OVERVIEW OF

Fund Governance Practices 1994–2008

KEY FINDINGS

- **FUND BOARDS, AS A GROUP, FOLLOW STRONG GOVERNANCE PRACTICES TO BEST SERVE THE INTERESTS OF SHAREHOLDERS.**
  Studies of board practices indicate that over the past 14 years, fund boards have adopted such practices in advance of, or in the absence of, any regulatory mandate to do so.

- **AS OF YEAR-END 2008, INDEPENDENT DIRECTORS MADE UP THREE-QUARTERS OF BOARDS IN ALMOST 90 PERCENT OF FUND COMPLEXES.**
  Between 2000 and 2008, the number of complexes reporting that independent directors hold 75 percent or more of board seats rose from 52 percent to 88 percent. Current SEC rules require only that funds relying on common exemptive rules have boards with a majority of independent directors.

- **NEARLY TWO-THIRDS OF FUND COMPLEXES REPORT HAVING AN INDEPENDENT BOARD CHAIR.**
  Sixty-three percent of complexes reported having boards with independent chairs at year-end 2008. When complexes that have boards with independent lead directors are also considered, 84 percent of participating complexes reported having an independent director in board leadership at year-end 2008.

- **MORE THAN NINE IN 10 FUND COMPLEXES REPORT THAT SEPARATE LEGAL COUNSEL SERVE THEIR INDEPENDENT DIRECTORS.**
  The total percentage of complexes reporting that independent directors are represented either by dedicated counsel or counsel separate from the adviser's has increased steadily, from 68 percent in 2000 to 96 percent at year-end 2008. More than half of complexes say their independent directors retain their own counsel—separate from both fund counsel and the adviser's counsel.

- **A VAST MAJORITY OF FUND COMPLEXES HAVE AN AUDIT COMMITTEE FINANCIAL EXPERT.**
  While current rules require only that funds disclose whether or not the audit committee includes a financial expert, 97 percent of participating complexes report having a financial expert on the audit committee.

INVESTMENT COMPANY INSTITUTE AND INDEPENDENT DIRECTORS COUNCIL

Background

Fund boards perform an important role in the oversight of the $10 trillion fund industry. The Investment Company Act of 1940 (1940 Act) and its related rules impose significant responsibilities on fund boards and dictate elements of board structures and practices. Over the past several years, there has been increased focus by fund boards as well as regulators on ways to enhance fund governance. In 1995, the Investment Company Institute (ICI) began to document fund governance practices by collecting data from fund complexes biennially.[1] The Independent Directors Council (IDC) was formed in 2004, and since then, the studies have been conducted jointly by ICI and IDC.

Board practices have been influenced by changing attitudes toward governance as well as by regulatory actions (see "Fund Governance Developments" below). In 1999, for example, a panel of interested and independent fund directors convened by ICI identified 15 practices to enhance the independence and effectiveness of fund directors. Their recommendations were published as the *Report of the Advisory Group on Best Practices for Fund Directors: Enhancing a Culture of Independence and Effectiveness* (*Best Practices Report*).[2] Studies since 1999 document the effect of the *Best Practices Report* and other developments on board practices industrywide.

This overview provides common fund governance practices covering the period from 1994 through 2008, and is an update to the overview published two years ago.[3] While the complexes participating in each biennial study have varied over the years, an examination of the data reveals certain trends. To put these data in context, this overview includes information on fund assets managed by complexes that participated in each of the biennial studies, the average fund assets served per director, the average number of funds served, and selected independent director characteristics.

FUND GOVERNANCE DEVELOPMENTS

Year	Development
1999	SEC hosts roundtable discussion on fund governance.
1999	ICI publishes advisory group report on best practices for fund directors (*Best Practices Report*).
2001	SEC adopts rule amendments focused on board governance requirements (2001 SEC Rules).[4]
2004	SEC adopts rule amendments focused on board governance, including requirements that fund boards be composed of at least 75 percent independent directors and chaired by an independent director (2004 SEC Rules).[5]
2006	Federal appeals court invalidates requirements in the 2004 SEC Rules that fund boards be composed of at least 75 percent independent directors and chaired by an independent director.[6]
2006	SEC seeks additional comment on 75 percent independent director composition and independent chair requirements.[7]

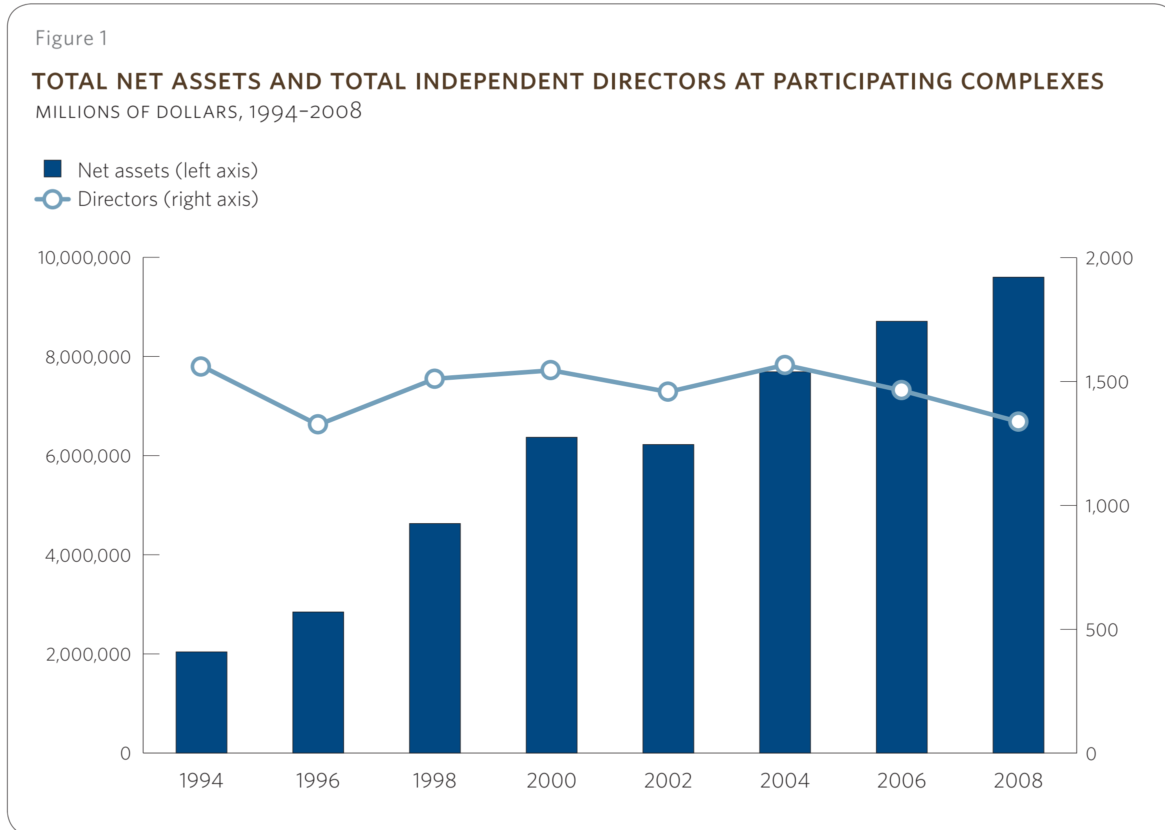
Fund Net Assets and Independent Directors at Participating Complexes

We present data on the aggregate fund net assets of complexes participating in each of the biennial studies to put our analysis in context. Further, we present the aggregate number of independent directors at these complexes. It should be noted that the number and identity of complexes participating in the studies change over time.

Figure 1

TOTAL NET ASSETS AND TOTAL INDEPENDENT DIRECTORS AT PARTICIPATING COMPLEXES

MILLIONS OF DOLLARS, 1994–2008



Fund Net Assets and Funds Served by Independent Directors

The average fund net assets served by independent directors has increased in each of the studies conducted over the 14-year period (Figure 2). The average number of funds served has been stable in recent years, but increased in 2008 (Figure 3). This increase may be attributable to changes in the study population.

Figure 2

NET ASSETS SERVED BY INDEPENDENT DIRECTORS

MILLIONS OF DOLLARS, 1994–2008

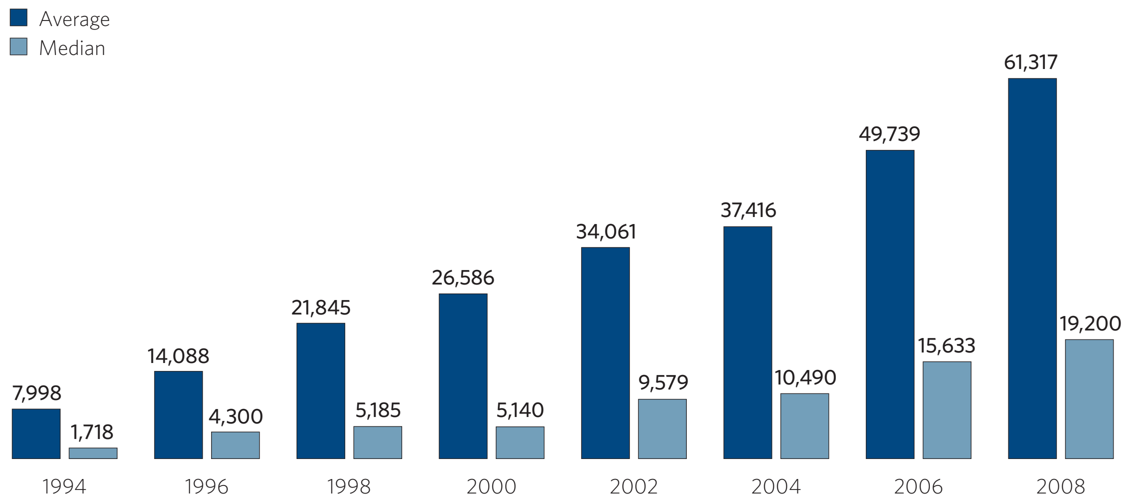
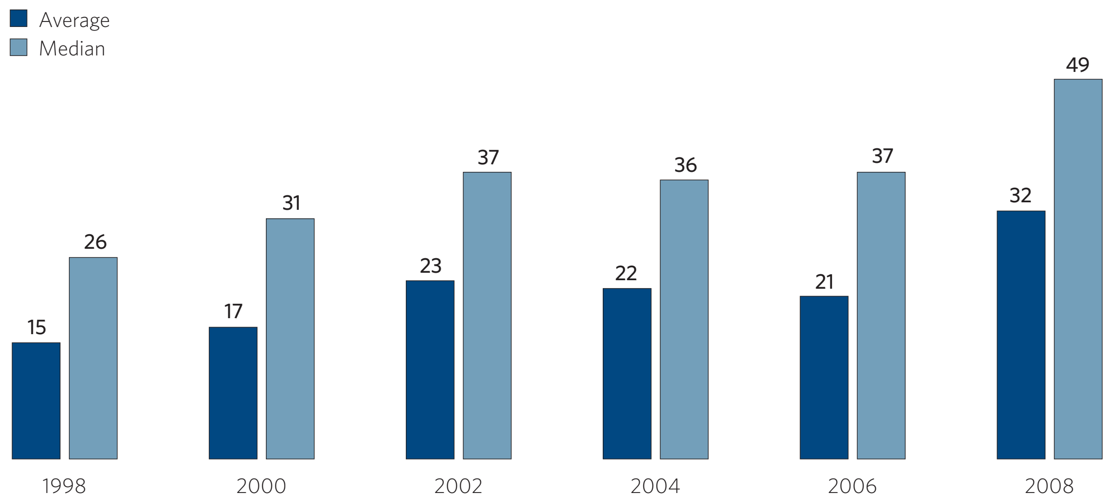


Figure 3

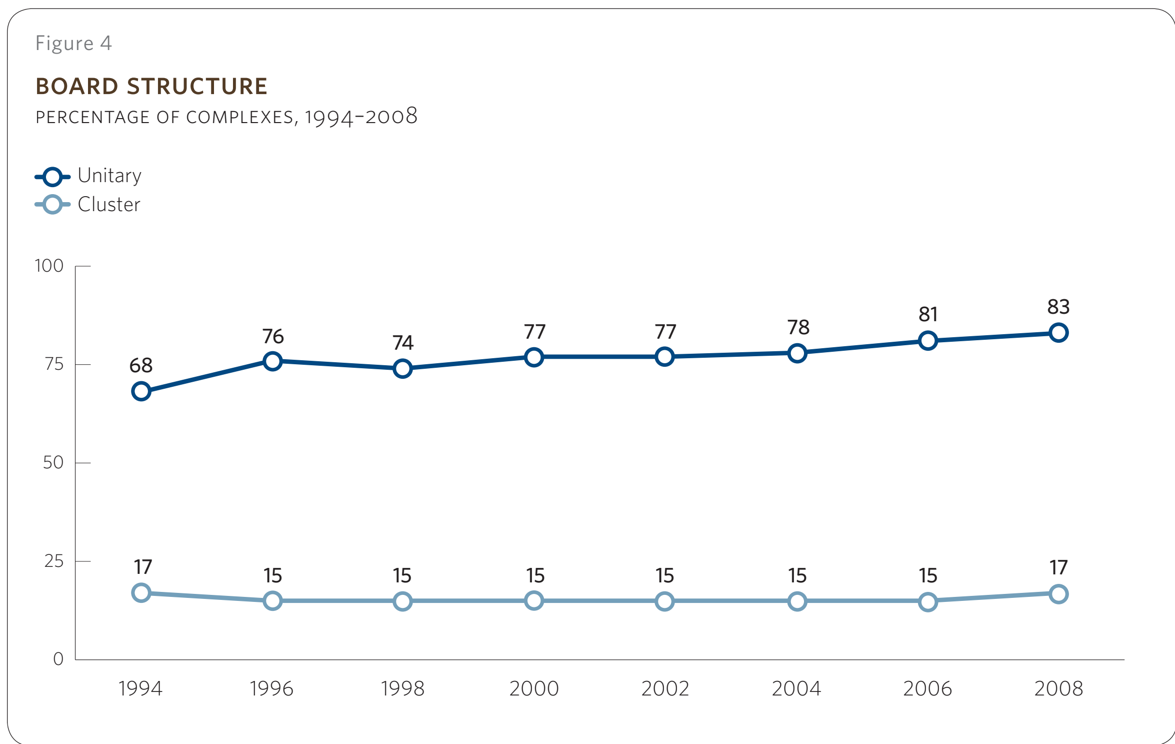
FUNDS SERVED BY INDEPENDENT DIRECTORS

NUMBER OF FUNDS, 1998–2008



Board Structure: Unitary or Cluster Boards

Since 1994, most complexes have employed a unitary board structure, meaning that a single board oversees all funds in the complex. As of 2008, 83 percent of participating complexes have a unitary board structure. Some complexes, particularly large ones, have adopted a cluster structure where there are several boards within the complex, each overseeing a designated group of funds. The number and makeup of the clusters may be determined by a number of factors, including the type of funds (e.g., money market, institutional) or whether the funds in a particular cluster were acquired by the complex as a group. The percentage of participating fund complexes using the cluster structure over the last 14 years has remained relatively stable at around 15 to 17 percent (Figure 4). ICI's *Best Practices Report* recommends that complexes adopt either a unitary or cluster board structure rather than have a different board oversee each fund in the complex.



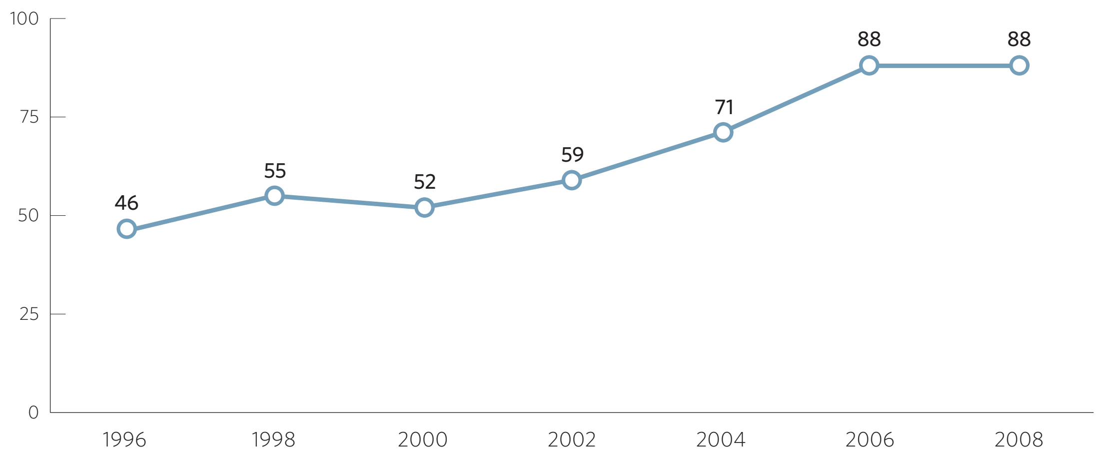
Complexes Where 75 Percent or More Board Seats Are Held by Independent Directors

Over the years, these studies have collected information on the number of independent directors relative to the total number of directors at a fund complex. Under the 1940 Act, independent directors—directors who are not "interested persons" of the fund under the 1940 Act—must constitute at least 40 percent of each board unless special circumstances (e.g., following a merger) dictate a higher percentage. ICI's *Best Practices Report* recommends that each board have a two-thirds majority of independent directors. The 2001 SEC Rules mandated a majority of independent directors for funds relying on certain exemptive rules, and the 2004 SEC Rules increased the required percentage to 75 percent independent directors on each board.[8] In 2006, a federal appeals court invalidated the 75 percent independent director requirement.[9] The SEC subsequently sought additional comment on that component of the fund governance rules, but has not taken further action. Whether the SEC will revisit this issue is uncertain.[10] Significantly, the number of complexes with a board composition of at least 75 percent independent directors has steadily increased in recent years (Figure 5). In 2004, the number of complexes with 75 percent of board seats held by independent directors increased to 71 percent, likely in response to the 75 percent mandate that was pending at that time. By 2006, the vast majority (88 percent) of complexes reported that 75 percent or more of the board seats at the complex were held by independent directors, and that percentage remained the same in 2008.

Figure 5

COMPLEXES WHERE 75 PERCENT OR MORE OF BOARD SEATS ARE HELD BY INDEPENDENT DIRECTORS

PERCENTAGE OF COMPLEXES, 1996–2008



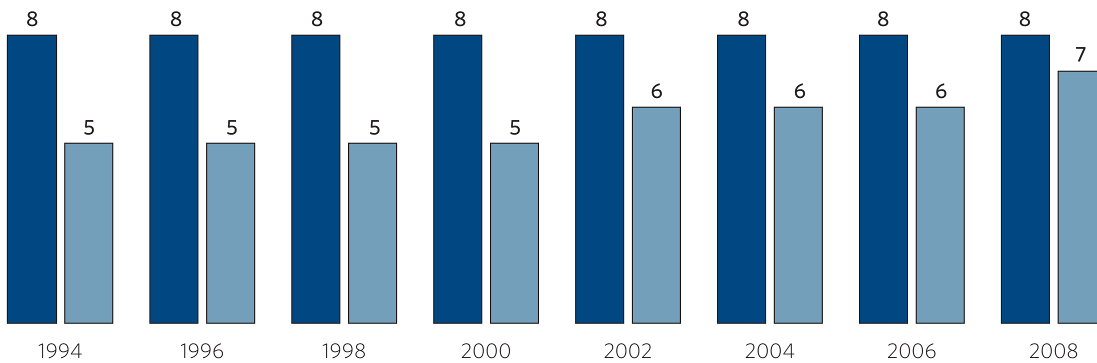
Number of Independent Directors for Each Complex

The number of independent directors in a given complex is influenced by the total number of directors on the board as well as the number of fund boards at the complex. The average number of independent directors per complex has remained unchanged over the course of the 14-year period (Figure 6). The median number remained constant through 2000 and increased slightly in 2002 and again in 2008. The 2002 rise may reflect the addition of independent directors on some boards in response to the 2001 SEC Rules requiring that independent directors make up a majority of each fund board. Results from the 2004 and 2006 studies did not appear to reveal a further increase in response to the 2004 SEC Rules, which raised the level of independent directors on each board to 75 percent.[11] These study results—along with the marked increase in the number of complexes with 75 percent of board seats held by independent directors—suggest that the higher composition of independent directors was achieved by decreasing the number of interested directors on the board. For the first time, the study reported the number of directors per board (in addition to the number for each complex). The median and average number of independent directors per board in 2008 was six. The study will continue to report the number of independent directors per board going forward.

Figure 6

INDEPENDENT DIRECTORS PER COMPLEX

1994–2008



Frequency of Board Meetings

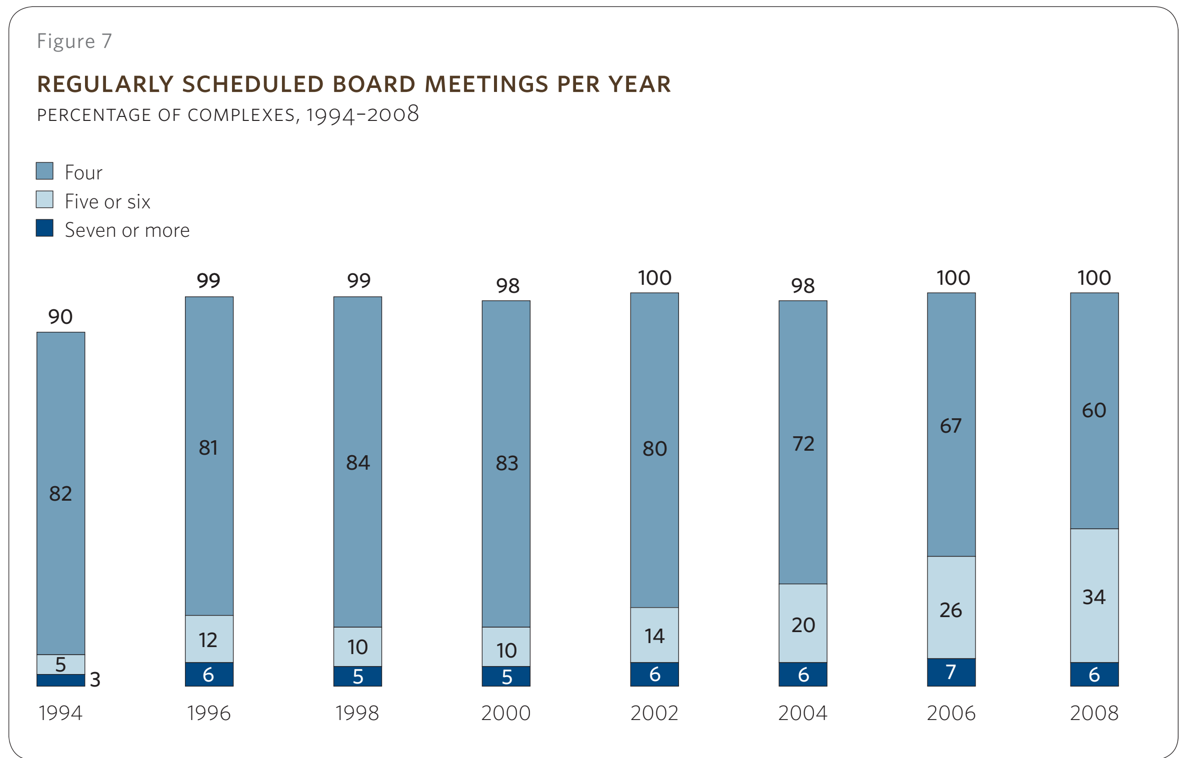
The frequency of regularly scheduled board meetings is not dictated by statute or rule. Approval of the advisory contract, among other duties, must occur annually at an in-person meeting, but the timing, length, and nature (e.g., in-person, telephonic) of the other meetings are matters to be determined by each board.[12] The decision on the frequency of meetings may be influenced by several factors, including the size of the board and the number of funds the board oversees. A board may also elect to meet less frequently but for more days each time. The workload for many boards has increased recently as a result of regulatory reforms and market developments, and the data, not surprisingly, reflect a move toward more frequent meetings (Figure 7). Forty percent of participating complexes indicate that they held five or more regularly scheduled in-person board meetings in 2008.

In actuality, however, fund directors quite often meet more frequently than called for by their regular schedule. Additional in-person or telephonic meetings are held, if necessary, to address specific issues.

Figure 7

REGULARLY SCHEDULED BOARD MEETINGS PER YEAR

PERCENTAGE OF COMPLEXES, 1994–2008



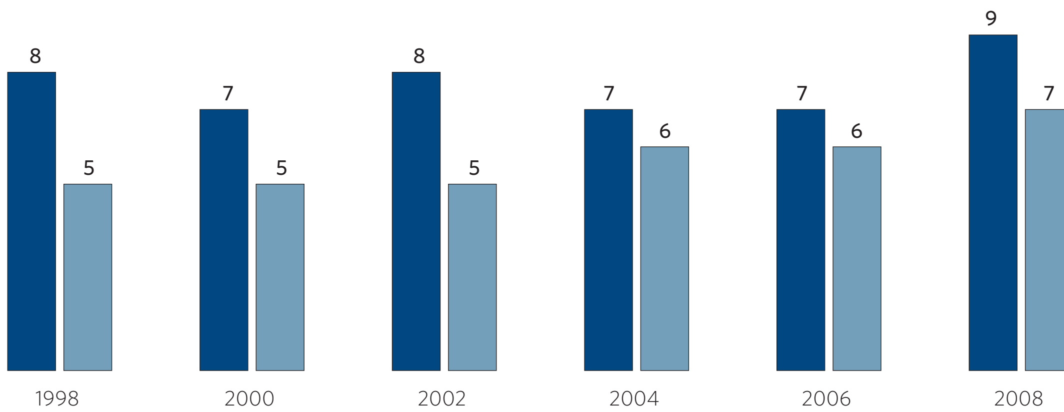
Board Meetings and Committee Meetings in Which Directors Participated

As noted, a board's regularly scheduled meetings may be augmented by nonscheduled or impromptu meetings. For that reason, since 1998, the studies have included information on the number of board meetings in which directors actually participated, either by phone or in person. Between 1998 and 2006, the number of board meetings averaged between seven and eight per year and increased to nine in 2008 (Figure 8). The turbulent market environment in late 2008 and the Department of Treasury's money market fund guarantee program may have prompted an increase in the number of impromptu board meetings. Some directors serving at cluster complexes may serve on more than one board. Such directors would normally attend four or more board meetings for each cluster they serve, and this practice likely would increase the reported average number of board meetings in which directors participated.

Figure 8

BOARD MEETINGS IN WHICH INDEPENDENT DIRECTORS PARTICIPATED
1998–2008

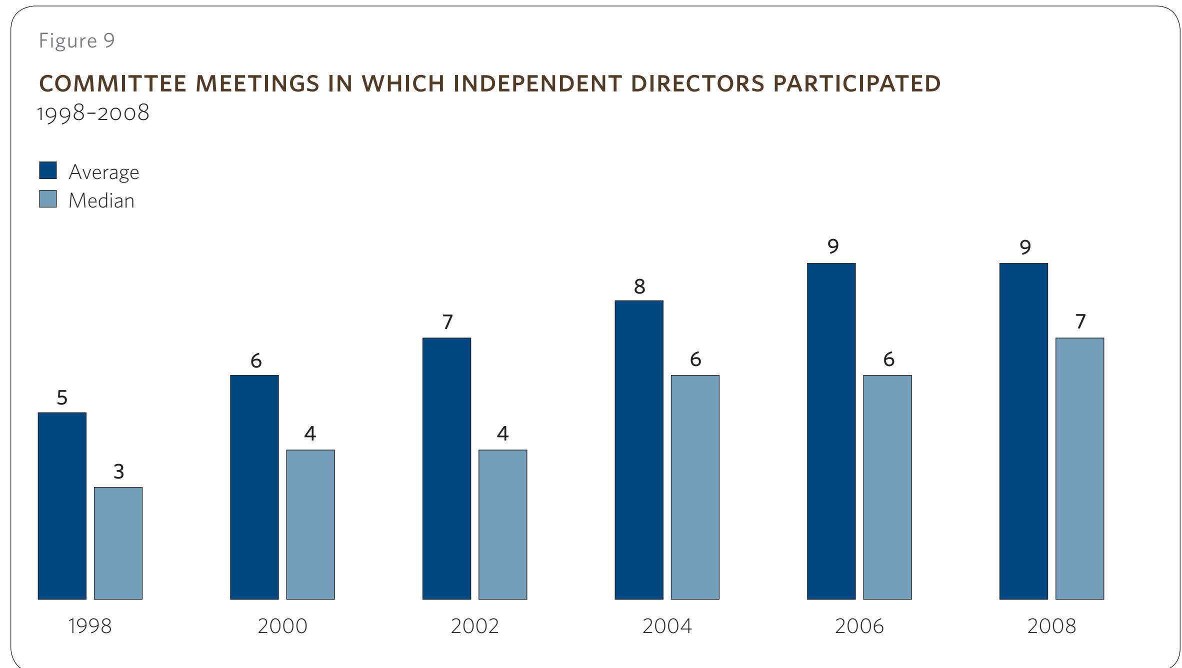
Average
Median



Quite often, committee meetings are held in conjunction with regularly scheduled board meetings. If necessary to accomplish their respective missions, committees may hold additional meetings. In addition, directors may serve on multiple committees.

Figure 9

COMMITTEE MEETINGS IN WHICH INDEPENDENT DIRECTORS PARTICIPATED
1998–2008



Independent Board Chair or Lead Director

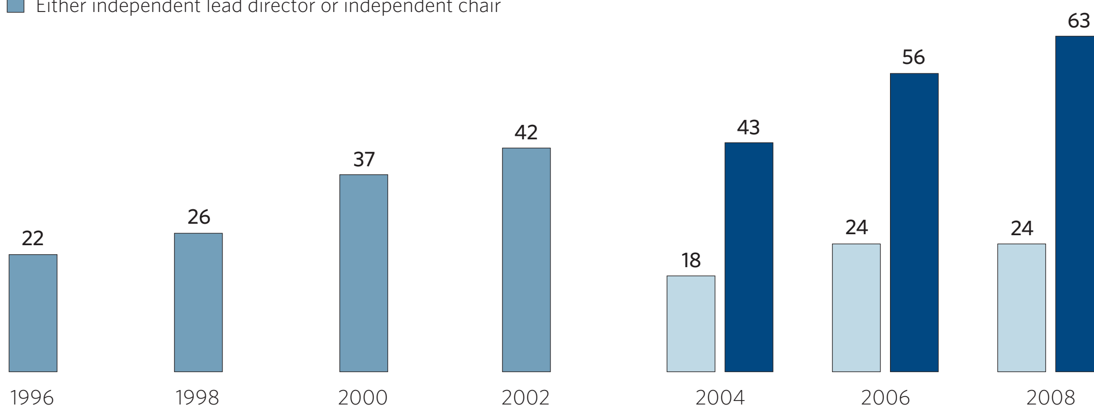
Board practices relating to independent directors serving as the board chair vary greatly. Prior to the repeal of the Glass-Steagall Act in 1999, independent board chairs were required for bank-sponsored funds. Some nonbank sponsored funds adopted the practice, but it was not widespread. Although no longer mandated after the enactment of the Gramm-Leach-Bliley Act in 1999, the independent chair practice was retained by most bank-sponsored funds. Other boards designated an independent director to serve as the primary liaison between independent directors and the adviser. This practice of designating an independent "lead director" was identified in ICI's *Best Practices Report* as an effective governance tool. The 2004 SEC Rules mandated an independent chair for all boards, but that requirement was invalidated by a federal appeals court.[13] In 2006, the SEC sought additional comment on that component of the fund governance rules, but has not taken further action. Whether the SEC will revisit this issue is uncertain.[14]

Beginning in 1996, survey participants were asked if they had either an independent board chair or an independent lead director, but they were not asked to distinguish between the two. The 2004 study, for the first time in the series, collected data separately on the incidence of independent board chairs and independent lead directors. The adoption of the 2004 SEC Rules and the board deliberations surrounding it resulted in a marked increase that year in the number of boards with independent board chairs. This trend continued in 2008 with nearly two-thirds (63 percent) of the participating complexes reporting that they have an independent board chair (Figure 10). As of year-end 2008, 84 percent of participating complexes reported having an independent board chair or an independent lead director.[15]

Figure 10

COMPLEXES THAT HAVE AN INDEPENDENT CHAIR OR INDEPENDENT LEAD DIRECTOR

PERCENTAGE OF COMPLEXES, 1996–2008



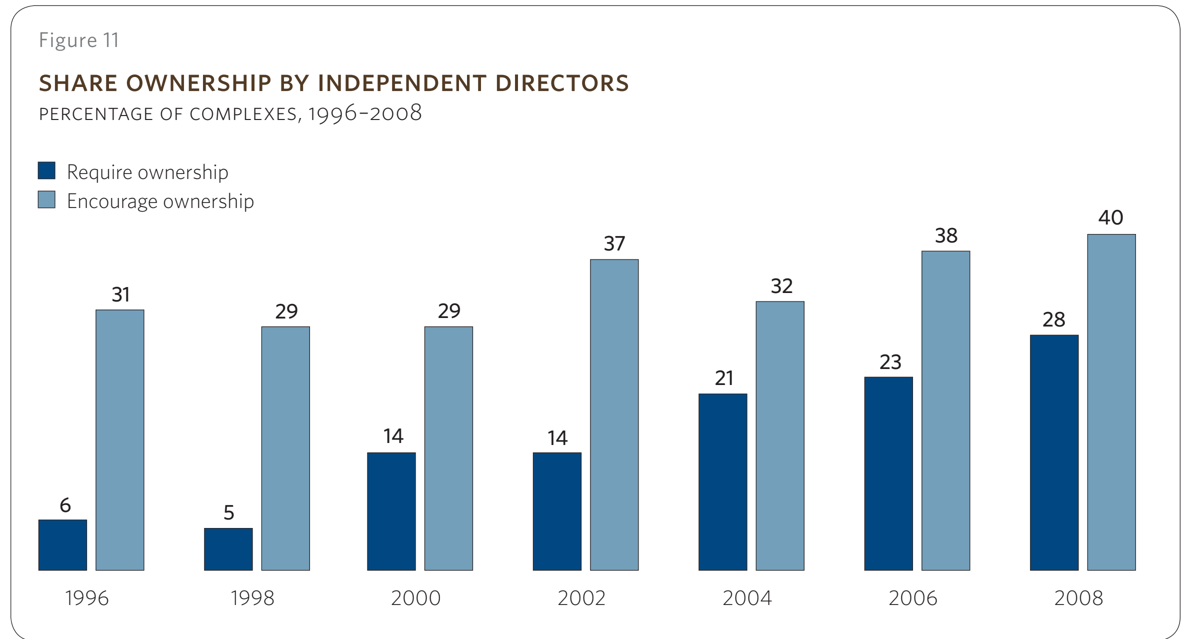
Independent Director Fund Share Ownership

While many directors choose to own shares of the funds they oversee, the practice is not routinely required. This issue attracts some attention because SEC rules require disclosure of fund share ownership by directors. The data indicate that the number of complexes formally requiring fund share ownership by directors has increased steadily since 1996 (Figure 11). As of year-end 2008, 28 percent of participating complexes reported that they have a formal policy requiring such fund share ownership. The segment of complexes encouraging, as opposed to requiring, ownership of fund shares was approximately 40 percent in 2008. ICI's *Best Practices Report* recommends that directors invest in the funds of the boards they serve.

Figure 11

SHARE OWNERSHIP BY INDEPENDENT DIRECTORS

PERCENTAGE OF COMPLEXES, 1996–2008



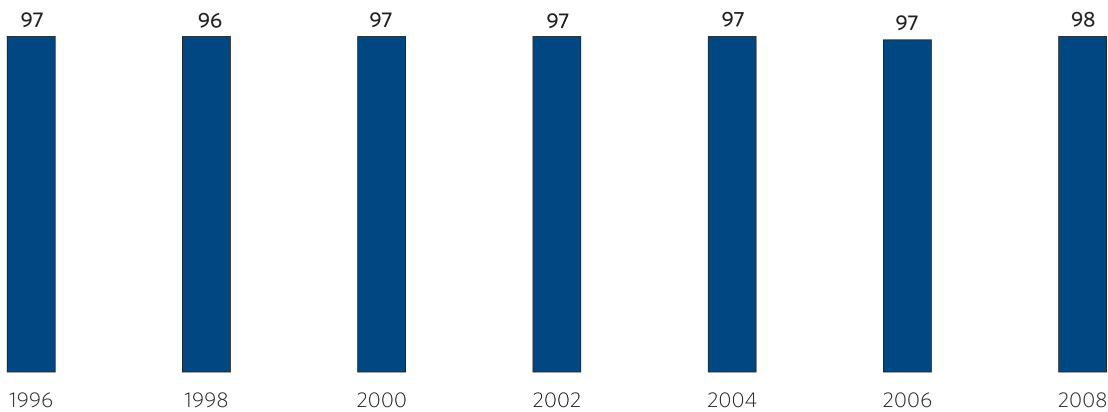
Director's Prior Affiliation with Complex

Director independence is important in a number of contexts. The 1940 Act provides that an individual is an "interested person" if he or she has certain personal, financial, or professional relationships with the fund, investment adviser, or principal underwriter. The SEC also may issue an order finding that a director who has had a material business or professional relationship with the fund, adviser, or principal underwriter within the past two fiscal years is an interested person.[16] ICI's *Best Practices Report* recommends always treating former officers or directors of the adviser, underwriter, or certain affiliates as interested persons in order to avoid any possible perception that such a director might not act in the best interests of shareholders. The studies reflect an appreciation for the letter and spirit of the law and industry best practices, as 98 percent of independent directors surveyed report never having been previously employed by the complex.

Figure 12

INDEPENDENT DIRECTORS NEVER PREVIOUSLY EMPLOYED BY COMPLEX

PERCENTAGE OF DIRECTORS, 1996–2008



Mandatory Retirement Policy

No regulatory requirement relating to retirement policies exists for fund directors, but the topic may be addressed in a board's annual self-assessment. The studies began collecting data regarding mandatory retirement policies in 1996. Since then, the percentage of complexes that have formally adopted such policies has increased gradually, reaching 69 percent in 2008 (Figure 13). ICI's *Best Practices Report* recommends that fund boards adopt policies on the retirement of directors, but declined to specify the type of policy (e.g., retirement age, term limits) or a recommended retirement age. For those complexes with a mandatory retirement policy, the average mandatory retirement age has hovered around 72 or 73 years old over the 12-year period.

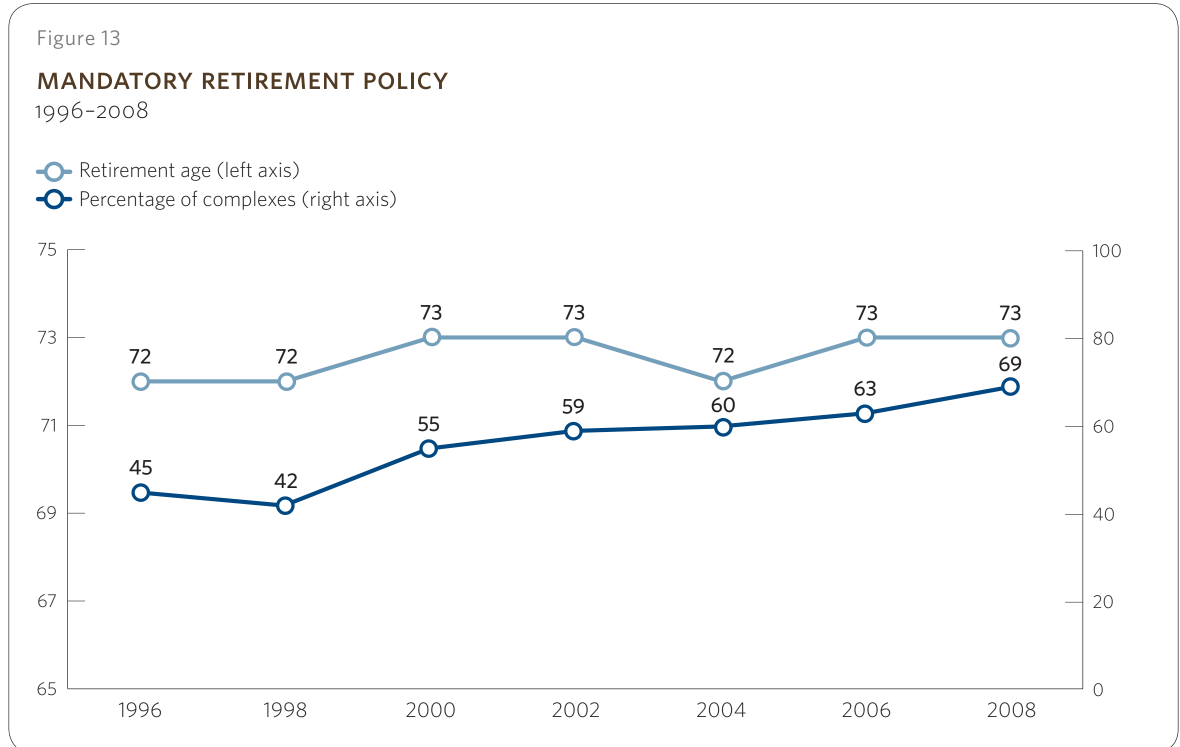


Figure 13

MANDATORY RETIREMENT POLICY
1996–2008

To help put a director's average retirement age in context, previous studies included the age of all directors participating in each biennial study and the number of years they had served their complexes as directors (Figure 14). Since 1996, the average age has edged up from 62 to 64, and the average number of years of service has increased from nine to 11 years (Figure 15).

Figure 14

AVERAGE AGE OF INDEPENDENT DIRECTORS

1996–2008

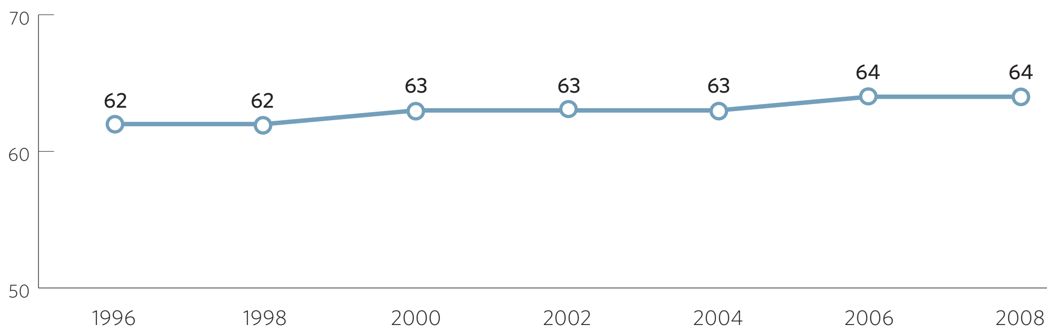
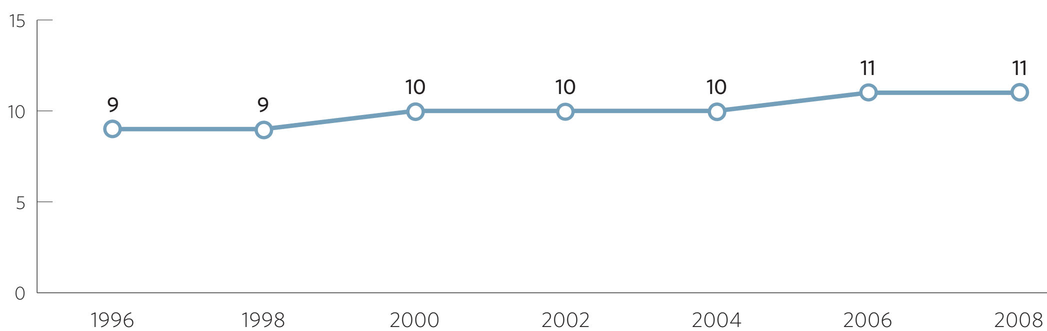


Figure 15

LENGTH OF SERVICE AT COMPLEX BY INDEPENDENT DIRECTORS

NUMBER OF YEARS, 1996–2008



Independent Counsel

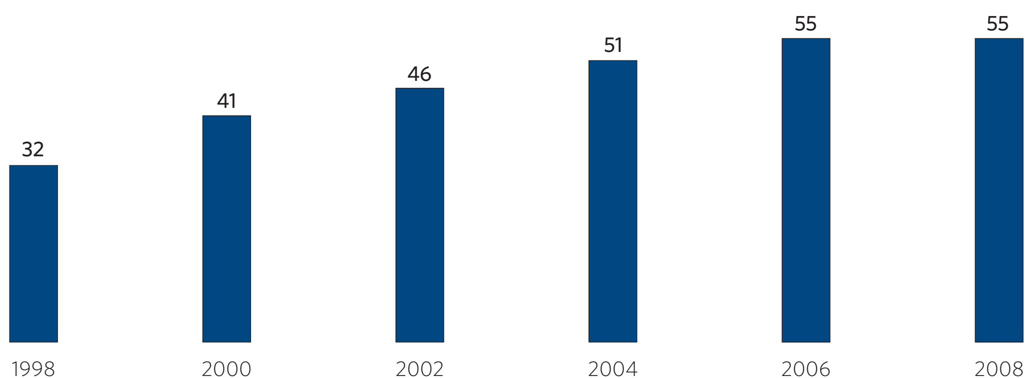
Fund boards employ a variety of arrangements in retaining counsel. Some independent directors have their own dedicated counsel, others formally retain counsel with the fund, and still others have no dedicated counsel but instead rely on counsel to the fund (or retain other counsel) on an as-needed basis. ICI's *Best Practices Report* recommends that independent directors have qualified investment company counsel who is independent from the investment adviser and the fund's other service providers. The report acknowledges that directors may elect to have their own counsel or rely on counsel to the fund and, as the data demonstrate, directors increasingly recognize this practice as a key component of effective fund governance. The 2001 SEC Rules further provide that, if the directors were to have counsel, it must be "independent legal counsel" as defined, but they decline to mandate representation.

The studies have collected data concerning director retention of counsel and, though the form of the query in the survey questionnaire has varied over time, certain trends emerge. The data show that instances where directors retain their own counsel—separate from fund counsel and the adviser's counsel—have increased markedly, from 32 percent of participating complexes in 1998 to 55 percent in 2008 (Figure 16). These instances include arrangements in which the fund, adviser, and directors are served by different counsel, as well as arrangements in which the fund and adviser share counsel, but the directors have separate, dedicated counsel.

Figure 16

INDEPENDENT DIRECTORS HAVE SEPARATE COUNSEL

PERCENTAGE OF COMPLEXES, 1998–2008

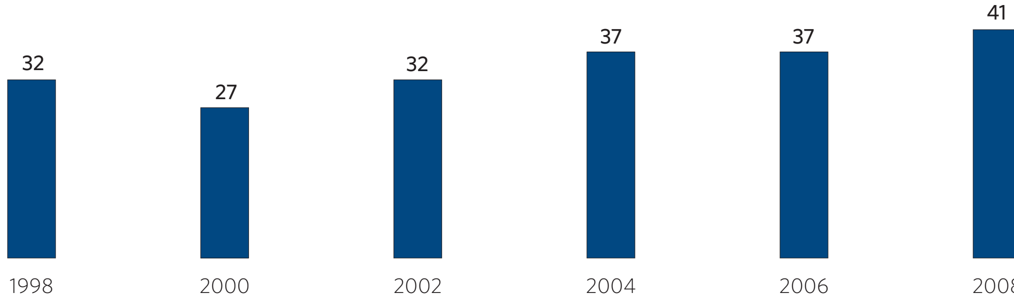


In instances where directors formally or informally rely on counsel to the fund, while the adviser is served by different counsel, the fund counsel would constitute "independent legal counsel." Complexes reporting that directors rely on fund counsel have increased from 32 percent of participating complexes in 1998 to 41 percent in 2008 (Figure 17).

Figure 17

INDEPENDENT DIRECTORS RELY ON FUND COUNSEL (DIFFERENT FROM ADVISER'S COUNSEL)

PERCENTAGE OF COMPLEXES, 1998–2008

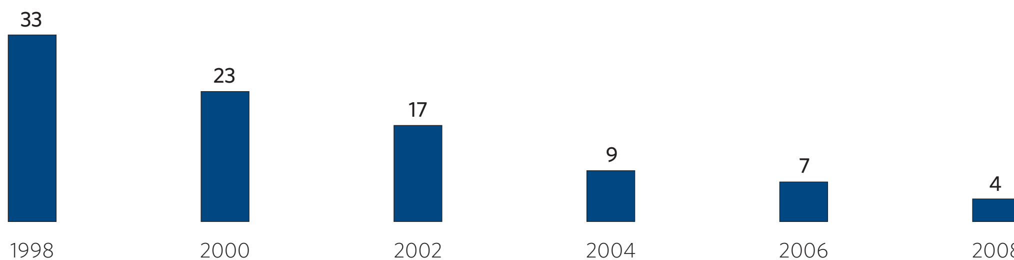


The percentage of complexes indicating that directors are not represented by counsel—and are not formally or informally relying on counsel to the fund—has declined sharply since 1998 (Figure 18). This decline was likely influenced by a number of factors, including ICI's *Best Practices Report*, the 2001 SEC Rules relating to independent counsel, and, most recently, the focus on director independence following the 2004 SEC Rules and litigation involving funds.

Figure 18

SAME COUNSEL REPRESENTS FUND AND ADVISER: INDEPENDENT DIRECTORS HAVE NO SEPARATE COUNSEL

PERCENTAGE OF COMPLEXES, 1998–2008



The data permit us to conclude that an increasing number of directors are represented by independent legal counsel. In fact, the total percentage of complexes indicating that directors either are represented by dedicated counsel or rely on the fund's counsel (different than the adviser's counsel) has increased steadily since the release of ICI's *Best Practices Report*, from 68 percent in 2000 to 96 percent in 2008. Given the increased amount of regulatory compliance matters being addressed by fund boards, such representation is beneficial to both the directors and the shareholders they represent.

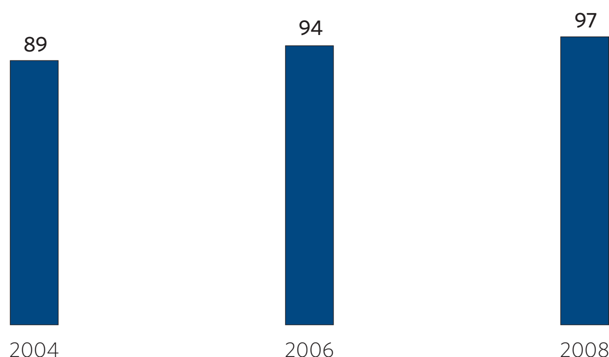
Audit Committee Financial Expert

In 2003, the SEC adopted rules that require funds to disclose whether they have at least one financial expert serving on the audit committee of the board and, if so, the name of the expert and whether the expert is independent of management. Funds that do not have an audit committee financial expert must disclose the reasons why.[17] Based on the new requirement, beginning in 2004, the studies include data on whether complexes have an audit committee financial expert. The vast majority (97 percent) of complexes have a financial expert serving on an audit committee, notwithstanding that they are not required to do so.

Figure 19

COMPLEXES WITH AUDIT COMMITTEE FINANCIAL EXPERT

PERCENTAGE OF COMPLEXES, 2004–2008



Conclusion

Fund governance practices have continued to evolve in response to emerging industry standards and often well in advance of, or in the absence of, explicit regulatory requirements. ICI and IDC will continue to document these and other trends in fund governance practices through their studies and will publish updated overviews every two years in conjunction with the biennial collection of data.

Notes

[1] ICI and IDC collect data on board practices from participating fund complexes through the *Directors Practices Study*. The first such study, conducted in 1995, collected data covering the year ended December 31, 1994, and 4,048 funds were represented. Subsequent studies covered 1996 (5,191 funds), 1998 (6,452 funds), 2000 (7,740 funds), 2002 (8,073 funds), 2004 (7,549 funds), 2006 (7,764 funds), and 2008 (7,690 funds). This overview will use the term “studies” to refer to all of the biennial studies collectively; results that are unique to a particular study will be identified by year.

[2] Investment Company Institute, *Report of the Advisory Group on Best Practices for Fund Directors: Enhancing a Culture of Independence and Effectiveness* (June 24, 1999).

[3] ICI and IDC, *Overview of Fund Governance Practices* (1994–2006).

[4] Securities and Exchange Commission, Investment Company Act Release No. 24816 (January 2, 2001).

[5] Securities and Exchange Commission, Investment Company Act Release No. 26520 (July 27, 2004). The 2001 and 2004 SEC Rules imposed conditions on fund boards that rely on any one of 10 popular exemptive rules. Most funds rely on at least one of these rules. Accordingly, this overview will discuss the conditions as generally applying to all funds. Because the 2004 SEC Rules now mandate certain fund governance practices that previously were optional (i.e., that boards conduct self-assessments and that independent directors meet in separate sessions), we have discontinued collecting data regarding those mandated practices and do not include such data in this overview.

[6] *Chamber of Commerce v. Securities and Exchange Commission*, 443 F.3d 890 (DC Cir. 2006). In 2005, the court stayed the effectiveness of the rule amendments requiring boards to be composed of 75 percent independent directors and have an independent chair until the litigation was concluded. See C*hamber of Commerce v. Securities and Exchange Commission*, No. 05-1240 (DC Cir. August 10, 2005).

[7] Securities and Exchange Commission, Investment Company Act Release No. 27395 (June 13, 2006) and Investment Company Act Release No. 27600 (December 15, 2006).

[8] See 2001 SEC Rules, note 4, supra, and 2004 SEC Rules, note 5, supra.

[9] See *Chamber of Commerce v. Securities and Exchange Commission*, note 6, supra.

[10] See 2006 SEC Releases, note 7, supra.

[11] As noted previously, a federal appeals court invalidated the 75 percent independent director requirement, and the SEC has sought additional comment on that component of the fund governance rules. See notes 6 and 7, supra.

[12] The frequency of board meetings is a topic that may be evaluated as part of the annual board self-assessment mandated by the 2004 SEC Rules. See also *Board Self-Assessments: Seeking to Improve Mutual Fund Board Effectiveness* (February 2005).

[13] See *Chamber of Commerce v. Securities and Exchange Commission*, note 6, supra.

[14] See 2006 SEC Releases, note 7, supra.

[15] A small percentage (3.1 percent) of complexes (typically complexes with cluster boards) reported having both an independent chair and an independent lead director. For purposes of Figure 10, these complexes are included in the percentages of complexes having an independent chair or independent lead director for 2008. Similarly, 3.1 percent of complexes in 2004 and 2.8 percent of complexes in 2006 reported having both an independent chair and an independent lead director, and they are included in the separate 2004 and 2006 percentages in the chart.

[16] Under Section 2(a)(19) of the 1940 Act, the SEC also may issue an order finding a person who had a material or professional relationship with the principal executive officer of the fund, investment adviser, or principal underwriter; with any other fund having the same investment adviser, principal underwriter, or the principal executive officer of such fund; or with any controlling person of the investment adviser or principal underwriter, within the past two fiscal years, to be an interested person.

[17] Securities and Exchange Commission, Investment Company Act Release No. 25914 (January 27, 2003).

The Investment Company Institute (ICI) is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs). ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers.

The Independent Directors Council (IDC) serves the fund independent director community and provides a venue to advance the education, communication, and policy positions of mutual fund independent directors.

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