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# Board Self-Assessments: Seeking to Improve Mutual Fund Board Effectiveness

Independent Directors Council
Task Force Report
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**INDEPENDENT DIRECTORS COUNCIL**
**REPORT OF THE TASK FORCE ON BOARD SELF-ASSESSMENTS:**
**SEEKING TO IMPROVE MUTUAL FUND BOARD EFFECTIVENESS**

# I. Introduction

Self-assessment by investment company boards is not a new concept. It is a tool successfully employed by some boards to gauge the performance of the board and its members and to evaluate other aspects of board operations. In its 1999 report, *Enhancing a Culture of Independence and Effectiveness*, the Advisory Group on Best Practices for Fund Directors recommended that fund directors:

> ". . . step back periodically and review their overall performance . . . conduct . . . an evaluation, which should focus on both substantive and procedural aspects of the board's operations."[1]

While board self-assessments to date have been voluntary, under new governance rules adopted by the U.S. Securities and Exchange Commission (the "SEC"), after January 16, 2006 virtually all investment company boards will be required to conduct self-assessments annually.[2] The Independent Directors Council convened a task force of 11 mutual fund directors (the "Task Force") to consider this requirement and to offer practical guidance to boards that will be undertaking self-assessments for the first time or that are re-examining their existing self-appraisal practices.[*]

Through the end of 2002, board self-assessments were not prevalent in the mutual fund industry. An Investment Company Institute study representing approximately 94% of industry assets under management reported that 61.7% of the participating complexes had no formal or informal policies or procedures for self-evaluations.[3] While the number of boards assessing their effectiveness may be higher today, a mandatory annual evaluation program will represent a new experience for many directors.

In its Adopting Release on the Governance Amendments, the SEC stated:

> "The annual self-assessment requirement is intended to . . . [strengthen] directors' understanding of their role and [foster] better communications and greater cohesiveness."[4]

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[*] The Independent Directors Council serves the mutual fund independent director community and provides a venue to advance the education, communication, and policy positions of mutual fund independent directors. The Council's members represent 28 fund complexes with $2.956 trillion dollars in assets, or 39% of the industry assets.

A list of Task Force members and their fund affiliations is attached to this Report in the Appendix.

For purposes of this Report, the term "director" includes "trustee," and the term "independent director" refers to a director who is not an "interested person" of the fund as that term is defined in Section 2(a)(19) of the Investment Company Act.

Importantly, the Governance Amendments do not proscribe the specific aspects of a board's operations that must be considered in a self-assessment, except in two areas: (i) the effectiveness of the board's committee structure, and (ii) the number of funds overseen by directors. Also, while the board's self-assessment does not need to be in writing, the SEC has stated that the minutes of the board meeting at which the self-assessment was discussed should reflect the substance of the matters covered.[5]

The annual self-assessment requirement differs from each of the other governance standards addressed by the Governance Amendments, because it specifically requires the "board of directors" to perform the annual evaluation (each of the other provisions applies only to "disinterested directors"). The Task Force believes this was not an oversight by the SEC and would expect "interested directors" to participate in the undertaking. The Task Force notes, however, that there may be certain issues (*e.g.*, nominations, director compensation) that are, by rule or practice, primarily within the purview of independent directors, and thus participation by interested directors in these areas of the self-assessment may not be appropriate.

Because mutual fund directors' history and experience with self-assessments is limited, and due to the recent pace of change in the mutual fund industry, the Task Force believes it is premature to offer "best practices" for the conduct of board self-evaluations. Furthermore, although every mutual fund board shares a fundamental commitment to overseeing and protecting the interests of fund shareholders, the actual structure, composition, and operating needs of boards of directors vary widely among different fund complexes. Because of this, the Task Force determined that it is not practicable to suggest a single methodology or to enumerate universally applicable criteria. That being said, the directors participating on the Task Force have pooled their experiences and reviewed examples of self-assessments shared by independent directors. This Report identifies what the Task Force regards as key considerations for a board embarking on the self-assessment exercise.

The Report begins with a discussion of various ways a board might consider conducting its self-assessment. Next, the Task Force identifies those aspects of its operations a board might decide to evaluate and offers specific guidance on several areas the Task Force regards as important. The Report then reviews the considerations involved in individual self-evaluations by directors and peer reviews. The final section of the Report comments on the importance of developing an action plan to ensure that any identified areas of weakness are addressed and recommended improvements are implemented.

The Task Force encourages boards to take ownership of their self-assessments and agree in advance on issues such as:

- methodology and coordination of the process;
- areas of focus;
- extent of the record to be maintained; and
- any appropriate follow-up to the findings of the self-assessment.

In offering this guidance, the Task Force wants to underscore the inherent benefits of self-assessments. Fully realizing these benefits requires a positive attitude on the part of directors as they proceed through the self-assessment process. Indeed, the Task Force believes that forthright, thoughtful and constructive consideration by a board as to whether it is operating effectively in the best interests of the fund and its shareholders is invaluable in strengthening the board's ability to fulfill its important responsibilities. The open communication encouraged by the self-evaluation program can sharpen the board's focus as a unit and, at the same time, optimize contributions by individual board members. Improving the overall effectiveness of a board and its members benefits shareholders and therefore is the overarching goal of any self-assessment program.

## II. Conducting a Self-Assessment

The Task Force concluded that, based upon its own experiences as well as informal discussions with industry representatives and other directors who have been through the process, there is no single best method for conducting self-assessments. It appears that some boards have successfully conducted evaluations informally with little documentation other than a discussion outline. Others have chosen instead to use detailed questionnaires with a summary compilation of responses, typically without attribution to any director.[6] Documentation practices vary, and it is worth repeating that the Governance Amendments do not require board self-assessments to be in writing, although the SEC has stated that it expects the board's minutes to "…reflect the substance of matters discussed . . . ".[7]

Among the threshold issues facing a board conducting a self-assessment is determining how the process should be administered and who the coordinator should be. For example, the process could be administered and coordinated by the chair of the board, the chair of the nominating committee, an outside third party consultant or counsel. It is important to recognize that these decisions will now be made in a context where board self-assessments are no longer merely a recommended "best practice" for investment companies but are, for most funds, required by regulation. As a result, the assessment may be subject to scrutiny by regulators or litigators. In such an environment, the Task Force acknowledges that any perceived threat to the confidentiality of directors' self-assessments can have a chilling effect on the entire process. In fact, by requiring only that board minutes reflect the substance of the matters discussed in board self-assessments, the SEC seems to have implicitly recognized the need to conduct self-assessments in an environment that fosters full and frank communication by directors.

Accordingly, in order to promote optimal constructive and open dialogue and to preserve any attorney-client privilege and/or other relevant privileges, the Task Force suggests that counsel be actively involved in all aspects of the self-assessment process.[8] In engaging counsel for this purpose, it should be understood that counsel's involvement is to provide legal guidance and to assist the board in meeting the self-assessment requirement of the Governance Amendments.[9] While the Task Force accepts that there is always a possibility that a court or regulator may choose not to recognize the privilege in connection with a self-assessment, it believes counsel's involvement in the process is the most prudent course of action.

A board may wish to consider all of these factors in determining the best way to conduct its self-evaluation. If the board elects to conduct the self-assessment orally, the Task Force believes that providing board members with a discussion guide or an agenda of topics in advance of the meeting will promote a more focused discussion at the meeting. Alternatively, if the board prefers to utilize a written questionnaire and to review response compilations, the Task Force believes the board, in consultation with counsel, should adopt a procedure for the disposition of the documentation. In each case, minutes of the meeting should document the process and record key board considerations and conclusions.

## III. Topics of Board Self-Assessments

The Task Force believes that the self-assessment process will be a more positive and constructive undertaking if, at the outset, directors agree specifically on which aspects of the board's operations are to be evaluated. This may be especially important for a board that has never engaged in a formal, or even an informal, review of its effectiveness. To achieve this "buy-in" and consensus, counsel or the individual identified as the coordinator of the process might share with directors in advance a draft of the discussion guide or questionnaire, if either is to be used. The Task Force identified the following topics that may be appropriate subjects for a board self-assessment.

### A. Composition of the Board

Each board is unique in its character and dynamics. And, though it seems obvious to say, the effectiveness of any board depends ultimately upon the directors themselves and how each understands and approaches his/her role and responsibilities. For existing boards, the composition of the board is determined by the board itself. Indeed, board nominating committees must be composed entirely of independent directors who retain sole responsibility for selecting fellow independent board members.[10] Beyond legal requirements for determining independence, a board may set its own criteria for filling board vacancies or for adding new directors.

In evaluating its composition or determining criteria for filling vacancies, a board's directors might ask themselves the following questions:

***Is the size of the board appropriate?*** The Task Force observes that the number of funds in a complex will likely be a key determinant of a board's size. Boards will most likely seek to have enough members to manage its workload effectively, as well as to have a breadth of perspective as it discharges its duties.

***Is the make-up of the board appropriate?*** For most funds, this question must be answered in the context of the Governance Amendments, which provide that on or after January 16, 2006, at least 75% of a board be comprised of independent directors and the board be led by an independent chair.[11] Noting that these new requirements were adopted by the SEC to strengthen a board's independence and that some boards successfully function with independent directors exclusively, the Task Force suggests evaluations weigh the relative advantages and disadvantages of having interested directors serve on the board. For example, some commentators have observed that boards can benefit from having a member who is affiliated with management.[12] Such an "inside" director may offer a level of industry expertise and perspective that is useful in the board's decision-making process and, at the same time, by serving on the board the inside director may gain an enhanced understanding of what fellow directors view as being in the best interests of the fund and its shareholders. While a senior representative(s) of the adviser who attends board meetings (as opposed to actually sitting on the board) also can provide this insight to the board, directors may conclude that a management representative who is a member of the board, with a duty to look out for the best interests of the fund and its shareholders, is in a better position to provide such insight.

***Should the board consider standards of independence that exceed statutory requirements?*** In view of the unique organizational structure of investment companies and the potential conflicts of interest inherent in that structure, the Investment Company Act imposes strict standards of independence applicable to boards and individual board members.[13] Commentators on industry best practices have urged that the background of individuals eligible to serve as independent directors be more closely examined to ensure their undivided loyalty to shareholders. Specifically, the Advisory Group Report recommended that former officers or directors of a fund's investment adviser, principal underwriter or certain of their affiliates never serve as independent directors of that fund.[14] In addition, the Investment Company Institute Board of Governors has recommended that boards prohibit "close family members" of employees of a fund, its adviser or principal underwriter from serving as independent directors.[15] Although these considerations go beyond minimum statutory requirements, the Task Force encourages boards to take these and other personal and business relationships into account when evaluating standards of independence for their directors.

***Does the board possess the right professional/educational experience and skills to address current issues it faces?*** There are no express qualifications for service on the board of an investment company. Some boards have adopted nominating committee charters and policies that specify personal attributes sought in board candidates, including having such characteristics as "unquestioned personal integrity" and "sound business judgment gained through broad experience in significant positions." The Task Force agrees that personal integrity and sound business judgment should be baseline attributes for all independent directors. A board also may wish to assess the experience of its current directors to determine if adding a director with specific expertise will enhance the board's oversight capabilities. In today's environment, given regulatory attention to matters of compliance and financial statement integrity, board candidates having investment, finance, legal or accounting backgrounds and even investment company experience are likely to be in greater demand.[16]

***Other possible considerations:*** A self-assessment also might consider such issues as whether the board should have a retirement policy, whether there should be term limits on directors' tenure, whether the board's age distribution and diversity is appropriate, and whether the board's nominating process effectively produces the best candidates.

## B. Board Committees

One of the items the Governance Amendments specifically require each board to determine is the effectiveness of the board's committee structure.[17]

It is undeniable that the time and effort required of 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 have frequently turned to standing committees as a technique to manage their workloads. Committees may be established for a variety of purposes. Some representative standing committees include:

Audit
Brokerage
Compliance[18]
Contracts
Governance
Investment Oversight
Nomination
Operations
Valuation

The Task Force does not want to give the impression that it is a "best practice" for funds to have every one of the committees listed above. Larger fund complexes with sizeable boards may establish more committees than smaller boards or boards overseeing fewer funds. In addition, boards may establish special purpose committees to address individual events, such as accounting or valuation issues, litigation or regulatory investigations, fund mergers or liquidations or changes of control of the adviser.

Generally, committees of the board are comprised of fewer directors than sit on the full board. However, small boards and boards that oversee a single fund may have "committees of the whole" where all the independent board members serve on certain board committees.

Many of the same types of questions used to assess the operations of the full board are also relevant for committees. Listed below are some suggested areas of inquiry specifically applicable to committee evaluations:

***Should there be more/fewer committees?*** The Task Force believes that appropriately structured and effectively operating standing committees can have a significant impact on how a board manages its workload. Broadly speaking, in establishing standing committees, the board is seeking greater in-depth review and oversight of a particular aspect of the fund's operations than it is able to accomplish practically as a full board. There is no optimum number of committees that should be established. While a board's size and the complexity and number of funds it oversees are basic considerations, the directors' perspective on workload management and their comfort in "delegating" elements of their role to a committee are important factors to probe as well.

In assessing the use and effectiveness of a board's standing committees, a board may wish to expand the scope of its inquiry to include consideration of whether additional committees should be formed to focus attention on specific aspects of the fund's operations. These might include the annual consideration of its relationship with its investment adviser and affiliated service providers, the fund's investment performance, best execution and related brokerage issues, valuation of the fund's portfolio securities, overall compliance matters, the fund's disclosure documents, matters relating to pricing and distribution of the fund's shares, and the fund's relationships with its non-affiliated service providers.[19] Each of these specific areas also might be evaluated separately in a self-assessment.

***Is the composition of each committee appropriate?*** Although regulations provide that under certain circumstances committees be comprised solely of independent directors, the size of these committees is left up to the board.[20] The Task Force observes that as a matter of practice standing committees typically are comprised of independent directors only, although in some cases (*e.g.*, valuation committee) an interested director may be included because regular input from management is a part of the committee's basic function. Committee memberships may be allocated among board members to divide the workload and minimize overlaps. Additionally, some boards may find it effective to rotate committee memberships periodically to broaden directors' exposure and to gain fresh perspective, although such an approach should be weighed against the loss of continuity and expertise that may result from such a practice.

***Is the scope of each committee's activities appropriate?*** The scope of a committee's activities is determined by the board's initial delegation of authority, typically reflected in a committee charter. In periodically assessing the effectiveness of a committee, questions should elicit board members' views concerning the need to adjust the scope of a committee's original delegation. For example, a nominating committee may be asked to expand its responsibilities to include board governance matters, including making recommendations to the full board regarding the annual self-assessment process. Also, since committee charters tend to be broad and non-specific, a committee may itself decide to elaborate on the board's delegation by adopting its own policies and procedures or working agenda for the year.

***Is the information flow and communication from the committee to the full board adequate to enable the board to make informed decisions and otherwise fulfill its responsibilities?*** A committee rarely takes action on its own. A committee of the board typically is charged with making recommendations to the full board based upon a comprehensive review and in-depth analysis. Committees do not take the place of the board, and committee actions remain subject to consideration and approval by the full board. Consequently, board members who do not sit on a particular committee depend upon full and accurate reports supporting the committee's recommendations.[21] Boards may receive written summaries (*e.g.*, committee minutes) and/or an oral report from the committee chair before acting upon the committee's recommendation. The adequacy and frequency of these communications are important matters to be evaluated.

## C. Board Meetings

The key decisions and oversight relating to a fund are made at regular or special meetings of directors. Consequently, the board meeting reflects the manner in which a board discharges its fiduciary responsibilities. Fundamental to a board's self-assessment and improvement is an in-depth analysis of how its meetings are conducted. In light of the increasing responsibilities being placed upon directors, especially independent directors, the Task Force recommends frequent evaluation of board meeting effectiveness and the process by which decisions are made on behalf of shareholders.

Here are some suggested areas of inquiry to assist a board in evaluating the effectiveness of its meetings:

***Are more frequent and/or longer meetings necessary to properly deal with expanding agendas?*** The increasing workload of directors stemming from the mandates in new statutory and regulatory requirements, together with demands relating to such matters as the number and/or type of funds overseen by the board, the funds' increasing complexity, and the variety of distribution platforms through which the funds are offered, may give rise to questions about whether the board should meet more frequently and/or for longer sessions. As recently as 2002, it was the prevailing practice for investment company boards to meet quarterly, possibly with a fifth meeting to consider annual contract renewals.[22] Many boards are now reevaluating not only the number of meetings, but also the number of hours/days each meeting will last. The Task Force observes that the examination of the frequency and length of meetings may be closely correlated with considerations regarding agenda management and the board's committee structure.

***Is the location and format for board meetings appropriate?*** Often for convenience and access to fund officers and portfolio management staff, board meetings are held at the adviser's offices. If directors prefer, meetings may be held at an off-site location, such as the offices of counsel or the funds' non-affiliated service provider(s). A board might evaluate the effectiveness of in-person meetings for board deliberations (other than meetings for consideration of the advisory agreement, for consideration of 12b-1 plans and for selection of the fund's independent auditors, which are required to be in-person meetings), and their impact on interaction among directors. Similarly, if a board meeting is held by teleconference or videoconference (which is not a legal substitute for an in-person meeting), directors may wish to assess such considerations as the frequency of these meetings, the length of agendas or the complexity of issues that can effectively be addressed at these meetings.

***Are board members satisfied with the process used for setting agendas? Are agenda items appropriate?*** Determining what matters are to be addressed at each board meeting and prioritizing agenda items are critical to meeting efficiency and effectiveness. The importance of agenda-setting and the chair's involvement in formulating the agenda was underscored by the SEC in the Governance Amendments in connection with the requirement that the chair of the board be an independent director.[23]

In practice, matters to be discussed and acted upon at board meetings can be determined jointly by management, the chair, and counsel. Input from fellow directors also may be solicited. Often, an annual calendar of recurring matters requiring board consideration provides the core agenda for regular board meetings. The Task Force encourages directors to evaluate this process routinely to ensure that they are satisfied with their ability to add issues to the agenda.

***Is board meeting time properly allocated among agenda items and between board discussion and management presentations? Are issues resolved in a timely and effective manner?*** To promote effective decision-making, board members should have an adequate opportunity to evaluate and discuss relevant aspects of each agenda item. At the same time, as necessary, time should be set aside for management to discuss items requiring board consideration. Managing this process and encouraging appropriate and meaningful dialogue, while simultaneously ensuring that sufficient attention is devoted to each agenda item to enable the board to reach a conclusion it is comfortable with, are among the most important and challenging responsibilities facing the chair and board and should be evaluated.

***Are open communication and meaningful participation by board members and management encouraged at meetings?*** A boardroom atmosphere enabling and encouraging open communication among board members as well as between independent directors and management is fundamental to directors' effectively fulfilling their role as shareholder representatives. The conduct of each meeting should promote this atmosphere and directors should confirm, through the assessment process, that they, as the shareholders' "watchdogs," are in a position to exercise independent judgment. A boardroom environment that supports constructive skepticism, diligent inquiry and engaged participation on the part of all directors is an essential ingredient to produce this result.

***Do the independent directors have sufficient opportunity to meet and deliberate separately from management?*** The Governance Amendments require that, on or after January 16, 2006, independent directors meet at least quarterly in a session at which no directors who are interested persons of the fund are present.[24] While some boards have conducted executive sessions without management present as a best practice,[25] now all boards will be required to do so. Among matters to be evaluated in terms of board effectiveness are whether the board should employ the executive session tool more frequently and whether the executive sessions to date have been useful and productive.

***Do the minutes of board meetings adequately reflect the considerations of and determinations by the board?*** While the Task Force recognizes that there are different approaches to the level of detail found in board minutes, directors should consider carefully whether the minutes form a record sufficient to support the discussions held and conclusions reached by the board. The board minutes form the official record of meetings and may be open to inspection by third parties, including regulators. In addition, in applying the "business judgment" rule, courts have relied on board minutes when showing substantial deference to decisions made by appropriately informed directors.

***Is there a reliable process in place to follow up on issues raised and not resolved at board meetings?*** Often, during the course of a board meeting, matters arise that need to be pursued by management, counsel, the chair, a committee, or the auditor after the meeting. In evaluating its effectiveness, a board should consider whether there is an affirmative and effective follow-up process in place or whether improvements in an existing process may be warranted. For example, rather than waiting for the minutes of the meeting to be drafted and circulated (typically with materials for the next quarterly meeting) where such issues would presumably be restated, before the meeting is adjourned, the board might consider requesting that counsel or management prepare a list of follow-up items and the agreed-upon person(s) responsible for addressing those items.

***Do board members have sufficient access to counsel, management, and/or each other between board meetings?*** Matters often arise between meetings that require the attention of independent directors' counsel, board or committee chairs, or the full board. The accessibility of counsel, management and board members merits consideration in a self-assessment. Questions to consider might be their availability, their responsiveness and their proficiency in effectively communicating with others.

## D. Meeting Materials

The efficacy of discussions held and decisions made at board meetings is influenced significantly by the quality of the background information directors consider in connection with their deliberations. For the most part, board materials received by directors in advance of their meetings, as well as written and oral presentations delivered at meetings, are provided by management. Certain issues may be addressed by information prepared and presented by independent third parties or by counsel. It is also not uncommon for board materials to be reviewed by counsel, the independent chair or lead independent director, or committee chairs, before distribution to board members. The self-assessment process provides an opportunity for a board to identify and implement improvements or refinements in connection with the form and/or content of meeting materials.

The Task Force believes the following questions about meeting materials may be appropriate to evaluate:

***Does the board receive sufficient information to permit directors to understand and evaluate agenda items? Are board materials presented in a form and with accompanying explanations that make the information clear and understandable?*** As meeting agenda and the volume of board materials continue to expand, ensuring that directors can reasonably digest the information and make informed decisions on behalf of shareholders is an increasing challenge. Task Force members agree that the quality of board materials received by directors in advance of their meetings can have a positive effect on meeting efficiency, deliberations and decision-making. Transmittal memoranda that summarize more detailed presentations and that identify and focus the key issues before the board can provide critical support to directors as they consider increasingly complicated and sensitive subject matter. Board members' views on sufficiency and the optimal form and content of board materials will undoubtedly vary, and this is a matter the Task Force suggests may warrant ongoing attention. Even reports where no action is called for may be subject to scrutiny for improvements (*e.g.*, board members may request that portfolio management and performance reports contain more charts and tables and that narrative be more focused on performance attribution).

***Are board materials received sufficiently in advance to allow directors adequate time to prepare for board meetings?*** In order to ensure that directors feel they have adequate preparation time for meetings, the Task Force recommends that board evaluations include questions regarding the timing and manner of distribution of material prior to board meetings. Directors may prefer to establish a minimum time period before the board meeting for delivery of materials or request to receive material in a staggered time frame so they can read through each agenda item as it becomes available. Perhaps directors would like to receive more web-based material or material on CD-Rom in advance of the meetings. When a board meeting involves proposals for the annual consideration of contract renewal pursuant to Section 15(c) of the Investment Company Act, the addition of new funds to the complex, fund reorganizations, changes in key service providers to the fund(s) or similar non-routine matters, directors may need additional time to review background materials, consider the proposals and, when appropriate, hold executive sessions for preliminary deliberations with counsel or outside advisors.

## E. Oversight of Multiple Funds

The other area that boards are expressly required by the Governance Amendments to consider when conducting board self-assessments is the number of funds overseen by each director.[26] The Task Force believes that the SEC intends for boards as a whole, and directors individually, to consider their ability to represent effectively the interests of a single fund and its shareholders while simultaneously overseeing additional funds in the same family or in a different fund complex.[27] Although the SEC has offered little guidance on the nature or scope of this consideration,[28] the Task Force believes workload management is fundamental to the issue of director oversight of multiple funds. How a board and its individual members manage the board's workload is affected by a variety of factors, and boards will likely reflect wide differences in how they address the issues.

Some of the questions that may be useful in evaluating the issue of directors' overseeing multiple funds include the following:

***Are directors able to devote sufficient time and attention to matters specific to each fund and matters common to all funds in the complex? Do the directors have sufficient experience and knowledge to effectively serve all of the funds over which they have oversight?*** Because mutual fund directors have a duty to act in the best interests of each fund they oversee and that fund's shareholders, it is important to confirm their ability to devote sufficient time and attention to issues both specific to each fund and common to all funds in the complex, as well as their expertise and ability to understand and address multiple investment products. The Task Force recognizes the increasing time commitment and personal dedication involved in serving as a director for multiple funds within a complex.[29] Nevertheless, the Task Force believes it is important to recognize that a director's overall workload is not measured simply by mechanically counting the number of funds he or she oversees. This is because, for funds that are part of a fund family, a significant portion of the directors' workload involves governance issues common to all of the funds. Even fund-specific matters, such as portfolio management, performance, fund expenses and valuation of portfolio securities, often involve aspects common to all funds or groups of funds (*e.g.*, equity, fixed-income, international).[30]

***Is the structure of the fund complex effective in enabling director oversight of multiple funds?*** The Task Force suggests that one potential factor affecting a director's ability to oversee multiple funds is how the fund complex is structured. Within a family of funds, a single board may oversee all of the funds in the complex (often called a "unitary" or "pooled" board) or several boards may oversee distinct groups, but not all, of funds within the complex (often called "cluster" boards). Occasionally, within a complex consisting of cluster boards, there may be directors who overlap one or more of the clusters. Directors' access to management and management's interaction with and responsiveness to board members may be affected by the number of different boards overseeing funds in a complex. The number of separately registered investment companies that comprise a fund complex and whether a series or a master-feeder structure is utilized by the complex can also affect workload levels. Directors may wish to consider whether the structure in place is appropriate for the protection of shareholders of each fund overseen.

***Are there techniques that could be employed or adjustments to existing procedures that might enhance the board's management of its workload?*** Many of the factors affecting the effectiveness and efficiency of board operations that have been covered in earlier sections of this Report, such as the size and makeup of the board, the use of board committees, the management of board meetings, and the quality of board materials, are directly pertinent to workload management and a director's ability to protect a fund's shareholders' interests while overseeing other funds. Factors associated with the structure of a fund complex mentioned above also are relevant. For example, fund families with cluster boards may find that joint sessions of boards or board committees may be more effective and efficient for considering relationships with common service providers or for considering other matters common to the funds (*e.g.*, joint insurance arrangements).

***Should the board adopt a policy limiting its members' ability to serve on other boards?*** The Task Force recognizes that while some boards have formal or informal policies regarding their members' ability to serve on other boards, others have not adopted such policies. Nevertheless, in view of increasing workloads for directors of investment companies and greater focus on fiduciary responsibilities of serving on corporate boards generally, boards may wish to address this subject in the context of a self-assessment.

## F. Director Compensation

Compensation levels and structure can be important in attracting and retaining highly qualified board members. Assessing compensation in the context of a board self-evaluation is appropriate and customary. A board might ask:

***Is the level and structure of director compensation fair and adequate? Is the board comfortable with its process for establishing compensation?*** Although there are different approaches to board compensation, a key goal is to develop a compensation system that produces a fair level of compensation and that is able to attract and retain qualified directors.[31] Commentators on fund governance practices recommend that independent directors determine their own compensation (level, structure and form) and that, in doing so, they seek data necessary to reach a fair conclusion.[32] Such data would likely include compensation paid by comparable boards (number and complexity of funds and overall assets in the funds are typical comparative measures) together with any special factors that may relate to the funds they oversee (*e.g.*, complexity of funds, use of sub-advisers, etc.). The board may wish to engage third party consultants to facilitate in the data-gathering and analysis.

Related questions a board might consider are: ***Should the board adopt a policy encouraging or requiring directors to invest in one or more of the funds? If so, should***

***a minimum amount of investment be established and should an allocation among funds be considered?***

Commentators on board practices have suggested that fund directors might be more effective in serving the interests of fund shareholders if they have ". . . a personal investment stake in one or more of the funds that they serve. Share ownership by fund directors helps to align their interests with those of fund shareholders."[33] The Task Force believes this is a subject many boards may want to discuss during their self-assessments.

Considerations relating to deferred compensation and retirement benefits may also fall within the scope of these questions.[34]

## G. Overall Effectiveness of the Board

Beyond the more specific aspects of board operations addressed above, in conducting a self-assessment, the Task Force suggests that the board step back and gauge its overall effectiveness from a broader perspective. The questions offered below are intended to provide directors with an opportunity to evaluate the board's performance applying broader, more qualitative measures.

Fundamental Role and Responsibilities:

***Does the board approach each issue with a perspective independent from the adviser?***

***Is the board given adequate time and opportunity to evaluate and comment upon the adviser's goals, strategies and long-term plans for the funds?***

***Does the board consistently ensure that all decisions are, first and foremost, to the benefit of the fund and its shareholders?***

***Is the board's process to identify and review conflicts of interest effective?***

***Do board members understand and respect the differences between the board's policy-making and oversight roles and the adviser's operating role?***

***Do new board members receive adequate training regarding their role and responsibilities?***

***Does the board provide, or do directors attend and participate in, ongoing educational and informational programs to strengthen directors' knowledge of issues relating to best practices and fund oversight?***

Oversight Role:

***Is the board generally well prepared for its meetings?***

***Does the board have a workable process to keep abreast of current regulatory developments and their potential impact on the fund?***

***Does the board receive the required information and assistance from counsel, fund accounting, fund compliance and fund outside auditors?***

***Do board members effectively raise issues and concerns with service providers?***

***Is the interface with the chief compliance officer appropriate?***

Leadership:

***Do board and committee chairs set a tone that encourages full participation, independent thinking, open communication and a healthy airing of all of the issues prior to their resolution?***

***Is the board effective in setting a "tone at the top" for legal and ethical expectations?***

***Has the board adopted and communicated policies and procedures that are adequate to guide and support the fund?***

Board Participation:

***Does the board get the full benefit of the experience and skills of all of its members as applied to the issues that come before it?***

***Does the board work well as a team?***

***Does the board effectively deal with disagreements among its members?***

## IV. Assessing Individual Board Members

Some directors believe a thorough and complete self-assessment by a board should extend beyond an evaluation of the board as a whole, and boards may want to consider whether to assess individual members as part of the self-assessment process. Self-appraisal (in which directors assess their own performance) and peer reviews (in which directors review each other) can be effective techniques for both self-improvement and team-building, although neither is required expressly by the Governance Amendments. The Task Force observes that carefully constructed individual self-evaluations can ultimately strengthen the entire board by making each board member more effective.

Further, a discussion of the process may stimulate a director to look more closely at the level of his or her own participation and his or her ability to make the commitment required to effectively contribute to the board's work.[35]

Task Force members recognize that director self-appraisals can be sensitive undertakings. It will be important for directors at the outset of the self-assessment process to know the evaluation criteria that will be used and how confidentiality will be maintained. Importantly, directors must feel secure that the collegiality and spirit of cooperation enjoyed by the board will not be jeopardized in the process.

Individual director self-evaluations might include such questions as:

***Do I attend board meetings on a regular basis?***

***Am I well prepared for board meetings?***

***Do I participate in board meetings in a constructive and effective manner?***

***Am I sufficiently aware of and do I have a good understanding of the issues affecting the fund and shareholders so that I am able to provide critical oversight?***

***Do I approach board deliberations with a perspective independent of management?***

***Am I accessible to address matters that may need attention between board meetings?***

***Do I work well and cooperatively with the other directors, always treating each with respect?***

***Do I keep abreast of industry developments affecting the fund?***

***Am I proactive in taking advantage of opportunities to strengthen my understanding of my role as an independent director?***

Most of the questions listed above also could be adapted for a peer review.[36] Introducing peer reviews into the evaluation process may be awkward for board members, and there is considerably less industry precedent for conducting peer evaluations. A board may prefer to develop experience with board and individual self-assessments before determining whether the process should evolve to include peer reviews as well. In deciding whether to incorporate a peer review into the self-assessment process, directors should understand that the purpose is not to focus on, or single out, shortcomings of any individual directors, but to identify where additional support may be beneficial to directors. The goal, as with all evaluations, is to energize the entire board across the spectrum of its responsibilities to improve its overall effectiveness in serving fund shareholders.

## V. Action Plan

A primary goal of the annual self-assessment process is to improve board effectiveness. With a comprehensive and positively approached process, directors will walk away with an in-depth understanding of the boards' collective views of its operations, if not also ideas regarding specific areas of potential improvement.

At the conclusion of the self-assessment board members should discuss the results and, as required by the Governance Amendments, minutes should reflect the substance of the matters evaluated. The Task Force encourages boards to develop an action plan for any matters to be pursued, including a timeline and follow-through program. At subsequent meetings there should be a discussion regarding the status of implementation and minutes of these meetings should record progress on and completion of the action plan.

[1] *See* Investment Company Institute, *Enhancing a Culture of Independence and Effectiveness*, Report of the Advisory Group on Best Practices for Fund Directors (June 24, 1999) at 29-30 [Advisory Group Report] available at http://www.idc1.org/getPublicPDF.do?file=11070.

[2] Investment Company Act Release No. 26520 (July 27, 2004) [Adopting Release] available at http://www.sec.gov/rules/final/ic-26520.pdf; *see also* Investment Company Act Release No. 26323 (January 15, 2004) [Proposing Release] available at http://www.sec.gov/rules/proposed/ic-26323.htm. The SEC adopted amendments to rules ("Governance Amendments") under the Investment Company Act of 1940 ("Investment Company Act") intended to enhance the independence and effectiveness of fund boards. The Governance Amendments require funds to adhere to certain fund governance standards if they rely on certain exemptive rules under the Investment Company Act. These rules include Rules 10f-3, 12b-1, 15a-4(b)(2), 17a-7, 17a-8, 17d-1(d)(7), 17e-1, 17g-1(j), 18f-3, and 23c-3 (collectively, the "Exemptive Rules"). For purposes of this Report, it is assumed that all funds rely on the Exemptive Rules.

With respect to the timing of the board self-assessments, the IDC confirmed with the SEC staff that the first self-assessment must be accomplished no later than January 16, 2007. Conversation between C. Hunter Jones, Assistant Director, Office of Regulatory Policy, Division of Investment Management, Securities and Exchange Commission, and Lisa C. Hamman, Assistant Counsel, Independent Directors Council (January 14, 2005).

[3] Data compiled from the Investment Company Institute Directors' Practices Study (July 25, 2003) [Directors' Practices Study].

[4] *See* Adopting Release, s*upra* note 2, at 24-25.

[5] *Id.* at p. 25.

[6] Where boards have used questionnaires to conduct directors' evaluations, the most prevalent practice the Task Force has seen has been a form of questionnaire that presents declarative statements about aspects of the board's operations and requests a graded response to each. For example, "The minutes of board meetings adequately reflect the considerations of and determinations by the board." The form might ask for a "satisfactory/unsatisfactory" response or an indication ranging from "outstanding" to "needs significant improvement." Explanatory comments or examples typically are encouraged.

[7] Adopting Release, s*upra* note 2, at 25.

[8] Courts have long recognized the attorney-client privilege and the work-product doctrine to protect and promote free and open communications between attorney and client, and to protect attorney work-product from normal discovery processes. *See* 8 J. WIGMORE, EVIDENCE, § 2290, at 542-43 (McNaughton rev. ed. 1961) (discussing attorney-client privilege); Edna A. Epstein, The Attorney-Client Privilege and the Work-Product Doctrine, 479 (4th ed., A.B.A. 2001) (discussing work-product doctrine). The Task Force understands that some courts also have recognized the "self-critical analysis" or "self-evaluation" privilege to further strong public interests in critical self-evaluations that might otherwise be curtailed if subject to normal discovery processes. *See, e.g.*, Clark v. Pa. Power and Light Co., No. 98-3017, 1999 U.S. Dist. LEXIS 5119 (E.D. Pa. 1999) (protecting disclosure of a confidential self-evaluation process under the self-critical analysis privilege); Flynn v. Goldman, Sachs & Co., 1993 WL 362380, *1-2 (S.D.N.Y. 1993) (recognizing privilege where "an intrusion into the self-evaluative analyses of an institution would have an adverse affect on the [evaluative] process, with a net detriment to a cognizable public interest"). Each of these legal principles may have application to communications, reports, and work-product in connection with board self-assessments.

The Task Force recognizes that, while the prevalent industry practice is for independent directors to retain counsel separate and independent from management, not all fund boards operate this way. In circumstances where "interested" directors will participate in the self-assessment, directors should seek counsel's advice regarding the applicability of the attorney-client privilege.

[9] Both counsel and the directors should consider taking appropriate steps to designate communications with counsel as privileged and to preserve the confidential nature of these attorney-client communications.
Matters that arise in a self-assessment also may encompass conduct or events that are the subject of pending or threatened claims, litigation, or government investigations and enforcement actions. Counsel should exercise care to recognize and preserve the confidentiality of attorney work product with respect to such matters.

[10] Rule 0-1(a)(7)(ii) under the Investment Company Act requires disinterested directors of a fund to select and nominate any other disinterested directors of the fund.

[11] *See* Adopting Release, *supra* note 2. *See also* Independent Directors Council, *Implementing the Independent Chairperson Requirement*, IDC Task Force Report (January 2004). A fund's board must continue to satisfy the Investment Company Act prerequisites for board composition and the Task Force reminds directors of Rule 31a-2(a)(4) under the Investment Company Act, which requires funds to maintain any documentation, including questionnaires, used to determine that a director is not an interested person of the fund.

[12] *See* Advisory Group Report, *supra* note 1, at 11-12; *see also Best Practices and Practical Guidance for Mutual Fund Directors*, Report of the Mutual Fund Directors Forum (July, 2004) at 7 [MFDF Report].

[13] *See* Rule 2(a)-19 under the Investment Company Act (defining the term "interested person") and Section 10(a) of the Investment Company Act (mandating at least 40% of directors on fund boards not be "interested persons" of the fund). *See also* Governance Amendments, *supra* note 2 (mandating at least 75% of directors on fund boards not be "interested persons" of the fund).

[14] *See* Advisory Group Report, *supra* note 1, at 13.

[15] *See* Investment Company Institute, *Resolution of the Board of Governors of the Investment Company Institute* (Oct. 3, 2003) available at http://www.ici.org/issues/dir/03_fund_gov_best_stmt.html.

[16] *See* Adopting Release, *supra* note 2, Dissent of Commissioners Cynthia A. Glassman and Paul S. Atkins, at fn. 35. Form N-CSR, adopted by the SEC pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 and implemented by amendment to Rule 30b2-1 under the Investment Company Act, requires an investment company to disclose whether it has at least one "audit committee financial expert" serving on its audit committee (*See* Item 3 of Form N-CSR).

[17] Adopting Release, *supra* note 2, at 25.

[18] Recently, in response to expanded board compliance oversight responsibilities generated by new Rule 38a-1, some boards have established compliance committees responsible for (i) overseeing the chief compliance officer's implementation and administration of the funds' compliance policies and procedures and monitoring the chief compliance officer's oversight of the compliance policies and procedures of the funds' service providers, (ii) recommending to the full board the appointment, compensation, and/or removal of the chief compliance officer, and (iii) receiving all reports delivered by the chief compliance officer between board meetings.

[19] For example, recent commentators have recommended that fund boards designate a committee, comprised of some or all of the board's independent directors, to "…oversee…the review process…" in connection with the board's annual consideration of the renewal of the fund's agreement with its investment adviser. *See* MFDF Report, *supra* note 12, at 28. A board might consider whether its review of this critical relationship could be materially enhanced by establishing such a "contracts" committee.

[20] Rule 32a-4 under the Investment Company Act exempts investment companies from the requirement that the selection of a fund's independent public accountant be submitted for ratification or rejection at the next annual shareholders' meeting if the board has established an audit committee composed ". . . solely of directors who are not interested persons of . . ." the fund. *See also* Rule 10A-3(b)(1)(iii) under the Securities Exchange Act of 1934, which requires a listed closed-end fund's audit committee to be comprised solely of independent directors and has been viewed by commentators as a "best practice" for open-end funds. *See* American Bar Association Section of Business Law, Fund Director's Guidebook (2d ed. 2003) at 12 [Director's Guidebook]. *See also supra* note 10.

[21] The Maryland Corporation Code provides that a director is entitled to rely on information prepared or presented by a committee of the board on which the director does not serve if the director reasonably believes the committee merits confidence. Maryland General Corporation Law §2-405.1(b)(1)(iii).

[22] *See* Directors' Practices Study*, supra* note 3, at 3.2.

[23] *See* Adopting Release, *supra* note 2, at 18-19.

[24] Rule 0-1(a)(7)(vi) under the Investment Company Act. *See also* Advisory Group Report, *supra* note 1, at 24.

[25] *See* Directors' Practices Study, *supra* note 3, at 3.5.

[26] *See* Adopting Release, *supra* note 2.

[27] The Independent Directors Council has formed a task force, consisting of 14 independent directors, to study and issue a report on issues relating to director oversight of multiple funds.

For purposes of this Report, the Task Force considers each investment portfolio that reports performance separately as a single "fund."

[28] *See* Proposing Release, *supra* note 2.

[29] *See "Depending on Independent Directors,"* Wall Street Journal, October 18, 2004 (quoting one director as saying "…workload is up a minimum of 50% from two years ago, but it's probably more than that").

[30] *See* C. Meyrick Payne and Jock Patton, *"Governing Many Funds with a Single Board,"* Mutual Fund Governance, available at http://www.mfgovern.com.

[31] The Task Force acknowledges that the adequacy of directors' and officers' liability insurance coverage and indemnification also is critical to attracting and retaining qualified directors and, in that context, is a subject closely related to compensation. While the Task Force recognizes that the adequacy of the directors' protection from personal liability could be included in a self-assessment program, D&O/E&O insurance otherwise is subject to in-depth consideration and analysis by a board on an annual basis.

[32] *See, e.g.,* Advisory Group Report, *supra* note 1, at 16-17; MFDF Report, *supra* note 12, at 10; and Director's Guidebook, *supra* note 20, at 26.

[33] *See* Advisory Group Report, *supra* note 1, at 17.

[34] The Task Force notes that disclosure of these items is required in a fund's statement of additional information. *See* Item 12 of Form N-1A.

[35] A fund's organizational documents often include provisions for the resignation and removal of board members.
[36] Beginning each of the above questions with "Do all of the directors . . . " or "Are all of the directors . . . " (versus "Do I . . . " or "Am I . . . ") could be an alternative way to address these subjects. If responses to the alternative questions suggest some shortcomings, directors may wish to follow-up with additional questions regarding individual director performance.

## APPENDIX

IDC TASK FORCE MEMBERS

| | |
|---|---|
| Paul Ades | Certain Smith Barney Funds |
| Herbert Eggerding | Thrivent Funds |
| David Gunning | MFS Funds |
| Debra McGinty-Poteet | Brandes Investment Funds |
| Peter Meenan (Task Force Chair) | MainStay Funds<br>Vantagepoint Funds |
| Anne Mills | Aquila Group of Funds |
| James Peterson | American Funds |
| Donald Romans | Burnham Investors Trust<br>The Phoenix Funds |
| Patrick Simpson | Columbia Funds |
| Marcia Wallace | North Track Funds |
| Jon Zeschin | ICON Funds |

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