

Mutual Fund Directors Forum Report on Best Practices and Practical Guidance for Independent Directors

I. Introduction

On July 28, 2004, the Mutual Fund Directors Forum ("MFDF" or the "Forum"), a nonprofit membership organization for independent directors of registered investment companies ("funds"),¹ released its report entitled Best Practices and Practical Guidance for Mutual Fund Directors (the "Report").² The Forum was responding to a request by William Donaldson, Chairman of the Securities and Exchange Commission ("SEC"), for the Forum to prepare a report on best practices for independent directors and provide them with guidance to carry out their fiduciary obligations. The Chairman had called on the Forum to provide guidance to fund directors in November 2003, in the midst of the scandals that started with the announcement of the case against Canary Capital and at a time when the SEC and Congress were contemplating means to address perceived abuses in funds. The SEC Chair requested that the MFDF focus on critical areas of fund activity: board review of management contracts and management fees; soft dollar, directed brokerage, and revenue sharing arrangements; Rule 12b-1 payments;³ valuation

and pricing; and conflicts of interest between funds and their managers. In the Report, the Forum recommended voluntary best practices and practical guidelines:⁴

- To enhance the independence of fund independent directors;
- To oversee soft dollar, directed brokerage, and revenue sharing arrangements;
- To review management agreements and management fees;
- To monitor valuation and pricing; and
- To enhance the effectiveness of fund independent directors with respect to conflicts of interest.

The MFDF affirmed the unique role of investment company independent directors as "watchdogs," best suited to carefully

recommendations concerning Rule 12b-1 until the SEC finished taking action in the area. (See Release No. IC-26356, Feb. 24, 2004). The comment period for the SEC proposals ended on May 10. As of the date of this memorandum, the Commission has acted on only one aspect of the proposals — directed brokerage — and the release is not yet available. The Forum expects to publish its own recommendations later in 2004.

¹ Independent directors are directors who are not "interested persons" of a fund as defined in Section 2(a)(19) of the Investment Company Act of 1940, as amended ("1940 Act").

² Best Practices and Practical Guidance For Mutual Fund Directions. Report of the Mutual Fund Directors Forum (July 2004).

³ Because the SEC had proposed a rule that would prohibit funds from paying for the distribution of their shares with brokerage commissions, the Forum decided to defer formulating

⁴ Although Chairman Donaldson requested that the Forum develop guidance and best practices for independent directors, the Forum pointed out that many of the best practices are also applicable to all directors.

monitor the relationship of the fund to its investment adviser and other service providers. In some instances, the recommendations are now present in SEC rules or are currently before the SEC as proposed rules. Sections II, III, IV, V, and VI summarize the Forum's recommendations and any recent applicable SEC activity.

II. Enhancing the Independence of Independent Directors

Several of the Forum's recommendations regarding fund governance have already been codified in SEC rules (the "Governance Rules").⁵ These controversial rules require that the chairman and at least 75 percent of a fund's board of directors be independent of the investment adviser.⁶ They also explicitly authorize the independent directors to hire employees and to retain advisers and experts necessary to carry out their duties.⁷ Beyond what are now statutory requirements for funds, the Forum recommended that:

- A fund's board should adopt a statement of fundamental ethical principles to the effect that all actions taken on behalf of the fund must be in the best interests of the shareholders. The principles could be set out in the fund's code of ethics contemplated by Rule 17j-1 under the 1940 Act;
- The definition of "independent of the investment adviser" should be broader than the definition of "interested person" in the 1940 Act,⁸ adding a requirement that such "independent director" should not have been affiliated with the fund's adviser or its affiliates for at least five years to ensure there is a "cooling off" period for the relationship;⁹
- A fund's independent directors should be solely responsible for determining the level of their

⁵ Release No. IC-26520 (July 27, 2004).

⁶ The Governance Rules provide that if the fund has three directors, all but one should be disinterested directors.

⁷ *Id.*

⁸ The SEC's adopting release for the Governance Rules, *supra*, note 5, also includes a suggestion that boards go beyond merely satisfying the legal and technical definition of independence.

⁹ In settling recent enforcement cases, the SEC has imposed a 10-year period. See *In the Matter of Putnam Investment Mgmt., LLC*, Rel. No. IC-26255 (Nov. 13, 2003).

compensation. The compensation should be commensurate with, among other things: (1) the nature and extent of committee assignments and other roles undertaken; (2) the complexity of the fund complex's operations; and (3) the fund's strategies, policies, and objectives; and

- The independent directors should retain legal counsel to advise them on an ongoing basis and have authority to engage staff, other independent consultants, and other advisers to assist the independent directors in carrying out their fiduciary duties.

III. Brokerage Commissions, as Assets of the Fund, Should Be Transparent

The Forum made recommendations regarding soft dollars, directed brokerage, revenue sharing arrangements, and the related subjects of best execution and transactions with affiliates. The Forum's recommendations in this area were guided by three principles: (1) because brokerage commissions are assets of the fund, they should be used in the interest of the fund and its shareholders; (2) best execution should govern the allocation of trades; and (3) transparency in fund brokerage transactions is important for clear identification of costs and benefits so independent directors can better understand, evaluate, and assess the costs of the transactions and their impact on fund performance. On the basis of these principles, the Forum recommended that fund boards:

- Require the fund's adviser to develop written policies on execution of portfolio transactions that should help ensure that the adviser seeks best execution. Best execution was defined as the execution of a securities transaction in such a manner that the total cost or proceeds are the most favorable to the fund under the circumstances;
- Instruct the fund's adviser that research received by it not be considered as a factor in best execution so as to avoid obscuring the quality of the execution for the fund;
- Request and review regular reports from the adviser on execution of portfolio transactions that include (1) summaries of commissions per share paid to broker-dealers; (2) explanations of unusual commissions; and (3) documentation that alternative execution channels were explored. These requirements would go beyond the SEC rule that requires fund advisers to have written policies to prevent statutory violations and to pursue best execution at all times. The

Report urged directors to seek the assistance of fund advisers or other experts to explore quantitative methods to assess the quality of execution;¹⁰

- Regarding “conventional” directed brokerage, a fund’s board should not permit the fund’s adviser to consider a broker-dealer’s sale of fund shares or shares of other funds in the complex as a factor in allocating trades;¹¹
- Regarding “expense reducing” directed brokerage, a fund’s board should request and review reports on the quality of execution the fund receives when the broker-dealer pays a rebate to the fund or uses a portion of the commission to pay the fund’s operating expenses;
- Regarding soft dollars, independent directors should not permit the fund’s adviser to participate in soft dollar arrangements in trades for the fund. The Report noted that soft dollar arrangements give rise to a potential conflict of interest between the adviser and the fund, give rise to benefits to the adviser that may not be transparent to independent directors, and make it difficult to confirm whether the fund has received best execution. In what has been considered the most controversial of the recommendations in the Report, the Forum recommended that directors not permit either formal or informal soft dollar arrangements for either proprietary or third-party research. The Report acknowledged that this recommendation may have an effect on fund advisers and on trading practices, but opined that the enhanced transparency and clearer focus on best execution would be in the long-term best interests of fund shareholders. If a board decides to continue to permit an adviser to use soft dollars, the Report said the directors should nonetheless insist that the fund receive best execution on the trades;
- Regarding transactions with affiliates, independent directors should require that any trades placed with an affiliated broker-dealer receive the most favorable commission rates that the broker-dealer gives to comparable clients to comply with Rule 17e-1 under the

1940 Act. The directors should review and compare the quality of execution a fund receives on transactions placed with an affiliated broker; and

- Regarding revenue sharing, independent directors should (1) require fund management to disclose revenue sharing arrangements to the board; (2) review any revenue sharing arrangements annually; and (3) consider revenue sharing arrangements to be part of the contract renewal process, where applicable. The annual presentation to the board would include any programs designed to gain shelf space for the fund or access to other preferred lists and should include the type of entity involved, the structure of payments, and the services received by the fund. Further, the Forum recommends that the pertinent revenue sharing information be disclosed in the prospectus.

IV. Reviewing Management Agreements and Fees

In the Report, the Forum states that:

When approving or continuing an advisory relationship, the basic objectives of the independent directors are to (1) assess the quality of the adviser’s services in relevant areas, such as performance and the risk undertaken for the funds; (2) determine the fairness of the advisory contract, including the fee structure, in relation to the services provided and the adviser’s profitability; and (3) consider whether the adviser can achieve economies of scale at higher asset sizes or other possible economies that should be shared with shareholders. Beyond evaluation of investment performance and fees, services evaluated should include, but are not limited to, transfer agent services, custody of fund assets, recordkeeping, accounting, shareholder services, and proxy voting. To best fulfill the fiduciary duty through the evaluations, the Forum recommended that:

- A fund’s board should create a committee with a written charter, with some or all of the independent directors to oversee the contract review process. This contract review committee should establish a process for its consideration of the advisory agreement that includes (1) consulting with legal counsel as needed; (2) establishing a structured process for consideration of the advisory contract; (3) requiring the adviser to commit by contract to provide the independent directors with all relevant information; (4) preparing a formal written request to the adviser under Section 15(c) of the 1940 Act; (5) asking counsel for a

¹⁰ Rel. No. IC-26299 (Dec. 17, 2003).

¹¹ On August 18, 2004, the SEC amended Rules 12b-1 to prevent funds from using brokerage commissions to pay for distribution of fund shares. At the time of the drafting of this memo, the adopting release was not available. For the proposing release, see Rel. No. IC-26356 (Feb. 24, 2004).

memorandum describing the duties of the independent directors in reviewing an investment advisory agreement; (6) considering retaining unaffiliated third-party consultants, who could provide an objective source to help determine comparative peer groups, review methodologies for determining profitability, analyze advisory fees, etc.; (7) meeting in person at least once with no representatives of the adviser, including directors who are affiliated with the adviser, and formulating a recommendation to the board regarding adoption or consideration of the advisory contract; (8) reviewing and deliberating on the response by the committee and the independent directors, and making further requests to the adviser, if necessary; and (9) discussion with the adviser, if desired; and

- At their in-person meeting, the independent directors should consider the adequacy of the report provided by the adviser. “In particular, the adviser’s response to the Section 15(c) request should demonstrate that the adviser has met the expectations of investors both in terms of the investment experience of the fund and in the services provided by the adviser, including services performed under separate contracts (such as administrative, fund accounting and shareholder servicing arrangements).” An appendix to the Report provides guidance on matters that independent directors could negotiate if they believe that proposed fees are not reasonable or that overall cost structure is not appropriate. With reference to fees, these matters include fee reductions, fee waivers, breakpoints that benefit shareholders, and expense caps. With reference to performance or service, these matters include engaging consultants to review disappointing services, engaging subadvisers to address underperformance, and outsourcing to address administrative or shareholder services. The appendix warns of costs and disruption that can result from cancellation of an advisory agreement.

V. Valuation and Pricing

The Report states that a fund’s board has the responsibility to make sure that the adviser has developed and implemented reasonable and effective valuation and pricing procedures and that those procedures are applied fairly and consistently. To do that, the Forum recommended that:

- A fund’s board should establish a standing valuation and pricing committee to provide objectivity, and the committee should have a

written charter. Committee members should become familiar with portfolio valuation techniques;

- A fund family’s valuation and pricing procedures should ensure that, in general, the same valuation is used consistently for a security throughout the fund family, including its public and private funds; and
- A fund’s board, or the board valuation and pricing committee, should establish valuation and pricing procedures consistent with both current regulatory guidance and the fund’s public disclosures. The board should remain regularly informed of regulatory developments and review its procedures periodically to make sure they remain appropriate.

VI. Effectively Dealing with Conflicts of Interest

The Report states that the 1940 Act addressed the obvious conflicts that were present in the traditional external management structure, but was enacted before full-service financial institutions became possible. Accordingly, the Forum stresses that it is important for a board to adequately address all other conflicts that could arise between the fund and its service providers. Since each board will face its own unique circumstances, the Forum recommended that:

- A fund’s board establish a process for identifying and reviewing conflicts of interest. A committee should be assigned the responsibility for addressing potential conflicts that may arise from the adviser’s other business activities, and a board should require the adviser to establish a process to identify potential conflicts and report them to the committee;
- A fund’s independent directors should establish guidelines for ownership of fund shares by directors and should make disclosure of their fund share ownership easily accessible to shareholders;
- A fund’s board should conduct the annual self-evaluation to evaluate (1) a director’s effectiveness; (2) the effectiveness of the committee structure implemented by the board; and (3) the effectiveness of the board as a whole. This self-evaluation should involve examining the nominating process for new directors, the retirement policies and term limits, the frequency of election of directors by shareholders, the amount and form of board compensation from each fund and the complex,

the degree of information coming from the fund to the directors, and any other relevant factors; and

- Each independent director of a fund should participate in ongoing educational and informational programs designed to enhance knowledge of issues relating to fund oversight.¹²

VII. Initial Response of Chairman Donaldson to the Report

On July 28, 2004, Chairman Donaldson thanked the Mutual Fund Directors Forum for delivery of the Report. He said:

I applaud the efforts of the Forum and its chairman, former SEC Chairman David Ruder, in preparing the Best Practices Report, and I look forward to reviewing the recommendations in detail. The Best Practices Report complements the Commission's recent rulemaking initiative to enhance the fund governance framework and represents an independent director-led effort to provide meaningful guidance to fund directors. I therefore encourage all fund directors to review and consider carefully the Report's recommendations.

¹² The Governance Rules do not include the last three items. See *supra*, Section II, **Enhancing the Independence of Independent Directors**.

Practice group contacts

If you have questions regarding the information in this update, please contact the Dechert attorney with whom you regularly work, or any of the attorneys listed. Visit us at www.dechert.com/financialservices.

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