New Directors Training Manual
Mutual Fund Directors Forum

April 2013

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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 broad and detailed 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 their board meetings. While aimed primarily at newer directors, more experienced directors will also find the Guide useful.

The Guide includes six reports published by the Forum. First, is the practical guidance on Rule 12b-1 in Tab 3, which governs the process by which fund assets are used to pay for distribution of fund shares. Second, is the Forum's guidance on board oversight of valuation in Tab 9. Third is the Forum's guidance on board self-assessments in Tab 11. Fourth is the Forum's Risk Report in Tab 14. Fifth is the Forum's report on board oversight of proxy voting in Tab 15. Sixth is the Forum's report on practical guidance for fund directors on the oversight of securities lending in Tab 16.

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 place for all questions that directors may have. Rather, it is intended to be a starting place for background information.

TAB 1

CHAPTER ONE

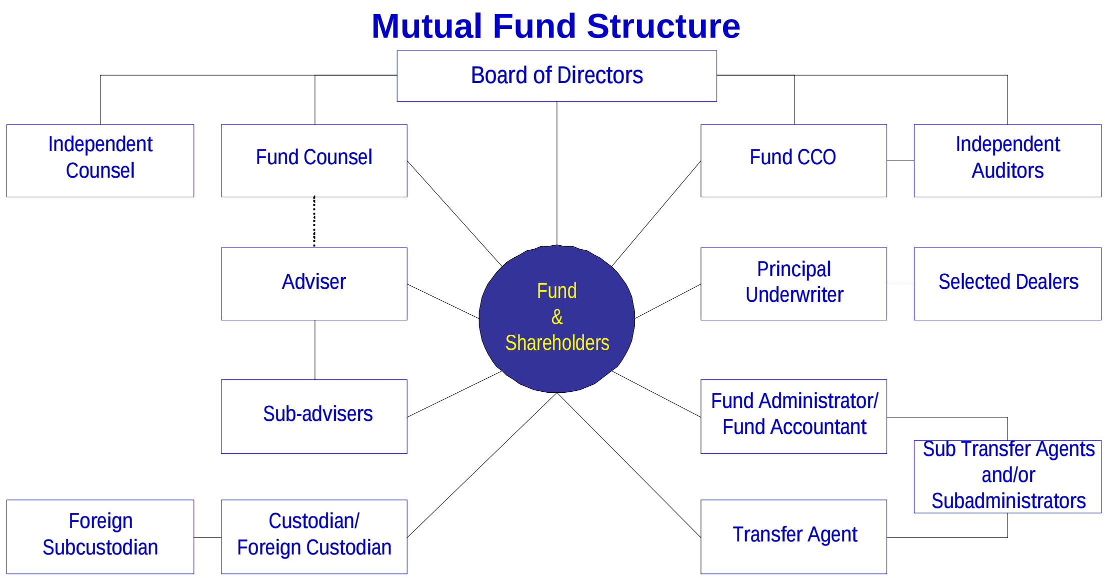
INTRODUCTION TO MUTUAL FUNDS AND THEIR STRUCTURE

What are mutual funds and how do they operate?

Mutual funds are "pools" of investments owned "mutually" by multiple investors ("Funds"). 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.

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.



<u>Who are the key mutual Fund service providers?</u>

1. ***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 the 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, as amended, (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 and ensuring that the Adviser fulfills its fiduciary duties to the Fund.

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 Chapter Two – 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.

2. *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 and Exchange Act of 1934, as amended (the "1934 Act"). The Distributor's activities are also governed by the Financial Industry Regulation Authority ("FINRA"), formerly known as the National Association of Securities Dealers. 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 the "sales charge." A portion of the sales charge is typically paid to the broker-dealer through whom the investor purchased his shares. FINRA governs 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 for 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.

This is a very rudimentary description of what has evolved into a very complex distribution structure within the Fund industry over the past quarter century. Please see Chapter 3, Report of "Mutual Fund Directors Forum - Best Practices and Practical Guidance for Directors under Rule 12b-1" for additional information. You should also be aware that the SEC has had on its agenda for the past several years an "overhaul" of Rule 12b-1. The use of these fees has evolved over time and the SEC wants to reexamine their usefulness in light of their current purpose, which is typically to compensate dealers for selling a Fund's shares.

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 bank 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).

4. *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.

5. ***Fund Administrator (including the Fund Accountant)***

A Fund's 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"). 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.

6. ***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 Chapter Seven - <u>Rule 38a-1 Compliance Policies and Procedures.</u>

7. ***Independent Auditor***

Section 32 of the 1940 Act requires a Fund to have an independent auditor review, sign or certify the Fund's financial statements before these are filed with the SEC (the "Independent Auditor"). 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.

8. *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 and Fund-related products to market.

9. *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 Fund's 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 Investment Company Act of 1940, as amended.

[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).

TAB 2

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, virtually every Board employs a slightly different process in considering each factor; no single process it 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 such 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.

What information do Boards need to fulfill this duty?

The Board needs to 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. 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 both shareholders and regulators. 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 singled out and 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 Agreement(s).

- 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 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. This is the result of a number 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 amounts of 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 as well as 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] During the Annual 15(c) Process, Independent Directors will consider detailed information about a Fund's performance, fees and expenses and investment objectives, policies and risk profile, and the Independent Directors will 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.[3] Independent Directors typically 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.[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 which they did not consider and why.[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 have the ability to:

- 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 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 arms length bargaining. This does not mean necessarily that actual arms 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 arms 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. Independent Directors receive information about the profitability to the investment adviser from its relationship with a Fund.

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 a certain period of time. (Typically 1 yr, 3yrs, 5yrs, 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 least every quarter throughout the year, at the Fund's regular quarterly board meetings, often in the Investment Committee or Performance Committee meeting. 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 (in light of its particular 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 number of quarters 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 manger(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 differing fee levels. The Adviser also could be reimbursing a certain amount of the Fund's expenses while peers are not.

The Independent Directors often consider requesting that the Adviser institute a fee waiver until the Fund's asset size grows and economies of scale are achieved or that the Adviser 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 policies 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 them. 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. This situation is typical for Funds that use novel investment strategies. 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.

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 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.

Independent Directors are often challenged with respect to sub-advisers (that is, in determining the degree of due diligence that they should conduct concerning the activities of the sub-advisers and the amount of the advisory fee that is paid to each of them). 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 get the sub-adviser to commit, 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 often obtains this information from the sub-advisers 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 of 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 Independent Directors. No single approach or methodology is mandated by law. Independent Directors should seek to use the approach that works best for that Board and Fund complex.

Recent Developments that may affect the Annual 15(c) Process

On March 30, 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,* the leading case since 1982 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). Recently, the Court of Appeals for the Seventh Circuit, in *Jones v. Harris Associates L.P*., rejected the approach taken by the Second Circuit in Gartenberg. 527 F.2d 627, 631-32 (7th Cir. 2008).

[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] The Supreme Court in the Jones v. Harris Associates case (U.S. March 30, 2010 at http://www.supremecourt.gov/opinions/09 pdf/08-856 pdf) in strongly endorsing Gartenberg, 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.

[4]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).

[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.

TAB 3

MFDF

Mutual Fund Directors Forum

The FORUM *for* FUND INDEPENDENT DIRECTORS

REPORT

of the

MUTUAL FUND DIRECTORS FORUM

BEST PRACTICES AND PRACTICAL GUIDANCE FOR DIRECTORS UNDER RULE 12b-1

May, 2007

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Report of the Mutual Fund Directors Forum: Best Practices and Practical Guidance for Directors under Rule 12b-1

I. 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

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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.*

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,

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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

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]

II. Background

In 1940, Congress was concerned with the potential conflicts of interest if mutual funds paid for distribution costs out of the assets of the fund. Section 12(b) of the Investment Company Act of 1940, as amended (the "1940 Act"), therefore makes it unlawful for mutual funds to distribute their own securities, but grants the SEC authority to regulate the use of fund assets to pay for the distribution of fund shares. [13] The SEC

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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.

13 *See* Section 12(b) of the 1940 Act. The legislative history characterizes the section as one that "protects the open-end company against excessive sales, promotion expenses, and so forth."

adopted Rule 12b-1 in 1980, following a prolonged period of net redemptions for the mutual fund industry as a whole in the latter half of the 1970s. Rule 12b-1 reflected the culmination of industry efforts in the 1970s urging the SEC to reexamine its position that fund assets may not be used for distribution of fund shares.[14] It sought to address the argument of mutual fund sponsors that it would be in the interest of fund shareholders to permit the use of fund assets as a supplemental source of financial support for the distribution of mutual fund shares as a way of addressing the problems created by industry-wide net redemptions.[15] Accordingly, Rule 12b-1 reversed the historic SEC position that fund assets should not be used for distribution.[16] In so doing, the rule recognizes the "serious conflict of interest that may exist between a fund and its investment adviser when fund assets are used to finance distribution."[17] The rule relies heavily on a fund's directors, particularly its independent directors, to manage that conflict. It reflects the view that, with appropriate safeguards, the independent directors of mutual funds should be permitted to make a business judgment that the use of fund assets to finance distribution, under some circumstances, would be in the best interest of the fund and its shareholders.

At the time of the adoption of Rule 12b-1, the SEC believed that distribution expenditures paid by a fund would actually benefit the fund and its shareholders only in limited circumstances. Accordingly, the Rule contains significant procedural and substantive standards.[18] A fund may make distribution-related payments only in accordance with a written plan, and any agreements relating to implementation of the plan also must be in writing. The plan initially must be approved by the fund's board of directors, including a majority of the independent directors, at an in-person meeting. The plan, if adopted after the fund's initial public offering, also must be approved by a

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Investment Trusts and Investment Companies: Hearings on H.R. 10065 Before a Subcommittee on Interstate and Foreign Commerce, 76th Cong., 3d Sess. 112 (1940) (Statement of David Schenker).

14 *See Bearing of Distribution Expenses by Mutual Funds* Investment Company Act Release No. 10862 (September 7, 1979) [44 FR 54014 (September 17, 1979)] ("Rule 12b-1 Proposing Release")

15 Supporters argued that increased sales: (1) could lead to economies of scale reflected in a decline of a fund's overall expense ratio as its size increases, (2) could permit a fund to employ a greater variety of portfolio management techniques and strategies, (3) generally permit a fund to obtain better, and lower cost, portfolio execution services, and (4) attract and retain higher quality investment and other personnel. *See* Memorandum for Staff Use in Responding to Public Inquiries Regarding Disclosure and Other Issues Raised by Certain Types of 12b-1 Plans (May 21, 1986) (pub. avail. June 4, 1986) ("Staff Memorandum").

16 The SEC's historic position was based on a concern that, if the expenditures were paid by the fund, a fund's adviser (who is typically compensated based on the size of the fund) might encourage the fund to pay excessive amounts for distribution in an attempt to increase the size of the fund and therefore the adviser's compensation. See Payment of Asset-Based Sales Loads by Registered Open-End Management Investment Companies, Inv. Co. Act Rel. No. 16431 (June 13, 1988) (the "1988 Release").

17 Staff Memorandum.

18 *See* Rule 12b-1. *See also* Staff Memorandum (observing that the procedural and substantive standards of Rule 12b-1 were intended to be more stringent than those that apply to the approval or renewal of an advisory contract).

majority of fund shares. Any material changes to the plan must be approved by both the board and shareholders. The board, including a majority of the independent directors, also must approve continuation of the plan annually based on findings that it continues to benefit the fund and its shareholders. The board must review, at least quarterly, reports of expenditures paid under the plan and their purposes. Rule 12b-1 also obligates parties (*i.e.*, the fund's distributor) to furnish the fund's board with all information reasonably necessary for the directors to make an informed decision to adopt or continue a plan. Further, the fund's board of directors must satisfy the fund governance standards contained in SEC rules. By the time the SEC finally approved Rule 12b-1 in 1980, the fund industry had emerged from net redemption status and started experiencing significant growth. Consequently, the Rule at first was seldom used and then only by no-load funds on a temporary basis. By the mid-eighties, however, an increasing number of intermediary-distributed funds began to use Rule 12b-1 as an alternative to the front-end sales load. Under these alternative arrangements, funds effectively allowed purchasers of shares to defer payment for the services of their intermediary by investing in a class of shares which paid an annual asset-based distribution fee instead of a front-end sales load. Often the distribution fee amounted to one percent of net assets annually, but some fees were higher.

By 1988, over 1,100 funds (approximately 52 percent of funds at the time) had adopted 12b-1 plans that provided an asset-based fee alternative to the front-end sales load.[19] Through the mid-eighties, the Division of Investment Management became increasingly concerned that Rule 12b-1 was being used for a purpose never intended or even anticipated by the SEC in 1980, and that potential abuses might arise from that use. Accordingly, in 1988, following the publication of the Staff Memorandum in 1986 and subsequent input from a number of sources, the Division recommended to the SEC, and the SEC issued, proposed revisions to Rule 12b-1.[20] The proposed revisions, although characterized as a "midcourse correction," essentially would have abolished the use of Rule 12b-1 as an alternative to the front-end sales load.[21]

The mutual fund industry vigorously opposed the SEC's 1988 proposal. It contended, among other things, that Rule 12b-1 provided a useful alternative to the front-end sales load for fund investors because it allowed the full amount of their investment to work for them immediately and that any abuses (and the industry contended that there was no evidence of abuse) could effectively be addressed by disclosure and regulatory initiatives.[22] To this end, the ICI suggested, among other things, that the level of 12b-1 fees be regulated by the National Association of Securities Dealers, Inc. (the "NASD")

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19 *See* 1988 Release.

20 *See id.*

21 The proposed revisions would have virtually eliminated "spread-load" plans by prohibiting 12b-1 payments for expenses incurred more than one year prior to payment, preventing underwriters from recouping, over time, distribution expenses fronted at the time of sale. *See id.*

22 *See id.*, citing the Statement of the Investment Company Institute Regarding the Operation of Rule 12b-1 Plans, submitted by the Investment Company Institute (the "ICI") in August 1986 in response to the Staff Memorandum.

with limitations that would be the "economic equivalent" of the limitations on front-end sales loads contained in NASD Conduct Rule 2830.[23] That limit was 8.5% of the public offering price, which amounted to 9.2% of the amount invested.[24]

At the behest of the SEC and the ICI, the NASD undertook a study to determine limits on asset-based sales charges that would be the economic equivalent of its front-end sales load limits. The study examined many factors, including the average holding period for fund investments and appropriate measurements for the time value of money. It found that the economic equivalency test would support an annual distribution fee of 75 basis points and that, in addition, an annual service fee of not more than 25 basis points would be appropriate to incentivize brokers and other intermediaries to provide their fund customers with continuing service.[25] Ultimately, with industry support, the SEC approved amendments to NASD Conduct Rule 2830 to impose these limitations on 12b-1 fees.[26] Over the years, front-end sales loads have declined from the 8.0% - 8.5% level that prevailed for equity funds at the time of the NASD study; they now hover around 5.25% - 5.75% of the public offering price (but they now often include a 25 basis point 12b-1 fee or service fee).[27] The NASD limits, however, have not been changed.

Today, 12b-1 fees are widely used in the fund industry. Virtually all intermediary-distributed funds, as well as an increasing number of funds which are primarily no-load funds but have intermediary-distributed share classes, have adopted 12b-1 plans. As noted above, when Rule 12b-1 was adopted, the SEC contemplated that fund assets to support distribution would be used for relatively short periods of time or to deal with particular distribution problems. In fact, they are seldom used in this way today. Instead, 12b-1 plans are used on a continuing basis for different purposes. First and foremost, they are used to provide shareholders with an alternative to the front-end sales load for compensating intermediaries. Second, 12b-1 plans are used to protect payments for administrative and shareholder services performed by distributors of fund shares against an attack that the distribution relationships might preclude fund managers from negotiating such service fees on an arm's-length basis. According to the ICI, over 95% of the 12b-1 plans are used for these two purposes.[28] In addition, some fund

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23 Although the NASD Conduct Rules only apply to fund distributors and not the funds themselves, by prohibiting distributors to sell fund shares with sales loads in excess of the proscribed amounts, the rules effectively regulate mutual fund sales charges.

24 *See* Sec. Exch. Act Rel. No. 30897 (July 7, 1992).

25 These limits are embodied in NASD Conduct Rule 2830(d)(2)(E), which prohibits the offer or sale of fund shares with an asset-based sales charge in excess of 75 basis points and NASD Conduct Rule 2830(d)(5), which prohibits the offer or sale of fund shares with a service fee (*i.e.*, payments by a fund for personal service and/or maintenance of shareholder accounts) in excess of 25 basis points.

26 The amendments revised, among other things, the definition of the term "sales charge" for purposes of the rule to include all "charges or fees that are paid to finance sales or sales promotion expenses, including ... asset-based sales charges" (*i.e.*, 12b-1 fees).

27 In addition, share classes sold without front end loads have grown in popularity in recent years.

28 *See* Use of 12b-1 Fees by Mutual Funds in 1999, *Fundamentals*, Vol. 9. No. 1 (April 2000) available at www.ici.org/pdf/fm-v9n1.pdf.

complexes, most notably the Fidelity Funds, have adopted so-called "defensive" 12b-1 plans which are designed to permit directors to consider the sponsors' distribution expenses in evaluating the reasonableness of management fees.[29]

The widespread use of 12b-1 fees has led mutual funds to establish multiple classes of fund shares in order to accommodate shares purchased under front-end sales load arrangements and under different types and levels of asset-based fee arrangements. The most common fund share classes are Class A, which charge a front-end sales load and often a small annual 12b-1 fee, Class B, which charge an annual 12b-1 fee and impose a contingent deferred sales load ("CDSL") and typically convert automatically to Class A after a period of six to eight years, and Class C, which charge an annual 12b-1 fee and impose a CDSL. Class B and C usually charge the highest 12b-1 fees and impose a sales charge on those shareholders who redeem their shares within specified periods. The CDSL consists of a percentage of redemption proceeds and may decline over the period of investment.

Other share classes commonly provide for reduced levels of 12b-1 fees for shares purchased by participant-directed retirement plans or to pay only for the administrative and servicing expenses in amounts usually not in excess of 25 basis points per year. The development of multiple share classes to accommodate these various 12b-1 plans has served to complicate what otherwise would be a relatively simple corporate or trust structure for investment of a pool of money contributed by a multitude of investors who seek professional management of a diversified portfolio of securities.

Within this context, we now recommend "best practices" for evaluating, and ultimately passing upon, a fund's 12b-1 plan in light of the current strictures of Rule 12b-1. These guidelines are not intended to be obligatory. Instead, because every fund faces different circumstances, directors will need to adapt and apply these guidelines sensitively and flexibly to the issues faced by the individual funds they oversee. Finally, these guidelines are not formulaic, and thus are not designed so that their correct application will somehow produce the "right" answer. Rather, they are designed to assist directors in more effectively applying their judgment to the complex distribution choices faced by funds.

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29 By acknowledging that the fund sponsor may make payments to support the distribution of fund shares, "defensive" 12b-1 plans seek to protect the fund's adviser from allegations that its management contract is merely a conduit for distribution spending.

III. Practical Guidance for Independent Directors Regarding Their Review of 12b-1 Plans

Developing an Understanding of the Fund's System of Distribution and the Role of the Fund's 12b-1 Plan in that System

1. All fund directors should have a general familiarity with the ways in which any fund for which they are responsible is distributed, irrespective of whether the distribution arrangements include a 12b-1 plan.

Along with good investment performance, effective distribution is key to the long-term success of virtually all mutual funds. Among other things, effective distribution of fund shares could reduce costs incurred by fund shareholders by smoothing out cash flows, enhancing and simplifying portfolio management, attracting (and retaining) talented investment professionals, and allowing the realization of economies of scale achievable with larger fund asset size.

In the current marketplace, provision of services to fund shareholders is often part of the distribution system. In particular, the payments that intermediaries receive for the sale of fund shares often includes a variety of components, including compensation for services ranging from the initial sale to the ongoing servicing of shareholder accounts to the provision of individually tailored advice to fund shareholders.

A fund's approach to distributing fund shares – including its use of a 12b-1 plan to finance that distribution -- is generally developed by the fund's adviser and underwriter and then presented to the fund's Board of Directors. Distribution may be paid for in any number of ways, including through front- or back-end loads, through 12b-1 plans, or by revenue sharing or other payments made by the fund's adviser or its affiliates. Because of the importance of distribution to the overall success of the fund, of which a 12b-1 plan is just one piece, directors should both understand the role of and oversee the performance of the fund's primary underwriter. While directors are not responsible for either the design or the day-to-day management of a fund's distribution system, their general oversight responsibilities include an understanding of the arrangements in place for distribution of fund shares.

2. Fund directors should understand how a fund's 12b-1 plan fits into the fund's overall distribution plan.

Accordingly, rather than considering the 12b-1 plan in isolation, directors should first seek to understand the manner in which fund shares are distributed, the economics of the distribution system, and the competitive environment within which their funds operate. By initially undertaking this broader task, directors will be better able to understand the role of the fund's 12b-1 plan in the context of the fund's distribution system.

As part of understanding the role of a fund's 12b-1 plan, directors should identify the types of distribution expenses that the plan is expected to fund. By doing so, directors will be in a better position to determine whether the expenses incurred are appropriate, what (if any) impact they can have on the amount of the expense, and, where there is any flexibility, whether the amount of the expense is reasonable.

Most broadly, 12b-1 plans are often used as a substitute for front-end loads and to pay for other direct expenses associated with the distribution of fund shares. Somewhat more specifically, the key categories of distribution expenses covered by 12b-1 plans are:

- Payments to brokers and other financial advisers for the sale of fund shares;
- Ongoing shareholder services;
- Reimbursements and other payments to fund underwriters; and
- Advertising and other promotional expenses.

In order to understand their fund's 12b-1 plan fully, including the specific types of payments made under the plan, directors should seek to understand how the categories of 12b-1 payments relate to other payments made to intermediaries and the competitive environment within which such compensation is paid.

3. Fund directors should request and obtain from management the materials and information necessary to evaluate the fund's 12b-1 plan, including a breakdown of how 12b-1 fees are being used.

Developing an understanding of the goals and underpinnings of a fund's 12b-1 plan is, by itself, not sufficient to permit fund directors effectively to analyze the plan. Rather, at least with respect to an existing 12b-1 plan, directors need to understand how the plan is, in fact, being used. In order to accomplish this, directors should obtain and review materials regarding the fund's 12b-1 plan, including detailed information regarding how payments are being made pursuant to the plan.

Rule 12b-1 explicitly states that directors have a right (indeed, a duty) to obtain materials related to the plan, including a requirement that directors be provided, on a quarterly basis, "a written report of the amounts so expended and the purposes for which such expenditures were made."[30] Directors need to exercise this authority thoughtfully, and should seek to ensure that they are receiving full and meaningful information about their fund's 12b-1 plan and that that information is sufficiently detailed to permit them to see the purposes for which expenditures are being made, who is the recipient of those expenditures and especially the amount, if any, of 12b-1 fees that are being retained by affiliates of the fund. Obtaining this type of information will place the Board in a better position to evaluate the overall efficacy of the fund's 12b-1 plan.

Directors may also employ other resources as part of their attempt to understand how a 12b-1 plan is functioning. Most notably, directors may wish to seek the assistance

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[30] Rule 12b-1(b)(3)(ii).

of the fund's chief compliance officer as well as their independent counsel in developing a more comprehensive understanding of the operations of the fund's 12b-1 plan. In addition, in more unusual circumstances, directors may consider hiring a consultant or other outside expert to help them understand or analyze particular aspects of a fund's 12b-1 plan.

Basic Steps in Evaluating the Fund's 12b-1 Plan

4. Fund directors need to judge whether continued distribution through the fund's existing intermediate channels is in the best interests of the fund's shareholders.

In analyzing a fund's 12b-1 plan, directors, in the broadest sense, must determine whether the 12b-1 plan is in the best interests of fund shareholders. As developed further below, the process of making this determination depends in large part on the purpose or purposes that underlie the plan, including the distribution channels that the plan is intended to permit the fund to access.

The task, at least on its face, appears most straightforward in situations in which the 12b-1 plan is used exclusively to pay for shareholder, accounting and other services – under these circumstances, directors presumably can focus on the nature, quality and cost of the services that are paid for out of the 12b-1 plan. Nevertheless, directors face the reality that their ability to influence the price paid for services provided by distributors of fund shares is limited and that their ability to influence precisely which services are obtained in return for participating in specific distribution channels is also likely to be restricted.

With respect to a plan that is used partly to pay for services and partly to pay for distribution, the analysis of the expenditures for services should be analogous. However, the analysis may not be simple, as rarely are the costs of the non-distribution services received readily separable from the cost of the distribution services and, in any event, are dictated by competitive conditions. The more that services are wrapped into distribution arrangements – that is, the more that services and distribution are provided to the fund from a single source in a bundled fashion – the more difficult the task becomes to evaluate the nature, quality and cost of the services or to effect changes in the arrangements without affecting the distribution relationship. For example, the services being provided in these circumstances may or may not be of value, and directors will likely not be in a good position to evaluate the value and quality of the services being provided or to influence the cost of the services. Directors may also discover that, as a result of the manner in which services are provided, their ability to evaluate and affect the quality of services is highly circumscribed. To the extent feasible, directors nonetheless should request information concerning the nature, quality and cost of services paid for out of 12b-1 plans.

As a general matter, fund shares must be distributed – assets are likely to decline if the fund is eliminated from significant distribution channels and fund expense ratios may likewise increase, perhaps significantly. Moreover, in the current environment, distribution must be paid for at prices that are set by the marketplace. Faced with these harsh realities, directors may sometimes, as a practical matter, be limited to doing little more than determining whether continued distribution of fund shares is in the best interests of shareholders; to the extent that directors believe that it is, and that the management company cannot fully defray distribution expenses, they may well have few options other than to approve the continuance of the fund's existing 12b-1 plan.

However, directors may find some bases on which they can further explore this analysis. For example, directors may examine the extent to which payments are made out of the fund to affiliates of the management company and to what extent they are made to non-affiliates (*e.g.,* selling brokers). While directors may have a very limited ability to assess and effect payments made to third parties, in some circumstances where competitive factors do not operate they may well consider whether to subject payments made to fund affiliates to additional scrutiny -- particularly if, due to the nature of these payments, they feel they have a greater ability to influence them.

5. The factors and considerations that fund directors use to analyze the value and efficacy of the fund's 12b-1 plan should be related to the purposes of the plan.

For many directors, the annual and quarterly reviews of a fund's 12b-1 plan can seem frustrating or pointless. Because most intermediaries demand a specific asset-based payment for their services (and will simply refuse to distribute a fund's shares absent such payments), most 12b-1 fees are effectively fixed by competitive forces. As a result, directors often feel that they have little control over the level of most 12b-1 expenditures – notably, 12b-1 fees paid in lieu of a sales load to cover payments to selling intermediaries are generally set by the marketplace and, in some sense, are specifically agreed to by shareholders as a result of their choices regarding which share class they purchase.

As a result of this frustration, directors may feel tempted to look at a standardized list of factors, such as those previously identified by the SEC, and adopt a "check the box" approach to evaluating the fund's 12b-1 plan. As described in more detail below, however, in order to successfully fulfill their obligations, directors need to resist this temptation. Instead, through careful analysis of the purposes of their fund's 12b-1 plan and of the expenditures it is actually making, directors should seek to identify a set of factors (whether or not those factors were on the SEC's original list) that is relevant to the plan they are evaluating, and use those factors to determine what action they should take with respect to the plan. Set forth below are factors that may be relevant in evaluating plans that, at least partially, substitute for a front-end load, and factors that may be relevant in evaluating plans that, at least partially, pay for administrative and shareholder support services received, in most instances, from distributors of fund shares. Many plans serve both of these purposes, and some plans may have other purposes. Whatever the circumstances, the evaluation is most effective when it is tailored to the actual purposes of a fund's 12b-1 plan.

6. **As part of their review of the fund's plan, fund directors should be aware of the factors identified in the SEC's initial adopting release for Rule 12b-1. However, they need consider only those factors relevant to their fund's circumstances, and should assign those factors an appropriate weight as part of their analysis of whether to continue, alter or eliminate their fund's 12b-1 plan.**

The SEC has identified factors that directors may wish to consider in their review of their fund's 12b-1 plans. Most prominently, in the Rule 12b-1 Adopting Release, the Commission identified nine factors, ranging from the consideration of alternative plans of distribution to the benefits that the plan would provide to persons other than the fund and its shareholders, that it believed were likely relevant to directors' consideration of 12b-1 plans.[31]

The SEC was very clear, however, that it was not mandating that "directors … consider any particular factors."[32] Thus, directors are neither legally obligated specifically to consider each of the enumerated factors nor prohibited from considering other factors that they identify as relevant. Given the complexity of the environment within which funds are distributed, this type of discretion is appropriate – review of a 12b-1 plan should not be a pro forma process in which a static list of factors is dutifully considered, but rather should be the result of an analysis by directors of how their fund is distributed and how the fund's 12b-1 plan is used to facilitate that process. As a result of this analysis, directors are likely to identify some factors that are important, some that are less important and some that are clearly irrelevant. While directors may well determine that few of these factors are ultimately relevant to their fund's specific circumstances, they nonetheless should review and consider the relevancy of the Commission's list of factors as part of their overall analysis.

Basic Considerations that May Warrant Use of Fund Assets in Support of Distribution

7. **Directors should consider the ways in which continued distribution of fund shares, and, in particular, the use of fund assets to pay for distribution, will potentially benefit fund shareholders.**

One might view the point of using fund assets to pay for distribution as little more than an attempt to increase a fund's size so that shareholders can more easily obtain, through reduced expense ratios, the benefits of any economies of scale realized by the adviser. This view, however, may seem overly simplistic from the perspective of directors required to review the benefits, in the context of current competitive fund industry, of continuing to pay for the distribution of fund shares and the potential impact on their fund of not doing so.

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31 For a list of the factors, see *supra* note 10.

32 Rule 12b-1 Adopting Release.

- For example, directors should consider whether continuance of a fund's 12b-1 plan will minimize the disruption to portfolio management that otherwise might be caused by the need to sell portfolio securities to satisfy ongoing redemption requests. A fund that experiences a prolonged period of net redemptions or even a fund that experiences uneven cash flows will likely be more difficult and expensive to manage than a fund with stable assets or a fund with steadily growing assets. In particular, every time that a portfolio manager is forced to sell securities solely to meet redemptions, the costs of doing so will be passed on to shareholders who remain in the fund. These costs may include everything from opportunity costs to transaction costs to the tax impact of engaging in unnecessary transactions. To the extent that continuing to distribute fund shares and supporting that distribution through a 12b-1 plan minimizes the need to engage in unnecessary transactions, directors may conclude that using a 12b-1 plan to support distribution is in the best interests of fund shareholders.

- Directors should also consider whether continuance of a fund's 12b-1 plan will lead to a greater stability of (or a more predictable change in) fund assets that, if achieved, will allow shareholders to obtain benefits that otherwise would not be realized. Directors examine economies of scale in a number of contexts, most notably as part of the annual 15(c) process. Review of the fund's system of distribution and its 12b-1 plan provides another context within which directors may consider this issue. In particular, to the extent that economies of scale exist, they cannot be realized unless the fund grows in size. One key variable affecting a fund's potential growth is the success of its distribution efforts. If directors believe that the fund can obtain further economies of scale by growing, and that the fund's 12b-1 plan reasonably contributes to the fund's growth and that growth will benefit shareholders, it is clearly appropriate for them to consider this possibility in evaluating the fund's 12b-1 plan.

- Directors may also wish to consider whether continuance of the fund's 12b-1 plan will permit fund shareholders to obtain other benefits from growth in assets (such as increased investment by the adviser in its compliance functions, its asset management capabilities, including portfolio management personnel, and back-office functions). Likewise, directors may conclude that asset growth (or at least asset stability) is necessary to motivate existing investment staff and to recruit new talent. While these benefits may not be as obvious as those produced by predictable cash flows and a growing asset base, they are nonetheless benefits that can have a significant positive impact on fund shareholders, and thus should appropriately be considered by directors as part of the 12b-1 process.

Evaluating those Parts of the Fund's 12b-1 Plan that Substitute for a Load

8. **Directors may consider the need of the fund to penetrate particular distribution channels in the marketplace, as well as the competitive conditions within those channels, as part of their analysis of the fund's 12b-1 plan.**

In the current market environment, many different distribution channels are available to funds and advisers. Because successful distribution of fund shares depends upon reaching as many potential shareholders as possible, most funds seek to use all or virtually all of the available channels. In most cases, the costs of using a particular distribution channel (such as distributing fund shares through a variety of prominent fund supermarkets) will not be negotiable. Hence, once a channel is selected, there is generally little choice but to pay the costs associated with the channel, whether through a load, fees paid by the management company or by the fund through a 12b-1 plan, or otherwise.

Because a major part of the costs of many of the channels are paid out of 12b-1 plans, directors need to understand how use of these channels fits in with the fund's overall plan of distribution. While the selection of a particular channel is best left to the business judgment of the fund's adviser, the directors' should seek to assure themselves that the costs associated with particular distribution channels are justified by competitive conditions and thus are not clearly unreasonable. In order to do so – as well as to better understand the fund's overall system of distribution – directors should seek to familiarize themselves, to the extent possible, with the competitive environment within which the various distribution channels operate.

9. **In appropriate circumstances, fund directors may wish to consider whether fund shareholders (or shareholders of a particular class) have effectively agreed to pay specific amounts to support distribution of the fund to them.**

For those funds that use 12b-1 fees as a substitute for loads, a significant portion of the expenditures made pursuant to a 12b-1 plan will be payments to brokers and other financial advisers who advise their clients whether to purchase the fund's shares and whether to continue to hold the fund's shares. These intermediaries require compensation for the services that they provide to fund shareholders, and their compensation is often financed through a fund's 12b-1 plan.

As discussed further below, the appropriateness of these payments likely depends less on the actions and review of fund directors and more on whether selling intermediaries provide their clients with full disclosure and engage in suitable selling practices. The compensation that intermediaries receive is generally fixed by the marketplace (and, to the extent it is negotiated, it is not negotiated by the shareholder, but rather results from negotiations between the adviser and the intermediary). These compensation arrangements also can be viewed as representing the shareholder's implicit agreement to compensate the intermediary upon whom he or she relies for advice. In addition, as a result of the growth in the number of funds that have multiple share classes with differing levels of 12b-1 fees, individual shareholders have some ability to choose the manner in which their representatives will be compensated. In these circumstances, it is appropriate for fund directors to be reluctant to upset what reasonably can be viewed as financial arrangements agreed upon by shareholders and intermediaries.

The success and fairness of distributing through intermediaries in this manner depends on whether the intermediaries that sell fund shares comply with their own legal obligations – that is, whether those intermediaries appropriately disclose the structure of their compensation arrangements, fully advise their clients on the impact of investing in different share classes and recommend the purchases of share classes that are appropriate for their individual clients. Funds and directors have a limited ability to monitor whether intermediaries are satisfying these obligations and, indeed, are not primarily responsible for ensuring that they do so. However, directors should be prepared to address their fund's share class structure carefully if it becomes apparent that that structure encourages unsuitable sales. In addition, although directors do not have an independent obligation to seek to identify abusive sales practices, they nonetheless should inquire whether the fund's adviser has processes in place to monitor distribution issues such as suitability, seek to understand how these processes function and take appropriate action if they become aware of widespread abuses. In the end, however, ensuring that sales are suitable and that appropriate disclosure is given to shareholders remains the primary responsibility of the intermediaries who sell fund shares.

10. Although fund directors should review carefully the need for a 12b-1 plan when a fund is closed to new investors, the need to repay amounts already spent distributing the fund can warrant continuance of the plan.

On the face of it, it may seem unnecessary for a fund that is closed to new investors to have a 12b-1 plan – after all, a fund that is not seeking to sell additional shares may seem not to need to pay for the distribution of shares.[33] However, as is true of

[33] The question of whether to close a fund to new investors (or to all new investment) may well arise as part of the directors' review of a funds 12b-1 plan. It can arise in many other areas as well, including as part of the annual 15(c) process or as part of the Board's review of the fund's performance.

While a full delineation of the factors that directors should consider in determining whether to close a fund is far beyond the scope of this paper, we nonetheless note the following. Under certain circumstances, closing a fund may benefit existing fund shareholders. For example, if the fund has grown quickly or invests in small or illiquid markets, continued growth in the fund's assets – and hence, continued distribution efforts – may no longer be in the best interests of fund shareholders. Needless to say, the issue of whether continued growth in fund assets benefits or harms shareholders involves a delicate balancing of many factors, including the potential benefits of achieving further economies of scale against the constraints potentially applicable to a larger fund – a balance that is rarely easily quantifiable. Further, the decision to close a fund raises numerous other issues -- including when to close it, whether to close it to all new investment or just new investors, and how to monitor the effectiveness of the closure – factors that, as noted above, are beyond the scope of this analysis of the role of directors in approving and monitoring 12b-1 plans.

a fund that remains open to new investors, a closed fund may still need to reimburse other parties for funds that have already been advanced to compensate selling intermediaries, in effect continuing the agreed upon financial arrangements reached between shareholders and intermediaries. If directors would have approved this use of the fund's 12b-1 plan had the fund remained open, they may approve use of a closed fund's 12b-1 plan for the same purposes.

More specifically, in many cases (as is discussed more fully above in point 9), the fund may have an ongoing responsibility to compensate intermediaries who have sold fund shares in the past (and may be continuing to provide services to find shareholders) or may need to reimburse the fund's sponsor or adviser for distribution-related costs that it has incurred. In cases such as this, directors may conclude that there are valid reasons for a closed fund to continue to have a 12b-1 plan. Again, as noted above, the decision to continue a 12b-1 plan under these circumstances depends upon a full understanding of the purposes of the plan within the fund's overall distribution system.

Evaluating those Parts of a 12b-1 Plan that Pay for Administrative and Shareholder Support Services

11. With respect to each of the services being funded through a 12b-1 plan, directors should examine whether the cost of the service is reasonable in light of the nature of the service generally and the quality of the specific service being obtained.

Evaluation of the services provided via a 12b-1 plan is, for directors, potentially similar to the evaluation of other services the purchase of which by the fund is overseen by directors. In particular, directors should attempt to evaluate the cost and quality of the service being purchased and should, if the appropriate data is available, compare the price and quality of the service being acquired with what is offered by other providers.

In many cases, however, this analysis will not be this simple. The services being analyzed – for example, sub-transfer agency services – often are packaged together with distribution services or come as part of a distribution platform. In circumstances like this, it may be difficult to determine accurately the true cost of the service being provided or accurately ascertain its quality. Moreover, if the service comes as part of a distribution channel or distribution platform that the fund desires or needs to use, acquisition of the service from the distribution partner may be, effectively, mandatory. Further, it is often difficult for directors, who are removed from day-to-day shareholder servicing activities, to evaluate fully the quality of services provided. In cases like this, analysis of the cost and quality of the service will quickly collapse into an inquiry into whether continued use of the distribution channel is in the best interests of fund shareholders, and all the difficulties involved in this type of analysis (as outlined above) will continue to exist.

IV. Conclusion

In sum, the requirements of Rule 12b-1 that provide for initial and ongoing review of 12b-1 plans put independent directors in an almost impossible position. Fund management companies face a conflict in administering 12b-1 funds, as they have an incentive to use fund assets to promote distribution of fund shares in order to increase the rate of growth in fund assets and thereby increase their own profitability. Doing so may also benefit fund shareholders, as increasing (or just stabilizing) inflows to the fund can have the effect of reducing the percentage level of fund expenses, but it will not necessarily do so – or, more importantly, different levels of spending on distribution may have very different impacts on how fund assets change and equally different impacts on the level of expenses.

However, the rule asks directors to engage in this almost impossible task. Directors are thus, in some ways, being asked to predict before the fact whether paying distribution costs will increase fund assets and thereby allow shareholders to reap the benefits of lower expense ratios. Even after the fact, it will be difficult – if not impossible – for directors to know the extent to which the 12b-1 plan has enhanced the distribution of a particular fund's shares. And, even if directors could determine conclusively that it did not, in considering whether to eliminate a 12b-1 plan in today's market environment, they would be faced with the possibility of halting distribution of shares, potentially seeing fund assets drop sharply, and potentially incurring an equally sharp jump in fund expenses.

In short, Rule 12b-1, as currently structured, simply does not reflect the current marketplace. Directors, who are required to evaluate 12b-1 plans to determine whether they are in the best interests of fund shareholders, are thus asked to take on a task that, in the present environment, they are not well-positioned to perform. Rule 12b-1 thus cries out for serious review and ultimately significant reform.

Nonetheless, fund directors must comply with existing law and, in the exercise of their fiduciary duties, should do as much as possible to ensure that the manner in which a fund's shares are distributed is consistent with the best interests of fund shareholders. The Forum remains committed both to the reform of Rule 12b-1 and its role in the fund distribution process on behalf of fund directors (and, ultimately, fund shareholders) and thus intends to continue studying potential alternative approaches to the existing system governing the payment of fund distribution costs. In addition, the Forum remains committed to producing papers such as these guidelines, as part of its mission of helping fund directors meet their obligations under existing law as effectively as possible.

TAB 4

CHAPTER FOUR

RULE 17a-7-AFFILIATED PURCHASES

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.

Section 17(b) of the 1940 Act permits that an exemption may be granted if the terms of the proposed transaction are reasonable and fair and do not involve overreaching on the part of any person concerned. Various rules under Section 17(a) allow for certain transactions between affiliated Funds without first obtaining an SEC exemptive order prior to the transaction taking place. These rules contain certain requirements to protect investors against overreaching of Funds participating in the transaction.

What does the Board need to do and why?

The Board, including a majority of the Independent Directors, is required to: (1) adopt procedures governing securities transactions between a Fund and its affiliated persons, and (2) determine no less frequently than quarterly that all such transactions made during the preceding quarter were effected in compliance with such procedures.

What are the standards?

As described in more detail below, the standards for review are set forth in Rule 17a-7. The Rule requires Directors to initially adopt Rule 17a-7 procedures to make and approve any changes and determine quarterly that all Rule 17a-7 transactions were conducted in compliance with these procedures.

What information do Boards need?

Quarterly, the Board must review for each Rule 17a-7 transaction whether:

- **the transaction is a purchase or sale solely for <u>cash payment against prompt delivery;</u>**
- **the transaction is effected at the <u>independent current market price</u> of the security;**
- **the transaction is <u>consistent with the policy</u> of each Fund participating in the transaction; and**
- **<u>no brokerage commission</u>, fee (except customary transfer fees) or other remuneration is paid in connection with the transaction.**

Who provides Boards with information?

The Board should request from the Adviser and/or the Fund's CCO information supporting the Board's review of each Rule 17a-7 transaction. Such information generally includes the name of the participating Fund and a statement ("yes" or "no") whether the transactions involved were between affiliated Funds. When the Fund operates under a MOM structure, the Rule 17a-7 transactions may be between a Fund in the Fund family and another fund managed by the sub-adviser. Many Boards also request a certification from the sub-adviser that all such transactions were conducted in material compliance with Rule 17a-7.

TAB 5

CHAPTER FIVE

RULE 17e-1-AFFILIATED BROKERAGE TRANSACTIONS

Policy

Section 17(e)(2) of the 1940 Act prohibits an affiliated person from receiving remuneration exceeding the "usual and customary broker's commission." Section 17(e) was intended to prohibit situations where an affiliated person would operate 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 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 is reasonable and fair as compared to remuneration received by other similar brokers in comparable transactions. Through Rule 17e-1, the SEC sought to ensure that an affiliated broker would receive no more than the remuneration which would be expected by an unaffiliated broker.

What does the Board need to do and why?

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; and (2) determine no less frequently than quarterly that all such transactions made during the preceding quarter were effected in compliance with such procedures.

Rule 17e-1 is designed to permit an affiliated person (e.g. a broker-dealer that is affiliated with the Fund's adviser or sub-adviser) to collect a brokerage commission on agency transactions, which are transactions where the affiliated person acts as an intermediary between the Fund and the buyer or seller on the other side of the trade. Rule 17e-1 does not permit the affiliated person to collect brokerage commissions for principal transactions, which are trades that the affiliated person buys or sells a security for its own account.

Normally, 17e-1 procedures are adopted by a Fund Board at the time of the Fund's organization. Subsequently, a Fund Board reviews all such transactions on a quarterly basis for compliance with the procedures.

What are the standards?

As described in more detail below, the standards for review are set forth Rule 17e-1. The rule requires Directors to initially adopt Rule 17e-1 procedures, make and approve any changes and determine quarterly that the procedures are being followed.

What information do Boards need?

Quarterly, the Board must review the following information on each Rule 17e-1 transaction, comparing the commission received by the affiliate to the commission 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.**

Who provides the Board with the information?

The Board should request from the Adviser and/or the Fund's CCO information supporting the Board's review of each Rule 17e-1 transaction. Such information typically includes: the name(s) of the Fund(s) involved in the affiliated brokerage transaction; the number of such transactions that the Fund(s) participated in during the preceding quarter; the total dollar amount of commissions paid to the affiliated broker; and the average commission paid per share. For Funds operating in a MOM structure, this information is provided by each Fund's sub-adviser(s). Many Boards also obtain a certification from each sub-adviser that each affiliated brokerage transaction during the preceding quarter was conducted in material compliance with Rule 17e-1.

TAB 6

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, or which an officer or director may be the principal underwriter.

The SEC adopted Rule 10f-3 in order to permit a Fund to purchase from an underwriting syndicate without first obtaining an exemptive order. The availability of Rule 10f-3 is subject to certain conditions that are intended to make it unlikely the purchase would not be consistent with the protection of investors.

What does the Board need to do and why?

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; and (2) determine no less frequently than quarterly that all such transactions made during the preceding quarter were effected in compliance with such procedures.

Normally, the Rule 10f-3 procedures are adopted by a Fund Board at the time of the Fund's organization. Subsequently, a Fund Board reviews all such transactions on a quarterly basis for compliance with the procedures.

What are the standards?

As described in more detail below, the Rule requires Directors to initially approve Rule 10f-3 procedures, to approve any changes in such procedures and to determine quarterly that all purchases made during the preceding quarter were done in compliance with the procedures.

What information do Boards need?

The procedures require the Board to review quarterly the following information for <u>each</u> Rule 10f-3 transaction to determine whether:

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

- **The <u>timing and price</u> of the transaction is consistent with the standards set forth in Rule 10f-3.**
- **The issuer has <u>3 years continuous operations</u>, including the operations of any predecessor.**
- **The security is part of a <u>firm commitment underwriting</u>. 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 those purchased by others pursuant to a rights offering, if the underwriters purchase any of the securities.**
- **The commission or spread by the principal underwriter is <u>reasonable and fair</u> compared to the commission or spread on similar securities being sold during a comparable period of time.**
- **The purchased security complies with the <u>percentage limitations</u> contained in Rule 10f-3.**
- **<u>No affiliated person (other than the affiliate that is part of underwriting syndicate) participates</u> directly or indirectly in the Fund's purchase.**

Who provides Boards with information?

The Board should request from the Adviser and/or the Fund's CCO information supporting the Board's review of each Rule 10f-3 transaction. Such information generally includes: the name of the Fund participating in the affiliated underwriting transaction; the name of the affiliated underwriter(s); the aggregate principal purchase/offering amount; the commission paid; and the date of the transaction. For Funds operating under a MOM structure, each sub-adviser must provide this information (including the identity of its affiliated underwriter). Additionally, many Boards receive a certification from each sub-adviser that all affiliated underwriting transactions in which a sub-adviser participated during the preceding quarter were conducted in material compliance with Rule 10f-3.

TAB 7

CHAPTER SEVEN

RULE 38a-1

COMPLIANCE POLICIES AND PROCEDURES

What do the Directors need to do and why?

The Board, <u>including a majority of the Independent Directors,</u> 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, Principal Underwriter, 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.

What are the standards?

As described in more detail below, the standards for review are set forth in 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 needs 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, Principal Underwriter, 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 in consultation 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), Principal Underwriter, Administrator, and Transfer Agent (each, a "Service Provider," and collectively, the "Service Providers"). The Board, including a majority of the Independent Directors, must approve the adoption of the Fund's written compliance polices 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.

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;
- 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.[3]

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).[4]

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[1] The SEC has adopted a separate rule, Rule 206(4)-7 under the Advisers Act that imposes similar, but not as extensive, 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 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].”

[4] 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.

TAB 8

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 transactional-related expenses are used properly to benefit the Fund.

This responsibility is not required by any statutory provisions but is inherent in the Directors' exercise of their fiduciary duty, particularly their duty of care. This responsibility is on-going throughout the year.

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 typically 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. 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.[1] In fulfilling their oversight responsibilities, Directors are subject to the state law duty of care and duty of loyalty.[2] 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."[3] 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.

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. For example, some firms may believe that their clients and process is 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 and 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.

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. Typically, commissions range from a penny per share to about 4 cents. Smaller cap issues tend to trade at higher rates, and some international securities may be significantly above these levels. Larger managers have the ability to generally 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.

Electronic trading is often thought to be the "best" way to execute trades due to low commission rates. However, these trades may be completed over a longer period of time with higher impact or delay costs unless the market is very deep or liquid. Studies have shown that execution rates are lower than other options (i.e. the whole trade is not always completed), and that speed of the execution can vary significantly.

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 more than 30 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, most recently in 2006.[4]

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.

While the SEC guidance addressed Adviser practices, many Directors remain uncomfortable with this oversight responsibility. It is a complex area, and commission dollars may represent a sizeable Fund asset. Commissions may cost shareholders as little as 1-2 basis points or as much as 75 basis points, depending on the type of Fund, the securities purchased and portfolio turnover. On average, commissions will reduce shareholder returns by 15-20 basis points. Trades done in exchange for research or services are typically done at higher commission rates, thus driving up the impact on shareholders.[5]

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

Though use of an affiliated broker is not widespread, it is an obvious area of potential conflict of interest. Directors should question the volume and types of trades which the 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. Information should be provided on the types of research or services purchased, and whether they are proprietary, mixed use or third party. Directors should be mindful that they have the authority to direct how their Fund’s Adviser uses soft dollars.

The Adviser should also 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 the 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 (i.e. 5-10 basis points), 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 obviously 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.

Additionally, in recent years, there has been continuing discussion of the possibility of unbundling the execution and soft-dollar portions of commissions to permit Directors and others to better understand and more effectively monitor soft dollars and the associated questions of best execution. A number of Directors have either considered or are beginning to insist on unbundling, at least in some circumstances, to better oversee how their Funds' trades are executed, how their Funds use soft dollars, and how the associated conflicts are managed.

Recent Developments

As the industry continues to develop alternative trading systems, regulators continue to keep the pressure on with respect to transparency in trading and execution costs. In October 2012, the SEC published its final rule requiring national securities exchanges and self-regulatory organizations (SROs) to submit a national market system ("NMS") plan to create, implement, and maintain a consolidated order tracking system, or consolidated audit trail, with respect to most publicly traded securities in the U.S. The NMS plan would capture information for orders in across all markets, from the time of order inception through routing, cancellation, modification, or execution, and will allow the SEC to better monitor inappropriate market manipulation. Additionally, FINRA recently built a unified surveillance system to examine markets and look for abuse across exchanges and dark pools. A report issued by FINRA noted that 50 threat scenarios have been identified and that the agency will continue to look for abuses based on the new threat scenarios and its own regulatory intelligence.

In July 2008, the SEC proposed guidance for Independent Directors in meeting their responsibilities in overseeing their Funds' soft dollar arrangements. The SEC has not moved to formally amend or adopt this guidance and it remains proposed.

In 2008 the Securities Industry and Financial Markets Association ("SIFMA") published a white paper *Best Execution Guidelines for Fixed-Income Securities* to address the dearth of 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."

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[1] *See* Report of the Mutual Fund Directors Forum: Best Practices and Practical Guidance for Mutual Fund Directors (July 2004) at 11 – 13.

[2] *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). Additionally, this proposed guidance reminds Directors that they also have fiduciary duties imposed by the 1940 Act due to the external management of mutual Funds.

[3] 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).

[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).

[5]A study completed in early 2007 of 169 mutual Fund companies (approximately 29% of the industry) evaluated the extent of soft dollar usage in the industry. Essentially all complexes have general language in their registration statements indicating the authority to purchase research and services with soft dollars.

Disclosure of the actual dollar amount of commissions directed to soft dollar activities is not required, and only 2/3 of the complexes reviewed provided this information. Among those companies choosing to provide dollar amounts, soft dollars represent about 33% of total commissions, with modestly higher use among complexes with less than $15 billion, and somewhat lower use by the larger complexes.

Within each peer group, the dispersion of the results was broad. Approximately 12% of the complexes reported no actual usage of soft dollars. At the other end of the spectrum, almost 17% used more than 75% of commissions to purchase research and brokerage services.

TAB 9

CHAPTER NINE

VALUATION OF PORTFOLIO SECURITIES

What do the Directors need to do and why?

Directors are required to establish procedures for, and oversee the valuation and daily pricing of the securities and other assets held by a Fund. This responsibility is required by Section 2(a)(32) and Rule 2a-4 under the 1940 Act. The process Directors' use is described below.

The valuation of portfolio securities is an important role for Fund Directors. The inspection Staff at the SEC has been focusing on policies and procedures that Directors have adopted to value portfolio securities and whether Directors adequately discharged their responsibility to monitor that those policies and procedures are being followed. The SEC has instituted enforcement actions against Funds and their Directors, including Independent Directors, in situations where portfolio securities were not properly valued.

What are the standards?

As described in more detail below, the standards for review are set forth in various SEC releases, no-action letters, speeches and enforcement proceedings.

What information do Directors need?

Directors need to review information about:

- **Characteristics of the Fund's portfolio securities and the markets in which they trade, and**
- **The daily pricing procedures used by the Fund's pricing agent.**

Who provides the information to the Directors?

Directors may receive information on portfolio pricing and the pricing protocols from the Fund's Treasurer or Fund administrator. Directors may also receive a legal memorandum from its Independent Counsel about the standards applicable to the Directors' consideration of valuation issues. In addition, Directors may also want to consult with the Fund's pricing agent and consultants of securities pricing issues from time to time.

Statutory Requirements

The 1940 Act requires Funds to sell and redeem their shares at a price based on "current net asset value" ("NAV"). Section 2(a)(32) and Rule 2a-4 under the 1940 Act define NAV as the amount that reflects calculations made substantially in accordance with the following guidelines:

- Portfolio securities for which market quotations are readily available must be valued at current market value;
- Other securities and assets for which market quotations are <u>not</u> readily available must be valued at fair value as determined in good faith by the Directors; and
- Changes in portfolio holdings must be reflected no later than the first business day following the trade date.

Though the 1940 Act does not define a "readily available market quotation," "fair value," or the term "good faith" in the context of the valuation of portfolio securities and assets, generally accepted understandings of the terms have evolved over time.

"Readily Available Market Quotation"

Exchange-traded securities generally have a readily available market quotation because they are regularly traded. Securities regularly traded by dealers in the 144A institutional market are also generally considered to have readily available market quotations. Other securities that are not listed on an exchange, but are regularly traded by dealers, are considered to have readily available market quotations. At some point however thinly traded securities do not have a regularly available market quotation. In addition, there are certain events that can cause a security to have a price that is not considered a readily available market quotation.

For example, the staff of the SEC (the "Staff") has indicated that a security may no longer have a readily available current market quotation under certain circumstances, including:

- When the market for the security closes before the Fund values its securities (typically 4:00 p.m. Eastern time, when the major U.S. exchanges close);
- When a security is subject to a trading halt and the halt remains in effect at the end of the day;
- When entire markets close, as a result of a significant event (weather, terrorism, natural disasters or massive electric outages);
- When markets close due to scheduled holidays;
- When there is no trading in a security; or
- When another "significant event" occurs, either with respect to an individual issuer, or with respect to a sector, the economy, or a country as a whole.

Once a determination has been made that market quotations are not readily available for a security, that security must be valued, in good faith, at its fair value.

Fair Value Determinations

In September 2006, the FASB issued FAS 157 on Fair Value Measurements. Additionally, since 1969, the Staff has issued five major interpretations of the 1940 Act's valuation standards. Each of the interpretations outlined below expanded the factors that Fund Directors and Advisers must take into account when making fair value determinations.[1]

<u>FAS 157 (September 2006)</u>

FAS 157 defines fair value and deals with two other primary areas: (1) fair valuation measurement protocols, and (2) financial statement disclosure of measurement techniques.[2] FAS 157's definition of pricing for Fair Value Measurements focuses on <u>the price that would be received upon the sale of the asset</u> (an exit price), not the price that would be paid to acquire the asset (an entry price). Fair value is a market-based measurement, not an entity-specific measurement: that is, the fair value price should be what the market would pay for the asset, not its intrinsic worth. FAS 157 is applicable to all public issuers of securities including Funds. The following is an overview of FAS 157 particularly as it applies to Funds.

FAS 157 considers the use of an "exchange price" as a key component of Fair Value Measurements. The exchange price is the price that would be received upon the sale of an asset in an orderly transaction between market participants in the principal or most advantageous market[3] at a measurement date. An orderly transaction is one that:

- Assumes exposure to the market for a period prior to the measurement date to allow for the marketing activities that are usual and customary for transactions involving such assets and
- Is not a forced transaction (for example, a forced liquidation) (a.k.a. "a fire sale").

Market participants are:

- Buyers and sellers in the principal (most advantageous) market;
- Independent of the reporting entity;
- Knowledgeable;
- Able to transact for the assets; and
- Willing to transact, motivated, but not forced to or otherwise compelled to engage in the transaction.

The reporting entity need not identify specific market participants. Rather, it should identify the characteristics that distinguish market participants.

Four elements are critical to a principal (most advantageous) market:

- The Fair Value Measurement assumes that the transaction would occur in the principal market for the assets, or in the absence of a principal market, the most advantageous market for the asset;
- The principal, or most advantageous market, should be considered from the viewpoint of the seller;

- The principal market is the market in which the reporting entity would sell the asset with the greatest volume and level of activity for such asset;
- The most advantageous market is the market in which the reporting entity would sell the asset with the price that maximizes the amount that would be received.

FAS 157 uses a hierarchy of valuation modes: market approach, income approach, and cost approach. It also establishes a fair value hierarchy for inputs into Fair Value Measurement techniques if there has been a significant event after the close of the market. In this circumstance, closing quoted prices may not accurately reflect Fair Value at the measurement date.

Valuation techniques used to measure fair value shall be consistently applied. However, a change in a valuation technique is appropriate if the change results in a measurement that is equally or more representative of their value in the circumstances.

Accounting Series Release No. 113 (Restricted Securities) ("ASR 113") (October 21, 1969)

ASR 113 defines fair value to be "the amount which the owner might reasonably expect to receive for [the securities] upon their current sale." Although there can be no "automatic formula" by which a Fund can value restricted securities, ASR 113 requires that the Fund's Directors consider all relevant factors, including the operations of the issuer, changes in general market conditions and the extent to which the inherent value of the securities may have changed.[4]

ASR 113 rejects four methods of valuation:

- The continued valuation of restricted securities at cost where changes in the issuer's operations or general market conditions indicate that cost no longer represents fair value.
- The application of either a constant percentage or an absolute dollar discount to the market price for unrestricted securities of the same class without regard to other relevant factors such as the extent to which the inherent value of the securities may have changed.
- The valuation of restricted securities by reference to the market price for unrestricted securities (this method improperly assumes that the market price for unrestricted securities of the same class is representative of the fair value of the restricted securities).
- The valuation of restricted securities, acquired at prices below market quotations for similar unrestricted securities, by amortizing the difference over a period of time on the assumption that the unrestricted securities will be sold at the market price at the expiration of such time period.

Accounting Series Release No. 118 (General Guidance) ("ASR 118") (December 23, 1970)

ASR 118 provides significant additional guidance with respect to the process by which a Fund values its portfolio securities. The SEC noted that where market quotations are not readily available, either as a result of the lack thereof or a Fund's determination that the existing quotations are unreliable or otherwise invalid, a Fund must price its securities at fair value. In fair value pricing:

> *It is incumbent upon the board of directors to satisfy themselves that all appropriate factors relevant to the value of securities for which market quotations are not readily available have been considered and to determine the method of arriving at the fair value of each such security . . . The board must also, consistent with this responsibility, continuously review the appropriateness of the method used in valuing each issue of security in the company's portfolio.*

ASR 118 delineates several non-exclusive methods of valuation Directors may use when acting in good faith to value portfolio securities. These valuation methods may be based on:

- A multiple of earnings;
- Discount from the market price of a similar freely traded security;
- A yield to maturity with respect to debt issues; or
- A combination of these principles.

Further, the Directors should consider several general factors when choosing a valuation method, including: the fundamental and analytical data relating to the investment; the nature and duration of any restrictions on disposition of the securities; and an evaluation of the forces which influence the market in which the securities are purchased and sold.

Finally, ASR 118 also specifies a number of more specific factors Directors should consider, including: (1) the type of security; (2) the financial statements of the issuer; (3) the costs of the security at the date of purchase; (4) the size of the Fund's holdings; (5) the discount from market value of unrestricted securities of the same class at the time of purchase; (6) special reports prepared by analysts; (7) information as to any transactions or offers with respect to the security; (8) the existence of merger proposals or tender offers affecting the securities; (9) the price and extent of public trading in similar securities of the issuer or comparable companies; and (10) any other relevant matters.

Taken together, these valuation methods, and the general and specific factors, provide a framework within which Directors must work to price at fair value securities for which market quotations are not readily available. However, ASR 118 makes clear that such factors are not exclusive. Rather, in order to comply with its duty of good faith, the Fund's Directors must take into account all available indicators of value in an effort to determine the amount that the Directors might reasonably expect to receive upon the current sale of each security.

Investment Company Institute No-Action Letter (December 8, 1999) (Emergency of Unusual Situations) ("1999 Letter")

The 1999 Letter sought to provide guidance with regard to the valuation of Fund shares during emergency or unusual situations. Specifically, the 1999 Letter clarified that market quotations for portfolio securities are not "readily available" when the exchange or market on which the securities trade is not open for trading for an entire day, and that Funds, accordingly, must price those securities based on their fair value.

The 1999 Letter also expands on ASR 118's list of general and specific factors Directors should consider when fair value pricing portfolio securities. For example, the Staff noted that the available fundamental, analytical information with respect to a security is generally the most important factor the Fund's Directors should consider. Directors also should consider the following external sources of information: (1) the value of other financial instruments, including derivative securities traded on other markets or among dealers; (2) the trading volumes on markets, exchanges or among dealers; (3) the value of baskets of securities traded on other markets, exchanges or among dealers; (4) changes in interest rates; (5) observations from financial institutions; (6) government (foreign or domestic) actions or pronouncements; and (7) other news events.

The 1999 Letter also seeks to provide Directors with some guidance as to what constitutes good faith in the context of fair value pricing. To that end, the 1999 Letter acknowledges that good faith is "a flexible concept that can accommodate many different considerations, including the incorporation of a variety of sources of information." Indeed, the action the Fund's Directors must take to satisfy its duty of good faith varies, depending upon the type of the fund, the circumstances under which the Directors are undertaking to price at fair value a security, and any pricing procedures the Directors have adopted.

The 1999 Letter acknowledges with approval that in light of the changes in the securities markets, Directors are generally only indirectly involved in the day-to-day pricing of a fund's portfolio securities. As such, the Staff recognizes that most Directors satisfy their pricing obligations by reviewing and approving pricing procedures and methodologies proposed by Fund management. When reviewing such pricing procedures, the Directors' good faith obligation requires the Directors to determine whether the proposed methodologies and procedures are reasonably likely to result in the valuation of portfolio securities at prices the fund could expect to receive upon their current sale.

Investment Company Institute No-Action Letter (April 30, 2001) (Foreign Markets) ("2001 Letter")

The 2001 Letter provides additional guidance on several other issues that arise in the valuation of portfolio securities, particularly foreign securities.

The 2001 Letter reiterates the Staff's view that the Fund's Directors must continuously review the appropriateness of the policies and procedures the Fund uses in valuing portfolio securities. Such reviews should evaluate whether those policies and procedures "continue to result in values that [the Directors] might reasonably expect to receive upon a current sale." Funds should assess the availability and reliability of market quotations, and should regularly test the accuracy of their fair value prices by comparing them with values that are available from other sources, including actual trade prices, as well as quotations from pricing services and dealers. In using pricing services, Funds should recognize that these services provide an indication of prices, and therefore they should be used for "evaluating" fair market value, not "valuation."

Moreover, in the Staff's view, a Board:

> *acts in good faith when its fair value determination is the result of the sincere and honest assessment of the amount that the fund might reasonably expect to receive for the security upon its current sale, based upon all of the appropriate factors that are available to the fund. Furthermore, . . . a Board acts in good faith when it continuously reviews the appropriateness of the method used in determining the fair value of the Fund's portfolio securities.*

By contrast, where Directors know or have reason to believe that its fair value determination does not reflect the amount the fund might reasonably expect to receive for the security upon its current sale, or the Directors act with reckless disregard for whether its fair value determination is appropriate, the Directors would not be deemed to have acted in good faith.

Richards Speech (Best Practices) (June 14, 2002)

In her speech, Ms. Richards, then Director of the SEC's Office of Compliance, Inspections and Examinations, discussed the results of recent SEC inspections of mutual fund pricing procedures and provided a list of recommendations that reflect the Staff's view of "best practices:"

- Guard against a lack of oversight of valuation -- make sure that there are good checks and balances in the valuation process.

- Because there is a degree of expertise needed to handle valuation and pricing issues, some Boards have established valuation committees to focus specifically on valuation issues when they arise. The Adviser may also have a valuation committee, and many funds have a Director on call. These committees should have written policies, hold regular meetings, and keep minutes.

- The more difficult a security is to value, the more the Directors should be involved in understanding the pricing methodology. The Directors need to understand the pricing process -- and will want to review the process with the Adviser -- including the criteria considered and the valuation methods used.

- If a pricing service is used, Directors should understand exactly what services that pricing service provides. Pricing services vary: some may give NASDAQ quotes; some may give their best estimate of value based on communications with the underwriter or issuer; or some may repeat information provided by the portfolio manager.

- Some Funds use more than one pricing service -- this allows the Fund to obtain two independent pricing recommendations, and can provide a check for discrepancies.

- The portfolio manager can be used as a reviewer of valuations of individual securities (he or she will have good knowledge of the market in that security, and could do an "end of the day check"). The portfolio manager's valuations should be reviewed because of possible conflicts. The same is true with respect to a sub-adviser's valuations in a manager-of-managers structure.

- Many Advisers have an automated checking routine that searches for day-to-day price changes in individual securities over some threshold percentage and that kicks these out for review. Directors should be sure that someone actually checks on the reasons for the increase or the decrease in the prices.

- Sometimes prices that come in from external sources (e.g., a pricing service or broker-dealer) are overridden by the Adviser. Directors should establish controls on pricing overrides.

- Ensure that someone who is not involved in the pricing process, such as compliance staff, reviews all overrides to look for individual overrides that are not supportable, and patterns of overrides that suggest problems. Also, Directors should receive a periodic report on all overrides and the reasons for them.

- Monitor for "stale pricing" (when the price of a security does not change). Is someone overriding incorrectly or is something wrong with the input?

Ms. Richards noted that if Funds are using fair value, they should compare any sales in the market to the fair value for accuracy. Also, Funds should review any differences that occur over time for any bias that suggests that the fair values being used are either consistently higher or lower than actual sales prices. Also consider providing this data to Directors (e.g. quarterly) so that they can ensure they are properly overseeing the process.

Douglas Scheidt Comments at MFDF webinar on Board oversight of Valuation (September 2012)

Mr. Scheidt, Associate Director and Chief Counsel for the Division of Investment Management of the SEC, made the following remarks at a recent Mutual Fund Directors Forum webinar on valuation:

- Under Section 2(a)(41)(B) of the Investment Company Act, fund boards of directors are required to determine in good faith the fair value of securities and other assets for which market quotations are not readily available. Fund directors may discharge their duty to determine fair value in more than one way.

- Although Section 2(a)(41)(B) of the Investment Company Act does not address whether fund boards may delegate their fair value obligations to others, it is the Commission's position that fund boards may delegate some, but not all, fair value functions to others. See ASR 118.

- ASR 118: "To the extent considered necessary, the [fund's] board may appoint persons to assist them in the determination of [fair] value, and to make the actual calculations pursuant to the board's direction.

- Fund boards must continuously review the appropriateness of any methodology used to fair value fund portfolio securities and other assets. See ASR 113 and ASR 118.

- Selecting or creating meaningful metrics involves a fundamental understanding of the valuation process and procedures in addition to risks associated with a fund's holdings, general market and economic conditions, and other relevant factors.

- Matrix prices provided by pricing service providers are neither readily available market quotes nor fair value prices. Rather they are opinions of a third party as to the value of a security. Board's should understand the matrix pricing methodologies used by pricing service providers and approve the use of such methodologies.

- Portfolio managers should not be the sole arbiters of fair value prices because of the acute conflicts facing portfolio managers.

Delegation of Board Functions to Fund Management

Notwithstanding the SEC's interpretations described above, it is well recognized that Boards are not typically in a position to be involved in day-to-day deliberations that take place in connection with value determinations. In ASR 118, the Staff provided for the Fund's Directors to "appoint persons to assist them in the determination of value and to make the actual calculations." The Directors' designees can thus assist in the formulation of those policies, procedures and methodologies used in fair value determinations. However, the Directors' good faith obligation extends to approval of the policies, procedures and methodologies its designees formulate, periodic review of the overall valuation procedures and adherence to those procedures, and consideration of any appropriate modifications.

Litigation

Recent litigation highlights the dangers of failing to keep up-to-date with SEC fair value pricing guidelines.

<u>In Re Parnassus Investments</u> (Adm. Proc. Initial Decisions Rel. No. 131; September 3, 1998)

In 1998, the SEC instituted administrative proceeding against the investment adviser, executive officers and independent trustees of the Parnassus Fund for mispricing a portfolio security from an issuer ("Margaux") that had filed for bankruptcy protection. The adviser and the Directors had priced the security (a convertible bond) after bankruptcy under different and various protocols over an extended period of time. These protocols included conversion valuation, conversion valuation with a premium, going concern valuation, and "orderly disposition" valuation. The Administrative Law Judge found that the Directors' valuation methods did not meet the standards required under ASR 113 and 118, and that the determinations made by the Directors' of the fair value of the Margaux convertible bond were not made in good faith.

<u>In the Matter of Western Asset Management Co. and Legg Mason Fund Advisor, Inc., Respondents</u> (IAA Rel. No. 1980; September 28, 2001)

On September 28, 2001, the SEC entered into an offer of settlement with Western Asset Management Co. ("Western") whereby Western agreed to pay $50,000 for failing to adequately supervise one of its portfolio managers when pricing securities which were not publicly traded. The offering documents of one of the Funds provided that in the absence of readily available market quotations, prices would be obtained from recognized broker-dealers in the same or similar securities. The offering documents of another of the Funds provided that securities with no readily available market quotes would be valued at fair value under the supervision of the Fund's managing director and supervisory board. In valuing fund securities without readily available market quotes, the portfolio manager instead relied on the investment banking firm from whom the securities were purchased to supply a valuation. The SEC found that Western failed to have adequate policies and procedures in place to ensure the Funds in question were priced in compliance with the Fund's offering documents.

<u>In re Hammes</u> *(ICA Rel. No. 26290; December 11, 2003)(Heartland)*

On December 11, 2003, the SEC brought a series of separate enforcement actions against the Adviser, executive officers, portfolio pricing agent and the Independent Directors of the Heartland Funds arising out of a significant mispricing of certain municipal bond securities in the Funds' portfolios. The SEC issued a cease and desist order against the Independent Directors noting that they had committed violations of Sections 17(a)(2) and 17(a)(3) of the Securities Act because they did not adequately discharge their responsibility to participate meaningfully in the valuation of Funds. The SEC stated that:

> While mutual fund directors are permitted to delegate some responsibility for pricing a fund's securities to a separate committee, each director retains responsibility to be involved in the valuation process and may not passively rely on securities valuations provided by such a committee….
>
> Furthermore, a director's failure to review financial statements, reports, contracts, and other documents relevant to the financial condition of the issuers of a fund's securities can result in the director's personal liability….
>
> Here, the [directors] failed to take adequate steps to follow up on their requests for information from Heartland Advisors, when they were on notice of the problems with the prices of the Funds' securities, in order to assure that the Funds' securities were priced at fair value.

<u>In the Matter of J. Kenneth Alterman, et al.</u> *(ICA Rel. No. 30300; December 10, 2012) (Morgan Keegan)*

In 2012, the SEC initiated cease-and-desist proceedings against the former board members of several Morgan Keegan funds, alleging that they failed to maintain appropriate fair-market valuations of debt securities held by the funds, which caused the funds' NAVs to be overstated. The securities were complex securities, including structured investment vehicles, collateralized debt obligations, collateralized mortgage obligations and collateralized loan obligations, home-equity loan-backed securities and mortgage-backed securities. The fair valued securities made up the majority—and in most cases upwards of 60%—of the funds' net asset values. The case dates back to 2007 when the SEC and other regulators charged the funds' managers with fraud, and the firms later agreed to pay $200 million to settle the charges.

The SEC alleges that:

- the directors "failed to designate a methodology for the calculations of these hard to value securities";
- "the directors did not continuously review the appropriateness of the method to be used in valuing each security in the company's portfolio";
- "the directors delegated their responsibility to determine fair value to a valuation committee without providing any meaningful substantive guidance on how those determinations should be made";
- the directors "made no meaningful effort to learn how fair values were actually being determined";
- the directors "at best [received] only limited information on the factors considered in making fair value determinations and almost no information explaining why particular fair values were assigned to portfolio securities,"

On January 3, 2013, the directors filed a response refuting the SEC's allegation. The matter is pending.

SEC RULE

Compliance Programs of Investment Companies -- Rule 38a-1 (ICA Rel. No. 26299; December 17, 2003)

In 2003, the SEC adopted a new compliance rule (1940 Act Rule 38a-1) that requires investment companies to adopt, and Directors to approve, written compliance policies and procedures including procedures covering the pricing of portfolio securities. The SEC in its adopting release noted that with respect to the pricing of portfolio securities, Funds must have written procedures to monitor for events that may necessitate fair value pricing, and must pay attention to circumstances that would suggest the need for using fair value pricing.

The SEC stated in the release adopting the Rule that Funds should adopt policies and procedures to:

- Monitor for circumstances that may necessitate the use of fair value prices;
- Establish criteria for determining when market quotations are no longer reliable for a particular portfolio security;
- Provide a methodology or methodologies by which the Fund determines the current fair value of the portfolio security;
- Regularly review the appropriateness and accuracy of the method used in valuing securities, and make any necessary adjustments; and
- Fair value their portfolio securities whenever market quotations become unreliable.

The SEC noted that the failure of a Fund to establish sufficiently sensitive criteria for using fair value pricing should be recognizable in subsequent reviews of the accuracy of the prices used to compute the net asset value of the Fund. In the adopting release, the SEC noted that in determining fair value, some Funds use correlations between the exchange prices of foreign securities and other appropriate instruments or indicators, such as relevant indices, American Depository Receipts, and futures contracts.

Disclosure Regarding Market Timing and Selective Disclosure of Portfolio Holdings (ICA Rel. No. 26418; April 16, 2004)

On April 16, 2004, the SEC expanded disclosure of certain Fund policies, requiring Funds (other than a money market fund) to provide a brief explanation of the circumstances under which it will use fair value pricing and the effects of using fair value pricing. In adopting this rule, the SEC noted fair value pricing protocols would differ based upon the characteristics of the portfolio securities. For example, the SEC indicated:

> "[I]f a fund invests exclusively in frequently traded exchange listed securities of large capitalization domestic issuers and calculates its NAV as of the time the exchange typically closes, there may be very limited circumstances in which it would use fair value pricing (e.g., if the exchange on which a portfolio security is principally traded closes early or if trading in a particular portfolio security was halted during the day and did not resume prior to the fund's NAV calculation). By contrast, if a fund invests primarily in securities that are traded on overseas markets, we would expect a fuller discussion of the circumstances under which the fund would use fair value pricing, such as specific events occurring after the close of the overseas exchange that would cause the fund to use fair value pricing."

The SEC clarified that this new rule does not "require disclosure of the specific methodologies and formulas that a fund uses to determine fair value prices. For example, if a Fund has a policy to fair value price securities traded on overseas markets in the event that there is a specific percentage change in the value of one or more domestic securities indices following the close of the overseas markets, the Fund will not be required to disclose the specific percentage change that would trigger fair valuation. In addition, a Fund's disclosure need not be so specific that the fund may not adjust the triggering events from time to time in response to market events or other changes."

The Staff's and FASB's pronouncements regarding valuation provide, at best, a general framework to utilize in pricing decisions. The Directors or their delegate must make an initial determination as to whether market quotations are readily available or whether fair value pricing must be used. If the Directors or their delegate determines that fair value pricing is appropriate, all relevant factors must be taken into account in arriving at a fair value for portfolio securities. Ultimately, though, the practical realities of valuation techniques – i.e., the use of pricing services and matrix pricing – place a significant burden on the Directors who are charged with valuing portfolio securities in good faith. Consequently, it is crucial to implement and monitor comprehensive valuation procedures under which appropriate crosschecks, automated red flag review and supervisory controls exist.

[1] This outline does not deal with valuation of securities in money market funds which are subject to a detailed valuation regime set forth in Rule 2a-7; see also Investment Company Act Release 9786 (May 31, 1977).
[2] FAS 157 requires detailed financial statement disclosure of the methodology used in Fair Value Measurements. This overview covers the fair valuation protocols, not the footnote disclosure in the financial statements.
[3] Unadjusted for transaction costs.
[4] *See* Investment Company Act Release No. 6121 (July 20, 1970) on valuation of securities subject to a "shelf" registration under the Securities Act of 1953. *See also* Letter of Andrew Bara, Chief Accountant of the SEC to Robert Maynard, Chairman – Committee on Investment Companies of the AICPA (December 16, 1970) on form of audit opinion relating to fair valuation procedures.

MFDF MUTUAL FUND DIRECTORS FORUM
The FORUM for FUND INDEPENDENT DIRECTORS

Report of the
Mutual Fund Directors Forum

Practical Guidance for Fund Directors on Valuation Oversight

June 2012

Executive Summary

Proper valuation of a fund's portfolio securities is critical to the calculation of a fund's daily net asset value per share. Credit crises, natural disasters, and wider use of increasingly complex securities have made this fundamental task more difficult. In addition, regulators have recently expressed a renewed interest in the valuation processes at mutual funds.

While fund independent directors do not generally play a day-to-day role in the pricing of a fund's individual investments, directors bear the ultimate responsibility for valuing those securities without a readily available market price.

Considering a fund's primary valuation risks can help boards carry out their valuation responsibilities. Having an understanding of these risks can help directors work with a fund's adviser to establish effective valuation policies and procedures. In addition to valuation risks, directors should consider a fund's particular investments, as well as the board's desired ongoing involvement when establishing a fund's valuation policies and procedures. These procedures will help directors gain a thorough understanding of the adviser's valuation process, a key to performing their oversight role.

A board's responsibility does not end with the approval of the valuation procedures; a board must monitor the implementation of the procedures. Boards need to determine how best to perform the ongoing monitoring, and consider how best to organize themselves to oversee the valuation process, what documentation to review regarding valuation determinations, and how often to communicate with management regarding the process. The documentation needs to be sufficient to allow directors to understand the adviser's valuation methodology. In addition, ongoing monitoring can help boards and advisers identify situations where the fund's current valuation policies and procedures no longer work.

A board has many resources at its disposal for helpful insight into how well the adviser's valuation process is functioning. For example, the fund's CCO is a valuable resource that is present at the management company and can therefore provide information about the ongoing functioning of the process. The fund's auditors can also provide a helpful outside perspective on the effectiveness of a fund's valuation procedures.

By providing oversight of the valuation process, fund directors not only fulfill their statutory valuation responsibilities, but also provide a valuation risk oversight function for the funds they oversee.

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Working Group

Ashok Bakhru	Chair, GS Mutual Funds Board
Andrea E. Baron	Associate, Dechert LLP
Geoffrey R.T. Kenyon	Partner, Dechert LLP
Kenneth Leibler	Independent Director, Putnam Funds
Patricia A. Maleski	President, JP Morgan Funds
John M. Perlowski	Managing Director, BlackRock, Inc.
Jeffrey S. Puretz	Partner and Practice Group Leader, Dechert LLP
Kenneth A. Rathgeber	Executive Vice President and Chief Compliance Officer, Investment Adviser and Fidelity Mutual Funds, Fidelity Investments (*Retired April 30, 2012*)
Raymond Stickel	Audit Committee Chair, The Invesco Funds

PwC provided extensive assistance with this report.

I. Introduction

Proper valuation of a fund's assets is critical for the calculation of daily net asset value per share. The Investment Company Act of 1940 ("1940 Act") permits transactions in fund shares only at a price based on the net asset value of its shares ("NAV").[1] Credit crises, natural disasters, and a proliferation of complex securities make pricing a fund's portfolio investments increasingly difficult.

Inaccurate valuation of a fund's underlying portfolio securities and other assets can give rise to some serious issues. If portfolio securities are not valued appropriately, one group of shareholders (either sellers of fund shares or buyers of the shares) will gain a windfall at the expense of the other group. In addition, mispriced fund shares can result in arbitrage opportunities as some investors exploit the fund's inaccurate share price, possibly at the expense of long-term shareholders. A robust and consistent valuation process can help ensure that all fund shareholders are treated equitably and is critical for effective portfolio management.

Valuation is one of the most significant areas of potential risks for funds, particularly those that hold complex or thinly traded securities that must be "fair valued". As directors consider their risk oversight responsibilities, they should pay careful attention to the adequacy of a fund's valuation policies and procedures.

Fund directors have a statutory obligation to determine the fair value of securities for which market quotations are not readily available; however, boards can and do delegate the day-to-day responsibility for determining the valuation of particular securities to the fund's adviser. (For the purposes of this report, "adviser" will be used to designate the party responsible for day-to-day valuation, even though the actual party may vary by fund complex.) Although directors themselves are rarely the subject of enforcement actions by the SEC,[2] directors do have the ultimate responsibility for valuation. The SEC has held directors responsible for failing to monitor the liquidity of a fund's portfolio securities, failing to adjust a fair value when an issuer's financial condition and liquidity were deteriorating; and failing to correct the mispricing of securities in a fund's portfolio.[3]

Because of the importance of valuation coupled with the general lack of day-to-day participation, boards strive to find the appropriate balance between delegation and participation in the valuation process. An important factor to consider as a board defines its involvement in the valuation process is the adequacy of the fund group's processes and personnel. The fund's Chief Compliance Officer ("CCO"), its external auditors, and independent counsel all provide directors with valuable guidance in the valuation process.

As with many other areas, directors should consider what may lie ahead. As the complexity of a fund's investment strategy and available investment products increases, the fund's valuation procedures should adapt to and keep up with these changes. Due to the constantly evolving nature of valuation issues, advisers and boards should work together to build a process that continues to be actively monitored and effective.

This report[4] is designed to provide information to boards about their responsibilities for fund valuation.[5] In addition, it will examine some practical issues regarding how boards carry out their oversight role in this area.[6]

II. Valuing a Fund's Portfolio Securities: Legal Requirements

The 1940 Act requires that mutual funds offer and redeem their shares at a price based on the fund's current NAV.[7] A fund's NAV is calculated based on the value of the fund's portfolio securities and other assets less any liabilities, divided by the total number of outstanding shares of the fund. Mutual funds calculate their NAVs on each business day at a time set by the fund.[8] Most funds calculate their NAVs at the time of the close of the New York Stock Exchange ("NYSE"), which is usually 4:00 pm eastern time.

If a security has a market quotation that is "readily available," its value is that market quotation.[9] However, in some cases, market quotations are not "readily available," even for securities trading on exchanges.[10] In such cases, as well as securities that have no current market price, the 1940 Act requires fund directors to determine in good faith the fair value of those securities.[11]

A. When Is a Market Quotation Not "Readily Available"?

There are situations when an exchange-traded security may need to be "fair valued." For example, the following are circumstances in which a fund may be unable to rely on the last market price:

- The primary market on which a security trades (other than the NYSE) closes before the time at which the fund's NAV is calculated;
- A security experiences a halt in trading;
- Events close markets early;
- Scheduled market holidays (other than NYSE holidays); and
- An absence of trading in a particular security.

A particular security may have had a market quotation, but the price may not be reliable. A market quotation may not be "readily available" if there has been a gap in time or if a significant event has taken place after the last market price, but before the fund's NAV is calculated so that the quotation does not reflect the current market value at the time a fund calculates its NAV. This is particularly relevant for equity securities of foreign issuers traded on foreign exchanges that close before the close of the NYSE, because the closing price from the foreign exchange may be several hours old at the time a fund calculates its NAV.

The SEC staff has stated that funds should continuously monitor for events that might necessitate the use of fair value prices and that funds should establish criteria for assessing the reliability of market quotations.[12] With respect to foreign securities, for example, many fund groups systematically ascertain the fair value of equity securities traded in foreign countries as of the time a fund calculates its NAV. Many fund groups employ services that offer methodologies involving statistical analyses and quantitative models for calculating fair value of foreign equities.

B. What Is "Fair Value"?

Once the fund has a procedure to determine whether a security needs to be "fair valued," the next question is what is that value? Fair value is the price the fund "might reasonably expect to receive for [the securities] upon their current sale."[13] Because valuation in circumstances where market quotations are not readily available or are unreliable is uncertain at best, there can be a range of appropriate values for a particular security.

Different boards can legitimately arrive at different prices for a particular security as long as they act in good faith. The SEC's Division of Investment Management described the "good faith" obligation as "a flexible concept" that varies "depending on the nature of the particular fund, the context in which the board must fair value price, and, importantly, the pricing procedures adopted by the board."[14]

In contrast to the 1940 Act, accounting rules do not distinguish between fair value and market value. Instead, ASC 820 (formerly, FAS 157)[15] calls for assets to be booked at their "fair value," which is defined as the price that would be received for the asset in an orderly transaction between market participants. ASC 820 looks to market value as one of the inputs used to value a particular security.[16]

Funds must report the "fair value" of their assets, as defined in ASC 820, in each annual and semi-annual report and must include information intended to show the levels of objectivity and transparency of the information used to determine that value. The reports can, therefore, help identify those assets in the fund's portfolio that rely on unobservable inputs in the determination of value and therefore may involve greater elements of judgment in ascertaining value. In addition, review of movements of securities between levels can help directors evaluate changes in the way the fund's securities are valued or changes in the composition of the fund's portfolio from period to period.

III. Fund Valuation Procedures

A. Boards May Choose to Delegate Day-to-Day Responsibilities for Valuation

Because mutual funds must calculate their NAVs daily, most boards adopt procedures to govern the method in which the NAV is to be determined on a day-to-day basis. The procedures generally delegate the determination of fair value for portfolio securities and other assets for which market quotations are not readily available to the adviser. Delegation is appropriate because the adviser generally has the required expertise to make judgments about fair value prices and is available to make valuation determinations on a daily basis. In most cases, the adviser or other service provider establishes a valuation committee composed of individuals with the experience and expertise necessary to value a fund's portfolio securities. Fund boards must then decide how best to review the fair value determinations made by the adviser.

B. What Must Be Included in a Fund's Fair Valuation Procedures?

Rule 38a-1 under the 1940 Act requires funds to adopt policies and procedures for fair valuing a fund's securities. The SEC stated that a fund's procedures should:

- Monitor for circumstances that may necessitate the use of fair value prices;
- Establish criteria for determining when market quotations are no longer reliable for a particular portfolio security;
- Provide a methodology or methodologies by which the fund determines the current fair value of the portfolio security; and
- Regularly review the appropriateness and accuracy of the method used in valuing securities and make any necessary adjustments.[17]

C. Monitoring for Circumstances that May Require Fair Value Pricing

For domestic securities, the SEC staff has asked funds to "carefully consider various indications of the validity and reliability of market quotations."[18] For example, infrequent sales, a thin market, or questionable quotations from broker-dealers may require fair value pricing.

Many funds have found that establishing triggering mechanisms is helpful in monitoring for circumstances that require the use of fair valuation models or tools with respect to foreign securities. Third party pricing services may be helpful in identifying triggering events as well. Boards are frequently called upon to exercise their judgment on whether a fair value service should be engaged, and if so, the trigger point at which fair value would be used. Usually, the trigger is a percentage of the daily change in the value of an index of domestic securities between the time of the close of a foreign exchange and the close of the NYSE. Triggers used by fund groups may vary, though they typically range from 0% to 1%.

D. Methodologies Used to Establish Fair Value

In addition, the board can expect the fair valuation procedures to include a description of the methodology that the adviser will use when making fair valuation determinations. The methodology should establish a hierarchy that determines the sources that an adviser will use when valuing securities. Different hierarchies can be established for different types of securities. Like establishing triggering mechanisms, defining hierarchies may help the board gain comfort that the adviser is using a consistent valuation process, even during difficult markets.

E. A Board Should Monitor the Implementation of the Fund's Valuation Policies and Procedures

A board's responsibility does not end with its approval of valuation policies and procedures. As Chief Counsel of the SEC's Division of Investment Management has stated, a board must "periodically review the appropriateness of the methods used to fair value price portfolio securities and the quality of the prices obtained through these procedures, and . . . make changes when appropriate."[19]

To carry out its oversight responsibility, a board should consider what documentation of the valuation process it would like to see from the adviser's valuation committee. The documentation should be sufficient for the directors to understand the methodology used by the adviser. Some boards may choose to designate one fund director (or available members of a committee of directors) as a liaison to discuss difficult valuation issues with management as they arise.

In addition to overseeing the adviser's compliance with the fund's policies and procedures, ongoing monitoring can help identify situations where the established procedures may no longer be appropriate. As funds and markets evolve, situations may arise in which the existing policies become less effective or outdated, prompting a discussion between the adviser and the board to identify areas that may warrant their own specific policies and procedures. The board may wish to establish a regular review of the procedures, and seek input from counsel and the fund's auditors, to ensure that any appropriate changes are considered in a timely fashion.

F. Examining a Fund's Primary Valuation Risks May Help Directors Carry Out Their Valuation Responsibilities.

As directors consider how best to carry out their valuation responsibilities, it is critical to consider the valuation risks for a particular fund. Having an understanding of valuation risks will help fund directors work with the adviser to put into place effective valuation policies and procedures. For example, directors may find it helpful to consider the following risks and related questions based on the particular circumstances of their funds.

Risks	Questions to Consider
Changing market liquidity	• How does limited liquidity factor into the fund's valuation procedures? • How does the adviser monitor liquidity of a fund's investments? • What happens if liquidity conditions change?
Valuations obtained from a single source or counterparty	• Under what circumstances will a security be valued using a single broker quote? • What controls are in place for valuing securities using a single source? • How are these securities classified under ASC 820 guidance?

Risks	Questions to Consider
Reliability of data provided by pricing services for securities that are not traded on an exchange	• Does the adviser test prices received from pricing services or broker quotes against subsequent sales or open prices? • Are the pricing services periodically reviewed? • To what extent does the pricing service consider adviser input?
Reliability of information provided by credit rating agencies	• If credit ratings are an input in a matrix pricing model for debt securities or asset backed securities, does the adviser have an understanding of the criteria used by the rating agency? • Does the adviser independently monitor for changes in credit ratings or events that could affect a security's credit rating?
Use of internal information provided by portfolio managers to estimate fair value	• What controls are in place to address the potential conflict where portfolio management personnel provide valuation information? • Is a committee used to make final judgments?
Use of internally developed models to value securities	• What controls does the adviser have in place to test the models? • Does the adviser have a process for reviewing the results of the model? • Are the assumptions underlying models reevaluated over time based on historical data? • Who is involved in developing the model's assumptions?

Risks	Questions to Consider
Extensive use of matrix pricing (Matrix pricing bases the price of a security on the price of another security that is comparable in credit rating, interest rate, etc.)	• Do the adviser and the board understand a pricing vendor's process for matrix pricing? • Do the adviser and the board understand any shortcomings from reliance on matrix pricing? • What percentage of a fund's portfolio is priced using matrix pricing? • Does a vendor's matrix pricing process account for differences in liquidity among securities? • Does a pricing vendor test the matrix prices against subsequent sales prices? • How are values derived from matrix pricing classified under ASC 820 guidance?
Process surrounding management overrides	• What controls are in place to address the potential conflict where portfolio management personnel seek to override a price from a pricing vendor? • How are overrides authorized and tracked? • Does the adviser have a procedure to monitor the overrides or the process used to generate an override?
Timely identification of significant events	• What process is used to prevent opportunities for timing arbitrage in the value of the foreign equity securities? • How does the adviser monitor for significant events that might require securities to be fair valued?
Complexity risk	• Does the adviser have an established procedure for vetting valuation complexities in new securities and other assets, including derivatives?

Recent history has confirmed that risk is not a static concept. All of the risks listed above may not be an issue for all funds at all times, and there may be others that arise, particularly when a fund begins to invest in a new instrument. When the adviser begins to invest in a new instrument, the board should be assured that the adviser has a thorough understanding of the product and has appropriate systems in place to value the security. In addition, new risks should be considered on a timely basis as part of the board's regular review of the fund's valuation procedures.

IV. How Can Boards Carry Out Their Valuation Responsibilities?

A. Directors Should Develop an Understanding of the Valuation Process.

Directors should work to gain an understanding of the valuation process. While they need not be experts in valuation, directors should have familiarity with valuation techniques in order to adequately evaluate the adviser's valuation process. For example, directors should be familiar with how the adviser values securities when there is no readily available market price, such as prices computed by quantitative models or based on quotations from dealers. Directors should be sure to understand and approve the fund's valuation policies and the adviser's internal governance structure. Taking the time to understand the adviser's internal processes will help directors evaluate whether the tone at the top supports strong valuation practices.

B. Directors Should Determine How Best to Organize Themselves to Appropriately Oversee the Valuation Process.

Directors who provide oversight of a fund's valuation and pricing policies, procedures, and practices should determine how they can best organize themselves to evaluate the adviser's valuation and pricing activities effectively and efficiently. Management and the board need to develop mutually agreed upon policies and procedures to guide the day-to-day activities.

Directors generally delegate the day-to-day determinations of valuation to the adviser's internal valuation or pricing committee to make decisions pursuant to the pricing procedures approved by the board. Typically, independent directors are not part of this valuation committee. Because independent directors may not be available in the time required to set the fund's NAV, it is often impractical to have them sit on the adviser's valuation committee. Further, some boards believe that "real time" participation in the business of managing the fund is inconsistent with an oversight function. There may be circumstances at a particular fund group that leads a board and adviser to determine that it is desirable for an independent director to be involved in day-to-day decision-making, whether as part of the adviser's valuation committee or by reviewing and ratifying the committee's decisions daily.

Even if no directors serve on the adviser's valuation committee, the fund board should be comfortable with the committee's composition. For example, at least one member of the valuation committee should be sufficiently familiar with markets to be able to assess market information as an input to a price determination. Directors also should understand the level of involvement of portfolio managers in the valuation process. While portfolio managers can provide invaluable information to the valuation committee, it may not be appropriate for investment personnel to constitute a majority of a valuation committee, or for portfolio managers to vote on the valuation committee as to securities in their respective portfolios, because they may have an interest in the outcome of the valuation decisions. To help assess the quality of the adviser's process, independent directors could participate periodically in meetings of the adviser's internal valuation committee or review the minutes of the meetings.

In addition to the adviser's valuation committee, some fund boards have created board valuation committees. These committees can help the board provide oversight of the adviser's internal valuation and pricing policies, procedures, and practices. If directors determine to establish a board valuation committee, the committee's charter should clearly distinguish between that committee's responsibilities and the responsibilities of the adviser's valuation committee. Boards that have no valuation committee frequently assign responsibility for valuation oversight to another committee, such as the board's compliance or audit committee. In other instances, valuation oversight is undertaken by the full board.

C. A Board Should Choose a Reporting Cycle for Valuation Determinations That Is Appropriate for a Particular Fund.

Boards must also consider how frequently the directors would like to receive reports on the valuation process. (More information about board reports is available in Section VII – Board Reporting.) Because boards cannot delegate ultimate responsibility for fair valuation, the reporting must be frequent enough so that the board can gain comfort that the adviser is fair valuing securities in accordance with the pricing policies set by the board.

Many boards review valuations quarterly. Some boards may determine that more or less frequent reviews are desirable – either because of the particular securities in a fund's portfolio or due to market conditions. For example, boards may want more communication with the adviser during times of market stress, such as that following the Japanese tsunami in March 2011 or the credit crisis of 2008. In addition, a board may wish to designate an independent director (or directors) as liaison to facilitate communication. The adviser could then contact the appropriate director(s) when any particularly difficult pricing issues arise.

To facilitate board oversight of the adviser's valuation determinations, the adviser should document why a particular security has been fair valued, the method used to arrive at the value, as well as the price determined by the committee. Boards may find it helpful for representatives of the adviser's valuation committee to attend meetings of the board (or meetings of a board committee responsible for valuation) to discuss valuation issues. Some boards have found it useful for a member of the board to participate in valuation committee meetings from time to time or conduct periodic discussions with valuation committee members to stay abreast of processes and methodologies being used. Some boards also receive information on the market price for a fair valued security if that information should become available.

D. Boards Should Understand the Role of Third Party Pricing Services.

Many funds use third party pricing services. Boards should develop an understanding of when their funds will or will not rely on third party pricing services to provide values for securities. Boards should understand that pricing services typically do not accept legal responsibility for prices they generate even if done negligently. Lastly, boards should also understand the circumstances under which management personnel may determine to override the prices provided by a pricing service and should review these actions or understand the checks and balances in place to review an override. An adviser may have a process for challenging quotations by a pricing service when the quotation is at odds with information known to the adviser, such as information on recent trades. The adviser may then accept the result of the challenge or override the service's price. Boards should recognize that these challenges can be part of a healthy valuation process.

The board should seek input from the fund's adviser on the performance of third parties that provide prices for fund portfolio securities. Boards also may wish to seek input from the third party itself. When conducting such a review, the board should be comfortable that the adviser conducted appropriate due diligence when selecting the pricing service. Boards can expect that the adviser's due diligence will include an examination of the financial stability of the pricing service, its ownership, and any affiliations that the pricing service has with the adviser. The board should also be aware of how management evaluates the quality of a vendor's prices.

The adviser also should have an established procedure for ongoing monitoring, including due diligence visits, to determine whether the pricing service continues to have competence in valuing particular securities and maintains an adequate control environment. Some directors may find it worthwhile to accompany management on its due diligence visits. Additionally, some boards may periodically interview the pricing vendors to determine their qualifications and independence.

E. The Board Should Understand the Adviser's Resources for Valuing Securities.

The board should determine what resources the adviser has at its disposal should there be a need to fair value the fund's portfolio securities. For example, a fund's portfolio manager can be a valuable resource when fair valuing securities. While it may not be appropriate for a portfolio manager to vote on the valuation committee as to securities in his or her portfolio or for investment personnel to constitute a majority of an internal valuation committee, a portfolio manager can still add value due to their understanding of the fund's portfolio securities. The portfolio manager also will be able to provide information during times when the price movement of a security is not what is expected.

> In addition to portfolio management personnel, the adviser may also develop its own proprietary pricing model methodologies. Quantitative pricing models can provide an important addition to or alternative to a market price – particularly with respect to difficult-to-value securities like certain derivatives. If such models are used, directors should receive information about the rationale for the models, how often the models are used, the key inputs and assumptions (including sources) used in the models, and whether the prices determined by the models are (or even can be) compared to market transactions.

F. Directors Should Understand How Broker Quotes Are Used in Valuing a Fund's Securities.

Funds can also look to brokers to provide valuations for securities. Directors should understand the process used when broker quotes are used to value portfolio securities.

First, directors should be aware of whether valuation procedures allow broker quotes to be the sole source used for determining the value of a particular security. Directors should understand whether the procedures include a preference for quotes from two or three brokers, as well as the circumstances under which only one quote can be relied on. A board may wish to inquire about an adviser's process regarding the selection of brokers, and how frequently those brokers are changed. For example, in one enforcement action, the SEC criticized a practice it described as follows:

In addition, from at least July 25, 2007, to June 16, 2008, the Valuation Committee valued one or more securities owned by the Ultra Fund in accordance with prices obtained from an individual broker-dealer located in Florida, whose method for determining prices it had not reviewed or approved. On various occasions in 2007 and 2008, third-party pricing vendors reduced prices on securities held by the Ultra Fund, but rather than reducing the prices for purposes of calculating the Fund's NAV, the portfolio management team recommended – and the Valuation Committee approved – vendor overrides, through which the Fund valued the securities in question in accordance with prices provided by the Florida broker-dealer rather than in accordance with the prices provided by the vendor.[20]

The board should also understand whose job it is to obtain the quotes – portfolio management personnel, traders, the custodian or accounting agent, or others. Boards may want to pay special attention to circumstances where portfolio management personnel obtain the quotations from broker dealers to make sure checks and balances are in place to guard against a result-oriented process.[21] Finally, the board should understand the procedure that management will use to value a security when obtaining quotes from broker dealers. Does the adviser average the quotes, discard the high and low quotes, or use another method? Additionally, how does management determine whether a transaction could be carried out at the quoted price?

G. Directors Should Understand How the Adviser Addresses the Valuation of a Security Held Across Multiple Funds in the Complex

Boards should be aware of any different valuation procedures the adviser uses across its business. The SEC staff has stated that "We generally believe, however, that a board could not arrive at different fair valuations for identical securities held by two or more funds that the board oversees consistent with its good faith obligation."[22] Accordingly, a board should understand that an adviser or other vendor bears a heavy burden if different values are assigned to a particular security from time to time. Boards should be aware of this possibility and understand the adviser's process in this area. In addition, a board may wish to consult independent counsel or its auditors with questions in this area.

H. Boards or Counsel Should Review Disclosure Regarding Valuation

Because fund directors sign fund registration statements, directors or their delegates should carefully review fund disclosure as well as the adviser's disclosure process management. The board should obtain assurances that the disclosure describing the fund's valuation methodology is consistent with the methodology used and accurately described. Disclosure should also be reviewed when any changes are made to a fund's valuation procedures.

V. Board Resources

A. The Fund's CCO Is a Valuable Source for Boards as They Carry Out Their Valuation Responsibilities.

A fund's CCO is a valuable resource for boards in the valuation process. The CCO can be helpful in establishing effective valuation policies and procedures. Further, the CCO is present at the management company and therefore can see how the adviser carries out its valuation responsibilities on a regular basis. A board can ask the CCO to perform compliance checks to provide insights into the on-going functioning of the valuation process and to devote special attention to any valuation overrides by the manager. In addition, the CCO may be able to identify potentially problematic patterns that arise in day-to-day pricing.

Boards should consider how involved they would like their CCO to be in the day-to-day valuation process. Some feel that because the CCO must test the adviser's valuation process, it may not be appropriate for the CCO to serve as a voting member of the adviser's valuation committee. However, directors may wish to have the CCO attend the meetings of the valuation committee (as a non-voting member) to gain additional insight into the committee's process.

B. A Fund's Auditors Can Be a Valuable Tool in Assessing the Functioning of a Fund's Fair Valuation Procedures.

A fund's auditor can provide the board with another perspective regarding the effectiveness of a fund's valuation procedures.[23] As of the year end reporting period, a fund's auditors assess the reasonableness of the valuation of all securities. In doing so, the auditors review the information presented to the board for securities that have been fair valued and may obtain comparative prices from a secondary source.[24] As such, the fund's auditors are able to provide an independent perspective on the implementation of a fund's valuation procedures and can discuss their independent valuation results with the board. Auditors, however, do not play a role in the fund's daily control environment; therefore, their perspective on the year end valuations are another source of data and insight for boards to consider but are not a control on which boards or the adviser can rely. Further, when auditing a fund's financial statements, valuation of securities is tested in the context of the financial statements taken as a whole; it is not the entire focus of the auditing process. A fund's auditor is able to provide a good perspective on the fund's processes, controls and valuations based on the testing performed to issue an audit opinion. Further, given their role, auditors can also provide broader industry insights in terms of best practices. However, it is important to also clearly understand the limitations in the role of the auditor in terms of the board's understanding and assessment of the valuation procedures.

VI. Board Reporting

A. A Board Should Determine the Depth of Valuation Reporting That Would Be Most Helpful to Provide Effective Oversight of the Valuation Process.

Boards should consider the information they want in reports on the valuation process for a fund group. Reports may vary depending on the volume of fair valuations and the types of securities or other assets held by the fund complex. Verbal reports provided at meetings of the board also vary. Approaches some boards have used include the following:

- *A case-by-case review of each asset that received a fair value*. This process provides the board or its committee with a comprehensive report and allows directors to ask questions about each fair value determination. This method may not be practical for a complex with a large number of assets that are fair valued during the reporting period.

- *A sampling approach*. In this approach, a representative from the adviser would provide a full report on an asset that was assigned a fair value that is intended to provide a sample of the methodology that is used by management. The intent is that over time, reports will be provided on each type of fair value process used for a complex. Typically a sampling would include those fair value situations that had the greatest impact on the fund's NAV.

- *A deep dive*. A board delegated director or group of directors would conduct an on-sight visit with personnel of the adviser responsible for valuation and observe the team in action. The directors would conduct a deep dive into the methodologies and seek to observe how fair value situations are identified, how information is gathered, how judgments are made, and how processes are applied. The directors may sit in on a meeting of the adviser's valuation committee as observers. These directors would then report to the full board or appropriate board committee. This method may make sense for a complex with a large number of fair value situations that come up on a routine basis.

B. A Board Should Determine What Reports and Analysis Are Most Helpful in Carrying Out Its Valuation Responsibilities.

Boards may find that different information is helpful depending on whether a particular security is routinely fair valued compared to those that are fair valued due to specific circumstances. In routine cases, the board may decide that summary information is sufficient. In unusual circumstances, however, the board may wish to receive more timely or additional information about the security being fair valued. For example, the board may ask to see the fair value price assigned to the security, the effect of that security on the fund's NAV, and the reason that the adviser decided to fair value the particular security.

Boards may find some of the following reports helpful as they oversee the adviser's implementation of the fund's valuation procedures.

Report	Purpose
NAV Accuracy Statistics	• Allows directors to review NAV errors, including an explanation of the error, the cause, the impact of the error on the fund's NAV, required action, and the date of the error • Can help directors identify issues with valuing securities
Disposition Analysis	• Allows directors to see how the sales price of a security compares to the prior day's price • Disposition analysis can help directors evaluate the effectiveness of a fund's valuation procedures • If the difference between the value and subsequent disposition is greater than a pre-established tolerance, a fund's valuation procedures may need to be reevaluated
Fair Value Look-Back	• Allows directors to compare the price of a security that was previously fair valued against a subsequent market price • Comparing the fair value price to a subsequent market price can help directors evaluate the quality of an adviser's valuation process
Liquidity Monitoring	• Because lack of liquidity is a factor in determining the need to fair value a particular security, the board should ensure that the adviser has a process for monitoring the liquidity of the fund's securities[25] • Can help directors ensure that the adviser is factoring liquidity into the valuation process
Broker Priced Investment/Sales	• Allows directors to evaluate the number and materiality of broker priced securities and the accuracy of those prices as well as the brokers most frequently used for prices • Can help directors identify issues with broker-priced securities and other assets

Report	Purpose
Fair Value Trend Analysis	• Allows directors to monitor changes in the number of fair valuations over different time periods • Prompt questions to the adviser if the number of fair valuations has significantly changed over time • Also can identify trends in the number of price overrides of prices provided by vendors which may indicate a quality or reliability issue with that vendor or a management bias
Trigger Analysis	• Identifies the triggers that adviser or other third party uses to identify circumstances where securities should be fair valued • The trigger analysis can be useful to directors as they evaluate the effectiveness and consistency of the implementation of the fund's pricing procedures

VII. Conclusion

Fund directors have a statutory obligation to determine the fair value of portfolio securities that do not have readily available market prices. However, they generally delegate the task of valuing a fund's securities to the adviser.

Delegating the day-to-day task of valuing portfolio securities to the adviser through the fund's valuation procedures does not absolve boards of responsibility for the process. Even though directors do not perform the day-to-day valuations, they should develop an understanding of the adviser's process and valuation resources in order to provide adequate oversight. Further, boards should determine the form and frequency of reporting on valuation in light of the portfolio investments in the complex.

By providing oversight of the valuation process, fund directors not only fulfill their statutory valuation responsibilities, but also provide a valuation risk oversight function or the funds they oversee.

Notes

1 See Rule 22c-1 under the 1940 Act, which applies to open-end funds and unit investment trusts. Calculation of NAV is also important for closed-end funds, including those closed-end funds that issue new shares. It also enables investors in exchange-traded closed-end funds to determine whether their shares are trading at a premium or discount. See Section 23(b) of the 1940 Act. Under rule 2a-7 under the 1940 Act, money market funds are permitted to use amortized cost or penny rounding method to value fund shares. This report does not address these issues.

2 For a recent example of an SEC suit against a fund's adviser, see, e.g., In the Matter of UBS Global Asset Management (Americas) Inc., SEC Administrative Proceeding File No. 3-14699 (January 17, 2012) (The SEC charged the investment advisory arm of UBS with failing to follow fund valuation procedures for certain non-agency mortgage backed securities.)

3 See, e.g., In the Matter of Heartland Advisors, Inc., William J. Nasgovitz, Paul T. Beste, Thomas J. Conlin, Greg D. Winston, Kevin D. Clark, Kenneth J. Della, and Hugh F. Denison, SEC Administrative Proceeding File No. 3-11351; Securities Act of 1933 Release No. 8346, and Investment Company Act of 1940 Release No. 26290 (December 11, 2003); In the Matter of Parnassus Investments, Initial Decision Release No. 131, Administrative Proceeding File No. 3-9317 (September 3, 1998).

4 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 group serves 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.

5 This guidance expands on the Recommendations with Respect to Valuation and Pricing contained in the Forum's original Best Practices and Practical Guidance for Fund Directors. See Best Practices and Practical Guidance for Fund Directors, Report of the Mutual Fund Directors Forum (July 2004) available at http://www.mfdf.org/images/uploads/resources_files/best_pra.pdf.

6 Results of the PwC Asset Management Valuation Survey (November 2010) provided the stimulus for this report. For more information and publications of interest to mutual fund directors, visit PwC's website at www.pwc.com/us/assetmanagement.

7 See Rule 22c-1 under the 1940 Act.

8 See Rule 22c-1(b) under the 1940 Act (requiring the NAV to be calculated at least once daily at the time or times set by the fund's board).

9 See Section 2(a)(41) of the 1940 Act.

10 See Investment Company Institute, SEC No-Action Letter (April 30, 2001) ("2001 Letter"). (If an event affects the price of a security after the close of the market on which it trades, but before the fund's NAV is calculated, the last market price would not be a "readily available" market quotation. Similarly, if trading in a particular security is halted prior to the close of the market, the last market quotation is not "readily available.") See also Accounting Series Release No. 118 (Dec. 23, 1970),

stating that quotations for securities with infrequent sales or a thin market are not "readily available."

11 See Section 2(a)(41) of the 1940 Act.

12 See 2001 Letter.

13 Statement Regarding Restricted Securities, Accounting Series Rel. No. 113, Investment Company Act Release No. 5847, SEC Accounting Rules (CCH) 3758-61 (Oct. 21, 1969).

14 Letter from Douglas Scheidt, Associate Director and Chief Counsel, Division of Investment Management, to Craig S. Tyle, General Counsel, Investment Company Institute (December 8, 1999). ("Scheidt 1999 Letter")

15 FASB Accounting Standards Codification 820: Fair Value Measurements and Disclosures.

16 It establishes a hierarchy, ranging from most objective to least objective, for determining the value of a security as follows:
Level 1: securities with quoted prices for identical securities in active markets
Level 2: securities with quoted prices from markets that are not active or securities valued using market prices of similar assets and other observable, non-proprietary information
Level 3: securities valued using a pricing model or the firm's own, nontransparent data.

17 Final Rule: Compliance Programs of Investment Companies and Investment Advisers, Release No. IC-26299, 68 FR 74714 (December 24, 2003).

18 2001 Letter.

19 Scheidt 1999 Letter.

20 In the Matter of Evergreen Investment Management Company, LLC and Evergreen Investment Services, Inc. Administrative Proceeding File No. 3-13507 (June 8, 2009).

21 In one enforcement action, the SEC charged that a portfolio manager influenced broker quotes on securities, see In the Matter of Morgan Asset Management, Inc.; Morgan Keegan and Company, Inc.; James C. Kelsoe, Jr.; and Joseph Thompson Weller, CPA, SEC Administrative Proceeding File No. 3-13847 (June 22, 2011). In that case, the SEC charged Morgan Keegan (an investment adviser), a portfolio manager and the head of fund accounting with failing to follow established valuation procedures by, among other things, failing to receive adequate documentation to support portfolio manager price adjustments and allowing the portfolio manager to choose which dealer price confirmations to use and which to ignore.

22 Scheidt 1999 Letter at footnote 16.

23 While this section focuses on a fund's external auditors, fund directors may also find a fund's internal auditors helpful in providing insight into a fund's valuation processes.

24 Recent Public Company Accounting Oversight Board ("PCAOB") inspection findings as disclosed in public reports show an increased focus on procedures around valuation for companies, including mutual funds.

25 Without procedures that require the ongoing monitoring of a particular security's liquidity, the value assigned to a particular security may be inaccurate. A number of enforcement actions can be attributed to a failure by the board or the adviser to monitor for changes in a security's liquidity and subsequent failure to adjust the price accordingly.

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TAB 10

CHAPTER TEN

MONEY MARKET FUND VALUATION (RULE 2a-7)

What do Directors need to do and why?

Section 2(a)(41) and Rule 2a-7 under the 1940 Act require that Directors establish procedures for, and oversee the valuation and daily pricing of, the securities and other assets held by a money market fund. Directors must:

- **Adopt written procedures to stabilize the money market's NAV per share at a specific value (typically $1.00) by use of the amortized cost method of valuation;**
- **Establish procedures to "shadow price" the fund's portfolio securities based on market value; and**
- **Take appropriate action upon material deviation between the market value and the amortized cost of the portfolio securities.**

This responsibility is an on-going responsibility throughout the year. Directors may delegate, under appropriate guidelines, the daily pricing and review of the portfolio securities and maintaining the money market Fund's stable NAV.

Described below is the process the Board goes through in performing these responsibilities.

What are the standards?

As described in more detail below, the standards for review are set forth in Rule 2a-7 and in various SEC releases, no-action letters, speeches and enforcement proceedings. In summary, Directors must exercise their fiduciary duty in establishing appropriate procedures and reviewing securities pricing so that net asset value of the mutual fund's share is accurate on a daily basis.

What information do Directors need?

Directors need to review information about:

- **Characteristics of the Fund's portfolio securities and the markets in which they trade; and**
- **Daily pricing procedures used by the Fund's pricing agent including mark-to-market or "shadow pricing" protocols and a periodic comparison of the market value ("shadow price") of a fund share to its amortized cost value.**

From whom do Directors get the information?

Directors should request from the Adviser and/or the Fund's Treasurer appropriate information on portfolio pricing and the pricing protocols.

Directors may also receive a legal memorandum from Independent Counsel about the standards applicable to their considerations.

In addition, Boards may also want to consult with the Fund's pricing agent and other consultants regarding securities pricing issues.

BACKGROUND - WHAT IS RULE 2a-7?[1]

Rule 2a-7 (the "Rule") under the 1940 Act permits money market Funds to maintain a stable price per share by use of the amortized cost method of valuation and/or the penny-rounding method of pricing. Under the amortized cost method, portfolio securities are valued by reference to their acquisition cost as adjusted for amortization of premium or accretion of discount, without adjustment for changes in credit quality of the issuer, changes in prevailing interest rates or illiquidity in the markets that affect the value of the security. Share price is determined under the penny-rounding method by valuing securities either at market value, fair value or amortized cost, and rounding the per share net asset value to the nearest cent on a share price of one dollar. The Rule sets forth conditions for use of these methods which are strict and complex. The conditions relate, generally, to the maturity, quality, liquidity and diversification of the portfolio.

By adhering to the Rule and using the permitted valuation and pricing methods the Fund can, in general, maintain a stable share value. Historically, with few exceptions, compliance with the Rule has allowed money market funds to maintain a stable share value. However, Funds faced challenges assuring stable NAV during the market turmoil of 2008, even though money market Funds generally are permitted to purchase only short term, high quality instruments. In response to those challenges, the SEC adopted amendments to the Rule on January 27, 2010 (the "2010 Amendments") to, among other things, add liquidity requirements to the Rule and to tighten the Rule's quality and maturity requirements. See further information below under "Review Shadow Price."

Typically, a money market Fund seeks to stabilize share value at $1.00 per share, though the Rule allows for stabilization at a different value that a Fund might select. The stable $1.00 share price has caused some shareholders to view the money market Fund as a cash equivalent. Some shareholders view the money market Fund as an alternative to a bank deposit or checking account, even though a money market Fund is not federally insured. Money market Funds have been exceedingly popular products.

In order to stabilize share value, a Fund must take an additional action besides operating under the Rule. That is, the Fund must declare dividends daily. If a Fund does not do so, the income accrued each day would constitute an accretion to share value, and share value would increase even though principal value is otherwise stable. (Some money market Funds have used the words "Daily Dividend Fund" as part of their name.)

A money market Fund not using the amortized cost method must calculate its current net asset value per share by valuing portfolio securities for which market quotations are readily available at market value, and other securities and assets at fair value as determined in good faith by the Board. A money market Fund not using the penny-rounding method is permitted to round per share net asset value to the extent not considered material. This would require rounding to the nearest one-tenth of a cent on a share price of one dollar. (The SEC stated this in the original proposing release for Rule 2a-7, and confirmed it in the 2010 release adopting amendments to Rule 2a-7.) Typically, money market Funds compute their share value using the amortized cost method and also round the share value to the nearest penny.

The Rule includes a number of conditions designed to reduce the likelihood that the net asset value of the Fund as determined by the amortized cost method will deviate materially from its net asset value as determined based on market values. The Rule's conditions limit permissible investments to those that are expected to have a relatively low level of volatility and thus to provide a greater assurance that the Fund will continue to be able to maintain a stable market price per share that fairly reflects the current amortized cost value per share of the Fund.

Rule 2a-7 is intended to alleviate both market risk, which primarily results from fluctuations in the prevailing interest rate, and credit risk. Generally, instruments with shorter periods remaining until maturity have reduced market risks and more stable values. Generally, instruments which are of higher quality have lower credit risks and more stable values. The 2010 Amendments to the Rule include provisions intended to make money market Funds more resilient to illiquid markets, such as requirements that money market Funds maintain buffers of cash and securities that reduce to cash promptly, which will reduce the likelihood that a Fund will need to meet redemptions by selling portfolio securities into a declining market. The Rule also eliminates currency risk, as all holdings must be U.S. dollar-denominated. Further, the Rule minimizes concentration risk by imposing strict diversification standards, so that the interest rate or credit problems posed by any one security holding should have a limited effect on the portfolio as a whole.

RESPONSIBILITIES OF THE BOARD

a. Adopt Procedures

Central to the Rule is the requirement that a Fund Board using the amortized cost method must adopt procedures to stabilize fund share value. The Rule states "In supervising the money market fund's operations and delegating special responsibilities involving portfolio management to the money market fund's adviser, the money market fund's board of directors, as a particular responsibility within the overall duty of care owed to its shareholders, shall establish written procedures reasonably designed, taking into account current market conditions and the money market fund's investment objectives, to stabilize the money market fund's net asset value per share, as computed for the purpose of distribution, redemption and repurchase, at a single value." The procedures must be *reasonably designed* to achieve their purpose; the Fund Board is not a guarantor that the procedures will achieve this goal.[2]

The Rule sets forth various specific provisions that must be included in Fund procedures. The procedures must provide for periodic testing of the Fund's ability to maintain a stable net asset value per share in the event of specified stress events (including interest rate changes, increased shareholder redemptions, downgrades of or defaults on portfolio securities and the widening or narrowing of spreads between yields on a selected benchmark and yields on types of securities held by the Fund ("Stress Testing Procedures")); an ongoing credit review of certain securities; a periodic determination of whether certain credit supports are being relied upon by the Fund; periodic review of the price stability of certain adjustable rate securities; determinations relating to the issuers underlying asset backed securities; recordkeeping requirements, etc. In addition to including the requirements specifically required to be included in procedures under the Rule, money market Fund procedures typically set forth the full panoply of requirements in the Rule relating to maturity, quality, liquidity and diversification of the portfolio. Boards are advised by both Fund Counsel and the Adviser regarding the content of the procedures, to ensure that the procedures both satisfy the Rule and address the investment needs of the portfolio.

b. **Review the Shadow Price**

Fund procedures are required to implement one of the fundamental requirements of Rule 2a-7: that the Board of a Fund using the amortized cost method compare the amortized cost value of a share to the market-based value of a share periodically ("shadow price"). Specifically, a money market Fund must have written procedures that provide "that the extent of deviation, if any, of the current net asset value per share calculated using available market quotations (or an appropriate substitute that reflects current market conditions) from the money market Fund's amortized cost price per share, shall be calculated at such intervals as the board of directors determines appropriate and reasonable in light of current market conditions. . ."

Determine Intervals for Calculation of Deviation. The Rule requires that Fund procedures provide for "the periodic review by the board of directors of the amount of the deviation as well as the methods used to calculate the deviation. . .", but the Rule does not set forth the frequency of the review. The SEC has said that:

> During periods of high market volatility, this requirement may necessitate that the deviation between such market-based value and price be monitored on a daily basis. During periods of lower volatility, it may be reasonable to monitor such deviation less frequently. The reviews should be frequent enough so that the board may become aware of changes in the market-based per share net asset value before they become material.[3]

Typically money market Funds calculate the deviation either daily or weekly. Some Fund procedures provide that the deviation will be calculated weekly, but upon the occurrence of any material change in interest rates or other event that could change significantly current market values, the Adviser or Fund valuation agent may determine to institute daily determinations of the deviation. Such Fund procedures may endow the Adviser, Fund valuation agent or Fund Board with authority to revert to weekly calculations upon a determination that the material change in interest rates or other event has been fully reflected in the marketplace.

Review Methods to Calculate Deviation – Matrix Pricing. In determining market-based net asset value per share, all securities for which market quotations (or appropriate substitutes that reflect current market conditions) are readily available must be valued at market value. Actual quotations may be used. Alternatively, estimates of market value obtained by a method approved by the Board may be used. Values may be derived from yield data relating to classes of securities obtained from reputable sources, provided that any pricing system based on yield data for selected securities must be based upon "market quotations for sufficient numbers and types of instruments to be a representative sample of each class of security held in the portfolio, both in terms of the types of instruments as well as the differing quality of the instruments."[4]

These estimates are often referred to as "matrix prices," as the price of a security is determined by reference to prices of similar securities whose characteristics may be thought of as providing a "matrix" of data points. The accuracy of the prices obtained through use of the matrix depends on the similarity of the securities being priced to the reference securities in the matrix. The Fund must periodically review the accuracy of the system based on yield data. As the Board is ultimately responsible for pricing, some Boards may wish to receive periodic reports on matrix pricing.

Portfolio securities for which market quotations (or appropriate substitutes that reflect current market conditions) are *not* readily available are valued at their fair value under the supervision of the Board, when determining market-based net asset value per share.

c. **Required Board Action upon Material Deviation or Unfair Results; Dilution**

Deviation Exceeds ½%. The Rule requires that the Board consider what action, if any, to take if the deviation between market value and amortized cost exceeds ½ of 1%. No particular action, and, in fact, no action at all, is specifically mandated by the Rule in this event. Procedures for some Funds include actions to be taken upon lesser deviations (for example, notification of officers, call of a Board meeting), so that Fund officers or the Board can take measures before the deviation approaches the point where the Fund is in danger of "breaking the dollar."

Material Dilution or Unfair Results. The Rule goes on to say that the Board must take such action as it deems appropriate to avoid material dilution or other unfair results. Specifically, "Where the board of directors believes the extent of any deviation from the money market fund's amortized cost price per share may result in material dilution or other unfair results to investors or existing shareholders, it shall cause the fund to take such action as it deems appropriate to eliminate or reduce to the extent reasonably practicable such dilution or unfair results." Action is required where the unfair result *may* occur; unfair result need not be a certainty to require Board action.

Dilution or unfair result could occur due to market fluctuations either above or below amortized cost value. If the net asset value of a Fund determined based on market values were to drop significantly below the net asset value determined by the amortized cost method, investors who redeemed their investment would receive more than their pro rata share of the Fund's assets, the interests of the other shareholders would be diluted, and purchasing investors would pay too much for their shares. Conversely, if the net asset value of a Fund determined based on market values were to rise significantly above the net asset value determined by the amortized cost method, investors who redeemed their investment would receive less than their pro rata share of the Fund's assets and purchasing investors would pay too little for their shares, diluting existing shareholders.

Examples of Board Action. When the SEC adopted the Rule, it stated that it did not propose to codify examples of actions a Board could take, to avoid any implication that other actions would be inappropriate. In the initial proposing release for the Rule, the SEC listed possible actions to take when unfair results may occur: "adjusting dividends; selling portfolio instruments prior to maturity to realize capital gains or losses or to shorten the average portfolio maturity of the money market fund; or redeeming shares in kind . . . if the board were ever to determine that the deviation was such that it could no longer conclude that the amortized cost price fairly reflected the value of each shareholder's interest in the fund, because of the possibility of dilution or other unfair results, it would have to discontinue use of the amortized cost method of valuation and calculate its price per share in accordance with the provisions of the [Investment Company Act] and rules thereunder."[5] This latter action might result in reducing the share price to less than $1.00 (or "breaking the dollar").

d. **Delegation by Board of its Responsibilities**

The Rule refers throughout to actions to be taken or determinations to be made by a Fund or its Board. However, all actions and determinations under Rule 2a-7, other than the actions listed at the end of this sub-section, may be delegated by the Board to the Adviser or officers of the Fund, provided the two conditions described below are satisfied.

Board must approve Guidelines for Delegation. First, the Board must "establish and periodically review written guidelines (including guidelines for determining whether securities present minimal credit risks as required in paragraph (c)(3) of [the Rule]) and procedures under which the delegate makes such determinations." To satisfy this requirement, Boards typically include in their written amortized cost procedures guidelines for an Adviser to follow in making the minimal credit risks determination and other determinations. The Board reviews these procedures, typically annually.

Board must Oversee Implementation of Guidelines. Second, the Board must "take any measures reasonably necessary (through periodic reviews of Fund investments and the delegate's procedures in connection with investment decisions and prompt review of the Adviser's actions in the event of the default of a security or Event of Insolvency with respect to the issuer of the security or any Guarantee to which it is subject that requires notification of the Commission under paragraph (c)(7)(iii) of [the Rule]) to assure that the guidelines and procedures are being followed." To satisfy this requirement for delegation, Boards typically receive reports from the Adviser on portfolio holdings and on actions taken under the Rule.

Non-Delegable Board Duties. Assuming that the Board establishes guidelines and oversees their implementation, the only duties under the Rule that reside solely with the Board and may *not* be delegated are those listed below. Duties (2) through (5) are described in more detail above. (The relevant paragraph of the Rule is cited.)

> (1) Board Determination. The Board must "determine, in good faith, that it is in the best interests of the fund and its shareholders to maintain a stable net asset value per share or stable price per share, by virtue of either the amortized cost method or the penny-rounding method." The "money market fund will continue to use such method only so

long as the board of directors believes that it fairly reflects the market-based net asset value per share." (c)(1)

(2) General required procedures. The Rule requires the Board to establish written procedures reasonably designed to stabilize net asset value per share of the Fund. (c)(8)(i)

(3) Shadow pricing. The Rule requires that the Fund's written procedures provide for calculation of the deviation between amortized cost and market value of a Fund share at such intervals as the Board determines. (c)(8)(ii)(A)

(4) Prompt consideration of deviation. The Board must promptly consider what action, if any, should be initiated by the Board in the event the deviation between amortized cost price and market value of a share exceeds ½%. (c)(8)(ii)(B)

(5) Material dilution or unfair results. If the Board believes the extent of any deviation from market value of the money market Fund's amortized cost value may result in material dilution or other unfair result, the Board must cause the Fund to take such action as it deems appropriate to eliminate or reduce the extent reasonably practicable dilution or unfair results. (c)(8)(ii)(C)

(6) Defaults and other events. The Rule requires, in summary, that upon certain defaults or events of insolvency (as defined in the Rule) of a portfolio security or if a portfolio security no longer presents minimal credit risks or is no longer an eligible security (as defined in the Rule), the Fund must dispose of the security, absent a finding by the Board that disposal would not be in the best interests of the fund. (c)(7)(ii) (If securities constituting ½ of 1% or more of a Fund's total assets experience a default or event of insolvency as defined, the Fund must promptly notify the SEC. A Fund must report on Form N-SAR any action taken with respect to defaulted securities and events of insolvency; deviations between amortized cost and market value of more than ½ of 1%; and any securities held on the final day of a reporting period that are not eligible securities under the Rule.) The Rule sets forth other negative events for which duty to act can be delegated to the Adviser (downgrade of a portfolio security from first tier; receipt by a portfolio security of a rating below second tier).

(7) Required procedures: Penny Rounding Method. The Board is required, in summary, to undertake to assure, to the extent reasonably practicable, that the Fund's price per share computed for purposes of share transactions, rounded to the nearest one percent will not deviate from the single price established by the board. (c)(9)

The following additional non-delegable Board duties were added to Rule 2a-7 in the 2010 Amendments (though the SEC has suspended the requirement to implement item 11).

(8) Approve Stress Testing Procedures. The 2010 Amendments require that the Board adopt Stress Testing Procedures. Stress testing will be done "at such intervals as the board of directors determines appropriate and reasonable in light of current market conditions."

(9) Authorize Suspension of Redemptions and Liquidation of the Fund. A rule adopted in 2010 permits a money market Fund's Board, including a majority of directors who are not interested persons of the Fund, to suspend redemptions if (1) the deviation between the Fund's amortized cost price per share and its market-based net asset value per share may result in material dilution or other unfair results to investors or existing shareholders (for example, if the Fund is about to "break the dollar"); (2) the Board, including a majority of the Board members who are not interested persons of the fund, irrevocably has approved the liquidation of the Fund; and (3) the Fund notifies the SEC prior to suspending redemptions. Currently a fund must obtain an order from the SEC to suspend redemptions. The SEC states that in the event of a threatened run on the Fund, this provision would allow for an orderly liquidation of the portfolio. The Fund is required to notify the SEC prior to relying on the rule.

(10) Establish "Know Your Customer Procedures." The 2010 Amendments require a Fund to hold sufficient liquid securities to meet reasonably foreseeable redemptions. In order to meet this requirement, the SEC stated in commentary in the adopting release for the 2010 Amendments that money market Funds would need to develop and adopt procedures to identify investors whose redemption requests could pose risks for the Fund. As a part of these procedures, a Fund would need to anticipate the likelihood of large redemptions. The SEC said that it "urges" money market Fund Boards to consider the need for establishing guidelines that address an Adviser's conflict between attracting additional assets (which may be "hot" money) and complying with its duty to manage the money market Fund in a manner consistent with maintaining a stable net asset value.

(11) Designate Rating Agencies and Annually Determine Reliability. Ratings by rating agencies are central to the requirements of Rule 2a-7, as the rule requires that each holding be rated in the top two short-term rating categories by rating agencies, or, if unrated, be determined by the adviser to be of comparable quality. The 2010 Amendments created a new Board duty relating to designation of rating agencies whose ratings would form the basis for certain quality determinations by a money market Fund. But, the SEC staff has permitted funds to suspend implementation of the provision and to comply with the requirements relating to rating agencies that were in the Rule prior to the 2010 Amendments. Further, the SEC has proposed to remove requirements in Rule 2a-7 relating to ratings entirely. The SEC took these latter two actions to implement a provision in the Dodd-Frank Wall Street Reform and Consumer Protection Act approved by Congress on July 15, 2010 (the "Dodd-Frank Act") that mandates removal of references to ratings from regulations.

The 2010 Amendments required a money market Fund Board to designate each year at least four rating agencies whose ratings the Board determines to be sufficiently reliable to be used by the Fund to determine whether a security is eligible under the Rule and to determine at least once each calendar year that the ratings by those agencies are sufficiently reliable for that use. (Prior to the 2010 Amendments, a rating agency need not be designated by the Board for its ratings to form the basis of certain quality determinations under Rule 2a-7.) The Fund must identify the designated rating agencies in the Fund's statement of additional information (initially by no later than Dec. 31, 2010). The SEC states in the adopting release for the 2010 Amendments that these provisions may foster competition among rating agencies to develop a specialized service of providing short-term ratings to money market Funds and may improve the quality of ratings. The SEC also says that when the Fund Board designates rating agencies, the Fund Board should have the benefit of the Adviser's evaluation of the quality of the rating agencies' ratings.

However, the Dodd-Frank Act directs the SEC to modify its regulations to remove references to ratings and requirements of reliance on credit ratings and to substitute such standard of creditworthiness as the SEC determines to be appropriate. The effect of this provision would be to render the designations by fund Boards irrelevant several months later when the SEC is required to eliminate references to credit ratings from its regulations. Accordingly, the SEC staff has issued industry-wide relief permitting Boards to delay designation of rating agencies pending implementation of the related provision of the Dodd-Frank Act. The SEC may modify or eliminate the provisions in Rule 2a-7 relating to rating agencies in order to implement that legislation.

On March 2, 2011, the SEC proposed amendments to Rule 2a-7 which would implement the mandate in the Dodd-Frank Act to remove ratings from Rule 2a-7. If the proposals are adopted, a money market Fund would no longer be required to limit its investments to those rated within the top two categories by rating agencies (or to unrated securities of comparable quality). Rather, the fund's board or its delegate (that is, the Adviser) would be required to determine whether each security presents minimal credit risks based on "factors pertaining to credit quality" and on "the issuer's ability to meet its short-term financial obligations."

e. **<u>Portfolio Management – Main Aspects of the Rule</u>**

In addition to the duties for which the Board is solely responsible, compliance with the Rule entails myriad duties normally carried out by the Adviser under Board-adopted guidelines. The outline below broadly summarizes the major portfolio management requirements of Rule 2a-7, to provide a flavor of the scope of the Rule's coverage.

(1) Quality

a. Each security must pose minimal credit risk.

b. Each security must be an eligible security as defined in the Rule, generally based on ratings in the top two rating categories, or a determination that an unrated security is of comparable quality to rated securities. There are special rules applicable to securities with a guarantee, with a conditional demand feature (as defined in the Rule), and for certain other types of securities.

c. The Rule limits second tier securities (as defined in the Rule) to 3% of total assets (reduced from 5% in the 2010 Amendments).

d. Miscellaneous Additional Quality Standards.

United States dollar-denominated
Guarantee – in general must be rated
Guarantee, demand feature, must provide notice of substitution

e. The Fund need not test compliance for guarantees and demand features not relied upon by the Fund.

(2) Diversification as to Issuer

a. Generally limited to 5% in an issuer.

i. Taxable and national tax-exempt Funds have an exception referred to as a "3 day safe harbor." The exception, in summary, permits the Fund to invest up to 25% of its total assets in first tier securities (as defined in the Rule)[6] of a single issuer for up to three business days.

ii. A single state Fund has an exception referred to as a "25% basket," that permits the Fund, in summary to exceed the 5% limit with respect to 25% of total assets for investments in first tier securities (as defined in the Rule).

b. Second tier issuer test - Generally a Fund is limited to 1/2% of assets in a second tier issuer (reduced from the greater of 1% of assets or $1 million, in the 2010 Amendments).

i. Exceptions to issuer diversification testing for:

U.S. Government securities
Securities with a guarantee issued by a non-controlled person
Shares of other money market Funds

ii. Special diversification treatment for certain securities, referred to as "look-through" treatment.

Refunded securities
Repurchase agreements
Conduit securities
Asset backed securities

(3) Diversification as to Credit Enhancements

Generally 10% limit in any one provider with 25% basket for first tier demand features and guarantees issued by a non-controlled person. The 25% basket, in summary, permits the Fund to exceed the 10% limit with respect to 75% of total assets for first tier demand features or guarantees.

i. Demand features and guarantees not relied upon.

ii. Exceptions to credit enhancement diversification testing for certain types of credit enhancements:

Issuer-provided guarantee
Issuer-provided demand feature
U.S. Government securities

iii. Special Rules for:

Fractional demand features and guarantees
Layered demand features and guarantees

(4) Maturity

a. Maturity of each investment must be appropriate to maintaining a stable NAV.

b. Maturity of each investment – may not exceed 397 days (except 45 days for a security that is second tier quality, under the 2010 Amendments). This provision is subject to provisions that permit a Fund to treat a security as having a maturity shorter than its nominal maturity (referred to as “maturity shortening” provisions).

c. Maturity of the portfolio – weighted average maturity may not exceed 60 days (reduced from 90 days in the 2010 Amendments).

d. Weighted average life of the portfolio – weighted average life of the portfolio may not exceed 120 days (requirement added in the 2010 Amendments.) (Rule 2a-7 permits maturity of certain adjustable rate securities to be deemed to be the next interest rate adjustment date. However, the new weighted average life requirement is measured without regard to interest readjustment dates. Accordingly, this test limits the Fund’s ability to invest in adjustable rate securities.)

(5) Liquidity (added in 2010 Amendments)

a. A money market Fund will hold securities that are sufficiently liquid to meet reasonably foreseeable redemptions.

b. A money market Fund shall not acquire more than 5% of total assets which are illiquid securities (reduced from 10% in the 2010 Amendments).

c. A money market Fund will not acquire less than 30% of total assets which are cash, Treasury securities and certain other securities convertible to cash within five business days and will not acquire less than 10% of total assets which are cash, obligations of the U.S. Government or securities that are convertible to cash within one business day.(The 10% test does not apply to a tax-exempt money market Fund.)

(6) Stress Testing (added in 2010 Amendments)

A money market Fund will stress test its portfolio for changes in interest rates, shareholder redemptions, defaults and downgrades of holdings and changes in the spread between the yield on an appropriate index and the yield on types of securities held by the Fund.

f. **<u>Reports for Board to Review</u>**

Rule 2a-7 includes very few requirements as to the contents of reports to the Board. Many Boards require reports in addition to those specified in the Rule, in order to support that the Board is fulfilling its duty to oversee operation of the fund as discussed above. The reports specifically required by the Rule are as described below.

(1) The Board must periodically compare the amortized cost and market – based values per share of each money market Fund, as explained under "Review Shadow Price" above. (c)(8)(ii)(A)(2) The report to the Board may show, for example, that on a particular day being reviewed, the value of a Fund share, based on market value of its holdings, is $1.0012 or $.996, as compared to the amortized cost value of $1.00 which is used for purposes of processing purchases and redemptions of Fund shares.

(2) The Board must periodically review the methods used to calculate the deviation between the amortized cost and market-based values per share of each money market Fund. See "Review Shadow Price" above for a discussion of methods for calculation of the deviation. (a)(1) and (c)(8)(ii)(A)(2)

(3) The Board must periodically review investments and the Adviser's procedures in connection with investment decisions. (e)(2)

(4) The Board must promptly review the Adviser's actions in the event of default or insolvency of an issuer. (e)(2)

(5) The 2010 Amendments added a requirement that the Board receive a report under the Fund's Stress Testing Procedures. (c)(10)(v)

(6) As explained above, the 2010 Amendments added a requirement that the Board designate at least four rating agencies whose ratings are sufficiently reliable to be used under the Rule's rating standards, though the SEC staff has permitted Boards to delay implementation of this requirement. The SEC's commentary in the release adopting the 2010 Amendments states that the SEC expects that, when, if ever, the Board implements the requirement and designates rating agencies, the Board should have the benefit of the Adviser's evaluation of the quality of the rating agencies' ratings in making that designation. As noted above, the SEC has proposed to eliminate references to ratings from Rule 2a-7 in response to a requirement in the Dodd-Frank Act. If references to rating agencies are eliminated, the Adviser may not need to report to the Board on its evaluation of rating agencies ratings.

Among additional reports that a Board may desire include:

(7) A representation that the Fund had invested only in acceptable instruments since the prior report;

(8) A list of any non-complying instruments;

(9) A report on portfolio maturity;

(10) Review of illiquid securities and a report on the adequacy of the Fund's liquidity;

(11) Review of second tier holdings;

(12) Review of repurchase agreement dealers;

(13) A report under Fund "know your customer" procedures; and

(14) A representation from the Fund's transfer agent or Adviser that the Fund has the capacity to process share transactions at other than $1.00 (that is, after the fund breaks the dollar). Funds were required to have this capacity by October 31, 2011 under the 2010 Amendments.

In addition, a Board may wish to receive reports upon specific events, for example, upon any change in procedures, upon significant deviations between amortized cost and market value and upon the negative events discussed above.

ADDITIONAL PROVISIONS IMPLEMENTED TO ADDRESS THE MARKET TURMOIL OF 2008

Shadow Pricing during Market Turmoil; Reporting of shadow prices and other information to the SEC under Rule 30b1-7. During the market turmoil of 2008, money market Funds faced significant challenges relating to the shadow pricing process. The credit quality, and therefore the market value, of some Fund holdings had declined. Further, markets which normally were liquid were, instead, frozen. There was limited appetite among buyers to purchase securities, even the relatively safe securities held by money market Funds. Accordingly, when money market Funds sought to shadow price their holdings, they sometimes found that market prices had declined to a point where the stable share value was threatened. Some Funds encountered this situation even where the securities did not pose any particular credit quality concern. In addition, some money market Funds faced liquidity challenges, as many shareholders redeemed at a time when it was unusually difficult for the Funds to generate cash to satisfy the redemption orders. Another difficulty Funds faced during this period was assuring the accuracy of pricing information. Regulators rapidly put in place a number of support programs for money market Funds at this time, including the Treasury's Temporary Guarantee Program for Money Market Funds which temporarily guaranteed the share value of certain money market Fund shares. In addition, numerous money market Fund sponsors provided support to their money market Funds, for example, by purchasing holdings to help the Fund raise cash to fund redemptions. Some money market Fund sponsors put in place "capital support agreements," which provided that the sponsor would make payments to the Fund under certain circumstances. (In some instances the money market Fund and/or its sponsor was required to obtain relief from the SEC from affiliated transaction prohibitions that would otherwise have forbidden the transaction.) Nevertheless, one money market Fund broke the dollar during this period -- The Reserve Primary Fund. This event highlighted the risks of money market Funds.

In response to these events, as part of the 2010 Amendments, the SEC enacted Rule 30b1-7,[7] which requires a money market Fund to provide the SEC specified monthly portfolio and valuation information, including the shadow price of a fund share. The information in the reports will be available to the public 60 days after the end of the month to which the information pertains. Prior to the new SEC rules, shadow price was not readily available to the public. Some industry professionals expressed concern that the requirement for public disclosure of the Fund's shadow price might encourage runs on funds by investors who may be alarmed by pricing deviations. The SEC said that the 60 day delay in making this information public would ameliorate many risks associated with public disclosure, for example by enabling funds to take steps to resolve issues that may raise concerns with investors and analysts, before the shadow price is disclosed.[8]

Ability to process share transactions at other than $1.00. When The Reserve Primary Fund broke the dollar in 2008, it faced operational limits on its ability to process share transactions at other than $1.00. To address those issues in the event another fund breaks the dollar, the 2010 Amendments require each money market Fund or its transfer agent to have the capacity to process purchases and redemptions electronically at a price other than $1.00 per share. This requirement would facilitate share redemptions if a Fund were to "break the dollar." Funds were required to comply with the new requirement no later than Oct. 31, 2011. The Board may wish to receive a representation from the Fund's Adviser or transfer agent periodically that the Fund has this capacity.

CONTINUING REGULATORY UNCERTAINTY FOR MONEY MARKET FUNDS AND ADDITIONAL REFORM INITIATIVES

The market turmoil of 2008 spurred regulators to consider further more fundamental reform of money market funds, in addition to the 2010 Amendments.

Reform Proponents Identify Systemic Risk of Money Market Funds

On October 21, 2010, the President's Working Group on Financial Markets (PWG)[9] released its report on possible fundamental reform of money market funds (the "PWG Report"), and directed the SEC to collect comments on the PWG Report and consider further regulation. Also, a staff report of the Federal Reserve Bank of New York[10] (the "Report") described regulators' concerns about the systemic risks of money market funds. The Report stated that money market funds are vulnerable to runs, and because money market funds are an important source of short-term funding, this vulnerability poses systemic risk to the U.S. financial system. The Report states that the "potentially dire" consequences of a run were evidenced during the liquidity crisis of 2008, when outflows from money market funds were "a key factor in freezing of short-term funding markets and a broader curtailment of credit supply." Some in the industry have taken issue with this analysis, which views money market funds as a cause of the financial crisis, and rather see money market funds as a victim of widespread financial dislocation. (See, for example, comment letters on the PWG Report filed by Melanie L. Fein posted on the SEC's website on June 28, June 26, May 11, April 18 and March 30, 2012.)

The Report states that money market funds' vulnerability to runs stems, in large part, from their stable $1.00 share value. Money market funds value their shares by using the amortized cost method to value their assets and rounding to the nearest penny on a $1.00 share. Under the amortized cost method, assets are valued based on acquisition cost, with no adjustment for factors that might be expected to affect share value, such as changes in creditworthiness of the issuer, changes in prevailing interest rates and reductions in liquidity in the market for the asset. The money market fund must calculate periodically the "shadow price" or market value per share. If shares have a market value of less than $0.995, the shares will no longer be valued based on amortized cost value but will "break the dollar" and be valued based on market values.

Critics of amortized cost valuation assert that the amortized cost value hides the true share value. Under this view, savvy shareholders (generally institutional investors, the Report states) have an opportunity to redeem shares for $1.00 when the shares are worth slightly less than $1.00, further diluting remaining shares. Accordingly, early redeemers have an advantage if shares are headed toward breaking the dollar. Proponents of the floating NAV argue that it will reduce the tendency of money market funds to experience large redemptions during periods of financial distress.[11]

Possible Regulatory Paths Forward

During August 2012, the SEC was nearly ready to issue proposals for the fundamental reform of money market funds. However, in an unusual announcement on August 22, 2012, SEC then-Chairman Mary Schapiro reported that the SEC would not propose structural reforms to money market funds at that time, because three of the five commissioners were unwilling to support a staff proposal.[12] Schapiro stated that other policymakers now had clarity that the SEC would not act to issue a money market fund reform proposal and could take that into account in deciding what steps should be taken to address this issue. In contrast, following Chairman Schapiro's statement, SEC Commissioners Gallagher and Paredes, said that they did not intend to "abdicate" their responsibility to regulate money market funds to other regulators.

The other regulators who may act include the Financial Stability Oversight Council ("FSOC"). The Dodd-Frank Act created FSOC, a council of regulators comprised of the chairs of the 10 major U.S. securities, banking and other financial regulators, including the chairman of the Federal Reserve and the chairman of the SEC. FSOC is charged with comprehensive monitoring to ensure the stability of the U.S. financial system by identifying threats to the financial stability of the U.S., promoting market discipline, and responding to emerging risks to the stability of the U.S. financial system.

As part of FSOC's risk oversight powers, it has specific authorities that could reach money market funds. Under Section 120 of the Dodd-Frank Act, FSOC has the power to provide for more stringent regulation of a financial activity or practice by issuing recommendations to the primary financial regulatory agency to apply new or heightened standards and safeguards for a financial activity or practice conducted by nonbank financial companies. (The SEC is the "primary financial regulatory agency" in the case of money market funds.) Under this power, FSOC could recommend to the SEC that the SEC impose additional regulations on money market funds. However, the SEC has the choice of either accepting the recommendation or explaining in writing why it has decided not to follow the recommendation.

Exercising the foregoing power, in November 2012, FSOC proposed to recommend to the SEC that money market funds implement one of three reforms.

1. Adopt a floating NAV.

2. Comply with new requirements to both:

(a) maintain a capital buffer of up to 1 percent of fund assets; and

(b) require that 3 percent of each shareholder's highest account value in excess of $100,000 during the previous 30 days (the "minimum balance at risk" or MBR) be subject to delayed redemption. The MBR would be used to restore losses that arise in the money market fund within a 30-day period following redemption and that completely deplete the capital buffer. A fund that completely depleted its capital buffer would be required to either (i) suspend redemptions and liquidate or (ii) operate with a floating NAV indefinitely or until it restored its buffer.

3. Maintain a capital buffer of up to 3 percent of fund assets and possibly implement additional reforms that FSOC might recommend. FSOC may determine that the additional measures would justify allowing a reduced buffer. Additional reforms that FSOC suggests include stiffer rules on portfolio diversification or portfolio liquidity, "know your customer" measures, and/or more frequent disclosure of fund holdings or shadow NAV.

FSOC also has solicited comment on proposed redemption fees and/or gates on redemptions that would take effect when a money market fund is under stress (for example, if the fund's liquidity or shadow NAV declined or at the discretion of the fund Board).

If FSOC finalizes its money market fund recommendations, the SEC is not required to propose and implement the recommendations. The Dodd-Frank Act requires that the SEC impose recommendations (or similar standards that FSOC deems acceptable) or to explain in writing to FSOC within 90 days of the final recommendation why the SEC has determined not to proceed.

If the SEC decides not to implement the recommendations, FSOC's only recourse under Section 120 would be in Congress: FSOC is required to report to Congress on its recommendations and the implementation or failure to implement its recommendations. Section 120 has been referred to by some as the "name and shame" provision.

FSOC has invited the SEC to circumvent the process at FSOC by pursuing reform on its own before FSOC finalizes recommendations under Section 120. FSOC said in the Proposed Recommendations:

> If the SEC moves forward with meaningful structural reforms of [money market funds] before [FSOC] completes its Section 120 process, [FSOC] expects that it would not issue a final Section 120 recommendation to the SEC.

Some expect that the SEC will proceed on its own. For the SEC to propose or approve money market fund reform, votes from a majority (three of five) SEC Commissioners are necessary. It is unclear whether a majority of the SEC Commissioners are willing to vote to propose money market fund reform at this time.

The stakes are high for the reform battle. Many believe reformed money market funds will be unappealing to investors and money market fund sponsors. Accordingly, funds will shrink, reducing an important source of financing to markets and an important cash management tool for investors. Further, money that exits money market funds may migrate to banks or to riskier alternatives, perhaps increasing systemic risk.

Other Powers of FSOC; the Federal Reserve

In addition to its power under Section 120 of the Dodd-Frank Act, FSOC also has the authority to designated a nonbank financial company as a "systemically important financial institution" (SIFI) to be supervised by the Federal Reserve Board. Under this power, FSOC could designate a money market fund or its sponsor as a SIFI that would be subject to supervision by the Federal Reserve Board. This authority to designate applies only to the particular compan(ies) designated as SIFIs, and not to the industry as a whole. Accordingly, this power appears ill-suited to money market fund reform, which is perceived as an industry-wide issue. Also, FSOC issued a rule on April 3, 2012 regarding the process for designating SIFIs, which appears to indicate that money market funds are not in the crosshairs for designation as a SIFI.

FSOC also could take a third approach: designate money market fund activities as a "financial market utility" or as a "payment, clearing, or settlement activity," to be subject to risk management standards imposed by the Federal Reserve. This approach seems to stretch the language in the Dodd-Frank Act, which does not, on its face, envision money market funds to be covered by this provision. If FSOC pursues this provision, the action might be subject to legal challenge by industry stakeholders.

A different regulator, the Federal Reserve Board, has authority over banks that could affect money market funds. Treasury Secretary Timothy Geithner, as Chairman of FSOC, has urged that

> the bank regulatory agencies should evaluate their authorities to impose capital surcharges on regulated entities that sponsor [money market funds], or restrict financial institutions' ability to sponsor, borrow from, invest in, and provide credit to [money market funds] that do not have structural protections. As currently conducted, such activities can pose risks to financial institutions' safety and soundness in a variety of ways, including the potential for [money market funds] to curtail funding for financial firms abruptly in times of market stress and the implicit support provided by firms that sponsor [money market funds].

International Reform Efforts that may Inform (or be Informed by) the Views of U.S. Regulators

Europe's Financial Stability Board (FSB) has issued for comment money market fund reform proposals that were prepared by the International Organization of Securities Commissions. Comments were due January 14, 2013. FSB expects to issue a final recommendation regarding money market funds during September 2013. Action by governments and the European Parliament would be necessary to implement any recommended changes.

Separately, the European Commission is also considering the need for further reforms to their regulation of money market funds.[13] The pressure of international views may make it more difficult for U.S. regulators to leave money market funds as they are.

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PRACTICAL APPLICATIONS RELATING TO BOARD DUTIES UNDER 2a-7

The following are some scenarios that the Board of a money market Fund may encounter, and possible courses of action the Board may take.

Scenario 1: A money market Fund's portfolio manager reports that the Fund is investing in (or proposes to invest in) an unusual or novel type of security.

While it is unlikely that a Board can perform a complete analysis of whether the acquisition of a particular security satisfies all the strictures of the Rule, the Board *can* ask questions about the Adviser's review of the security. The following are some examples of questions that a Board may ask about unusual or novel investments.

- Will the value of the security be affected by interest rate changes in the marketplace? Is it possible to "stress test" the security to determine its value in various interest rate scenarios?
- If the security has an adjustable interest rate, does the Adviser reasonably expect that the security's market value will approximate amortized cost at each interest readjustment (or every day for a floating rate security)?
- How will market values for the security be obtained for purposes of shadow pricing? Are market quotes or substitutes available? Is the pricing source accurate, or is there more than one source to check the price?
- If market quotations or substitutes are not available, how can the security be fair valued?
- Does the security raise any new issues relating to diversification that need to be addressed (for example, multiple credit exposures that should be tested under the diversification rules)?
- Are the Fund accountants and auditors comfortable with the accounting for this instrument?
- What are the benefits to the Fund of this investment and what are the risks?
- Does this instrument raise any tax issues?
- Does the Adviser understand how the instrument operates and have the controls in place to address compliance testing for the instrument?

Scenario 2: A money market Fund is performing well above or below its peers.

While outperformance is a good thing, being an "outlier" can raise questions, particularly for money market Funds, which, as a class, tend to provide limited opportunity to vary investment approach. A Board may ask the Adviser the source of the strong performance. Is the Fund investing in securities that its peers do not purchase? What are these?

And, as with any Fund, the Board may ask about the reason for underperformance. Expenses have a particular impact on money market Fund performance, where yields are typically lower than for other types of portfolios.

Scenario 3: A money market Fund's market value is diverging from its par value.

While there will normally be some divergence between market value and par, the Rule requires prompt consideration of what action, if any, should be initiated if the deviation exceeds ½%. Fund procedures typically call for notice to officers and/or board meetings well before such benchmark is reached. Further, where the Board believes the extent of deviation may result in material dilution or other unfair results to investors or existing shareholders, the Board shall cause the fund to take such action as it deems appropriate to eliminate or reduce to the extent reasonably practicable such dilution or unfair results. When the stable NAV of a money market Fund is threatened, the Board may ask the Adviser to arrange for more frequent shadow pricing and stress testing. Examples of actions that could be considered if market value substantially deviates from par include:

- Shorten average portfolio maturity;
- Improve the credit quality of holdings in the portfolio generally;
- Where market value falls substantially below par:
    - increase assets by limiting dividends
    - increase assets by selling securities to realize gain
    - have the Adviser or other affiliate purchase a troubled instrument from the portfolio to shore up net asset value
    - have the Adviser or other affiliate make a capital contribution to the Fund to increase asset size and dilute the effect of a low-valued security.
    - have the Adviser enter into a capital support agreement that requires the Adviser to make payments that stabilize share value under specified circumstances;
- Where market value substantially exceeds par:
    - reduce the asset base by selling a security at a loss
    - sell securities at a gain and distribute the gain; or
- Ultimately, a Board could decide to cease using the amortized cost method to value shares, and value shares at market value.

The Board may consider with the Adviser whether the Adviser would be willing to provide support to protect the fund from breaking the dollar. The Board may be called on to discuss with the Adviser whether the fund should retain or dispose of a security whose value is impaired. Under the 2010 Amendments, the Board has the authority to suspend redemptions in order to liquidate a money market Fund, under certain circumstances. The fund will need to carefully consider operational, accounting, tax and disclosure issues relating to these decisions.

Scenario 4: A money market Fund's amortized cost procedures are being approved and the Adviser is presenting an annual report on the money Funds.

There are various aspects of money market Fund compliance that a Board may examine during a review of money market Funds. A few possible examples are listed below.

- Pricing – The Adviser may report on the accuracy and fairness of the pricing system used. Is matrix pricing used? Is the matrix price based on yield data sufficient for the Board to determine whether appropriate valuations are being obtained? Is the system based on market quotations for sufficient numbers and types of securities to be a representative sample of each class of security held by the Fund, in terms of type and quality of security? If a valuation service is used, does it provide fair and accurate values?

- Quality – What is the Adviser's process for determining minimal credit risk and eligible security ratings?

- Diversification – What is the Adviser's process for testing diversification?

- Maturity – What is the Adviser's process for assuring compliance with maturity requirements and determining what maturity is appropriate under particular conditions?

- Liquidity – How does the Fund ensure adequate liquidity? What illiquid instruments does the Fund hold?

- Monitoring – The Rule requires a Fund to monitor certain aspects of compliance on an ongoing basis. Is the Adviser monitoring as required, and doing so with sufficient frequency? (Ongoing reviews relate to such matters as whether the Fund is relying on certain credit supports or not; the interest rate volatility of certain adjustable rate securities; diversification of asset-backed securities; minimal credit risk determinations for certain securities with demand features.)

- The Rule requires the Adviser to make certain determinations before investing in securities with conditional demand features (for example, that there is minimal risk that the circumstances that would result in the conditional demand feature not being exercisable will occur; and (*1*) The conditions limiting exercise either can be monitored readily by the fund, or relate to the taxability, under federal, state or local law, of the interest payments on the security; or (*2*) The terms of the conditional demand feature require that the fund will receive notice of the occurrence of the condition and the opportunity to exercise the demand feature in accordance with its terms). Does the Adviser make these determinations?

Scenario 5: A money market Fund has difficulty selling assets to generate cash to honor redemptions.

Many money market Funds encountered limited liquidity during the market turmoil of 2008. There are several options a Fund could consider to address a liquidity crunch, though some of these options take time to implement, and are best put into place before the acute need arises.

- Line of credit from a bank or Fund sponsor purchases securities from the Fund (may require relief from the SEC);
- Fund sponsor makes investment in the Fund;
- Fund sponsor makes capital contribution to the Fund;
- Fund sells an asset to an affiliated Fund under the Funds' procedures for affiliated purchases/sales under Rule 17a-7; or
- Interfund lending and borrowing (requires exemptive relief from the SEC).

If the liquidity need is dire, the Fund can also consider:

- Delaying redemptions for up to seven days;
- Suspending redemptions to liquidate under a new rule that allows the Board to take such action without SEC relief. The troubled fund would cease operations and wind up;
- Seeking a "white knight" Fund to acquire the assets of the troubled Fund and issue its shares to the shareholders of the troubled fund. This would mean the acquired Fund would no longer exist as a separate Fund.

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[1] Adapted with permission from *The Guide to Rule 2a-7: A Map Through the Maze for the Money Market Professional* © Joan Ohlbaum Swirsky 2011.
[2] For a money market fund using the penny-rounding method, the Rule does not include a parallel general statement relating to procedures. Instead the Rule includes the general requirement that the Board must undertake, "as a particular responsibility within the overall duty of care owed to its shareholders, to assure to the extent reasonably practicable, taking into account current market conditions affecting the money market fund's investment objectives, that the money market fund's price per share as computed for the purpose of distribution, redemption and repurchase, rounded to the nearest one percent, will not deviate from the single price established by the board of directors." Rule 2a-7(c)(9)
[3] 2/5/82 proposing release for amendments to Rule 2a-7.
[4] 2/5/82 proposing release for amendments to Rule 2a-7.
[5] 2/5/82 proposing release for Rule 2a-7.
[6] First tier securities, in general summary, are Eligible Securities (as defined in Rule 2a-7) that are rated in the top rating category by rating agencies, equivalent quality unrated securities, U.S. government securities (as defined in the Rule) and shares of other money market funds.

[7] Rule 30b1-7 replaced Rule 30b1-6T, which the SEC enacted temporarily on September 18, 2009 to require a money market fund to provide the SEC specified weekly portfolio and valuation information if the market-based net asset value per share was below $.9975. In addition to the new filings with the SEC, the 2010 Amendments require money market Funds to include on their websites monthly disclosures of specified information about the Fund's portfolio and holdings.

[8] 2/23/10 adopting release for amendments to Rule 2a-7.

[9] The PWG, established by executive order of President Reagan in 1988, is comprised of the Secretary of the Treasury (who serves as its Chairman), the Chairman of the Federal Reserve Board of Governors, the Chairman of the SEC, and the Chairman of the Commodity Futures Trading Commission.

[10] "The Minimum Balance at Risk: A Proposal to Mitigate Systemic Risks Posed by Money Market Funds," posted on the New York Federal Reserve Bank website on July 19, 2012. The report is authored by FRBNY personnel Patrick E. McCabe, Marco Cipriani, Michael Holscher and Antoine Martin.

[11] The Report notes two additional negative consequences of rapid redemptions. First, money market funds meet redemptions by disposing of their highly liquid assets rather than selling a cross section of holdings, which typically may include less liquid assets. Accordingly, nonredeeming shareholders are left with a claim on a less liquid portfolio. Second, redemptions that force one money market fund to sell less liquid assets at a loss may exert downward pressure on asset prices, placing other money market funds at risk of loss and prompting shareholders in those other funds to redeem shares pre-emptively.

[12] SEC, Press Release No. 2012-166, Statement of SEC Chairman Mary L. Schapiro on Money Market Fund Reform (Aug. 22, 2012), *at* http://www.sec.gov/news/press/2012/2012-166.htm.

[13] European Commission Green Paper on Shadow Banking (March 19, 2012).

TAB 11

Report
of the
Mutual Fund Directors Forum

Practical Guidance for Directors on Board Self-Assessments

January 2008

I. Introduction

Annual self-assessments provide directors with an important opportunity to review whether they are meeting their fiduciary responsibilities and adding value to shareholders. The Securities and Exchange Commission ("SEC") required fund boards to conduct annual self-assessments in January 2006, though many boards had conducted in-depth performance reviews long before then.[1,2] Prior to the implementation of the SEC's rules, the Independent Directors Council ("IDC") issued helpful guidance to boards undertaking self-assessments.[3] This report will provide further guidance to mutual fund directors after almost two years of experience with the operation of the rule.[4]

Although there are a wide range of possibilities for how a board conducts its self-assessment, there are several generally accepted base-line requirements. Every board should:

- Ensure that every director is involved;
- Provide all directors with adequate opportunity to discuss the findings that are made during the process; and
- Plan follow-up action after the self-assessment is complete, based on the conclusions reached during the process.

Directors should not approach their board's self-assessment as just another "check the box" exercise, but instead should take the opportunity to ask difficult, thought provoking questions. A robust self-assessment will continually challenge directors to take a hard look at their board practices and avoid validating existing practices without regard to whether those practices remain in the best interest of fund shareholders.

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1 *See Investment Company Governance*, Rel. No. IC-36520 (July 27, 2004) ("Adopting Release"). *See also* Rule 0-1(a)(7)(v) under the Investment Company Act of 1940.

2 In its report on best practices for mutual fund directors in 1999, the Investment Company Institute recommended that directors periodically review their performance by evaluating procedural aspects of the board's operations. *See Report on the Advisory Group on Best Practices for Fund Directors: Enhancing a Culture of Independence and Effectiveness*, Investment Company Institute, June 24, 1999.

3 *See Board Self-Assessments: Seeking to Improve Mutual Fund Board Effectiveness*, IDC Task Force Report, February 2005.

4 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 PricewaterhouseCoopers LLP. Members of the working group participated in the report 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 Board of Directors and Steering Committee, and their comments have been integrated into this document. The report does not necessarily represent the views of all Forum members in every respect.

II. Regulatory Requirements

In the wake of market timing, late trading, and other mutual fund scandals, the SEC adopted a series of rules designed to improve mutual fund governance that became effective in January 2006.[5] The SEC requires that funds relying on commonly used exemptive rules evaluate the performance of the board and its committees at least once annually.[6] The board self-assessment requirement and other reforms were intended to strengthen the independence of the board and to ensure that directors protect shareholders' interests.[7] The requirement gives directors the opportunity to step back from their regular board duties and examine what, if any, changes can be made to improve their governance process.[8] The SEC felt that by reviewing their own operations, boards would gain a better understanding of their role, improve communication among directors, foster greater cohesiveness of the board as a whole, and help directors identify any areas that may need improvement.[9,10]

Due to the diversity of board processes, the SEC provided little guidance regarding what must be covered during the annual review, affording fund boards wide latitude to develop a self-assessment process most appropriate for a fund's particular circumstances. The SEC requires only that the evaluation:

- Consider the effectiveness of the board's committee structure.[11]
- Consider the number of funds served by each director to determine whether they have taken responsibility for too many funds.[12] The SEC imposed this requirement because of the difficulty in prescribing an optimum number of funds that may be overseen by a group of directors.[13]
- Include the substance of the board's discussion of the results in the board minutes.[14]

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5 *See* Adopting Release.

6 *See* Rule 0-1(a)(7)(v) under the Investment Company Act of 1940.

7 *See id.* at 3.

8 *See Investment Company Governance*, Rel. No. IC-26323 (January 15, 2004) ("Proposing Release").

9 *See id.*

10 In addition to the SEC's requirement, the New York Stock Exchange requires exchange listed closed-end funds to periodically review the performance of their audit committees. *See* New York Stock Exchange Rule 303A.07(c)(ii).

11 *See* Adopting Release at 9. This requirement is "designed to focus the board's attention on the need to create, consolidate, or revise the board's committees and to facilitate a critical assessment of the effectiveness of the current board committees." (Adopting Release at footnote 62) *See also* Rule 0-1(7)(v).

12 *See* Adopting Release at 9. *See also* Proposing Release. *See also* Rule 0-1(7)(v).

13 *See* Adopting Release at 9.

14 *See id.*

III. Board Accountability

Boards should periodically review the process they use for their self-assessments. Although a board may benefit from using the same process for several years to establish continuity and allow for comparisons to be made from year to year, self-assessments should evolve over time to meet changing industry practices and changes within the board itself. Even the most highly functioning boards can improve their operations. If the annual self-assessment yields only consistently high praise for a board's current governance methods with no suggestions for improvement, it may be time for an in-depth review of the process to make sure the board is serving shareholders in the best possible way.

All funds are not equal. They differ dramatically in terms of investment strategy, size, distribution channels, and procedures. Fund boards are no different – there are vast variations in terms of size, experience, working style, governance structure, and many other factors. Because of these differences, it is important that boards consider their unique circumstances before determining how best to pursue their self-assessment process.

IV. Asking the Right Questions

Though self-assessments vary among boards, several key areas are common to boards of all sizes and types. The list below is not exhaustive of those items that a board may consider and not all of the areas discussed below are relevant to all funds; it is intended only to serve as a starting point as directors consider what they should think about during a review of their boards.

Number of Funds Overseen by the Board

As discussed above, the SEC requires boards to consider the number of funds for which the directors are responsible. To assess whether the board is overseeing an appropriate number of funds, directors should consider

- Whether, in light of the number of funds and their responsibilities to each of those funds, they are able to provide effective oversight for each fund.

Board Composition

Board composition is an important key to providing the best possible oversight for the benefit of fund shareholders. Directors should consider:

- Whether the members of the board represent a diverse mix of characteristics, experience, and skills appropriate to carry out the board's responsibilities;[15]

- Whether the board is the right size to discharge its duties effectively; and

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15 This issue may be particularly important to boards of small funds because the SEC mandated considerations may be less relevant to these boards. It is vital that boards of all sizes consider if any gaps exist in the skill sets of the boards and how best to fill those gaps, including education, training or other appropriate methods.

- Whether the proportion of independent directors to interested directors is appropriate.

Board Information

Boards are not able to function effectively if they do not have access to the information necessary to make good decisions. Directors should consider the information flow between management and the board, particularly:

- The overall quality and timeliness of information received prior to board meetings;
- The quality of information provided to the Board related to specific areas of responsibility, including the advisory contract renewal process, fund performance, compliance, and approval of fund distribution arrangements;
- The quality of information that the board receives about service providers;
- Whether the board receives sufficient information about important issues and trends in the mutual fund industry and how those areas impact the funds;
- Whether the information addresses matters that are important to fund shareholders;
- Whether the board has sufficient access to fund officers between meetings; and
- Whether the board has sufficient access to resources, including counsel, outside auditors, and others outside of board meetings.

Meeting Process

Once directors have reviewed the materials they receive both in conjunction with meetings and between those meetings, they should examine the meetings themselves. For example, they should consider:

- Whether the number, frequency, and locations of board meetings are appropriate;
- Whether the length of meetings is appropriate to cover all necessary information;
- Whether agenda items are appropriate and whether independent directors have sufficient input as to those items;
- Whether the meetings foster open communication, meaningful participation, and timely action; and
- Whether sufficient executive sessions are scheduled and whether they are constructive and encourage open discussion even in areas where directors may disagree.

Committee Structure

In evaluating the board's committees, directors should consider both the structure of their committees and how each committee functions.

With regard to the structure of committees, directors should consider:

- Whether the board has established the appropriate committees, given the fund complex's particular structure;

- Whether the number, frequency, and length of committee meetings are appropriate; and

- Whether the governing charters for each committee provide adequate guidelines for the operation of each committee.

The board should also take time to evaluate how its committees function. Directors should consider:

- Whether committee meetings are conducted in a way that encourages communication, participation, and timely action by all members of a committee and
- Whether the communication between the committees and the full board is sufficient to allow the full board to take appropriate action and fulfill its fiduciary responsibilities.

Board Accountability

No evaluation is complete without an honest assessment of the board's performance. Therefore, directors should consider:

- Whether board members are sufficiently prepared for meetings;

- Whether directors have an appropriate understanding of the mutual fund business in order to provide adequate oversight;

- Whether the board has a sufficient understanding of industry and fund performance data;

- Whether the board spends its time on the appropriate items by focusing on board issues and delegating other items to management;

- Whether the board effectively uses its chief compliance officer to provide appropriate oversight;

- Whether the board appropriately follows up on action items from prior meetings;

- Whether each board member understands a director's fiduciary responsibilities and adequately discharges those duties;

- Whether there is open and honest communication between the board and management and other service providers; and

- Whether the board provides adequate guidance to – and oversight of – the investment manager and other relevant service providers.

Other

In addition to the areas discussed above, directors also should consider:

- Whether the present level of the board's compensation is fair and adequate;

- Whether there are any areas where the board feels there is a gap in their knowledge about the funds;

- Whether the board has considered the necessity of a succession plan;

- Whether the board's current policy on director investment in the funds is appropriate; and

- Whether the process encourages directors to share ways to improve the board's self-assessment.

V. Process for Board Self-Assessments

The board also must determine the appropriate process to use for its self-assessment. Directors should consider the amount of time and money they can devote to the process, the culture of the board, the board's experience, and counsel's recommendations. The common examples of self-assessment processes discussed below do not represent an exhaustive list of possibilities and are merely designed to provide directors with what other boards have found to be effective.[16] Any method the board chooses must provide a mechanism to allow the directors to identify issues and provide an opportunity to improve in those areas. Boards should review their process from time to time.

In each of the examples below, the independent directors generally have an initial discussion during an executive session of the board. Independent directors then discuss the self-assessment during a meeting of the full board to receive the benefit of the inside directors' input on whether the board is functioning as effectively and efficiently as possible.

Discussion

Directors generally begin this process by reviewing a list of topics that cover all aspects of the board's operation and identifying those items that each director thinks should be topics for a board discussion. Directors are encouraged to identify other important issues for discussion that are not included on the original list circulated to directors. This method allows all independent directors to have an input into the issues that need to be discussed by the board. Those items identified by directors are then put on the agenda and a facilitator then leads the discussion.

[16] For a discussion of these methods in corporate audit committees, *see Board Governance Series*, Volume IX at 8 (2007).

- Pros and Cons of the Discussion Method

These discussions can encourage an honest assessment of the board's progress over the last year and help identify areas that the board wishes to improve. Discussions allow directors to elaborate on their opinions in a way not always practical with written questions. Boards must ensure that the discussion facilitator is effective, however, if results are going to be truly representative of the board's feelings. Some directors also may be reluctant to share their thoughts on sensitive issues in a group discussion format.

Questionnaire

Many boards use a questionnaire as the starting place for their self-assessments. All board members are asked to complete the questionnaire that may ask directors to rate how they are doing on a range of topics or ask directors to identify issues that directors feel should be discussed.[17] Questionnaires also generally include an open-ended question that allows directors to address items that otherwise are not covered by the questionnaire. The individual coordinating the process compiles the questionnaire responses and the appropriate party creates an agenda covering those items of concern identified by directors. Directors should discuss the maintenance of questionnaires with independent counsel.

- Pros and Cons in the Use of Questionnaires

Questions can be carefully considered and changes to questionnaires can be made as the funds evolve. However, if directors are not attentive, over time the use of questionnaires can lead to an overly optimistic outlook on the board's processes. Further, it may be difficult to solicit concrete suggestions for improvement in written form. Boards should include a vigorous discussion of questionnaire results to ensure that their practices continue to evolve and improve over time.

Interview

Much like the discussion method above, the interview method begins with a list of items for each director to consider. This list is circulated to directors who are encouraged to offer additional suggestions of topics that should be addressed. The interviewer, often counsel to the independent trustees or an appropriate board member, then calls each director individually to discuss how the board is functioning generally, the items on the list, and any other items a particular director would like to discuss. The interviewer then consolidates all of the comments and provides a summary of the results to the board during an executive session. All comments are shared without attribution.

- Pros and Cons of the Interview Method

The interview process allows directors to provide nuances to their opinions that may not be evident from written questionnaire responses. Interviewers also have the chance to ask follow-up questions that shed more light on a particular issue. It is critical that directors have complete trust in the party conducting the interviews, so that directors can be totally open and honest in

[17] Questionnaires asking directors to identify items that should be discussed by the board are often used as a basis for the discussion method outlined above.

their responses. Additionally, the interviewer must have the ability to interpret the information revealed during interviews with board members. The interview process can be time consuming, and board members must be willing to commit the necessary time if the process is going to be beneficial. If conducted by counsel or other paid third-parties, interviews are generally more costly than other methods of conducting the self-assessment process.

VI. Use of Third Parties

A board may choose to use only directors in its self-assessment process. In these cases, the chair of the board or of the governance committee often will coordinate the process. Other boards may wish to use a third party to aid with the annual self-assessment process. The choice of whether to use a third party, and who that third party should be, is entirely up to the board.

Some boards may benefit from the independent perspective of someone who is not a member of the board. An experienced board outsider can also provide a comparison among a number of funds, allowing directors to compare their process with others used in the industry. Further, a third party can provide helpful guidance on appropriate follow-up in areas where the board may need improvement.

The most widely used third party in the mutual fund context is counsel to the independent directors.[18] Boards may ask counsel to conduct interviews and report back to the board. Even in cases where the directors do not rely on independent counsel to participate directly in the process, counsel often drafts the questionnaires used as a basis for the process and tabulates responses.[19]

In the corporate context, boards also look to trade associations, board consultants, and other service providers to conduct board self-evaluations.[20] These entities have developed substantive knowledge and breadth of experience through conducting many such evaluations for different boards and may have developed specialized skills that can help boards get the most out of the self-assessment process, and their greater distance from board members may in some cases result in greater objectivity during the evaluation process. Mutual funds, however, have not yet widely embraced the use of third parties other than fund counsel for the self-assessment process. In the future, as mutual fund boards become more comfortable with the process, they may follow the example set by corporate boards and seek the assistance of outside parties who can provide an additional perspective to the board self-assessment.

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18 The board should ensure that counsel is kept well-informed about the board self-assessment, whether or not counsel is directly involved in the process.

19 Though some boards may use counsel to the independent directors with the hope that the results of the process will be protected by attorney-client privilege, most lawyers agree that these types of communications may be discoverable.

20 *See, e.g. What Directors Think: Annual Board of Directors Survey,* 2007 Results (Corporate Board Member Magazine and PricewaterhouseCoopers). The survey indicates that 53.4% of respondents use internal general counsel to facilitate the process, 16.2% used an internal officer, 16.7% used an outside attorney, and 13.7% used another third party adviser. *See also Board Evaluation: Improving Director Effectiveness,* Report of the NACD Blue Ribbon Commission, 2005.

VII. Individual Director Evaluations

SEC rules require only a board level review – no evaluation of the performance of individual board members is necessary. Whether or not to conduct individual evaluations must be carefully considered on a board by board basis, taking into account the personality of the board members and the board's working style. Boards that have used personal evaluations find them helpful in identifying whether board members have the right skill sets to perform their duties and whether members need additional training. Individual directors can be evaluated using self-assessments and peer evaluations.

Questions to Ask When Conducting Individual Director Evaluations

Boards who determine it is in their best interest to conduct individual director evaluations should consider:

- The director's understanding of the legal and fiduciary responsibilities of a fund director;
- The director's understanding of the fund's business and the fund industry as a whole;
- The director's attendance at meetings;
- The director's preparation for meetings;
- The director's ability to work with other directors and management;
- Whether the director actively participates in board and committee meetings;
- The impact of the director's outside interests and business activities on that director's independence; and
- The director's overall contribution to the board and its committees.

Individual Self-Assessments

Self-evaluations can only be effective if the individual board members are willing to be totally honest about their contributions to the entire board. In order to encourage honest feedback, responses should not be shared with the board as a whole. Individual self-evaluations may be conducted using a questionnaire or interview process. In light of the dramatic changes in the mutual fund industry, individual self-evaluations may provide directors with a mechanism to reevaluate their commitment to the funds in an ever-changing environment.

Peer Evaluations

Much like the individual self-evaluation process, boards can use either a questionnaire or interview process for peer evaluations. The process must focus on generating constructive comments that will have a positive impact on the board's culture. Comments should be kept confidential, and shared with individual directors without attribution, to reduce the risk that any director will be alienated as a result of the process. Any records of the peer evaluations should be destroyed once the evaluations are complete.

The board needs to make sure that the peer evaluations do not deteriorate and result in blaming a particular director for any board issues or give a forum to directors who have personality conflicts. Further, the board needs to be satisfied that its directors will honestly evaluate all board members, especially if they have concerns about one particular director's commitment.

VIII. Follow-Up

Once directors identify areas for possible change, they should develop a plan to address those issues over the coming year. Self-assessments that provide evaluation but no mechanism for follow-up will not allow directors the appropriate opportunity to improve their processes over time. Boards should develop an action plan that outlines the findings and assigns responsibility for every item that the board feels needs to be addressed. Responsibilities can be assigned to directors, board committees, the chief compliance officer, management, or other appropriate parties. The board should review the action plan at each meeting to ensure that the board continues to monitor its progress throughout the year.

Improvements implemented by boards as a result of the self-assessment process include:

- Requiring continuing education programs;
- Procedures to ease the transition for new directors;
- Board realignment, including the addition of new board members and the retirement of existing directors;
- Adding and consolidating board committees;
- Management presentations on areas of concern to the board;
- Tailoring activities of board committees to make them more effective;
- Using technology to make meetings more effective;
- Appointing vice chairs to board committees to facilitate succession planning;
- Streamlining board materials; and
- Improving communication with the chief compliance officer.

IX. Conclusion

A board self-assessment is not a one-size fits all exercise. Regulations allow directors to craft a self-assessment that is most appropriate for their particular board. Directors should embrace the annual review as an opportunity to compare their progress from year to year and improve their service on behalf of fund shareholders.

Boards routinely report improvements in operations as a direct result of issues and opportunities identified during board self-assessments. Change is not possible, however, without a genuine commitment to the process on the part of each member of the board. Boards must review their process to ensure that the board continues to improve over time and does not become complacent about its governance.

TAB 12

CHAPTER TWELVE
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; and[6]
- 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.

Responsibilities of the Independent Directors

In order to obtain an optimal level of insurance coverage, Independent Directors must:

- Assess the likely risks, the tolerance for those risks, and the internal controls to determine the right level of insurance for the Fund;[9]
- Notify the affected parties and the SEC of any changes made to the policy; and
- Notify the affected parties when there is a potential claim against the insured company. Typically, this duty is required when a lawsuit or a regulatory investigation is brought against the company for which coverage may be available under the insurance policy. (In practice, it is typically the Adviser who receives first notice of a lawsuit or regulatory investigation against a Fund and thus the Adviser is generally the one to advise the insurance provider on behalf of the Fund and the Board.)

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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(d)(1).

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

[9] Rule 17g-1(d)(1) or (d)(2).

TAB 13

CHAPTER THIRTEEN

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 and negligence.

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 legal 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 the 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. 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.

1. <u>D&O Insurance</u>

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.

2. <u>E&O Insurance</u>

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.

3. 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.

4. 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, costs of corrections coverage include:

- 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.

TAB 14

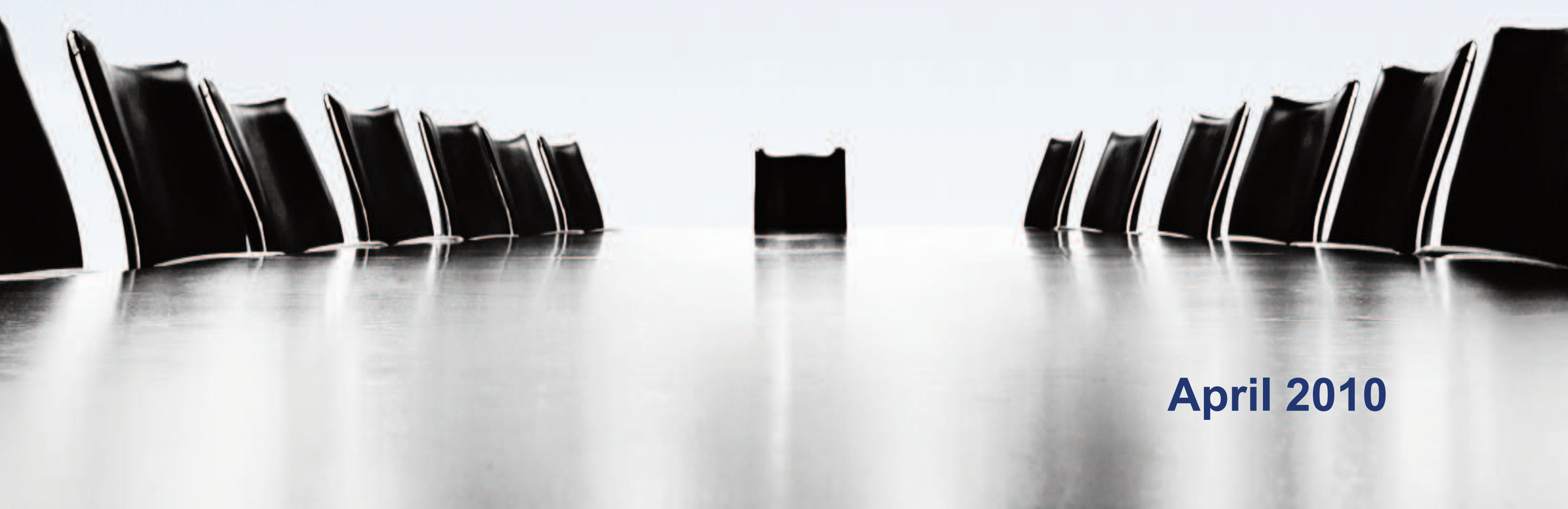
MFDF

MUTUAL FUND DIRECTORS FORUM

The FORUM *for* FUND INDEPENDENT DIRECTORS

Risk Principles for Fund Directors

Practical Guidance for Fund Directors on Effective Risk Management Oversight



April 2010

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Introduction

"Risk" is inherent in the investment management business. In particular, investment managers cannot invest their clients' funds and hope to earn a positive return without taking some measure of risk. In addition, in managing their businesses, investment advisers face a wide variety of risks, ranging from compliance-oriented risks to reputational risks to risks to the systems they use to run their businesses and beyond. Because risk is at the core of the investment management business, how advisers choose what risks to take and how they monitor and manage those risks is fundamental to their – and their clients' – success.

In light of the events of the past few years, the environment in which mutual fund investment advisers, mutual funds, and mutual fund directors operate has become significantly more "risk conscious" and the question of what constitutes effective "risk management" has become a key focus for regulators, legislators and academics. Not surprisingly, therefore, fund directors seek to understand better their role in the risk management process.

While a number of groups have undertaken to define what constitutes best practices in risk management[1] for various types of asset management companies, to date these efforts have focused on the role of management rather than the role of fund directors. In response to the growing interest of directors in this issue, the Forum organized a working group of Forum members, members of the Forum's Advisory Board, and other risk experts to assist in crafting practical guidance on risk governance focused specifically on the needs of fund directors.[2] The resulting document is intended to help fund directors understand their responsibilities with regard to the risks undertaken by their funds, and to provide tools and references useful to assist them in determining the best means to oversee their fund's risks effectively.

The Forum recognizes that the diversity among funds and fund families and the constantly evolving universe of risks in the market make it impossible to develop a "one-size-fits-all" approach to risk governance. Consequently, directors should consider fund size, the assets and number of funds in the fund family, the structure of management and service arrangements and fees, and the nature of fund investment objectives and strategies, among other factors, to determine whether and to what extent particular principles are applicable and appropriate.

The Risk Oversight Process

"Risk" is a fundamental part of the investment management business and cannot be eliminated. However, participants in the investment management business need to understand risk so that they can evaluate intelligently what risks to assume and manage those risks appropriately.

The goal of effective risk management is not to eliminate risk – indeed, neither fund management, other service providers, nor the board itself should be seeking to eliminate risk fully from a specific fund or fund complex. After all, while "risk" can be thought of as the possibility that something will go wrong from either an investment or operational perspective, fund shareholders will not be better off if risk is eliminated. Rather, from the investment perspective, managing risk requires balancing the probability that an investment will go bad against the possibility that it will perform well, taking into account the anticipated potential losses and gains associated with the investment. Similarly, from an operational perspective, managing risk involves balancing the possibility that something will go wrong, and the likely costs that would be incurred in that event, against the cost of mitigating or eliminating the risk.

In order to best determine what risks to take, and how they can be managed, fund managers need to understand what those risks are and evaluate and analyze them effectively. A failure to do so can result in an unrecognized, unanticipated, or misunderstood risk that might harm fund shareholders. Unless an adviser has a risk aware culture, its systems and processes for risk management are likely to be ineffective. In other words, effective risk management requires a culture where management employees all understand risk and take responsibility for managing it.

While fund directors generally cannot be expected to directly identify and analyze risks – tasks much more appropriately performed by the adviser and its personnel – their oversight responsibility impels them to ask whether the adviser has appropriate systems and processes in place for identifying, analyzing, and managing risk. Hence, much of the guidance outlined below is designed to help fund directors better understand how risk can be managed in the mutual fund business so that they can better assess whether, given the specific facts relevant to the funds they oversee, their funds' adviser and other service providers address risk in a manner that protects the interests of fund shareholders.

Mutual fund directors are expected to oversee the investment adviser's management of the risks associated with the funds they serve. The nature and scope of this obligation, however, is not clearly defined.

Current discussions of risk clearly assume that directors, including the directors of mutual funds, have a role in overseeing the risks taken by the entities on whose boards they sit, and often at least imply that role is legally mandated. Nonetheless, the source of directors' obligations with respect to risk may not be obvious. Most notably, federal laws, particularly the securities laws, say little about directors' obligations in this area.[3] Under state law and under section 36 of the Investment Company Act of 1940 ("Investment Company Act"), however, fund directors have a responsibility to oversee[4] their fund's affairs, including, presumably, a responsibility to oversee risk management that is similar in scope and nature to their other oversight responsibilities.

The directors' obligation to oversee risk management is implicit rather than explicit and, in many instances, is interwoven with their other duties. For example, a fund board has a duty to exercise informed oversight with respect to the investment strategies employed by the funds they oversee. To perform this duty effectively, directors need to understand the types of securities in which the funds invest as well as the nature of the risk posed by those securities and strategies. In most circumstances, the directors' understanding will be enhanced by an inquiry into whether fund management has implemented appropriate risk reporting systems and controls. Directors should understand the basics of how management's risk management systems work (and thus be in a position to assess management's use of those systems and to insist that management act on any significant warnings or "red flags" these systems provide).[5] ***Fund directors are not, however, responsible for designing and implementing the systems and procedures that are used to identify, analyze and track these risks. Instead, boards typically oversee risk management by reviewing and approving investment and risk management policies and procedures; evaluating the performance of the fund's adviser, any sub-advisers, and other services provider; and periodically reviewing the policies and procedures for material departures.*** Exhibit A provides a useful overview of the components of a risk management framework.

Most fundamentally, fund directors should be satisfied that their fund's adviser has a "risk aware" culture and, to the extent appropriate, seek to foster that culture.

Risk oversight by the board involves an assessment of the investment manager's

culture and risk awareness, and encouragement of the implementation and continuous improvement of a robust process for identifying, managing, prioritizing and monitoring the business and investment risks involved in fund management.

For fund directors, this first requires an understanding of the key risks affecting the funds on whose boards they serve. Directors should seek to understand the particular market, credit, legal, fiduciary, reputational, operational, organizational and other risks applicable to the fund's products and strategies. They should also seek to understand the 'risk appetite' of each fund, and how that risk appetite is rooted in investor expectations and affected by changing market conditions. Additionally, directors should understand how policies set at the board level relate to a fund's risk appetite, and should be satisfied that a robust and responsive process is in place to periodically review and revise risk tolerances as set forth in fund guidelines, position limits, counterparty credit limits, concentration limits, valuation policies and other relevant policies and procedures. Boards should also periodically review the effectiveness of the risk controls that have been established. The questions in Exhibit B may help boards determine whether their fund's adviser has established and maintains a risk aware culture throughout the fund complex.

Fund directors should understand the systems, practices and procedures that the funds' adviser uses to manage the various risks that its funds face.

At the most fundamental level, risk management in a fund complex grows out of the organizational structure that the adviser uses to identify and manage risk. As previously noted, fund directors are not responsible for designing, managing or operating the risk management system employed by the adviser. Given their oversight responsibilities, however, directors should seek to understand how the adviser's (and other key service providers') risk management systems are designed and operate.

From the adviser's perspective, risk management begins with the creation and use of organizational checks and balances and the segregation of functions within the organization as a means of mitigating risk. Although what constitutes good risk governance varies from fund complex to fund complex, and from fund type to fund type, directors generally may wish to determine that the adviser has addressed the following issues:

- Does the organizational structure provide adequate checks and balances, including appropriate segregation of front, back, and middle office functions?[6]

- Are there independent control groups including, where appropriate, an independent risk manager focusing on the risks of the fund as well as the broader organization, and who reports to – or has access to – the chief compliance officer ("CCO"), the fund's board, executive committee or the equivalent?

- Are adequate controls and performance analytical tools in place to manage the risks associated with new products and strategies?

In order to assist fund directors in answering these questions, the following material discusses each of these issues and identifies questions that boards may wish to ask.

Organizational Checks and Balances

In general, good risk governance encompasses the segregation of control functions from line functions as well as the segregation of front office functions from middle and back office functions. Thus, personnel charged with measuring and monitoring investment performance and risk, including tracking risk limits (and approving/disapproving exceeding established limits), should be organizationally separate from portfolio managers and traders. Similarly, those responsible for valuing positions, calculating net asset values ("NAV"), checking and entering trade details in fund systems, confirming, comparing and settling trades, approving and tracking counterparty credit, monitoring margining and collateral movements, and similar duties, should not report to portfolio management and trading personnel. These organizational separations help to assure to the degree possible within each fund and advisory firm that controls are administered – and transactions are verified – independently.

Independent Control Groups Including an Independent Risk Manager

Control groups, including legal, compliance, financial control, internal audit, credit, and risk management, all play important roles in managing risks attributable to the fund's business. These groups can have various reporting lines and be structured in various ways depending on the size and nature of the funds with which they are associated; but to the extent they perform monitoring functions, they need to have sufficient independence from the areas they monitor to perform these functions with integrity. Typically this means reporting outside the business lines they are charged with monitoring.

While the need for independence for some of these functions, such as the CCO, is well-established from a regulatory perspective, in the case of an independent risk manager or chief risk officer, regulation and practice are less well-developed. Thus, although every fund is required by the SEC to have a CCO with an appropriate reporting line to the fund's board, there is no comparable regulatory requirement with respect to the risk function.

Some fund groups have derived great utility from vesting risk management functions in a chief risk officer, while others have found similar success using existing business unit reporting in concert with active use of the CCO reporting to the board or a board committee. See "The Use of Board and Adviser Resources in the Risk Oversight Process."

To date, there is not universal understanding of the responsibilities of risk management personnel. In some mutual fund complexes, the risk management function consists primarily of monitoring and enforcing limits. In other complexes, risk management activities may also include a broader, more strategic function which includes consideration of risk on both an enterprise-wide and discrete basis, coordinating the periodic identification of risks in different areas, and providing input into investment strategy, risk budgeting, portfolio construction and the like. Similarly, some investment advisers place responsibility for both enterprise risk management and investment risk management in one organizational unit while others separate these responsibilities. Reporting lines vary accordingly, with some chief risk officers reporting to the board and/or the adviser, while others report to the adviser's chief financial officer and/or to the fund's CCO and still others report to the head of investments/portfolio management. Although an independent chief risk officer and/or dedicated risk management staff may not be appropriate for all funds/fund managers, a knowledgeable and skilled risk manager reporting to or, at a minimum, having access to the fund board or the board's executive committee or equivalent can provide an important risk control.

Given the current focus on risk management, fund directors may wish to discuss with the adviser whether a chief risk officer and/or dedicated risk management staff is appropriate or necessary, taking into account the size and complexity of their funds and the adviser and if so, whether the structure of the function is appropriate from a risk governance perspective. The list of questions in Exhibit C may help a board to determine whether the risk management function is appropriately organized and staffed and, depending on the answers to the questions, the board will be in a position to determine its level of comfort with existing structure and staffing.

Evaluating New Portfolio Investments

Introduction of new investment products and strategies into a fund's portfolio often presents valuation, systems, legal and other risk issues which, if not properly addressed, could give rise to losses. Prior a fund engaging in a new type of portfolio investment, the board should be satisfied that the adviser has considered the risks of the new investment and determined that the instruments are appropriate in light of the fund's risk tolerance and investment strategies.

In order to fulfill their oversight obligations, fund directors should satisfy themselves that there is a process in place for reviewing the issues raised by new products and strategies before they are traded. Fund board members generally are involved in the process of approving new products, with some boards establishing a "new products committee" for the purpose of evaluating the appropriateness of new kinds of investments for the fund's portfolio. Some of the questions that fund directors might want to ask are listed in Exhibit D. By obtaining answers to questions similar to those outlined in the exhibit, boards will be in a better position to determine whether risks attributable to new products are being adequately addressed and to request additional clarification or to require remedial action to be taken if necessary.

Fund directors should seek to understand, in a broad sense, the types of risks that funds face.

The types of risk inherent in the fund business, and thus relevant to directors' oversight of risk, are operational risk and investment risk.

Operational Risk is the risk that issues will arise or errors or omissions will occur in the ordinary course of business or that, for whatever reason, will adversely affect the business enterprise. "Operational Risk Management" is the process of managing the risk that errors and mistakes may occur, or that the business will not be able to operate, whether in the ordinary course of business or during a disaster. Compliance risk generally is considered to be a kind of operational risk, but may be implicated in certain aspects of investment risk as well.

Investment Risk is the risk associated with the investments that a fund makes. "Investment Risk Management" is the process of identifying, measuring, monitoring and controlling economic risks attributable to the fund's investments.

Fund directors should understand how fund management identifies and manages operational risk.

Operational risk includes the risk to the business enterprise of all types of errors and mistakes that can be made both in the ordinary course of business and in a disaster. A partial list of such errors includes fails, reconciliation differences, customer complaints, guideline breaches, collateral disputes, systems problems and the like. In addition to risks attributable to errors, operational risks are also presented by the use of spreadsheets and models, as well as risks related to systems and resources, risks related to disaster recovery and backups, and risks related to record maintenance and security. Unlike investment risk, there is no potential upside associated with operational risk.

In managing (and overseeing the management of) operational risks, it is important for a fund adviser to have adequate methods of monitoring and tracking such risks over time, identifying trends that could indicate emerging or intensifying problems, and implementing an exception/escalation process that assures that such problems are brought to the attention of increasingly higher levels of management so that they can be properly addressed. Fund directors should understand whether systems and resources are adequate, whether adequate back-up and disaster recovery plans exist and whether sufficient attention has been paid to record retention and security issues. They should receive information about whether various types of errors are increasing or decreasing, how current levels of problems compare with historic levels, and how fund managers are dealing with them.

In addition, fund directors should satisfy themselves that "spreadsheet risk" is considered, addressed and controlled, particularly with respect to derivative instruments and complex securities. "Spreadsheet risk" is the risk attributable to the use of spreadsheets and other end-user tools that are used to trade products and instruments that cannot be processed by a firm's existing computing and accounting systems. Spreadsheets and other end user tools warrant extra scrutiny because they often exist outside the regular internal controls and testing established for a fund's accounting systems, books, and records. ***Fund directors may also wish to direct management's attention to the adequacy of controls used to manage model risk – that is, the risk that models relied on for valuation and risk management purposes have been properly vetted, with a view to determining, among other things, the appropriateness of the assumptions and data on which such models are based.*** Similarly, fund directors may wish to ascertain that management has considered what types of backup and disaster recovery plans are in effect, how records are maintained and secured, and how often backup and restore functions are tested.

In considering these issues, directors may wish to review the answers to some or all of the questions presented in Exhibit E. By obtaining information relating to the issues set forth above, directors will be better equipped to review the mechanisms that have been adopted to control operational risk.

Fund directors should develop a foundational understanding of risks that arise as part of the investment management process and should be satisfied that their funds' adviser is effectively managing those risks.

As noted above, in investment management, taking risks is essential – if a fund does not take risks, it cannot earn a return on its investments. Because funds must take risks, that some investments do not perform as expected does not show that the fund's risk management processes are ineffective or unsuccessful. However, portfolio managers and others involved in investing fund assets should take risks in a thoughtful manner – they should do so knowingly and should monitor and manage the risks they take continually.

Fund directors have a clear role in this process. Because they are deemed to sign the fund's registration statement, they should be comfortable that the risks taken by the fund are consistent with the risks disclosed to shareholders. In order to discharge this obligation, ***directors need to have access to a variety of information that facilitates an understanding of how investments are performing as well as the various risks they entail.*** While the specific tools needed to manage investment risk will vary from fund to fund, depending on the fund's strategy and the nature of its investments, in general, boards should consider whether adequate mechanisms are in place to address the following issues:

- Are investment performance and investment risk monitored in a meaningful way?
- How is valuation risk handled to assure that valuations are fair and consistent?
- How does the adviser monitor the use of complex securities to ensure they are within a fund's investment guidelines?
- How is issuer and counterparty credit risk managed?

Because of a board's role in reviewing and overseeing fund performance, fund directors may take a more active role in overseeing investment-related risk than other types of risk. However, in doing so, directors need to recognize that risk is an inherent part of the investment process – if an actively managed fund never takes a risk, then no benefits will ever accrue for its shareholders. With that caveat, a discussion of each of these issues and what a board needs to consider in addressing them is set forth below.

Measuring and Monitoring Investment Performance and Investment Risk

Mutual funds are charged with investing shareholder money in accordance with strategies designed to achieve investment returns consistent with the risks undertaken, and disclosed to investors in fund offering documents. Typically, boards review their funds' performance by examining total return calculations with data provided quarterly or monthly by the portfolio manager. In most cases, a fund's performance is measured against a benchmark, although in some instances it is measured on an absolute return basis. In either case, a key risk is that performance will fall short – either of the benchmark or of returns commensurate with the level of risk assumed. Thus performance analysis, that is, tracking how a fund performs against its defined benchmark or other objective, is an important component of investment risk management which should be monitored over time, and may provide useful insights on performance trends.

Fund directors should focus on policies that drive performance, and should always be mindful of how much risk is being undertaken to generate incremental performance. Most boards request performance information that takes into account some measure(s) of risk be included in their 15(c) materials (and providers of fund performance data such as Lipper tend to suggest they do). In order to better understand the risk and return profiles of their portfolios, some boards have begun to move beyond benchmarking, and request additional and more sophisticated forms of analysis from their fund's portfolio manager, in particular, performance attribution analysis of how individual securities may have affected fund performance from quarter to quarter. Though not an entirely new practice, given market volatility and the recent declines in fund performance, fund boards increasingly are asking for management to undertake this kind of analysis of their funds' portfolios in order to better understand how individual securities contribute to fund performance from quarter to quarter. Though boards should avoid the temptation to micromanage in this area, asking management to utilize attribution analysis tools and to share the results with the board, will provoke discussion of the risk profile of particular kinds of securities, and the corresponding returns the fund derives from taking those risks. Taken together with other performance and risk measures and indicators, attribution analysis can provide yet another valuable tool in understanding and measuring risk relative to return.

The key issues in assessing risk-adjusted performance data are how risk is defined and what mathematical models provide the most insight. "Risk" in this context can also be defined beyond volatility as the probability that a fund's goals may not be achieved. As described below, some methods embrace standard deviation, others employ the Sharpe ratio[7], and still others use the information ratio[8]. Each is different in its own way and all have their limitations.

Besides tracking performance, it is also important for fund managers to measure and monitor various aspects of investment risk utilizing metrics such as standard deviation, tracking error, expected shortfall, downside semi-standard deviation, value at risk (VaR) and other metrics. There are numerous metrics available for measuring risk on an ex post or ex ante basis. Each metric has its strengths and weaknesses and no one statistical or quantitative measure is sufficient to describe complex investment risk in its entirety. VaR for instance, is useful for estimating how much one can expect to lose every day or every month, based on historical experience, but is not indicative of potential cumulative loss. Standard deviations of return provide information about the past, not the future, and do not take into account the effect of liquidity, bid/offer spreads, frequencies of marks to market, etc. What is appropriate for a particular fund depends on the instruments employed and strategies being traded. But since no single metric can tell the whole story, it is important, particularly in cases where complex instruments and strategies are being traded, to use a variety of tools.

It may also be helpful to utilize stress testing to increase an understanding of the sensitivity of the particular portfolio to various market changes and anticipating the potential effect of trends or events such as changes in interest rates and volatility, correlation changes, widening or narrowing of credit spreads, various historical crises, and potential 'worst case' management nightmares, *e.g.*, stagflation, unemployment over a defined percentage, etc. Notwithstanding the foregoing, it should be emphasized that fund directors are not expected to engage in statistical or mathematical analysis. Their role is to use basic business judgment to assess whether management has the appropriate tools and the necessary sophistication to use those tools.

In addition to the statistical measures and stress tests described above, as recent market events have demonstrated, there may be significant risks associated with liquidity, concentrations, and leverage. Thus, it is important to take into account liquidity risk, including the liquidity of individual instruments in a portfolio and the implication of such liquidity on pricing as well as any mismatches between the liquidity of the portfolio versus the daily liquidity offered to fund investors. Similarly, the potential effects of concentration (large, undiversified positions at the portfolio level and large concentrations across portfolios under common management) need to be measured and monitored.

Leverage risk may be of particular concern to fund boards and should be monitored closely. Leverage risk manifests itself when a derivative in which a fund invests is structured to produce a substantial value change in proportion to the initial cash invested, thereby magnifying the risk of loss as well as the potential gains. Because they enable investors to buy or sell exposures without committing cash equal to the instruments' notional values, investments in derivative securities can result in a magnification of risk, or leverage effect. For this reason, such investments should be measured and closely monitored for leverage risk.[9]

Accordingly, in overseeing and assessing the adequacy of a fund's investment risk management, fund directors may wish to consider asking some or all of the questions in Exhibit F.

Valuation Risk

Valuation risk is a critical issue for mutual funds and their directors because inaccurate valuations result in incorrect NAVs, potentially causing unfair treatment to one set of shareholders versus another. For this reason, fund directors are legally obligated under Section 2(a)(41) of the Investment Company Act to determine the fair value of securities for which market quotations are not readily available, and to consider the adequacy of a fund's fair valuation procedures. ***While boards are permitted to delegate day-to-day valuation responsibilities to an investment adviser or committee (which may or may not include board members), boards retain ultimate accountability for valuations and, according to the SEC, boards as a whole need to consider the adequacy of their fund's fair valuation policies and procedures.***

To discharge this obligation, directors need to understand the characteristics of the securities in which the fund invests as well as the risks posed by the securities, since the riskiness of a security can affect the price a third party is willing to pay for it. Complex over-the-counter derivatives, high-yield bonds, mortgage and asset-backed securities, collateralized debt obligations, collateralized loan obligations, and other complex and/or illiquid securities, for example, may not have readily available fair market values, and must be 'fair valued' using independent pricing services, pricing models or other mechanisms in accordance with valuation policies and procedures. Boards need to assure themselves that the valuation methodologies that have been developed and implemented are reasonable and effective and that strong controls are in place to assure that they are being consistently applied.

Fund directors may find the questions in Exhibit G useful in helping to assess the adequacy of the fund's valuation policies and procedures, particularly with respect to complex and hard to value instruments. By periodically satisfying themselves as to the answers of some or all of the questions set out in Exhibit G, directors will be in a position to better discharge their oversight responsibilities regarding valuations.[10]

Risks of Complex Securities

When funds use more complex securities such as repurchase agreements, reverse repurchase agreements, forward commitments and similar arrangements, options, futures and other derivative transactions and synthetic instruments, boards are expected to give heightened attention to the potential risks of these instruments.[11] Indeed, the SEC has made clear that, with regard to derivatives and complex securities, boards have a "particular responsibility to ask questions concerning why and how the fund uses futures and other derivatives instruments, the risks of using such instruments, and the effectiveness of internal controls designed to monitor risk and assure compliance with investment guidelines regarding the use of such instruments."[12] Further, when examining the activities of funds using derivatives, the SEC has focused on adequate prospectus disclosure, valuation procedures for derivatives, liquidity assessments, as well as strong management controls to monitor and control the risks associated with derivatives and complex securities. Fund directors should consider these areas carefully in their oversight of fund investments.[13]

Issuer and Counterparty Credit Risk

Mutual funds face two types of credit risk:

1. Issuer credit risk is the credit risk attributable to individual securities.

2. Counterparty credit risk is the risk attributable to the downgrading and/or insolvency of a counterparty in an over-the-counter security or derivative trade.

The importance of managing both types of credit risk has never been clearer than during the recent market turbulence, when numerous issuer and counterparty credit ratings have dropped by multiple notches in single downgrades, in some instances falling from triple A to below investment grade, and when formerly top-rated counterparties have failed or experienced major credit impairments. ***Indeed, the default of Lehman Brothers demonstrates just how real and expensive counterparty credit risk can be.***

From a fund perspective, the risks attributable to issuer and counterparty credit are significant. First, unless levels of issuer and counterparty credit risk are consistent with what has been disclosed to investors, funds face potential liability. Second, the deterioration of issuer and counterparty credit quality can give rise to significant losses. Third, in the case of money market funds, in accordance with Investment Company Act Rule 2a-7, portfolio securities need to have “minimal credit risk” as determined by a fund’s board. While in the past many money market funds relied primarily on ratings issued by rating agencies, recent experience has demonstrated that such ratings are not necessarily reliable measures of credit risk. Fourth, credit risk exposure is not static, but rather may fluctuate over time. Thus, it may be important to track potential future exposure as well as current exposure. Finally, there is a growing understanding that issuer and counterparty credit risk arise in multiple contexts, including through exposure to debt and equity portfolio holdings, over-the-counter derivatives counterparty exposure, securities lending and repo counterparty exposure, as well as exposure to custodians and other service providers. Therefore, in order to address credit risk in a meaningful way, it is important to look at it in the aggregate and develop limits or other means of managing it.

In overseeing issuer and counterparty credit risk management, therefore, fund directors may wish to consider addressing some or all of the issues outlined in Exhibit H. By determining the answers to these and similar questions, directors can establish a foundation on which to evaluate the adequacy of their funds’ approach to issuer and counterparty credit risk management.

The Use of Board and Adviser Resources in the Risk Oversight Process

The board should employ the funds' CCO to assist in its oversight of risk.

In the current regulatory framework, the CCO, acting on behalf of the board, is essential in assisting boards to oversee risk management effectively.[14] Because most boards are engaged in evaluating the risk assessment and management practices at their funds and their service providers as part of the existing fund management and compliance reporting process, it is important to recognize that the CCO already plays a role in many aspects of risk management that may be thought of as being outside the realm of compliance risk assessment (*e.g.*, operational, investment, credit and counterparty, and market risks). Further, because many of the compliance controls and procedures already in place at a fund, like those for valuation, portfolio management, securities lending, performance reporting, disclosure, etc., are also designed to address certain aspects of risk, a fund's CCO is an integral part of risk governance.

In assessing how a board may wish to employ its CCO in its risk governance activities, directors should start by assessing whether the CCO possesses the requisite training and competence to assist the board in meeting its fiduciary duty to evaluate risk matters outside areas more traditionally considered compliance-related. ***A knowledgeable CCO can assist the board in a wide range of risk governance and data gathering activities. Boards should be mindful, however, of the CCO's workload and how most appropriately to use the CCO's time.***

Risk Inventory Matrix

An effective compliance function requires a thorough and thoughtful appraisal of areas of risk applicable to the fund and its adviser. A useful tool for both CCOs and boards to identify and understand these risks is a "risk inventory" or "risk matrix." Such an inventory, developed with the assistance of internal audit and the adviser's business units, will help a CCO step beyond technical legal considerations and serve as a method to identify compliance, operational, investment, and other risks beyond the factors identified in the compliance rule (Investment Company Act Rule 38a-1). The risk inventory matrix may also be structured not just to pinpoint risks, but also to (a) provide examples of quality control processes and compliance policies and procedures in place to mitigate the risks, (b) provide examples of review procedures and forensic tests the compliance staff has performed with regard to each identified risk, and (c) highlight required disclosure changes. A risk inventory can also serve to rate risks and point to specific policies in need of refinement or revision.

Identification of Red Flags

The CCO, through the risk inventory process and his or her daily engagement with the operations of the adviser's business units, can also identify "red flags" or risk areas that might require extra attention from the board such as:

1. NAV, pricing issues, or impairment of value;
2. Frequent or unusual overrides of policies;
3. Conflicts of interest;
4. Areas of compliance, at the fund or among its competitors, identified by regulators as having experienced shortcomings;
5. Special or unusual aspects of the fund that may require attention (*e.g.*, heavy use of derivatives or complex securities);
6. Developments at the adviser, the adviser's parent, or affiliates: and
7. Industry issues that highlight particular regulatory concerns (*e.g.*, SEC sweeps, exams, or enforcement cases).

As stated above, a vital part of the role of fund directors in risk management oversight is monitoring the compliance and risk management systems put in place by the adviser, and insisting that management act on any significant warnings or "red flags" that may arise.

Fund directors may rely on other personnel at the adviser to assist it in overseeing risk.

As previously discussed, some fund complexes employ personnel specifically devoted to risk management including, in some cases, a chief risk officer. In such situations, directors may find it useful to develop a relationship with risk management personnel and use their knowledge and insights to assist in fulfilling the board's oversight responsibilities. Depending on specific circumstances boards may also wish to consider whether there should be risk management staff who report directly to and are responsible to the board. (See "Independent Control Groups Including an Independent Risk Manager").

Fund directors may wish to consider modifying their board's structure to improve the effectiveness of oversight of risk management.

Some fund boards have formed risk oversight committees.[15] The practice is not yet widespread, with many fund directors feeling that separate risk committees may not be appropriate for fund boards because risk considerations are integral to all of the duties of fund directors, with risk awareness being a vital component of good business judgment. Further, many directors believe individual risks can be more competently and efficiently governed from within existing committees including the audit committee, investment committee, valuation committee, or new products committee. However, in certain circumstances, a risk oversight committee for a fund board may be particularly useful and appropriate for risks that do not fall neatly within exiting board committee structures. Such a committee may be an appropriate forum for board considerations of enterprise risk, that is, requesting and understanding information about what the affiliates – or the parent – of the fund's adviser are doing to incorporate the fund in risk considerations for the greater enterprise. ***Regardless of the structure a board adopts to address risk management oversight, risk awareness and an ongoing and robust dialog with the fund's management regarding its reactions to emerging or evolving risks facing the fund is vital to good governance.***

Other Obligations With Respect to Risk

Boards are required to disclose to shareholders how they are overseeing the risks their funds face.

In December 2009, the SEC approved rules requiring new disclosure in investment company proxy statements and registration statements describing the extent of the board's role in the risk oversight of their fund.[16] In the final Rule Release, the Commission stated that it considers risk oversight a "key competence of the board." Given the board's central role, the Commission reasoned that additional disclosures would improve investor and shareholder understanding of the role of the board in a fund organization's risk management practices, and would provide important information to investors about how a fund perceives the role of its board and the relationship between the board and the fund's adviser in managing material risks facing the fund.

The disclosure requirement is fairly flexible, and gives little guidance about the level of detail funds must employ in describing how the board administers its risk oversight function.[17] The Rule Release gives one example of what this new risk disclosure might contain:

> *Disclosure about the board's approach to risk oversight might address questions such as whether the persons who oversee risk management report directly to the board as whole, to a committee, such as the audit committee, or to one of the other standing committees of the board; and whether and how the board, or board committee, monitors risk.*[18]

Boards should work closely with the adviser, fund counsel, and board counsel in crafting this new set of disclosures.

Oversight of Sub-Advisers

The use of sub-advisers for day-to-day portfolio management is not uncommon among US mutual funds. While the use of sub-advisers may offer many potential benefits for fund advisers and fund shareholders, fund directors face a number of unique challenges in overseeing their funds' use of sub-advisers, including governing a sub-adviser's risk-taking activities, poses a number of unique challenges for fund directors. Though a board's duties with respect to the oversight of sub-advisers are similar to the oversight of a fund's investment adviser, practical considerations, such as the complications involved in obtaining and reviewing comprehensive information from sub-advisers, make the board's responsibilities more challenging. Key components of effective risk governance of sub-advisers are: (a) active involvement in the adviser's selection of a sub-adviser; (b) ensuring the adviser employs a vigorous vetting process; and (c) with the assistance of the fund's CCO, monitoring of the performance and compliance activities of the sub-adviser, including understanding how the sub-adviser monitors risks associated with the use of complex instruments.

The Forum has addressed the oversight of sub-advisers at length in its April 23, 2009 *Report of the Mutual Fund Directors Forum: Practical Guidance for Directors* on the Oversight of Sub-Advisers. The report contains comprehensive practical guidance to assist fund directors in the complex task of overseeing all phases of their funds' sub-advisory relationships – from entering sub-advisory relationships, through monitoring existing relationships, to ending these relationships. The guidance in the report may also be used as the foundation for effective risk governance.

Conclusion

Risk is an integral part of the investment management business, and no set of principles or guidance can take the place of a rigorous and thoughtful examination of the particular and unique role risk plays in the return and operation of a fund. As fund directors reexamine their risk oversight practices in the wake of the financial crisis, it is important that they resist the urge to micromanage or overemphasize process over more thoughtful and practical considerations. On a threshold level, though, the board can work with the fund's adviser to encourage the proper "tone at the top," that is, that risk is an important issue, and that effective risk management is good for return, not harmful. Beyond helping to set the tone, fund directors should consider their oversight of risk management, not as an oversight duty separate from those they are accustomed to, but as an awareness of and consciousness about the concept of risk as they perform those familiar duties.

Notes

[1] See, for example, "Best Practices for the Hedge Fund Industry: Report of the Asset Managers' Committee to the President's Working Group on Financial Markets" (2009) http://www.amaicmte.org/Public/AMC%20Report%20-%20Final.pdf ; "Risk Principles for Asset Managers" prepared by the Buy Side Risk Managers Forum (2008). Because "Risk Principles for Asset Managers" was created by a group of chief risk officers at major traditional asset management companies and addresses best practices for dealing with the risk management issues that are most relevant to mutual funds, this report relies heavily on that paper in identifying key issues.

[2] This report was developed by a working group of leaders in the independent director community with advice given by members of the Forum's Advisory Board, and with extensive aid from and collaboration with Capital Market Risk Advisors, a financial advisory firm specializing in risk management, risk diagnosis, financial forensics and risk governance, and with the advice and material input of risk professionals at PricewaterhouseCoopers LLP. Members of the working group participated in this report 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 Board of Directors and Steering Committee. This report does not necessarily represent the views of all Forum members in every respect.

[3] As discussed below, however, the SEC recently has adopted a requirement that boards outline in proxy statements and registration statements the extent of the board's role in risk oversight. (See, Note 16) While this does not establish any requirement in the Commission's regulations that directors manage risk, it does suggest that the SEC has increasing expectations of directors. In some specific areas, the SEC is also beginning to require that directors play a specific role in overseeing an adviser's risk management processes. Most notably for mutual fund directors, the recently adopted amendments to the rules governing money market funds require that directors play a role in portfolio stress testing. See, Release No. IC-29132 (Mar. 3. 2010) [75 FR 10060, 10079 (Mar. 4, 2010)].

[4] See, Md. Code Ann. Corp. & Assoc. §2-405.1.

[5] See, In re Caremark International, Inc. Derivative Litigation, 698 A 2d 959, 971 (Del.Ch. 1996), and progeny.

[6] Financial services companies are often thought of as being broken logically into three parts: the front office includes investment management, sales personnel and corporate finance; the middle office manages risk and IT resources; and the back office provides administrative and support services. Middle offices may or may not exist in smaller fund management companies. From a control perspective, it is less important that a middle office exist than that there is appropriate segregation of functions between the front office (portfolio managers and traders) and persons required to monitor and control their activities.

[7] The Sharpe ratio is used to characterize how well the return of an asset compensates the investor for the risk taken.

[8] The "information ratio" is a measure of the risk-adjusted return of a financial security (or asset or portfolio). It measures the expected active return of a portfolio divided by the amount of risk that the manager takes relative to the benchmark.

[9] Investments in derivatives should also be monitored closely for compliance with SEC regulations. Insofar as they are contractual obligations under which the fund may be required to pay more money in the future than the amount of its initial investment, certain investments in derivatives may be considered "senior securities," and violate leverage prohibitions of the Investment Company Act. See Section 18 of the Investment Company Act of 1940. See also, Investment Company Act Rel. No. 10666 (April 18, 1979).

[10] The SEC has assembled a bibliography, "Valuation of Portfolio Securities and other Assets Held by Registered Investment Companies – Select Bibliography of the Division of Investment Management," intended to assist funds and their counsel in understanding and applying the valuation requirements under the Investment Company Act. Also included are proposing releases, select staff guidance (including no-action letters), and enforcement actions in this area. This bibliography may serve as a key resource for boards in fulfilling their valuation responsibilities.
http://www.sec.gov/divisions/investment/icvaluation.htm

[11] Keynote Address at Mutual Fund Directors Forum Program by Gene Gohlke, Associate Director, Office of Compliance Inspections and Examinations (Nov. 8, 2007). Available at www.sec.gov/news/speech/2007/spch110807gg.htm.

[12] Rule 17f-6 Adopting Release, Investment Company Act Release No. 22389, Dec. 11, 1996 [61 FR 66207, 66209 (Dec. 17, 1996)].

[13] In addition to the special considerations relevant to derivatives, boards also must make determinations of credit quality with respect to investments in debt securities of issuers deriving more than 15 percent of their revenues from securities-related activities, and must adopt certain policies and procedures with respect to investments in money market funds permitted by Investment Company Act Rule 12d1-1. While not specifically related to directors' oversight of risk, obligations such as these sometimes require that directors understand the risk characteristics of the securities.

[14] SEC Chairman William H. Donaldson, Remarks Before the Mutual Fund and Investment Management Conference, March 14, 2005. http://www.sec.gov/news/speech/spch031405whd.htm

[15] Senators Charles Schumer (NY-D) and Maria Cantwell (WA-D) have introduced a bill, the "Shareholder Bill of Rights Act of 2009," which among other things would impose certain corporate governance standards, including requiring boards of public companies to have a risk committee. The proposed language requiring risk committees reads:

> *Each issuer shall, 1 year after the date of issuance of final rules under paragraph (2), establish a risk committee, comprised entirely of independent directors, which shall be responsible for the establishment and evaluation of the risk management practices of the issuer.*

The legislative language would also give the SEC the rulemaking powers necessary to effectuate the requirements for risk committees. The proposed bill in its current form does not exempt investment companies from the risk committee requirement. http://www.corpfinblog.com/uploads/file/bill-text-shareholders-bill-of-rights-act-of-2009%282%29.pdf

[16] Release No. IC-29092 (Dec. 16, 2009) [74 FR 68334] ("Rule Release")

[17] Generally speaking, funds with fiscal years ending on or after December 20, 2009 must follow the new disclosure rules for proxy and registration statements (or post-effective amendments) for their filings on or after February 28, 2010.

[18] 74 FR 68334, 68345

Exhibits

Exhibit A
Risk Management Framework Components

Organization and Governance

- Is there adequate independence, accountability and segregation of duties involved in the oversight and management of risks?
- Does the existing structure allow for an enterprise-wide view of risk management?
- Are policies and procedures adequately governing risks and operational controls?
- Is senior management and the board properly informed of risks and mitigating controls?

Culture

- Does our culture and "tone at the top" support sound risk management practices?
- To what extent are the incentive structures and talent management promoting the "right" behaviors?

Risk Management and Process - Risk Appetite, Strategy and Asset Allocation

- Is risk appetite/tolerance clearly defined?
- Are our strategies and asset allocation processes aligned with our risk appetite?

Risk Management and Process - Risk Identification and Assessment

- Have we identified relevant and material Market, Credit, Operational, Liquidity and Counterparty risks?
- Is our product approval process adequate to identify risks and ensure proper controls?

Risk Management and Process - Risk Measurement and Analysis

- Do we have sufficient risk measurement tools and processes?
- Is management able to aggregate risk exposures, identify concentrations, and manage risk as a portfolio?

Risk Management and Process - Risk Mitigation, Control and Monitoring

- Do we have an effective process to escalate risk issues?
- Are our limit structure and management practices adequate?

Risk Management and Process - Reporting and Performance Measurement

- Do current risk reports facilitate timely and informed management decision making for board level and senior management?
- Do we evaluate our performance on a risk-adjusted basis?

Risk Management and Process - Periodic Review

- Are we executing our risk management strategies effectively?
- Are our processes consistent with industry leading practices?

Infrastructure

- Is our infrastructure appropriate given our growth strategy and complexity of the investments and type of risk?
- Are there adequate controls to guarantee risk and finance data completeness, integrity and adequacy?

Information in this exhibit presented with the permission of PricewaterhouseCoopers LLP

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Exhibit B
A Risk Conscious Culture

To determine whether a risk aware culture exists, directors should consider questions similar to the following:

- Is there some mechanism in place to identify relevant enterprise and investment risks on an ongoing basis?

- Are risk tolerances defined in fund disclosure documents and monitored over time in light of changing market conditions?

- Who establishes a risk aware culture?

- Does executive management embrace the culture or risk awareness?

- Is there an organizational structure in place in which responsibilities for managing various types of risks are clearly defined?

- Has senior management set an appropriate fiduciary and ethical tone for the organization?

- Do employees understand their fiduciary and ethical responsibilities?

- Do written risk policies and procedures exist and if so, do they identify specific people within an organization with responsibility to approve various actions, make exceptions, etc.?

- Are risk policies and procedures realistic or aspirational?

    - Are they well communicated to affected employees?

    - Are they enforced?

    - What happens when they are violated?

- How often have ‘surprises’ or situations in which results differ significantly from expectation occurred?

- Have changes been made in response to such surprises?

- Do employees receive training and educational programs that help them understand risk, risk management and the fund's requirements?

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Exhibit C
Staffing and Organization of the Risk Function

From a board perspective, it is important to understand whether the adviser has in place an adequately robust and empowered risk management program, taking into account the size and complexity of the fund or fund complex. The following questions may help a board to determine whether the risk management function is appropriately organized and staffed:

- Does the fund/fund manager have in place dedicated risk management staff, or are risk monitoring duties the responsibility of department or business unit heads?
- Is risk monitoring adequate in terms of numbers of people and levels of expertise?
- If the fund has a chief risk officer, does he or she have enough seniority, knowledge and organizational respect to be effective?
    - To whom does he/she report?
    - Is he/she considered a member of senior management and does he/she have ongoing access to senior management?
    - Does he/she have access to the board on a regular basis?
    - Does he/she have access to the CCO?
    - Does he/she provide risk reports to management and the board, either directly or through the CCO?
- If risk management includes a risk monitoring as opposed to strategic function, is it located outside the portfolio management and trading functions?
- If risk management responsibilities are divided between different areas, i.e., investment risk management versus enterprise risk management, are their respective responsibilities clearly defined?
- Do various people/groups with risk management responsibilities communicate

with senior management, the board, the CCO, and each other on a regular basis?

- Does the board receive adequate risk information? Does the risk manager have in camera sessions with the board?

- Is there a level of comfort among board members that sufficient resources and attention are devoted to risk management?

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Exhibit D
Evaluating the Risks Attributable to New Investments

In order to discharge their oversight obligations, board members must satisfy themselves that there is a process in place for reviewing the issues raised by new investment products and strategies before they are added to the fund's portfolio. Some of the questions that a board might want to ask are as follows:

- Is there a formal new products policy or procedure?
- Is there a new products committee?
- Who signs off on new products and have people from all affected areas, including legal and compliance, risk, operations, valuations, etc., had an adequate opportunity to review the products and the issues they raise?
- How many new products have been considered in the relevant time frame?
- How is seed capital budgeted?
- Has consideration been given to whether the risks of these products are commensurate with potential returns?
- How are new risks associated with new ideas assessed and discussed?
- Are the products permissible investments under applicable fund guidelines?
- Do the products require development of new valuation and/or risk models?
- Can the products be properly booked and accounted for using existing systems?
- Do they create increased "spreadsheet risk"?
- Do they place an undue burden on back and middle office personnel?
- Have any proposed new products been turned down and if so, why?

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Exhibit E

Determining the Mechanisms for Controlling Operational Risks

By asking the questions below, directors may be better equipped to determine the adequacy of mechanisms that management has adopted to control operational risk.

- Is the board receiving adequate information to assess how operational risk is being handled?

- Are fails, reconciliation differences and other types of errors increasing or decreasing? If so, why?

- Are systems and resources adequate to deal with the products and strategies traded?

  - In this regard, does the fund/fund manager have appropriate tools to meet its research, portfolio management, portfolio risk measurement, sales support, trading, settlement and record-keeping needs?

- How frequently does the fund/fund manager reassess the adequacy of its systems?

- What systems changes/enhancements are contemplated over the next year and what are the system priorities?

- How much reliance is placed on spreadsheets and other end-user tools?

  - What plans, if any, exist to eliminate such reliance? In what time frame?

- Are models independently validated? By whom?

- Who controls access to models?

- How are key model assumptions vetted?

- How have key models performed?

- Are models used for valuation purposes the same as or different than models used for risk purposes?

- What model weaknesses have been revealed by the current market situation and how are they being addressed?

- What kind of off-site backup is there of key systems and information?

    - o Is the backup located in a different region and power grid than the primary business location?

    - o Do key employees have access to backup and disaster plans on their desks? At home? In their cars? At remote locations?

- Have plans been developed for various types of disasters, i.e., terrorism, fire, water, power problems, pandemics, quarantines, etc?

- What type of record management and retention programs are in effect?

    - o Do they meet legal and regulatory retention requirements?

    - o Are they periodically tested and revised to take into account changing circumstances and regulatory requirements?

- How is confidential client and employee information safeguarded?

- What types of physical security exist?

- How are computer networks protected?

- What attention has been given to information security, including safeguarding access to information, disposing of information, identity management and the like?

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Exhibit F

Assessing the Adequacy of a Fund's Investment Risk Management

In overseeing the adequacy of a fund's investment risk management, boards may wish to consider asking some or all of the following questions.

- How is investment performance measured and monitored?
- Are the benchmarks or objectives against which performance is measured appropriate to the strategies traded?
- Is there a stated policy on the amount of risk to be taken?
- Is there a risk budget for particular strategies or instruments?
- Are causes of under and over-performance tracked and understood?
- Is performance attribution measured in a meaningful way?
- How is investment risk measured and monitored?
- Are multiple metrics utilized?
- Are the metrics both forward and backward looking?
- What type of stress-testing is done?
- Were the stress tests in use helpful in predicting the effect of recent market upheavals on the portfolio?
- If not, what changes should be made going forward?
- What sensitivity does the fund's portfolio have to various events such as historical market events, changes in interest rates and correlations, potential worst case scenarios?
- How is liquidity measured and monitored?

- Has management encountered problems relating to liquidity and if so, what has it learned?

- What liquidity concerns does management have going forward and are appropriate steps being taken to deal with them?

- How are illiquid positions valued? What issues has the fund encountered with respect to such valuations?

- How are concentration risks measured and controlled?

- What concentration concerns does management have going forward and are appropriate steps being taken to deal with them?

- Are concentrated positions subjected to valuation haircuts in recognition of potential difficulties in selling such positions?

- How is leverage defined?

- How is leverage measured and monitored?

- Are both economic and structural leverage measured and monitored?

- Is the fund's leverage consistent with disclosures made to investors?

- What leverage concerns does management have going forward and are appropriate steps being taken to deal with them?

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Exhibit G

Assessing the Adequacy of a Fund's Valuation Polices and Procedures

In overseeing a fund's valuation process, boards need to satisfy themselves as to the answers to some or all of the following questions:

- Are there written policies and procedures for valuing all types of instruments traded by the fund?
    - Do they spell out the methodologies to be used with sufficient specificity to assure consistency?
    - Are these methodologies consistent with disclosures provided to investors and if not, what remedial steps are being taken?
    - Do the policies clearly define the events that could give rise to a need to fair value securities? If so, is there a process for monitoring for the occurrence of such events?
- Is there a valuation committee? If so, what is its composition?
- How many securities have been fair valued in the current reporting period? Is the number trending up or down?
- How many meetings has the valuation committee held during the current reporting period and what do the minutes reveal about the committee's deliberations?
- Where broker quotes are relied on, are they obtained by personnel who are independent of portfolio management/trading? Is there a prescribed methodology (*i.e.*, averaging, discarding the high and the low, marking to bid/offer/mid) etc.?
- Under what circumstances are single broker quotes relied on, and what controls are in place?
- Where independent pricing services and/or third party service providers are utilized, what due diligence does the fund perform to assure itself of the vendor's competence, control environment, etc.?

- How are pricing services used with respect to complex instruments?

- Are independent pricing services/service providers periodically reviewed/reevaluated?

- Where independent pricing services are relied on, is there a prescribed methodology for challenging prices? If so, how are challenges documented and who is responsible?

- Where models are relied on, is there a process for independently validating the model and vetting the assumptions used?

    - Who determines the reasonableness of such assumptions?

- When prices derived from established methodologies are overridden, by whom are they authorized and how are they tracked?

- How many overrides occurred in the current reporting period? Over time? What trends are being observed?

- Are marks to market for purposes of margin and collateralization (in the case of over the counter derivatives) compared to marks to market for books and record purposes? Are discrepancies between the fund's marks to market and counterparty marks to market taken into consideration?

- Are valuation methodologies reevaluated in light of changing market conditions?

- Are prices obtained from independent pricing services and/or models periodically compared with actual transaction prices where possible?

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Exhibit H
Issuer and Counterparty Credit Risk Management

In overseeing issuer and counterparty credit risk management, boards may want to consider addressing some or all of the issues outlined below.

With respect to issuer credit risk:

- What sources are used to evaluate issuer credit risk?
- If reliance is placed exclusively on ratings issued by rating agencies, is there an understanding on the part of the board and relevant fund personnel of the criteria used by the rating agency?
- Are other factors, such as internal rating systems, credit default spreads, analyst reports and the like taken into consideration?
- What factors are evaluated for nonrated issuers? In this regard, are equity-based credit exposure measurement tools used?
- Are maturities considered in evaluating unrated debt obligations?
- Are changes to issuer credit ratings monitored over time, and if so, what is required in situations where credit quality is deteriorating? How have these situations worked out?
- Are there credit limits in place and if so, who monitors them?
- Have there been limit exceptions? Are they trending up or trending down?
- How often is credit quality reviewed?
- How are downgrades and other credit events monitored?
- Is issuer credit exposure monitored in the aggregate?
- Are counterparty collateral arrangements in place?

- Who monitors the current value of counterparty collateral?

- What arrangements are in place if the fund complex must pay out collateral?

With respect to counterparty credit risk:

- Is counterparty credit exposure monitored in the aggregate (i.e., OTC derivatives plus repos plus securities lending plus outsourced relationships such as custodianship)?

- Are there counterparty risk limits? Concentration limits?

- Is potential future exposure to OTC derivatives counterparties taken into account?

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MUTUAL FUND DIRECTORS FORUM

The FORUM *for* FUND INDEPENDENT DIRECTORS

Report of the
Mutual Fund Directors Forum

Practical Guidance for Fund Directors on Oversight of Proxy Voting

September 2012

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Working Group

We would like to thank the numerous individuals and organizations that contributed to this report. Our member fund directors provided many helpful comments and suggestions. In addition, we spoke to a number of people integrally involved in fund proxy voting at their respective organizations whose insight into and observations of the proxy voting process were invaluable. Some of these organizations include:

American Funds

BlackRock

Columbia Management

Fidelity Management & Research Company

Franklin Templeton Funds

ING Funds

MFS Investment Management

OppenheimerFunds, Inc.

Pioneer Investment Management USA, Inc.

Putnam Funds

T. Rowe Price Associates, Inc.

TIAA-CREF

I. 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]

II. What Concepts Should Boards Consider When Establishing and Evaluating Proxy Voting Processes and Procedures?

In establishing or evaluating their funds' proxy voting procedures, there are a number of broad concepts Boards may wish to consider that will help determine how to best structure a fund's voting processes and procedures. This section discusses some of these key concepts. Section III and the Appendix provides additional context on these decision points by describing common proxy voting processes and procedures used throughout the industry.

A. To What Extent Should Proxy Voting Duties Be Delegated?

The threshold decision a Board must consider when determining how to structure its funds' proxy voting process is which voting responsibilities will be retained by the Board and which will be delegated. A few Boards have decided to retain voting authority over all of their funds' proxy votes. However, the majority of Boards delegate some or all voting power to an adviser. In situations where the Board has delegated its voting authority, the Board retains oversight responsibilities and may have some voting discretion in specified situations.

The following are examples of how some Boards participate in fund voting decisions:

- <u>No Delegation: Board Retains All Voting Authority.</u> A few Boards do not delegate any voting authority. The Board makes all voting decisions and the adviser usually serves in an administrative role. This model is discussed in more detail in Section III and the Appendix.

- <u>Partial Delegation: Board Provides Input on High Profile Votes, Material Votes or Novel Issues Not Covered by Proxy Policies.</u> Some Boards that delegate voting authority to a third party still choose to be involved on certain votes, such as those that are high profile, of particular interest to the Board, or that involve novel issues that are not covered under the fund's proxy guidelines. The level of involvement by Boards on these key votes varies – some Boards may want to make the voting decisions, others may provide in-depth advice on the issue, and some may only want to receive a report about how the adviser intends to vote so that they can raise concerns if necessary.

  However a Board chooses to be involved, it should decide what type of procedure will be used. The Board should determine what types of information should be considered and who should be involved in the process – for example, the full Board, a committee, or a Board or committee chair. One Board we are aware of assigns a Board committee member to research the vote at issue and present it to the committee responsible for proxy voting. The committee then discusses the matter and provides feedback to the adviser. The committee also reports its discussions to the full Board.

  If the ultimate voting decision represents a new policy stance or shift in current policy then the Board also should consider whether the fund's voting guidelines should be amended at the same time.

- <u>Partial Delegation: Board Determines Votes when Adviser has Conflict of Interest.</u> As discussed later in this section under "*How Should Conflicts of Interest Be Handled?*", some Boards become involved in the voting process when an adviser has a conflict of interest concerning a vote. For example, many proxy voting procedures call for votes to be elevated to the Board when the adviser does not believe it is able to recommend a vote without the appearance of bias (*e.g.*, if the adviser wants to override the proxy voting guidelines in favor of a company with which the adviser has a potential conflict of interest).

B. How Should Third Party Proxy Firms Be Utilized?

It is important for Boards to understand the role that proxy service vendors play in their funds' proxy voting process. Vendors offer a variety of services which most fund complexes use to at least some degree. For some funds, vendors may assist solely with administrative functions, while for others, vendors may play a key role in the proxy voting process (for more information, see the discussion regarding proxy voting models in Section III and the Appendix).

The following is a list of some of the proxy vendor services that are often used by funds:

- **Administrative/Back Office Functions**

    - Receipt and Execution. Most fund groups use proxy service vendors to perform some administrative or back office functions. For example, proxy service providers will monitor the receipt of ballots and execute votes according to fund instructions.

    - Pre-population. Some fund groups also use vendors to perform an initial analysis of how a fund would likely vote under the fund's own custom policies (not the vendor's policies). Funds using this service typically have the vendor pre-populate the fund's vote in its voting software. Adviser personnel then analyze each vote and make the final determination of how it will be cast. Many fund groups find this service makes the voting process more efficient.

    - Casting Votes According to Specific Instructions. Some fund groups use a proxy service vendor to cast votes according to a fund's custom voting guidelines. In these arrangements, the vendor executes routine votes where the fund's voting policy is clear. The vendor is typically asked to escalate to the adviser any votes where the guidelines are silent on the issue, the guidelines are unclear on the matter or the guidelines specify that the vote is to be analyzed on a "case-by-case" basis. Fund groups who use this vendor service typically have the adviser oversee this process to ensure the votes are cast in accordance with the funds' procedures. The adviser usually conducts a retroactive review of the votes cast and any votes missed and may have regular meetings with the vendor about how the policies are being implemented.

- **Use of Vendor Research and Analysis.** Most fund groups use research and analysis reports from one or more proxy service vendors. Vendors typically offer a report on each proposed vote which contains relevant statistics, facts and analysis. The vendor may provide information on financial performance, executive compensation and board membership and convey insight gained from the vendor's engagement with portfolio companies. Fund groups often find that these reports are a helpful resource in making their own voting determinations, especially in markets where the proxy team and/or investment professionals have less expertise or lack relevant language skills (such as smaller foreign markets).

- **Using Vendor Vote Recommendations for Reference.** Proxy service vendors also offer vote recommendations based on the vendor's own guidelines. Some fund groups include these recommendations as part of the total mix of information used to decide how to cast votes that are being considered on a case-by-case basis. These fund groups do not automatically follow a vote recommendation, but they will take it under consideration when evaluating the matter.[12]

- **Following Vendor Vote Recommendations.** Some funds vote all of their proxies according to proxy service vendor voting recommendations while others may follow vendor recommendations for specific types of votes. Often fund complexes use this service as a cost-effective means to gain expertise they otherwise lack. For example, some fund advisers do not have personnel specializing in corporate governance issues and others lack expertise on specific issues or markets. Some fund families also use vendor recommendations as a way to handle votes involving a potential conflict of interest. By deferring to a vendor, the conflict of interest of the adviser and/or fund may be avoided because the adviser and Board do not take an active role in determining the vote.[13]

- **Use Vendor Expertise to Draft Voting Guidelines.** Some fund groups use a proxy service vendor to assist them in creating or updating their voting guidelines. A vendor may be able to offer additional experience and expertise to the funds, which may be especially helpful on complicated voting issues.

Boards should be aware that vendors may have potential conflicts of interest themselves. Some vendors advise public companies about how to structure a proposal to be voted on at a shareholder meeting and then make vote recommendations to funds about how to vote on that proposal.[14] Vendors may also have a conflict if they provide proxy voting services to an asset management client that is owned by a publicly listed company (the vendor could end up providing vote recommendations and analysis on that company's proxy). Most proxy service vendors have taken steps to mitigate the potential influence of conflicts of interest, such as establishing internal firewalls or disclosing the conflict to its clients.[15] However, it is important that those involved in the funds' proxy voting process be aware of these potential conflicts of interest and understand how they are handled by the vendors.[16]

C. To What Extent Should Investment Professionals Be Involved in the Voting Process?

In establishing proxy voting processes and procedures, funds need to consider whether and how to involve investment professionals, such as portfolio managers and analysts, in the process. The majority of actively-managed fund complexes appear to involve investment professionals in the process to some degree.[17]

Common responsibilities given to investment professionals include:

- <u>Voting Authority Over Some or All Votes.</u> Some fund complexes give complete voting discretion to the portfolio managers of the fund that holds the portfolio company (see the discussion on *Model 2(c): Board Delegates to Adviser's Portfolio Managers* in Section III and the Appendix). Other fund families give portfolio managers voting authority over certain specified types of votes – for example, portfolio managers may have the power to decide votes pertaining to specific issues, such as mergers and acquisitions, or portfolio managers may have discretion over all votes that are required to be considered on a case-by-case basis.

- Input on All or Certain Votes. Some fund groups seek input from investment professionals on all or certain types of votes. In these situations, the portfolio manager or analyst does not make the final voting decision, but the investment professional's recommendation is considered as one factor in the decision making process.

- Overrides. Most fund groups allow portfolio managers to recommend that the fund cast a vote contrary to its stated voting guidelines. As discussed in more detail in "*What Process Should Be Used for Overriding a Fund's Voting Guidelines?*" below, overrides should only be permitted pursuant to established processes and procedures.

On the other hand, some actively-managed fund complexes choose to exclude investment professionals from the proxy voting process as much as possible. Funds that take this position, however, often still seek input from investment professionals on issues where they have unique expertise. For example, with respect to votes regarding mergers and acquisitions, investment professionals are often in the best position to evaluate whether the transaction would benefit the fund; on executive compensation issues, they can provide insight on whether pay is commensurate with performance; and on social and environmental issues, investment professionals may have the most expertise on whether and how the vote may affect the company's operations and performance.

Those who believe investment professionals should play a limited role in proxy voting argue that investment professionals have a potential bias toward management. Portfolio managers and analysts often work closely with their funds' portfolio companies and may be hesitant to vote against management's recommendation for fear that it would harm their relationship with the company. In addition, minimizing investment professionals' involvement in the proxy voting process could reduce the potential for inappropriate influence by portfolio companies, proxy solicitors and other third parties.

Despite these concerns, many believe that the expertise of investment professionals who actively manage funds is too valuable to ignore. They believe that proxy voting is part and parcel to the investment process and that investment professionals are the ones with the most extensive knowledge of the portfolio companies and their operations. Smaller complexes with fewer resources, including limited or no experienced corporate governance personnel, may be especially interested in leveraging their resources by utilizing the expertise of investment professionals.

Those fund complexes that choose to involve investment professionals in the voting process usually try to limit the effect of any bias toward management by including non-investment professionals in the process. Their participation helps to ensure that the portfolio managers' or analysts' recommendations and input are reasonable and appropriate for the funds. How non-investment professionals are involved in the process will vary depending on the particular circumstances of the funds and its proxy voting procedures. At least one fund family requires a recommendation from both a portfolio manager and the proxy management team for every pending vote. Fund families also usually have a non-investment professional review and/or approve any override request, and the rationale therefore, from a portfolio manager. In addition, if the adviser has an internal proxy voting committee charged with overseeing the voting process ("Proxy Voting Committee"), it usually has at least one non-investment professional as a member. These committee members usually come from the proxy governance, legal and/or compliance teams.

D. What Process Should Be Used for Overriding a Fund's Voting Guidelines?

Many Boards have adopted proxy voting guidelines that are rule-based,[18] specifying how a fund will vote depending on the fund's specific circumstances.[19] Most of these funds also have a process for overriding a voting guideline when circumstances warrant. Usually, a request to override the proxy guidelines comes from an investment professional or a member of the proxy team. If the fund complex has a Proxy Voting Committee, the Committee is usually charged with approving the override request. If the fund group does not have a Proxy Voting Committee, a proxy governance team (a group of personnel that specialize in corporate governance and proxy voting) along with legal and/or compliance may be required to approve the request. If voting discretion resides with the Board, the Board or its designee (*e.g*., the Board chair) will usually have final approval over the override request. While the exact process for approving the override will vary, the Board should understand the process for overrides, what information will be considered in approving an override and who will be involved in the decision to override a guideline.

E. Should Funds in the Same Complex Be Permitted to Split Votes?

Another issue for funds and their Boards to consider is whether they should allow funds in the same family to split their votes (*i.e.*, allow two funds to vote differently on the same vote for the same portfolio company).

Many fund groups have a policy that they will strive to vote proxies in the best interests of fund shareholders. Some believe that in order to do this, the fund family should ascertain the best vote for all of the funds' shareholders and then vote all shares owned by funds in the complex the same way.

Other fund families believe that the vote that is in the best interest for shareholders of one fund may be different from that which is best for the shareholders of another fund. To try to ensure that votes are being cast in the best interest of each fund's shareholders, these complexes will allow split votes (although some ask that disagreeing portfolio managers attempt to come to an agreement before a split vote is permitted).[20]

Still, other fund complexes strike a middle ground and allow funds to split votes on specific issues. For example, many fund groups allow funds to split votes on merger and acquisition transactions on the belief that the impact of the transaction could vary for each fund depending on the fund's investment objectives, strategies and other portfolio holdings.

F. How and When Should Funds Engage with Portfolio Companies on Upcoming Votes?

Most fund families are open to engaging with portfolio companies on voting issues. During proxy voting season, portfolio companies often reach out to funds with information about upcoming votes, and funds will also contact portfolio companies with questions. Many fund managers have reported that engagement by portfolio companies increased with the introduction of "say-on-pay" votes.

It is also common for portfolio companies to engage fund complexes before proxy season begins. Portfolio companies are typically interested in what changes will be made to the funds' proxy voting guidelines for the upcoming season and may discuss specific policies with the fund complexes.

Fund families that hold a significant position in a company may also use methods outside of the proxy voting process to try to improve corporate governance. For example, a fund family may agree to vote for an issuer's proposal on the condition that the company agrees to consider other policy changes in the future.

Depending on who is involved in the proxy voting process, engagement may be made by the proxy governance team, investment professionals or both. If both proxy governance and investment personnel are involved in the voting process, they typically make an effort to ensure that everyone involved in the process receives the same information. In addition, in fund complexes where the Board retains voting discretion, the lead Board member responsible for voting often receives contact from issuers, generally after the votes are cast.

Post-Vote Reporting. Several fund groups also contact issuers after votes are cast, either through letters, by phone, or in some geographic areas, in person. For fund groups where the fund Board retains voting discretion, the Board chair may routinely send out letters explaining the Board's vote. The Board may choose to send out these types of letters for all votes or only for certain types of votes (*e.g*., when a vote is cast against management).

Fund families where the Board does not retain full voting discretion do not usually have a specific process for communicating with portfolio companies after voting. These fund groups typically believe that they are able to communicate any necessary information to the portfolio companies during the proxy voting process. Adviser personnel may send a letter after the vote in special circumstances, such as if they believe their vote needs further explanation or they wish to communicate directly with the portfolio company's board (rather than its personnel) about how the fund voted.

G. How Should Conflicts of Interest Be Handled?

An important consideration in establishing or reviewing proxy voting procedures is how potential conflicts of interest are handled. Proxy voting decisions should be made in the best interest of fund shareholders and not in the interest of other parties. However, when an adviser has been delegated proxy voting responsibilities, conflicts of interest may exist between the adviser and its vendors, broker-dealers, institutional clients and affiliates. For example, a fund adviser that also runs a pension business could be in the position of determining how a fund will vote the shares of one of the adviser's large pension clients. The potential exists for the adviser to make a decision based on the pension client's business relationship with the adviser (or an anticipated business relationship) and not on what is in the best interest of the fund. The proxy voting procedures approved by fund Boards often state that proxies must be voted in the best interest of fund shareholders, but determining the best method to identify potential conflicts of interest is typically delegated to the adviser.

The following are some examples of approaches employed to handle an adviser's potential conflicts of interest (some fund groups may use a combination of these):

- <u>Firewall Between Client Groups and Proxy Voting Team.</u> Most fund advisers that have other institutional clients isolate the fund proxy voting process from those departments and individuals that primarily deal with client management, marketing or sales. By keeping these two functions separate, the potential for influence from a large institutional client on fund voting is reduced.

- <u>Follow Voting Policy.</u> Conflicts of interest can be mitigated by following a fund's proxy voting guidelines and not allowing overrides if a potential conflict of interest exists. It is important to note that this approach only works when the guidelines are clear on how to vote given the specific circumstances. Votes that must be dealt with on a case-by-case basis would have to be handled in an alternative manner.

- <u>Vote According to a Proxy Service Vendor's Recommendations.</u> Some fund policies state that a fund will follow a proxy service vendor's vote recommendation whenever the adviser has a potential conflict of interest. Often the policy will only call for a fund to defer to a proxy vendor when the fund's guidelines don't specify how to vote (*i.e.*, the fund must analyze the vote on a case-by-case basis). Funds may also defer to a proxy vendor when the adviser does not feel it can appear to be unbiased, such as if shares of the portfolio company at issue are owned by the adviser.

- <u>Disclosure/Non-Disclosure and Review.</u> Some funds have implemented a system where a potential conflict of interest is identified and disclosed to every person involved in the voting process. Those who follow this approach believe that it encourages those making voting decisions to take extra care to be unbiased. Alternatively, some fund groups take the opposite approach and employ procedures to ensure that potential conflicts of interest are <u>not</u> disclosed during the proxy voting process.

Those who follow this approach believe that personnel who do not know of a conflict of interest are less likely to be influenced by it.

Whether the conflict is disclosed or not, most fund groups require that vote recommendations involving a potential conflict of interest be subject to an extra layer of review by the legal, compliance and/or conflicts departments. Some fund complexes also require those who made the vote recommendations to certify that they were not influenced by the potential conflict of interest. As part of their oversight role, directors also may receive a voting report on those votes that involved potential conflicts of interest.

- Board Vote. Some Boards mitigate an adviser's potential conflict of interest by elevating the voting decision to the Board or to a designated Board member. For example, at least one fund complex requires the Board to approve a vote where the adviser is recommending an override of the voting guidelines in a way that is favorable to the party involved in the conflict. Votes where the adviser does not believe it can make an unbiased decision (or a decision that appears unbiased) may also be elevated to the Board or to a designated Board member.
- Abstain. Some funds may choose to abstain from a vote if a conflict of interest is involved.

Fund directors may also have potential conflicts of interest–for example if a director of a fund is also a board member of a company owned by the fund. This could result in the fund director having to decide how the fund will vote on his or her own re-election to the portfolio company's board. Fund directors who have potential conflicts of interest will usually recuse themselves from the voting decision.

H. How Should Funds Handle Proxy Voting for Their Loaned Securities?

Funds that engage in securities lending should also consider how proxy voting will be handled for securities on loan.[21] Typically when a mutual fund lends its securities, the right to vote those borrowed securities at a shareholder meeting is also transferred to the borrower.[22] Therefore, the fund is not able to vote those securities unless it recalls them, terminating the loan and receiving the securities before the record date.

Funds may handle securities on loan in a variety of ways:

- Recall Loaned Securities if the Vote is Material. Most fund groups recall securities on loan only if the vote is material. Materiality can be evaluated in several ways. Most fund families believe a vote is material if the economic value of voting the securities outweighs the cost of recalling the securities (mainly, lost revenue).[23] Generally, the economic value of casting a vote is less than the cost of recalling, either because the vote will not have a large economic consequence or because the outcome of the vote will not be affected by the fund voting its shares on loan. However, sometimes a fund family may consider a vote to be material for qualitative reasons. For example, a portfolio manager may believe there is value in voting the shares as a way to send a message to the company, even if the fund's vote will not affect the outcome.

- Recall All Loaned Securities. Some fund groups have a policy to attempt to recall any and all securities on loan before the record date as long as they receive timely notice of the shareholder meeting.[24]

- Litmus Test. Some funds follow a litmus test on when they recall securities. For example, they may have a policy to only recall securities if the fund owns more than a certain percentage of the company's stock.

III. Proxy Voting Models: How Does the Industry Currently Structure its Proxy Voting Practices and Procedures?

As discussed, there are a number of concepts that funds must consider when establishing or evaluating methods and processes to vote proxies ("proxy voting models"). To help put these decision points in context, the following is an overview of proxy voting models that are commonly used throughout the industry. No two proxy voting models are alike; however for ease of understanding we have grouped proxy voting models into three general categories. Additional information about each of these models can be found in the Appendix.

Model 1: **Board Retains All Voting Authority.** In these proxy voting models, the Board has retained all voting authority.

Model 2: **Voting Authority Delegated to Adviser.** In these proxy voting models, the Board has delegated voting authority to the fund's adviser. This category is divided into further subgroups based on the type of adviser personnel that are charged with overseeing the voting process. Fund groups typically use one of the following structures:

Model 2(a): Board Delegates to Adviser's Proxy Voting Committee. Many funds vest voting authority in an adviser-level Proxy Voting Committee that is made up of personnel from various departments, often including a representative from legal/compliance, a representative from the proxy governance staff and, in some cases, investment professionals.

Model 2(b): Board Delegates to Adviser's Proxy Governance Staff. Some funds vest all voting authority in a proxy governance team that specializes in corporate governance and proxy voting. The team may have assistance and input from investment professionals.

Model 2(c): Board Delegates to Adviser's Portfolio Managers. Some funds allow portfolio managers to make voting decisions for all the shares held in their fund.

Model 3: **Board Delegates to Proxy Service Vendor.** In these models, voting authority largely resides with an independent proxy service vendor who votes according to Board approved voting guidelines that may be created using proxy service vendor input and recommendations.

IV. Board Oversight of Proxy Voting

Boards are required to oversee the proxy voting process as part of their fiduciary duties. The fund's specific processes and procedures will influence how much time and what type of information the Board needs to fulfill its responsibilities.

Some of the threshold governance decisions a Board need to make include the following:

- <u>Full Board or Committee Jurisdiction.</u> Directors need to decide whether it is appropriate and desirable to delegate proxy voting responsibilities to a Board committee. The approach a Board chooses to take will depend on the Board's specific characteristics, including the number of directors that serve on the Board, the Board's current committee structure, and the extent of the Board's involvement in the proxy voting process. Those who delegate to committees may ask the committee to report back to the full Board on certain matters.

- <u>Number of Meetings.</u> Boards also vary on how many meetings they devote to proxy voting. At a minimum Boards should annually review the proxy voting procedures and receive a report about votes that have been cast during the previous year. Some Boards routinely discuss proxy voting more frequently (anywhere between 2-4 times a year) and many discuss any pressing issues as the need arises. As discussed above, Boards who have not delegated proxy voting authority, and therefore are integrally involved in the voting process, usually also have a Board or committee chair that is in constant contact with the adviser.

- <u>Types of Reports.</u> Directors also need to consider what information would be most useful to help them oversee proxy voting. Information can be presented in a variety of ways, including reports of raw data (*e.g.*, a list of all votes reported), statistical analysis that may include voting trends and benchmarking, and summaries that include third party analysis and commentary. Boards receive a wide variety of reports and each Board needs to determine what amount and type of information will be most useful to them in fulfilling their duties. *Below are some of the types of reports that some Boards receive:*

  - ***Voting Report*** – A list of how votes were cast (*e.g*., for, against, or abstained);
  - ***Analysis*** – An analysis of why votes were cast a certain way;
  - ***New or Novel Issues*** – Information about votes cast on issues not covered by the proxy voting guidelines;
  - ***Overrides*** – Information about instances where voting policy was overridden and the rationale therefore;
  - ***Conflicts of Interest*** – Information about how votes were cast when a conflict of interest was present;
  - ***Votes Against Management*** – Information about votes cast against the recommendation of the portfolio company's management;

- ***Benchmarking*** – Statistics comparing a fund's record against its peers and/or a proxy service vendor's recommendations;
- ***Votes That Differ From Institutional Accounts with the Same Adviser*** – Disclosure regarding any vote where institutional accounts served by the adviser voted differently than the mutual funds. This typically occurs when the institutional accounts have different voting guidelines than the mutual funds;
- ***Votes Not Cast*** – A report on how many fund proxies were not voted in time to be counted at the shareholder meeting or were not voted due to share blocking,[25] lack of power of attorney or other administrative impediments;
- ***Errors*** – Information about errors made in voting;
- ***Engagement*** – Information about engagement with issuers;
- ***Recall of Loaned Securities*** – Information about securities on loan that were or were not recalled; and
- ***N-PX Filings*** – Information on the timely filing of Form N-PX (an annual required filing regarding proxy votes cast by mutual funds).

- Management Presentations. Boards should consider how often they want the adviser to make in-person proxy voting presentations. Typically, the adviser reviews any reports given to the Board on proxy voting. Additionally, many advisers annually review the proxy voting procedures with the Board and suggest amendments to the procedures. At the end of proxy voting season, some advisers also present an overview of the proxy season to the Board, highlighting any novel issues that arose. On an ad hoc basis, Boards may also ask advisers to present about specific proxy issues – most recently, many Boards received presentations on say-on-pay votes.

V. Conclusion

In sum, there is no "one" way for funds to handle proxy voting. In approving and annually reviewing their funds' proxy voting procedures, Boards should ensure that they understand the processes and procedures used for voting fund proxies and be comfortable that they are appropriate for their funds. Boards should also take care in overseeing the voting process and ask any questions they feel are necessary to fully understand how important issues, such as conflicts of interest, are addressed.

Notes

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).

12 It is worth noting that there are some fund groups that will never consider the voting recommendations of proxy service vendors in their deliberations. These fund groups typically have large in-house resources that include a well-established and experienced proxy governance team (personnel that specialize in corporate governance and proxy voting).

13 *See, e.g.*, Egan-Jones Proxy Services, SEC Staff No-Action Letter (May 27, 2004) ("Egan-Jones No-Action Letter").

14 *See, e.g.*, Concept Release On The U.S. Proxy System (IC-29340) (July 26, 2010) ("Concept Release"); Egan-Jones No-Action Letter.

15 *See, e.g.*, Concept Release.

16 The SEC staff has stated in a no-action letter that advisers that retain a third party to make recommendations on how to vote fund proxies must take "reasonable steps to verify that the third party is in fact independent of the adviser based on all of the relevant facts and circumstances." According to the letter, "[a] third party generally would be independent of an investment adviser if that person is free from influence or any incentive to recommend that the proxies should be voted in anyone's interest other than the adviser's clients." Egan-Jones No-Action Letter.

17 It is important to note that this decision point may not be relevant for index-based fund families or funds using quantitative strategies. The portfolio managers and investment analysts supporting these funds do not usually have expertise about the companies held by the fund since investments are chosen based on an index or a quantitative process. Many complexes with both passively-managed funds and actively-managed funds will vote the passively-managed funds' shares in accordance with how the actively-managed funds' shares are voted.

18 Some fund families analyze every vote on a case-by-case basis. These fund groups typically adopt voting guidelines that are guidance rather than hard and fast rules. In these situations, there is no need for an override process because the decision makers (*e.g.*, the Proxy Voting Committee, portfolio managers or proxy team) are able to vote however they believe is in the best interest of the fund's shareholders.

19 Even within rule-based voting guidelines, certain voting areas are usually designated as "case-by-case" decisions that the fund or its delegate will have to consider individually. For example, most merger and acquisition votes are handled on a case-by-case basis.

20 Fund families that vest voting discretion in their investment professionals are also likely to permit split votes. As discussed above in Section II in "*What Concepts Should Boards Consider When Establishing and Evaluating Proxy Voting Processes and Procedures?–To What Extent Should Investment Professionals Be Involved in the Voting Process?*", those fund families that give voting discretion to investment professionals usually believe that voting is closely tied with the investment process and, as such, each portfolio manager is in the best position to determine what is in the best interest of fund shareholders. Following this reasoning, it makes sense that portfolio managers should be permitted to make their own decisions for their fund, even if they come to a different conclusion than other portfolio managers in the complex.

21 Additional information and guidance for fund directors on securities lending is available in the Mutual Fund Directors Forum report titled: Practical Guidance for Fund Directors on the Oversight of Securities Lending (May 2012) (available at http://www.mfdf.org/newsroom/article/report_seclend/).

22 *See, e.g.*, Concept Release.

23 It is often challenging for funds to obtain enough information to make a materiality determination in time to recall the security. In order to vote a security, it must be recalled before the record date and proxy statements are not typically mailed out until after the record date has passed. *See* Concept Release.

24 Most funds do not have a policy to recall all non-U.S. securities on loan because it's impracticable due to insufficient advance notice of proxy materials, record dates or vote cut-off dates.

25 Share blocking is a mechanism used by certain countries in which shares are frozen and may not be traded for a specified period of time prior to a meeting of shareholders.

Common Proxy Voting Models

Model 1: Board Retains All Voting Authority

Description and Defining Characteristics	Key Benefits of Model
A few Boards have decided to retain full voting authority and delegate administrative functions to the adviser. Routine votes are usually handled by the adviser who casts votes according to Board approved guidelines; however, the Board retains ultimate voting authority and makes vote determinations in non-routine situations. *Non-routine situations may include:* • <u>"Overrides."</u> Votes where either the Board decides or the adviser recommends that a vote be cast contrary to the voting guidelines. • <u>"Case-by-case" or "refer" votes.</u> Votes on matters that the Board has determined require case-by-case analysis of the specific facts and circumstances. Examples of votes that typically receive this treatment are those associated with compensation, mergers and acquisitions, and auditor independence. • <u>Votes Not Addressed by Proxy Voting Procedures.</u> New or unique votes that are not addressed by proxy voting procedures and need further analysis before a vote can be cast. When Boards decide to retain the ability to make voting decisions in non-routine situations, they typically vest this power in a Board chair, a Board committee or the chair of the Board committee. In addition, some Boards require that the full Board ratify any decisions made by that committee or chair. When a committee is charged with making vote determinations, the committee chair has usually been given the authority to act when quick decisions are needed. The Board, committee, or chair will generally have assistance from dedicated staff. They may receive a variety of information to help them make each voting decision, including voting recommendations and analysis from the fund's portfolio manager or investment analyst, and/or one or more proxy service vendors. They or their staff also usually have a working relationship with someone from the adviser's corporate governance team who can provide additional information and answer any questions.	• Board retains full control over votes cast • Potential conflicts of interest of the adviser are handled through Board involvement

Model 2(a): Board Delegates to Adviser's Proxy Voting Committee

Description and Defining Characteristics	Key Benefits of Model
Several Boards have delegated most or all of their voting authority to the adviser. The process that the adviser uses to vote proxies varies among fund groups, but for many advisers, the voting decisions are made by an internal Proxy Voting Committee and a corporate governance team. The exact division of voting authority between these two groups varies among fund complexes. At a minimum, the Proxy Voting Committee is generally responsible for reviewing and recommending amendments to the proxy voting guidelines. This is important because the guidelines specify what factors will be considered on any voting issue and may dictate how the fund will vote on specific issues. Most Proxy Voting Committees review the voting guidelines on an annual basis, but will consider changes off-cycle if the need arises. **Proxy Voting Committee Duties**. Depending on the unique circumstances of a fund complex and its adviser, Proxy Voting Committees are charged with varying responsibilities. *Below are some of the duties that Proxy Voting Committees may have in the proxy voting process:* • <u>Proxy Voting Committee Decides All Votes.</u> A Proxy Voting Committee may be responsible for voting every proxy. The Committee of one fund complex that follows this model considers a variety of information for every vote including a summary of the proposal and other relevant data gathered by a proxy analyst, as well as vote recommendations from an investment analyst and the proxy governance team. • <u>Proxy Voting Committee Decides Non-Routine Votes.</u> A more common approach is to charge the Proxy Voting Committee with overseeing the voting process and the power to make non-routine voting decisions, such as overrides, case-by-case votes or votes on which the voting guidelines are silent.1 Proxy Voting Committees also may be charged with handling potential conflicts of interest as discussed earlier. Proxy Voting Committees that only make vote determinations on non-routine votes are usually assisted by a proxy governance team that handles all routine votes. The Committees may also receive input from portfolio managers about the pending vote.	• Systematic and organized method to bring the knowledge, experience and perspectives of personnel from a variety of departments into proxy voting decisions • Delegating voting responsibilities to an adviser reduces the amount of Board time and resources spent on proxy voting

1 Proxy Voting Committees may also be used to help a fund complex avoid splitting votes (see "*What Concepts Should Boards Consider When Establishing and Evaluating Proxy Voting Processes and Procedures?–Should Funds in the Same Complex Be Permitted to Split Votes?*"). For example, one fund family, which normally allows portfolio managers to determine how to vote case-by-case votes, will elevate the voting decision to the Committee if the portfolio managers of multiple funds can't agree. The Proxy Voting Committee will consider the arguments of each portfolio manager and then make the ultimate decision on how all of the funds will vote their shares.

Model 2(a) (continued): Board Delegates to Adviser's Proxy Voting Committee

Description and Defining Characteristics	Key Benefits of Model
Information considered by the Proxy Voting Committee in deciding non-routine votes will vary by complex. In determining how to cast votes that are considered on a case-by-case basis, at least one fund family requires its Proxy Voting Committee to consider all of the following: (1) a portfolio manager/investment analyst's vote recommendation and reasoning; (2) analyses from proxy service vendors; (3) discussions with the issuer and (4) how the fund has previously voted on similar issues. With respect to override votes, the Proxy Voting Committee is often used as a control device to help ensure that overrides are being made in the best interest of the fund. The Proxy Voting Committee will typically receive the override request, and rationale therefore, when determining how to vote. • Proxy Voting Committee Provides Voting Oversight Only. Another approach is to vest a Proxy Voting Committee with overseeing proxy voting, but no day-to-day voting authority. In this model, a proxy governance team generally is responsible for casting the votes. The governance team may receive input from the fund portfolio managers on specified categories of votes – for example, votes on economic transactions, votes where the proxy governance team is recommending a vote against management or instances where the fund owns a specified percentage of shares. The Proxy Voting Committee oversees the voting activity in a variety of ways, including (a) reviewing and recommending amendments to the proxy voting guidelines, (b) offering consultation on controversial, sensitive or high profile votes, (c) reviewing and monitoring overrides to the voting guidelines, (d) handling conflicts of interest and/or (e) generally overseeing the voting process and votes cast by the proxy team or service provider. **Proxy Voting Committee Membership and Governance**. In our experience, Proxy Voting Committees usually consist of between 3-15 people. Typically, a representative from legal and/or compliance is either a member of the Committee or a non-voting participant in Committee discussions. Other members of the Committee may include proxy governance staff and/or investment professionals. If investment professionals serve on the Committee, there is generally an effort to make sure they represent the various strategies and markets used by the funds (either by including the Chief Investment Officer or multiple portfolio managers). No fund group we spoke to has an official rotation policy for Committee members. Proxy Voting Committees generally meet at least quarterly and more often if necessary to discuss pending votes.	

Model 2(b): Board Delegates to Adviser's Proxy Governance Staff

Description and Defining Characteristics	Key Benefits of Model
Some fund groups vest all voting authority in the proxy governance team of the adviser (a group of personnel that specialize in corporate governance and proxy voting). The proxy governance team may receive input from legal and/or portfolio managers on certain types of votes (*e.g.*, votes on economic transactions or votes not covered by policy), but generally the team is responsible for casting all votes for the fund in accordance with the Board approved proxy guidelines. The proxy governance team also is responsible for reviewing and recommending amendments to the voting policy and guidelines. In this model, the proxy governance team must be large enough to handle the volume of votes received. There is typically a proxy governance team leader who oversees the process and is consulted on certain types of votes (*e.g.*, votes that are high profile or are contrary to voting guidelines or precedence). The proxy governance team staff also usually works closely together to ensure consistency in their approach and to get additional feedback on specific votes	• Vests voting responsibility in a team of personnel experienced in corporate governance and proxy voting matters • Delegating voting responsibilities to an adviser reduces the amount of Board time and resources spent on proxy voting

Model 2(c): Board Delegates to Adviser's Portfolio Managers

Description and Defining Characteristics	Key Benefits of Model
Another proxy voting model gives voting discretion to the portfolio manager of the fund that owns the shares being voted. This model is typically only used for actively-managed portfolios, because these portfolio managers tend to have in-depth experience and knowledge about the portfolio companies and their proxy proposals. Under this model, a proxy management team of the adviser typically provides information about an upcoming vote to the portfolio managers, including research, analysis and a voting recommendation. The proxy management team also facilitates communication between portfolio managers when multiple funds own stock in the company. Although portfolio managers may collaborate on the matter, the portfolio managers almost always have the final say on how the votes in their portfolio will be cast. In fact, the fund's voting guidelines are often adopted as non-binding guidance and a portfolio manager has complete discretion to vote contrary to those guidelines.	• Every vote is decided by those with specific knowledge of the portfolio companies and their operations, as well the fund's investments • Delegating voting responsibilities to an adviser reduces the amount of Board time and resources spent on proxy voting

Model 2(c) (continued): Board Delegates to Adviser's Portfolio Managers

Description and Defining Characteristics	Key Benefits of Model
Funds using this model may have an adviser-level committee that is responsible for reviewing the policy guidelines and procedures each year. The internal committee members would typically include a member of the proxy governance staff, a member from legal, and portfolio managers representing a wide variety of fund strategies. This type of committee has substantially fewer powers and responsibilities than the Proxy Voting Committee described in Model 2(a): Board Delegates to Adviser's Proxy Voting Committee.	

Model 3: Board Delegates to Proxy Service Vendor

Description and Defining Characteristics	Key Benefits of Model
Some funds delegate voting responsibility to an independent proxy service vendor who votes according to Board approved voting guidelines that may be created using proxy service vendor input and recommendations. Funds that choose this model often find that it is more cost efficient than hiring a full time proxy governance staff. Some funds, especially those that are not actively-managed, may choose to follow this model because they believe the proxy service vendor provides a level of knowledge and expertise on the portfolio companies and voting issues that is valuable. Voting according to vendor recommendations is also used to handle potential conflicts of interest that the Board or adviser may have, because the adviser and Board do not take an active role in determining the vote[2]. If voting responsibility has been delegated to a proxy service vendor, the adviser usually provides oversight of the vendor's services. Additional information about the use and oversight of proxy service vendors is discussed in Section II(B): *"How Should Third Party Proxy Firms Be Utilized?"*	• Vendors may provide additional knowledge, expertise and perspective to the voting process • Potential adviser conflicts of interest are handled through vendor involvement • Cost efficient • Delegating voting responsibilities to a vendor reduces the amount of Board time and resources spent on proxy voting

[2] *See, e.g.*, Egan-Jones No-Action Letter.

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MFDF MUTUAL FUND DIRECTORS FORUM
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Report
of the
Mutual Fund Directors Forum

Practical Guidance for Fund Directors on the Oversight of Securities Lending

May 2012

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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]

The Mechanics of Securities Lending

Borrowers and Lenders

Virtually any long-term, beneficial holder of securities can lend securities. Owners of securities have an incentive to lend securities as the fees received in return for lending can boost portfolio performance (or otherwise offset the costs of managing a portfolio). Lenders of securities earn a return in two complementary ways – from fees often received in connection with lending securities, particularly those that are in high demand, and from the investment return on cash collateral received in return for a loan. Most securities can be lent, including domestic and foreign equities, American and global depository receipts, exchange-traded fund shares, government and agency bonds, supranational bonds, mortgage-backed securities and corporate bonds.

Not surprisingly, mutual funds are significant players in this market – indeed, as of January 2012, United States registered mutual funds represented 22% of the lending market. Other significant lenders include U.S. and foreign-based pension plans, foreign-registered mutual funds, insurance companies and central banks. Like other owners of securities, most mutual funds lend for a simple purpose: to improve the performance of their underlying investment portfolio.

Typical borrowers of securities include broker-dealers, prime brokers, hedge funds and others who use borrowed securities to implement specific investment strategies. Securities are often borrowed to facilitate the shorting of those securities because someone who shorts a security must still deliver the security to the purchaser at the other end of a short sale. Hence, a short seller must borrow the security in order to meet its delivery obligation. In addition, there are other reasons that market participants need to borrow securities. For example, securities lending facilitates the market-making businesses of broker-dealers, permits investors to engage in certain types of arbitrage strategies and permits borrowers to use a borrowed security to collateralize a separate transaction.

The Structure of a Loan of Securities

Securities lending is, most fundamentally, a collateralized transaction that takes place between two parties. In a loan of securities, the beneficial owner of those securities (the "lender") temporarily transfers title to a security as well as the associated rights and privileges of ownership to a borrower. Loans typically have a number of important features:

- The borrower will either be required to return the borrowed securities on demand (an "open loan") or on a specific, agreed date (a "term loan"). Contracts governing term loans can, however, have provisions requiring return of the security on demand. Most loans are made on an open basis although there are borrowers that prefer term facilities.

- While the borrower receives all interest, dividends and corporate action rights on the security, the borrower is required to repay the economic value of these benefits back to the lender.[3]

- The borrower also holds any voting rights attached to the security while the loan is in place.

- Even if structured as a term loan, the loan contract typically permits the lender to recall the security at any time for any reason. Term trades will sometimes operate with a "right to substitution" which allows the lender to change the security as long as it is of a similar type. Mutual funds that are lenders, for example, often recall lent securities in order to cast important proxy votes with respect to the security.

In return for lending the security, the lender receives collateral from the borrower. The value of the collateral typically exceeds the value of the lent security. This collateral typically takes the form of cash – indeed, in the majority of cases it consists of cash in the United States and most of this section focuses on this as a result — but can sometimes consist of highly liquid securities such as short-term government bonds. In addition:

- The value of the collateral typically ranges from 102%-105% of the value of the lent securities.

- The amount of collateral can depend upon a variety of factors, including whether it is denominated in the same currency as the lent security, the credit-worthiness of the borrower and other factors the lender considers relevant.

- The value of the security lent (as well as the value of any securities provided as collateral) is marked-to-market daily, and the amount of collateral backing the loan is adjusted accordingly.

When a securities loan is collateralized by cash, the lender earns its return, in part, from the investment of the collateral. (Issues associated with the investment of collateral are discussed below.) Normally, however, the lender must share part of this return with the borrower and/or with third parties that arrange the transaction. Lenders can earn a higher return on securities that are in high demand by borrowers either through payment of a lower rebate back to the borrower or through other compensation received from the borrower in return for lending these "specials."

Management/Investment of Cash Collateral

A lender typically receives collateral for the loan simultaneously with or prior to delivery of the borrowed securities. Thus, from the outset of the loan, a lender of securities also needs to manage the cash collateral that it receives during the time that securities are lent out. While the lender of securities benefits from the loan by retaining some portion of the investment return earned on the invested collateral, the lender will nonetheless want to limit the risk of loss on the invested collateral. Hence, collateral is typically invested in a money-market fund or cash pool operating under investment constraints similar to that of a money market fund. Among the options available to lenders are:

- Affiliated or unaffiliated money market funds;

- An affiliated but unregistered cash pool managed by the fund's adviser (or other investments as directed by the adviser); or

- An unregistered cash pool managed by a third party (often the fund's custodian or other party otherwise managing the fund's lending program).

Each of these approaches does have some risk associated with possible loss of capital. We discuss many of these risks in section III, below.

Routes to Market

Very few fund complexes have the expertise or resources to operate and manage a securities lending program by themselves. Most funds that wish to engage in securities lending therefore need to choose a route to market – that is, they need to choose who will run the program on their behalf. There are three basic options:

Custodian Agency Model – The most traditional – and perhaps the easiest – way of operating a securities lending program is to retain the fund's custodian to run the program. Typically, the custodian pools a participant's securities with those held by other clients. The custodian then allocates loans made among its clients using an automated algorithm designed to ensure that all its clients are treated fairly. In this type of arrangement, cash collateral is sometimes invested in a commingled pool that may be advised by an affiliate of the custodian. Lenders may, however, seek to enter into alternative arrangements for the management of the cash collateral they receive.

Custodial pools are typically large, which can be attractive to borrowers who are looking to ensure liquidity and availability of securities. Custodians often price their lending services on a bundled basis together with other services they provide to their clients. Depending upon the viewpoint of a fund's adviser and board, this can be either a benefit or a drawback – while some prefer the simplicity of a single price for all custody and custody-related services, others conclude that they cannot determine whether they are getting a fair deal on the costs of their securities lending program unless this aspect of their custodian's services is priced separately.

Third-Party Agency Model – Alternatively, a fund can hire a third party agent to operate and manage its securities lending program. A third party agent typically manages its lending activities similarly to the custodian model. As with custodians, third party agents may offer lenders the ability to invest cash collateral in a pool they manage or may make other options available.

"Principal Exclusive" Model — In a "principal exclusive" arrangement, the lender (or its agent) negotiates an exclusive arrangement with a principal counterparty. The borrower pays a fee for exclusive access to a particular portfolio or subset of the portfolio. The lender may thus be able to establish a number of different exclusive arrangements with various borrowers (for example, each lending fund in a complex may have its own relationship). While this approach ensures that the lender receives a stable and consistent fee during the term of the relationship, it also means that the lender is foregoing any potential profits it could make in the market over and above the agreed-upon fee.

Managing Risk in Securities Lending Programs

As with virtually any investment activity, there are risks associated with securities lending. For the most part, when a fund or fund complex engages in securities lending, the adviser will have primary responsibility for identifying and taking steps to monitor and mitigate the risks associated with the activity. However, in order to engage in effective oversight, fund directors need to be aware of the key risks associated with securities lending. We therefore outline the primary risks below.

Counterparty Risk

Counterparty risk is the risk that the borrower of the securities defaults and fails to return the securities it borrowed. If this occurs, the lender will need to apply the collateral (or liquidate it, if it is other than cash) to repurchase the lent securities. As a result, counterparty risk also entails some degree of market risk – that is, the risk that the market value of the security will increase following default such that the collateral is not sufficient to cover the cost of repurchasing the security.

A lender can take a variety of steps to mitigate the counterparty risk that it faces. Most simply, in the typical lending arrangement, the value of the collateral exceeds the value of the lent security by a specified percentage and is marked-to-market on a daily basis. Hence, from an operational perspective, the lender must have appropriate processes and controls in place to ensure that the lent security is marked-to-market on a daily basis and that the amount of collateral is adjusted as appropriate. In addition, the lender or its agent can engage in extensive and ongoing credit reviews of potential borrowers and can limit its lending activities to well-capitalized, high quality borrowers. Finally, the lender's agent may be willing to indemnify the lender by contract against the risk of default.

Reinvestment Risk

Reinvestment risk is the risk that losses are incurred on the cash collateral that is invested during the term of the loan. Reinvestment risk also encompasses the risk that the invested collateral underperforms relative to other investment options or earns less than the rebate that is paid to the borrower if the rebate is a fixed or minimum amount rather than a percentage of the return on the invested collateral. Because cash collateral is typically invested in money-market funds, unregistered pools that invest in accordance with rule 2a-7 or in other similar instruments, this risk can easily seem negligible. However, as the market disruptions of 2008-2009 demonstrated, lenders of securities face real risks in this area. Risks include both that the advisers to the pools in which cash collateral is invested may limit their ability to withdraw the cash at will because of problems in the underlying fixed income markets and that actual losses will be experienced with respect to these investments.

Reinvestment risk highlights the need for lenders to establish appropriately conservative reinvestment guidelines. Often, this can be accomplished by investing cash collateral in carefully-screened and selected money market funds.[4] If cash collateral is invested in other types of pools, a lender should ensure that it understands the risks and investment goals of the pool, and that the pool provides sufficient transparency to permit ongoing monitoring of how cash collateral is being invested. In other cases, lenders may choose to use in-house investment capabilities in order to exercise more control over how cash collateral is invested. In such cases, the lender will need to focus on such typical money market issues as the maintenance of liquidity, the credit quality of the underlying money market instruments, issuer diversification in the underlying portfolio and the weighted average maturity of the portfolio. As part of their oversight of securities lending programs, boards should understand these risks, including the risk that the reinvested collateral will underperform. They should also understand who bears the risk of deterioration in the market value of the collateral.

Operational Risk

Operational risk is the risk that processing, bookkeeping, compliance or other types of internal problems will arise. In most cases, an adviser should take the same steps in identifying and mitigating operational risk as it does with the rest of its operations, and directors can oversee these efforts in the same manner.[5]

As with some other investment activities, securities lending can pose legal and contractual risks; that is, the risk that the parties are out of compliance, either inadvertently or purposefully, with either the contracts governing their relationship or with the law generally. Included within this category are the risks that the contracts either do not provide the lender with sufficient protection or that the lender does not fully understand its rights and obligations under the contracts. In many cases, these risks can be mitigated by ensuring that personnel are fully trained, that appropriate legal counsel has been retained and that the contracts and other documents supporting the lending program have been carefully reviewed and understood by the adviser's personnel. Lenders can also mitigate this risk through the use of standardized contracts and through robust audit and compliance reporting.

One specific risk worth noting is the risk attendant to exercising rights on the collateral in the event of a borrower default. Even if the market value of the collateral is appropriate, it may take time to realize that value, and the process may be subject to litigation risk, particularly in a case involving bankruptcy of the borrower.

The Legal Requirements Imposed on Securities Lending by Registered Funds

The discussion that follows outlines the legal restrictions that United States law places on the ability of registered mutual funds to lend portfolio securities.[6] These laws and regulations are not necessarily applicable to other lenders. Moreover, in establishing and conducting a securities lending program, a fund, its board of trustees and adviser should always consult with counsel.

- **Funds are permitted to lend securities –** The Securities and Exchange Commission ("SEC") has long interpreted the Investment Company Act of 1940 ("1940 Act") to permit a registered investment company to lend its portfolio securities. However, the fund's policies must permit securities lending (that is, a lending fund must not have adopted a fundamental policy that precludes the lending of securities) and the fund's disclosure documents must accurately reflect the existence of the securities lending program and its principal risks. In addition, a fund must earn a reasonable return on the securities it lends. This reasonable return can consist of any combination of returns on invested collateral and fees and interest received in return for the loan. (Of course, separate from the reasonable return, the lending fund must receive all dividends, interest and other distributions paid in connection with the security during the time it is lent.)

- **Boards must approve and oversee securities lending programs –** Funds clearly cannot lend securities without the approval of their boards. Specifically, boards should review and approve appropriate securities lending policies and procedures. These policies and procedures may be more or less detailed and should establish standards and limitations that address a wide range of issues, including permissible borrowers, the selection of and fees to be paid to the fund's lending agent and/or other service providers, how collateral will be invested and what route(s) to market lending funds will use. Boards should oversee the fund's compliance with these policies and procedures and review them as appropriate.

- **Loans must be appropriately collateralized** — At the time each loan is entered into, the investment company lender must receive from the borrower not less than 100% of the market value of the securities loaned at the time the loan is made; furthermore, the loan must be marked-to-market on a daily basis, and the collateral must continue to equal at least 100% of the value of the lent securities. (Since industry practice is for collateral to equal between 102% and 105% of the value of the lent securities, this is typically not a problem.)[7] Moreover, funds may accept only cash, U.S. government or agency securities or irrevocable bank letters of credit as collateral.

- **Lending programs must comply with the leverage restrictions of the 1940 Act** – The SEC staff has required that funds limit their securities lending in the same manner that they are required to limit borrowings. More specifically, an investment company may not loan securities with a value in excess of one-third (33 1/3%) of its total asset value, including collateral received from such loans (in other words, the fund may loan up to 50% of net assets). This limitation is the same as the 300% asset coverage requirement imposed under section 18 of the Act.

- **A lending fund must be able to terminate a loan —** An investment company that has lent securities must be able to terminate the loan at any time and recall the loaned securities within the normal and customary settlement time for securities transactions. Funds typically recall securities because, consistent with their proxy voting policies, they need to participate in a vote with respect to the issuer of the security. Hence, a lending fund's policies and procedures should be designed to permit the fund sufficient time to recall any security that its policies require to be voted. However, a fund may need to recall securities for other reasons, including the need to deliver the security after it has been sold.

- **Restrictions on affiliate transactions apply to securities lending —** An investment company lender may engage an affiliate as its lending agent or to perform administrative or ministerial functions in connection with securities lending activities. However, fees paid by an investment company to such an affiliate may not be based on the revenue or profit derived by the fund from securities lending unless an exemptive order has been obtained from the SEC specifically approving such arrangements.[8] Finally, securities generally may not be lent to an affiliate of the fund absent exemptive relief.

Notes

[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 group serves 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.*

[3] Payments received by the borrower for the foregone interest or dividends on the lent securities are deemed "in lieu of payments" which do not qualify for reduced tax rates on qualified dividend income for underlying fund shareholders. Some expenses of securities lending may, however, be offset against these payments, thus limiting the detrimental tax impact.

[4] Funds can experience losses even when collateral is invested in money market funds because the adviser to the money market fund may be unable or unwilling to guarantee the $1 per share price.

[5] *See generally* Mutual Fund Directors Forum, *Risk Principles for Fund Directors: Practical Guidance for Fund Directors on Effective Risk Management Oversight* at 8-9 (Apr. 2010) (discussing the identification and monitoring of operational risk in fund complexes).

[6] Most of the legal guidelines regarding securities lending, including those we discuss below, derive from a series of no-action letters issued by the SEC staff over the past 40 years. These letters include *State Street Bank and Trust Co.* (Jan. 29, 1972), *State Street Bank and Trust Co.*(Sept. 29, 1972), *Salomon Brothers* (Sept. 29, 1972), *Norman F. Swanton Associates* (Oct. 13, 1973), *Standard Shares, Inc.* (Aug. 28, 1974), *Adams Express Co.* (Oct. 9, 1974), *Salomon Brothers* (May 4, 1975), *Merrill Lynch Capital Fund, Inc.* (Mar. 9, 1978), *Adams Express Co.* (Oct. 20, 1979), *SIFE Trust Fund* (Feb. 17, 1982), *Twentieth Century Investors, Inc.* (Nov. 26, 1982), *Norwest Bank Minnesota, N.A.* (May 25, 1995), *Morgan Guaranty Trust Co. of New York* (Apr. 17, 1996), *The Brinson Funds* (Nov. 25, 1997), *Chase Manhattan Bank* (July 24, 2001) and *Investment Company Institute* (Dec. 14, 2005). *See also Division of Investment Management, Generic Comment Letter to Chief Financial Officers* (Nov. 7, 1997).

[7] Should the possibility ever arise, a board should consider whether collateral levels below 102% are adequate in light of the operational costs and risks which may attach to realizing the value of the collateral.

[8] We do not addresss the standards that the SEC uses in granting such exemptive relief in this report. However, as of the date of this publication, the SEC does not appear to be granting this type of relief to funds. Funds that wish to engage in affiliate transactions of any sort as part of the securities lending program should consult with counsel.

Appendix
Board Considerations Regarding Securities Lending Programs

1. **The board should determine whether some or all of the funds it oversees will be permitted to engage in securities lending.**

   The board has an important role in overseeing a fund's securities lending activities. As noted in the text of this report, a fund may not lend securities unless lending is permitted by its investment policies. Prior to the fund engaging in securities lending, the board, working in conjunction with management, the funds' portfolio managers and others, should determine whether, in their business judgment, lending securities is likely to be of benefit to the funds and their shareholders. In most cases where an adviser wishes its funds to engage in securities lending, fund management will present to the board its case for why the funds will benefit from loaning securities and how it intends to manage the risk of the lending program.

   As part of determining whether to permit its funds to lend securities, the board should seek to understand the costs of the securities lending program (i.e., what fees will be paid to third parties that help manage the program) and what the funds are likely to earn by lending securities. Thus, the board will want to understand, at least in general terms, which securities will likely be lent (including whether the fund will limit its focus to highly-demanded securities or seek more broadly to lend the securities in its portfolio). In addition, the board should review how cash collateral will be invested, what the anticipated return on those investments is and how those earnings are to be divided among the borrower, the funds and the funds' agents.

   In the broadest terms, boards should make sure that they have discussed with the adviser why the adviser is recommending that some or all of the funds in the complex lend securities, what route to market the adviser plans to use, what key service providers the adviser plans to use and – with respect to all of these issues – what alternatives the adviser considered. Before approving a securities lending program, the board must have confidence that securities lending will benefit the fund and the adviser is able appropriately to manage the risks of securities lending.

   At the end of the day, the board cannot and should not attempt to run or manage the securities lending programs of the funds they oversee any more than they should attempt to manage other investment activities of the fund. Rather, once the board decides that securities lending is permissible, it should leave the daily management of the program to the fund's adviser and to other third parties retained to run the program. Put differently, the actual operation of a securities lending program is akin to a fund's normal investment operations.

Boards should recognize that particular portfolio managers may not wish to lend securities from their portfolios or may choose not to lend certain securities (although the adviser, who has ultimate responsibility for management of the fund, may choose to override the wishes of individual portfolio managers). For example, in some cases, a portfolio manager or adviser may be concerned that lending activity will aid short-sellers of the security to the detriment of the fund. Indeed, some boards discuss the risk that participating in securities lending may harm the funds that they oversee, particularly funds that invest in smaller markets or less liquid securities where short selling may have a disproportionate impact of the value, at least in the short term, of the lent security.

2. **The board should review and approve the contracts between the fund and the third parties that will implement and manage the fund's securities lending program.**

   Whether a fund uses its custodian or some other party, the third parties who implement the securities lending program are service providers like any other service provider that that the fund hires. In considering which third party to engage for a fund's securities lending program, directors may find it helpful to review quotes from several agents or consult a service that reviews and ranks the performance of securities lending agents.

   Once the third party has been selected, the board should therefore review and approve the contract(s) in the same manner that it reviews and approves contracts with other service providers. And, as is the case with other service providers, this is not a one-time activity at the time the contract is initially executed. Rather, the board should review and approve these contracts on a regular basis, and should include in its review process an analysis of whether the service provider is performing as expected and whether the fees it charges remain appropriate. As part of this process, boards may also wish to review whether the fund is and will likely continue to benefit from lending securities.

3. **The board should have an understanding of the risks associated with securities lending and understand the manner in which the fund's adviser will identify, monitor and mitigate those risks.**

   As described more fully above, securities lending poses operational risks, counterparty risks (that is, the risk that a borrower of a security will not return it) and risks associated with the investment of cash collateral. The board needs to understand these risks and have confidence that fund management also understands and can manage the risks – in particular, the board should have a strong understanding of how fund management identifies and tracks risks and how it mitigates those risks.

Working in conjunction with fund management, the board may also wish to adopt guidelines (or place limits on the securities lending program) with respect to certain of the risks. For example, the board may wish to place limits on how cash collateral is invested during the term of any loan or require that someone other than the fund's lending agent be used to manage and invest the collateral that the fund receives. The board should also generally review a list of acceptable borrowers and review the form of agreement between the fund and borrowers.

Likewise, because the board also has the obligation to oversee a fund's compliance with the securities laws, the board should seek assurances that securities lending programs are subject to appropriate controls.

4. **Securities lending should be conducted pursuant to written policies that have been reviewed by the board.**

Written policies can play a critical role in managing and mitigating the risks of securities lending programs. Boards and management generally use written policies to govern such important factors as which securities can be lent out, what types of collateral are acceptable, how cash and non-cash collateral is to be invested or handled, limits on counterparty exposure, and so forth. In many cases, boards also review and approve a list of acceptable borrowers that has been prepared by the adviser.

5. **Funds should be treated fairly in the context of larger securities lending programs.**

At times – particularly when an adviser uses its custodian to conduct a securities lending program – securities owned by the funds may be placed in the same pool for lending as securities owned by other clients of the adviser. In these circumstances, securities owned by the fund must be lent in a fair and equitable rotation with those of non-fund clients (or loans of individual securities owned by both funds and non-fund adviser clients must be divided fairly). It may, however, be very difficult for the board or the adviser to determine whether the fund is, in fact, being treated fairly.

6. **The board should seek to ensure that appropriate policies are in place to recall securities in order to vote proxies as appropriate and desired.**

The right to vote the proxies of the securities it owns is an important asset of a mutual fund. In the ordinary course, boards have an obligation to ensure that proxies are voted appropriately; often, boards adopt policies directing how proxies will be voted on specific issues.

As has been discussed above, however, the proxies of securities that have been loaned out cannot be voted. Funds that engage in securities lending should therefore have policies outlining when securities will be recalled in order to vote proxies. These policies can range from a requirement that any security be recalled when a proxy could be voted to criteria that require recall for certain types of votes to criteria that require recall when the fund's stake in a company is particularly high. There is no correct answer to this question; rather, boards, working with the adviser and portfolio managers, should exercise their business judgment to balance the value of voting proxies against the benefits of allowing securities to remain out on loan.

7. **The board should obtain regular reports about the securities lending program from fund management.**

   In order effectively to oversee a securities lending program, the board should seek regular reports from management. These reports may cover topics including compliance, risk management, operational information (e.g., whether there have been fails or other problems), collateral reinvestment, income earned and, as appropriate, performance benchmarking. The board may also seek information, when appropriate, on changes and trends in securities lending generally and other trends in the securities lending marketplace.

8. **The board should review the performance of the securities lending program on a regular basis.**

   Because revenue from securities lending is part of the investment return of the fund, boards should review those returns in the same manner as they review other components of the fund's performance. In reviewing the earnings from securities lending, boards may wish to consider, among other factors, the utilization rate of securities in the fund's portfolio, the extent to which earnings on lending are attributable to specific contract terms in the loans and the extent to which those returns are attributable to the reinvestment of cash collateral. The board may also wish to review whether the earnings actual earnings from the program are consistent with the returns initially predicted.

9. **The board should actively use the CCO to help it oversee securities lending programs.**

   Securities lending can be complicated and dynamic and these programs can generate significant amounts of information regarding performance, compliance and other operational issues. Given these complexities, the fund's CCO is an invaluable resource in assisting the board in its oversight responsibilities and in identifying potential problems or red flags before they become significant.

More specifically, the fund's CCO is in an excellent position to monitor compliance with relevant law, compliance with lending policies adopted by the board and the adviser, compliance with proxy voting and related security recall procedures and the adequacy and appropriateness of loan collateralization. The CCO can also assist the board in overseeing the adviser's management of the risks of the securities lending program. In general, the CCO ought to report to the board on securities lending at least yearly (and more frequently if problems or red flags are identified).

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TAB 17

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.

130/30 Fund. A fund that pursues an investment strategy to simultaneously hold both long and short market positions. This specialized investment strategy gives the fund the ability to profit from declines in equity securities that the fund shorts while maintaining an overall long investment strategy. The "130" represents that the fund may invest up to 130% of assets in long positions while the "30" represents that the fund may invest up to 30% of assets in short positions. To achieve this long-short exposure, the fund necessarily must employ leverage.

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. This rule is similar to Rule 206(4)-7 for investment advisers.

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 a mutual fund calculates the daily net asset value ("NAV") of the fund, used in determining the fund's NAV per share. (Investor purchases and redemptions of fund shares are based on the fund's daily 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 Lehman 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 affect 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.

Long-Short Fund. *See* 130/30 Fund.

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.

Naked Option. An uncovered option—*e.g.*, a call option written by a fund, when the fund does not own the underlying security.

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 affect 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. **A**rrangements 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.

TALF. Term Asset-Backed Securities Loan Facility. A program from the Federal Reserve of the United States intended to boost the issuance of asset-backed securities by authorizing the Federal Reserve Bank of New York to lend up to $1 trillion on a non-recourse basis to the holders of asset-backed securities in exchange for a security interest in those securities. The terms of TALF loans are intended to be economically helpful for TALF borrowers (which can include investment companies, hedge funds, and other investment funds) so as to encourage borrowers to make additional market purchases of asset-backed securities.

TARP. Troubled Asset Relief Program. Created in 2008 amidst the deterioration of the financial markets, TARP allowed the United States Treasury to purchase up to $700 billion of so-called "troubled" assets from institutions in the United States. Troubled assets include residential and commercial mortgages and any securities based on such assets, or any other financial instrument that the Treasury Secretary considers necessary to promote financial stability. From 2008 to 2009, the Treasury Department applied TARP monies to purchase a wide variety of financial and non-financial assets from banks, insurance companies, and other firms, taking these assets "off the books" of these firms in exchange for equity interests.

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).