

## Frequently Asked Questions About Mutual Fund Directors

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### I. Introduction to Mutual Fund Boards and Directors

#### **What is a mutual fund and how is it structured?**

A mutual fund is a pool of stocks, bonds, and other investments owned by the fund's investors (the shareholders). A fund is typically externally managed; it is not an operating company and it has no employees in the traditional sense. Instead, a fund relies on third parties or service providers that are either affiliate organizations or independent contractors (the investment adviser, distributor, custodian, transfer agent, and others) to invest fund assets and carry out other business activities. All mutual funds are required by law to have a board of directors (sometimes referred to as a board of trustees).

#### **What does a mutual fund's board of directors do?**

In broad terms, the board oversees the management and operations of the fund on behalf of the fund's shareholders. Directors also have significant and specific responsibilities under the federal securities laws. Among other things, they oversee the performance of the fund, approve the fees paid to the investment adviser for its services, and oversee the fund's compliance program. A director's role is to provide oversight and not to be involved in day-to-day management.

#### **What is the role of the board's independent directors?**

The Investment Company Act of 1940 (1940 Act)—the primary federal law governing mutual funds and directors—imposes specific responsibilities on independent directors and looks to them to monitor potential conflicts of interest between the fund and its adviser.

According to the Supreme Court, the independent directors have “the primary responsibility” for looking after the interests of the fund's shareholders and serve as “independent watchdogs” who “furnish an independent check” upon the management of the fund. The 1940 Act requires a certain percentage of each fund's directors to be independent.

#### **What makes a director “independent”?**

A director must satisfy a number of specific and stringent requirements to be “independent.” In general, under the 1940 Act, an independent director cannot currently have, or at any time during the previous two years have had, a significant business relationship with the fund's adviser, principal underwriter (distributor), or affiliates. An independent director also cannot own any stock of the investment adviser or certain related entities, such as parent companies or subsidiaries.

#### **How are mutual fund boards different from or similar to corporate boards?**

Like the directors of a corporate board, mutual fund directors oversee the management and operations of a company (the fund) and have a fiduciary duty to represent the interests of shareholders. The focus of mutual fund directors, however, is slightly different because of the structure of mutual funds. Because a fund has no employees and relies on the adviser and other service providers to run the fund's day-to-day operations, the board focuses on the performance of these entities under their respective contracts and monitors potential conflicts of interest. As discussed [below](#), the 1940 Act and its rules set forth specific duties of mutual fund directors.

It is important to note that the mutual fund board is not the board of the fund adviser. In fact, in some cases, the adviser may itself be a public company with its own board of directors and shareholders. Thus, while the fund board oversees the services the adviser provides to the mutual fund, it does not oversee the management and operations of the adviser.

### II. Duties and Responsibilities

#### **What is a director's fiduciary duty?**

Directors have the fiduciary duty to represent the interests of the fund's shareholders and are subject to state law duties of loyalty

and care. The duty of loyalty requires that directors use their positions of trust and confidence to further the interests of the fund and its shareholders ahead of their private interests. Fundamental to the duty of loyalty is the avoidance of self-dealing and of conflicts of interest that are detrimental to the fund. The duty of care requires directors to perform their duties in good faith, in a manner reasonably believed to be in the best interests of the fund, and with the degree of care that an ordinarily prudent person in a like position would exercise under similar circumstances. The duty of care also requires that directors be informed, apply their business judgment, and reach reasonable decisions.

### **What specific responsibilities does a mutual fund director have?**

The federal securities laws impose significant responsibilities on mutual fund directors and on independent directors in particular. One of the board's most important statutory responsibilities is to annually evaluate and approve the fund's contract with the adviser (the advisory contract). Directors also must approve certain distribution plans (e.g., distribution plans commonly referred to as "Rule 12b-1 plans").

The federal securities laws also specifically require directors to oversee, among other things:

Fair valuation determinations for certain securities held by the fund;

Voting of proxies for the fund's portfolio securities;

The compliance function, which includes approving written policies and procedures and the hiring and compensation of the fund's chief compliance officer; and

The process by which fund disclosure (including prospectuses) is prepared, reviewed, revised, and updated.

Also, as part of its general oversight responsibilities, the board monitors various fund matters, including investment performance, risk management, custody of assets, and shareholder services.

### **How does a mutual fund board fulfill its responsibilities?**

Throughout the year, mutual fund boards are engaged in a variety of ways in overseeing funds. They meet regularly, request and review numerous reports relating to fund matters (including investment performance and the compliance function), and engage in discussions with the adviser, counsel, and others.

A good example of how a mutual fund board fulfills its responsibilities is the annual review and approval of the advisory contract. Directors are required to approve the contract at an in-person meeting. However, as noted [below](#), the process of preparing for that meeting is rigorous and takes several months, if not the entire year. Directors continuously assess the quality of the services provided by the adviser. Should any of those services need improvement, directors can and do require advisers to provide appropriate additional resources to resolve the issue.

### **What are directors' responsibilities in approving the adviser's fees?**

The adviser's fees are part of the advisory contract that directors review and approve every year. The board is required to request and evaluate—and the adviser is obligated to furnish—the information that may be reasonably necessary to evaluate the contract. The SEC requires boards to consider a host of factors and for funds to disclose the basis for the board's approval. Directors participate in numerous meetings to consider and review hundreds if not thousands of pages of detailed information in the contract approval process.

Directors are not required to negotiate for the absolute lowest rate with the adviser. Instead, regulators and the courts recognize that directors must balance a number of considerations, including the nature, extent, and quality of the services provided by the adviser. Good performance, which is ultimately what shareholders are seeking, may best be achieved by paying the adviser a competitive rate, rather than the lowest possible fee. In the fee approval process, however, directors do often require the adviser to take steps to bring fees down, such as instituting breakpoints at specified asset levels, waiving fees, reducing fees outright, or enhancing services.

The overall fee-setting process works. [Fund fees and expenses](#) have declined over the past 20 years and shareholder services have increased.

### **Can the board fire the fund's investment adviser?**

It's possible, but it rarely happens, for a number of reasons. Unless there are extreme circumstances, such as fraud, a change of advisers would be costly, disruptive, imprudent, and, of greatest significance, contrary to shareholders' express intention to invest with a particular money manager.

Directors have other means to effect more targeted changes to increase the quality of the adviser's services or the fund's investment performance. For example, they can urge the adviser to hire a new portfolio manager for the fund, move to a team approach of portfolio management, increase its investment research capability, retain a subadviser, or merge the fund.

In a memorandum cited in IDC's [brief](#) to the Supreme Court in *Jones v. Harris*, the SEC explained that "[t]he infrequency with which fund directors have rejected investment advisory contracts does not necessarily indicate that directors . . . have not been forceful

enough in representing shareholder interests.” This is because “directors can and frequently do employ means other than contract termination to effect changes in the best interests of funds.”

### **Can directors be held liable for their actions?**

The 1940 Act authorizes the SEC to bring an action against any director who, through personal misconduct, breaches his or her fiduciary duty. The federal securities laws also make mutual fund directors civilly liable for materially misleading statements made by the fund in its prospectus.

Directors also can be liable for a breach of their fiduciary duties (such as the duties of loyalty and care discussed above) under state law. A state law concept known as “the business judgment rule” may protect independent directors from personal liability where they have acted on an informed basis, in good faith, and in the honest belief that the action taken was in the best interests of the fund.

## **III. Service on a Mutual Fund Board**

### **How are mutual fund directors selected?**

All directors on a mutual fund board have been elected by the fund’s board and, in many instances, by fund shareholders. New independent directors generally are elected by the existing independent directors and, when necessary (or if deemed desirable by the board), by the fund’s shareholders. The 1940 Act generally requires that at least two-thirds of the board be elected by the fund’s shareholders. When a new fund complex is launched, the fund sponsor (often an investment adviser) typically is the initial and sole shareholder of the new funds and elects the initial slate of directors.

### **Are there any requirements for who can be on a mutual fund board?**

There are no legal requirements pertaining to the qualifications of a director. Boards commonly are composed of directors with diverse backgrounds in accounting, law, investment management, academia, general business, and other professions and fields. Background and other information about each director are included in fund documents, which are available on the SEC’s website and from the fund. Certain persons (such as those convicted of a crime within the past 10 years) are ineligible from serving as a fund director.

### **How are directors compensated?**

Independent directors of mutual funds are compensated for their time and service generally by the funds they oversee. The adviser typically pays the compensation of directors who also are officers or employees of the adviser.

Compensation varies within the industry and may depend on a number of factors. Differences in the complexity and size of funds and fund groups overseen by a director; the time commitment required for meetings and other duties; the number of meetings; and the compensation levels necessary to attract highly qualified people all can play a role in determining compensation.

Director compensation may be structured in different ways and can include an annual retainer, meeting attendance fees, a deferred compensation plan, a retirement program, or other benefits. Independent chairs, lead independent directors, and committee chairs may receive additional compensation for their added responsibilities. Unlike corporate directors, mutual fund independent directors do not receive shares or options in the mutual fund.

### **Who determines director compensation?**

Independent directors set their own compensation. This is consistent with a recommendation of the Investment Company Institute’s (ICI) [Advisory Group on Best Practices for Fund Directors](#), which found that 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. Directors frequently rely on independent sources of information, such as industry surveys, when considering their compensation.

### **How long do directors typically serve on a mutual fund board?**

Director tenure generally is not governed by law, so practices regarding terms for mutual fund directors vary. Some boards have mandatory retirement policies based on age or length of service (term limits).

### **Where can investors find information about a mutual fund’s directors?**

Every mutual fund is required to disclose information about its directors, including their compensation, ownership of fund shares, other directorships, and experience and qualifications in the fund’s statement of additional information. Some fund groups provide information about their funds’ boards on their websites.

## **IV. Board Structure and Practices**

### **How many directors are independent on a typical fund board?**

While board sizes vary, the 1940 Act requires that at least 40 percent of the directors on a board be independent. In [practice](#), independent directors hold an overwhelming majority (75 percent) of board seats in nearly 90 percent of fund complexes.

### **What role do independent directors play in the leadership of fund boards?**

Research by ICI and the Independent Directors Council (IDC) shows that mutual fund boards at nearly two-thirds of fund complexes have an [independent director](#) serving as the board's chair. At almost one-fourth of complexes, independent directors serve as independent lead directors on the funds' boards. Practices in this area vary, and boards have the discretion to determine the leadership structure and role for independent directors that works best for them and the funds they oversee.

### **What is the role of the independent board chair or independent lead director?**

The independent board chair leads the board in all aspects of its responsibilities. The independent lead director does the same, on behalf of the other independent directors. Both the independent board chair and independent lead director typically participate in the formulation of board meeting agendas; serve as a liaison between the independent directors and management between board meetings; and serve as the primary contact for the board's counsel.

### **What are some governance practices that mutual fund boards follow to achieve independence and effectiveness?**

The SEC has established governance standards for mutual fund boards that must be followed by funds that rely on certain exemptive rules. Nearly all funds fall into that category. These standards include:

- Independent directors must select and nominate other independent directors. Independent directors, not the fund's adviser or interested 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.
- Any attorney for independent directors must be "independent legal counsel" (generally with a law firm that does little or no work for the adviser and certain of its affiliates). Although independent directors are not required to have independent legal counsel, research by [IDC and ICI](#) shows that virtually all do.
- Boards must conduct annual self-assessments designed to increase their effectiveness. The self-assessment is intended to strengthen directors' understanding of their role, foster better communications and greater cohesiveness, and help directors identify potential weaknesses and deficiencies in the board's performance.
- Independent directors must meet in executive session at least quarterly. These executive sessions offer an important opportunity for the independent directors to talk with their counsel and with each other about significant matters on the board agenda. Such sessions also help to strengthen the collegiality and cohesiveness, and thus the effectiveness, of the independent directors.

The [ICI Advisory Group on Best Practices for Fund Directors](#) recommended these and other practices in its 1999 report. The report also recommended that:

- Independent directors establish the appropriate compensation for serving on fund boards;
- Fund directors invest in funds on whose boards they serve;
- Boards generally be organized either as a unitary board for all the funds in a complex or as cluster boards for groups of funds within the complex, rather than as separate boards for each individual fund;
- Fund boards adopt policies on retirement of directors;
- Former officers or directors of the adviser, principal underwriter, or certain of their affiliates not serve as independent directors of the fund; and
- New fund directors receive appropriate orientation, and all fund directors keep abreast of industry and regulatory developments.

### **How often do mutual fund boards meet?**

Boards generally meet quarterly, and many have a fifth meeting devoted to the review and approval of the advisory contract. These meetings allow directors to be informed about the affairs of the fund, ask questions, and deliberate and vote on issues important to the fund and its shareholders. Throughout the year, directors may have additional meetings (in person or by telephone) to address specific issues that may arise.

### **Do mutual fund boards have committees?**

Yes, many boards establish committees to focus on specific subject matters (e.g., audit, governance, investments). The time and effort required of mutual fund directors, especially independent directors, have grown exponentially as the industry has increased in size and complexity and as new regulations have expanded directors' duties. In this environment, boards frequently use committees to help manage their workloads and to enable greater in-depth review and oversight of particular aspects of the fund's operations.

### **Are mutual fund directors required to invest in the funds they oversee?**

No, directors are not required by law to own shares in funds they oversee. Many boards, however, have adopted policies requiring or encouraging their directors to do so. The SEC requires disclosure of the dollar value (in ranges) of a director's investment in any funds that he or she oversees. While fund ownership may help to align directors' interests with those of fund shareholders and

enable them to learn more about the quality of the services from a shareholder's perspective, there is no evidence that requiring director ownership leads to improved investment returns for the funds.

### **Do mutual fund directors oversee multiple funds?**

Yes. The unique structure of mutual funds and fund complexes make board oversight of multiple funds within a fund complex an efficient and effective approach to governance.

Most boards are organized according to one of two models: 1) a "unitary" board with one group of directors who sit on a single board overseeing every fund in the complex, or 2) "cluster" boards with two or more separate boards, each overseeing a different group of funds within the complex (e.g., one board may oversee the equity funds, and another board the fixed-income funds).

This structure is efficient and cost-effective because all of the funds within the same complex usually receive necessary services (including, for example, portfolio management and shareholder recordkeeping) from the same entities, are served by common personnel, and are organized around common operating features.

### **What types of resources do directors have available as they do their work?**

The fund's chief compliance officer (CCO), who reports directly to the board, is an important resource. The CCO provides regular reports to the board about the fund's compliance policies and practices and meets with the independent directors in executive session at least annually.

Most independent directors also rely on independent legal counsel for advice to help ensure that they understand their responsibilities, ask pertinent questions, and receive the information necessary to carry out their responsibilities. Fund directors also rely on reports, opinions, and certifications from the fund's adviser and other service providers.

Mutual fund directors also use a variety of resources to stay informed about industry and regulatory developments and to continually enhance their understanding of the many complexities of mutual funds and their operations. IDC, an organization that is part of ICI, is dedicated to serving the needs of the mutual fund director community and provides an array of educational resources for directors.

### **What is the role of the Independent Directors Council?**

IDC is the voice of fund directors at ICI. It has a four-part mission: 1) to advance director education, 2) promote director engagement, 3) assist in the formulation of policy positions, and 4) promote public understanding of directors' role. IDC sponsors [events](#) that provide a forum for directors to gather and discuss recent developments and emerging industry trends affecting their work in the boardroom, including conferences, workshops, and regional meetings across the country. IDC also has published a number of task force reports and other [publications](#) that examine governance trends and offer practical guidance for independent directors on a range of topics. IDC keeps the director community informed of regulatory and industry developments through regular communications, including memoranda highlighting developments of interest and a monthly newsletter, Board Update. IDC also is actively engaged on policy matters impacting the role of fund directors. For example, it filed an [amicus brief](#) in the Supreme Court case, *Jones v. Harris*, and submits [comment letters](#) on SEC rule proposals that may affect the role of fund boards.

*For more information, please see [IDC's Overview of Fund Governance](#).*