MUTUAL FUND DIRECTORS FORUM
The FORUM for FUND INDEPENDENT DIRECTORS

STRADLEY RONON

Newer Director Guide

September 2021

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Mutual fund director responsibilities continue to increase in scope and complexity. Board meetings today are significantly different and much more time and labor intensive than those that took place just a few years ago. As a result, directors are increasingly expected to have much more knowledge of the fund industry – from accounting issues to fund distribution. This Guide is designed to be a practical reference for fund directors. It is not a substitute for guidance provided by legal counsel, but instead is meant to be a source of background information on important issues mutual fund directors routinely face. While aimed primarily at newer directors, more experienced directors will also find the Guide useful.

The Guide references a variety of Mutual Fund Directors Forum reports and other resources, including:

- Oversight of fund distribution, including Rule 12b-1 in Tab 3;
- Board self-assessments in Tab 10;
- Oversight of risk in Tab 13;
- Oversight of proxy voting in Tab 14;
- Oversight of securities lending in Tab 15;
- Oversight of cybersecurity in Tab 17; and
- Guidance on fund mergers and adviser combinations in Tab 18.

Each of the topics included in this Guide could easily be the subject of its own volume. This Guide is not meant to be the stopping point for all questions that directors may have. Rather, it is intended to be a starting point for helpful background information.

CHAPTER ONE

INTRODUCTION TO MUTUAL FUNDS AND THEIR STRUCTURE

What are mutual funds and how do they operate?

Mutual funds ("Funds") are "pools" of investments owned "mutually" by multiple investors. A Fund has a board of directors (if the Fund is organized as corporation) or trustees (if the Fund is organized as a business or statutory trust) that governs the Fund and is responsible for overseeing the various service providers that provide services to the Fund, principally the Fund's investment adviser (the "Adviser"), as discussed more fully below. Funds are unique in that they usually have no employees of their own but instead rely on their various service providers to provide the necessary investment management, distribution, custody, administration, transfer agency, accounting and other services to the Fund.

Fund directors also may be responsible for funds that are structured differently than mutual funds, including exchange traded funds ("ETFs"), and closed-end funds. This guide is focused on mutual funds. Responsibilities of directors for ETFs and closed-end funds differ in certain ways from the role of a mutual fund director. For example, ETF directors, oversee the fund's market trading, such as premiums and discounts, intra-day trading spreads, and trading volumes. Similarly, closed-end funds also can trade at discounts, and are subject to different rules than mutual funds on topics such as offerings, leverage, liquidity. Nonetheless, much of this Guide is relevant to ETF and closed-end fund directors. More specifically, all directors will oversee issues such as performance and compliance, and review the advisory agreement.

What is your responsibility as a Fund Director?

Directors are not responsible for day-to-day management of the Funds they oversee - that is what the Fund sponsor (a.k.a. "management") and each of the respective service providers do. Rather, directors are expected to exercise their reasonable "business judgment" in overseeing the Fund's performance and that of its service providers. Directors' two key duties are: (1) a duty of care, which requires the level of care that a "reasonably prudent person" would exercise with respect to his or her own business; and (2) a duty of loyalty, which requires directors to put the interests of the Fund and its shareholders ahead of their own interests and those of the Fund's management or its service providers. Directors who are "independent" directors[1] ("Independent Directors") are also expected to watch out for potential conflicts that may arise between their Fund and its service providers.

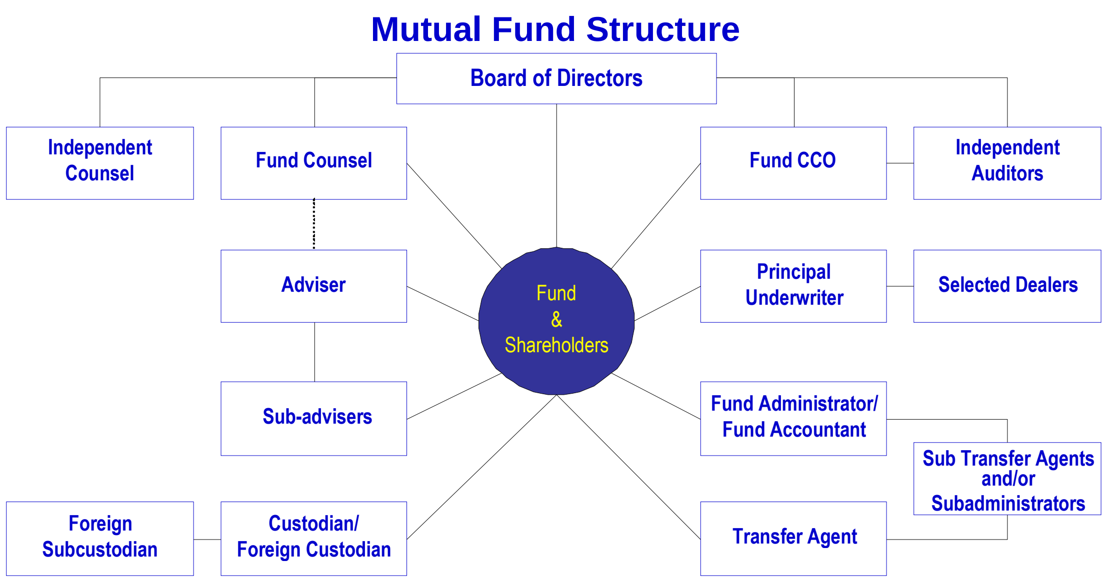
Board Structure and Fund Governance

Fund boards are composed of "independent" and "interested" directors. Whether a director is independent or interested depends on a highly technical legal definition, but in summary, interested directors have some kind of relationship with fund management and its affiliates in addition to the director role, while independent directors do not. Most fund boards are required to have a majority of independent directors to provide for independent oversight of fund operations by the board.

Fund boards typically are led by a chair, who plays a key role in setting the agenda and running the meetings. While many boards appoint an independent chair, others are led by an interested chair. Boards with interested chair often appoint a lead Independent Director. Boards also typically appoint committees to which they delegate specific functions. Common committees include audit, compliance, and governance. Committees can be standing or ad hoc.

Board size varies widely. Optimal size depends on a number of factors, including number of funds, and diversity and complexity of investment strategies. Similarly, the number of meetings varies with the circumstances. Many boards meet quarterly, but others meet more frequently. Regardless of the number of meetings, good minutes of those meetings are essential.

Boards generally are required to conduct an annual self-assessment. This assessment evaluates the performance of the board and its committees and is intended to identify any weaknesses in performance. For more information on such assessments, please see the resources in Chapter 10 of this Guide.



WHO ARE THE KEY FUND SERVICE PROVIDERS?

The Investment Adviser

Each Fund has an Adviser (and many also have one or more sub-advisers) that provide professional, day-to-day management of the Fund's portfolio of securities. The Adviser's employees (portfolio managers, research analysts, and traders) typically provide continuous management to the Fund, including research about what securities to buy, hold or sell for the Fund's portfolio, in order to pursue the Fund's investment objective. The Adviser also provides the directors with periodic reports about the Fund's investments and performance.

The Adviser may also recommend one or more sub-advisers to provide day-to-day portfolio management for the Fund. The Adviser typically retains overall responsibility for the management of the Fund's portfolio, monitors the performance of each sub-adviser and, when there are multiple sub-advisers, determines the allocation of Fund assets among the various sub-advisers. The Adviser (and any sub-advisers) must follow the principal strategies and limitations that have been disclosed in the Fund's prospectus and must also be mindful of the attendant risks described in the prospectus.

Some investment advisers outsource all of the direct portfolio management responsibilities to sub-advisers and provide no direct portfolio management to a Funds. This is known as a "manager-of-managers" ("MOM") structure. Advisers who operate under this structure typically obtain an exemptive order under the Investment Company Act of 1940 (the "1940 Act"), permitting the Adviser to hire sub-advisers with board approval only, without having to obtain a vote of the Fund's shareholders.

Advisers to Funds are required to be registered with the U.S. Securities and Exchange Commission ("SEC") and are subject to the rules and regulations of the Investment Advisers Act of 1940 (the "Advisers Act"). An Adviser has a general fiduciary duty under Section 206 of the Advisers Act, which requires the Adviser to put the interests of the Fund and its shareholders ahead of the Adviser's own interests. The Adviser must disclose to a Fund's directors any potential conflicts of interest it may have with the Fund.

Additionally, Section 36 of the 1940 Act imposes specific fiduciary duties on a Fund's Adviser (including its officers and directors), including prohibitions against personal misconduct and the receipt of excessive compensation from the Fund.

A Fund's Independent Directors are responsible for overseeing the activities of the Adviser (which is typically also the sponsor and an affiliate of the Fund) and serve as "watch dogs" in identifying and/or monitoring actual or potential conflicts of interest that may arise between the Fund and its Adviser.

A number of tools exist to assist Independent Directors in their oversight responsibility, including:

- The authority to annually approve and renew (after the initial two-year term of the agreement) the agreement between a Fund and its Adviser (as well as contracts with any sub-advisers) ("Investment Advisory Agreement"). The key factors directors typically consider in this approval process are discussed in detail, in Tab 2 – A Practical Guide to the "15(c) Process;

- Receipt of regular reports from the Adviser regarding the Fund's compliance with its policies and procedures; and
- Disclosure by the Adviser of potential conflicts of interest.

Fund directors also are responsible for overseeing other service providers to the Fund, some of which are described below. The directors generally rely in the Adviser to carry out the day-to-day oversight of the Fund's other service providers.

The Principal Underwriter (commonly known as the "Distributor")

Funds issue shares to each investor based on the dollar amount invested and the current net asset value ("NAV") of the Fund. The Fund's Distributor is the service provider that sells or "distributes" the Fund's shares. The Distribution Agreement (or Underwriting Agreement) between the Fund and its Distributor sets forth the duties of the Distributor in distributing the Funds' shares including:

- Soliciting orders for the Fund's shares;
- Conducting advertising and promotional programs on behalf of the Fund;
- In the case of Funds sold with a sales charge, compensating brokers, dealers and sales personnel who sell shares of the Fund; and
- Printing and delivering copies of a Fund's current prospectus to prospective investors.

The activities of the Fund's Distributor are governed by the SEC under the Securities Exchange Act of 1934 (the "1934 Act"). The Distributor's activities are also governed by the Financial Industry Regulatory Authority ("FINRA"). Section 15 of the 1940 Act, which governs the consideration and approval of a Fund's Investment Advisory (and any sub-advisory) Agreements, also governs directors' approval of Distribution Agreements.

In carrying out its activities, the Fund's Distributor typically sells Fund shares at the public offering price (i.e., the net asset value plus any applicable sales charge) either directly to investors or through broker-dealers, advisers or other intermediaries. In a typical "no-load" distribution arrangement, shares are sold to investors at NAV without any additional charges. Conversely, in a typical "sales load" distribution arrangement, a shareholder pays the Fund's Distributor a portion of the amount used to purchase Fund shares. This amount is commonly called a "sales charge." A portion of the sales charge is typically paid to the broker-dealer through whom the investor purchased his shares. FINRA rules govern the maximum amount of any sales charge that can be paid to a broker-dealer, including the Fund's Distributor. These sales charges come in numerous forms and may be paid at the time shares are purchased ("front-end sales charges"), when shares are redeemed ("back-end sales charges" also called "contingent deferred sales charges" or "CDSCs") or in small amounts over time (pursuant to Rule 12b-1 and sometimes referred to as "level-load").

The Fund's Distributor may sell Fund shares directly to shareholders through its own employees, such as in a no-load distribution arrangement, or through an internal sales force. Alternatively, a

Fund's Distributor may engage a number of other "outside" broker-dealers to assist it in distributing Fund shares. These broker-dealers will enter into an agreement with the Fund's Distributor, commonly referred to as a "dealer agreement." These dealer agreements authorize a broker-dealer to sell Fund shares for the Distributor in return for a portion of the sales charge paid by the shareholder. These broker-dealers must be licensed by FINRA and are expected to possess an appropriate level of understanding of the various Funds that they sell and protect prospective investors from investing in Funds that may not be suitable for their investment goals and risk tolerance.

Additionally, Rule 12b-1 under the 1940 Act permits the use of Fund assets to pay for distribution assistance by such broker-dealer provided that any such payments are made in accordance with a written plan (commonly called a "Rule 12b-1 Plan"). These Rule 12b-1 distribution payments paid by the Fund are in addition to or in lieu of the front-end sales charges or CDSCs described above that are paid by the individual shareholder. In order to implement a Rule 12b-1 Plan, the directors, including a majority of Independent Directors, must determine that there is a reasonable likelihood that the Rule 12b-1 Plan will benefit the Fund and its shareholders. Directors must make this determination at the time of the initial approval of the Rule 12b-1 Plan, and annually thereafter. The Fund's Distributor may utilize multiple broker-dealers to assist it in selling Fund shares and/or in providing certain permitted services to Fund shareholders, and may compensate the broker-dealers with a portion of the Fund's Rule 12b-1 fees which the Distributor collects from the Fund. If Fund assets will be used for this purpose, Rule 12b-1 requires directors to initially approve and annually reconsider renewal of these dealer agreements (commonly called "Rule 12b-1 related agreements"). Independent Directors must also review quarterly all Rule 12b-1 Plan payments.

For further resources on the complex issues associated with Fund distribution, including so-called "distribution in guise," see the resources provided in Tab 3.

The Custodian

Each Fund is required to have a custodian, which is typically a bank (the "Custodian"). Each business day, the Fund's Custodian:

- Holds in a segregated account the investments and cash owned by the Fund;
- Collects all incoming cash that shareholders have invested or that results from the sale of the Fund's portfolio of securities;
- Subtracts the amount of cash necessary to honor that day's redemption requests at the close of business;
- Notifies the portfolio managers how much cash the Fund has available for the portfolio manager to invest;
- Processes corporate actions, such as stock splits or reverse stock splits, for securities held by the Fund; and
- Receives notice of shareholder meetings, class action and bankruptcy proceedings involving securities held by the Fund.

Directors are charged with initially approving the Fund's Custodian and the agreement with the Custodian. The directors may also have additional responsibilities when a Fund's Custodian is affiliated with the Fund or its Adviser.

Funds that invest in foreign securities typically have a foreign Custodian to hold the Fund's foreign securities. Frequently, a single Custodian serves as the Fund's domestic as well as its foreign Custodian (often called a "Global Custodian") and provides custodial services through its network of domestic and foreign sub-custodians. Rule 17f-5 under the 1940 Act governs custody of Fund assets outside of the United States and its companion rule, Rule 17f-7, governs custody of Fund assets with foreign securities depositories.

Rule 17f-5 describes the actions directors must take in order to appoint the Fund's Custodian to serve as its Foreign Custody Manager ("FCM") and to delegate to the FCM, or to the Fund's Adviser, the directors' duties with respect to overseeing the safekeeping of the Fund's foreign assets. As a practical matter, many directors bifurcate this responsibility by delegating oversight and assessment of sub-custodian risk to the Fund's FCM (because the Custodian is usually the service provider in the best position to assess the capabilities and risks of the various sub-custodian banks in its network) and delegating the assessment of "country risk" to the Fund's Adviser, because this assessment is closely related to the Adviser's ongoing assessments of "investment risk" (i.e. the Adviser's decision to invest in a particular country).

The Transfer Agent

The transfer agent is the service provider that processes all shareholder account purchases, redemptions, and exchanges and maintains the Fund's shareholder account records, including each record shareholder's name, address and the number of shares held (the "Transfer Agent"). The Transfer Agent also confirms purchases and sales to the shareholder or the applicable dealer. On a regular basis, the Transfer Agent calculates and pays shareholders' dividends and capital distributions and sends out account statements recapping shareholders' investment activity. Transfer agents also keep track of CDSCs, redemption fees, small balance fees and other account-specific fees and restrictions.

The Transfer Agent typically provides support services to shareholders by responding to their inquiries, sending annual and semi-annual reports, and sending year-end tax statements (such as Form 1099s), which shareholders use in preparing their annual federal and state income tax returns. The Transfer Agent also oversees a Fund's anti-money laundering ("AML") program and its various privacy policies and the Fund's policies against market timing in the Fund.

Directors initially approve the agreement between the Fund and its Transfer Agent. They also typically set the amount of dividend and capital gains payments as well as record and payable dates, although some Funds ask their directors to approve standing dividend resolutions (sometimes called "evergreen resolutions") that provide a formula for regular dividend payments. In either case, directors should receive regular reports detailing a Fund's distributions.

Increasingly, financial intermediaries that sell or distribute Fund shares assume transfer agency responsibilities on behalf of their customers. In these "sub-transfer agency" arrangements, the intermediary opens a single account (or small number of accounts) in its name on the books of the

Fund's Transfer Agent and the agrees to perform the traditional transfer agent functions for its customers through sub-accounts maintained on the intermediary's books. The intermediary would, therefore, process purchase and sale transactions, process dividend payments, keep track of CDSCs, send out shareholder statements, among other tasks. The intermediary would also be responsible for ensuring that its customers adhere to the Fund's prospectus limitations, such as maintaining a minimum account size and paying redemption fees, when required. Intermediaries that operate through a sub-transfer agency arrangement often seek payment from the Fund for providing these services.

Although best practices in this area are still developing, the big picture questions typically asked by directors relate to the specific services being provided by the intermediaries, how management is overseeing these arrangements and the fees being paid by the Fund for these services.

Fund Administrator (including the Fund Accountant)

A Fund's administrator (the "Administrator") is the service provider that typically provides the facilities, equipment and personnel necessary to carry out the Fund's administrative, accounting and, in some cases, compliance functions. The Administrator's duties generally encompass the provision of all services necessary for the Fund to operate on a daily basis that are not already provided by one of the Fund's other primary service providers. These services may include:

- Preparing, filing, and maintaining the Fund's governing documents, including the Fund's Articles of Incorporation or Declaration of Trust, the Bylaws, and the minutes of board and shareholder meetings;
- Preparing and filing with the SEC and the appropriate state securities authorities the Fund's registration statements and related amendments, proxy statements, shareholder reports and other required documents;
- Assisting the independent auditors in their audits of the Fund;
- Compiling and publicly disclosing information on the Fund's proxy voting record;
- Preparing, negotiating and administering contracts on behalf of the Fund with, among others, the Fund's Custodian and other third parties and supervising service providers;
- Advising the directors on matters concerning the Fund and its affairs, including preparation of board materials for board meetings;
- Monitoring the Fund's compliance with tax laws;
- Obtaining and maintaining insurance policies for the Funds; and
- Providing the Fund with Fund accounting services, including calculating the Fund's NAV each business day and preparing the Fund's semi-annual and annual shareholder reports, as well as providing other accounting and tax services.

Chief Compliance Officer ("CCO")

Rule 38a-1 requires Funds to have a CCO who administers the Fund's compliance policies and procedures.[2] The rule requires that the Independent Directors hire a CCO who is competent and knowledgeable regarding the federal securities laws. Independent Directors must ensure that the CCO has sufficient resources and authority to implement the Fund's compliance policies and procedures. Regulators look at the CCO (in a similar way they look to a Fund's Independent Directors) as an ally.[3]

Although the CCO is often employed by the Adviser or Administrator, the CCO is hired, fired and evaluated by the board. The directors also determine the CCO's compensation. If directors choose to outsource the CCO role to someone not affiliated with the Adviser, they need to ensure that the third-party CCO still has the intimate knowledge of the Fund required to administer the Fund's compliance programs. For more information about the CCO and Fund compliance programs in general, see Tab 7 - Rule 38a-1 Compliance Policies and Procedures.

Independent Auditor

Section 32 of the 1940 Act requires a Fund to have an independent auditor (the "Independent Auditor") review, sign or certify the Fund's financial statements before these are filed with the SEC. Directors are required to initially approve, and to annually reapprove, the Fund's Independent Auditors. A Fund's shareholders will not be required to ratify approval of the Independent Auditors if the Fund's directors have formed an audit committee, comprised entirely of Independent Directors to oversee the Fund's accounting and auditing process. Therefore, as a practical matter, most Fund boards establish an independent audit committee.

The audit committee of the board typically oversees preparation of the Fund's financial statements including discussion of the Fund's financial statements with the Independent Auditor. Audit committees are also charged with monitoring and determining the independence of the Fund's Independent Auditor and with annually approving the engagement of the Fund's Independent Auditor. The audit committee also determines whether the provision of any non-audit services by the Fund's Independent Auditor to the Fund's Adviser or its affiliates, is consistent with the Independent Auditor's independence.

Fund Counsel

Funds typically retain outside legal counsel to serve as "Fund Counsel" to provide advice with respect to forming, registering and launching a Fund and maintaining the effectiveness of the Fund's registration statement. Fund Counsel also helps to prepare board materials and reports. Additionally, Fund Counsel assists the Fund and its Adviser in preparing shareholder disclosure and reports and with bringing new Funds to market.

Independent Counsel

The 1940 Act does not mandate that Independent Directors hire their own legal counsel. However, where the Independent Directors determine to do so, the 1940 Act requires that such counsel be "independent" from the Fund's management and its key service providers, principally its Adviser and Distributor. SEC rules also require that any counsel to the Independent Directors be "Independent Counsel" if the Fund wants to be able to rely on certain key exemptive rules under the 1940 Act (under which virtually all Funds operate).[4] Therefore, as a practical matter, most Funds' Independent Directors employ their own Independent Counsel to assist them in performing their duties and in order for the Fund to be able to rely on the key exemptive rules under which most in the industry operate.

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[1] Independent Directors are those directors who are not "interested persons" of the fund's Adviser or principal underwriter as defined in Section 2(a)(19) of the 1940 Act.

[2] See Final Rule: Compliance Programs of Investment Companies and Investment Advisers, Investment Company Act Release No. 26299 (December 17, 2003).

[3] *See The New Compliance Rule: An Opportunity for Change*, speech by Lori A. Richards at the Investment Company Institute/Independent Directors Council Mutual Fund Compliance Program Conference, Washington, D.C. (June 28, 2004).

[4] These Exemptive Rules are: (1) Rule 10f-3 (permitting a fund to purchase securities in a primary offering when an affiliated broker-dealer is a member of the underwriting syndicate, if the fund directors, including a majority of the independent directors, approve procedures governing the purchases and review quarterly reports on purchases); (2) Rule 12b-l (permitting use of fund assets to pay distribution expenses pursuant to a plan approved by the fund directors, including a majority of the independent directors); (3) Rule 15a-4(b)(2) (permitting a fund board to approve an interim advisory contract without shareholder approval when the Adviser or a controlling person receives a benefit in connection with the assignment of the contract, if the fund directors, including a majority of the independent directors, review and approve the contract); (4) Rule 17a-7 (permitting securities transactions between a fund and another client of the fund's investment adviser, if the fund directors, including a majority of the independent directors, approve procedures governing the transactions and review quarterly reports on such transactions); (5) Rule 17a-8 (permitting mergers between certain affiliated funds if the fund directors, including a majority of the independent directors, request and evaluate information about the merger and determine that the merger is in the best interests of the fund and its shareholders); (6) Rule 17d-1(d)(7) (permitting a fund and its affiliates to purchase joint liability insurance policies if the fund directors, including a majority of the independent directors, annually determine that the policies are in the best interests of the fund and its shareholders); (7) Rule 17e-l (specifying conditions under which a fund may pay commissions to affiliated brokers in connection with the sale of securities on an exchange, including a requirement that the fund directors, including a majority of the independent directors, adopt procedures for the payment of the commissions and review quarterly reports of any commissions paid); (8) Rule 17g-1 (permitting a fund to maintain a joint fidelity and requiring fund independent directors to annually approve the bond); (9) Rule 18f-3 (permitting a fund to issue multiple classes of voting stock, if the fund board of directors, including a majority of the independent directors, approves a plan for allocating expenses to each class); and (10) Rule 23c-3 (permitting the operation of an interval fund by enabling a closed-end fund to repurchase shares from investors, if the directors adopt a repurchase policy for the fund and review fund operations and portfolio management in order to assure adequate liquidity of investments to satisfy repurchase payments).

CHAPTER TWO

A PRACTICAL GUIDE TO THE "15(C) PROCESS"

What are the board's responsibilities?

One of the most important responsibilities an Independent Director has is the annual Section 15(c) review and approval of the Funds' Investment Advisory Agreements.

This annual approval process is governed by Section 15(c) of the 1940 Act, so it is often referred to as the "Annual 15(c) Process." The statute, in essence, requires Independent Directors to consider each Investment Advisory (and sub-advisory) Agreement for every Fund at the time of initial implementation (for a two-year initial term) and every year thereafter, to prevent the Adviser, who is often also the sponsor of the Fund complex, from taking advantage of its relationship with the Funds. Described below is the process Independent Directors generally use in reviewing and approving the Investment Advisory Agreements. While boards typically consider the factors listed below, every board employs a slightly different process in considering each factor; no single process is mandated or optimal. Each board must determine what process works best for it and the shareholders of the Funds such board oversees.

What are the legal standards?

While Section 15(c) does not set forth a particular legal standard, various court decisions, as described in more detail below, establish legal standards for approval, most notably the *Gartenberg* case and the U.S. Supreme Court's March 2010 decision in the *Jones* case. Independent Directors are required to exercise their fiduciary duty in considering the terms of the Investment Advisory Agreement and most particularly, the nature and quality of services provided by the Adviser and the fees paid by the Fund for such services, such as any economies of scale, ancillary benefits to the Adviser and profitability of the Adviser. Funds are required to provide a discussion of the basis for the board's approval of the advisory contract in the shareholder report.

What information do boards need to fulfill this duty?

The board must review information about:

- The nature, extent, and quality of the services the Adviser provides to the Fund;
- The performance of the Fund;
- Fees and other payments made by the Fund to the Adviser;
- Comparative information about the performance and fees of similar funds; and
- The financial condition and profitability of, and any fallout benefits to, the Adviser.

Who typically provides information to the board?

Section 15(c) requires Independent Directors to request from the Adviser (and similarly requires the Adviser to provide) the information described above as well as any other information the Independent Directors deem necessary and appropriate for their review and consideration of a Fund's Investment Advisory Agreement.

Independent Directors typically also receive a detailed memorandum from their Independent Counsel about the applicable legal standards and the Independent Directors' fiduciary duties under federal and state law. Boards also frequently receive updates on litigation developments involving fund advisory fees. In addition, some boards may also retain independent consultants to assist them in the Annual 15(c) Process.

The 15(c) "Process" and How it Typically Works

The Independent Directors are called upon to serve as the "watch dogs" of the Funds they oversee on behalf of shareholders. Nowhere is this more evident than in the regulatory process that Congress put in place to govern the directors' review and approval of Investment Advisory Agreements between a Fund and its Adviser. In particular, under the 1940 Act, the board is responsible for overseeing the provision of advisory services by a Fund's Adviser, and the Fund's Independent Directors are further charged with initially approving and annually reviewing and renewing the Fund's Investment Advisory Agreements.

While no two boards conduct their Annual 15(c) Process in precisely the same way, as a practical matter, the Annual 15(c) Process generally entails:

- The preparation and delivery of a written request by the Independent Directors (or their Independent Counsel on behalf of the Independent Directors) to each Fund's Adviser, including any sub-advisers, requesting information that the Independent Directors believe is reasonably necessary or desirable in order for them to evaluate the Investment Advisory Agreements;
- The preparation and delivery of the Adviser's response, which could include additional information that the Adviser believes will be helpful to the board in evaluating the Funds' Investment Advisory Agreements (often including statistical data provided by an independent, third-party comparing the Fund's performance, fees and expenses to those of similar funds);
- Review of the materials and deliberation by the board in preparation for the 15(c) meeting, which can involve one or possibly more meetings and discussions with the Adviser and/or executive sessions of the Independent Directors prior to the 15(c) approval; and
- Approval of each Fund's Investment Advisory Agreements at an <u>in-person</u> meeting by Directors, including a majority of the Independent Directors, which is called specifically for this purpose.

Each step in the Annual 15(c) Process is important, because the "process" is, essentially, as important as the outcome. The 1940 Act requires Independent Directors to request "such information as may reasonably be necessary to evaluate" the terms of the Investment Advisory Agreement. The 1940 Act also imposes a corresponding duty on the Fund's Adviser to provide this information and any other information that may reasonably be necessary to the Independent Directors. Typically, Independent Counsel will assist the Independent Directors in determining what information to request and in evaluating the information received from the Adviser in response to their request.

Information requested and provided during the Annual 15(c) Process has become somewhat standardized across Fund groups, the result of unsuccessful lawsuits by Fund shareholders who challenged the amounts of the investment advisory fees received by the Advisers of those Funds. In these cases, the courts found that the fees paid to the Advisers were not excessive based on, in part, the fact that the Independent Directors of those Funds had approved the fees after consideration of certain kinds of information.[1] These cases demonstrate that the Independent Directors' oversight and approval protects both the Fund and the Adviser from claims that the Adviser has failed in exercising its fiduciary duties to the Fund's Shareholders. Such protection is available when the Independent Directors received complete information from the Adviser and were careful and deliberate in their review of the Investment Advisory Agreement(s) and the information the Adviser provided to assist them in their review.

The factors typically considered by Independent Directors in approving Investment Advisory Agreements often are called the "Gartenberg factors" (named after a party in one of the seminal cases).[2] Independent Directors focus primarily on the amount of compensation that the Adviser receives under the Investment Advisory Agreement, its expenses in providing the services, the profitability to the Adviser of its relationship with the Fund, and the performance and expense ratios of the Fund.[3] To appropriately evaluate these factors, Independent Directors typically compare the performance, fee and expense information with that other similar unaffiliated funds as well as with the Adviser's other similar (unregistered) accounts if such a comparison is apt.[4] The factors relating to the Independent Directors' approval of the Investment Advisory Agreement are required to be disclosed to shareholders and the public and if the Independent Directors determine not to consider a particular factor, they must disclose that factor and why it was not relevant to their approval of the contract.[5]

During an Independent Director's tenure with a Fund, numerous instances will arise during which the Independent Director and Adviser will, in essence, negotiate on a matter. The relationship between the two frequently is a matter of give and take, and the most successful relationships (e.g. those in which Funds and their shareholders benefit) are typically marked by trust and mutual respect. The Annual 15(c) Process is only one element of this relationship (albeit an important one), and Independent Directors should approach the process with a firm understanding of their powers and responsibilities, as well as the limits on these, with respect to the process.

In "negotiating" the advisory contract, Independent Directors may:

- request fee waivers and/or expense limitations or a new breakpoint level;
- place a Fund on a heightened monitoring status (sometimes called a "watch list");
- request that the Adviser commit more resources (personnel, systems or other) to the Fund;

- request that management consider replacing a portfolio manager or, in the case of a "manager of managers" structure, adding another or replacing a current sub-adviser;
- request that management present options to the directors for the merger or liquidation of a Fund; or
- terminate the Adviser.

This last option is commonly referred to within the industry as the "nuclear option" because, as a practical matter, it is extremely difficult for a board to fire the Fund's Adviser because the Adviser is typically also the sponsor (primary funding source) as well as distributor of the Fund(s) it advises and thus doing so would not be expected to be in the Fund's (or its shareholders') best interests. Additionally, it is important to note that in the very few instance(s) where Independent Directors took this course, the shareholders ultimately reapproved the advisory agreement.[6]

Funds and shareholders are served best when Independent Directors have established a good working relationship with the Adviser. A good working relationship will make it possible for the Adviser and its personnel to concentrate on running the Fund most effectively. Thus, Independent Directors should seek to maintain a delicate balance between wielding authority over and working cooperatively with the Adviser to help achieve the Fund's goals. In the mutual fund industry, many refer to this working relationship as one in which Independent Directors "trust, but verify" with respect to Adviser actions and recommendations.

To assist new Independent Directors in their role as Fund watch dogs with respect to the Annual 15(c) Process, below we pose some common questions that Independent Directors typically raise during the process, and we provide some possible responses to these questions.

How does a board "review" an Investment Advisory Agreement?

When Independent Directors review (in order to approve or renew) an Investment Advisory Agreement, they examine whether the advisory fee is reasonable in light of all of the relevant facts and circumstances, including the nature and quality of services that the Adviser provides. *Gartenberg* held that "an advisory fee must not be so disproportionately large that it bears no reasonable relation to the services rendered and could not possibly be the result of arm's length bargaining." This does not mean necessarily that actual arm's length bargaining took place with respect to each particular Investment Advisory Agreement and fee; it simply means that the fee is within a range that would have been the product of arm's length negotiations. This is an important, and often, misunderstood distinction. Indeed, Independent Directors are not expected under the various court decisions to negotiate the lowest possible fee. Former SEC Chairman Levitt succinctly summed up the duty of Independent Directors with respect to management fees as follows: "Directors don't have to guarantee that a Fund pays the lowest rates. But they do have to make sure that fees fall within a reasonable band."[7]

Similarly, Independent Directors are not expected or required to initiate a competitive bidding process for the right to serve as Adviser to a Fund. As a practical matter, directors must take into account that: (1) shareholders have chosen the Adviser in the context of the public disclosures upon which they base their investment decision about the Fund and the Adviser, including in the

Fund's prospectus; and (2) in virtually every case, the Fund's Adviser formed, seeded, launched and operates the Fund. As one of the 1940 Act's original draftsmen noted in 1964:

> "The board of directors does not act in a vacuum . . . [The] stockholders either have chosen the existing management or they have bought their shares in probable reliance on such management. Presumably, they have confidence in the management and would not expect the directors to take action to change it except in unusual circumstances."[8]

While Independent Directors review the profitability of the Adviser's relationship with the Fund, Independent Directors should be mindful that the Adviser is entitled to profit from the advisory relationship – and a seemingly high level of profit does not necessarily mean that the Fund is paying an excessive fee. The fee paid to an Adviser must be considered in light of, among other things, the investment performance of the Fund. An Adviser that provides a Fund with better performance than is the case of many of the Fund's peers may legitimately deserve to profit more from the advisory relationship.

How should Independent Directors evaluate a Fund's performance?

Independent Directors monitor Fund performance and typically develop strategies in working with the Adviser, to address ongoing poor performance. At the annual 15(c) meeting, the Adviser will provide the Independent Directors with the Fund's performance results over certain periods of time (typically 1 year, 3 years, 5 years, and "since inception" or some combination thereof). The Adviser typically provides a comparison of the Fund's performance results to the performance results of other funds in the peer group with the same performance benchmark. Many Advisers provide this information at the Fund's regular quarterly board meetings, often in the Investment Committee or Performance Committee meeting as applicable to the particular board. The Independent Directors should evaluate the Fund's performance relative to its peer group and (1) discuss with the Adviser whether poor performance of a Fund versus its peers is the result of the effects of the overall market on the Fund due to the Fund's investment portfolio and strategies, including cyclical market factors; or (2) poor stock or sector selection or other factors. The Adviser should be able to provide the Independent Directors with an explanation of why a Fund's performance is good or bad. The Independent Directors may also consider meeting with the Fund's portfolio manager to discuss the situation.

If factors affecting performance relate to the overall market, the Independent Directors could expect that the Fund's performance would not differ greatly from the average performance of its peer group. If the Fund's performance differs widely from its peers, the Independent Directors should consider the possible reasons for this: (1) whether the Fund's investment style has drifted away from the rest of the peer group (in which case the peer group may no longer be appropriate) or (2) whether it is due to extraordinary events, such as a significant increase in the Fund's assets or overall market share. For example, it should be noted that a small Fund can be greatly affected by a few successful investments that would have had an inconsequential effect on the performance of a larger Fund. Also, the ability of a small Fund to participate in investment opportunities of limited availability, like initial public offerings, can affect the Fund's performance in a significant yet temporary manner. Furthermore, smaller Funds can be hurt by non-asset-based fees (such as administration and/or transfer agency fees) because, when a Fund is charged the same amount as all other Funds in the complex regardless of its size, smaller Funds feel the effect of these fees more significantly.

If a Fund's performance consistently declines or consistently underperforms the average performance of its peer group and/or benchmark, the Independent Directors should consider questioning the Adviser about the possible causes on a more frequent basis, rather than waiting for the next 15(c) meeting. Many boards create a "review plan" for a poorly performing Fund, whereby the Fund's performance is examined in detail at each board meeting over a period of time to help determine the causes of the poor performance and the potential solutions to cure continuing poor performance. As part of the review plan, the Adviser should be expected to explain any steps it will take to address the situation. Realistically, while the board may have the power to recommend the Adviser take a particular action to address performance (e.g., reduce the portfolio turnover), the Adviser is in the best position to assess the most suitable approach and boards typically give considerable weight to the Adviser's recommendations and should only be expected to insist upon a different course in extreme circumstances.[9] If the performance does not improve over a period of time deemed reasonable by the Independent Directors, they can take a number of different steps including discussing with the Adviser the replacement of the portfolio manager(s), or changing the Fund's investment focus (for instance, when the Fund and its peer group experience chronic poor performance). For some Funds, a new sub-adviser could be hired. In addition, the directors may discuss with the Adviser the long-term viability of the Fund, including options such as mergers or closure of the Fund.

How should Independent Directors evaluate a Fund's investment advisory fees?

If a Fund has satisfactory performance but high fees compared to its peer group, the Independent Directors should question the Adviser to understand why the Fund's fees are comparatively high. The Adviser should be able to provide well-reasoned and documentable information to the Independent Directors in support of the higher fee. Subtle differences in the services provided by the Adviser compared with the Fund's peers could warrant different fee levels. The Adviser also could be reimbursing a certain amount of the Fund's expenses while peers are not.

The Independent Directors may request that the Adviser: institute a fee waiver until the Fund's asset size grows and economies of scale are achieved or consider implementing additional breakpoints that would call for set reductions in the fee at certain points as the Fund's asset base increases. Independent Directors may request that an Adviser institute fee breakpoints to address the concern that advisory fees may become excessive when a Fund grows very large. In this manner the Adviser shares with Fund shareholders any economies of scale that it has realized due to the Fund's size.

How should Independent Directors evaluate a Fund's benchmark and peer group?

The selection of an appropriate benchmark and peer group for a new Fund is very important. Additionally, the choice of the benchmark and peer group should be reviewed on an ongoing basis to make sure the initial choices are still appropriate for the Fund. The benchmark is a securities index that is not run or established by the Adviser. The peer group is a collection of Funds in other Fund complexes that have investment objectives and strategies that are the most similar to the

Fund's. In addition, for purposes of evaluating expenses, the members of the Fund's peer group should, if possible, have similar distribution structures, sales charges and asset sizes.

While Independent Directors do not select a Fund's peer group, they should understand the criteria used to select the peer funds. The criteria should be objective and sensible and if different from the criteria used to select the peer group for other Funds or series, the Adviser should explain why it has deviated from normal practice, and the explanation should make sense in light of the Fund's investment objectives, strategies and policies.

For example, a modification to the normal criteria may be necessary in the case of a unique Fund. If there is not yet a broad enough sampling of substantially similar funds a peer group may need to be assembled using Funds that invest their assets in a slightly different manner than the Fund at issue. Independent Directors should ask questions about the similarities and differences between the Funds and their peers to confirm that peers were not selected to show the Fund's performance and other data in the most favorable light. The advice of specialized service providers may be helpful in the assembly of a peer group and other information to assist in the 15(c) process. In addition, to address a unique Fund, more than one benchmark and/or peer group could be used.

What if the Adviser does not provide all of the information that the Independent Directors request?

Because the 1940 Act requires Advisers to provide information the board deems reasonably necessary in its consideration of the renewal of the Investment Advisory Agreement, it is unusual for an Adviser to refuse to provide information. In this unlikely event, any refusal should be dealt with swiftly by the board.

There may be circumstances where Independent Directors may request information that, while not absolutely essential for approval of the Investment Advisory Agreement, they view as desirable. Independent Directors should be mindful that Adviser staffing and systems resources may be more highly taxed at certain times of the year, such as during the Annual 15(c) Process. Advance notice and dialogue between the board and the Adviser can assist in making certain the board receives what it needs without disrupting the Adviser's ongoing daily investment management processes and other required duties. Additionally, some Independent Directors find it useful to take a long-term approach to getting such information, working with the Adviser over several meetings to refine the document request and obtain the information. Even with adequate time, there may still be cases where the Adviser would have legitimate reasons for not providing information deemed desirable by the board. For example, such information may overly expensive or unreasonably time consuming to prepare. In such cases, the board and the Adviser may work together to develop similar information that would be responsive to the board's request.

Also, some Independent Directors may wish to consider including in new Investment Advisory Agreements (particularly in agreements with new sub-advisers) a requirement that the Adviser provide within reasonable timeframes any and all information that Independent Directors request. If a board sets reasonable time frames for information, continual or repeated instances in which the Adviser is unable to meet agreed upon deadlines for information may indicate problems with the Adviser's operations that the Independent Directors should investigate.

What are some of the special considerations for the 15(c) Process of "manager-of-manager" ("MOM") Funds?

Funds that operate in a MOM structure present special challenges for their directors based on, among other things, the number of sub-advisers and the nature of the Investment Advisory Agreements with the primary Adviser and the sub-advisers. The 1940 Act requires that the Independent Directors approve not only the Investment Advisory Agreement with the primary Adviser, but also the Investment Advisory Agreements with each sub-adviser. Frequently, MOM Funds pay a single fee to the primary Adviser for all of the advisory services that are provided by the primary Adviser and each sub-adviser. The primary Adviser then negotiates the fee paid to each sub-adviser (out of the Adviser's fee). The Independent Directors evaluate the reasonableness of the Adviser's fee in light of all of the advisory services that are provided to the Fund, as well as the reasonableness of the fees paid over by the Adviser to each sub-adviser in light of the services that the sub-adviser provides to the Fund.[10]

The 15(c) Process in the case of the primary Adviser often differs somewhat from the 15(c) Process for the sub-advisers. In particular, the 15(c) Process for the primary Adviser is basically the same process that takes place for the Advisers of non-MOM Funds. In the case of a MOM Fund, however, the primary Adviser may not directly manage any Fund assets. Rather, the primary Adviser is typically responsible for monitoring, overseeing and evaluating the activities and performance of the sub-advisers. The Independent Directors should understand how the primary Adviser goes about those tasks with respect to the activities of the sub-advisers. That understanding will help Independent Directors evaluate the reasonableness of the amount of the advisory fee paid out to the sub-adviser and the amount retained by the primary Adviser.

As a general matter, of course, a Fund cannot pay an advisory fee to two Advisers for providing the same services. Thus, there should be no overlap between the services provided by the primary Adviser and any sub-adviser. In addition, insofar as the primary Adviser directly manages a portion of the Fund's assets (e.g. cash or a "sleeve"), in addition to supervising the sub-advisers, the Independent Directors should understand how much the Fund is paying to the primary Adviser for those distinct services.

Determining the degree of due diligence that Independent Directors should conduct concerning the activities of the sub-advisers and the amount of the advisory fee that is paid to each of them can be challenging for boards. Some Independent Directors have found it difficult to obtain from a sub-adviser the extensive 15(c) information that they expect to receive from primary Advisers. Thus, the Independent Directors may wish to obtain a commitment from the sub-adviser, during the meeting at which the sub-adviser first is approved, to provide the Independent Directors with information in the future. Alternatively, it may be appropriate in certain circumstances, to obtain the necessary information about its sub-advisers from the primary Adviser who may receive the information throughout the year as part of the primary Adviser's quarterly due diligence process and questionnaires.

Independent Directors often inquire about the degree to which they should rely on information from and the views of the primary Adviser concerning the appropriateness of the advisory agreements with the sub-advisers. Some Independent Directors focus particular attention on the comparative information about the performance of a sub-adviser's portion of a Fund's portfolio as well as the sub-adviser's fees. Those Independent Directors generally ask the primary Adviser for and rely on a summary of the other kinds of 15(c) information concerning the sub-advisers.

In the case of a MOM Fund that has a significant number of sub-advisers, the sheer number of sub-advisers may, as a practical matter, preclude the attendance of each sub-adviser at the annual 15(c) meeting. Some Fund groups rotate sub-adviser personnel through board meetings on a regular basis throughout the year based on various considerations, such as performance and risk. Some Independent Directors request that all of a Fund's sub-advisers make themselves available by telephone during board meetings in case the Independent Directors have questions and still others Fund boards establish investment committees to vet sub-advisers and evaluate and determine which issues concerning the sub-advisers should be brought to the attention of the full board. No single approach or methodology is mandated by law. Independent Directors should use the approach that works best for that board and Fund complex.

Supreme Court Case on the Annual 15(c) Process

In 2010, the U.S. Supreme Court handed down its unanimous decision in *Jones v. Harris Associates* (130 S. Ct. 1418 (2010)) strongly endorsing *Gartenberg v. Merrill Lynch Asset Management* and holding that courts must give comparisons between the fees charged to different types of clients the weight they merit in light of the similarities and differences between the services the clients in question require. The Supreme Court stated, however, that courts must reject comparisons where the services rendered are sufficiently different that a comparison is inappropriate. Significantly, the Supreme Court also stated that courts must be mindful that the 1940 Act does not necessarily ensure fee parity between mutual funds and institutional clients.

Interestingly, the Supreme Court stated that courts should not rely too heavily on comparisons with fees charged to mutual funds by other advisers, which may not result from arms-length negotiation. This data has long been among the statistical information most boards receive from independent service providers in connection with their 15(c) Process.

Finally, the Supreme Court made clear the importance of the board's process in conducting its 15(c) review, stating that when a board's process for negotiating and reviewing advisory compensation is robust, a court should afford considerable deference to the outcome of its process. Conversely, when the board's process is deficient or the Adviser withholds important information from the board, the court should take a more rigorous look at the outcome. As a practical, as well as a legal matter, the board's exercise of its reasonable business judgment is to be respected unless there is a clear and serious deficiency in its 15(c) Process.

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[1] The lawsuits claimed that the Advisers received excessive compensation from the Funds and thereby breached the fiduciary duty that is imposed on them under Section 36(b) of the 1940 Act. *See* Kalish v. Franklin Investment Advisers, Inc., 742 F. Supp. 1222 (S.D.N.Y. 1990), *aff'd* 928 F.2d 590 (2d Cir. 1991); Krinsk v. Fund Asset Mgmt., Inc., 715 F.Supp. 472, 485 (S.D.N.Y. 1988), *aff'd*, 875 F.2d 404 (2d Cir. 1989); Schuyt v. Rowe Price Prime Reserve Fund, Inc., 835 F.2d 45 (2d Cir. 1987); Gartenberg v. Merrill Lynch Asset Mgmt., Inc., 694 F.2d 923, 930 (2d Cir. 1982).

[2] *Gartenberg v. Merrill Lynch Asset Management*, 528 F. Supp 1038 (S.D.N.Y 1981), articulated the factors generally considered by a Fund's board when evaluating the Fund's advisory fee. These factors include: the nature and quality of services provided to the shareholders; profitability of the Fund to the Adviser; economies of scale; how the Fund's fees compare to other similar funds; and fallout benefits to the Adviser. SEC rules

require Funds to disclose in their semi-annual reports to shareholders (and certain proxy statements) the material factors and the conclusions with respect to those factors that formed the basis for the board's approval of the Investment Advisory Agreement.

[3] Directors typically also consider information comparing the services rendered and amounts to be paid under the Fund's Investment Advisory Agreement with those under other Investment Advisory Agreements, including contracts between the Fund's Adviser and its other clients (e.g. pension plans).

[4] The Supreme Court in Jones v. Harris Associates, L.P. 559 U.S. 335 (2010) at http://www.supremecourt.gov/opinions/09 pdf/08-856 pdf) strongly endorsed Gartenberg, and said courts must give such comparisons the weight they merit in light of the similarities and differences between the services the clients in question require.

[5] SEC Form N-1A, Item 22(d)(6).

[6] In this regard it is important to keep in mind the Fund Advisers act as fiduciaries for the Funds they advise, including with respect to the amount of fees they receive from the Funds. Thus, Fund Advisers and Independent Directors may be able to find common ground from which to address the best interests of the Fund.

[7] Remarks by Chairman Arthur Levitt, U.S. Securities and Exchange Commission, Investment Company Institute, Washington, D.C. (May 15, 1998).

[8] Alfred Jaretzki, Jr., Duties and Responsibilities of Directors of Mutual Funds, 29 *Law & Contemp. Probs*. 777, 786 (1964).

[9] Fund Advisers want a Fund's performance to excel both because Advisers are fiduciaries and because they are in the business of providing investment advice.

[10] Sometimes, the Fund pays both the Adviser and the sub-adviser directly.

CHAPTER THREE

BEST PRACTICES AND PRACTICAL GUIDANCE FOR DIRECTORS ON FUND DISTRIBUTION, INCLUDING UNDER RULE 12B-1

Excerpt from the Report of the Mutual Fund Directors Forum: Best Practices and Practical Guidance for Directors under Rule 12b-1, *published May 2007*

Introduction

Over 25 years ago, the Securities and Exchange Commission ("Commission" or "SEC") reversed a long-held position and adopted Rule 12b-1[1] to permit, under certain circumstances, mutual funds to use fund assets to pay for the distribution of fund shares.[2] The rule, among other things, requires fund boards to approve annually the plans that govern distribution payments. In adopting Rule 12b-1, the Commission contemplated that the plans would be used by a fund for limited periods of time and, in that context, provided directors with guidance on what factors they should consider in reviewing and approving 12b-1 plans.[3] Accordingly, the guidance that was given was largely limited to situations where a fund was facing net redemptions or other temporary difficulty.

In fact, 12b-1 plans have been rarely used for that purpose. Instead, they have achieved widespread popularity because of their use for two very different purposes. First, they compensate brokers and sellers of fund shares for shareholder accounting and other services provided to fund shareholders; and second, and most important, they offer purchasers of fund shares the alternative of paying for the services of a broker or other intermediary through a continuing 12b-1 fee rather than through the traditional front-end load – a use never contemplated by the Commission when Rule 12b-1 was adopted.

Moreover, the competitive landscape in which 12b-1 fees are used has become significantly more complex since the adoption of 12b-1. Today, 12b-1 fees cover only one portion of the elaborate and highly competitive range of distribution payments to intermediaries. Because the SEC has provided fund directors with little formal guidance regarding Rule 12b-1 since its original adoption, there essentially is none that addresses the competitive landscape in which Rule 12b-1 is used today – a landscape in which funds are distributed through numerous intermediary channels not controlled by the funds, the sales and other charges for using those channels are largely nonnegotiable, and access to those channels is increasingly viewed as a necessity for even traditional no-load funds to remain viable. In addition, many directors have found that the avid market competition for inflows (and the costs associated with that competition) makes altering existing 12b-1 plans virtually impossible in the absence of regulatory change.

Perhaps in recognition of the absence of guidance relevant to today's mutual fund distribution systems, when then-SEC Chairman William Donaldson requested that the Forum develop best practices for the governance of mutual funds in 2003, he also asked that the Forum draft best practices for the review of 12b-1 plans.[4] Subsequently, in 2004, the Forum released its best practices report containing recommendations on, among other things, fund governance and director oversight of soft dollars, directed brokerage, revenue sharing arrangements and valuation and pricing. However, the Forum deferred addressing 12b-1 with the expectation that the SEC or its staff would provide further guidance on what direction it was going to take.[5]

Although neither the staff nor the Commission has since released additional guidance on Rule 12b-1, recently, there has been an acknowledgement that the uses of 12b-1 have changed substantially since the adoption of the Rule. Both Chairman Christopher Cox and Division Director Andrew Donohue have stated that the Commission will begin to reexamine Rule 12b-1 (and the financing of distribution generally) by the end of 2007.[6] We welcome this comprehensive reexamination of Rule 12b-1 – and of the issues associated with distribution generally. As a follow-up to this report, the Forum intends to continue studying potential avenues for reforming the regulatory structure that governs distribution payments and will work with the Commission with respect to any proposed regulatory reforms.

Fund boards, however, cannot wait for thoroughgoing regulatory reform. In spite of the problems inherent in the Rule as currently written, directors must still abide by it. More specifically, the Rule requires the independent directors of a fund initially to approve adoption of a Rule 12b-1 plan,[7] to review quarterly reports of the expenditures made pursuant to the fund's 12b-1 plan,[8] and finally to approve continuation of the plan annually based on findings that the plan continues to benefit the fund and its shareholders.[9] While fund directors often receive voluminous material in connection with the annual approval process, there is little meaningful guidance from the SEC or elsewhere on the issues that are relevant to the continuance of the plan. Indeed, the factors that the Commission suggested in 1980 should guide directors in their review of 12b-1 plans are today, in the context of current systems of distribution, largely irrelevant.[10] Therefore, to assist fund directors as they struggle to evaluate plans fairly, the Forum is now publishing "practical guidance" for directors under Rule 12b-1. This guidance was developed with significant input from leaders in the independent director community, who not only have thought deeply about these issues, but also have faced them on a regular basis as directors of both large and small funds.[11] While these guidelines necessarily reflect the imperfections of the current regulatory structure, they nonetheless should provide a basis for fund directors who must make crucial decisions about their funds' distribution plans.[12]

Continue reading *Report of the Mutual Fund Directors Forum: Best Practices and Practical Guidance for Directors under Rule 12b-1*: https://www.mfdf.org/docs/default-source/default-document-library/publications/white-papers/12b-1-best-practices.pdf

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1 *See* 17 CFR 270.12b-1.

2 *See Bearing of Distribution Expenses by Mutual Funds*, Investment Company Act Release No. 11414 (October 28, 1980) [45 FR 73898 (November 7, 1980)] ("Rule 12b-1 Adopting Release")

3 *See id*.

4 *See* Letter from William H. Donaldson, Chairman, U.S. Securities and Exchange Commission, to David S. Ruder, Chairman, and Allan S. Mostoff, President, Mutual Fund Directors Forum (November 17, 2003), http://www.mfdf.com/UserFiles/File/best_pra.pdf.

5 The expectation was based on the fact that, at the time that the Commission banned directed brokerage in early 2004, it also sought comment on how to reform Rule 12b-1.

6 *See* Speech by the SEC Chairman: Address to the Mutual Fund Directors Forum Seventh Annual Policy Conference by Chairman Christopher Cox in Washington, D.C., April 13, 2007 (available at www.sec.gov/news/speech/2007/spch041207cc.htm). *See also* Speech by SEC Staff: Keynote Address at 2007 Mutual Funds and Investment Management Conference by Andrew J. Donohue, Director, Division of Investment Management, Palm Desert, California, March 26, 2007 (available at www.sec.gov/news/speech/2007/spch032607ajd.htm).

7 Rule 12b-1(b)(2).

8 Rule 12b-1(b)(3)(ii).

9 Rule 12b-1(b)(3)(i); Rule 12b-1(e).

10 Although directors are not required to consider any particular factors, the Rule 12b-1 Adopting Release suggests that the following factors "may provide helpful guidance to directors" when considering Rule 12b-1 plans: (1) consider the need for independent counsel or experts in reaching a determination; (2) consider the nature of the problem or circumstance which purportedly makes implementation or continuation of such a plan necessary or appropriate; (3) consider the causes of

such problems or circumstances; (4) consider the way in which the plan would address these problems or circumstances and how it would be expected to resolve or alleviate them, including the nature and approximate amount of the expenditures; the relationship of such expenditures to the overall cost structure of the fund; the nature of the anticipated benefits, and the time it would take for those benefits to be achieved; (5) consider the merits of possible alternative plans; (6) consider the interrelationship between the plan and the activities of any other person who finances or has financed distribution of the company's shares, including whether any payments by the company to such other person are made in such a manner as to constitute the indirect financing of distribution by the company; (7) consider the possible benefits of the plan to any other person relative to those expected to inure to the company; (8) consider the effect of the plan on existing shareholders; and (9) consider, in the case of a decision on whether to continue a plan, whether the plan has in fact produced the anticipated benefits for the company and its shareholders

[11] To prepare this Report, the Forum organized a working group that consisted of members of the Forum and the Forum's Advisory Board. Members of the working group participated in this effort in their individual capacities, and not as representatives of their organizations, the fund boards on which they serve, or the funds themselves. Drafts of this Report were reviewed by the Forum's Steering Committee and Board of Directors, and their comments have been integrated into this document. The Report does not necessarily represent the views of all Forum members in every respect.

[12] In recommending these best practices, the Forum recognizes that each fund and fund family is unique, that fund directors need to assess whether a particular practice makes sense for a particular fund, and that in some circumstances the independent directors of a fund may reasonably conclude that the recommended practice may not be in the best interests of their fund's shareholders. The Forum's recommendations are not intended to be legally mandated, nor should they carry any implication that current or prior practices not consistent with the recommendations involve a breach of fiduciary duty or a violation of law. Finally, this Report is not intended, nor should it be relied upon, as a substitute for appropriate professional advice with respect to the applicability of laws and regulations in particular circumstances, nor is it intended to express any legal opinion or conclusion concerning any specific policy, procedure, practice or activity.

CHAPTER FOUR

RULE 17A-7: AFFILIATED PRINCIPAL TRANSACTIONS

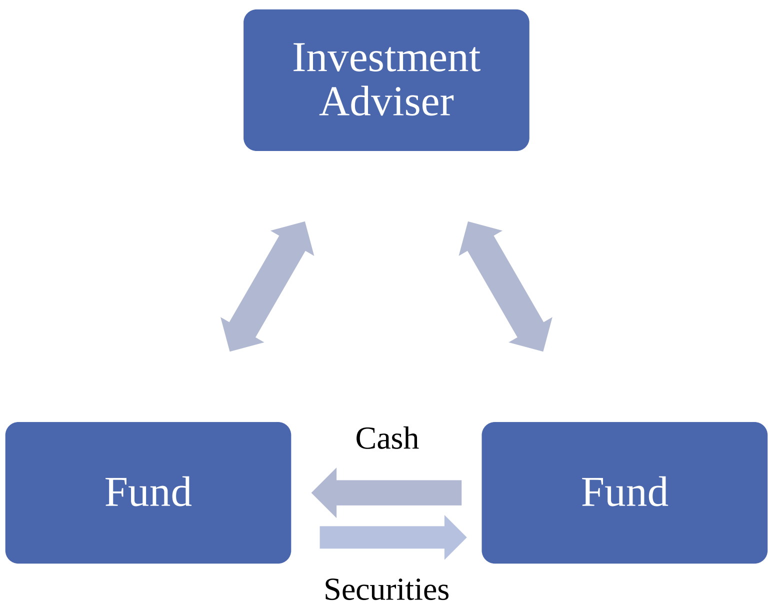
Policy

Section 17(a) of the 1940 Act prohibits an affiliated person of a Fund, acting as principal, from selling to or purchasing from the Fund any security. Section 17(a) was designed to prohibit self-dealing and other forms of overreaching of a Fund by its Adviser and other affiliates that have both the ability and the pecuniary incentive to influence the actions of the Fund.

Various rules under Section 17(a) allow for certain transactions between Funds and their affiliates. These rules contain certain conditions to protect investors against overreaching of Funds participating in the transaction. One of these rules is Rule 17a-7, which among other things permits purchases and sales of portfolio securities between affiliated Funds.

What is a Rule 17a-7 transaction?

A diagram of a typical transaction under Rule 17a-7 is as follows:



To be exempt under Rule 17a-7, a transaction must be:

- a purchase or sale solely for cash payment against prompt delivery of a security for which market quotations are readily available;
- effected at the independent current market price of the security, as defined specifically in the rule;

- consistent with the policy of each Fund participating in the transaction; and
- without brokerage commissions, fees (except customary transfer fees) or other remuneration paid in connection with the transaction.

What does the board need to do under Rule 17a-7?

The board, including a majority of the Independent Directors, is required to oversee the conflicts of interest in Rule 17a-7 transactions. Specifically, they must: (1) adopt procedures that are reasonably designed to provide for compliance with the conditions of the rule, (2) make and approve such changes as the board deems necessary, and (3) receive, at least quarterly, a written representation from the Fund's CCO that transactions effected in reliance of Rule 17a-7 complied with the board's adopted procedures.[1]

[1] Independent Directors Council, SEC No-Action Letter (pub. avail. Oct. 12, 2018).

CHAPTER FIVE

RULE 17E-1: AFFILIATED BROKERAGE TRANSACTIONS

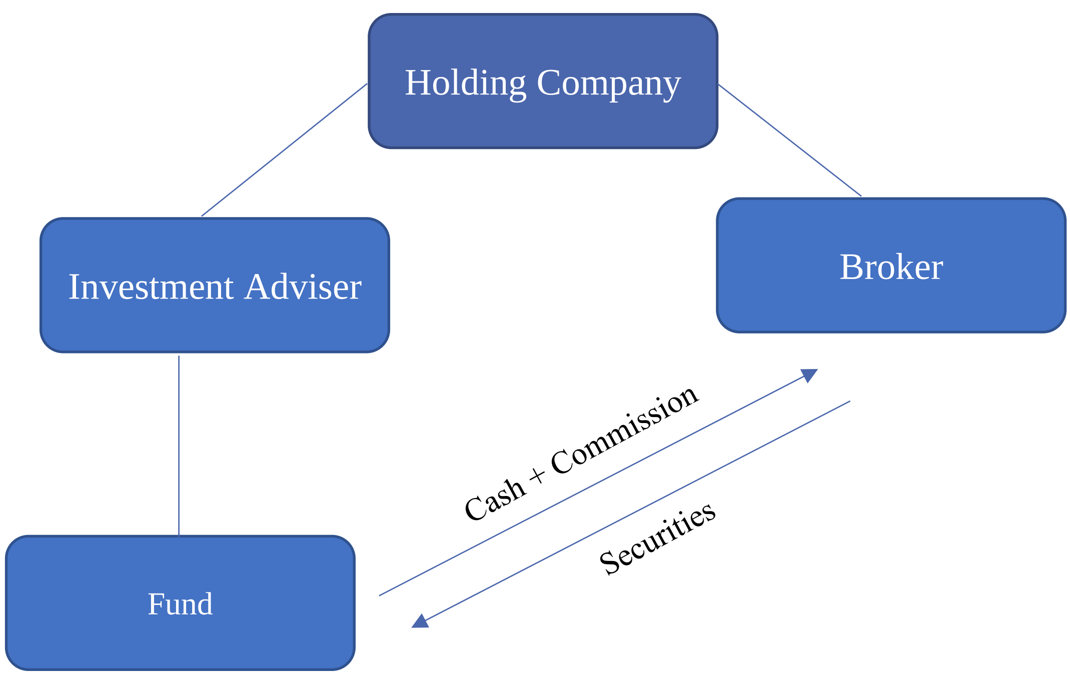
Policy

Section 17(e)(2) of the 1940 Act generally prohibits an affiliated person from acting as broker in connection with the sale of securities by or to a Fund and receiving remuneration exceeding the "usual and customary broker's commission." Section 17(e) was intended to prohibit an affiliated person from operating on behalf of a Fund while under a conflict of interest, such as by receiving gratuities for effecting particular transactions.

The SEC adopted Rule 17e-1 to define the conditions under which an affiliated person (e.g., a broker that is affiliated with the Fund's investment adviser) could receive remuneration without exceeding the "usual and customary broker's commission." The conditions the SEC imposed in order to comply with Rule 17e-1 were designed to ensure the remuneration received by an affiliated broker is reasonable and fair as compared to remuneration received by other similar brokers in comparable transactions.

What is a Rule 17e-1 transaction?

A diagram of a typical purchase transaction under Rule 17e-1 is as follows:



Each Rule 17e-1 transaction requires comparing the commission, fee, or other remuneration received by the affiliate to what is received by other brokers in connection with:

- comparable transactions;
- involving similar securities;
- being purchased or sold on a securities exchange;
- during a comparable period of time.

What does the board need to do under Rule 17e-1?

The board, including a majority of the Independent Directors, is required to: (1) adopt procedures governing the payment of a brokerage commission, fee or other remuneration to an affiliated person on securities transactions; (2) make and approve such changes as the board deems necessary; and (3) receive, at least quarterly, a written representation from the Fund's CCO that transactions effected in reliance of Rule 17e-1 complied with the board's adopted procedures.[1]

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1 Independent Directors Council, SEC No-Action Letter (pub. avail. Oct. 12, 2018).

CHAPTER SIX

RULE 10F-3-AFFILIATED UNDERWRITINGS

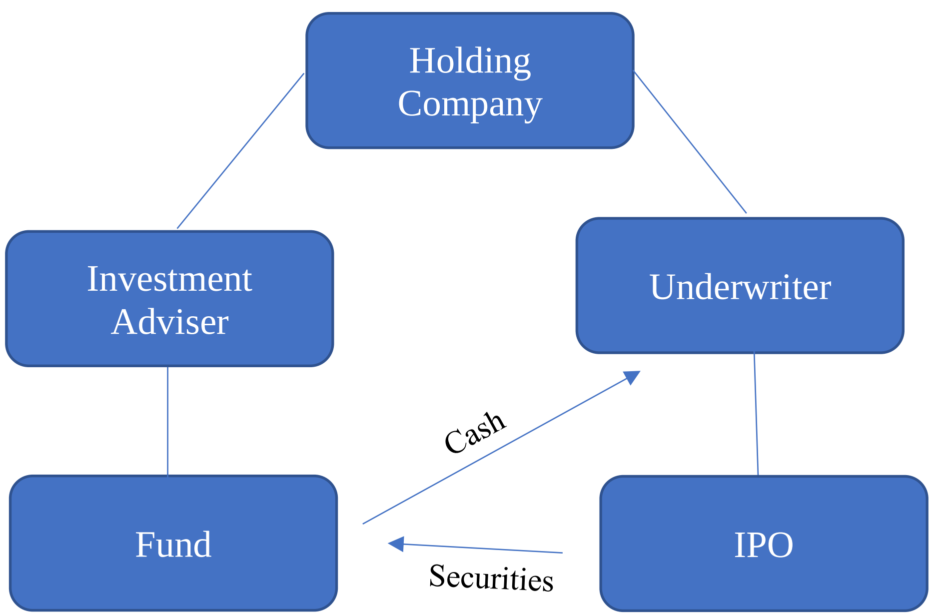
Policy

Section 10(f) of the 1940 Act prohibits a Fund from purchasing any security during an underwriting or selling syndicate if the Fund has certain affiliated relationships with a principal underwriter for the security. Section 10(f) was designed to protect the Fund from being compelled by an affiliate to purchase part of any security issued.

The SEC adopted Rule 10f-3 in order to permit a Fund to purchase from an underwriting syndicate including one or more affiliates subject to certain conditions that are intended to make the purchase consistent with the protection of investors.

What is a Rule 10f-3 transaction?

A diagram of a typical transaction under Rule 10f-3 is as follows:



Each Rule 10f-3 transaction must comply with the following conditions:

- **Types of securities:** The security is an <u>eligible security</u>, as defined in the Rule 10f-3. Eligible securities include registered US securities offerings as well as various foreign offerings, municipal securities, and Rule 144A offerings.

- **Timing and price:** The timing and price of the transaction is consistent with the standards set forth in Rule 10f-3.

- **Firm commitment underwriting:** The security is part of a firm commitment underwriting. A "firm commitment" underwriting is where the securities are offered pursuant to an underwriting or similar agreement under which the underwriters are committed to purchase all of the securities being offered (except in certain rights offerings).

- **Reasonable commissions:** The commission or spread by the principal underwriter is reasonable and fair compared to the commission or spread on similar securities being sold during a comparable period of time.

- **Percentage limitations:** The purchased security complies with the percentage limitations contained in Rule 10f-3.

What does the board need to do under Rule 10f-3?

The board, including a majority of the Independent Directors, is required under Rule 10f-3 to: (1) adopt procedures governing the purchase by a Fund of a security where an affiliate of the Fund is a participant in the underwriting syndicate; (2) make and approve such changes as the board deems necessary; and (3) receive, at least quarterly, a written representation from the Fund's CCO that transactions effected in reliance of Rule 10f-3 complied with the board's adopted procedures.[1]

[1] Independent Directors Council, SEC No-Action Letter (pub. avail. Oct. 12, 2018).

CHAPTER SEVEN

RULE 38A-1 COMPLIANCE POLICIES AND PROCEDURES

What do the directors need to do and why?

The board, including a majority of the Independent Directors, is required to adopt compliance policies and procedures reasonably designed: (a) to prevent the investment company from violating the federal securities laws; and (b) to provide for the oversight of compliance by each Adviser, Distributor, Administrator, and Transfer Agent of the Fund.

The board is required to designate a Fund CCO who is responsible for administering the Fund's Rule 38a-1 compliance policies and procedures. The board is also required to review, at least annually, the Fund's Rule 38a-1 compliance policies and procedures for their adequacy and effectiveness of implementation.

The process the board employs to carry out this responsibility is described below. For further information on the board/CCO relationship, see the Forum's paper at https://www.mfdf.org/docs/default-source/default-document-library/publications/white-papers/board-cco-relationship-4-2015.pdf?sfvrsn=da0c3ba9_0 .

What are the standards?

As described in more detail below, the standards for review are set forth in Rule 38a-1 and related guidance from the SEC, including the adopting release for Rule 38a-1. The Rule requires directors to exercise their fiduciary duty in establishing a compliance program and approving the appointment of a Fund CCO.

What information do Directors need?

The directors need to review information about:

- A Fund's compliance policies and procedures, as well as summaries of the compliance policies and procedures of the Fund's Adviser, each sub-adviser, Distributor, Administrator and Transfer Agent.
- Certifications from each of these entities that their respective procedures, as they relate to the Fund, are reasonably designed to prevent violations of the Federal Securities Laws.

Who provides directors with this information?

Directors should request from the Adviser and/or the Fund's CCO appropriate information on the Fund and the various service providers' compliance programs. The Fund CCO typically prepares his/her report to the board providing the CCO's assessment of the adequacy and operation of the

Fund's Rule 38a-1 compliance policies and procedures. This assessment is based on testing done throughout the year by the Fund CCO and his/her compliance team. The decision about which of the Fund's compliance policies and procedures will be tested by the CCO is typically made by the Fund CCO, who will highlight this testing with the board or a Committee designated by the board to oversee compliance. For larger Fund families, the Fund family's Internal Audit Department or Risk Management Officer may also be consulted in making this determination. The board may also receive a memorandum from its Independent Counsel about the legal standards applicable to the board's consideration.

Adoption and Implementation of Compliance Policies and Procedures

Rule 38a-1 (the "Fund Compliance Rule") generally requires a Fund[1] to adopt and implement policies and procedures reasonably designed to prevent the Fund from violating the Federal Securities Laws,[2] and to review the policies and procedures at least annually for their adequacy and effectiveness. While the Fund Compliance Rule permits considerable flexibility as to the content of a Fund's policies and procedures, they must include measures for the oversight of compliance programs of its Adviser (including each sub-adviser), Distributor, Administrator, and Transfer Agent (each, a "Service Provider," and collectively, the "Service Providers").[3] The board, including a majority of the Independent Directors, must approve the adoption of the Fund's written compliance policies and procedures, and the compliance policies and procedures of each Service Provider as they relate to the Fund.

The SEC has stated that directors generally may meet their obligations under the Fund Compliance Rule by reviewing summaries of a Fund's or a Service Provider's compliance policies and procedures that are prepared by the CCO, legal counsel or other persons familiar with the policies and procedures, including the Service Providers themselves. These summaries should include key details about the Rule 38a-1 compliance policies and procedures and describe how they address significant compliance risks.

When considering approval of compliance policies and procedures, the board should consider any higher risk areas (e.g., illiquid or hard to value securities), the nature of the Fund's exposure to compliance failures and the sufficiency of the policies and procedures in light of recent compliance experiences. The SEC has also recommended that Independent Directors consult with Independent Counsel, compliance specialists or other experts familiar with successful compliance practices when considering the approval of compliance policies and procedures.

Appointment of the Chief Compliance Officer

The Fund Compliance Rule requires that the board designate a Fund CCO responsible for administering the Fund's compliance program.

In order to assure the CCO's independence, the Fund Compliance Rule specifies that:

- The board, including a majority of its Independent Directors, must approve the designation of the CCO;

- The board, including a majority of the Independent Directors, must approve the compensation of the CCO, and any changes in the CCO's compensation, including any bonuses; and
- The board, including a majority of its Independent Directors, can remove the CCO from his or her position and responsibilities to the Fund at any time if the board loses confidence in his or her effectiveness. The board can also prevent either the Adviser or Fund officers from removing the CCO.

In addition to overseeing a Fund's compliance policies and procedures, the Fund CCO is charged with overseeing compliance with the Fund Compliance Rule by the Service Providers. The CCO is expected to take measures to assure herself that each Service Provider has implemented effective compliance policies and procedures that are administered by competent personnel. The CCO must be familiar with each Service Provider's operations and understand those aspects of the Service Provider's operations that expose a Fund to compliance risks. SEC staff has stated that fund complexes typically seek a combination of information to conduct Service Provider oversight, including, but not limited to, service provider presentations, on-site visits, questionnaires, certifications, independent control reports, and summaries of programs and testing, where appropriate.[4]

The CCO must meet separately with the Fund's Independent Directors at least once a year, without either management or the Fund's interested directors being present (Independent Counsel, however, may be present). In this way, the Fund Compliance Rule furnishes Independent Directors with direct access to a single person with overall compliance responsibility for the Fund who answers directly to them.

Annual Review by the CCO and Report to the Board

The Fund Compliance Rule requires annual review of the adequacy of the Fund's and the Service Providers' compliance policies and procedures. This review must consider significant compliance events, changes in business arrangements and regulatory developments. The Fund Compliance Rule requires the CCO to provide an annual written report to the board that, at a minimum, must address:

- The operation of the policies and procedures of the Fund, the Adviser, each sub-Adviser, the Principal Underwriter, the Administrator and the Transfer Agent;
- Any material changes to the policies and procedures since the last report;[5]
- Any recommendations for material changes as a result of the annual review; and
- Each "Material Compliance Matter" that has occurred since the date of the last report.[6]

The Fund CCO also must bring any "serious" compliance issues to the attention of the board promptly (i.e., the CCO cannot delay informing the board of these issues until an annual report is due).[7]

[1] The SEC has adopted a separate rule, Rule 206(4)-7 under the Advisers Act that imposes similar, but not identical, compliance requirements on registered investment advisers.

[2] The Fund Compliance Rule defines "Federal Securities Laws" to mean the 1940 Act, the Advisers Act, the Securities Act of 1933, 1934 Act, the Sarbanes-Oxley Act of 2002, portions of the Gramm-Leach-Bliley Act, any rules adopted by the SEC under any of these statutes, the Bank Secrecy Act, as it applies to investment companies, and the rules adopted thereunder by the SEC or the Department of the Treasury.

[3] The SEC has stated that by limiting the term Service Provider in this way, they are not lessening a fund's obligation to consider compliance as part of its oversight of other service providers, such as pricing services, auditors, and custodians.

[4] See Business Continuity Planning for Registered Investment Companies, SEC IM Guidance Update No. 2016-04 (June 2016).

[5] Rule 38a-1 does not require fund boards to approve amendments to policies and procedures of the Fund or its Service Providers, although some boards do approve such amendments as a matter of practice.

[6] The Fund Compliance Rule defines a "Material Compliance Matter" as "any compliance matter about which the Fund's Board of Trustees would reasonably need to know to oversee Fund compliance, and that involves, without limitation: (i) a violation of the Federal Securities Laws by the Fund, its [Service Providers] (or officers, Trustees, employees or agents thereof), (ii) a violation of the policies or procedures of the Fund [or its Service Providers] or (iii) a weakness in the design or implementation of the policies and procedures of the Fund [or its Service Providers]."

[7] The SEC has also stated that a Fund should review its compliance policies and procedures more frequently, if necessary, in light of industry or regulatory developments.

CHAPTER EIGHT

BEST EXECUTION, TRADING AND SOFT DOLLARS

What directors need to do and why?

Directors have a fiduciary duty to oversee the investment and use of Fund assets and Fund expenses. This responsibility includes oversight of the trading of portfolio securities, including whether the Fund's Adviser (or sub-adviser) is obtaining best price and execution. In addition, directors are responsible for overseeing whether commission dollars and other transaction-related expenses are used properly to benefit the Fund.

What are the standards?

As described in more detail below, the standards for review of portfolio transactions ("best price and execution") and soft dollars are set forth in various SEC releases, no-action letters, speeches and enforcement proceedings. Directors must establish appropriate procedures and review the use of Fund assets to ensure that it is in the shareholders' best interest.

What information do Directors need?

Directors need to review information about:

- Execution of the Fund's portfolio securities transactions and the markets in which they trade.
- The commissions and other execution-related expenses paid by the Fund.
- The use of soft dollars by the Fund's Adviser.

Who provides Directors with the necessary information?

Directors should request from the Adviser appropriate information on portfolio trading, commission payments and the use of soft dollars. Directors also may receive a legal memorandum from Independent Counsel about the standards applicable to the board's consideration.

Responsibilities of Directors

Directors are responsible for evaluation and oversight of trading practices.[1] Trade execution costs can have a significant impact on the ultimate return to shareholders, so directors must monitor an Adviser's trading practices. Directors must determine that a Fund's commission dollars (which are Fund assets) are used in the best interests of a Fund and its shareholders. In fulfilling their oversight responsibilities, directors are subject to the state law duty of care and duty of loyalty. In addition to general oversight, directors also consider best execution and soft dollars during the annual review of the Fund's Investment Advisory Agreements.

Best Execution

Advisers have an obligation to obtain "best execution" for all client trades. This responsibility predates Federal securities laws and is derived from the common law obligations of undivided loyalty and reasonable care that an agent owes to its principal. Thus, a Fund Adviser should not disadvantage either the Fund or the Adviser's other clients when executing trades.

In seeking best execution, Advisers must "execute securities transactions for clients in such a manner that the client's total cost or proceeds in each transaction is most favorable under the circumstances."[2] In short, an Adviser must attempt to minimize the transaction costs paid by its client. Transaction costs consist of more than just the commission rate. In addition to such explicit costs (which also include fees paid to exchanges and taxes), an Adviser must also consider the implicit costs, including the price impact of placing an order to trade and opportunity costs. There is no single way for directors to determine whether Funds are receiving best execution.

What Factors are Important in Evaluating the Trading Function?

To effectively evaluate best execution, directors should dedicate sufficient time to understand the Adviser's general trading philosophy and practices. Directors should ask which factors management considers most important in attaining best execution. The following summarizes some important factors for directors to consider.

Trading Philosophy

Trading philosophies vary across Advisers and across different markets (e.g., stock versus bond markets), and a firm's approach to a particular market needs to be considered when evaluating the components of best execution.[3] For example, some firms may believe that their clients and process are best served by completing orders within a short time period after receipt. Others may believe that their ideas are best implemented by a more measured approach to trading. There is no single correct way to approach the market, nor is there any single correct way to measure results.

Business Mix

Business mix will have a significant impact on how an Adviser's trading practices are established, and the results achieved. There are two components of the business that are relevant.

- First is the nature of the securities that are traded. For example, large cap stocks will typically have wider availability, more sources and lower commissions than smaller cap stocks. International securities require additional expertise and will likely be more expensive. It may be appropriate to ask for information by market segment or style in order to facilitate the evaluation process.
- Second is the nature of the accounts that the Adviser manages, and how trades are handled across multiple accounts. Many Advisers manage a mix of mutual Funds, large individual accounts, other commingled funds, and wrap accounts. Directors should understand how trades are handled when a number of different accounts are managed in the same investment style. Advisers must have policies and procedures to ensure that all accounts receive fair and equitable treatment and directors should understand those policies.

Organizational Structure

Organizational structure can also affect trading practices and the approach to best execution. Directors should understand where the trading function is located within the Adviser's organization. Some Advisers will have a centralized team responsible for all trading which simplifies the implementation of policies and procedures. For some larger firms or firms with a "boutique" approach, there may be multiple trading desks, each handling specific types of trades. Trading desks in diverse locations create more oversight challenges.

Often the trading function is separated from portfolio management and research to allow the trading staff to focus specifically on the technical aspects of trading or to better manage the portfolio manager's ability to influence broker selection decisions.

Other organizational considerations may include:

- The depth and experience level of the trading staff, how their performance is measured, and how they are compensated.
- The Adviser's oversight process. A Trade Oversight Committee or similar group may exist to monitor overall results, consistency of approach, and implementation of policies. In addition, broker lists are often developed to allow portfolio managers and analysts to provide input on which firms provide good coverage or ideas. The information can then be balanced with execution capabilities.
- The role of Compliance in monitoring the trading function.

Broker Selection

Most firms maintain a limited list of firms with which they execute trades. The list is developed with input from the portfolio managers, analysts and trading staff, and may be updated one or more times per year. Actual trade-by-trade decisions are the responsibility of the trading staff based on their knowledge of the market and the securities being traded.

Trades can typically be executed with a range of counterparties. These include "execution only" where commissions are low, and no services are provided. Execution-only firms include discount type brokers as well as ECNs and other electronic systems. Full-service firms will charge higher rates, provide research, commit capital and provide other input that may be of benefit to execution. Soft dollar firms will use a portion of their commissions to cover third party research costs. They typically charge commissions comparable to full-service firms. Advisers may also use alternative trading systems including "dark pools", algorithmic trading systems, crossing networks, and high frequency trading.

A broad range of capabilities may be considered in broker selection, including:

- Promptness of execution;
- Broker reputation and integrity;
- Block trading and arbitrage capabilities;

- Access to new securities (IPOs);
- Ability and willingness to commit capital;
- Sophistication of trading systems;
- Quality of confirmations, statements, and reporting;
- Ability and willingness to correct errors;
- Market focus and expertise; and
- Access to information, ideas, and research.

The Costs of Trading

Portfolio managers implementing an "active" management strategy undertake trades in order to generate "alpha" or returns in excess of a benchmark. The trading desk focuses on limiting "alpha loss" related to the execution process. There are three factors that create alpha loss:

- Commissions. Commission rates vary. Smaller cap issues tend to trade at higher rates than large cap issues, and some international securities may be significantly above these levels. Larger managers generally have the ability to command lower commissions.
- Market impact. This is the effect of the trade hitting the market and driving prices away, either higher or lower. Market impact is likely to be more significant in thinly traded stocks.
- Trading delay. This is the cost incurred due to market inefficiencies and other delays from time of trading desk receipt to time of execution.

Market impact and trading delay costs, though less visible than commissions, can have a greater impact on the cost of a trade. Both tend to increase as market capitalization of the securities decreases, a reflection of the available volume and liquidity of securities, lower efficiency in terms of market knowledge and access to buyers and sellers.

How do Soft Dollars relate to Trade Execution?

The practice of using Fund commissions to pay for research and services ("soft dollars") has been in existence for many years. Section 28(e) of the 1934 Act established a safe harbor for Advisers who pay for certain services beyond execution with Fund commissions, which are an asset of the Fund, not the Adviser. The SEC has provided interpretations of which services Advisers may receive with soft dollars.[4] It is a complex area, and commission dollars may represent a sizeable Fund asset. Because a fund's brokerage commissions are considered assets of the Fund, an Adviser's use of these commissions, including obtaining research for them, represents a potential conflict of interest.

Typically, soft dollar items fall into one of three categories.

- Proprietary research and services provided by the firm selected to execute the trade;

- Third party research and services where the executing broker agrees to use a portion of its commission to pay an unaffiliated firm on behalf of the Adviser; and
- Mixed use items where items may partially meet the requirements of the safe harbor. The Adviser is required to maintain clear records and documentation of how the costs are split between "hard" and "soft" dollars, and the analysis of what portion of the item qualified for payment with soft dollars and what did not.

Where do Conflicts Exist?

There are a number of possible conflicts that can arise in the trading and portfolio management process. Thorough questioning of portfolio management and trading staff can provide comfort that risks in this area are mitigated by reasonable controls.

Allocation of Shares

Most firms maintain policies that provide for a pro rata allocation of shares when a trade cannot be fully completed. This is also an issue when trades are split across brokers or time in order to minimize the overall costs. Directors should ask questions about these policies and should also be certain that the CCO is testing in this area.

Front Running and Insider Trading

Though these activities are both illegal, directors should still question what procedures and information is used to monitor improper trading activity. The monitoring process should look not only at personal trading, but also at possible activity in client accounts.

Performance Fee Accounts

When advisory fees are based on performance, there is more risk that these accounts will be the beneficiary of investment ideas or favorable trading opportunities. Evaluation of the dispersion of returns between these and similarly managed accounts can provide Directors (or the CCO) with a measure of comfort in this area.

Affiliated Brokers

Directors should question the volume and types of trades which an affiliate receives. It would also be beneficial to understand what commission rates are and whether the rate is consistent with that charged to other similar brokerage clients. Section 17(e) of the 1940 Act, which is discussed in Chapter Five, imposes certain limitations on affiliate brokers trading for Funds.

Soft Dollars

Utilization of client commissions to pay for research and brokerage raises obvious conflict questions because the Adviser is using Fund assets to purchase research and other services for which the Adviser would otherwise have to pay "hard" dollars. The research and other services benefit the Adviser and may or may not also benefit the Fund. A particular concern is whether the Funds bear more of the soft dollar burden than other types of accounts the Adviser manages.

How Should Directors Evaluate Soft Dollars?

As part of the oversight process, directors should have a thorough understanding of the Adviser's use of soft dollars. Boards should receive information regarding the types of research or services purchased, and whether they are proprietary, mixed use or third party, as well as the process for determining a soft dollar budget, and the process for allocating commission dollars (including how the Adviser evaluates the quality of research).

The Adviser also should provide an analysis of soft dollar commissions in relation to total commissions for both the Funds and the firm as a whole. Directors should evaluate whether the Funds are bearing a comparable burden to other clients based on this information.

Comparison to industry data will allow directors to understand whether the pattern and practice is in line with industry norms. If the numbers appear high, additional questions should be asked of the Adviser.

Directors should also understand, at least conceptually, the absolute impact on shareholders. If total commissions are low relative to assets, the impact of some soft dollar usage will not be significant. As commissions trend upwards overall or the use of soft dollars trends upward, the impact will obviously become more significant.

Directors consider the total value of services purchased with soft dollars when evaluating the Investment Advisory Agreement. The ability to use client assets for this purpose results in a higher profit margin for the Adviser. Soft dollars may provide a significant fall-out benefit to an Adviser that directors must consider when determining whether the advisory fee is appropriate.

Other Developments

As with other issues for which directors bear oversight responsibility, directors should endeavor to stay abreast of industry developments relating to best execution, trading, and soft dollars. For example, some brokers now charge no or very low commissions on certain trades. In addition, some Advisers "unbundle", or pay for trading commissions and research separately. Directors should ask questions of the Adviser in an effort to understand the impact of such developments on the Funds that they oversee.

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[1] In July 2008, the SEC proposed guidance for Independent Directors in meeting their responsibilities in overseeing their Funds' soft dollar arrangements. Although the SEC has not moved to formally adopt this proposal, it provides useful guidance for boards. *See* Commission Guidance Regarding the Duties and Responsibilities of Investment Company Boards of Directors with Respect to Investment Adviser Portfolio Trading Practices, Investment Company Act Release No. 28345 (July 30, 2008).

[2] Interpretive Release Concerning the Scope of Section 28(e) of the Securities Exchange Act of 1934 and Related Matters, Exchange Act Release No. 23170 (April 23, 1986).

[3] In 2008 the Securities Industry and Financial Markets Association ("SIFMA") published a white paper *Best Execution Guidelines for Fixed-Income Securities* to provide guidance about best execution in the context of fixed income markets, which as SIFMA points out, "differ significantly from equity markets and are fragmented and often subject to limited transparency as a result of the absence of a centralized reporting mechanism for completed transactions."

[4] *See* Commission Guidance Regarding Client Commission Practices Under Section 28(e) of the Securities Exchange Act of 1934, Exchange Act Release No. 54165 (July 18, 2006).

CHAPTER NINE

VALUATION OF PORTFOLIO SECURITIES

What is valuation?

Valuation is the process of assigning values to fund portfolio holdings. It is important because valuations of portfolio holdings are needed to determine a fund's net asset value ("NAV"), which is the price at which fund shares are purchased and redeemed by fund investors. Many funds calculate their NAV each business day. Valuation also impacts the accuracy of asset-based and performance-based fee calculations; disclosure of fund fees, performance, and portfolio holdings; compliance with investment policies and limitations; and accounting and financial reporting obligations. For many assets, valuation can be as simple as using a market quotation. However, in certain situations, such as for more thinly traded securities, market quotations may not be available. In these situations, fund assets must be assigned a "fair value."

What do directors need to do and why?

According to the 1940 Act, each fund's board of directors is ultimately responsible for determining the "fair value" of assets whose market quotations are not "readily available." However, much of the process can be designated, allowing directors to assume an oversight role.

What is required in the valuation process?

In December of 2020, the SEC adopted Rule 2a-5 under the 1940 Act (the "Valuation Rule" or the "Rule") which outlines the requirements for determining fair value of fund assets.[1] As described in more detail later in this Chapter, the Valuation Rule requires assessment of valuation risks; establishment, application, and testing of fair value methodologies; oversight of pricing services; and board reporting.

Who conducts the valuation process?

Under the Valuation Rule, fund boards can designate some or all of their fair valuation determination duties to a "valuation designee," who in most cases will be the fund's Adviser. If the board elects to do so, their role becomes one of oversight. Boards and Advisers can obtain assistance from others, such as pricing services, fund administrators, sub-advisers, accountants, or counsel, in fulfilling their valuation duties.

Legal Requirements

Section 2(a)(41) of the 1940 Act defines "value" as the market value of a fund's portfolio securities when market quotations for those securities are readily available, and, when market quotations are not readily available, the fair value of the security or asset, as determined in good faith by the fund's board of directors. So, by virtue of this section, the ultimate responsibility for good faith determinations of fair value falls on the shoulders of a fund's board of directors. However, under the SEC's Valuation Rule, the board can look to others, including the fund's investment adviser, for assistance. The Valuation Rule provides that a market quotation is "readily available" for purposes of section 2(a)(41) of the 1940 Act with respect to an investment only when that quotation is a quoted price (unadjusted) in active markets for identical investments that the fund can access at the measurement date, provided that a quotation will not be readily available if it is not reliable.

The Valuation Rule consists of four main requirements for determining fair value in good faith which either the fund's directors or the designated valuation designee must carry out in order to be considered to have properly determined fair value in good faith. After this Chapter describes each of these requirements in more detail, it goes on to discuss the board's responsibilities if it elects to designate fair value determinations to a valuation designee. It then discusses Rule 31a-4 under the 1940 Act (the "Recordkeeping Rule"), which the SEC implemented at the same time as the Valuation Rule to mandate recordkeeping requirements that accompany fair value determinations. It concludes by summarizing SEC enforcement actions relating to fund valuation involving fund directors.

Fair Value Determinations

Diagram 1 below outlines the four requirements for fair value determinations in the Valuation Rule. If a fund's board elects to designate fair value determinations to a valuation designee (as allowed by the Rule) the **designee**, and **not the board**, is responsible for fulfilling these requirements.

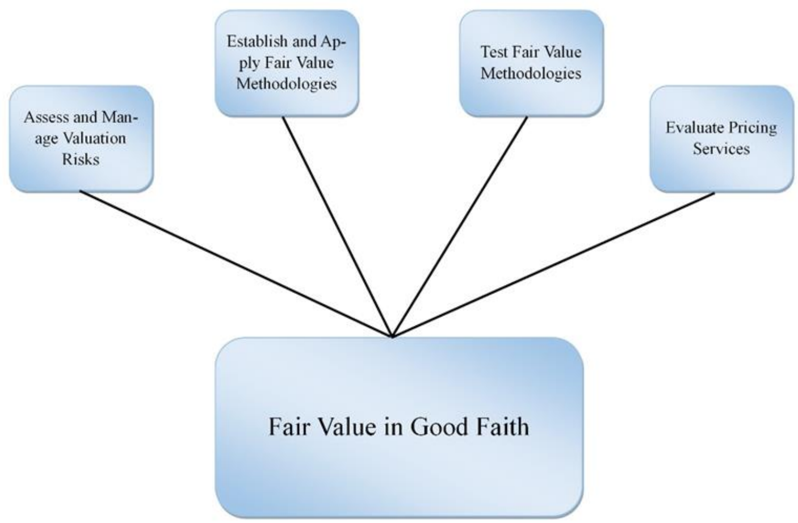


Diagram 1: Good Faith Fair Valuation Determination

Assess and Manage Valuation Risks

The Valuation Rule requires periodic assessment of any material risks associated with the determination of fair value of a fund's investments, including any material conflicts of interest. Once risks are identified, they must be managed. The Rule does not prescribe the frequency which with these risks must be assessed and reassessed. Thus, boards or valuation designees have leeway to determine a frequency that is appropriate for their fund's unique circumstances. While the Rule only prescribes that "material risks" be assessed, including "material conflicts of interest," when adopting the Rule, the SEC provided a list of non-exhaustive examples to help inform this process:

- the types of investments held or intended to be held by the fund and the characteristics of those investments;

- potential market or sector shocks or dislocations and other types of disruptions that may affect a valuation designee's or a third-party's ability to operate;

- the extent to which each fair value methodology uses unobservable inputs, particularly if such inputs are provided by the valuation designee;

- the proportion of the fund's investments that are fair valued as determined in good faith, and their contribution to the fund's returns;

- reliance on service providers that have more limited expertise in relevant asset classes, the use of fair value methodologies that rely on inputs from third-party service providers, and the extent to which third-party service providers rely on their own service providers (so-called "fourth-party" risks); and

- the risk that the methods for determining and calculating fair value are inappropriate or that such methods are not being applied consistently or correctly.

Establish and Apply Fair Value Methodologies

The Valuation Rule requires establishing and applying fair value methodologies, which must entail:

- selecting and applying appropriate fair value methodologies, including specifying the key inputs and assumptions specific to each asset class or portfolio holding;

- periodically reviewing the appropriateness and accuracy of the methodologies selected and making any necessary changes or adjustments; and

- monitoring for circumstances that may necessitate the use of fair value.

When adopting the Rule, the SEC explained that there is no single methodology for determining fair value because fair value depends on the facts and circumstances of each investment, including the relevant market and market participants. The SEC further explained that for any particular investment, there may be a range of appropriate values that could reasonably be considered "fair value." Thus, while the Rule provides requirements that must be *included* in any program, beyond that, a fund may apply a range of different methodologies.

Testing of Fair Value Methodologies

The Valuation Rule requires testing the appropriateness and accuracy of the fair value methodologies used, which must include identifying such testing methods, and the frequency with which the fund will use them. The Rule does not prescribe particular testing methods that must be used or a minimum frequency for testing, leaving this to boards or valuation designees to determine based on each fund's circumstances. Calibration and back-testing are common examples of testing used by funds.

Pricing Services

The Valuation Rule requires oversight of any pricing services used by funds. This oversight must include establishing a process for approval, monitoring, and evaluation of each pricing service provider. Additionally, funds must have a process in place outlining the circumstances under which they may challenge prices provided by pricing services. When adopting the Rule, the SEC provided a list of factors that should generally be considered by boards or valuation designees *before* deciding to use a pricing service, including the:

- qualifications, experience and history of the pricing service;

- valuation methods or techniques, inputs and assumptions used by the pricing service for different classes of holdings, and how they are affected (if at all) as market conditions change;

- quality of the pricing information provided by the service and the extent to which the service determines its pricing information as close as possible to the time as of which the fund calculates its net asset value;

- pricing service's process for considering price "challenges," including how the pricing service incorporates information received from pricing challenges into its pricing information;

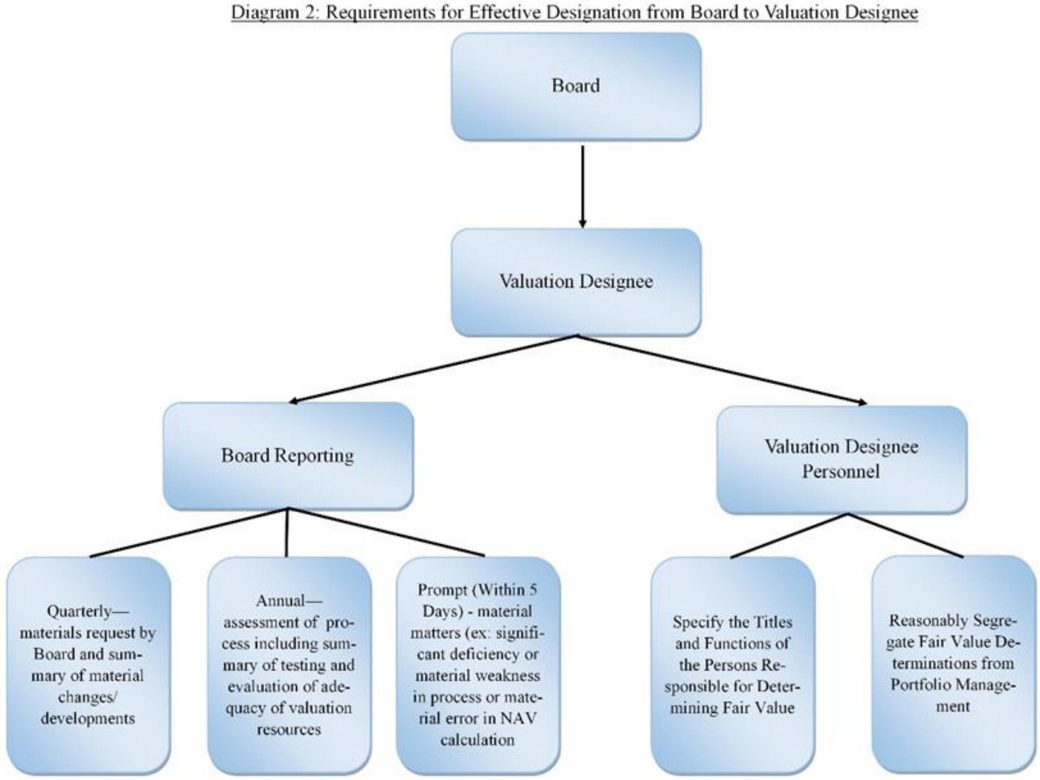
- pricing service's actual and potential conflicts of interest and the steps the pricing service takes to mitigate such conflicts; and

- testing processes used by the pricing service.

Designation of Fair Value Determinations

When fund boards determine to designate fair value determinations for some or all of fund assets to a valuation designee, their valuation responsibilities for those assets shift from the hands-on responsibilities outlined in the section above, to the oversight and other responsibilities outlined in this section. The valuation designee may be a fund's Adviser, or in the case of an internally managed fund, an officer of the fund. Boards generally designate these responsibilities to the fund's Adviser.

Diagram 2: Requirements for Effective Designation from Board to Valuation Designee



Board Oversight

If the board designates fair valuation determinations to a "valuation designee," its role becomes one predominantly of oversight. As part of this oversight, directors should ask questions and seek relevant information, request follow-up information when appropriate, and take reasonable steps to see that matters identified are addressed. When adopting the Rule, the SEC recommended the board should, among other things:

- seek to identify potential conflicts of interest, monitor such conflicts, and take reasonable steps to manage such conflicts (e.g., those of the valuation designee and other service providers);

- periodically review the financial resources, technology, staff and expertise of the valuation designee, and the reasonableness of the valuation designee's reliance on other fund service providers, relating to valuation;

- consider the valuation designee's compliance capabilities that support the fund's fair value processes, and the oversight and financial resources made available for the fair value process;

- consider the type, content and frequency of the reports the board receives. While a board can reasonably rely on the information provided, it is incumbent on the board to request and review such information as may be necessary to be fully informed of the valuation designee's process for determining fair value of fund investments; and

- inquire about material matters it becomes aware of and take reasonable steps to see that they are addressed.

Board Reporting

When the board elects to assign fair value determinations to a valuation designee, the Rule requires the valuation designee to provide written reports to the board, as outlined below. The reports can be made to the board or a board committee composed of a majority of Independent Directors.

- Quarterly Reports: At least quarterly, the valuation designee must provide the board a written report including any materials requested by the board related to fair value or the valuation designee's process for fair valuing fund investments. The report must also include a summary or description of material fair value matters that occurred in the prior quarter, including:

    - material changes in the assessment and management of valuation risks, including conflicts of interest that present a valuation risk;

    - material changes or deviations from the fair value methodologies that occurred; and

- material changes to the valuation designee's process for selecting and overseeing pricing services/any other material events relating to pricing service oversight.

- Annual Reports: At least annually, the valuation designee must provide the board with a written report including an assessment of the adequacy and effectiveness of the valuation designee's process for determining the fair value of the designated portfolio of investments. This report must include:

  - a summary of the results of the testing of fair value methodologies; and
  - an assessment of the adequacy of resources allocated to the process for determining the fair value, including any material changes to the roles or functions of the persons responsible for determining fair value.

- Prompt Reports: The valuation designee must provide written notification to the board on the occurrence of matters that materially affect the fair value of the designated portfolio of investments. Such reporting must occur within a time mandated by the board, but in no event later than five business days after the event. Examples of material matters would be:

  - a significant deficiency or a material weakness in the design or effectiveness of the valuation designee's fair value determination process; and
  - material errors in the calculation of the net asset value.

Specification of Responsibilities and Separation of Functions

The Rule requires the valuation designee to specify the titles of the persons responsible for determining the fair value of the designated investments, including specifying the particular functions for which the persons identified are responsible. Additionally, valuation designees must separate making fair value determinations from portfolio management responsibilities. This requirement is designed to prevent a Fund's portfolio manager from determining or exerting substantial influence over the fair value determination. However, the Rule does not prevent portfolio managers from providing inputs into the fair value determination process, because of the unique insights that portfolio management may have regarding the value of fund holdings.

Policies and Procedures and Disclosure

A Fund (or its Adviser if designated) must adopt policies and procedures with respect to the Valuation Rule, and the board must approve these policies and procedures. Though the Valuation Rule itself does not specifically require policies and procedures, the SEC explained when adopting the Valuation Rule that policies and procedures are nonetheless required under Rule 38a-1 of the 1940 Act, which provides that a Fund's board, including a majority of its Independent Directors, must approve policies and procedures reasonably designed to prevent violation of the federal securities laws by the Fund and its service providers. This approach was meant to preserve the flexibility to tailor fair value policies and procedures to the unique facts and circumstances of each Fund. In addition, Funds are required to disclose in their registration statements the circumstances under which they will use fair value pricing, and the effects of using fair value pricing.

Recordkeeping Rule

The Recordkeeping Rule requires a fund or its Adviser (depending on whether fair value determinations have been designated) to maintain "appropriate documentation to support fair value determinations." The SEC explained when adopting the Recordkeeping Rule that "appropriate documentation" should include documentation that would allow a third-party (such as the SEC staff) to verify the fair value determinations made. Such records, which include the board reports described above, must be maintained for six years – the first two of which the documents must be kept in an "easily accessible place."

SEC enforcement actions against directors regarding valuation

The SEC has brought a number of enforcement actions involving fund valuation issues. In the cases against directors, the SEC has focused on the need for the board to ask questions and seek follow-up information when appropriate, including with respect to conflicts of interest, and understand the methodologies used to value instruments in the portfolio, among other issues. These cases emphasize the importance of director responsibilities in overseeing the fund valuation process.

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[1] Good Faith Determinations of Fair Value, Release No. IC-34128 (Dec. 3, 2020) https://www.sec.gov/rules/final/2020/ic-34128.pdf .

CHAPTER TEN

PRACTICAL GUIDANCE FOR DIRECTORS ON BOARD SELF-ASSESSMENTS

Excerpt from the Report of the Mutual Fund Directors Forum: Practical Guidance for Fund Directors on Board Self-Assessments, *published July 2021*

Executive Summary

The regulatory framework around mutual fund board self-assessments has not changed since it was adopted in 2006, although the duties and responsibilities of mutual fund directors have expanded and evolved to a significant degree. Fund board workloads have increased due to a range of market and industry developments that include fund regulation; heightened risks from technology and market events; evolving product distribution channels and shifting investor demand; and, most recently, a global health crisis. Boards that employ a robust evaluation process can be well-positioned to effectively meet current and future industry challenges.

Boards have wide latitude to make their self-assessments dynamic and to choose methods best suited to their particular board. This paper outlines a number of options for fund boards to consider.

The evaluation process can be most beneficial when all board members are involved and each director's contribution is valued. The board may wish to ensure that the process is transparent with well-defined objectives and outcomes that are monitored throughout the year. Governance specialists have advocated for the self-assessment process to be thoughtful, transparent, and ongoing throughout the year with attention paid to achieving realistic outcomes. Although a board may benefit from using the same evaluation process for several years, self-assessment processes can evolve over time to meet changing industry practices and board characteristics. Boards may wish to refresh their approach periodically and utilize evaluation strategies that envision continuous improvement for individual directors and the entire board.

The self-assessment process may also anticipate the issues boards will face and future skillsets that may be desired on the board. Emerging topics on the radar of regulators and other industry participants include crisis preparedness; cybersecurity; ESG; and diversity, equity, and inclusion. Boards may wish to encourage education in these areas in order to engage with the adviser and fund service providers on their responses to these wider market trends and to be prepared to oversee potential related risks. Boards that are attuned to and educated on these emerging issues may prove more agile and adaptable to change.

This paper also revisits the primary methods through which boards conduct their assessments. Many boards continue to prefer the interview or questionnaire methods. A few boards utilize peer reviews and individual assessments. Boards are responsible for conducting their own evaluations; however, many boards use third parties, commonly independent legal counsel, to guide the process. Boards have achieved the positive outcomes discussed in this paper as a result of making changes to and expecting more from their evaluation process.

Read the complete *Report of the Mutual Fund Directors Forum: Practical Guidance for Fund Directors on Board Self-Assessments*: https://www.mfdf.org/docs/default-source/default-document-library/publications/white-papers/mfdf-self-assessments.pdf

CHAPTER ELEVEN

FIDELITY BOND

What do directors need to do and why?

Section 17(g) and Rule 17g-1 under the 1940 Act require directors to approve (and annually reapprove) the form and amount of a fidelity bond protecting the Fund from losses arising from larceny and embezzlement by an officer or employee.

What are the standards?

As described in more detail below, the standards for approval are set forth in Rule 17g-1 under the 1940 Act, which sets forth the minimum amounts of coverage required based on a Fund's assets under management ("AUM"). Directors must ensure that the protection provided against larceny and embezzlement is appropriate and consistent with at least the minimum bond amounts set for in Rule 17g-1.

What information do directors need?

Directors need to review information about the Fund's:

- Aggregate assets;
- Custody arrangements; and
- Portfolio securities.

Who provides information to the directors?

Directors should receive information about and a copy and terms of the fidelity bond from the Adviser and/or the Fund's Treasurer. Independent Directors should also receive a memorandum from Fund Counsel or their Independent Counsel about the legal standards applicable to their consideration of the fidelity bond. In addition, directors may also wish to consult with the insurance broker about coverage provided by the fidelity bond policy and any exclusions.

Rule 17g-1 requires each Fund to provide and maintain a bond issued by a fidelity insurance company for each officer and employee that accesses the Fund's assets. Fidelity bonds provide coverage against larceny, embezzlement, and other fraudulent acts committed by any affiliated person of a Fund that could possibly misappropriate the assets of that Fund. Rule 17g-1 requires:

- Directors, including a majority of the Independent Directors, to determine at least annually that the fidelity bond is reasonable in amount and form and that it conforms to specified minimum bond amounts;[1]

- The fidelity bond to provide for notices to affected parties and the SEC prior to cancellation, termination, or modification;[2] and
- The fidelity bond and all related materials be filed with the SEC, and each Fund must designate an officer to make the filings.[3]

The rule requires coverage based on a Fund complex's gross assets. Coverage requirements range from $50,000 for Funds with gross assets up to $500,000 to a maximum bond amount of $2,500,000 for Funds with gross assets in excess of $2,000,000,000.

Joint Insured Fidelity Bonds

Rule 17g-1 allows Funds to maintain joint insured fidelity bonds that not only cover the Fund, but also the Fund's Adviser and Distributor, other Funds managed or distributed by these persons, and certain other related persons.[4]

In addition to the general requirements of Rule 17g-1, a Fund that chooses to take advantage of joint fidelity bond coverage must satisfy the conditions listed below:

- A majority of the directors of the Fund must be Independent Directors and the Independent Directors must select and nominate any other Independent Directors;[5]
- Any person who acts as legal counsel for the Independent Directors of the Fund must qualify as Independent Counsel;
- The Fund and other named insureds must execute an agreement providing that in the event recovery is received as a result of a loss by the Fund and one or more of the other insureds, the Fund will receive its equitable share, but not less than the amount it would have received had it maintained a single insured bond with the required minimum coverage;[6] and
- The majority of Independent Directors of the Fund must approve the portion of the premium to be paid by such company, taking into consideration the relevant factors.[7]

Rule 17g-1(d)(2) provides a schedule of minimum coverage for joint fidelity bonds. The joint fidelity bond must equal the sum of (1) the total amount each Fund named as an insured would have been required to maintain if covered by a single insured bond and (2) the amount of each bond that named insureds, other than Funds, would have been required to maintain under other federal statutes or regulations had they not been named under joint fidelity bond. For example, where three Funds, with $50 million each in assets, acquire a joint fidelity bond, the required minimum for the bond would be three times what would be required for a Fund with $50 million ($1,200,000) rather than what would be required for a single Fund with $150 million in assets ($600,000).[8] Where the Fund fits into the Master Fund/Feeder Fund structure, only the Master Fund is required to obtain fidelity bond coverage.

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1 Rule 17g-1(d)(1) or (d)(2).

2 Rule 17g-1(c).

3 Rule 17g-1(g).

[4] Section 17(d) of the 1940 Act and Rule 17d-1 thereunder prohibit any joint transactions between a Fund and any of its affiliated persons. Congress enacted section 17(d) to limit or prevent participation by the Fund, or a company it controls, on a basis different from or less advantageous than that of the affiliated participant.

[5] *See Investment Company Governance*, Release No. IC-26520 (July 27, 2004).

[6] *See* Rule 17g-1(f).

[7] Relevant factors for consideration include, but are not limited to, the number of other parties named as insureds, the nature of the business activities of such other parties, the amount of the joint insured bond, and the amount of the premium for such bond, the ratable allocation of the premium among all parties named as insureds, and the extent to which the share of the premium allocated to the Fund is less than the premium such company would have to pay if it had provided and maintained a single insured bond.

[8] Thomas P. Lemke, Gerald T. Lins & A. Thomas Smith III, *Regulation of Investment Companies*, § 8.03 (Rel. 19-4/2006 Pub.002).

CHAPTER TWELVE

DIRECTORS AND OFFICERS / ERROR AND OMISSION INSURANCE

What do the directors need to do and why?

While directors are not required under the 1940 Act to obtain Director and Officer and Error and Omission insurance ("D&O/E&O Insurance"), most fund groups and boards do obtain such coverage as a matter of good corporate practice. As detailed below, D&O/ E&O Insurance protects the directors, officers, Adviser and the Fund itself from claims arising from lawsuits. For additional information on this topic, including with respect to insurance coverage for cybersecurity risk, see the Forum report at: https://www.mfdf.org/docs/default-source/default-document-library/publications/white-papers/d-o.pdf?sfvrsn=e091751c_0 .

What are the standards?

The directors must exercise their fiduciary duty in considering the protection to the Fund and its directors and officers provided by such D&O/ E&O Insurance coverage policies.

What information do directors need?

Directors need to review information about:

- The nature and type of a claim that might arise from lawsuits and acts of negligence and errors;
- The potential Fund expenses arising from these events; and
- The nature and scope of the Fund's indemnification provisions and how these provisions relate to insurance coverage.

Who provides information to the directors?

Directors should request from the Adviser and/or the Fund's Treasurer appropriate information and a copy and terms of the D&O/E&O Insurance policy.

Directors should also receive a memorandum from Fund Counsel or Independent Counsel about the indemnification provisions in the Fund's organizational documents and the potential for claims. In addition, directors may also want to consult with a broker about the coverage provided by the D&O/ E&O Insurance policy and any exclusions.

Funds occasionally encounter losses in connection with operational activities, including sales, underwriting, shareholder voting and proxy questions, advisory services, share registration, and other matters.

To mitigate the potential losses caused by investment management compliance errors, Funds may rely on insurance policies. By utilizing insurance, Funds can effectively minimize operational management risks. Specifically, insurance policies function to: (1) protect shareholders, Funds, and related entities by providing a comprehensive means to address the risks that effect all industry participants; (2) enhance operational efficiency by creating financial incentives for Funds to improve internal controls and risk management programs; and (3) promote risk management by reducing operational risks by providing an underwriting process, risk analysis studies, and risk management programs. Insurance policies have become an essential component of a Fund's risk management program.

Generally, there are two different categories of insurance typically obtained by investment companies: D&O insurance, and E&O insurance. The SEC adopted several rules and regulations under the 1940 Act regarding insurance coverage for investment companies. The only type of policy that a Fund is required to procure under the 1940 Act is the fidelity bond coverage, which is described in Chapter 11 of this Guide. However, most investment companies obtain both D&O and E&O Insurance policies. In addition to fidelity bond coverage, excess coverage and cost of corrections policies have been regularly obtained by many Funds.

D&O Insurance

Investment companies maintain D&O Insurance policies to cover claims made against its directors and officers for designated acts, errors, or omissions in operating and managing the insured Fund. Typically, D&O Insurance policies are subdivided into "company reimbursement" and "direct" coverage. Company reimbursement coverage reimburses Funds for the amount, to the extent permitted by law, the Fund has indemnified the directors and officers for claims brought against them. Under direct coverage, the directors and officers are directly covered when the Fund is not legally permitted or is financially unable to indemnify them for claims made against them.

There are limitations to the level of protection provided by D&O Insurance policies, however. In particular, direct coverage may be unavailable where coverage would violate applicable law. Therefore, D&O Insurance policies do not provide coverage for conduct that is prohibited by state corporate codes or industry policy forms.

E&O Insurance

E&O Insurance policies provide coverage for claims brought specifically against the insured company (a.k.a. the Fund) (as opposed to its directors or officers) for designated acts, omissions, or errors committed by the entity in operating and managing the Fund. Funds will also provide E&O Insurance policies for persons whose acts, errors, or omissions the Fund is legally responsible. Generally, E&O Insurance policy will cover the following:

- Restricted and impermissible investments;
- Inaccurate execution of trade orders;
- Pricing errors;
- Sales practice violations;

- Unauthorized trading;
- Inaccurate recording of trades;
- Inaccurate/incomplete disclosure; and
- Failure to disclose.

Scope of Coverage for D&O and E&O Insurance

Although intentional conduct is usually excluded, D&O and E&O Insurance policies typically cover claims for virtually all negligent acts, errors, and omissions committed by the insured entity or by directors, officers, and other persons for whose acts, errors, or omissions the entity is legally responsible. Most insurance policies include coverage for lawsuits or threats of lawsuits filed against the insured as well as possible proceedings brought against the insured by a regulatory agency. Losses covered by the policies include the amounts that the insured company is legally obligated to pay, such as damages, judgments, settlements, and costs of defense, but usually does not include punitive damages, fines, penalties, or two-thirds of treble damage awards. However, a number of standard exclusions are generally found in D&O and E&O Insurance policies, including intentional conduct (as discussed above), personal torts, profit or advantage to which the insured was not entitled, and insured v. insured provisions (see below).

Insured v. Insured Provision

Most insurance policies exclude claims brought by one insured against another through insured v. insured provisions. The provision serves as a deterrent to possible collusion among the insureds. However, the insured v. insured provision often contains an exception for derivative claims brought by shareholders and for claims that are required to be made in order to avoid liability. The SEC has indicated that the exception to the insured v. insured provision benefits shareholders because it allows Independent Directors to engage in good faith performance of their responsibilities under the 1940 Act without concern for their personal financial security. However, the SEC has noted that obtaining this type of coverage would likely result in premium increases by some insurance providers for joint liability insurance policies.

Joint Insurance Policies with Affiliated Persons

Much like the joint fidelity bonds, D&O and E&O Insurance policies can be obtained by joint persons/entities. Accordingly, Rule 17d-1(d)(7) under the 1940 Act permits a Fund and an affiliated person (such as another Fund in the same Fund family or its Adviser) to participate in a liability insurance policy on a joint basis, without applying for exemptive relief from the SEC, provided that the following conditions are met:

- A majority of the Fund's Directors need to be Independent Directors and those Independent Directors need to select and nominate other Independent Directors when vacancies occur;
- Any person who acts as legal counsel for the Independent Directors of the company is Independent Counsel;
- The Fund's participation in the joint liability insurance policy is in the best interests of the Fund;

- The proposed premium for the joint liability insurance policy does not exclude coverage for bona fide claims made against any Independent Director or against the Fund if it is a co-defendant with the Independent Director in a claim brought by another person insured under the joint liability insurance policy; and
- The directors, including a majority of the Independent Directors, determine at least annually that the Fund's participation in the policy is in its best interests and the proposed premium to be allocated to the Fund is fair and reasonable.

Excess Coverage Policies

As previously discussed, D&O Insurance policies directly cover claims for directors and officers and reimburse insured companies for the amount the Fund has indemnified its directors and officers. E&O Insurance covers the Fund itself for claims not included in the coverage provided by the D&O Insurance policy. Notwithstanding these three lines of coverage, D&O and E&O Insurance policies generally provide a single combined limit of coverage, which usually includes the costs of defending against potentially covered claims. Where joint coverage is obtained, directors should be satisfied that the premium portion allocated to the Fund is at least as favorable as what the Fund would pay for separate coverage. Directors should be aware that the coverage limit available to directors may be reduced by claims made by and paid to the Adviser or other joint insureds.

Pursuant to these concerns, dedicated excess coverage policies can be obtained in order to provide additional coverage to Independent Directors for any claims specifically brought against them. Thus, excess coverage policies provide a safety net for Independent Directors and have become a norm as part of a Fund's obligations toward its Independent Directors.

Costs of Corrections Coverage

In addition to D&O and E&O Insurance policies, Funds can obtain costs of corrections policies to provide additional preventive measures against potential claims. Cost of corrections coverage is considered a critical component of a complete insurance program for Funds. By obtaining costs of corrections coverage, insured companies can preemptively correct situations that, if not corrected, would result in potential claims against the company. Specifically, the policy covers loss, cost, or expense incurred by a Fund pursuant to their attempts to correct the errors with the insurer's consent. Although the costs of corrections coverage does not require a claim to be made before the insured can attempt to fix the error, the insured company must maintain legal liability for the losses. Typically, the cost of corrections coverage includes:

- Errors in effecting foreign currency exchange transactions;
- Violations of investment restrictions;
- Errors in pricing and calculating net asset value;
- Errors in processing 401(k) plan contributions;
- Errors in purchases and sales of foreign securities;

- Incorrect processing of wire order transactions for purchases and redemptions of Fund securities;
- Errors with respect to the purchase or sale of Fund shares;
- Errors in rebalancing a Fund’s portfolio;
- Over-purchases of shares of a portfolio security; and
- Violations of regulatory restrictions.

Independent Directors should consult with their Independent Counsel, the Funds’ insurance broker and/or other independent experts on the appropriate types and amounts of these coverages.

CHAPTER THIRTEEN

MFDF RISK REPORT

Funds are subject to a variety of risks. Directors are responsible for overseeing how a Fund's Adviser manages the Fund's risks, including risk management and oversight of the Fund's service providers. Below are a number of resources that describe the key issues associated with this oversight:

Role Of The Mutual Fund Director In The Oversight Of The Risk Management Function
May 2020: https://www.mfdf.org/docs/default-source/default-document-library/publications/white-papers/mfdfriskoversightpapermay2020f.pdf?sfvrsn=95c2cce4_4

Measuring The Investment Risk Of Equity Funds: A Reference For Fund Directors:
https://www.mfdf.org/docs/default-source/default-document-library/publications/white-papers/measuringrisk.pdf?sfvrsn=d00b8398_2

Role Of The Mutual Fund Director In The Oversight Of The Risk Management Function
February 2017: https://www.mfdf.org/docs/default-source/default-document-library/publications/white-papers/riskpaperfinal2017.pdf?sfvrsn=87916d4a_4

Risk Principals For Fund Directors: Practical Guidance For Fund Directors On Effective Risk Management Oversight: https://www.mfdf.org/docs/default-source/default-document-library/publications/white-papers/risk-publication_web.pdf?sfvrsn=8c16ab5e_4

CHAPTER FOURTEEN

PRACTICAL GUIDANCE FOR FUND DIRECTORS ON OVERSIGHT OF PROXY VOTING

Excerpt from the Report of the Mutual Fund Directors Forum: Practical Guidance for Fund Directors on Oversight of Proxy Voting, *published September 2012*

Introduction

Through proxy voting, mutual funds have substantial power to influence corporate governance around the world. As the owners of the shares held in their portfolios, funds have the right, and possibly an obligation,[1] to receive proxy materials and vote on matters presented to shareholders for a vote at shareholder meetings. Considering that funds own over a quarter of the outstanding shares of U.S. stocks, this represents an enormous amount of the voting power in the United States alone.[2]

The task of voting proxies is no small endeavor. Each proxy season, fund complexes must cast a large number of votes, often thousands, in a relatively short amount of time. Proxies must be voted in the best interest of fund shareholders and the voting record is subject to public scrutiny. Fund Boards are responsible for adopting proxy voting procedures that govern this intricate process. This paper explores the following decision points that fund directors should take into consideration:

1. To What Extent Should Proxy Voting Duties Be Delegated?
2. How Should Third Party Proxy Firms Be Utilized?
3. To What Extent Should Investment Professionals Be Involved in the Voting Process?
4. What Process Should Be Used for Overriding a Fund's Voting Guidelines?
5. Should Funds in the Same Complex Be Permitted to Split Votes?
6. How and When Should Funds Engage with Portfolio Companies on Upcoming Votes?
7. How Should Conflicts of Interest Be Handled?
8. How Should Funds Handle Proxy Voting for Their Loaned Securities?

To put these decision points in context, the paper also summarizes common proxy voting structures and processes used throughout the industry. Finally, the report discusses processes and procedures used by Boards to oversee the proxy voting process. This paper is based largely on discussions with directors and management representatives from fund families of all sizes (representing over 50% of U.S. mutual fund assets under management)[3] and two of the major proxy voting service providers.

Under federal[4] and state law, fund directors have a responsibility to oversee their fund's affairs, including the voting of the fund's proxies. This oversight duty is part of the directors' general fiduciary duties of care and loyalty. Therefore, although a Board may delegate proxy voting duties to an adviser or other third party, the Board retains ultimate oversight responsibility and must exercise reasonable judgment when overseeing the funds' proxy voting process.

Boards are also legally required to approve and annually review their funds' proxy voting procedures as part of the funds' compliance program. Under the Investment Company Act of 1940, as amended, Boards must determine that the funds' proxy voting procedures are "reasonably designed to prevent violation of the Federal Securities Laws by the fund, and by each investment adviser, principal underwriter, administrator, and transfer agent of the fund."[5]

A fund's proxy voting procedures detail the process for voting fund proxies, including the role of the fund directors and any responsibilities that have been delegated to the adviser, subadviser and/or proxy voting service. The procedures also often include voting guidelines that state how particular proxy votes will be cast.[6] For example, voting guidelines often include rules that specify when a fund will vote for or against a certain type of proposal, or they may provide that certain voting issues be considered on a "case-by-case" basis.[7]

Funds are required to make certain disclosures regarding proxy voting to shareholders. Each fund must describe its proxy voting policies and procedures in its registration statement[8] and annually file with the SEC information about any proxy votes made during the previous year.[9]

When the Board has delegated proxy voting to an adviser or subadviser (referred to herein collectively as the "adviser"), the Board may choose to have the adviser's proxy voting policies govern the fund's proxies. In these situations, the fund's proxy voting procedures typically reference the adviser's procedures and call for the periodic review of the adviser's policies.[10] It is important to note that if the adviser has been delegated proxy voting authority, the adviser itself is subject to additional regulation. The Investment Advisers Act of 1940 requires advisers that exercise voting authority over clients' proxy voting to adopt policies and procedures reasonably designed to ensure that the adviser votes proxies in the best interests of clients, discloses to its clients information about those policies and procedures and also discloses to clients how they may obtain information on how the adviser has voted their proxies.[11]

Continue reading *Report of the Mutual Fund Directors Forum: Practical Guidance for Fund Directors on Oversight of Proxy Voting*: https://www.mfdf.org/docs/default-source/default-document-library/publications/white-papers/oversight_of_proxy_voting.pdf

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[1] *See* Final Rule: Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management Investment Companies (IC-25922) (Jan. 31, 2003) (stating "[b]ecause a mutual fund is the beneficial owner of its portfolio securities, the fund's board of directors, acting on the fund's behalf, has the right and the obligation to vote proxies relating to the fund's portfolio securities). Each shareholder vote has an economic value because of its ability to affect corporate change. Although funds may choose to abstain from voting a proxy for a number of valid reasons, the fact that a certain degree of economic value may be lost should be considered. This loss may be de minimus depending on the size of the position the fund holds in the company.

[2] *See e.g.,* 2012 Investment Company Factbook (stating that in 2011, U.S. Investment companies owned 29% of U.S. equity stocks).

[3] Based on data regarding assets and market share of fund managers reported by Strategic Insight, an Asset International Company (June 2012).

[4] *See* § 36 of the Investment Company Act of 1940, as amended.

[5] 17 C.F.R. § 270.38a-1 (2012).

[6] Voting guidelines are often the same for all funds in one complex, but may be customized for funds that have a specific focus – for example, socially responsible funds.

[7] Some Boards require their funds to abstain from all votes on social issues because they believe fund shareholders would have differing views on how the shares should be voted.

[8] Item 17(f) of Form N-1A. "Unless the Fund invests exclusively in non-voting securities, describe the policies and procedures that the Fund uses to determine how to vote proxies relating to portfolio securities, including the procedures that the Fund uses when a vote presents a conflict between the interests of Fund shareholders, on the one hand, and those of the Fund's investment adviser; principal underwriter; or any affiliated person of the Fund, its investment adviser, or its principal underwriter, on the other. Include any policies and procedures of the Fund's investment adviser, or any other third party, that the Fund uses, or that are used on the Fund's behalf, to determine how to vote proxies relating to portfolio securities."

[9] 17 C.F.R. § 270.30b1-4 (2012).

[10] Fund families with multiple advisers may adopt the proxy voting policies of several advisers. In these situations, the proxy voting policy of each adviser usually governs the assets under that adviser's control.

[11] 17 C.F.R. § 275.206(4)-6 (2012).

CHAPTER FIFTEEN

PRACTICAL GUIDANCE FOR FUND DIRECTORS ON THE OVERSIGHT OF SECURITIES LENDING

Excerpt from Report of the Mutual Fund Directors Forum: Practical Guidance for Fund Directors on the Oversight of Securities Lending, *published May 2012*

Introduction

Securities lending plays a significant role in today's capital markets. In general, securities lending is believed to improve overall market efficiency and liquidity. In addition, securities lending plays a critical role in certain hedging strategies, acts as a useful tool in risk management and helps facilitate the timely settlement of securities trades. As of January 2012, the balance of securities on loan globally exceeded $1.8 trillion, demonstrating the manner in which securities lending has evolved from a back office, operational function to an investment management and trading function.

At the same time, securities lending – including securities lending by mutual funds – has received increased attention in recent years, some of it negative. While securities lending is a long-established practice, can boost the performance of lenders' portfolios and is collateralized, the practice is not without risk. In particular, the crisis in the financial markets following the failure and default of Lehman Brothers in 2008 highlighted many of the risks inherent in securities lending. Prior to 2008, participants in securities lending, especially the lenders of securities, tended to focus on the risk that lent securities would not be returned or could not be recalled when desired – discrete risks that the lenders of securities tended to view as both small and manageable. The crisis, however, highlighted both these risks and the risks surrounding the investment of the collateral received by lenders in securities lending transactions – particularly the risk that there could be losses on the invested collateral or that it could be locked up in collateral pools for longer than expected. In short, the market turbulence of 2008-2009 demonstrated that lenders of securities could, in fact, experience real losses.

Mutual fund directors are thus left with the question of whether to permit the funds they oversee to engage in securities lending, and if so, how to oversee that activity effectively. In order to make these decisions, directors must have a strong understanding of how the market for securities lending works – in particular, the mechanics of loans, the manner in which collateral for loans is handled and how securities are recalled and loans unwound. In addition, directors need to be aware of the risks inherent in securities lending, how severe these risks are and how they might be mitigated.

The goal of this publication[1] is to help directors address these questions and build the necessary knowledge to make informed decisions about securities lending. We begin by describing the securities lending market and the mechanics of securities loans. We also highlight the various risks to which lenders can be exposed. We then seek to provide directors with practical guidance on their decision-making around and oversight of securities lending. Our goal is not to provide an authoritative answer on whether directors should permit the funds they oversee to lend – indeed, there is no correct answer to this question, and directors may well reach different conclusions based on the facts and circumstances of each fund they oversee. Likewise, our goal is not to dictate how boards oversee any lending in which their funds engage. Instead, our goal is to provide some helpful pointers that may assist directors in determining how to oversee securities lending activities and deciding what questions to ask the adviser, their portfolio managers and others involved in the process.[2]

Continue reading *Report of the Mutual Fund Directors Forum: Practical Guidance for Fund Directors on the Oversight of Securities Lending*: https://www.mfdf.org/docs/default-source/default-document-library/publications/white-papers/board-oversight-of-securities-lending-(may-2012).pdf

[1] This publication has been reviewed by the Forum's Steering Committee and approved by the Forum's Board of Directors, although it does not necessarily represent the views of all members in every respect. One representative from each member groupserves on the Forum's Steering Committee. The Forum's current membership includes over 675 independent directors, representing 97 independent director groups. Nothing contained in this report is intended to serve as legal advice. Each fund board should seek the advice of counsel for issues relating to its individual circumstances.

[2] This report was developed by leaders in the independent director community with advice given by members of the Forum's Advisory Board, with extensive assistance from eSecLending, Inc. For more information on securities lending, eSecLending has published a paper entitled Securities Lending Best Practices: A Guidance Paper for US Mutual Funds.

CHAPTER SIXTEEN

BOARD OVERSIGHT OF DERIVATIVES AND OTHER ALTERNATIVE INVESTMENTS

What are derivatives?

Derivatives are securities whose trading price relies on the value of an underlying asset or group of assets. These assets include commodities such as raw materials, financial instruments and measures, currencies, and pools of stocks or bonds.

Why are derivatives important?

Investing in derivatives can be a valuable strategy for mutual fund investment advisers because the practice can magnify gains, hedge against losses, and provide, in some instances, more efficient exposure than direct investment. While useful, derivative investments also pose certain risks for funds. They can cause volatility and liquidity issues, heighten the risk of significant losses, and potentially expose funds to legal risks.

What are the responsibilities of funds relating to derivatives?

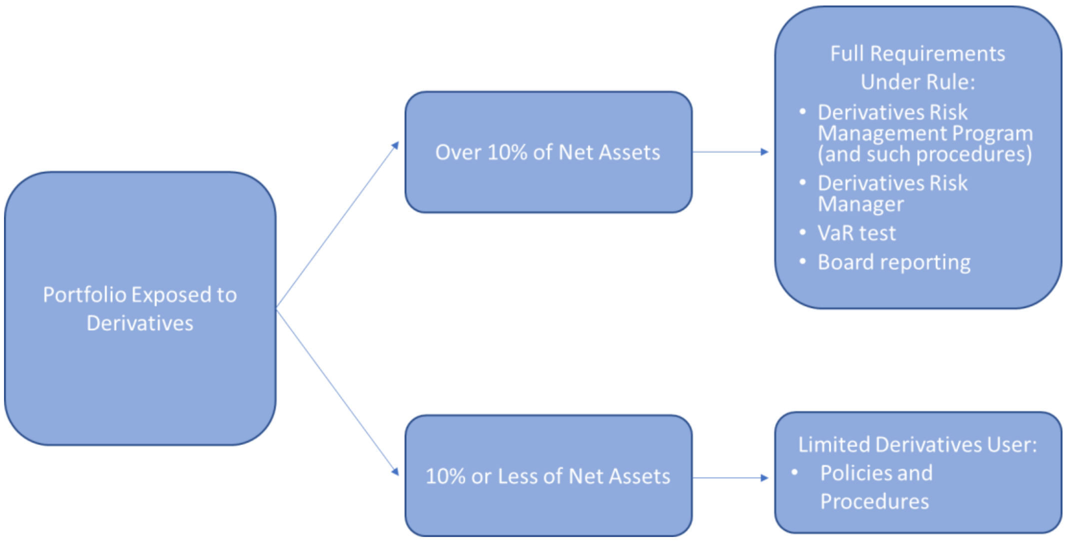
In late 2020, the SEC adopted Rule 18f-4 (the "Derivatives Rule") under the 1940 Act, creating a new regulatory regime pertaining to und use of derivatives and certain responsibilities for fund directors.[1] The Derivatives Rule requires funds investing in derivatives (other than those using derivatives in a limited way) to appoint a derivatives risk manager to administer a derivatives risk management program subject to board oversight. This chapter summarizes the important elements of the Derivatives Rule for fund directors. For additional information about board oversight of alternative investments more generally, please see the Forum's report on that topic at: https://www.mfdf.org/docs/default-source/blog-files/board-oversight-of-alternative-investments---january-2014.pdf.

What is required of fund directors under the Derivatives Rule?

The board's role under the Derivatives Rule is largely one of oversight, though within this role the board has various key responsibilities. The board, including a majority of its independent directors, must approve the designation of a fund's derivatives risk manager. The board is then responsible for fielding reports from the derivatives risk manager at various intervals regarding the fund's use of derivatives and the effectiveness of the derivatives risk management program.

Legal Requirements

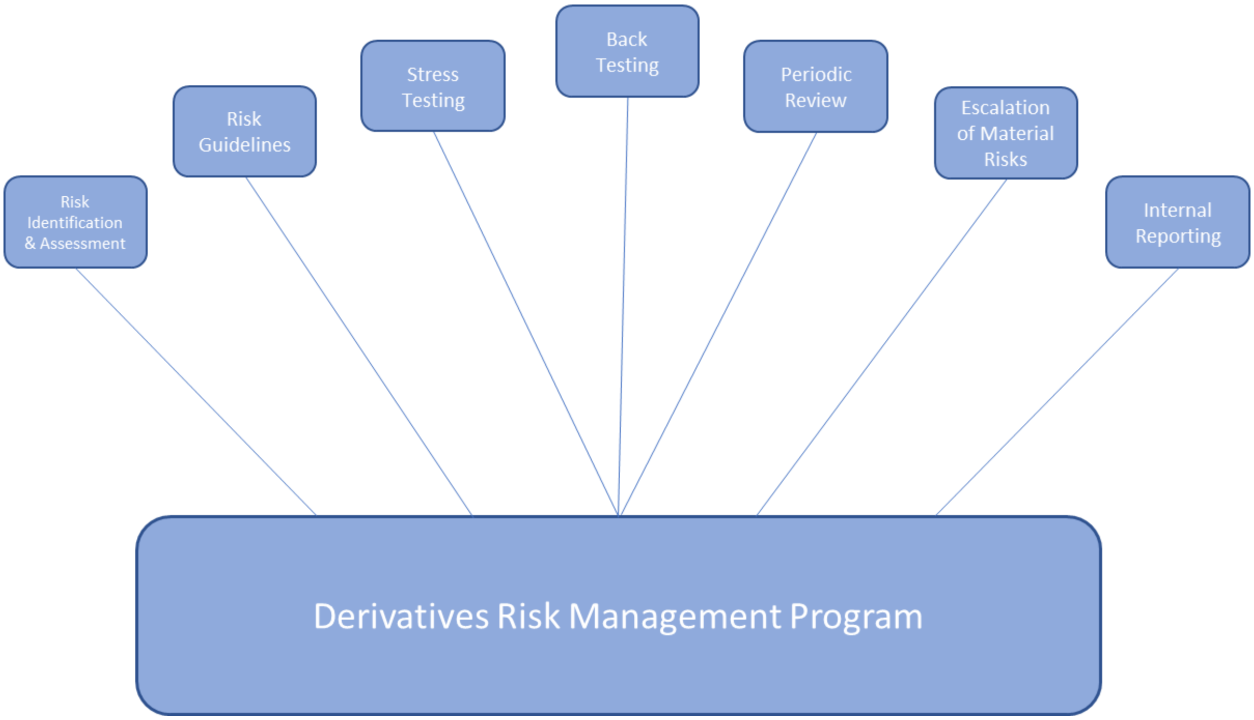
The Derivatives Rule applies to funds that invest in derivatives comprising more than 10% of net assets. Funds investing in derivatives comprising 10% or less of nets assets are largely exempted from the rule's requirements, provided they adopt and implement policies and procedures reasonably designed to manage their derivatives risks.



Funds investing in derivatives exceeding 10% of net assets must adopt a derivatives risk management program. The program must:

- Be designed and administered by a derivatives risk manager, who must be an officer of the fund's Adviser, and must be appointed and overseen by a fund's board.
- Identify and assess its fund's unique derivatives risks, establish measurable guidelines relating to derivative investments, and provide actions to be taken if those guidelines are exceeded.
- Provide for at least weekly stress testing to monitor for potential losses to the fund's portfolio as a result of derivatives investments.
- Require that the derivatives risk manager report to the board at specified intervals and when certain events arise.

Additionally, a fund must comply with an outer limit on fund leverage risk based on value-at-risk ("VaR"). VaR is an estimate of potential losses on an instrument or portfolio, over a specified time horizon and confidence level. This VaR calculation will also be used to create an outer limit on leverage risk created by derivatives transactions, measuring the fund's VaR against that of a "designated reference portfolio," which may consist of a fund's portfolio exclusive of derivatives transactions, or a securities index meeting certain requirements.



Board Responsibilities

The board's role in the derivatives risk management program is predominantly one of oversight. Nonetheless, within with this oversight role the Derivatives Rule provides multiple key responsibilities for the board, which are explained in greater detail below.

Approving the Derivatives Risk Manager

The designation of a derivatives risk manager must be approved by a fund's board, including a majority of its independent directors. By virtue of this approval, the board has the final say as to whether a derivatives risk manager is qualified and may be designated. However, boards may request the fund's Adviser, who is in a strong position to evaluate and put forth candidates, play a key role in the process. For instance, the board may utilize the Adviser to conduct due diligence on candidates, review resumes, conduct interviews, and nominate and provide to the board its view of candidates. The SEC has explained that derivatives risk managers must have "relevant experience regarding the management of derivatives risk." Thus, boards, in evaluating candidates, should consider candidates' experience, as well as all other relevant factors.

Internal Reporting and Escalation

The internal reporting and escalation feature requires the derivatives risk management program to provide circumstances in which the derivatives risk manager must report to a fund's portfolio manager on guidelines exceedances and results of stress testing. Additionally, the derivatives risk manager must also directly inform a fund's board of directors of material risks to the fund resulting from derivatives investments, which may become apparent as a result of guidelines exceedances.

The derivatives risk manager bears the ultimate responsibility of determining when and what material risks must be escalated to portfolio managers and, when appropriate, fund boards. Nonetheless, the Rule does not prevent boards from engaging with the derivatives risk manager to assist in determining the circumstances which matters should be escalated to the board.

Board Reporting

In addition to the internal escalation requirement, the Derivatives Rule requires the derivatives risk manager to submit written reports to the board at fixed intervals. The reporting is described below.

- Annual Reports: The annual report must provide a representation that the derivatives risk management program is reasonably designed to manage the fund's derivatives risks and to incorporate the required elements of the program, as well as a basis for this representation. This report must also include information that allows the fund's board to evaluate the adequacy of the program and the effectiveness of its implementation. Additionally, the derivatives risk manager must include the basis for approving, changing, or electing not to use the designated reference portfolio.

- Regular Reports: Under the regular reporting requirement, the derivatives risk manager must report to the board, at a frequency determined by the board, a written summary of the results of the fund's stress testing and backtesting, as well as exceedances of the fund's risk guidelines. These reports must include information sufficient to allow the board to analyze the fund's response to exceedances and results of stress testing. In determining the frequency with which reports are submitted, boards should look at the unique facts and circumstances of the fund. The derivatives risk manager need not submit an itemized list of every exceedance, and in fact, an itemized list standing alone would be an insufficient list for compliance with the Rule. Instead, these reports may be submitted in summary form, and must analyze exceedances generally.

- Ad Hoc Reports: Additional board reporting is required in certain specific circumstances. In particular, reporting should occur when a fund that is a limited derivatives user can no longer be characterized as such a limited user. In addition, events that trigger SEC reporting (e.g., VaR test breaches) should be reported promptly to the board.

- Policies and Procedures: Fund boards are also responsible for overseeing compliance with the Derivatives Rule by virtue of Rule 38a-1 under the 1940 Act, which requires a fund's board, including a majority of its independent directors, to approve policies and procedures reasonably designed to prevent violation of the federal securities laws by the fund and its service providers. Thus, fund directors must be familiar with the components of the Rule in order to make an informed approval of such policies and procedures.

[1] Use of Derivatives by Registered Investment Companies and Business Development Companies, Release No. IC 34078 (Oct. 28, 2020), https://www.sec.gov/rules/final/2020/ic-34084.pdf .

CHAPTER SEVENTEEN

BOARD OVERSIGHT OF CYBERSECURITY

Excerpt from Report of the Mutual Fund Directors Forum: Board Oversight of Cybersecurity, *published November 2015*

Introduction

Mutual fund boards have long had a role in overseeing the manner in which fund management and others identify, monitor, and mitigate the risks that their funds face. One key risk category for mutual funds is operational risk.[1] As we noted in our 2010 Report on risk oversight, "operational risk is the risk that issues will arise or errors or omissions will occur in the ordinary course of business that . . . will adversely affect the business enterprise" resulting in "the business not be[ing] able to operate, whether in the ordinary course of business or during a disaster."[2]

Today, virtually every aspect of a fund's operations relies in some way on technology, and thus the risks posed by that technology have become a fundamental aspect of the operational risk faced by funds. In short, a failure of technology will translate to difficulty conducting fund business, whether that means the fund is unable to process shareholder transactions, manage sensitive shareholder and portfolio data, properly value its portfolio and compute its net asset value, or ensure safe and accurate custody of the securities it owns, to name a few critical functions.

Technology can fail for numerous reasons, including issues with hardware, programming mistakes, or corrupted data.[3] But of late, a new risk has become prominent—the risk that the technological framework on which the fund relies will be attacked by someone with malicious intent. Funds, management companies, and other fund service providers are thus devoting ever-increasing resources to "cybersecurity," the primary means by which they protect themselves from this risk.

While many of the recent publicly-acknowledged attacks have focused on retailers and banks, mutual funds remain a potential target due to sensitive investor information, fund trading records, and other proprietary information. As attacks in other industries have demonstrated, cyber attacks can take numerous forms. Gaining access to a fund's systems, for example, can be as simple as tricking employees into turning over credentials, either through broad-based communications (known as "phishing") or through elaborate and personal communications (known as "spear phishing"). Alternatively, outsiders may try to use "vulnerabilities," or weaknesses, in systems to gain unauthorized access. To simply cause a disruption, attackers may utilize a distributed network of compromised computers to overwhelm the target system with useless requests in a "Distributed Denial of Service" (DDoS) attack, causing the system to be unable to meet the requests of legitimate traffic. Destructive attacks may even come from within, initiated by disgruntled employees. Moreover, the modes of attack continue to evolve.

Efforts to bolster fund operations against attack and to improve the protection of sensitive information have, not surprisingly, become areas of interest for regulators. The SEC's Examination Priorities for the past two years have identified cybersecurity issues as an area of focus.[4] At the Forum's 2014 Policy Conference, SEC Commissioner Luis Aguilar noted that "[c]ybersecurity is an area that will only grow in importance, and fund boards need to get out in front of the problem to help prevent and mitigate investor harm."[5]

In April 2014, the SEC's Office of Compliance Inspections and Examinations (OCIE) announced that it would conduct a sweep focused on understanding how broker-dealers and investment advisers address cybersecurity.[6] In February 2015, it released a summary of findings from the first round of examinations.[7] While the vast majority of firms had taken some steps to implement a cybersecurity program, the summary revealed gaps in preparation. For example, a small minority of firms had yet to even adopt a written information security policy.[8] In September 2015, OCIE released an additional risk alert and announced a second round of examinations, which it noted would "involve more testing to assess implementation of firm procedures and controls."[9]

The associated risk alerts and sample requests provide a starting point for any organization as it considers cybersecurity readiness. Guidance from the SEC's Division of Investment Management following the initial sweep report acknowledged "that it is not possible for a fund or adviser to anticipate and prevent every cyber attack," but that "[a]ppropriate planning to address cybersecurity and a rapid response capability may, nevertheless, assist funds and advisers in mitigating the impact of any such attacks and any related effects on fund investors and advisory clients, as well as complying with the federal securities laws."[10]

Given the risks posed by cyber attacks and the increased attention and resources being devoted to this issue, fund boards have become increasingly involved in overseeing management's cybersecurity activities. The Investment Company Act and rules promulgated thereunder do not explicitly charge directors with cybersecurity oversight. Nonetheless, as a result of the board's obligation to approve the fund's policies and procedures along with the policies and procedures of certain service providers under Rule 38a-1,[11] boards should have a sense of how these service providers are preparing for and would respond to a cybersecurity incident. In addition to the service providers covered under Rule 38a-1, others, such as custodians, are critical to the day-to-day functioning of the fund, and therefore boards have an interest in learning how these entities have prepared for a cybersecurity incident.

Every fund is different; therefore, a board's cybersecurity oversight will vary based on factors including fund size, number of funds, and the fund's service providers, to name a few. This report[12] is designed to aid fund directors by outlining some of the risks in this area as well as providing some examples of how boards may wish to address their ongoing oversight responsibilities.

Continue reading *Report of the Mutual Fund Directors Forum: Board Oversight of Cybersecurity*: https://www.mfdf.org/docs/default-source/default-document-library/publications/white-papers/cybersecurity.pdf

[1] Another key risk is "investment risk," which encompasses all the risks that are inherent in the investment strategies employed by a fund and the types of securities it owns in order to execute those strategies.

[2] *See* Mutual Fund Directors Forum, *Risk Principles for Fund Directors* (April 2010) at 8, (available at https://www.mfdf.org/docs/default-source/default-document-library/publications/white-papers/risk-publication_web.pdf).

[3] Prominent recent examples of technology failures include outages at a fund accountant platform and an exchange. While not caused by malicious intent, these events can give rise to similar considerations to those contemplated in this report.

[4] Securities and Exchange Commission, National Exam Program of the Office of Compliance Inspections and Examinations, *Examination Priorities for 2015,* January 13, 2015, http://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2015.pdf; Securities and Exchange Commission, National Exam Program of the Office of Compliance Inspections and Examinations, *Examination Priorities for 2014*, January 9, 2014, http://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2014.pdf.

[5] Commissioner Luis A. Aguilar, Taking an Informed Approach to Issues Facing the Mutual Fund Industry (April 2, 2014), available at http://www.sec.gov/News/Speech/Detail/Speech/1370541390232.

[6] Securities and Exchange Commission, National Exam Program of the Office of Compliance Inspections and Examinations, *Risk Alert: OCIE Cybersecurity Initiative*, April 15, 2014, http://www.sec.gov/ocie/announcement/Cybersecurity-Risk-Alert--Appendix---4.15.14.pdf ("2014 Risk Alert").

[7] Securities and Exchange Commission, National Exam Program of the Office of Compliance Inspections and Examinations, *Cybersecurity Examination Sweep Summary*, February 3, 2015, http://www.sec.gov/about/offices/ocie/cybersecurity-examination-sweep-summary.pdf.

[8] In reviewing the results, however, it may be worth considering that three-fourths of the advisers included in the sweep had assets under management of less than $900 million and that virtually none of the advisers oversee mutual funds.

[9] Securities and Exchange Commission, National Exam Program of the Office of Compliance Inspections and Examinations, *OCIE's 2015 Cybersecurity Examination Initiative*, September 15, 2015, http://www.sec.gov/ocie/announcement/ocie-2015-cybersecurity-examination-initiative.pdf ("2015 Risk Alert").

[10] Securities and Exchange Commission, Division of Investment Management, *Guidance Update: Cybersecurity Guidance*, April 2015, http://www.sec.gov/investment/im-guidance-2015-02.pdf.

[11] Regulation S-P, 17 C.F.R. pt. 248 (2009), and Regulation S-ID, 17 CFR Part 248 (2013), are particularly relevant as they relate to the safekeeping of customer information. The SEC recently fined an adviser for violations of Regulation S-P for failing to adopt written policies and procedures regarding the security and confidentiality of client information. In 2013, the sensitive information of more than 100,000 individuals in its care was potentially stolen from a third-party server. *In the Matter of R.T. Jones Capital Equities Management, Inc.,* File No. 3-16827 (SEC September 22, 2015).

[12] This report has been reviewed by the Forum's Steering Committee and approved by the Forum's Board of Directors, although it does not necessarily represent the views of all members in every respect. The Forum's current membership includes over 888 independent directors, representing 124 mutual fund groups. Each member group selects a representative to serve on the Forum's Steering Committee. Nothing contained in this report is intended to serve as legal advice. Each fund board should seek the advice of counsel for issues relating to its individual circumstances.

CHAPTER EIGHTEEN

PRACTICAL GUIDANCE ON FUND MERGERS AND ADVISER COMBINATIONS

Excerpt from Report of the Mutual Fund Directors Forum: Practical Guidance for Fund Directors on Mutual Fund Mergers, *published May 2019*

Introduction and Summary

The upward trend in industry consolidation is expected to continue with increasing mergers of funds and investment adviser acquisitions. Mutual fund mergers have been a time-tested way to manage a complex's fund lineup, and the decision to merge away or acquire a new fund is often a prudent strategic move. These transactions trigger Securities and Exchange Commission ("SEC") rules and regulations and hold practical and legal considerations for fund independent directors. This paper[1] discusses fund independent directors' oversight of fund mergers. A companion Mutual Fund Directors Forum publication will address directors' responsibilities with respect to mergers and acquisitions involving investment advisers.

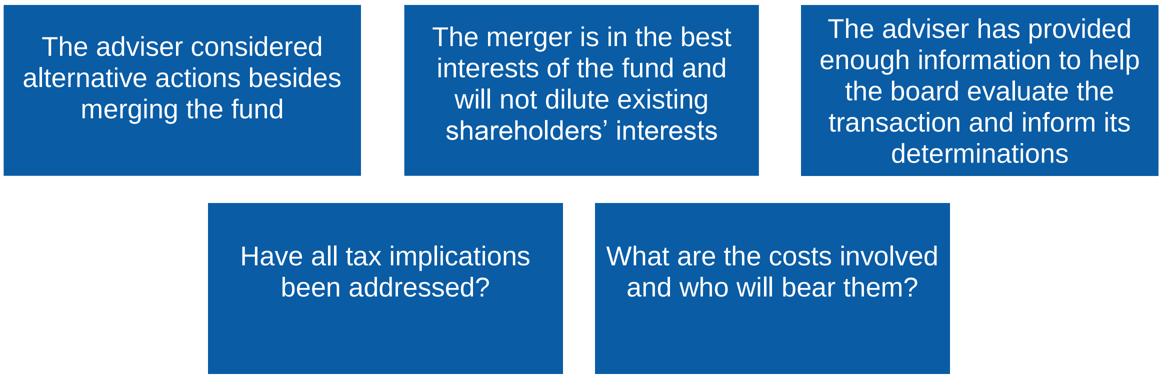
Business Considerations: Fund mergers can be used to manage a complex's fund lineup. Fund mergers can reduce redundancies in investment objectives across a fund complex's lineup, achieve economies of scale by making funds larger, spin off a poorly performing business line, and expose a fund to greater distribution opportunities. Chief among a board's considerations will be the adviser's analysis of which funds to merge, why the funds are being merged, and the effect of the merger on the funds and fund shareholders.

Regulatory Considerations: The Investment Company Act of 1940 (the "1940 Act") requires fund independent directors to make critical determinations before approving a fund merger or a new advisory contract. The SEC requires that each fund's board (including a majority of disinterested directors) determine that the merger is in the best interests of the fund and will not dilute the interests of shareholders.[2] State laws also impose on directors overall fiduciary duties of care and loyalty toward the fund and shareholders. Additionally, under most states' laws there is a presumption that directors will use their business judgment to determine whether a fund merger is in the fund's best interests.[3]

Governance Considerations and Challenges: Certain merger transactions may call for consolidation of fund boards, which will affect directors on both sides of the transaction. Boards with strong governance and nominating committees and policies and procedures that anticipate oversight of complex transactions, transition, and changes to board makeup and culture will be better equipped to handle the challenges that may arise from fund mergers.

From proposal to consummation, a fund merger may take several months, or even years, depending on complexity. Necessary steps include the initial proposal from the adviser, negotiation of the merger terms, and, if necessary, preparation and review of proxy proposals and filings, and holding shareholder meetings. Boards will need adequate time to gather information from the adviser, conduct due diligence of the materials received, and make their determinations and approvals.

Board Determinations Before Fund Merger Approval



Continue reading *Report of the Mutual Fund Directors Forum: Practical Guidance for Fund Directors on Mutual Fund Mergers*: https://www.mfdf.org/docs/default-source/default-document-library/publications/white-papers/mergersweb.pdf

Excerpt from **Report of the Mutual Fund Directors Forum: Practical Guidance for Fund Directors on Adviser Mergers & Acquisitions,** ***published June 2019***

Introduction and Summary

Mutual fund investment advisers and their parent companies combine, reorganize and restructure to grow and streamline their businesses or gain access to new markets, technology or expertise. These transactions trigger Securities and Exchange Commission rules and regulations and hold practical and legal considerations for fund independent directors. This paper[4] discusses the responsibilities of fund independent directors with respect to adviser mergers and acquisitions. Adviser mergers and acquisitions can result in the reorganization and mergers of mutual funds. A companion Mutual Fund Directors Forum publication discusses mutual fund mergers and fund directors' related obligations and responsibilities.

Business Considerations: An acquiring adviser may consider a merger or joint venture with another firm to expand its product lineup, enter new markets and distribution platforms, gain technological expertise or brand-name recognition, among other reasons. For a selling adviser, a joint venture or merger may be an attractive option in periods of slow growth, declining assets, and limited resources. While a mutual fund board does not oversee the adviser's operations, both the acquiring and selling firm are obligated to notify their fund boards in advance of the transaction and to provide the board with the information necessary to make certain required determinations. The board, at a minimum, may wish to be assured by the adviser that the transaction will not negatively impact the day-to-day operations of the adviser or the services provided to the funds.

Regulatory Considerations: A merger or acquisition involving a fund adviser may result in the automatic termination, via "assignment," of the fund investment advisory contract and trigger the need for board and shareholder approval of a new advisory contract. Assignment of an advisory contract generally involves a transfer of the contract or a controlling block of stock representing more than 25 percent of the adviser's (or its parent company's) outstanding voting securities.[5] When a change of control and assignment occurs, the adviser must obtain consents from the shareholders of the acquired funds and clients of the adviser that has undergone the change in control.[6] A fund board will need to approve the new advisory agreement, an interim advisory agreement in some cases, authorize a shareholder meeting and, as applicable, approve changes to other fund service providers.

Governance Considerations and Challenges: As a result of certain adviser transactions, two fund boards may be combined, or an existing board may be reduced in size. Early in the process, directors potentially affected by these transactions may wish to consider and discuss transition planning, board composition, and director and officer insurance coverage and indemnification for departing directors, among other issues. From proposal to consummation, adviser transactions may last months, or even years, depending on complexity. For fund directors, important steps could include everything from consideration of the initial proposal from the adviser, requests and supplemental requests for information, negotiation of a new advisory contract, and, if necessary, preparation and review of proxy proposals and filings, and holding shareholder meetings. Boards will need adequate time to gather information from the adviser, conduct due diligence of the materials received, and make the necessary determinations and approvals.

Director Considerations for Adviser Reorganizations

- Understand the economic impetus for the reorganization to determine the degree of advisory contract trafficking concerns, if any
- Understand the terms and structure of any new investment advisory agreement
- Consider the long term effects on the funds
- Consider of the nature, quality and extent of services that will be provided to the funds going forward
- Confirm that the transaction does not create any independence issues for fund directors or board counsel

Continue reading *Report of the Mutual Fund Directors Forum: Practical Guidance for Fund Directors on Adviser Mergers & Acquisitions*: https://www.mfdf.org/docs/default-source/default-document-library/publications/white-papers/advisercombinationsweb.pdf

[1] This report has been reviewed by the Forum's Steering Committee and approved by the Forum's Board of Directors, although it does not necessarily represent the views of all members in every respect. The Forum's current membership includes over 1100 independent directors, representing 137 fund groups. Each member group selects a representative to serve on the Steering Committee. Nothing contained in this report is intended to serve as legal advice. Each fund board should seek the advice of counsel for issues related to its individual circumstances.

[2] Rule 17a-8(a)(2)(i) of the 1940 Act. See: SEC Release No. IC-25666; File No. S7-21-01, July 26, 2002. Accessible at: https://www.sec.gov/rules/final/ic-25666.htm#mergers

[3] See for example: MD Corp & Assn Code § 2-405 (2013) and Smith v. Van Gorkum, 488A.2d 858 (Del. 1985).

[4] This report has been reviewed by the Forum's Steering Committee and approved by the Forum's Board of Directors, although it does not necessarily represent the views of all members in every respect. The Forum's current membership includes over 1075 independent directors, representing 137 fund groups. Each member selects a representative to serve on the Steering Committee. Nothing contained in this report is intended to serve as legal advice. Each fund board should seek the advice of counsel for issues related to its individual circumstances.

[5] See, e.g. Dean Witter, Discover & Co.; Morgan Stanley Group Inc., 1997 SEC No-Action Letter, LEXIS 548 (April 18, 1997). Accessible at: https://www.sec.gov/divisions/investment/ noaction/1997/deanwitter041897.pdf and https://www.sec.gov/divisions/investment/noaction/1997/ americancentury122397.pdf

[6] See: Mergers and Acquisitions of Investment Managers: Assignment of In-vestment Advisory Agreements. By Jon S. Rand, J. Stephen King, Jr. and Mary C. Carty. The Investment Lawyer June 2002, Vol. 9, No. 6 edition.

GLOSSARY OF COMMONLY USED TERMS

12b-1/12b-1 Fee. A fee paid that is by a mutual fund out of its own assets for distribution and marketing expenses, as permitted by Rule 12b-1 under the Investment Company Act of 1940. The amount of the fee is typically based on the amount of assets in the fund. Often, 12b-1 fees are paid to a fund's principal underwriter which distributes payments to the broker-dealers that sold the fund's shares.

15(c). Section 15(c) of the Investment Company Act of 1940. Section 15(c) mandates that in order for a person to serve as the investment adviser of a mutual fund, the investment advisory contract between the fund and the Adviser must be approved for an initial two-year term and annually thereafter by a majority of the independent trustees of the mutual fund. The process whereby the independent trustees request and consider information about the advisory relationship, in order to make that approval, is commonly known as the 15(c) process.

17a-7. Rule 17a-7 under the Investment Company Act of 1940. Rule 17a-7 allows mutual funds within the same fund complex to buy and sell securities to one another provided that certain enumerated criteria are met. In the absence of Rule 17a-7, a securities transaction between two mutual funds in the same fund complex would be a prohibited affiliated transaction.

17e-1. Rule 17e-1 under the Investment Company Act of 1940. Rule 17e-1 provides standards for brokerage commissions that a mutual fund may pay to an affiliated broker-dealer to execute securities trades for the fund. In the absence of Rule 17e-1, the payment of brokerage commissions from a fund to an affiliated broker dealer would be a prohibited affiliated transaction.

18f-3. Rule 18f-3 under the Investment Company Act of 1940. Rule 18f-3 provides standards by which a mutual fund may issue more than one class of shares for investment by the public (*e.g.*, Class A, Class B, and Class C shares) without any the classes of shares being considered a prohibited senior security.

1933 Act. *See* Securities Act.

1934 Act. *See* Exchange Act.

1940 Act. *See* Investment Company Act.

2a-7. Rule 2a-7 under the Investment Company Act of 1940. Rule 2a-7 specifies legal standards for the operations of money market mutual funds.

206(4)-7. Rule 206(4)-7 under the Investment Advisers Act of 1940. Rule 206(4)-7 imposes an obligation upon registered investment advisers, including the Advisers to mutual funds, to implement policies and procedures reasonably designed to prevent violations of the Advisers Act. This rule is similar to Rule 38a-1, which requires funds to have compliance programs reasonably designed to prevent violation of the federal securities laws.

36(b). Section 36(b) of the Investment Company Act of 1940. Section 36(b) imposes a fiduciary duty on mutual fund investment advisers with respect to the fees they charge to mutual funds.

Mutual fund investors may sue under Section 36(b). This provision was at issue in the U.S. Supreme Court's decision in *Jones v. Harris Associates*.

38a-1. Rule 38a-1 under the Investment Company Act of 1940. Rule 38a-1 requires mutual funds and closed-end funds to implement, and the boards of directors thereof to approve, compliance programs that are reasonably designed to prevent violations of the federal securities laws and that provide for the oversight of compliance by each investment adviser, principal underwriter, administrator, and transfer agent of the fund.

4:00 p.m. Close. The daily closing time of the securities markets in the United States: 4:00 p.m. Eastern Standard Time. Also the time at which most mutual funds calculate the daily net asset value ("NAV") of the fund, used in determining the fund's NAV per share.

401(k). Section 401(k) of the Internal Revenue Code. Section 401(k) establishes standards for 401(k) plans, which are tax-advantaged defined-contribution retirement plans for corporate employees. 401(k) plans allow eligible employees to make salary contributions on a pre-tax (or post-tax) basis with the expectation of later withdrawing the contributions and earnings in retirement. Earnings in the plan accrue tax-deferred. 401(k) plans may be advised by an SEC-registered investment adviser. 401(k) plans are subject to federal securities laws, tax laws, and the Employee Retirement Income Security Act of 1974 ("ERISA").

403(b). Section 403(b) of the Internal Revenue Code. Section 403(b) establishes standards for 403(b) plans, which are tax-advantaged retirement plans for employees of non-profit or public employers. 403(b) plans are similar to 401(k) plans.

482. Rule 482 under the Securities Act of 1933. Rule 482 governs the appearance of mutual fund advertisements and sales literature, including required disclosures and legends.

Adviser/Subadviser. The investment adviser to a mutual fund, closed-end fund, institutional account or other client that provides investment advice and related services for a contractually agreed-upon fee.

Advisers Act. *See* Investment Advisers Act.

Affiliated Transaction. A transaction between a mutual fund and an affiliated person of the fund (which includes: the fund's officers, directors, and employees; investors owning 5% or more of the fund's voting securities; and any person directly or indirectly controlling, controlled by, or under common control with the fund). Many types of affiliated transactions are prohibited by Section 17 of the Investment Company Act, although some exceptions to these prohibitions exist as well. The prohibitions against affiliated transactions are intended to prevent persons associated with a mutual fund from using their positions to benefit themselves.

After-Tax Return. The financial return on an investment or account after adjustment for taxes on the investment or account, often expressed as a percentage of total assets.

All-In Fee. The total fee charged to a fund or account (including advisory fees, marketing and distribution fees, and other charges), designed to show the total economic costs being charged.

Alpha. Risk-adjusted investment returns greater than (or less than) a broader financial market. Alpha may be seen as the value a portfolio manager adds to (or detracts from) a mutual fund when the performance of the fund is benchmarked to an appropriate market index. *See also* beta.

American Depository Receipts (ADRs). ADRs are receipts issued by a U.S. bank or trust company evidencing its ownership of underlying foreign securities. Most ADRs are denominated in U.S. dollars and are traded on a U.S. stock exchange.

Amortized Cost Pricing. The pricing of portfolio securities based on the acquisition cost of the asset, adjusted for amortization of premium and accretion of discount. This price ignores all fluctuations in value of the asset that may occur based on interest rate changes in the marketplace, credit quality changes of the security and changes in liquidity in the markets. Money market funds typically price their portfolio securities using amortized cost pricing.

Annual Report. A report describing a mutual fund's performance for the past twelve months and containing financial and other information; required to be sent to investors every year and to be filed with the SEC.

Asset-Backed Security (ABS). An asset-backed security is a security the payments on which are derived primarily from the cash flow of a discrete pool of self-liquidating assets that by their terms convert to cash within a finite period of time. The underlying assets are usually financial assets, such as mortgage, automobile or student loans or credit card receivables.

Audit Committee. A committee of the board of directors/trustees, generally responsible for overseeing the accounting, financial reporting, and internal controls of an investment company, including the quality of the investment company's financial statements and the conduct of the annual external audit by an independent auditor.

Auditor. A person, whether internal or external to a mutual fund complex, who is responsible for examining a mutual fund's financial statements and related business records. *See* auditor independence.

Auditor Independence. A mutual fund is required to have an independent external auditor perform an annual audit and to issue an auditor's report as to whether the fund's financial statements have been prepared in accordance with Generally Accepted Accounting Principles.

AUM/Assets Under Management. For an investment adviser, the assets held in accounts (such as mutual funds, closed-end funds, institutional clients and other accounts) that are advised by the investment adviser. AUM is one measure of size between investment advisers.

Back End Load. The commission or fee, if any, charged by a mutual fund to investors when investors sell shares in the fund. A back end load is one form of commission, along with front end load and no load fee structures.

Back Testing. The process of testing a trading strategy under historical market conditions to gauge its effectiveness.

Balanced. A mutual fund that invests in more than one type of security or asset class (such as, for instance a mix of equities and bonds) in order to diversify the fund's holdings and achieve the fund's growth, income, and risk-tolerance objectives.

BDC/Business Development Company. A company created to help small business enterprises grow; similar to a venture capital fund. BDCs are often structured similarly to closed-end funds and list their shares for trading on a securities exchange.

Benchmark. A standard against which financial performance can be measured. Mutual funds often use a particular market index as a benchmark against which to measure and evaluate the performance of the fund.

Beta. A measure of the volatility or risk associated with an investment portfolio when compared to the overall financial markets. A beta of 1.0 indicates that an investment portfolio moves in tandem with the overall financial markets. A beta greater than 1.0 indicates above-market volatility, while a beta below 1.0 indicates below-market volatility. *See also* alpha.

Board Self-Assessment. The internal review process that boards of directors/trustees are obligated to perform at least once annually pursuant to Rule 0-1(a)(7)(v) under the Investment Company Act. Pursuant to the terms of the rule, the self-assessment process should evaluate the board's own performance, the performance of board committees, the effectiveness of the board's committee structure, and the number of funds for which each board member services as a director.

"Break the Buck." When a money market fund's NAV per share falls below $1.00, such as due to a loss of value in the securities held by the money market fund. (Money market funds intend to maintain a $1.00 NAV per share in perpetuity.) Breaking the buck occurs infrequently.

Breakpoints. Can refer to two types of discounts on mutual fund fees. First, a breakpoint may be a discount in a mutual fund's fee structure for larger sized investments. For instance, a mutual fund with a front end load may set up a graduated fee structure, charging marginally lower fees for investments above certain levels. Second, a breakpoint can also refer to discounts in a mutual fund's fee structure as the fund's total assets grow above certain levels. In this type of breakpoint, all investors in the fund benefit from reduced fees as the fund's assets grow.

Brokerage Commission. The commission charged by a broker-dealer to execute a purchase or sale of securities or other financial instrument.

Call Option. A call option is a financial contract that gives the holder the right (but not the obligation) to buy the underlying asset at a specified price (strike price) during a specified period for a premium. Conversely, the writer of a call option is obligated to sell the underlying asset to the holder at the strike price upon its exercise at any time prior to the expiration date. European call options differ from American primarily insofar as they must be exercised on a specified date rather than at any time before expiration.

Capital Appreciation. The rise in value of an investment due to an increased market price for the investment.

Capital Gains/Losses. A profit or loss realized from the sale of a capital asset, such as portfolio securities, as defined in the Internal Revenue Code. The sales of investment securities (such as stocks and bonds) by a mutual fund generate capital gains/losses for the fund.

Commodity Futures Trading Commission/CFTC. The Federal regulatory agency established by the Commodity Futures Trading Act of 1974 to administer the Commodity Exchange Act.

Commodity Pool. An investment trust, syndicate, or similar form of enterprise operated for the purpose of trading commodity futures or option contracts. Typically thought of as an enterprise engaged in the business of investing the collective or "pooled" funds of multiple participants in trading commodity futures or options, where participants share in profits and losses on a pro rata basis.

Commodity Pool Operator/CPO. A person engaged in a business similar to an investment trust or a syndicate and who solicits or accepts funds, securities, or property for the purpose of trading commodity futures contracts or commodity options. The commodity pool operator either itself makes trading decisions on behalf of the pool or engages a commodity trading advisor to do so.

Commodity Trading Advisor/CTA. A person who, for pay, regularly engages in the business of advising others as to the value of commodity futures or options or the advisability of trading in commodity futures or options, or issues analyses or reports concerning commodity futures or options.

Chief Compliance Officer/CCO. The designated compliance officer of an investment adviser, fund or other entity; responsible for overseeing and managing the organization's compliance with internal policies and procedures and for ensuring that those policies and procedures appropriately reflect legal requirements that affect the organization. Funds and Fund Advisers must have CCOs, and often it is the same person.

Chief Investment Officer/CIO. The senior investment officer in an investment adviser or other entity; usually responsible for overseeing and managing the organization's investment decision-making system, which includes developing investment strategies, evaluating investment opportunities, and ensuring investments are suitable for a particular fund or client.

Class (Shares). Mutual funds and other securities issuers may issue one or more class of shares. Each class of shares represents its own set of rights and, potentially, commitments. Where a mutual fund issues more than one class of shares, the classes may be distinguished by, for instance, different minimum initial investment requirements and different fee arrangements.

Cloned Fund/Performance. A mutual fund that seeks to replicate the investment strategy of a pre-existing fund or index. A cloned fund may be useful for investors who cannot invest directly in the underlying investment vehicle (such as, for instance, if the underlying fund is closed to new investors).

Closed-End Fund. Like a mutual fund, a publicly-traded investment company registered with the SEC. Unlike a mutual fund, though, closed-end funds do not continuously offer share but instead raise initial capital through an initial public offering and issue a fixed number of shares into the marketplace for trading. These shares then trade in a secondary market, typically on a securities exchange. In addition, because shares trade on an exchange, the share price of a closed-end fund usually fluctuates throughout the trading day (unlike a mutual fund, where the daily NAV per share is calculated at the 4:00 o'clock close). The shares of a closed-end fund should tend to reflect the value of the underlying investments held by the closed-end fund.

Collar. A collar is an investment strategy that uses options to limit to a specific range the possible range of positive or negative returns on an investment in an underlying asset. To establish a collar, an investor simultaneously purchases a put option and sells (writes) a call option on an asset.

Collateralized Debt Obligation (CDO). A CDO is a debt security issued by a trust, the payments on which are based on the cash flow of underlying assets such as a portfolio of bonds, loans, or similar assets. CDOs are similar to ABS in that the payments are based on a portfolio of financial assets but differ from ABS in that the portfolio is actively managed.

Collateralized Mortgage Obligations (CMO). A CMO is a special purpose entity that owns pools of mortgage loans or mortgage-backed securities and issues classes or tranches of bonds with different principal balances, interest rates, average lives, prepayment characteristics and final maturities. CMOs allow investors with different investment horizons, risk-reward preferences and asset-liability management requirements to purchase mortgage-backed securities tailored to their needs. In order to issue CMOs without the issuing entity being taxed as a corporation, the issuing entity must make a tax election to be treated as a real estate mortgage investment conduit, or REMIC, and must be structured to meet the REMIC requirements. By making the REMIC election, tax will not be imposed on the issuing entity even though it issues securities, the payments on which are not pro rata. Because of the pervasiveness of the REMIC structure, the terms "CMO" and "REMIC" are used interchangeably.

Commercial Mortgage-Backed Securities (CMBS). A CMBS is a mortgage-backed security the payments on which are derived from a discrete pool of commercial mortgage loans.

Commercial Paper. Unsecured debt sold by a corporation, usually of short duration (*e.g.*, maturing in nine months or less). Corporations may issue commercial paper to fund their current operations, and use commercial paper in lieu of bank borrowings. Commercial paper does not have to be registered with the SEC as long as the maturity is 270 days or less. Money market funds are a common investor in commercial paper.

Company Act. *See* Investment Company Act.

Compliance Committee. A committee of the board of directors/trustees, generally responsible for overseeing the establishment of, and compliance with, internal policies and procedures by an investment company, its investment adviser(s) and related affiliates. The compliance committee may be responsible for overseeing the Chief Compliance Officer and related compliance staff.

Conflict of Interest. Any issue that actually causes, or potentially could cause, a mutual fund board member, investment adviser, or affiliated person thereof to disfavor the interests of a mutual fund and its investors in favor of the interests of a board member, Adviser, affiliated person, or third party.

Contingent Deferred Sales Charge (CDSC). A sales charge imposed on redemptions, often related to an issuer's distribution or marketing expenses under a Rule 12b-1 plan. A CDSC will generally be reduced or eliminated for investors who have invested in a fund for a pre-determined length of time. A CDSC is a form of back end load.

Convertible Debt Security. A convertible debt security is a security that can be converted into another security at the option of the issuer and/or the holder. A convertible bond is a type of bond that can be converted into shares of stock in the issuing company, usually at some pre-announced ratio. A convertible bond will typically have a lower coupon rate because the holder is also compensated by the value of the holder's ability to convert the bond into shares of stock. In addition, when it is first issued, the bond is usually convertible into common stock at a substantial premium to its market value.

Counterparty. The opposite party in a bilateral (*i.e.*, two-sided) transaction, often used for the opposite party in an over-the-counter derivatives transaction (such as a swap or forward) and in discussions of counterparty risk.

Counterparty Risk. The risk that the counterparty to a bilateral transaction will not fulfill its obligations under the transaction. Counterparty risk occurs particularly in over-the-counter (*i.e.*, non-exchange-traded) transactions, but the risk may be reduced through certain types of hedging.

Credit Default Swap. A credit default swap is a contract whereby the parties agree to isolate and separately trade the credit risk of a third party. In a credit swap agreement, the buyer agrees to make one or more payments in exchange for the agreement of the seller to pay an amount equal to the decrease in value of a specified bond or a basket of debt securities upon the occurrence of a default or other "credit event" relating to the issuer of the debt. In such transactions, the buyer effectively acquires protection from decreases in the value of the securities relating to the creditworthiness of the debt issuer. The seller agrees to provide credit protection in exchange for the premium payments.

Custodian. The person, usually a bank or trust company, responsible for receiving delivery of and safekeeping an investment company's cash, securities, or other assets.

D&O Insurance. Directors and officers liability insurance. A form of liability insurance, usually purchased by a business entity, for the benefit of directors and officers of the entity as well as the business entity itself that provides coverage for damages or costs associated with legal proceedings against the officers, directors, or business entity. The terms and scope of coverage of a particular policy will be governed by the D&O contract executed with the D&O insurance carrier.

Derivative. A derivative is an instrument whose price is dependent upon, or derived from, one or more underlying assets. The derivative itself is merely a contract between two or more parties. Its value is determined by fluctuations in the underlying assets. The most common underlying assets include stocks, bonds, commodities, loans, currencies, interest rates and market indexes.

Distributor. An entity, usually a broker-dealer registered with the SEC and FINRA, that markets and sells shares in a fund to investors. A distributor may be affiliated with the mutual fund or be an unaffiliated third-party. Historically, mutual funds were sold through a single distributor, but today mutual funds are commonly sold through multiple distribution channels by many distributors (or directly to the public, such as through a mutual fund's website).

Dividends. Payments from a corporation to the holders of the corporation's preferred and/or common shares, usually paid out in cash from a portion of the corporation's current net income. Mutual funds also may issue dividends to investors in the fund based on income generated by the fund's portfolio holdings.

Duty of Care. Along with the duty of loyalty, a legal obligation imposed on directors/trustees of a mutual fund or other corporate entity. The duty of care obligates mutual fund directors/trustees to execute their responsibilities prudently—*i.e.*, with the care that a reasonably prudent person in like circumstances would employ.

Duty of Loyalty. Along with the duty of care, a legal obligation imposed on directors/trustees of a mutual fund or other corporate entity. The duty of loyalty obligates mutual fund directors/trustees to execute their responsibilities in the best interests of the fund and its investors.

Economy of Scale. The economic, managerial, or informational efficiencies that accrete to an enterprise (such as an investment adviser or investment company) by virtue of the growth of that enterprise. For example, an investment adviser may achieve economies of scale and achieve greater efficiencies for its clients as its number of clients, assets under management, or size grow. Similarly, an investment company may achieve economies of scale as the number of its mutual funds grows, making it comparatively easier to launch new mutual funds than when the investment company was smaller.

EDGAR. Electronic Data Gathering, Analysis, and Retrieval system. The SEC's online system for filing forms and reports. Much of the information submitted to the SEC via EDGAR is publicly available and searchable over the Internet. The SEC is in the process of upgrading the EDGAR system to XBRL, which is intended to make the information in the database more interactive and user-friendly.

Equity Security. A security, such as common stock, that represents the capital stock of a corporation. Equity securities confer ownership interests (and usually voting rights as well) in the corporation and represent a claim on the corporation's assets. Equity securities are traded on securities exchanges and in the over-the-counter (OTC) securities market. (Equity securities may be contrasted with fixed income securities.)

ERISA. The Employee Retirement Income Security Act of 1974. This federal statute provided minimum standards for pension plans in private industry and established rules on the tax treatment of transactions associated with employee benefit plans. ERISA does not require employers to establish pension plans. ERISA is enforced principally by the U.S. Department of Labor, the Internal Revenue Service, and the Pension Benefit Guaranty Corporation (PBGC).

ETF/Exchange-Traded Fund. A security traded on a securities exchange the value of which is related to an underlying portfolio of investments, market index, or other referent. ETFs are not mutual funds, nor are they closed-end funds. However, ETFs share some characteristics of each of these two investment vehicles. First, ETFs are a pooled investment vehicle. ETFs usually invest in a particular type of investment. For example, an ETF might invest solely in U.S. securities or foreign securities, or in the securities of a particular industry. An ETF might also attempt to replicate the performance of a particular market index, such as the S&P 500 or Dow Jones Industrial Average. Some ETFs are actively managed, though, making them very similar investment vehicles to a mutual fund. Like closed-end funds, ETFs trade on a securities exchange and the value of an ETF will fluctuate throughout the trading day. An ETF's share price generally should correlate to the underlying value of the investment portfolio, market index, or other referent that the ETF is intended to track. Finally, some ETFs employ leverage to attempt to boost returns.

Exchange Act. The Securities Exchange Act of 1934. This statute provides standards for securities trading in the United States including the registration and activities of securities exchanges, broker-dealers, and related market participants. The statute also contains an antifraud provision, Section 10(b) and Rule 10b-5, that courts consider a broad "catch all" antifraud measure. Mutual funds, and mutual fund boards of directors/trustees, are subject to this antifraud provision as well as other aspects of the Exchange Act.

Exchange-Traded Option. An exchange-traded option is one with terms that are standardized by the exchange on which it trades. The exchange acts as an intermediary to all transactions, and takes an initial margin from the option writer to act as a guarantee. Over-the-counter options are contracts that are traded directly between two parties, without going through an exchange or other intermediary.

Expense Cap. An agreement between an investment company and its investment adviser limiting the Adviser's fee or the total expenses to the investment company, usually to an amount based on a stipulated relationship between total expenses and average net assets.

Expense Ratio. A measure of what it costs an investment adviser to operate a mutual fund, expressed as a ratio of the fund's annual operating expenses to total assets. The expense ratio takes into account advisory or management fees, 12b-1 fees, and other administrative or operating expenses.

Fair Value Pricing. A process for determining the fair market value for a security or other financial instrument for which no readily available market pricing exists. Fair value pricing is often used to value illiquid securities.

FAS 157. Statement of Financial Accounting Standards No. 157, Fair Value Measurements. An accounting standard issued by the Financial Accounting Standards Board (FASB) in 2006 that defines fair value, establishes a framework for measuring fair value under GAAP, and expands disclosures about fair value measurements. FAS 157 emphasizes that fair value is a market-based measurement and should be determined based on the assumptions that market participants would use in pricing an asset or liability (commonly termed mark-to-market accounting).

FAS 161. Statement of Financial Accounting Standards No. 161, Disclosures About Derivative Instruments and Hedging Activities. An accounting standard issued by the Financial Accounting Standards Board (FASB) that requires enhanced disclosures about an entity's derivative and hedging activities to improve the transparency of financial reporting. Entities are required to provide enhanced disclosures about (a) how and why an entity uses derivative instruments, (b) how derivative instruments and related hedged items are accounted for under Statement 133 and its related interpretations, and (c) how derivative instruments and related hedged items affect an entity's financial position, financial performance, and cash flows.

FASB. The Financial Accounting Standards Board. FASB is a private, independent, nonprofit organization that develops GAAP used in the United States. FASB's expressed mission is to establish and improve standards of financial accounting and reporting for the guidance and education of the public, including issuers, auditors, and users of financial information.

Fee Waiver. The waiver of fees otherwise owed by a mutual fund to a service provider (such as an investment adviser). Mutual fund managers may, for instance, choose to waive a portion—or all—of a fee in order to improve the net return to investors of a fund that has performed below other peer funds, or may be contractually obligated to waive a certain amount of fees if the fund underperforms.

Fidelity Bond. A debt obligation posted by a financial services firm for the benefit of policyholders to be made available to policyholders in the event that they suffer a loss due to misconduct by the firm or its employees. Broker-dealers are required to post fidelity bonds to protect their brokerage customers. Investment advisers are not required to post fidelity bonds, though the SEC has considered imposing such an obligation.

Fiduciary. A legal term used to refer to a person that owes duties of good faith, trust, and confidence to another or who is obligated to exercise a high standard of care in managing another's money or property.

FIN 48. Financial Accounting Standards Board Interpretation No. 48, Accounting for Uncertainty in Income Taxes. Issued in 2006, FIN 48 establishes standards for accounting for uncertain tax positions and applies to all entities that prepare GAAP financial statements. FIN 48 governs the accounting for all material positions taken (or expected to be taken) on an income tax return.

FINRA. The Financial Industry Regulatory Authority. FINRA is a private self-regulatory organization for broker-dealers and registered securities representatives in the United States. FINRA was formed in July 2007 out of the consolidation of the former National Association of Securities Dealers (NASD) and New York Stock Exchange (NYSE) member regulation, enforcement, and arbitration functions. FINRA establishes and enforces professional and disciplinary standards for member broker-dealers and registered representatives, under the authority of the SEC. FINRA also provides a forum for investor arbitration disputes against FINRA member firms and individuals.

Fixed Income. A debt security or preferred stock that provides a stated dollar or percentage income return. (Fixed income securities may be contrasted with equity securities.)

Floating Rate Securities (Floaters). Floating rate securities are debt securities that pay an interest rate which is reset periodically based on the movement of a representative interest rate index.

Floor. A floor is a lower limit on an interest or payment rate.

Forward Contract. A forward contract is an agreement to purchase or sell an asset at a pre-arranged future point in time at a pre-determined price. Forward contracts do not have standardized terms. They are traded over-the-counter.

Front End Load. The commission or fee, if any, charged by a mutual fund to investors when investors purchase shares in the fund. A front end load is one form of commission structure. Other forms include back end load and no load fee structures.

Fund Accountant. Pursuant to Section 32(a) of the Investment Company Act, the independent directors of a registered investment company must select an independent public accountant to audit the investment company's financial statements for submission to the SEC.

Fund Counsel. The legal adviser to an investment company (usually referring to an external law firm retained by the investment company to provide legal counsel).

Futures Contract. A futures contract is a standardized contract, traded on a futures exchange, to purchase or sell an underlying asset, such as a physical commodity or a financial instrument, at a certain date in the future at a specified price. Some futures contracts may call for physical delivery of the asset, while others may be settled in cash. The contracts are executed through a clearinghouse, which is an agency or separate corporation of a futures exchange responsible for settling trading accounts, clearing trades, collecting and maintaining margin monies, regulating delivery and reporting trading data.

GAAP. Generally Accepted Accounting Principles. GAAP refers to the standards, conventions, and rules followed in a particular jurisdiction (such as the United States) for preparing and reporting financial statements. In the United States, FASB is responsible for establishing U.S. GAAP.

GAAS. Generally Accepted Auditing Standards. GAAS refers to a set of broad auditing principles to be applied by auditors when conducting financial audits. GAAS requires an auditor to plan the audit in advance, be independent of the client, and always obtain reliable evidence. In addition, the client should present its financial statements in accordance with GAAP, be consistent in its financial treatments, and disclose all pertinent information to the auditor.

Gartenberg Factors. A multi-factored test first used by the Second Circuit Court of Appeals in its 1982 decision, *Gartenberg v. Merrill Lynch Asset Mgmt.* Courts have used the Gartenberg Factors to resolve disputes about whether an investment adviser's fees are permissible under Section 36(b) of the Investment Company Act. The SEC has also incorporated the Gartenberg Factors into line item disclosures in certain mutual fund filings. As most commonly summarized, the Gartenberg Factors are: (1) the nature and quality of services provided to a fund; (2) the profitability of the fund to the Adviser; (3) the extent to which ancillary benefits of the advisory relationship inure to the Adviser; (4) whether any economies of scale were realized as fund assets increased; (5) the fee structures of comparable funds; and (6) the degree of independence and conscientiousness of the board of trustees.

Governance Committee. A committee of the board of directors/trustees, generally responsible for evaluating the operations of the board of director/trustees itself and the committees thereof and for making recommendations as appropriate regarding the board's effectiveness in governing an investment company.

Gramm-Leach Bliley Act. Known as the Financial Services Modernization Act of 1999, this 1999 federal legislation repealed the longstanding prohibition from the Glass-Steagall Act of 1933 against any single firm providing commercial banking, investment banking, and insurance services. Gramm-Leach Bliley therefore led to a wave of consolidation amongst commercial banks, investment banks, securities firms, and insurance companies and allowed financial services firms to provide a much wider array of financial products than they had been able to do before.

Growth Fund. An investment strategy employed by a mutual fund that seeks to generate returns by investing in securities (usually stocks) with high perceived potential for capital appreciation. Because a growth fund generally seeks maximum capital appreciation consistent with acceptable risk, the fund may be willing to pay higher prices for securities (*e.g.*, purchase securities with higher price-to-earnings ratios) than other types of funds. (This strategy may be contrasted with a value fund or an income fund.)

Hedge Fund. A private, pooled investment vehicle that does not require registration with the SEC. Hedge funds are similar to private equity funds and venture capital funds that also do not require SEC registration. Hedge funds got their name from the fact that, historically, they had employed hedging tactics (such as short selling of securities) that registered investment companies did not perform. Hedge funds do not actually need to engage in any such hedging activities. Because hedge funds are private investment funds, they are not marketed or sold to retail investors. Instead, hedge funds may receive investments from institutional investors and certain high net worth individuals. Hedge funds usually have high minimum investment requirements (requiring several hundreds of thousands—or even millions—of dollars be invested) and may impose limitations on investors' ability to freely withdraw investments from the hedge fund.

IFRS. International Financial Reporting Standards. IFRS is an accounting system promulgated by the International Accounting Standards Committee (IASC) Foundation. IFRS uses a principles-based set of standards. IFRS is intended to provide a single financial reporting system that can be used internationally, and IFRS is currently in use in over 100 foreign countries.

Illiquid Security. A security for which there is little or no market trading. Illiquid securities may be difficult to value, as they may lack reliable market pricing information.

Income Fund. An investment strategy employed by a mutual fund that seeks to generate maximum current income from the fund's investment portfolio.

Incubator Fund. An investment company that begins as a private fund and only becomes open for public investment after an incubation period (that may take many years). An incubator fund may be seeded with initial capital by an investment management company in order to test the portfolio performance of the fund. If successful, the fund may then be registered for investment by the public. Upon registration, the SEC may allow the fund to use its performance while it was privately held in the fund's marketing to the public.

Independent Director. A director (or trustee) who is not an interested director. Section 10(a) of the Investment Company Act requires that at least 40% of the directors of a registered investment company be independent. The Investment Company Act also imposes significant responsibilities upon independent directors.

Independent Directors' Counsel. Legal counsel retained by the independent members of a board of directors/trustees to provide advice to these individuals separately from the full board. Independent directors often retain separate legal counsel in order to help the directors fulfill their unique responsibilities under the Investment Company Act (such as the 15(c) process). Rule 01-(6) of the Investment Company Act specifies standards related to independent directors' counsel.

Index (Performance). A composite statistical measurement of an underlying collection of securities, industry, or financial products. There are a wide variety of financial indexes throughout the world and they are used to benchmark the performance of U.S. and/or foreign financial instruments. Some of the more well-known indexes include the Dow Jones Industrial Average, the S&P 500 Index, the Barclays Aggregate Bond Index, and the MSCI World Index.

Index Option. An index option is a call or put option on a financial index (e.g., the S&P 500). It is cash settled.

Inflation Risk. The risk that the value of an investment (particularly a fixed income investment) will decline due to an increase in the rate of inflation and the concomitant decrease in the purchasing power of a currency.

Institutional Investor. The term institutional investor may refer to entities such as banks, insurance companies, private corporations, pension funds, hedge funds, endowments, or family trusts (among others) that typically are deemed to have some level of financial sophistication.

Interactive Data Corporation. Interactive Data Corp. is a large provider of market data and analytics services to financial services firms. Customers (such as mutual funds) may use Interactive Data to provide, for instance, market pricing information with which to value a fund's portfolio holdings.

Interested Director. A director of an investment company who is also directly or indirectly affiliated with the investment management company or investment adviser to the investment company (and certain other persons). For example, a fund director who is also a senior executive at the management company of the fund would be an interested director. The definition is set forth in the Investment Company Act and is very detailed. The Investment Company Act precludes interested directors from participating in some aspects of mutual fund governance. *Compare* independent director.

Investment Advisers Act. The Investment Advisers Act of 1940. A federal statute administered by the SEC that establishes legal standards, duties, and prohibitions related to SEC-registered investment advisers, including fund Advisers.

Investment Company Act. The Investment Company Act of 1940. A federal statute administered by the SEC that establishes legal standards, duties, and prohibitions related to investment companies such as mutual funds and closed-end funds.

Large Cap. A company with a large market capitalization, commonly understood as being above $5 billion. Mutual funds that invest in large cap companies are often termed large cap funds. Compare to mid-cap, small cap, and micro-cap.

Leverage. The use of debt to finance the operations of a fund. When a fund borrows money from a bank in order to invest in securities, the fund uses explicit leverage (and the ability to do so if limited under the 1940 Act). The use of certain financial instruments and trading practices have a leveraging effect on a fund's portfolio. For example, when a fund engages in short selling, trading options, and uses certain financial derivatives (futures and swaps), the fund uses implicit leverage.

Lipper Indexes. A mutual fund performance rating system developed by Lipper, Inc., that can be used as performance benchmarks for different investment styles or strategies of mutual funds.

Load. A sales charge applied to a purchase (front end load) or redemption (back end load) of mutual fund shares. Some mutual funds have no load.

Long (Long Position). The ownership of a security or other financial instrument, usually with the expectation that holding the instrument will generate a profit through capital appreciation or income accrual. For example, if an investor holds a particular stock because the investor expects the stock's value to rise over time, the investor is said to have a long position in the stock. A long position is the opposite of a short position.

Market Capitalization. The aggregate market value of a company as calculated by multiplying the current stock price by the number of shares of stock outstanding. Market capitalization (also termed market cap) is one way to value a company, and reflects the current total notional value of a company to its shareholders. Companies may be separated into four broad categories based on market capitalization: large cap, mid cap, small cap, and micro-cap.

Market Maker. A broker-dealer that agrees to stand ready and able to buy or sell the securities of a particular issuer (called making a market in the security) at publicly quoted bid and ask prices. Market makers accept economic risk in making a market because the market maker must maintain an inventory of securities for sale and, at the same time, be willing to immediately purchase securities from investors. However, market makers expect to profit from making a market because of the small spread (usually, a few pennies) between the bid and ask prices at which the market maker executes trades. Market makers operate in a dealer market, such as the Nasdaq, and there may be multiple market makers for a security.

Market Neutral Strategy. A market neutral strategy is a trading strategy that involves the purchase of securities long and the sale of securities short in order to protect a portfolio from exposure to broad market moves. The goal is to profit from relative mispricings between related instruments – going long on those that are perceived to be underpriced while going short on those perceived to be overpriced – while avoiding systematic risk.

Market Quote. The reported price at which a security traded in a securities market.

Market Timing. Generally, the attempt to profit from securities trading based on predictions of future directions in a securities market. In the case of mutual funds, though, market timing refers to the practice of trading rapidly into and out of mutual funds (which may be in contravention of a fund's public disclosures and/or internal policies) in the hopes of profiting from short term fluctuations in the value of a fund's assets and NAV.

Mark-to-Market. Mark-to-market refers to the accounting practice of valuing a financial instrument at the current market price for the instrument. Mark-to-market accounting is comparatively easy for financial instruments that trade in liquid markets (such as stocks and bonds) but can be more difficult for illiquid securities, certain financial derivatives, or unique or rare financial assets.

Master-Feeder Fund. A structure in which one or more funds (feeder funds) invest in another fund (master fund). This structure may provide the feeder funds with economies of scale by pooling their investments into a larger master fund.

Material Weakness. The finding by an auditor that one or more of the internal controls of an audited company is ineffective and could lead to a material misstatement in the company's financial statements. (An auditor's finding of a material weakness does not necessarily imply that a misstatement has already occurred.)

Micro Cap. A company with a very small market capitalization, commonly understood as being below $250 million. Compare to large cap, mid cap, and small cap.

Mid Cap. A company with a medium market capitalization, commonly understood as being between $1 and $5 billion. Compare to large cap, small cap, and micro-cap.

Money Market. The domestic and international financial market for short-term borrowing and lending. The money market includes short term Treasury bills, commercial paper, repurchase agreements, and bankers' acceptances, among other instruments.

Money Market Fund. A mutual fund that invests solely in money market instruments. Money market funds are subject to Rule 2a-7 under the Investment Company Act, which restricts money market fund investments by quality and maturity. Money market funds generally seek to maintain a stable $1.00 NAV per share at all times. However, if a fund's NAV per share falls below $1.00 (such as because of a decline in the value of the fund's assets), the fund is said to "break the buck."

Morningstar Ratings. A ratings system created by Morningstar Inc. that ranks mutual funds based on funds' risk adjusted performance over various periods of time. Morningstar ratings vary from "1" (lowest) to "5" (highest).

Mortgage-Backed Securities (MBS). A mortgage-backed security is an asset-backed security, the payments on which are derived from a discrete pool of mortgage loans. The security represents an undivided beneficial ownership interest in the pool of assets. The most basic type of MBS is a simple "pass-through" security that entitles the holders to receive a pro rata share of the principal and interest payments on the underlying mortgage loans.

Mutual Fund. The commonly used term to describe an open-end, management investment company that is registered with the SEC under the Investment Company Act. Mutual funds sell and redeem their shares on a daily basis.

N-1A. SEC Form N-1A. An SEC form that must be filed by mutual funds in order to register the offering of the mutual fund's shares to the public under the Securities Act. Form N-1As are publicly available on EDGAR, and the forms must include information about a mutual fund such as the fund's investment objectives, risks, and management. Part A of Form N-1A is the fund's prospectus, which must be delivered to shareholders. Part B is the Statement of Additional Information, which is available upon request to the fund.

Names Rule. Rule 35d-1 under the Investment Company Act requires a mutual fund with a name suggestive of a particular investment style to invest at least 80% of its assets in securities within that investment style. For example, a mutual fund that included "growth" in its title would be obligated to invest at least 80% of its assets in growth stocks.

NAV (Net Asset Value). The excess of a fund's assets minus the fund's liabilities. This represents the total shareholders' equity of the fund. NAV is computed for a mutual fund as of the daily 4:00 o'clock close. Dividing the daily NAV by the total number of shares outstanding yields a fund's NAV per share, which is the price at which investors purchase or redeem shares of the fund. (Note: NAV is commonly used in place of NAV per share.) Mutual funds must forward price their shares – that is, sell them at the price next determined after receipt of an order.

N-CSR. SEC Form N-CSR. A form completed by mutual funds and filed with the SEC after transmission of annual and semi-annual reports to investors.

New Products Committee. A committee used by some boards of directors/trustees to evaluate new investment products that may be used by an investment company.

No-Action Letter. A letter from the staff of the SEC, responding to a specific written request, agreeing that the staff would not recommend that the SEC take enforcement action against the requestor based upon a set of facts and circumstances presented to the staff by the requestor. An individual or entity that is unsure of whether a prospective course of conduct would violate the federal securities laws may request a No-Action Letter from the staff seeking the staff's assurance that it would not recommend enforcement action if the requestor undertook the course of conduct. The staff is not required to respond to the request.

No Load. If a fund does not charge any fees or commissions to investors at the time of investment (a front end load) or at the time of redemption (a back end load), then the fund is said to have no load. However, the investment adviser and related service providers to a no load fund will still require fees or commissions be paid through other means, such as through an annual management fee assessed to the fund. As a general matter, a no load fund must have limited Rule 12b-1 fees, if any.

N-PX. SEC Form N-PX. An annual form completed by mutual funds and filed with the SEC to report the fund's proxy voting record for the previous twelve-month period.

N-Q. SEC Form N-Q. A form completed by mutual funds and filed with the SEC every quarter to disclose the fund's complete portfolio of holdings.

NRSRO. Nationally Recognized Statistical Rating Organization. NRSRO is a term used in federal securities and banking laws to apply to certain credit rating agencies whose credit ratings financial firms may use for required regulatory purposes. Federal regulations encourage or even require financial firms in certain circumstances to use ratings from an NRSRO to the exclusion of credit ratings from non-NRSROs. There are several NRSROs, although the three most prominent are Standard & Poor's, Moody's, and Fitch.

N-SAR. SEC Form N-SAR. A form completed by mutual funds and filed with the SEC to report semi-annual and annual financial information about a fund, such as shares sold and portfolio turnover.

NSMIA. The National Securities Markets Improvement Act of 1996. NSMIA enacted several changes to the securities laws, including removing the need for SEC-registered mutual funds to register their funds with the state securities offices (though states could still require mutual funds to notice file and pay state filing fees).

OCIE. The SEC Office of Compliance, Inspections, and Examinations. OCIE is responsible for conducting examinations of SEC-registered investment advisers, investment companies, and broker-dealers. OCIE examines investment advisers on a periodic basis and, potentially, on a for-cause basis (*i.e.*, for a specific cause or on suspicion of misconduct).

Open-End Fund. A mutual fund; also known as an open-end management investment company.

Performance Fee. A fee structure in which an investment adviser is paid a fee based on the financial performance of the fund, not the total assets in the fund or the size of an investor's investment in the fund.

Pricing Error/NAV Error. The incorrect valuation of a financial asset held by a fund, which may result in overstatement or understatement of the NAV of the fund. NAV errors can also occur when operational failures prevent the proper recording of fund assets.

Pricing Service. A service, usually a third-party vendor, that provides market quotes or other pricing information with which to value portfolio securities or other investments.

Profile. The investment style of a mutual fund, taking into account such issues as asset class, portfolio risk, investment objectives, volatility, and time horizon.

Prospectus. The document that is required to be provided to investors in connection with the purchase and sale of fund shares. There are very specific requirements imposed by the securities laws for what information may or must be contained in a prospectus.

Proxy. A person authorized to vote a security interest on behalf of a shareholder of the security. Also refers to the written authorization from a shareholder granting such voting authority.

Put Option. A put option is a financial contract that gives the holder the right (but not the obligation) to sell the underlying asset at a strike price during a specified period for a premium. Conversely, the writer of a put option is obligated to buy the underlying asset from the holder at the strike price upon its exercise at any time prior to the expiration date. European put options differ from American put options insofar as they must be exercised on a specified date rather than at any time before expiration.

Quant (Quantitative Analysis). A style of investing (and, especially, an individual who employs such a style) that applies sophisticated mathematical or computer modeling techniques to explain or predict the movements of a financial market. A mutual fund that selects securities based on quantitative analysis may be termed a quant fund.

Quarterly Report (Form 10-Q). A report filed with the SEC by publicly-traded companies reporting financial performance, earnings, and other information about the issuer. (Mutual funds report portfolio holdings on a quarterly basis as well; *see* Form N-Q.)

Regulation S-X. A regulation issued by the SEC that sets forth accounting rules for the form and content of financial statements and schedules filed with the SEC under the Securities Act and Exchange Act.

Registration Statement. A filing that is required to be submitted with the SEC before securities may be offered or sold to investors in the United States through a general solicitation. There are several different SEC forms (such as Form N-1A) that serve as registration statements, depending upon the type of securities to be offered for sale.

Repurchase Agreement (a repo).A repo is an agreement whereby a fund (or other buyer) takes cash and purchases a financial instrument or securities and simultaneously agrees to sell them back to the counterparty, at a later date.

Revenue Sharing. An agreement whereby an investment adviser or its affiliate makes payments to another entity (such as a printer) out of the legitimate profits from the advisory fees it receives from the fund. Revenue sharing payments generally are made to pay for fund share distribution-related activities.

Reverse Floater (Inverse Floater).A reverse or inverse floater is a floating rate security that pays an interest rate which fluctuates inversely with an interest rate index – increasing when the index decreases and decreasing when the index increases.

Reverse Repurchase Agreement. An agreement whereby a fund (or other person) sells a financial instrument or security at one price and simultaneously agrees to repurchase the same financial instrument or security at a later date, at a higher price. Reverse repos have a leveraging effect on a fund's portfolio.

Risk-Return Summary. A standardized, required disclosure in a mutual fund's prospectus and on a mutual fund's website about the fund's investment objectives and strategies, costs, risks, and past performance. The risk-return summary is intended to provide investors with a simple way in which to compare mutual funds.

S&P (Standard & Poor's). A large financial research and analysis firm, S&P is an NRSRO and provides credit ratings for various securities. S&P also provides financial research and securities analysis information, and is the proprietor of certain financial indexes such as the S&P 500 Index.

Sarbanes-Oxley Act. The Public Company Accounting Reform and Investor Protection Act of 2002. This 2002 federal legislation, enacted after significant corporate and accounting scandals such as the collapse of Enron Corp., enhanced accounting and internal controls requirements for publicly-traded companies, created the Public Company Accounting Oversight Board (PCAOB), and heightened penalties for financial frauds (among other changes).

SSAE 16 (formerly, SAS 70). Defines the professional standards to be used by an auditor to assess the accounting and internal controls of a service organization. An audit performed in accordance with these standards is widely recognized as representing that the service organization has been through a thorough audit of its internal control activities.

SEC. The Securities and Exchange Commission. The federal agency charged with administering and enforcing the securities laws of the United States. The SEC's stated mission is to protect investors, maintain fair, orderly and efficient markets, and facilitate capital formation. The SEC's Division of Investment Management regulates investment companies and registered investment advisers. OCIE inspects registered investment companies and investment advisers. The Division of Enforcement investigates and brings lawsuits for violations of the securities laws.

Securities Act. The Securities Act of 1933. This federal statute governs the offer and sale of securities in the United States. Mutual funds are subject to this statute (as well as the Investment Company Act) in their offers and sales of shares to investors.

Securities Lending/Securities Finance. A process whereby the owner of a security agrees to lend the security to another person in exchange for fee. The person borrowing the security will then be entitled to execute a short sale or other permitted transaction as if the person had full ownership rights over the security. Entities with large securities holdings, such as mutual funds, often enter into securities lending arrangements in order to earn additional income on their portfolio holdings.

Self-Dealing. The improper act by a fiduciary of placing the fiduciary's own interests (or the interests of an affiliate) above the interests of a beneficiary to whom the fiduciary owes a duty of care and duty of loyalty.

Senior Security. A security (usually debt) that has higher priority for repayment than common stockholders in the event of the bankruptcy of the issuer. Under the Investment Company Act, a senior security is any obligation evidencing indebtedness by a fund, or any class of securities with priority over any other class of securities regarding the distribution of assets of the fund or payment of dividends by the fund. Section 18(f) of the Investment Company Act generally prohibits mutual funds from issuing senior securities.

Series. The legal term associated with an investment company that offers multiple, separate portfolios for investment. Each separate portfolio in the series investment company is a mutual fund.

Shareholder Servicing Agent. A financial institution or other entity that provides shareholder services to an investment company or corporate securities issuer (such as distribution, transfer agent, or custodial services) on behalf of the investment company or other security issuer. A shareholder servicing agent will provide these services in exchange for compensation from the issuer.

Short (Short Position). The sale of a borrowed security (short sale), or other financial position in which a party hopes to profit from an expected decline in the value of an underlying financial instrument. In the context of options trading, a party that writes an options contract creates a short position. Short is the opposite of long. The term can be used to refer to various financial transactions whereby a person takes the position that the reference asset will decline in value.

Short Sales. An investment strategy whereby an investor sells securities that the investor does not own and borrows the securities from its broker to deliver to the purchaser. The investor believes that it will be able to purchase those same securities in the future at a lower price, the difference being the expected profit. Short sellers make money if the stock goes down in price by more than the cost of borrowing the securities.

Soft Dollar Arrangements. Arrangements whereby an Adviser receives research or brokerage products (such as research) or services from a broker-dealer in exchange for placing securities transactions with that broker-dealer. Soft dollar arrangements involve the use of client commission dollars (i.e., soft dollars) in order to receive the products or services. In order to receive the products or services, the Adviser may pay more than the lowest possible commission rate.

Sticker. A supplement or change to a previously filed statutory prospectus that affects a change to the prior prospectus.

Structured Note. A structured note, which is sometimes referred to as "hybrid debt," is a debt security whose interest payments are linked to the movement of an interest rate, stock, stock index, commodity, or currency.

Style Drift. The divergence of a mutual fund's investment portfolio from the fund's stated investment strategies. Style drift can result from intentional decisions by portfolio managers or from unplanned changes to the overall structure of an investment portfolio.

Subchapter M. Subchapter M of the Internal Revenue Code is the portion of the code that allows investment companies to pass capital appreciation and income through to investors and thereby avoid double taxation on the fund's investments.

Subordinated Debt. Debt that is junior in claim on assets to other debt and, therefore, is repayable only after other debts with higher claim have been satisfied.

Suitability. The obligation of an investment adviser or broker-dealer to ensure that investment recommendations to a client are consistent with the client's risk tolerance and investment objectives.

Summary Prospectus. A shortened prospectus that, by SEC rule, mutual funds may deliver to investors in lieu of a formal statutory prospectus. If a mutual fund intends to fulfill its prospectus delivery requirement through a summary prospectus, the fund must make its statutory prospectus and other information easily accessible to the public through the fund's website. A summary prospectus must contain the same information as required by the summary portion of a statutory prospectus, including the fund's investment objectives, risks, and costs.

Swap. A swap transaction is an agreement between two parties to exchange different streams of cash flows based on a specified or "notional" amount. The cash flows exchanged in a specific transaction may be, among other things, payments that are the equivalent of interest on a principal amount, payments that would compensate a purchaser for losses on a defaulted security or basket of securities, or payments reflecting the performance of one or more specified securities or indices.

T+3. The settlement period of a securities transaction, three days after the transaction date. "T" stands for the transaction date. "T+3" therefore refers to settlement three business days after the transaction. Equity trades are supposed to settle within T+3, though other types of securities have different permitted settlement times.

Total Return Swap. A total return swap is a contract whereby a buyer agrees to make payments that are the equivalent of interest on a specified notional amount in exchange for the right to receive payments equivalent to any appreciation in the value of an underlying security, index or other asset, as well as payments equivalent to any distributions made on that asset. If the value of the asset underlying a total return swap declines over the term of the swap, the buyer may also be required to pay an amount equal to that decline in value to its counterparty.

Transfer Agent. An agent, often a bank or trust company, responsible for maintaining shareholder records, including records of investor purchases and sales, preparing and mailing shareholder statements, and delivering shareholder reports. A transfer agent may also serve as the custodian.

Underwriter. *See* distributor.

Valuation Committee (often called a Pricing Committee). A committee established by the board of directors/trustees of a fund, generally responsible for overseeing the implementation and operation of valuation policies and procedures on behalf of an investment company. Valuation committees also determine the fair values of fund assets based on specific, board-approved methodologies that are set forth in formal valuation procedures. Such valuation committees are comprised of personnel of the fund's investment adviser and administrator. Some fund boards also establish committees that are comprised of independent trustees to oversee the work of such a valuation committee.

Value Fund. An investment strategy employed by a mutual fund that seeks to generate returns at acceptable risk by investing in securities that are priced at or below the perceived fair market value of the securities. A value fund may tend to invest in the securities of established, well-known issuers that are seen as "on sale" in the marketplace. For this reason, value funds may be more concerned by securities valuation metrics (such as price-to-earnings ratios) than growth funds. (This strategy thus may be contrasted with a growth fund or an income fund.)

Variable Annuity Product. A form of variable insurance product, a variable annuity is a contract in which the insurance company provides a guaranteed payment stream in return for an initial lump sum premium payment or a series of premium payments during an accumulation period from the policyholder. Unlike a fixed annuity, a variable annuity provides a policyholder with a minimum guaranteed stream of income and the possibility of increased income if the investment vehicles in which the annuity is invested grow. However, the policyholder also bears the risk that the annuity may not perform as hoped. Variable annuities are regulated as securities by the SEC.

VIP (Variable Insurance Product). A form of insurance that is regulated as a security by the SEC. A VIP includes an insurance component, such as a death benefit to be paid to a beneficiary, as well as a variable (securities) component. The variable component of the policy, which may be invested in one or more investment funds maintained by the insurance company, offers the potential for capital appreciation in the account (though this also necessarily requires the account holder to bear some market risk).

When-Issued Security. A when-issued security transaction involves the pre-purchase of securities that will be issued at a future date. These transactions are made conditionally because issuance of the underlying securities, although authorized, may not always take place.

Wrap Program/Wrap Account. An account in which a broker or investment adviser manages the account for a flat fee, which includes all advisory, administrative, and commission services. A mutual fund wrap program gives investors access to an assortment of funds in which to invest, also usually for a flat fee (though a mutual fund wrap program may also include additional fees charged by each mutual fund).