Mutual fund directors are entrusted with many key responsibilities under the Investment Company Act of 1940, as amended (1940 Act), such as approval of the advisory agreement and monitoring for potential conflicts on behalf of fund shareholders. Under the 1940 Act and state law, directors are responsible for overseeing the operations of the fund and its portfolios, including the fund’s investment objective and policies, performance, risk management, regulatory compliance, and service provider arrangements, among numerous other duties. Independent directors play a particularly important role in fulfilling these duties. As noted by the Supreme Court, independent directors serve as “independent watchdogs” who act as a check on the management of investment companies.1 The mutual fund industry is thus heavily dependent on the successful recruitment and retention of qualified independent directors to serve on the board.2 There are currently approximately 1,900 independent directors overseeing more than $18 trillion in assets at approximately 10,500 investment companies.3

Ideally, a board should include directors with varying skillsets and backgrounds, as well as experience in areas relevant to mutual funds, such as finance, investments, distribution, and legal matters. Individual directors must be able to collaborate and function together effectively as a working board. New directors are usually nominated by the nominating committee or independent directors as a group. In addition to identifying candidates with appropriate qualifications and skills who are able to mesh well with the other directors, the nominating committee must also take into account the legal requirements on board composition under the 1940 Act and state law, including shareholder approval of directors and minimum percentages of independent directors. Once a properly constituted board is in place, the board must ensure that directors continue to contribute and serve effectively on behalf of shareholders.

This article will explore how directors are identified, nominated, elected and retained as part of an effective and legally compliant mutual fund board. Because “interested” directors are normally readily identifiable based on their relationship with the fund sponsor or other service provider, we will focus on the recruitment, retention and retirement practices of independent directors.

I. Selection and Nomination of Independent Directors

Fund governance has taken the spotlight at various times in recent years, such as in 2004 when the Securities and Exchange Commission (SEC) adopted a series of amended fund governance rules
“designed to enhance the independence and effectiveness of fund boards and to improve their ability to protect the interests of the funds and fund shareholders they serve.” The amendments provided that funds relying on ten common exemptive rules (Exemptive Rules) comply with certain governance requirements, including rules on board composition, an independent chairman of the board, an annual self-assessment, executive sessions and the authority to retain independent director staff.

However, since 2001, incumbent independent directors have been required to select and nominate new independent directors if they served on the boards of funds relying on the Exemptive Rules pursuant to amendments adopted at that time. The SEC’s rule proposals that set forth the self-selection and self-nomination requirement borrowed from the best practice recommendations of an advisory group organized by the Investment Company Institute (ICI), as well as a public roundtable hosted by the SEC to discuss the role of independent directors of mutual funds. In connection with the proposal, former SEC Chairman Arthur Levitt said, “[i]ndependent directors should nominate any new independent directors. Many boards already meet that standard. Funds that pay for their own distribution expenses under Rule 12b-1 are required to have self-nominating independent directors. If the primary role of independent directors is to protect the shareholder interest and act as a check on management, wouldn’t self-nomining independent directors be more effective—not just in distribution issues—but in any conflict of interest with management?”

Even for funds that do not rely on the Exemptive Rules, many funds operate under a nominating committee charter or governance policy that requires the independent directors to select and nominate other independent directors.

While independent director nominees of most funds must be selected by the incumbent independent directors, either due to legal requirements, internal governance policies or best practices, what this means in reality will vary from fund complex to fund complex. Some boards may welcome input from management, while at others, the independent directors will operate completely independently of management to identify new independent director candidates. In the 2001 Adopting Release, the SEC addressed the role of the adviser and shareholders in the process:

Several commenters asked that we clarify the extent to which fund shareholders or a fund’s adviser may participate in the selection and nomination process under the amendments. Control of the selection and nomination process at all times should rest with a fund’s independent directors. These amendments are not intended to supplant or limit the ability of fund shareholders under state law to nominate independent directors. The adviser may suggest independent director candidates if the independent directors invite such suggestions, and the adviser may provide administrative assistance in the selection and nomination process. Independent directors, however, should not view participation by shareholders and investment advisers in this process as precluding or excusing the independent directors from the responsibility to canvass, recruit, interview, and solicit independent director candidates.

Notwithstanding the ability of an adviser to suggest candidates, independent directors’ responsibility to select and propose candidates requires that they play an active role in the recruitment and consideration process. The SEC Staff has stated that independent directors may not satisfy this requirement if the only candidates considered were nominated by someone other than the independent directors and not all of the candidates ultimately nominated for election were interviewed by the independent directors.

It is common for the nominating committee to handle the independent director recruitment process. Alternately, in the case of small boards,
the independent directors may not have formed a nominating committee and may handle the recruitment process as a group. As a best practice, the nominating committee (or full board, depending on the structure) should meet at least annually to review prospective candidates, the composition of the board, and desired skill sets and other criteria of new candidates. This also may be handled as part of the annual self-assessment process. In the case of unexpected vacancies or to recruit board members with a specific skill set, the nominating committee may wish to retain a third-party search firm.

Once a candidate or candidates have been identified, the incumbent independent directors typically meet with the prospective nominee to assess his or her interest, ability and potential “chemistry” with the rest of the board, and to address any questions, before formally nominating the candidate. In addition, the candidate should complete an independent director questionnaire to identify any potential conflicts, affiliations, disclosure items or other independence issues.

Once the incumbent directors agree on the selection of a candidate, he or she will be nominated for election by the full board and, if required, fund shareholders. If a candidate is submitted for election by shareholders, the proxy statement must disclose the nomination process a fund uses in selecting candidates for election. These disclosure requirements, as well as the requirement for shareholder approval of directors, are discussed below. Additionally, in nominating candidates for service on the board, incumbent board members should be aware of the 1940 Act requirements pertaining to the percentage of the board that must be comprised of independent directors, which are also discussed below. The shareholder approval and director independence requirements may influence a board’s consideration of certain candidates and the timing of a candidate’s nomination.

II. Shareholder Approval Requirements

Section 16(a) of the 1940 Act requires that a fund’s initial board of directors be elected by shareholders. The SEC had previously taken the position that Section 16 required a mutual fund’s public shareholders to elect the fund’s directors. Subsequently, the SEC’s view on Section 16 evolved to permit election of directors by the initial shareholder of a mutual fund (typically, the investment adviser or other sponsor). Thereafter, vacancies on the board may be filled by election by the current board of directors, provided that immediately after filling such vacancy, at least two-thirds of the board has been elected by shareholders.

If, at any time, less than a majority of directors has been elected by shareholders, Section 16(a) requires a board to call a meeting of shareholders to elect directors within 60 days. Rule 10e-1 under the 1940 Act extends this period to 150 days if there has been a death, disqualification, or bona fide resignation of any director which results in the fund not being able to meet the 1940 Act requirements regarding the composition of the board of directors. In the adopting release for Rule 10e-1, the SEC noted that it was allowing the extended time period to provide relief if the fund no longer has a majority of independent directors because of the sudden loss of one or more directors, without facing the consequences of losing the availability of the Exemptive Rules. A footnote to the release states: “The time periods begin to run when the fund no longer meets the applicable board composition requirement, even if the fund is not yet aware that it no longer meets the requirement. Funds and directors should be mindful of their responsibilities to maintain the required percentage of independent directors, and should monitor director independence (and other composition issues) accordingly.” Given the wording of Rule 10e-1 and the release’s reference to “other composition issues,” the extended time periods should apply not only when a board does not have the requisite number of independent directors but also if it does not meet the shareholder election requirements.

Section 16 does not prescribe the manner in which directors must be elected. Prior to calling a shareholder meeting to elect directors, a board...
should understand applicable state laws and any requirements set forth in the fund’s governing documents regarding shareholder meetings and the election of directors.

A board should consider the 1940 Act’s shareholder election requirements when addressing the succession issues discussed in Section VI below. A thoughtful approach to succession planning with the shareholder approval requirements in mind can serve to provide the board with maximum flexibility and minimize the number of shareholder elections that will need to be held at (potentially) significant cost to the fund.

III. Independence

According to a joint study conducted by the Independent Directors Council (IDC) and the Investment Company Institute (ICI), 85 percent of fund boards were composed of at least 75 percent independent directors as of year-end 2012, as opposed to 46 percent of fund boards in 1996. A board’s composition with respect to its percentage of independent directors will be influenced by a number of factors, including the size of the board, the number of management-affiliated directors, the legal requirements of the 1940 Act and best practices.

Legal Requirements

- Under Section 10(a) of the 1940 Act, all funds must have a board of which at least 40 percent of the members are independent directors.
- Under Section 10(b) of the 1940 Act, a fund may not use an affiliated broker or affiliated underwriter unless a majority of the board is not affiliated with the broker or underwriter.
- If the fund relies on any of the Exemptive Rules, a majority of the board must be independent. The SEC had adopted a provision as part of the 2004 Fund Governance Rules that would have required boards of funds relying on any of the Exemptive Rules to have independent directors comprising at least 75 percent of the board, but this provision of the rules was never implemented due to a legal challenge.
- In connection with the change of control of an adviser, Section 15(f) of the 1940 Act provides that at least 75 percent of the board must be independent for at least three years if the fund’s adviser or any of its affiliates received any benefit in connection with such change of control.

The 1940 Act does not prescribe a minimum size of a board, and the size of mutual fund boards varies. Regardless of the size of the board, the composition of its members should ensure there are enough directors, and enough independent directors, to “perform the required oversight functions, as well as to conduct thorough deliberations and to render sound decisions.”

A survey from Management Practice Inc., an industry consulting group, indicates that the majority of fund boards have three to six independent members, with eight percent at one-two independent members and 10 percent at eight-ten independent members.

What Does “Independent” Mean?

Under the 1940 Act, independence is defined by statute in relation to affiliations or relationships that make a person an “interested person” of the fund. Section 2(a)(19) provides that an interested person includes an “affiliated person” of the fund and an “interested person” of the fund’s investment adviser, subadviser or principal underwriter, a person who has served as fund or adviser legal counsel for the past two years, or a person that owns even a de minimus amount of stock of the adviser, the subadviser, the principal underwriter, or their control persons, such as a public company parent. The definition also includes immediate family members of fund affiliates.

The SEC can also determine by order that a natural person is not independent based on a “material business or professional relationship” with the fund, adviser, subadviser or principal underwriter within the past two years. The SEC will no longer respond.
to requests for no-action relief in this area because the above provisions require that the SEC find a person to be an interested person as a result of a material business or professional relationship by order.\(^{23}\) Although the 1940 Act does not specify what constitutes a material business or professional relationship, SEC no-action letters stress that such a relationship would be material if it might tend to impair the independence of a director.\(^{24}\) For example, the Staff denied no-action relief when a fund proposed to add a new director who could receive economic or professional benefits as a result of the relationship.\(^{25}\)

Additional SEC guidance states that key factors in evaluating whether an individual’s relationships might impair his or her independence include the level of that individual’s responsibility or compensation received in positions held with the fund’s adviser, subadviser or underwriter.\(^{26}\) For instance, individuals who have served as a fund’s portfolio manager within the past two years would have had a material business relationship with a fund and its investment adviser due to the significant responsibilities such a position entails.\(^{27}\) Depending on the facts and circumstances, former directors, officers and employees of the fund’s adviser, subadviser or principal underwriter may be viewed as having had a material business or professional relationship that would preclude service as an independent director.\(^{28}\) On the other hand, if the fund’s adviser manages an advisory or brokerage account for a director, but does not discount its fees or otherwise give the director special treatment, this alone would not form the basis for concluding that a material business or professional relationship exists.\(^{29}\)

Under the 1999 ICI Study, the advisory group took a more expansive view of independence. In particular, the advisory group recommended that former officers or directors of a fund’s investment adviser, principal underwriter or certain affiliates not serve as independent directors of the fund. The report acknowledged that former officers and directors of the fund’s adviser or principal underwriter 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.’ ”\(^{30}\) The advisory group determined not to recommend prohibiting all former employees of the fund’s adviser and principal underwriter, noting that such a prohibition could lead to “absurd results,” but suggested that nominating committees carefully scrutinize the appropriateness of any such individual serving as an independent director.\(^{31}\) The prohibition on former officers and directors is not included in the 1940 Act, which defines interested person to include current officers, directors and employees of fund advisers, and principal underwriters, as well as those with a material professional or business relationship within the past two years.

**Other Views of Independence**

In the fund governance amendments contained in the 2004 Adopting Release, the SEC urged independent directors to look beyond the minimum criteria for independence under the 1940 Act.\(^{32}\) In the SEC’s view, independent directors should:

\[E\]xamine whether a candidate’s personal or business relationships suggest that the candidate will not aggressively represent the interests of fund investors. Persons who have served as executives of the fund adviser or who are close family members of employees of the fund, its adviser or principal underwriter would, in our view, be poor choices for candidates, although they may meet the minimum statutory requirements. We recognize that “legal” independence does not equate with “real” independence. We therefore encourage independent directors, in selecting and nominating other
independent directors, to identify individuals who have the background, experience, and independent judgment to represent the interests of fund investors.\textsuperscript{33}

Given the number of factors that may impact a director’s independence, it is important that boards adequately review whether candidates for election or existing directors qualify or continue to qualify as independent. An important part of this process is to have candidates and directors complete independent director questionnaires on an annual basis and to have those questionnaires reviewed for conflicts, affiliations and disclosure items.

IV. Independent Chair/Lead Independent Director

While the 1940 Act requires mutual fund boards to be at least 40 percent independent, there is no legal requirement for a board to have an independent chair or lead independent director. The 2004 Fund Governance Rules would have required mutual fund boards to have an independent chair in order to rely on the Exemptive Rules. In the 2004 Adopting Release, the SEC highlighted the important role board chairs play “in setting the agenda of the board, and in establishing a boardroom culture that can foster the type of meaningful dialogue between fund management and independent directors that is critical for healthy fund governance.”\textsuperscript{34} The release further noted that an independent chair could play an important role in providing a check on the adviser, negotiating on behalf of shareholders when reviewing the advisory contract, and providing leadership focused on the long-term interests of investors.\textsuperscript{35}

The United States Chamber of Commerce challenged the 2004 Fund Governance Rule requiring an independent chair (and, as noted previously, the requirement that boards have at least 75 percent independent directors) on the grounds that the SEC had not allowed adequate opportunity for public comment on the proposed rule.\textsuperscript{36} The US Court of Appeals for the District of Columbia ruled in favor of the Chamber of Commerce and stayed the effectiveness of the provisions requiring mutual fund boards to be composed of 75 percent independent directors and to have an independent chair.\textsuperscript{37} In 2006, the SEC sought additional comment on the amendments that were the subject of the litigation, but has not taken further action.\textsuperscript{38} Whether the SEC will revisit this issue is uncertain.

Although it is not a requirement for a mutual fund board to have an independent chair or lead independent director, it is a best practice to do so. As part of the 1999 ICI Study, the advisory group identified 15 practices to enhance the independence and effectiveness of fund boards, all of which were endorsed by the ICI’s Board of Governors.\textsuperscript{39} Among the best practices identified by the advisory group was the recommendation that the independent directors designate one or more lead independent directors.\textsuperscript{40}

Additionally, empirical data suggests that most mutual fund boards have chosen to have either an independent chair or a lead independent director. An ICI study on mutual fund governance practices found that 62 percent of investment company boards had an independent chair at year-end 2012, and 88 percent of investment company boards had either an independent chair or a lead independent director.\textsuperscript{41} The number of boards choosing to have either an independent chair or lead independent director has grown since the ICI began collecting the data. In 2004, for example, 61 percent of boards surveyed by the ICI reported having either an independent chair or a lead independent director.\textsuperscript{42}

Lead independent directors or independent chairs can play an important role in setting the tone for board meetings and serving as a liaison between the independent directors and fund management. The responsibilities of the independent chair and lead independent director can be similar. As noted above, independent chairs typically set the agenda for board meetings, chair board meetings and carry out other responsibilities set forth in the
fund’s governing documents. The responsibilities of a lead independent director can vary from fund to fund and are often set forth in the fund’s governing documents. Lead independent directors often play a significant role in ensuring effective performance of the board, establishing a strong relationship between the board and fund management and serving as the single point of contact when the views of the independent directors are needed.

V. Diversity

Another issue to consider when assembling a board is the diversity of the board, not just in terms of traditional concepts of diversity such as race and gender, but also in terms of diversity of education, professional and cultural background, expertise, viewpoint, geography and other attributes. While there is no legal requirement for diversity on a US mutual fund (or other corporate) board, proxy statements for the election of directors are required to include disclosure regarding whether and how a nominating committee considers diversity in recommending board candidates. This, coupled with calls for greater boardroom diversity, including from SEC Chairman Mary Jo White in a recent speech and activist shareholders, has a growing number of mutual fund boards making diversity in the boardroom a priority.

Although recent studies provide conflicting views on the relationship between diversity and financial performance, with some studies finding positive correlations between board diversity and financial performance and others finding the opposite or no significant correlation, there is some evidence to suggest that when diversity is well managed, it can improve decision making by lessening the tendency of the board to engage in group think — a phenomenon whereby efforts to achieve consensus override the board’s ability to consider alternative courses of action. This, in turn, can lead to a more engaged, and effective, board. Board diversity can also enhance the fund’s public image by signaling to shareholders and others that diversity is important to the organization, and that the organization is committed to inclusion not only in principle, but also in practice, particularly when women and minorities are represented on the board at more than token levels.

Diversity alone should not be the goal in creating or adding to a board; rather, it should be one of many factors considered when seeking the best person for the seat. Even so, it should be one of the more important factors considered, given the value that diversity can bring to a board and the fund organization.

VI. Succession Planning, Retirement Policies, and Term Limits

Unlike public operating companies, mutual funds are not required to hold annual shareholder meetings and, therefore, mutual fund directors do not stand for re-election on a regular basis. In the past, it was not uncommon for a mutual fund board to allow its members to serve for an indefinite term, resulting in lifetime appointments for most directors. To today, with calls for board refreshment and concerns that directors no longer qualify as independent after 10 years of service, many fund boards are finding that having no policies, or weak policies, to deal with succession planning is simply not good corporate governance. Boards should consider succession planning with an understanding of, among other things, the 1940 Act requirements pertaining to shareholder approval of directors, independence and nomination of directors. Considering these issues proactively will enable boards to effectively plan for director transitions.

Boards can benefit from thinking strategically about succession planning, taking a holistic approach to managing director turnover rather than dealing with it on a piecemeal basis. For example, the board can strive to recruit new members with an eye toward filling gaps identified through the annual self-assessment process. The self-assessment process can also be used as a tool to remove underperforming directors or those whose skills no longer fit with the fund company’s strategic needs. While most fund boards conduct self-assessments of the board as a whole, some boards also evaluate
individual board members through a peer review process. Conducting peer reviews as part of the annual board self-assessment may help to identify individual board members who are underperforming or who lack the skills or other attributes desired by the fund company and/or the board as a whole. Feedback provided in these circumstances should be as specific as possible, particularly when dealing with an underperforming director, so that guidance can be provided to improve performance. The feedback should also set forth the time period allotted for such improvement before other remedial action will be considered. Because these are difficult conversations to have, it might be useful to conduct peer reviews anonymously, using outside counsel or another third party service provider who can also facilitate taking action based on the results of the review. The board should also familiarize itself with the fund’s governing documents to determine if and how the board may remove an underperforming director, including whether removal can occur with or without cause.

Boards should consider whether to adopt, or adjust, tenure-limiting policies, such as age limits, term limits or some combination of both. While there is no legal requirement that a fund board have such policies, like self-assessments, they can be useful tools to refresh the board. Many fund boards have mandatory age-based retirement policies, but fewer have term or maximum length of service limits. An advantage to having an age or term limit policy is that this is a predictable manner in which to facilitate board turnover. It is difficult to tell a director that he or she is no longer contributing, so age or term limits provide a handy default mechanism. Term limits in particular can also help avoid erosion of genuine independence that can occur over time, and can address the longstanding reluctance of some boards to appoint younger directors. An age or term limit policy also establishes consistent, objective criteria for the completion of a director’s service on the board, and makes room for traditionally underrepresented pools of talent, such as women and minorities, thereby increasing the board’s diversity. A disadvantage is that a policy requiring that directors step down after reaching retirement age or the end of their term might require highly productive directors to leave the board at a time when they continue to add value to the board. In addition, any time a new director is to be added to the board, the fund complex must determine whether shareholder approval will be required, which, if required, can be costly.

There is no “one-size-fits-all” solution for board succession planning. Self-assessments may be an effective means to deal with this issue for some boards, while age and/or term limits may be another. The point here is that this is an issue that should be considered by every fund board on a regular basis.

**VII. Disclosure Requirements**

As noted above, mutual fund boards must navigate numerous legal and other considerations with respect to nomination and election of directors, director independence and diversity. Funds must include prescribed disclosure in SEC filings related to these matters. For example, funds are required to make certain disclosures about the qualifications of their directors, the fund’s process for nominating directors, and each candidate’s relationship with the fund’s adviser and principal underwriter. Form N-1A and Schedule 14A (in the event of a shareholder vote to elect directors) both require the following disclosures for each independent director or candidate for election:

- age, positions held with the fund, length of time served in each position, experience and qualifications and other directorships held during the last five years.
- a description of any positions held with the fund’s adviser or principal underwriter or their affiliates, or any other investment company or private fund with the same investment adviser or principal underwriter as the fund.
- a description of any arrangement between the director and any other person pursuant to which that the director was chosen to serve on the board of the investment company.

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ownership interest in the investment adviser or principal underwriter of the fund and a description of any financial interest in certain transactions or series of transactions involving the fund’s officers, investment adviser, principal underwriter and officers or affiliated parties of the fund’s principal underwriter or investment adviser.\textsuperscript{62}

If a mutual fund has a nominating committee, Form N-1A and Schedule 14A also require disclosure of whether the nominating committee will consider candidates recommended by shareholders, and if so, the procedures for submitting such recommendation.\textsuperscript{63}

Additionally, while mutual funds are not required to have an independent chair, they are required to disclose in their registration statements whether they have an independent chair.\textsuperscript{64} If the board chair is an interested person, a fund must disclose whether it has a lead independent director and if so, the specific role the lead independent director plays in the management of the fund.\textsuperscript{65} A mutual fund’s registration statement must also disclose why it has determined that its leadership structure is appropriate given its specific characteristics and circumstances.\textsuperscript{66}

When a mutual fund submits director candidates for election by shareholders, Schedule 14A requires the proxy statement to include disclosures describing the nomination process. The proxy statement must include a description of the process for identifying and evaluating candidates including whether, and if so how, the board (or nominating committee) considered diversity in identifying candidates to serve as director.\textsuperscript{67} In fulfilling this requirement, the SEC permits mutual funds to define diversity as they see appropriate and recognizes that companies may define diversity to include differences in viewpoint, professional experience, education or skill as well as concepts such as race, gender and national origin.\textsuperscript{68} If the board (or nominating committee) has a policy with regard to the consideration of diversity in identifying director candidates, Schedule 14A requires a description of how the policy is being implemented.\textsuperscript{69} A proxy statement must also disclose who recommended each candidate for election, including whether the candidate was recommended by a director, officer or employee of the fund’s investment adviser.\textsuperscript{70} To the extent a mutual fund has a policy with respect to the consideration of candidates proposed by shareholders, the proxy statement should describe that policy.\textsuperscript{71}

While proxy statements and registration statements are typically prepared and/or reviewed by fund counsel, directors play an important role in this process. Fund counsel and other service providers rely on independent directors to provide much of the information needed to fulfill the relevant disclosure requirements. The disclosure requirements are detailed and specific. The disclosure regime thus demonstrates the importance that the SEC, and shareholders, place on ensuring a director’s independence and describing the process used to select and nominate directors.

\section*{VIII. Conclusion}

Creating an effective, well-functioning and legally compliant mutual fund board is no easy task. There are many variables to consider, and finding truly independent candidates with the right mix of skills, experience and willingness to devote the time necessary to serve can be difficult and time consuming. When assembling a board, or adding to an already existing board, it is important that all constituencies understand both the legal requirements as well as the practical issues involved. With these issues in mind, the resulting board should be well-positioned to advocate for shareholders, work together to effectively oversee fund operations, and fulfill its “watchdog” role.

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NOTES


2 For purposes of this article, the term “mutual fund” refers to an open-end, registered investment company; however, the governance requirements described herein apply equally to open-end, closed-end and exchange-traded funds (ETFs), although closed-end funds and ETFs may be subject to additional requirements depending on if and where their shares are listed. Mutual funds are typically organized as corporations or statutory trusts under state law, and are overseen by a board of directors or trustees. This article uses the term “directors” to refer to both directors of corporations and trustees of statutory or business trusts, and “independent directors” to refer to directors or trustees who are not considered “interested persons” of the investment company for purposes of the 1940 Act.


5 The ten exemptive rules are:

   (1) Rule 10f-3 (permitting a fund to purchase securities in a primary offering when an affiliated broker-dealer is a member of the underwriting syndicate);
   (2) Rule 12b-1 (permitting use of fund assets to pay distribution expenses pursuant to a plan approved by the board);
   (3) Rule 15a-4(b)(2) (permitting a fund board to approve an interim advisory contract without shareholder approval when the adviser or a controlling person receives a benefit in connection with the assignment of the contract, if the fund directors, including a majority of the independent directors, review and approve the contract);
   (4) Rule 17a-7 (permitting securities transactions between a fund and another client of the fund’s investment adviser, if the fund directors, including a majority of the independent directors,

   approve procedures governing the transactions and review quarterly reports on transactions);
   (5) Rule 17a-8 (permitting mergers between certain affiliated funds if the fund directors, including a majority of the independent directors, request and evaluate information about the merger and determine that the merger is in the best interests of the fund and its shareholders);
   (6) Rule 17d-1(d)(7) (permitting a fund and its affiliates to purchase joint liability insurance policies if the fund directors, including a majority of the independent directors, annually determine that the policies are in the best interests of the fund and its shareholders);
   (7) Rule 17e-1 (specifying conditions under which a fund may pay commissions to affiliated brokers in connection with the sale of securities on an exchange, including a requirement that the fund directors, including a majority of the independent directors, adopt procedures for the payment of the commissions and review quarterly reports of any commissions paid);
   (8) Rule 17g-1 (permitting a fund to maintain a joint insured fidelity bond and requiring fund independent directors to annually approve the bond);
   (9) Rule 18f-3 (permitting a fund to issue multiple classes of voting stock, if the fund board of directors, including a majority of the independent directors, approves a plan for allocating expenses to each class); and
   (10) Rule 23c-3 (permitting the operation of an interval fund by enabling a closed-end fund to repurchase shares from investors, if the directors adopt a repurchase policy for the fund and review fund operations and portfolio management in order to assure adequate liquidity of investments to satisfy repurchase payments).

6 This aspect of the new rules was never implemented. See Section V.

7 Role of Independent Directors of Investment Companies, Securities Act Release No. 33-7932, Investment


In the rule proposal, the SEC stated: “[O]ne recognized method of enhancing the independence of directors is to commit the selection and nomination of new independent directors to the incumbent independent directors. Independent directors who are selected and nominated by other independent directors, rather than by the fund’s adviser, are more likely to have their primary loyalty to shareholders rather than the adviser. In addition, when independent directors are self-selecting and self-nominating, they are less likely to feel beholden to the adviser. Thus, they may be more willing to challenge the adviser’s recommendations when the adviser’s interests conflict with those of the shareholders.” Role of Independent Directors of Investment Companies, Investment Company Act Rel. No. 24082 (Oct. 14, 1999).

“SEC Chairman Arthur Levitt Proposes Significant Reforms to Mutual Fund Governance Structure,” SEC Press Release 99-31 (Mar. 22, 1999). Independent directors of funds relying on Rule 12b-1 have been required to select and nominate new independent directors since that rule was first adopted in 1980.

2001 Adopting Release, supra n.7.

See The Robinson Humphrey Co., SEC No-Action Letter (Sept. 4, 1976). (Analyzing the term “selected and proposed for election” in Section 16(b) of the 1940 Act and concluding that the independent directors had not been properly selected by the other independent directors.).

See Section VI regarding succession planning strategies.

Dreyfus Conn. Municipal Money Market Fund, SEC No-Action Letter (Dec. 5, 1990). (“For 35 years, it has been the staff’s position that an investment company will not comply with Section 16(a) unless its public shareholders elect the board of directors.”).

See, e.g., Letter from Marianne Smythe, Director, SEC, Division of Investment Management to Matthew P. Fink, President, Investment Company Institute, SEC No-Action Letter (Nov. 6, 1992). (“The Division will also no longer require an undertaking to conduct a meeting to elect directors.”).

Section 16(a) of the 1940 Act.

2001 Adopting Release, supra n.7.

Id. at n.29.


See Rule 0-1(a)(7)(i) under the 1940 Act. See also Chamber of Commerce v. SEC, 412 F.3d 133 (D.C. Cir. 2005) [hereinafter Chamber of Commerce].


See, e.g., Alterman Investment Fund, Inc., SEC No-Action Letter (Jan. 20, 1980), in which the Staff refused no-action relief when a proposed director of an investment company also served as an officer of a bank that provided banking services to the investment company. The Staff noted that “a serious question could arise as to whether the proposed director might stand to gain from accommodating the policies or wishes of the controlling directors on the company’s board as a means of assuring the continuity of the banking relationship.”


Id.

Id.

Id.

1999 ICI Study, supra n.8 at 12.
Although there is no such requirement in the United States, more than a dozen other countries have implemented quotas to increase women’s representation on boards, and many more have adopted voluntary quotas in their corporate governance codes. See Susan Franceschet & Jennifer M. Piscopo, “Equality, Democracy, and the Broadening and Deepening of Gender Quotas,” 9 Pol. & Gender 310, 311 (2013).

In contrast to mutual (open-end) funds, directors of closed-end funds or ETFs listed on stock exchanges do stand for re-election on a regular basis (typically every three years if the board is classified, or annually, if the board is not classified).

For example, proxy advisory firm Institutional Shareholder Services has increased its focus on this issue through its governance rating system, QuickScore 2.0, which views tenure of more than nine years as an “excessive” length that potentially compromises director independence. Similarly, the Council of Institutional Investors now includes tenure as a factor in determining director independence. Many foreign jurisdictions support limiting director tenure as well, such as the European Commission, which recommends that European Union-based companies limit director tenure to 12 years or three terms.

As mentioned in Section I, fund boards relying on the Exemptive Rules are required to conduct an annual self-assessment. See Rule 0-1(a)(7)(v) of the 1940 Act.

According to the IDC, peer reviews are still rather uncommon, with 77 percent of fund complexes having no formal policies, or only general policies, on peer reviews; 16 percent of fund complexes where peer reviews occur, despite no formal policy; and only 7 percent of fund complexes having a formal peer review policy. See Independent Directors Council, “Considerations for Board Composition: From Recruitment through Retirement,” (Oct. 2013) [hereinafter IDC Board Composition Report], available at http://www.idc.org/pdf/pub_13_considerations_board_comp.pdf.
The Mutual Fund Directors Forum (MFDF), in its July 2004 report entitled “Best Practices and Practical Guidance for Mutual Fund Directors,” suggested as a best practice that a fund’s directors annually assess the fund’s retirement policy, if it has one, as well as the effectiveness of that policy, or consider whether to adopt a retirement policy if it doesn’t already have one. In doing so, MFDF suggested that directors determine what factors, such as age, years of service and other criteria, are relevant to a retirement policy. According to the IDC, an increasing number of fund complexes have adopted mandatory retirement policies, from 45 percent in 1996 to 67 percent in 2012, with an average mandatory retirement age of 74. Some boards specify terms for board service, but this practice is uncommon and may be more relevant for boards with younger directors who might be able to serve for a number of years (e.g., 30 years) before reaching a mandatory retirement age. See IDC Board Composition Report, supra n.53.

While exceptions to such policies can certainly be made, to ensure consistency and predictability, such exceptions should be rare and should apply to all board members. If this is a concern, a board could consider granting an outgoing director emeritus status, which would allow the director to be a nonvoting board member for a period of time.

See Section II.

Form N-1A Item 17(a)(1); Schedule 14A Item 22(b)(1)-(2).

Form N-1A Item 17; Schedule 14A Item 22(b)(4).

Form N-1A Item 17(a)(3); Schedule 14A Item 22(b)(3).

Form N-1A Item 17(b)(5)-(10); Schedule 14A Item 22(b)(5)-(9).

Form N-1A Item 17(b)(2); Regulation S-K Item 407(c)(2)(iv), made applicable to funds by Schedule 14A Item 22(b)(15).

Form N-1A Item 17(b)(1).

Id.

Id.

Regulation S-K Item 407(c)(2), made applicable to funds by Schedule 14A Item 22(b)(15).


Id.

Regulation S-K Item 407(c)(2)(vii), made applicable to funds by Schedule 14A Item 22(b)(15).

Regulation S-K Item 407(c)(2)(ii)-(iii), made applicable to funds by Schedule 14A Item 22(b)(15).