

» Having the director abstain from voting on matters relating to the potential conflict

» Having the director disclose the matter to the full board and continue to vote or

» Not allowing the director's vote to be the deciding one in approving any matter relating to the potential conflict

When determining its approach, the board and its counsel should take into account the nature of the potential conflict; whether it will be ongoing; whether any other persons or entities, such as a service provider of the fund, are involved in a particular matter requiring board attention; and any other relevant factors.

Sample: Independent Director Self-Reporting Guidelines

Each independent director shall inform the chairman of the board of any changes in his or her business, professional, or personal situation that are likely to affect his or her objectivity when considering matters to be brought before the board, his or her ability to continue serving on the board, or his or her ability to devote sufficient time and attention to board matters. These changes may include, but are not limited to:

» Any regulatory or legal action connected to the independent director's service on another board in which the director is a defendant

» Any regulatory or legal action brought against the independent director personally, if the action relates to matters affecting the personal integrity or financial acumen of the director, including a personal or self-owned business bankruptcy

- Joining or resigning from a corporate or fund board of directors
- Changes in full-time employment
- Taking on other business or professional activities or consulting relationships that are likely to result in a substantial overall increase in the independent director's time commitment devoted to matters other than fund board matters
- Changes in an immediate family member's employment that are likely to impact the independent director's objectivity, even if it does not impact his or her independence for 1940 Act purposes
- A health issue that may impair the independent director's ability to carry out his her duties

In addition, if a fund is considering entering into a contract or other arrangement with a principal service provider and an independent director or his or her immediate family member has a significant business or professional relationship with that service provider, the independent director shall inform the board chairman of the relationship. Disclosure is not required if the independent director is a client of a principal service provider, or invests in a product sponsored by the service provider, and receives no significant preferential treatment over similarly situated clients or investors.

Appendix B: Examples of Board Self-Assessment Discussion Items

Set forth below is a nonexclusive list of discussion items for a board's self-assessment. After a discussion and evaluation of the results of the self-assessment, the board may consider developing an action plan, including a timeline and an assignment of responsibilities, for any items the board identifies as needing follow-up.

Board Composition and Resources

- Size: Does the board have the right number of directors?
- Number of funds: Is the board able to devote sufficient time and attention to matters specific to each individual fund it oversees and matters common to all funds?
- Qualifications of directors: Does each director possess the appropriate level of sophistication, skill, experience, and business acumen to contribute effectively to the board in its oversight role? Are there skills or experience not represented on the board that would be valuable to the fund and its shareholders?
- Ratio of interested to independent directors: Is the current mix of interested and independent directors appropriate, both from a legal perspective and from the perspective of ensuring that the board will be an effective watchdog for the interests of fund shareholders?
- Term limit or retirement policy: Should the board adopt a term limit or retirement policy? If there is a term limit or policy, is it appropriate?
- Resources: Does the board have sufficient resources to effectively perform its function? Do the directors take advantage of ongoing continuing education opportunities to assist them in carrying out their responsibilities?
- Compensation: Is the board and committee compensation, including its structure, appropriate?

Conduct of Meetings

- Meetings: Is the frequency appropriate? Is the length of the meetings such that directors may adequately consider agenda items and other issues that arise?
- Agenda: Do the directors have sufficient input into the agenda?
- Information provided to the board: Assess the adequacy and quality of the information directors receive. Is it complete, informative, and presented in a manner that facilitates understanding of the material?
- Meeting dynamics: Do the directors actively participate in board meetings? Do board meetings contain the desired degree of flexibility to allow directors to appropriately explore areas of interest? Do meetings focus on important issues, or is too much time spent on ancillary matters? Do directors meet in closed sessions with management, independent auditors, counsel, and the chief compliance officer when appropriate?
- Effectiveness of board leaders: Assess the performance of the chairman, lead independent director, and committee chairs. Are the meetings efficient and well run?

Relationship with Management

- Access to senior management: Are sensitive or important matters discussed with appropriate senior levels of management? Is management available during and in between meetings? Does management bring important issues to the board or chairs as they arise in between regularly scheduled meetings?
- Overall relationship with management: Assess whether the board has established a good and trusted relationship with management.

Relationship with Chief Compliance Officer and Counsel

- Relationship with chief compliance officer: Assess the board's relationship with the chief compliance officer.
- Relationship with legal counsel: Assess the board's relationship with the chief legal officer, board counsel, and fund counsel.

Committees

» Structure: Consider the board's committee structure. Does the board have the right number and mix of committees to facilitate director oversight of common issues among all funds overseen by the board as well as issues specific to each individual fund? Is each committee's composition and scope of responsibilities appropriate?

» Meetings: Does each of the board's committees meet on an appropriate basis with special meetings called as needed? Is the length of meetings sufficient so that members may adequately consider agenda items and other issues that arise? Are committee members provided with suitable information and materials sufficiently in advance of the meetings to carry out their responsibilities?

» Audit committee: Assess the committee's relationship with the fund's independent registered public accounting firm and the process for determining auditor independence. Does the committee receive sufficient information to adequately oversee the audit of the fund's financial statements? Is the audit committee adequately apprised of issues that may arise during the course of the audit?

Notes

1 The Investment Company Institute (ICI) and IDC collect information on fund board practices from participating fund complexes through the *Directors Practices Study.* This paper includes information collected in the *Directors Practices Study* covering the year ended December 31, 2012, some of which is reported in the *Overview of Fund Governance Practices, 1994–2012,* available at www.idc.org/pdf/pub_13_fund_governance.pdf. The *Directors Practices Study* covering the year ended December 31, 2012, reported information collected from 171 fund complexes with 227 boards. These complexes managed approximately 93 percent of industry assets and 88 percent of industry funds.

2 This requirement is part of the fund governance standards contained in Rule 0-1(a)(7) under the Investment Company Act of 1940. Funds relying on certain exemptive rules under the 1940 Act, which are the vast majority of funds, must comply with the fund governance standards.

3 The 1940 Act imposes certain other technical requirements regarding board composition. For example, Section 10(b) prohibits a majority of the board from being (i) a broker or an affiliated person of a broker, (ii) a principal underwriter of a fund or an interested person of the principal underwriter, or (iii) an investment banker or an affiliated person of an investment banker. Similarly, Section 10(c) prohibits a majority of the board from being an officer, director, or employee of any one bank or bank holding company. Also, Section 9 deems that persons who are involved in certain serious misconduct resulting in criminal prosecution or enjoinment are not eligible to serve as fund directors.

For closed-end funds, the New York Stock Exchange (NYSE) imposes certain additional requirements. For example, NYSE rules require that each audit committee member for a closed-end fund be financially literate—as interpreted by the board's business judgment—and that at least one member have accounting or related financial management expertise. See NYSE Listed Company Manual § 303A.07.

4 See Form N-1A, Item 17(b)(10).

5 The 1940 Act generally requires that upon the addition of a new director, at least two-thirds of the total number of board members must have been elected by the fund's shareholders and that a shareholder meeting is required when less than 50 percent of the directors have been voted on by shareholders.

6 For the sake of simplicity, the term "board" is used throughout this paper to refer to the group, whether it be a nominating committee, some other committee, or all of the independent directors, that is charged with researching, recruiting, considering, and/or formally naming potential board candidates.

7 In analyzing the statutory independence of candidates, boards should be mindful of any disclosure requirements that may be triggered. For example, Form N-1A Item 17(b)(6) requires disclosure of any interest, the value of which exceeds $120,000, of independent directors and their immediate family members in any adviser or principal underwriter of the fund. Similarly, Form N-1A Item 17(b)(7) requires disclosure of any material interest of independent directors and their immediate family members in any transaction(s) with the fund or a related party when the amount exceeds $120,000.

8 It is considered an industry best practice for any person formerly affiliated with the fund's adviser, principal underwriter, and their affiliates not to serve as an independent director of the fund. See Investment Company Institute, *Report of the Advisory Group on Best Practices for Fund Directors: Enhancing a Culture of Independence and Effectiveness* (June 24, 1999) (*Best Practices Report*), available at www.idc.org/pdf/rpt_best_practices.pdf. Furthermore, any receipt of ongoing retirement benefits by such person from the fund's adviser, principal underwriter, and their affiliates may disqualify the individual from serving as an independent director.

[9] See Item 407(c)(2)(vi) of Regulation S-K (made applicable to funds by Item 22(b)(15)(ii)(A) of Schedule 14A). See also "Making Investors a Priority in Regulatory Reform" by Luis A. Aguilar, Commissioner, U.S. Securities and Exchange Commission, before the Independent Directors Council Spring Workshop (April 17, 2009), available at www.sec.gov/news/speech/2009/spch041709laa.htm.

[10] See *Proxy Disclosure Enhancements,* SEC Rel. Nos. 33-9089; 34-61175; IC-29092 (Dec 16, 2009), available at www.sec.gov/rules/final/2009/33-9089.pdf.

[11] See Item 407(c)(2)(vii) of Regulation S-K (made applicable to funds by Item 22(b)(15)(ii)(A) of Schedule 14A). The proxy rules also require disclosure about any policy regarding the consideration of candidates recommended by shareholders or, if no such policy exists, the reason why it is appropriate not to have such a policy.

[12] See supra, note 5.

[13] In such circumstances, advisers may also want to consider the applicability of Section 15(f) of the 1940 Act, which provides, generally, that an "unfair burden" may not be imposed on funds in connection with a sale of an adviser's fund business.

[14] See Investment Company Act Release No. 26520 (July 27, 2004).

[15] NYSE rules require the audit committee of a closed-end fund to have a written charter that addresses an annual performance evaluation of the audit committee. See NYSE Listed Company Manual § 303A.07.

[16] Directors of closed-end funds listed on stock exchanges are typically elected for one- or three-year terms, but may be reelected at the end of each term.

[17] ICI's *Best Practices Report* recommends that fund boards adopt a policy on director retirement, but leaves the type of policy (e.g., retirement age or term limits) to the discretion of the board.

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