Overview of

Fund Governance Practices

1994 – 2004

The Investment Company Institute (ICI) has collected data on board practices biennially since 1995.[1] The most recent study, which reported year-end 2004 data, was conducted on behalf of the Independent Directors Council (IDC). While the number and makeup of the boards participating in each biennial study have varied over the years, an examination of the data reveals certain trends. In general, while individual fund boards may differ, as a group they have gravitated toward practices thought to best serve the interests of shareholders. In many cases, fund boards adopted these practices well in advance of any regulatory mandate.

The Investment Company Act of 1940 (1940 Act) and its related rules impose certain requirements on mutual fund boards that dictate their structure and practices. But board structure and practices may be influenced by other factors as well, including the size of the board, the number of funds and the amount of assets a board oversees, broad industry practices, and, in some cases, conditions of settlement of administrative actions.

During the course of the past 10 years, several developments have focused increased attention on board governance practices. In February 1999, the Securities and Exchange Commission (SEC) hosted a roundtable discussion on fund governance. Later that same year, ICI formed an advisory group of interested and independent directors that issued a report on best practices for fund directors (ICI Best Practices Report).[2] The report included 15 recommendations of practices followed by some of the industry's most experienced boards. In 2001, and again in 2004, the SEC adopted rule amendments that focused on board governance requirements (2001 SEC Rules[3] and 2004 SEC Rules,[4] respectively).[5]

In this overview, we focus on a number of mutual fund board structures and practices common across the industry. We analyze trends over the past 10 years, or other relevant periods for which we have data. Unique events or factors that may have influenced a particular practice during the period are noted in the accompanying commentary. To put these data in context, we also report 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.

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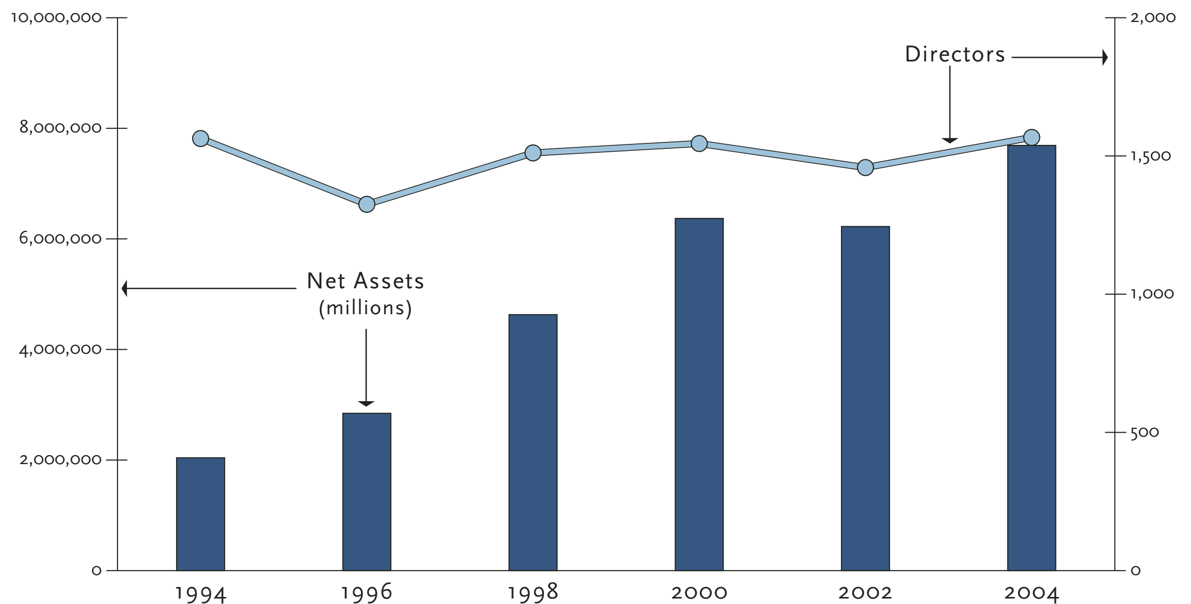
Fund Net Assets and Independent Directors at Participating Complexes

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.

Total Net Assets and Total Independent Directors, by Year

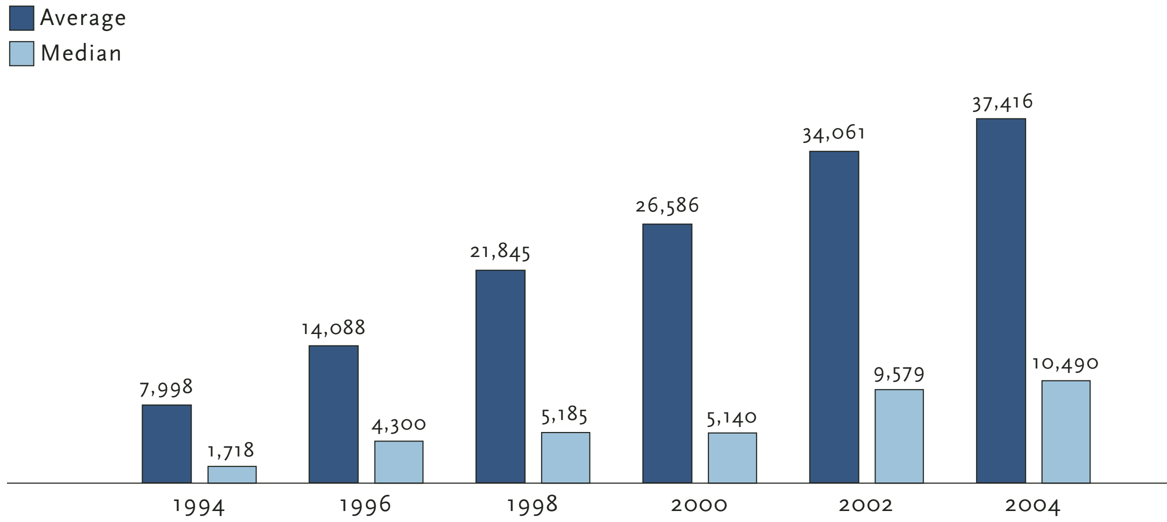


Fund Net Assets and Funds Served by Independent Directors

The average fund net assets served by independent directors have increased in each of the studies conducted over the 10-year period. The average number of funds served increased steadily from 1998 to 2002, and appeared to plateau in 2004.

Net Assets Served by Independent Directors*

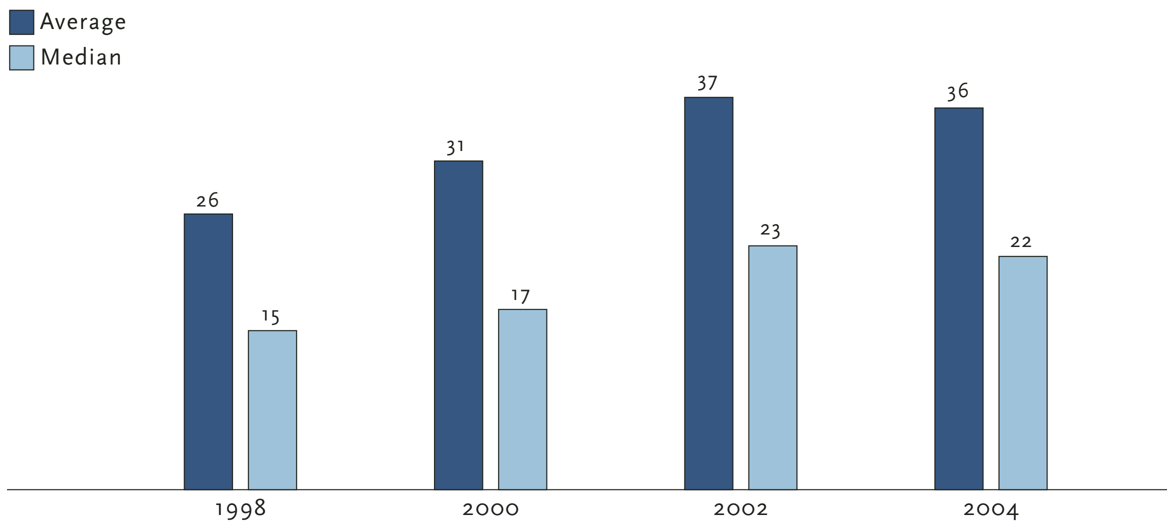
(millions of dollars)



*average and median across all reporting independent directors

Funds Served by Independent Directors*

(number of funds)



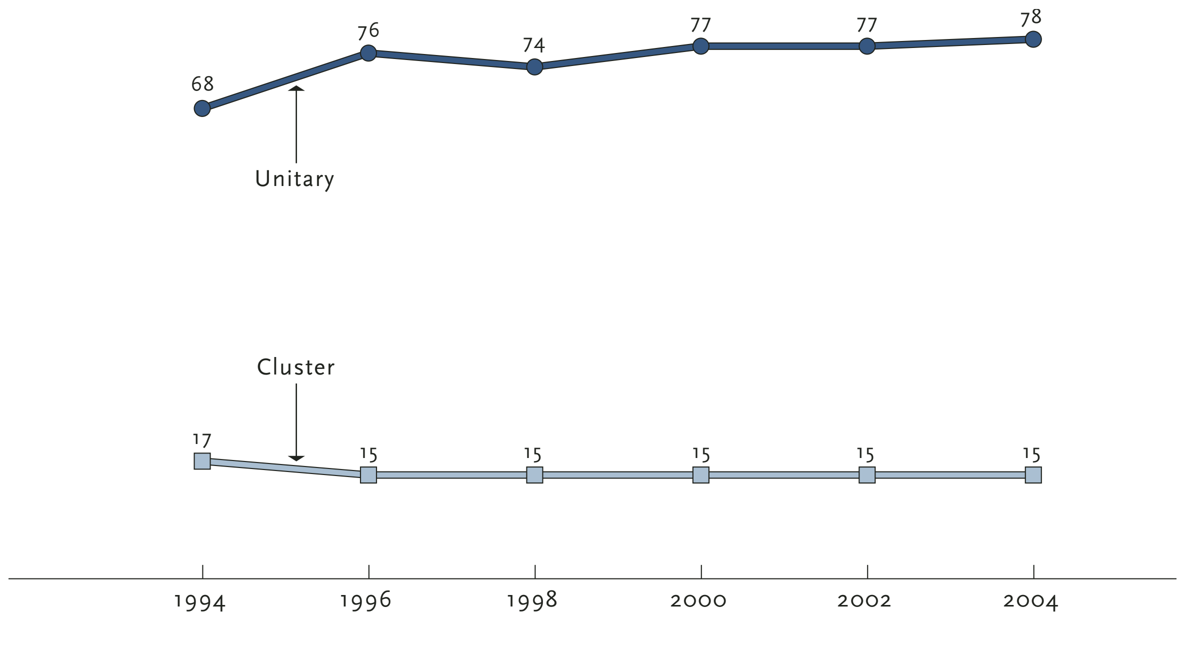
*average and median across all reporting independent directors

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 2004, 78 percent of participating complexes had 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. These complexes find that the cluster structure helps manage the workload associated with a large number of funds.[6] The number and makeup of the clusters may be determined by a number of factors, including the type of funds (*e.g.*, money market or institutional funds) or the fact that the funds in a particular cluster were acquired by the complex as a group. The percentage of participating fund complexes utilizing the cluster structure over the last 10 years has remained relatively stable at around 15 percent. The ICI Best Practices Report recommended that complexes adopt either a unitary or cluster board structure rather than having a different board oversee each fund in the complex.

Board Structure

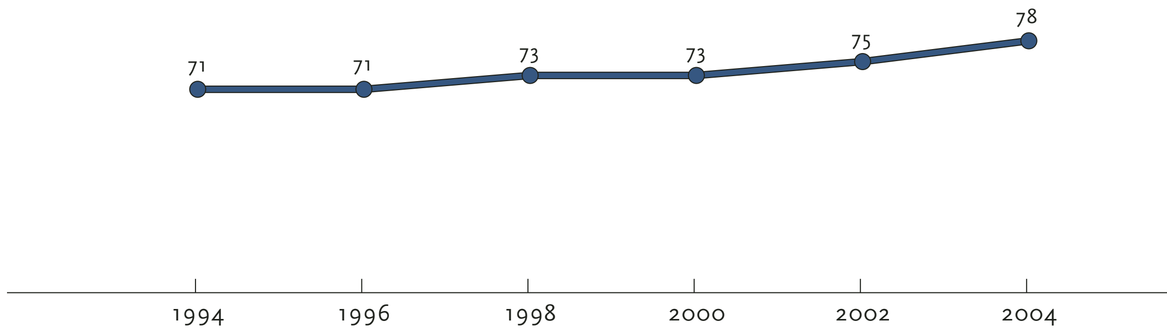
(percent of complexes)



Ratio of Independent Directors to Total Directors

The studies over the years 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. The 1999 ICI Best Practices Report recommended that each board have a two-thirds majority of independent directors. The 2001 SEC Rules mandated a majority of independent directors, but the 2004 SEC Rules increased the required percentage to 75 percent independent directors on each board beginning in January 2006.[7] Significantly, the ratio of independent directors to total directors at participating complexes has consistently exceeded these regulatory requirements and the ICI Best Practices Report recommendation. The small increase in the ratio of independent directors to total directors observed in 2004 likely reflects changes in response to the pending 75 percent mandate.

Ratio of Independent Directors to Total Directors*

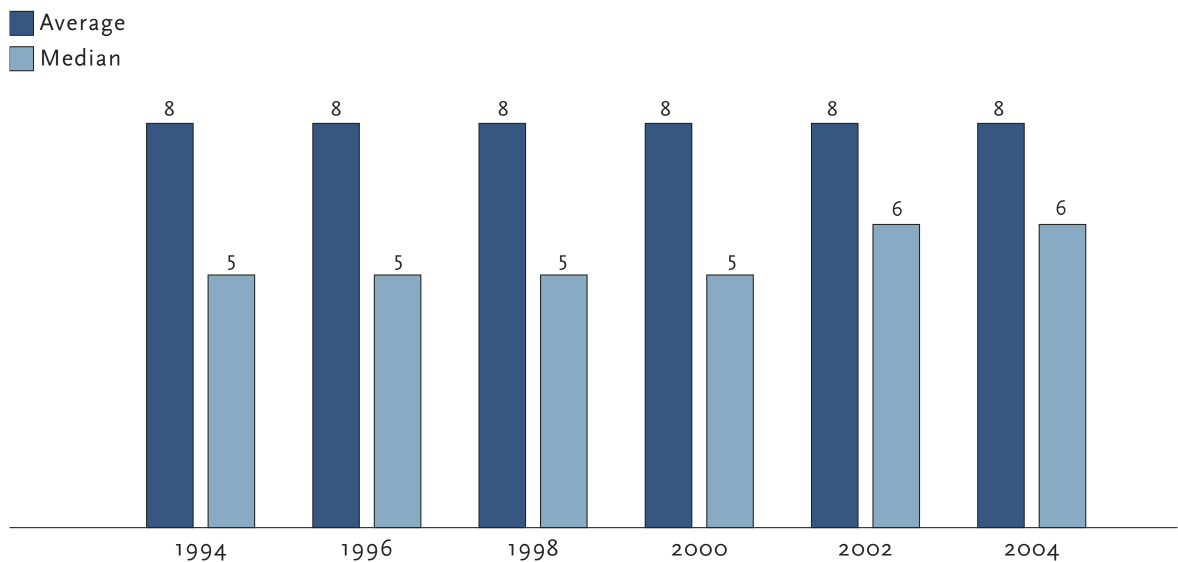


*average ratio across all reporting complexes in each year

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 10-year period. The median number remained constant through 2000, and increased slightly in 2002. This rise may reflect the addition of independent directors on some boards in response to the 2001 SEC Rules requiring that independent directors comprise a majority of each fund board. Results from the 2004 study 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. These study results may suggest that the independent directors added in previous years elevated the percentages on the board to the new required level, or indicate that the required percentage was achieved by decreasing the number of interested directors on the board. It is also possible that some boards are awaiting the outcome of litigation challenging the 75 percent requirement before adding members to their boards.

Independent Directors Per Complex*



* average and median across all reporting complexes in each year

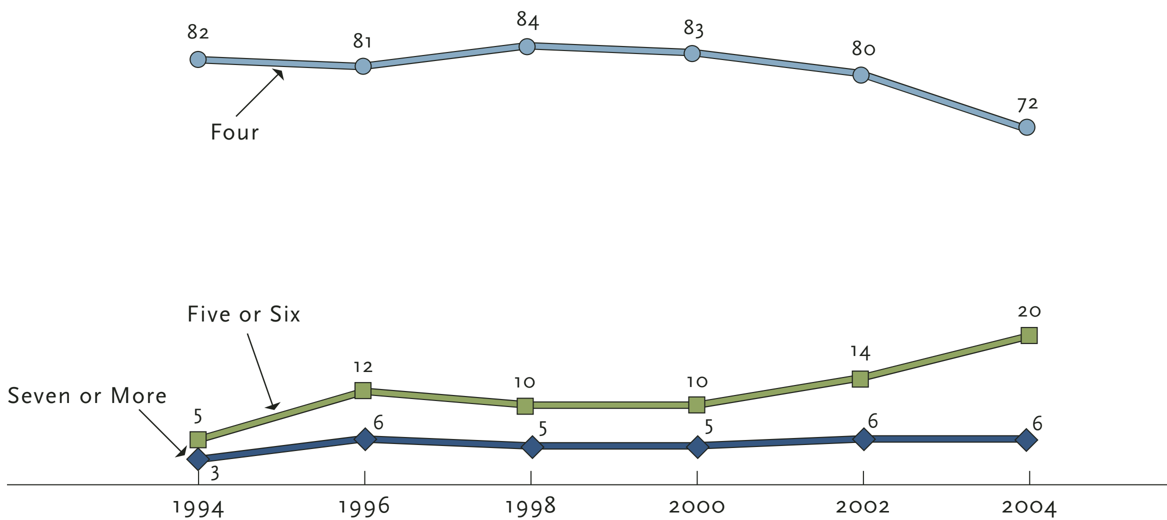
Frequency of Board Meetings

The frequency of regularly scheduled board meetings is not dictated by statute or rule. Approval of the advisory contract, among other duties, must occur at an in-person meeting but the timing, length, and nature (*e.g.*, in-person or telephonic) of the other meetings are matters to be determined by each board.[8] 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 the data not surprisingly reflect a move toward more frequent meetings. Nevertheless, the majority of boards continue to hold four regularly scheduled, in-person board meetings each year.

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.

Regularly Scheduled Board Meetings During the Year

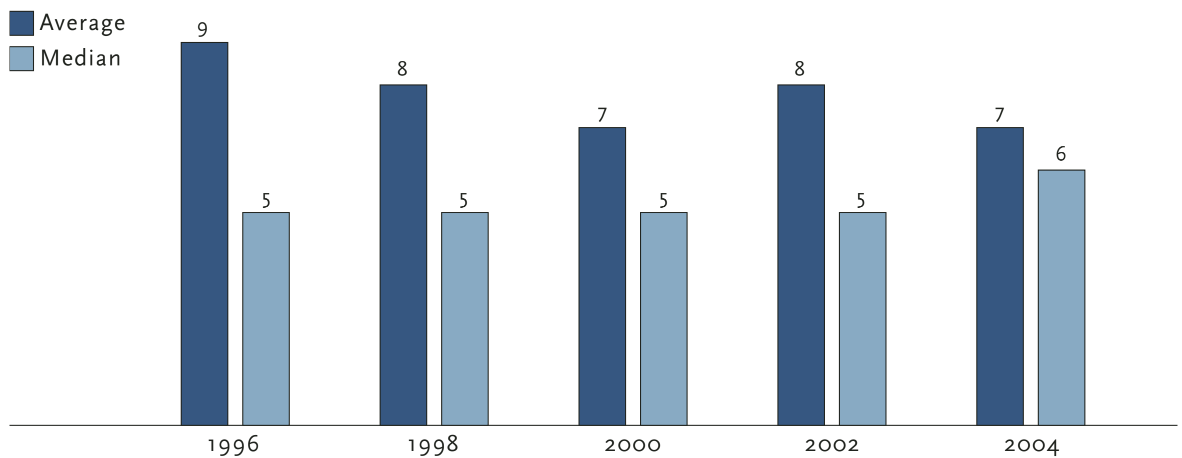
(percent of complexes)



Board Meetings and Committee Meetings in Which Directors Participated

As noted, the number of a board's regularly scheduled meetings may be augmented by non-scheduled or impromptu meetings. For that reason, since 1996, the studies have included information on the number of board meetings in which directors actually participated, either by phone or in-person. On average, these board meetings have numbered between seven and eight per year since 1998. 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 a director participated.

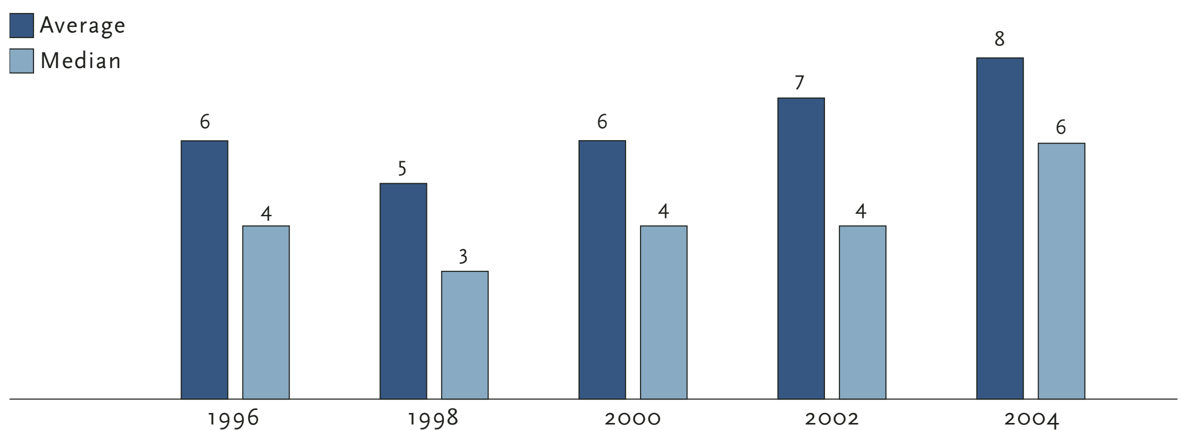
Board Meetings in Which Independent Director Participated*



*average and median across all reporting independent directors

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.

Committee Meetings Attended by Independent Directors*



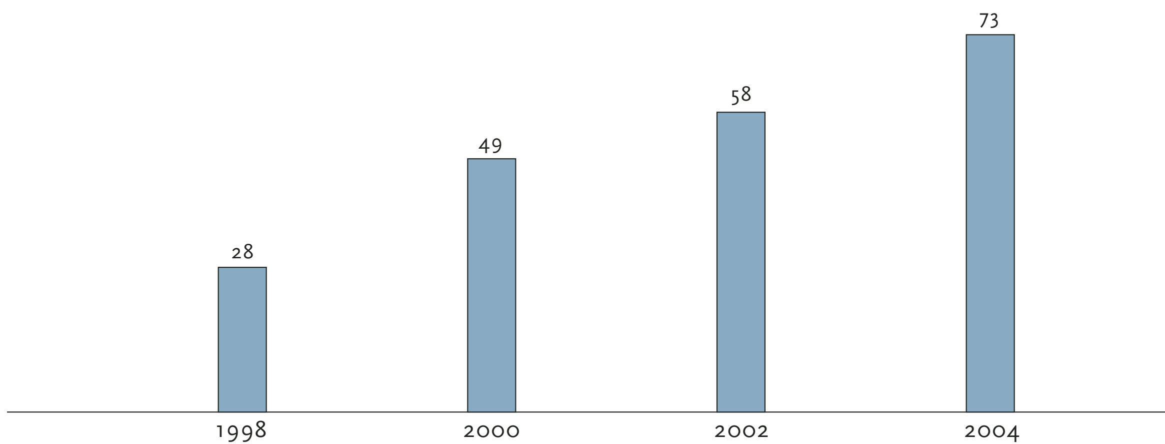
*average and median across all reporting independent directors

Separate Meetings Without Management

Starting in 1998, the studies asked participating complexes whether independent directors met as a group outside the presence of management or other employees of the adviser. In 1998, fewer than 30 percent of participating complexes reported separate meetings for independent directors, while in 2004 more than 70 percent conducted separate meetings. The upward trend over the past six years reflects a strong response to two developments. In 1999, the ICI Best Practices Report recommended separate director meetings to consider the advisory and underwriting contracts and otherwise as the independent directors deemed appropriate. The 2004 SEC Rules required that, beginning in January 2006, independent directors meet at least once every quarter in a separate session at which no interested persons of the fund are present.

Separate Meetings of Only Independent Directors*

(percent of complexes)



*question asked only from 1998 forward

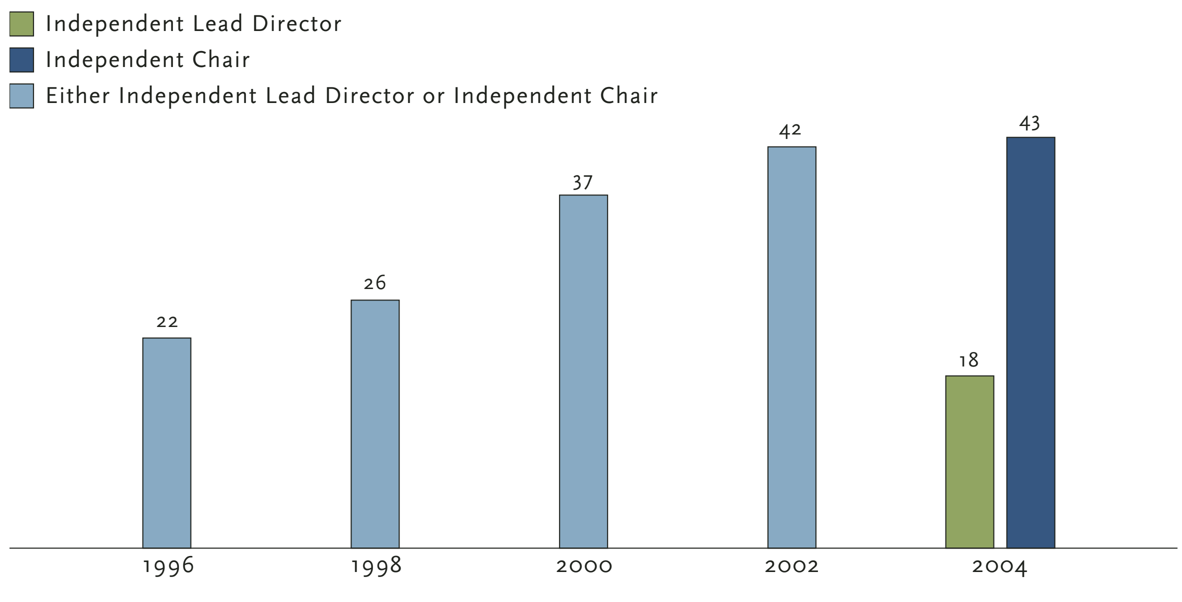
Independent Board Chair

Board practices relating to independent directors serving as the board chair vary greatly. Prior to repeal of the Glass-Steagall Act in 1999, independent board chairs were required for bank-sponsored funds. Some non-bank-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 the independent directors and the adviser. This practice of designating an independent "lead director" was recommended by the ICI Best Practices Report as an effective governance tool. The 2004 SEC Rules would mandate an independent chair for all boards beginning in January 2006.[9]

Beginning in 1996, the studies asked participants if they had either an independent board chair or an independent lead director, without distinguishing between the two. The 2004 study, for the first time in the series, collected data separately on the independent board chair and independent lead director positions. The adoption of the 2004 SEC Rules and the board deliberations surrounding it resulted in a marked increase in 2004 in the number of boards with independent board chairs. As of year-end 2004, 58 percent of participating complexes reported either an independent board chair or an independent lead director. If the independent chair mandate becomes effective, approximately 57 percent of fund boards would name new chairs.[10]

Independent Chair or Independent Lead Director

(percent of complexes)

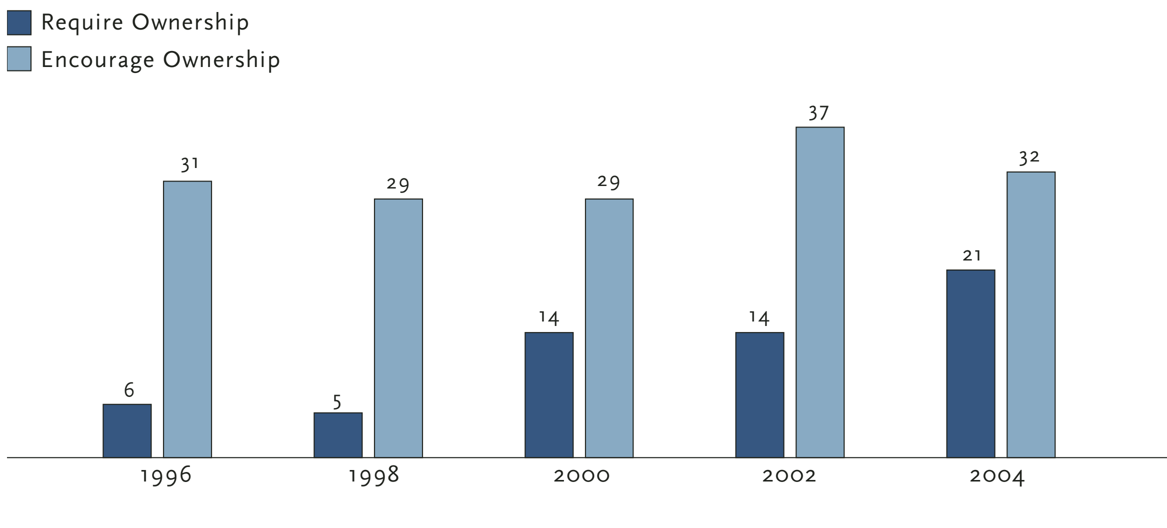


Director Fund Share Ownership

While many directors choose to own shares of the funds they oversee, it is not routinely required. This issue has attracted more attention lately because recently adopted SEC rules require disclosure of fund share ownership by directors. The data indicate that the number of complexes formally requiring fund share ownership has increased steadily since 1996 to over 20 percent as of 2004. The number of complexes encouraging, as opposed to requiring, ownership of fund shares was approximately 30 percent in 2004, down from a high of 37 percent in 2002 but closer to figures reported in previous years. The ICI Best Practices Report recommended that directors invest in funds on whose boards they serve.

Share Ownership by Independent Directors

(percent of complexes)

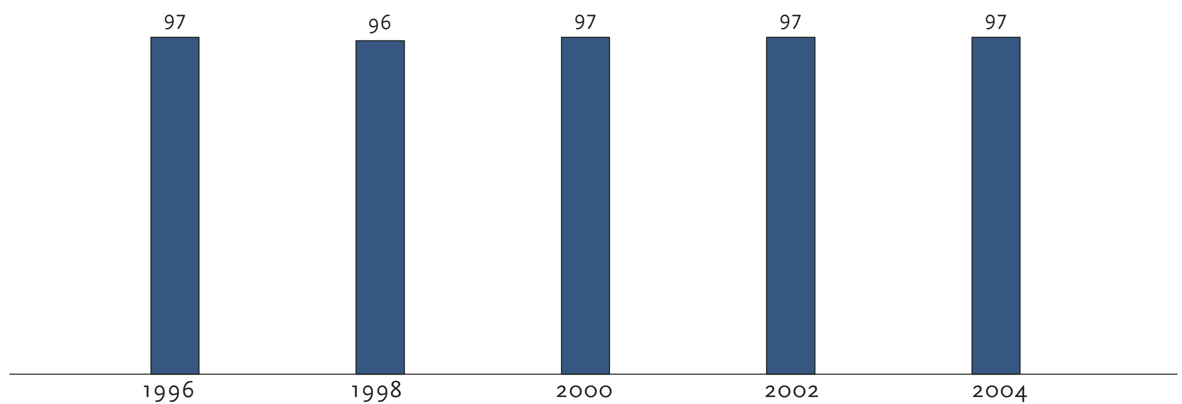


Director's Prior Affiliation with Complex

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 investment adviser, principal underwriter, or the investment company. The SEC also may issue an order finding that a director who has had a material business or professional relationship with the fund, the adviser or the principal underwriter, or the principal executive officer of such company within the past two fiscal years is an interested person. The ICI Best Practices Report recommended always treating former officers or directors of the adviser, underwriter, or certain affiliates as interested in order to avoid any possible perception that such a director may not act in the best interests of shareholders.[11] The studies reflect an appreciation for the letter and spirit of the law and industry best practices as 97 percent of independent directors surveyed report never having been previously employed by the complex.

Independent Directors Never Previously Employed by Complex

(percent of directors)



Annual Questionnaire on Director Relationships

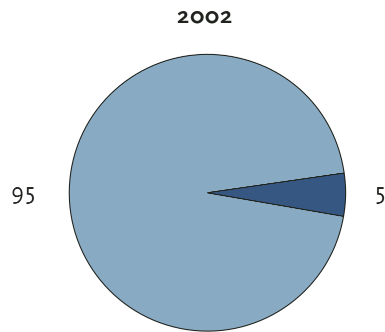
To help monitor for changes potentially impacting the independence of the funds' independent directors, many fund complexes ask directors to complete an annual questionnaire that requests information on the directors' relationships with the fund's adviser, underwriter, service providers, and affiliates of the adviser. The ICI Best Practices Report recommended this practice in 1999. Study data, which are available in 2002 and 2004 only, indicate that a vast majority of participating complexes follow this practice.

Do Independent Directors Answer Annual Questionnaire Regarding Relationships with Adviser, Underwriter, Service Providers, and Affiliates?

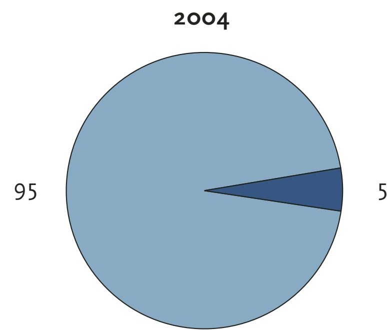
(percent of complexes)

Yes
No

2002



2004



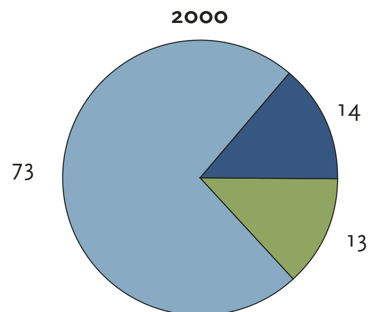
Board Self-Assessments

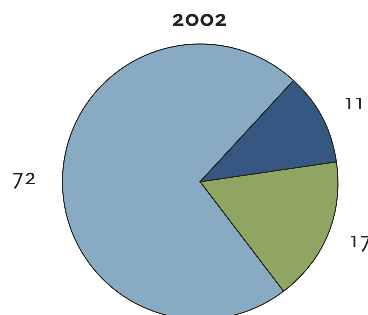
Prior to the 2004 SEC Rules, boards were not required to conduct self-assessments. Pursuant to these rule amendments, beginning in January 2006, fund directors must evaluate, at least once annually, the performance of the board and its committees. The ICI Best Practices Report in 1999 recommended that directors periodically evaluate the board's effectiveness, but did not address whether it must be pursuant to a formal policy. The studies collected data on this question beginning in 2000. Coincident with the adoption of the 2004 SEC Rules, the percentage of participating complexes with formal policies on self-assessments jumped sharply. The percentage of participants with informal policies has risen as well, but less markedly. The 2004 data reflect that 63 percent of participating complexes have either a formal or informal assessment process. Nevertheless, nearly 60 percent of participating complexes will need to adopt formal policies prior to January 2006.[12]

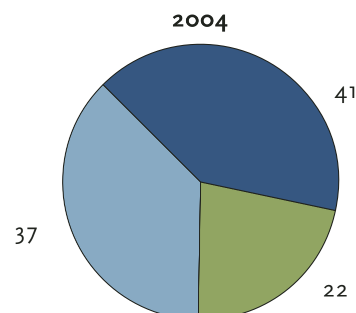
Fund Board Self-Assessment

(percent of complexes)

Formal Policy Requiring Self-Assessment
No Formal Policy but Self-Assessment Occurs
No Self-Assessment



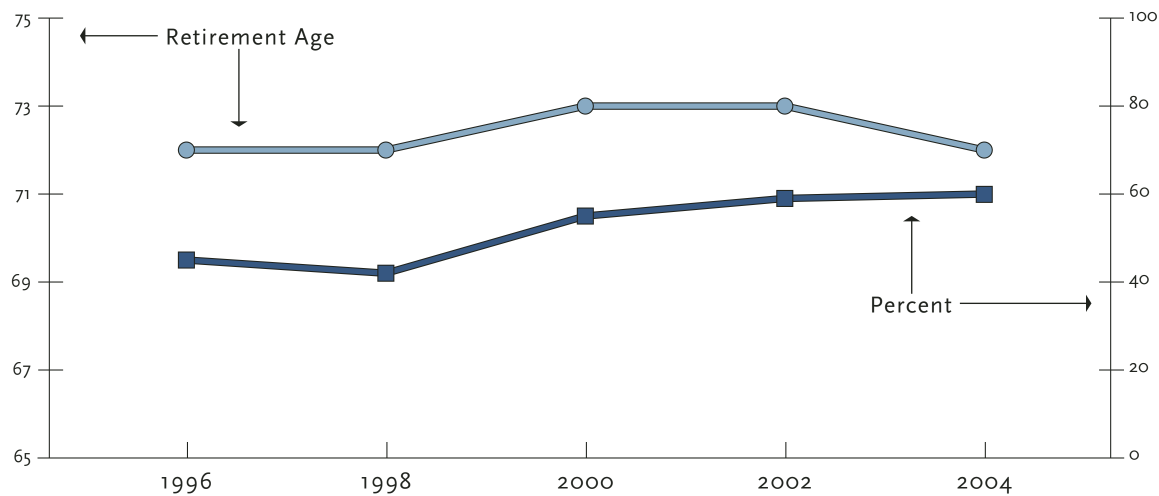




Mandatory Retirement Policy

No regulatory requirement relating to retirement policies exists for fund directors, although the topic may be addressed in a board's annual self-assessment. The study first solicited data regarding mandatory retirement policies in 1996. Since then, the percentage of complexes that have formally adopted such policies has increased gradually to about 60 percent in 2004. The ICI Best Practices Report recommended that fund boards adopt policies on the retirement of directors but declined to specify the type of policy (*e.g.,* retirement age or 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 eight-year period.

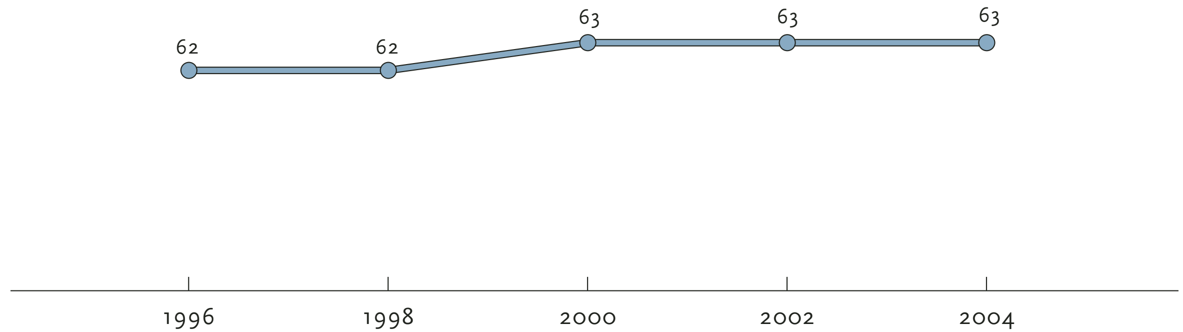
Mandatory Retirement Policy*



*question asked only from 1996 forward

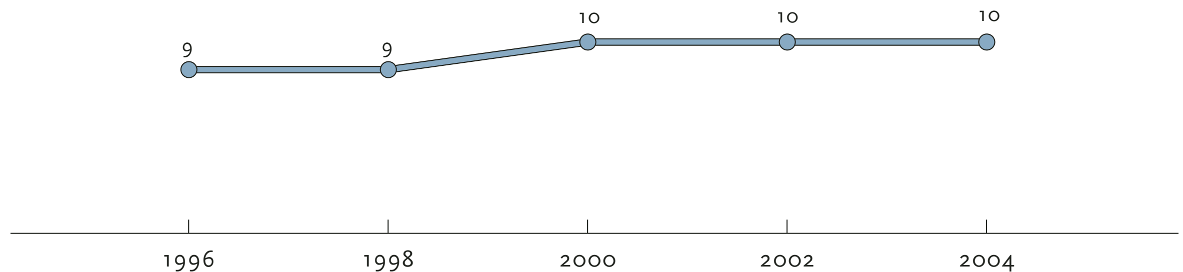
To help put this average retirement age in context, the studies solicited the age of all directors participating in each biennial study and the number of years they had served their complexes as a director. Since 1996, the average age has edged up from 62 to 63, and the average number of years of service has increased from nine to 10 years.

Average Age of Independent Directors



Length of Service at Complex by Independent Directors

(number of years)



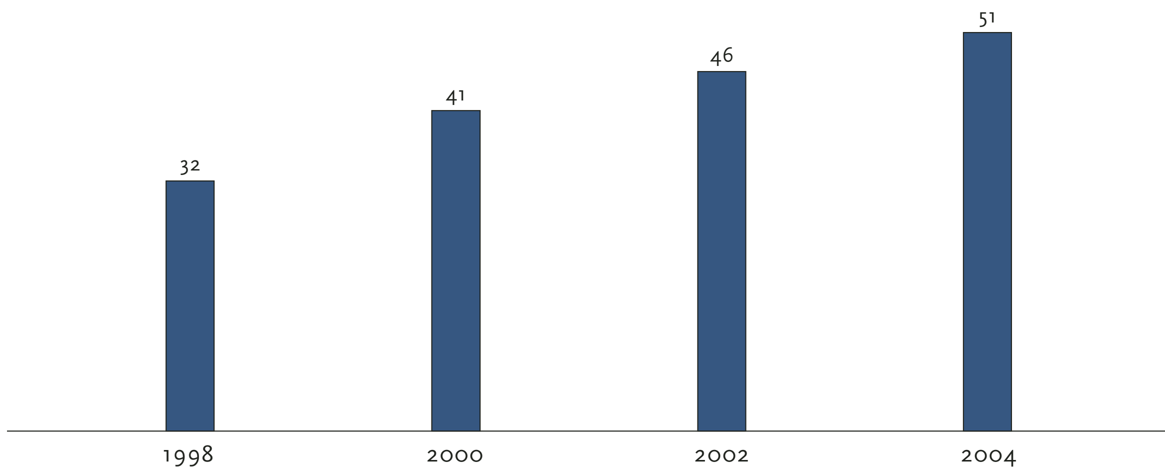
Independent Counsel

Practices among fund boards with respect to their retention of counsel vary greatly. Some independent directors have their own dedicated counsel, others formally retain counsel with the fund, and still others have no dedicated counsel but rely on counsel to the fund (or retain other counsel) on an as-needed basis. The ICI Best Practices Report recommended that independent directors have qualified investment company counsel who is independent from the investment adviser and the fund's other service providers. The Report acknowledged that directors may elect to have their own counsel or rely on counsel to the fund and, as the data below demonstrate, directors increasingly recognize this practice as a key component of effective fund governance. The 2001 SEC Rules further provided that, if the directors were to have counsel, it must be "independent legal counsel," as defined, but declined to mandate representation.

The studies have collected data concerning director retention of counsel and, though the form of the query in the questionnaire has varied over time, certain trends emerge. The data show that instances where directors retain separate counsel has increased markedly, from 32 percent of participating complexes in 1998 to 51 percent in 2004. This includes the model where the fund, adviser, and directors are served by different counsel, as well as the model where the fund and adviser share counsel but the directors have separate, dedicated counsel.

Independent Directors Have Separate Counsel

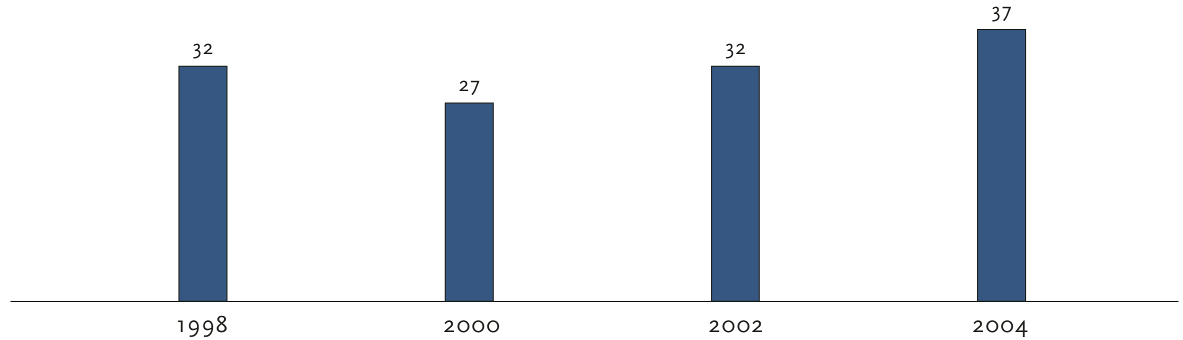
(percent of complexes)



Another model of counsel representation includes instances where directors formally or informally rely on counsel to the fund. In such cases, the counsel to the fund differs from the counsel that represents the adviser and would constitute "independent legal counsel." The number of boards relying on fund counsel has increased from 32 percent of participating complexes in 1998 to 37 percent in 2004.

Independent Directors Rely on Fund Counsel (Different from Adviser's Counsel)

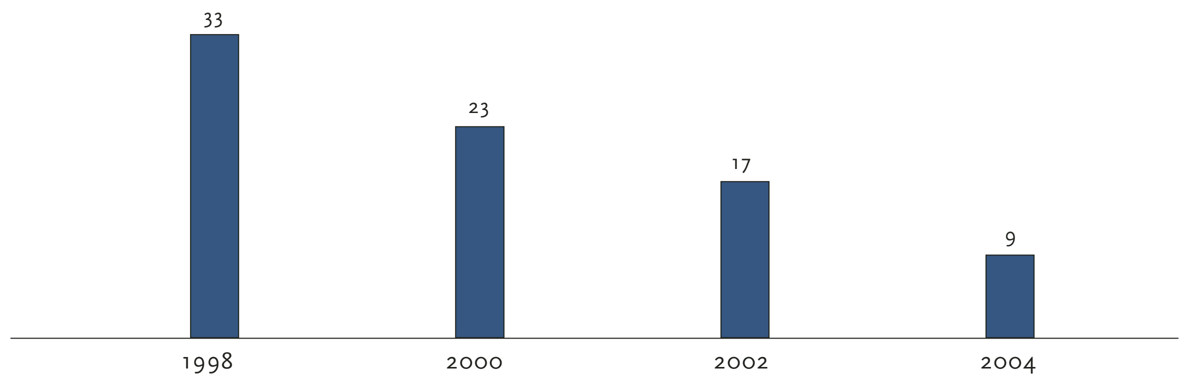
(percent of complexes)



The percentage of boards indicating that they are not represented by counsel, and are not formally or informally relying on counsel to the fund, has declined sharply since 1998. This steady decline was likely influenced by a number of factors, including the ICI Best Practices Report in 1999, the 2001 SEC Rules relating to independent counsel, and, most recently, the focus on director independence following the 2004 SEC Rules and litigation involving mutual funds.

Same Counsel Represents Fund and Adviser; Independent Directors Have No Separate Counsel

(percent of complexes)



The data permit us to conclude that directors are being represented by counsel in ever increasing numbers. In fact, the total percentage of complexes indicating that directors either are represented by dedicated counsel or are relying on the fund's counsel (which is different than the adviser's counsel) has increased steadily since the release of the ICI Best Practices Report, from 68 percent in 2000 to 88 percent in 2004. Given the increasing amount of regulatory compliance matters being addressed by fund boards, such representation is beneficial to both the directors and the shareholders they represent.

Conclusion

The studies reflect the continuing evolution of fund governance practices in response to emerging industry standards and often well in advance of explicit regulatory requirements. Future studies will continue to document trends in this area.

Endnotes

[1] The 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 cover 1996 (with 5,191 funds represented), 1998 (with 6,452 funds represented), 2000 (with 7,740 funds represented), 2002 (with 8,073 funds represented), and 2004 (with 7,549 funds represented). 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] Securities and Exchange Commission, Investment Company Act Release No. 24816 (January 2, 2001).

[4] Securities and Exchange Commission, Investment Company Act Release No. 26520 (July 27, 2004).

[5] The 2001 and 2004 SEC Rules impose 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.

[6] *See IDC Task Force Report on Director Oversight of Multiple Funds* (May 2005).

[7] This requirement, included in the 2004 SEC Rules, is currently being challenged in a lawsuit filed against the SEC by the U.S. Chamber of Commerce. The federal appeals court has stayed the effectiveness of the relevant rule amendments that would impose this requirement until the litigation is concluded.

[8] 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 IDC Task Force Report on Board Self-Assessments* (February 2005).

[9] This requirement for boards is likewise stayed pending the outcome of litigation. *See* note 7 *supra*.

[10] *See IDC Task Force Report on Independent Chair Requirement* (January 2005).

[11] Guidance issued by the Mutual Fund Directors Forum in 2004 recommended that persons formerly affiliated with the adviser, underwriter, or affiliates be deemed "interested" for only five years after that affiliation ends.

[12] *See IDC Task Force Report on Board Self-Assessments*, note 8 *supra*.

The Investment Company Institute (ICI) is the national association of U.S. investment companies. 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 mutual 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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