MUTUAL FUND DIRECTORS FORUM

"THE FORUM FOR FUND INDEPENDENT DIRECTORS"

REPORT

of the

MUTUAL FUND DIRECTORS FORUM

BEST PRACTICES AND PRACTICAL GUIDANCE FOR MUTUAL FUND DIRECTORS

July, 2004

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I. BACKGROUND

The Mutual Fund Directors Forum ("Forum") is a nonprofit membership organization for directors of U.S. registered investment companies ("funds") who are free of any affiliation with, or interest in, their fund's investment adviser ("independent directors"). The Forum offers fund independent directors opportunities to discuss critical issues confronting fund investors, the funds and their directors. It seeks to promote vigilant, dedicated and well-informed independent directors and to serve as their voice regarding important policy matters.

The "best practices" described in this report were developed by the Forum at the request of William H. Donaldson, Chairman of the Securities and Exchange Commission ("SEC").[1] Noting that "statutory provisions and regulations can only go so far," Chairman Donaldson asked the Forum to provide practical guidance to fund independent directors in five areas in which director oversight and decision-making is critical for the protection of fund shareholders.[2]

- Board review of management contracts and management fees;
- Soft dollar, directed brokerage and revenue sharing arrangements;
- Valuation and pricing;
- Rule 12b-1 payrnents;[3]
- Conflicts of interest between funds and their managers.

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); Letter from David S. Ruder, Chairman, and Allan S. Mostoff, President, Mutual Fund Directors Forum, to William H. Donaldson, Chairman, U.S. Securities and Exchange Commission (November 21, 2003) *(See* Attachment A).

2 The term "director," as used in this report, includes a "trustee" of a mutual fund structured as a business or statutory trust. "Independent directors," as used in this report, are directors who are not "interested persons" of a fund (as defined in Section 2(a)(19) of the Investment Company Act of 1940, as amended ("1940 Act"), provided that the term may also include the expanded definition recommended in Section III, "Recommendations to Enhance the Independence of Fund Independent Directors." Although, the terms "fund" and "mutual fund" generally refer to an open-end investment company registered under the 1940 Act, as used by the Forum in this report they also apply to closed-end investment companies.

Because Rule 12b-l under the 1940 Act has since become the focus of potentially far-reaching regulatory changes, the Forum has deferred consideration of the issues raised by 12b-l payments to permit review and assessment of comments to the SEC's and its further actions in this area. *See Prohibition on the Use of Brokerage Commissions to Finance Distribution,* Investment Co. Act Rei. No. 26356 (Feb. 24, 2004). ("Brokerage Commission Release") *See also* notes 40 and 42, *infra.* The Forum anticipates formulating recommended best practices relating to Rule 12b-l payments later this year.

To assure that the recommended best practices reflect, to the extent feasible, the views of its independent director members, the Forum organized a member Steering Committee consisting solely of independent directors to guide the formulation of the best practices. The Steering Committee has approved this Report, although not all members of the Committee agree with all ofthe recommendations. These best practices represent a consensus view of the Forum's Steering Committee and also enjoy widespread support of the membership, although not all Forum members agree with every recommendation.

To prepare this Report, the Forum organized five separate Working Groups -- each to assist in addressing one of the areas identified by Chairman Donaldson. Each Working Group was composed of persons who are members of the Forum or the Forum's Advisory Board, was chaired by a member of the Forum's Board of Directors and was coordinated by a member of the Forum's Advisory Board. Drafts prepared by each Working Group were reviewed by the Steering Committee and the Forum's Board of Directors, and their comments were integrated into this consolidated document.[4]

In considering the recommended best practices, the Forum recognizes that the diversity among funds and fund families means it is not possible to develop a "one-size-fits-all" set of best practices that can be applied by independent directors to oversee policies, procedures and practices for all funds and fund families. Although Chairman Donaldson requested that the Forum develop guidance and best practices for independent directors, many of the best practices identified in this Report are also applicable to all fund directors. 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 things, to determine whether and to what extent a particular best practice is appropriate.

Each fund and fund family is unique and distinct, and fund directors will need to assess whether those policies, procedures and practices make sense under their own circumstances. 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. Rather, they are intended for use as future consideration and guidance. Although a number of funds already follow some of the recommended best practices, and many more can be expected to do so, the recommendations may not be appropriate for every fund or fund family, or even for each fund in a family in all instances. In addition, it is not realistic to expect all fund boards to consider and act on all of the recommendations at one time - for this reason they may be viewed as aspirational.

Finally, this Report is designed to inform and assist mutual fund directors and other interested parties with respect to their oversight of fund management in the areas discussed. It is not intended, nor should it be relied upon, as a substitute for appropriate

4 Members of the Steering Committee, the Working Groups and the Forum's Board of Directors participated in this effort in their individual capacities, and not as representatives of their organizations or the fund boards on which they serve or the funds themselves.

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.

II. THE UNIQUE ROLE OF INVESTMENT COMPANY INDEPENDENT DIRECTORS

Unlike a typical publicly held operating company, a mutual fund's business -the investment of its assets, its operations, and the servicing of its shareholders - is usually managed by a separate organization referred to in the 1940 Act as an "investment adviser." Similarly, the promotion and distribution of its shares is usually performed by a separate underwriter, most often affiliated with the fund's investment adviser. The adviser generally organizes and promotes the fund and assumes the associated entrepreneurial risk. This type of "externalized management" structure, typical in the fund industry, is rare in the corporate world. Recognizing the potential for abuse when investment management and other essential services are provided by one or more entities other than the officers and employees of the funds themselves, Congress specifically stated in the 1940 Act that "[t]he national public interest and the interest of investors are adversely affected…when investment companies are organized, operated [and] managed…in the interest. ..[of others], rather than in the interest of [their shareholders]."[5] The statute deals with this unique organizational structure by requiring that a fund have a significant proportion of "independent" directors and vests with them responsibility for monitoring carefully the relationship of their fund to its investment adviser and other service providers.[6]

The term "watchdog" has been used by Congress, the courts and regulators to describe the responsibilities of fund independent directors to provide an independent check on management. Thus, in addition to their general oversight responsibilities, fund independent directors are expected to monitor areas where conflicts exist between the interests of the fund and its shareholders, on the one hand, and the interests of its adviser and service providers, on the other hand. The 1940 Act specifically addresses these traditional conflicts by requiring fund boards to have minimum percentages of independent directors and by providing that they vote separately on key matters. More recently, as the investment management business has increasingly become part of full service financial businesses, the task of identifying and monitoring conflicts has become more complex and difficult.

To enhance the watchdog function of fund independent directors, the SEC in recent years has, among other things, acted to encourage an increase in the required

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5 1940 Act, § l(b)(2).

6 As used in this Report, "adviser" includes investment advisers that provide management services in addition to investment advice.

proportion of fund independent directors and also to increase disclosures designed to illuminate any conflicting interests of independent directors.[7]

The best practices recommended in this Report are designed to support the independence of independent directors and to address critical areas in which independent director oversight is particularly important. However, independent directors also should be alert to other situations that may involve actual or potential conflicts of interest between their fund and its shareholders and the fund's adviser, and they should monitor the impact of industry developments on these relationships.

Most mutual funds today are part of a mutual fund complex, a group or "family" of funds with different investment objectives managed by the same adviser. Funds in a complex tend to have the same "branding" and distribution, as well as the same operations and administrative support, and similar policies and procedures. They may be distinguished primarily by their investment objectives, investment strategies, and portfolio managers. Because of the significant overlap in issues and oversight, fund boards usually oversee a number of funds in a complex. Much of the activity of the directors relates to the core issues shared among the funds, although on specific matters, including investment performance and management fees, directors must focus on the individual fund. In assessing the Forum's recommendations, it useful to keep this structure in mind.

The 1940 Act specifically requires that at least 40% or more members of a fund's board be persons who are independent directors. In 2001, the SEC amended many of its rules for funds to require, among other things, that disinterested directors of funds that rely on those rules constitute a majority of their fund's board and that they determine annually that any counsel retained to represent them is an "independent legal counsel" as defined in Rule O-l(a)(6) under the 1940 Act. *Role of Independent Directors of Investment Companies*, Investment Co. Act Rel. No. 24816 (Jan. 2, 2001) ("Independent Directors Release"). The rules include: Rule 1Of-3 (purchase of securities during a primary offering where a fund affiliate is a member of the underwriting syndicate); Rule 12b-l (use of fund assets to pay distribution expenses); Rule 15a-4 (approval of interim advisory contracts without shareholder approval); Rule 17a-7 (securities transactions between a fund and certain of its affiliated persons); Rule 17a-8 (mergers of certain affiliated funds); Rule 17d-l(d)(7) (joint liability insurance policies with affiliates); Rule 17e-l (commissions funds pay to affiliated brokers); Rule 17g-l(j) (joint insured bonds); Rule 18f-3 (multiple classes of shares); and Rule 23c-3 (repurchase offers by closed-end funds allowing them to operate as interval funds). New rule amendments under the 1940 Act, adopted by the SEC on June 23, 2004, will require that a fund relying on these rules have a board of directors at least 75% of whose members are independent directors and that the board chair be an independent director. Registration statements and proxy statements must disclose independent directors' material interests and material transactions involving fund affiliates.

III. RECOMMENDATIONS TO ENHANCE THE INDEPENDENCE OF FUND INDEPENDENT DIRECTORS

Introduction

Each of the measures discussed below is designed to promote an "environment of independence," in which the independent directors may be best able to discharge their responsibility to ensure that the fund is operated at all times in the best interests of the shareholders and without undue influence from the fund's adviser and its affiliates.

RECOMMENDATIONS

1. A fund's board should adopt a statement of fundamental ethical principles to the effect that all actions taken on behalf of the fund must be in the best interests of its shareholders.

All directors of a fund, regardless of their relationship to the fund's adviser and entities affiliated with the adviser,[8] are fiduciaries under state law with respect to the interests of the fund's shareholders[9] and are expected always to consider their duties to shareholders first in any action they take. To emphasize their commitment to their fiduciary role, fund directors should adopt a statement of fundamental ethical principles to the effect that all actions taken on behalf of the fund must be in the best interests of shareholders. The principles could be set out in the fund's code of ethics contemplated by Rule 17j-l under the 1940 Act, in another written document that the directors determine is appropriate, or on the fund's website.

Directors of a fund who are, among other things, officers, employees or directors of a fund's adviser are deemed "interested persons" of the fund within the meaning of the 1940 Act. Directors of a fund not having such affiliations with the adviser are typically referred to as "disinterested" directors. The definition of interested person is set out in pertinent part in note 15 *infra.*

9 *See* Jean Gleason Stromberg, *Governance of Investment Companies*, in *Investment Company Regulation Deskbook* §§ 4.1-2 (AmyL. Goodman ed., 1997). *See, e.g.,* Section 36(a) of the 1940 Act, which authorizes the SEC to bring an action against a mutual fund director for breach of his or her fiduciary duty to the fund's shareholders. *See also* William H. Donaldson, *America's Need for Vigilant Mutual Fund Directors*, Remarks to the Mutual Fund Directors Forum (Jan. 7, 2004) ("The board of directors of a mutual fund has significant responsibility to protect investors. By law, directors are generally responsible for the oversight of all of the operations of a mutual fund.") ("Donaldson Remarks"); Paul F. Roye, *What Does It Take To Be An Effective Independent Director of a Mutual Fund?* Remarks at the ICI Workshop for New Fund Directors (Apr. 14, 2000) ("[I]t is impossible to overstate the importance of effective independent directors to the future health of the fund industry... [Y]ou are on the front line for investors. You are the principal guardians of investors' trust in the industry.").

2. The chairman of a fund's board of directors should be a person who is independent of the investment adviser and of entities affiliated with the adviser.

A fund's board can address potential conflicts of interest between the fund and its adviser, and between the fund and entities affiliated with the adviser, by limiting the adviser's control over the affairs of the fund. This goal can best be achieved if the fund's board is chaired by a person who is not affiliated with the fund's adviser or affiliates of the adv1ser.[10]

The Forum recognizes that the belief that a fund's chairman should be independent of the fund's adviser is not today accepted by some in the mutual fund industry.[11] Nonetheless, the Forum has concluded, on balance and in light of the importance of the role of a fund's board chairman in creating and steering the agenda of board meetings and in guiding discussions of the board on various matters,[12] that the goal of seeking to ensure that the interests of a fund's shareholders are protected from conflicts involving the fund's adviser can best be met when the fund's board is chaired by an independent director.

Although a fund's board chairman should be an independent director, the independent chairman's duties should not include supervision of the fund's day-to-day operations, which should remain with its adviser. The role of the independent chairman, by contrast, should be to assure that the independent directors control meeting agendas, the tone and tempo of board meetings, the topics discussed, the amount of time spent on each topic and the order in which topics are addressed. To enhance the participation and effectiveness of the independent directors, the independent chairman should endeavor to ensure, both directly and through regular communication with the fund's external service providers, that the fund's independent directors are kept informed of developments between meetings on a regular basis, as well as, of course, any significant events.

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10 Recognizing the importance of an independent chair, the rule amendments adopted by the SEC on June 23, 2004 also will require most funds to designate an independent director chair, *supra* note 7.

" *See* William H. Donaldson, Statement at SEC Open Meeting (Jan. 14, 2004). *("Opening Meeting Statement").* ("[The proposals, including the independent chairperson of a fund board proposal,] that are before the Commission today are not without controversy.").

12 *See Investment Company Governance,* Investment Co. Act Rei. No. 26323 (Jan. 15, 2004) ("Governance Proposing Release") ("The chairman of a fund board can largely control the board's agenda, which may include matters not welcomed by the adviser. ... [T]he chairman of the board can have a substantial influence on the fund's boardroom culture. The boardroom culture can foster (or suppress) the type of meaningful dialogue between fund management and independent directors that is critical for healthy fund governance.") More recently, Paul F. Roye, the Director of the SEC's Division of Investment Management, observed in his opening statement to the Commission on June 23, 2004, "...[a] fund board with an independent chairman and independent leadership is more likely to ask the tough questions, more likely to say "no" when necessary, and more likely to be an effective check on fund management....".

3. At least 75 percent of a fund's directors should be persons who are independent of the investment adviser and of entities affiliated with the adviser.

Setting a tone and environment of independence for a fund's board can be greatly facilitated not only by having an independent chairman, but also by having at least 75 percent of the fund's board be similarly independentY This standard of independence should strengthen control over the full board's voting or approval process by those directors not affiliated with the adviser on all matters generally and in particular on those matters in which the adviser's interest may conflict with those of the fund's shareholders.[14]

The Forum's conclusion that at least 75 percent of a fund's board be independent directors should not be interpreted as indicating that the Forum does not appreciate the importance of the contribution of directors who are affiliated with the fund's adviser. "Inside" directors can lend significant input and experience to the consideration by a fund's board of a host of matters ranging, by way of example, from fund operations to industry trends. Further, their service on the board can enhance the adviser's awareness of its fiduciary duty to the fund and its shareholders.

4. The definition of "independent of the investment adviser" should be broader than the definition of "interested person" in the Investment Company Act, adding a requirement that such "independent director" should not have been affiliated with the fund's adviser or its affiliates for at least 5 years.

The Forum concluded that the definition of "independent," as used in connection with the best practices of having an independent chair and a board at least 75 percent of whose members are independent of the investment adviser, should be broader than the concept of "disinterested" as contemplated in the 1940 Act and as used throughout the fund industry. In particular, an "independent" director of a fund should be defined as a person (1) who is not an "interested person"[15] and (2) who has not been for a period of

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13 *Opening Meeting Statement, supra* note 11. ("Management-dominated boards may be less likely to effectively undertake the many important responsibilities assigned to them"........A board of directors whose independent directors constitute at least seventy-five percent of the board may help strengthen the board of independent directors when dealing with fund management. ...") In this connection, in 1999 the Investment Company Institute ("ICI") recommended that independent directors constitute at least two-thirds of the directors of fund boards. As the ICI stated:

> This will help assure that independent directors control the voting process, particularly on matters involving potential conflicts of interest with the fund's investment adviser and other services providers. Investment Company Institute, *Enhancing A Culture of Independence and Effectiveness,* p. 10, June 24, 1999.

14 This requirement also was included in the rule amendments adopted by the SEC on June 23, 2004, *supra* note 7.

15 Section 2(a)(19)(A) of the 1940 Act defines an "interested person" of a fund in pertinent part as: (i) any affiliated person of the fund; (ii) any member of the immediate family of any natural person who is an affiliated person of the fund; (iii) any interested person of any investment adviser

five years (a) an "affiliated person"[16] of the fund's investment adviser; or (b) an affiliated person of an affiliated person of the fund's investment adviser. The principal difference between the Forum's definition of independent director and the concept of a disinterested director in the 1940 Act is that the Forum recommends a five year "cooling off' period for a person once affiliated with a fund's adviser. [17] The Forum has concluded that five years is an appropriate time to pass before a former affiliated person should be deemed no longer potentially influenced by his or her relationship to the adviser.

5. A fund's independent directors should retain knowledgeable independent legal counsel to advise them on an ongoing basis and should have express authority to employ staff, other independent consultants and advisors to assist them in carrying out their fiduciary duties to the fund's shareholders.

The mutual fund industry is one of the most heavily regulated industries in the United States. The far-reaching regulatory scheme applicable to funds is subject to

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of or principal underwriter for the fund; (iv) any person or partner or employee of any person who at any time since the beginning of the fund's last two completed fiscal years has acted as its legal counsel; (v) any person or any affiliated person of a person (other than a registered investment company) that, at any time during the six month period preceding the date of the determination of whether that person or affiliated person is an interested person, has executed any portfolio transactions for, engaged in any principal transactions with, or distributed shares for the fund, any other fund having the same investment adviser as the fund or holding itself out to investors as a related fund for purposes of investment or investor services, or any account over which the fund's investment adviser has brokerage placement discretion, any person or any affiliated person of a person (other than a registered investment company) that, at any time during the six month period preceding the date of the determination of whether that person or affiliated person is an interested person, has loaned money or other property to (I) the fund; (II) any other fund having the same investment adviser as such fund or holding itself out to investors as a related company for purposes of investment or investor services; {III) any account for which the fund's investment adviser has borrowing authority, or any natural person whom the Commission by order shall have determined to be an interested person by reason of having had, at any time since the beginning of the last two completed fiscal years of the fund, a material business or professional relationship with it or with its principal executive officer, or with any other fund having the same investment adviser or principal underwriter, or with the principal executive officer of such other fund.

16 Section 2(a)(3) of the 1940 Act defines an "affiliated person" of another person as:

> (A) any person directly or indirectly owning, controlling, or holding with power to vote, 5 per centum or more of the outstanding voting securities of such other person; (B) any person 5 per centum or more of whose outstanding voting securities are directly or indirectly owned, controlled, or held with power to vote, by such other person; (C) any person directly or indirectly controlling, controlled by, or under common control with, such other person; (D) any officer, director, partner, copartner, or employee of such other person; (E) if such other person is an investment company, any investment adviser thereof or any member of an advisory board thereof; and (F) if such other person is an unincorporated investment company not having a board of directors, the depositor thereof.

17 In settling recent enforcement cases, the SEC has imposed a ten-year period. *See, e.g., In the Matter of Putnam Investment Mgmt., LLC,* Investment Co. Act Rei. No. 26255 (Nov. 13, 2003).

continual changes and reinterpretation. Recognizing the importance of experienced lawyers in interpreting the scope of this regulation, the Forum recommends that the independent directors of a fund retain separate legal counsel to advise them on an ongoing basis.[18]

To the extent the independent directors retain counsel, that counsel should be "an independent legal counsel" as defined in Rule 0-1(a)(6)(i) under the 1940 Act.[19] Independent legal counsel with demonstrated expertise and experience in the investment management area, can, among other things, provide directors with relevant business and legal information and materials, address issues identified by the directors with respect to their fund's investment and administrative operations, and render ongoing assistance to the independent directors in carrying out their fiduciary duties to the fund's shareholders.[20]

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18 Courts have long considered independent counsel as providing valuable assistance to mutual fund directors. *E.g.. Schuyt v. T. Rowe Price Prime Reserved Fund*, 663 F. Supp. 962, 965 (S.D.N.Y. 1987), *aff'd*, 835 F.2d 45 (2d Cir. 1987), *cert. denied*, 485 U.S. 1034 (1988) ("Schuyt") ("during all relevant times, the independent directors of Prime Reserve Fund had their own counsel. . . . [Counsel] spoke weekly or biweekly with the outside directors. In addition, he furnished the directors with detailed written and oral advice regarding their duties, including their responsibilities in evaluating the Agreements between the Adviser and the Fund. [Counsel] apprised them, on a continuing basis, of pertinent legal developments relating to mutual funds, including their responsibilities under section 36(b) of the [1940 Act]").

19 Rule 0-1(a)(6)(i) under the 1940 Act provides in pertinent part:

> A person is an independent legal counsel with respect to the independent directors if: a majority of the independent directors reasonably determine in the exercise of their judgment (and record the basis for that determination in the minutes of their meeting) that any representation by the person of the company's investment adviser, principal underwriter, administrator ("management organizations"), or any of their control persons, since the beginning of the fund's last two completed fiscal years, is or was sufficiently limited that it is unlikely to adversely affect the professional judgment of the person in providing legal representation to the independent directors; and the independent directors have obtained an undertaking from such person to provide them with information necessary to make their determination and to update promptly that information when the person begins to represent, or materially increases his representation of, a management organization or control person. The independent directors are entitled to rely on the information obtained from the person, unless they know or have reason to believe that the information is materially false or incomplete. The independent directors must re-evaluate their determination no less frequently than annually (and record the basis accordingly), except as provided in this Rule.

20 *See* Paul F. Roye, *Enhancing the Fund Director's Tool Box,* Remarks to the Mutual Fund Directors Forum (Jan. 8, 2004) ("Independent legal counsel can assist directors in drilling down though the mounds of paper and other information [a director] receive[s] before each board meeting to reach the core issues that require particular director attention and evaluation."). *See also* "Independent Directors Release" *supra* note 7 ("Given the vital role of independent directors in the resolution of conflicts between the fund and its investment adviser, it is important that they have access to counsel who is free from conflicting loyalties.")

Should the independent directors of a fund determine - because of cost imperatives - not to use the services of independent legal counsel,[21] the Forum recommends that if a specific conflict arises and is reported to the board, the board reconsider whether to retain independent legal counsel. In any event, the Forum recommends that a decision not to retain independent counsel be reviewed annually.

Although directors already have authority under applicable state law to retain experts as deemed advisable, the Forum also suggests that a fund's board make this authority explicit for the independent directors. Independent directors should consider from time to time the advisability of hiring and consulting with other experts in connection with carrying out their fiduciary duties to the fund's shareholders.[22] The costs of any expert assistance should generally be borne by the fund so that the reporting lines ofthe expert are clear. The Forum recognizes that, in some cases, as discussed above in the case of independent legal counsel, the costs of retaining experts may outweigh the anticipated benefits.

6. A **fund's independent directors should be solely responsible for determining the level of their compensation.**

In order to avoid undue adviser influence, the Forum recommends that a fund's independent directors have sole responsibility, either acting as a group or as a committee, for determining their compensation. "Compensation" for these purposes, should include any benefits a fund director receives for serving in that position, including cash, fund shares, deferred compensation and retirement plans.

When determining the appropriate level of compensation, the independent directors should seek to ensure that the directors are compensated on the basis of the duties they perform, considering other pertinent factors, such as the nature of the fund and fund complex. In principle, a director's compensation should be commensurate with, among other things: (1) the nature and extent of committee assignments and other specific roles undertaken by the director in fulfilling his or her duties and responsibilities to the fund and its shareholders; (2) the complexity of the fund's and fund complex's operations; and (3) the fund's investment strategies, policies and objectives.

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21 As noted *supra,* page 2, in the case of all recommended best practices the Forum recognizes that the independent directors might conclude, in a particular situation or after a cost benefit analysis or at a particular time, to do otherwise.

22 *See* Governance Proposing Release, *supra* note 12. ("Use of staff and experts [by independent mutual fund directors] may be important to help independent directors deal with matters that are beyond the level of their expertise, or help give them an understanding of better practices among mutual funds.").

IV. RECOMMENDATIONS FOR OVERSIGHT OF SOFT DOLLAR, DIRECTED BROKERAGE AND REVENUE SHARING ARRANGEMENTS[23]

Introduction

In this section, the Forum recommends a number of best practices for fund boards respecting transactions in portfolio securities.[24] These practices are intended to apply primarily to funds that invest in equity securities and are most pertinent to secondary market transactions involving equity securities in a legal environment in which commission rates are not fixed. Although the recommendations and the discussion also may be relevant to debt securities and, to some degree, principal transactions, these areas were not a focus of the Forum. The Forum also recognizes that funds vary in their circumstances, and that some funds, such as "multi-manager" funds with sub-advisers not affiliated with their primary advisers, will face greater complexity than others in implementing the recommended best practices.

In its recommendations respecting transactions in portfolio secunt1es for investment companies, the Forum was guided by the following fundamental principles:

Brokerage Commissions are an Asset of the Fund.

> When a fund's adviser decides that the fund should buy or sell a portfolio security, the adviser places a trade for the transaction with a broker-dealer, and the fund pays that broker-dealer a commission for effecting the transaction. The brokerage commission paid by the fund is an asset of the fund and should be used in a fashion that is in the interests of the fund and its shareholders.[25] Fund directors should endeavor to assure that this result prevails.[26]

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23 In his November 17, 2003 letter, Chairman Donaldson identified soft dollar, directed brokerage and revenue sharing arrangements. In this Report, the Forum makes recommendations with respect to these practices 'and the related subjects of best execution and transactions with affiliates which are also important for independent directors.

24 The recommended best practices respecting transactions in portfolio securities apply to both open and closed-end funds that invest in equity securities, while the recommended best practice respecting revenue sharing arrangements presumably would not apply to closed-end funds other than those that offer their shares continuously.

25 *See* Testimony of William H. Donaldson, Before the Senate Committee on Banking, Housing and Urban Affairs (Nov. 18, 2003) ("Clearly, fund assets, including use of a fund's brokerage commissions, must be used in a manner that benefits fund investors."); see also Office of Compliance Inspections and Examinations, Inspection Report on the Soft Dollar Practices of Broker-Dealers, Investment Advisers and Mutual Funds (Sept. 22, 1998) ("SEC Soft Dollar Report") ("Under traditional fiduciary principles, a fiduciary cannot use assets entrusted by clients to benefit itself.")

26 The SEC has stated that portfolio transaction costs are a significant issue for consideration by fund directors. It noted that advisers are subject to a number of conflicts in allocating portfolio transactions, and that fund directors play a pivotal role in monitoring these conflicts. *Request for*

Best Execution Should Govern.

Best execution should govern the allocation of trades m portfolio securities to broker-dealers.[27]

Transparency is an Important Objective.

Clear identification of costs and benefits, or transparency of fund transactions, is basic to understanding the economics of transactions between funds and broker-dealers. If an adviser allocates a fund's trade to a broker-dealer, and the fund pays a commission to the broker-dealer solely for execution of the trade, the cost of that trade is readily identifiable. If, on the other hand, the adviser also receives a research service from that broker-dealer, it is more difficult to identify the cost to the fund for execution of the trade, as opposed to the research service. It is also more difficult to identify the adviser's overall costs for research inasmuch as the adviser receives at least some research at no apparent cost.

Transparency better enables fund boards and, in appropriate circumstances, shareholders, to evaluate and assess costs of securities transactions and their impact on fund performance.[28] Transparency can facilitate comparisons of the costs of securities trades,[29] analysis of a fund's operating expenses, and analysis of an investment adviser's revenues and expenses in managing a fund.

Comments on Measures to Improve Disclosure of Mutual Fund Transaction Costs, Investment Co. Act Rei. No. 26313 (Dec. 18, 2003) ("Concept Release").

27 This is discussed in greater detail below and in Recommendations 7 and 8 of this Report.

28 As the United Kingdom's Financial Services Authority ("FSA") stated: "A system in which costs are opaque and accountability to fund management customers is deficient gives little comfort that the underlying conflicts of interest are being controlled effectively, or that dealing arrangements result in good value for money for investors." Financial Services Authority, *Bundled Brokerage and Soft Commission Arrangements,* Consultation Paper 176, §1.5 (Apr. 2003) ("FSA Consultation Paper"). After seeking comment on proposals to unbundle brokerage commissions, the FSA recently reported that: "[d]espite the wide divergence in opinion, there was a consensus that present practice does not operate in the best interests of fund manager's clients and that transparency and accountability could and should be improved." *Financial Services Authority, Bundled Brokerage and Soft Commission Arrangements- Feedback on CP176,* Policy Statement (May 2004) ("FSA Policy Statement"). Significantly, some U.S. fund managers also are calling for greater transparency in brokerage commissions. *See* Comments of David Jones, Senior Vice President and Product Strategy & Communications, and Eric D. Roiter, Senior Vice President and General Counsel, of Fidelity Management & Research Company, on SEC File No. S7-29-03, Mar. 2, 2004, commenting on the SEC's concept release on *Measures to Improve Disclosure of Mutual Fund Transaction Costs,* (Dec. 19, 2003), ("Fidelity Comment Letter") ("New disclosure rules are needed to promote 'unbundled' disclosure of these bundled commissions... We encourage the Commission to consider the use of its rulemaking powers to foster comparability in the disclosure of soft dollar research by adopting recordkeeping rules requiring brokers to account separately for their expenses in preparing internal research.").

29 *See* Concept Release, *supra* note 26.

RECOMMENDATIONS

Best Execution

7. A fund's board should require the fund's adviser to develop written policies on execution of portfolio transactions, which should be designed to help ensure that the adviser seeks best execution on all brokerage transactions.

It is generally recognized that an investment adviser owes a fiduciary duty to its client to obtain best execution of the client's portfolio transactions.[30] Although "best execution" is not easily defined, the Forum considers best execution as the execution of a securities transaction in such a manner that the total cost or proceeds in the transaction are the most favorable to the fund under the circumstances.[31] The ability to trade at a favorable price is normally the most important aspect of best execution, but other factors also may be important, including execution speed, confidentiality, market depth, capital commitment, recent order flow, and knowledge of the other side of a trade.[32] Commissions paid to a broker-dealer can be an important factor to the extent that a lower commission contributes to the benefit of the overall execution.

The Forum recommends that directors instruct their fund's adviser that research received by it not be considered as a factor in best execution.[33] In other words, research received by an adviser should not influence the selection of a broker-dealer for allocation of trades. The focus should be solely on the quality of the execution and the total transaction cost or proceeds to the fund, and research received by the adviser can obscure the analysis.

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30 *See, e.g., Disclosure by Investment Advisers Regarding Soft Dollar Practices* Investment Advisers Act Release No. 1469 (Feb. 14, 1995); SEC Soft Dollar Report, *supra* note 25.

31 This definition is borrowed from the SEC. *See Interpretive Release Concerning Scope of Section 28(e) of the Securities Exchange Act of 1934,* Exchange Act Rel. No. 23170 (Apr. 23, 1986); *In the Matter of Kidder Peabody & Co., Inc.,* Investment Advisers Act Rel. No. 232 (October 16, 1968).

32 This is not intended to be a complete list. *See* Lori A. Richards, *Valuation, Trading, and Disclosure: Three Compliance Imperatives,* Remarks at the ICI's 2001 Mutual Fund Conference (June 14, 2001). In obtaining best execution, the SEC recently stated that other factors may be relevant, such as (1) the size of the order, (2) the trading characteristics of the security involved, (3) the availability of accurate information affecting choices as to the most favorable market center for execution and the availability of technological aids to process such information, and (4) the cost and difficulty associated with achieving an execution in a particular market center. *See Regulation NMS,* Exchange Act Rel. No. 49325 (Feb. 26, 2004); *see also* Gene A. Gohlke, Remarks at the ICI's 2000 Securities Law Developments Conference (Dec. 4-5, 2000).

33 *See* Recommendation 11 recommending that soft dollar arrangements for research be prohibited.

8. A fund's board should request and review regular reports from the fund's adviser on execution of portfolio transactions.

To help promote best execution, the Forum recommends that directors request and review regular reports from the fund's adviser on execution of portfolio transactions. Reports should include information on the quality of execution.[34] The Forum acknowledges that it is difficult to measure the quality of execution, but many fund advisers have devised quantitative methods to attempt to assess the quality of execution.[35] Moreover, several commercial services have developed quantitative tools to assess the quality of execution.[36] Independent directors should seek the assistance of the fund's adviser or other experts to explore measurements of execution. Because execution can be measured in different ways and at different costs, a board should assess which type of measurement it finds meaningful and reasonable. Directors should review reports that use these analytical tools and ask their fund's adviser to use these tools in making allocation decisions on trades in portfolio securities.

As part of their review of portfolio transaction execution, directors should consider the impact of commission rates on the ability to obtain best execution. With respect to commission rates, the Forum recommends that directors: (1) request reports summarizing commissions per share paid to broker-dealers, (2) seek explanations for commissions that exceed the usual and customary commission paid in a particular securities market, and (3) encourage their fund's adviser to explore alternative execution channels through which brokerage can, where appropriate, be effected at commission rates below the usual and customary rates. Such alternative execution channels could include program trades, direct access to exchange floors, use of systems such as the New York Stock Exchange "SuperDot" system, and electronic communications networks, or ECNs, all with a view to ascertaining whether best execution can be achieved through other channels.

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34 As Paul F. Roye observed, "Fund directors have a duty to inquire about the execution process. Fund managers need to drive hard bargains with their brokers. There is no substitute for asking hard questions about order routing arrangements, to ensure investors reap the full benefits of the dynamic competition unfolding in our markets. Brokerage is an asset of the fund and its shareholders." *The Challenge of Making Best Practice, Common Practice,* Remarks at the ICI's 2000 Securities Law Developments Conference, December 4, 2004.

35 *See* John A. Hill, Remarks at The Conference on the Role of Independent Investment Company Directors, U.S. Securities and Exchange Commission, Washington, D.C. (Feb. 23, 1999) (noting that a committee of the board of directors of a fund group examines brokerage and holds regular meetings to review data regarding best execution and best net price). Mr. Hill is an Independent Director and Chairman of the Board of the Putnam Group of Funds.

36 One such service measures total trading costs by adding: (i) hard dollar commissions paid; and (ii) an "execution cost," which is determined by comparing execution price to volume weighted average price of the security on the trade date and adding (or subtracting) the difference. Total costs are then compared to a variety of market indicators and other participants in the firm's database. Another service measures average gain/loss and estimates equity trading costs on pending transactions and suggests the appropriate level of trade costs based upon historical experience on comparable trades.

The SEC has recently adopted rules that require fund advisers and fund boards to adopt and implement written policies and procedures reasonably designed to prevent violation of pertinent securities laws.[37] These procedures must address, to the extent relevant, trading practices, including procedures by which an adviser satisfies its best execution obligation.[38] The Forum recommends that the means by which a fund's adviser will seek and monitor best execution, including the use of analytical tools to measure execution, and the provision of reports to the board recommended above, be reflected in these written policies and procedures.

Directed Brokerage

9. A fund's board should not permit the fund's adviser to consider a broker-dealer's sale of the fund's shares or shares of other funds in the complex as a factor in allocating trades to broker-dealers.

Consideration by an investment adviser of the sale of a fund's shares as a factor in selecting broker-dealers to execute transactions in portfolio securities for the fund is sometimes referred to as "directed brokerage."[39] This practice, referred to in this Report as "conventional directed brokerage,"[40] presents a conflict of interest between a fund and

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[37] *See* Rule 206(4)-7 of the Investment Advisers Act of 1940, as amended, and Rule 38a-l under the 1940 Act. *Compliance Programs of Investment Companies and Investment Advisers,* Investment Advisers Act Rel. No. 2204 (Dec. 17, 2003) (effective Feb. 5, 2004 for advisers and Oct. 5, 2004 for funds) ("Compliance Programs").

[38] Id.

[39] NASD Conduct Rule 2830(k)(7)(B) permits a broker-dealer to sell mutual fund shares to customers where the fund has a policy of considering past sales of fund shares in selecting broker-dealers to execute portfolio transactions, subject to the requirements of best execution. However, NASD Conduct Rule 2830(k) prohibits NASD members from favoring the sale of mutual fund shares based on the receipt of brokerage commissions. An arrangement may violate Rule 2830(k) when a broker-dealer accepts trades from an investment company under an arrangement in which it provides a credit against hard dollar payment obligations by the investment company distributor. *See NASD Charges Morgan Stanley with Giving Preferential Treatment to Certain Mutual Funds in Exchange for Brokerage Commission Payments,* NASD Disciplinary Action (Nov. 17, 2003). *See also In the Matter of Morgan Stanley DW Inc.,* Securities Act Rel. No. 8339 (Nov. 17, 2003); *In the Matter of Massachusetts Financial Services Co.,* Investment Advisers Act Rel. No. 2224 (Mar. 31, 2004).

[40] In February 2004, the SEC proposed to amend Rule 12b-l under the Investment Company Act to prohibit a fund from compensating a broker-dealer for promoting or selling fund shares by directing fund portfolio brokerage business to that broker-dealer. *See* Brokerage Commission Release, No. *supra* note 3. On February 10, the NASD submitted a proposed rule change to the SEC to amend NASD Conduct Rule 2830(k) to prohibit NASD member firms from selling the shares of funds that consider the sale of shares in allocating fund brokerage. Letter from Barbara Z. Sweeney, Senior Vice President and Corporate Secretary, NASD, to Katherine A. England, Assistant Director, Division of Market Regulation, U.S. Securities and Exchange Commission (Feb. 10, 2004) (submitting *Proposed Amendments to Rule Relating to Execution of Investment Company Portfolio Transactions,* File No. SR-NASD-2004-027).

its management because it could encourage allocation of a transaction to a broker-dealer for a reason other than best execution for the fund.[41]

Because the sole criterion in placing securities transactions for a fund should be best execution, the Forum recommends that a fund's board should require that the sale of shares of the fund or other funds in the same complex not be a factor in allocating trades to broker-dealers.[42]

10. A fund's board should request and review reports on the quality of the execution a fund receives on transactions in its portfolio securities that are placed with broker-dealers in arrangements involving expense reducing directed brokerage.

The term "directed brokerage" is sometimes also used to refer to the practice of directing transactions in a fund's portfolio securities to broker-dealers who pay a rebate to the fund or use a portion of the commissions received in a trade to pay some of the fund's operating expenses. This practice is referred to in this Report as "expense reducing directed brokerage."

Expense reducing directed brokerage can be beneficial to a fund because it can lower the cost of a transaction in a portfolio security or can lower the fund's operating expenses. Such brokerage arrangements do not give rise to an apparent conflict of interest between the fund and its management. Where these arrangements reduce operating expenses, they do not impede transparency of the fund's actual expenses, because SEC rules require that a fund's expenses be "grossed up" in its statement of operations to reflect actual expenses prior to the reduction.[43]

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41 Sales of a fund's shares could result in increased fund assets and therefore greater investment advisory or other fees. The Forum does not intend to imply that (i) distribution of a fund's shares may not be in the best interests of a fund and its shareholders, or (ii) a broker-dealer that sells shares of a fund should not be eligible for allocation of trades.

42 This measure could be instituted by limiting the ability of the fund distributor's personnel to communicate with the personnel who staff an adviser's trading desk. *See Global Research Analyst Settlement*, SEC Litigation Rei. No. 18438 (Oct. 31, 2003) (in connection with a recent regulatory action, investment firms reformed their organizational structure and formed barriers between their analysts and distribution channels). The SEC has proposed an amendment to Rule 12b-l under the 1940 Act that would prohibit funds from paying for the distribution of their shares with brokerage commissions. The proposed rule would also prohibit "step-outs" (described as an arrangement in which the adviser selects another broker to execute the transaction and requires the executing broker to "step out" a portion of its commission to pay the other broker) and similar arrangements designed to compensate selling brokers for selling fund shares, such as the use of arrangements in which a portion of a fund's brokerage commissions are "rebated" to an account maintained for the fund and later paid to a selling broker. *See* Brokerage Commission Release, *supra* note 3. In addition, the Investment Company Institute has called on the SEC to change its rules to ban directed brokerage. *See* Letter from Matthew P. Fink, President, ICI, to William H. Donaldson, Chairman, U.S. Securities and Exchange Commission (Dec. 16, 2003) and ICI Press Release, ICI-03-143 (Dec. 15, 2003) ("ICI Proposals").

43 *See* Rule 6-07(g) of Regulation S-X.

One issue, however, is whether, apart from the benefit of the expense reduction, the fund also receives best execution on such trades. Fund boards should review the quality of the execution a fund receives on transactions in its portfolio securities that are placed with broker-dealers in these arrangements. The directors should compare the quality of the execution on these trades to the quality on other trades, with a view to assuring that the fund is receiving best execution. The commercial service providers referred to in note 36, *supra,* may be of assistance to directors in this analysis.

Soft Dollars

11. Independent directors should not permit the fund's adviser to participate in soft dollar arrangements in trades for the fund.

For purposes of this recommendation, "soft dollars" means arrangements under which, in addition to execution of securities transactions, proprietary or third party research services or products are obtained by an adviser from or through a broker-dealer in exchange for the direction by the adviser of client brokerage transactions to the broker-dealer.44 These research services or products are often used by the adviser in both servicing the client whose trade generated research and in servicing other clients. An adviser may receive a broad variety of research services and products in soft dollar arrangements.[45] According to one recent estimate, the soft dollar market for investment research and related services exceeds **$1** billion.[46]

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44 This definition is borrowed from the SEC. *See SEC Soft Dollar Report, supra* note 25. Section 28(e) of the Securities Exchange Act of 1934, as amended ("Exchange Act") generally provides that an adviser exercising investment discretion with respect to an account shall not be deemed to have acted unlawfully, or to have breached a fiduciary duty, solely by reason of the adviser having caused the account to pay a broker-dealer an amount of commission for effecting a securities transaction in excess of the commission another broker-dealer would have charged for effecting that transaction, if the adviser determined in good faith that the amount of commission was reasonable in relation to the value of the brokerage and research services provided by the broker-dealer.

45 After an inspection sweep of soft dollar practices by the SEC staff, the staff published a report that indicated that services/products obtained by advisers included research reports, such as general company and general economic reports, news services, pricing services, portfolio management data, and computer related products, among other things. *See SEC Soft Dollar Report, supra* note 25. The following are included in a lengthy list of items that have been identified by various authorities as "research" that comes within the safe harbor of Section 28(e): performance measurement services; stock price quotation services; computerized historical financial databases and equipment to retrieve such data; credit rating services; brokerage analysts earnings estimates; computerized links to current market data; hardware and software dedicated to research; and portfolio modeling. Thomas P. Lemke and Gerald T. Lins, *Soft Dollars and Other Brokerage Arrangements,* §3.03[B][2][a] (Glasser Legal Works, ed. 2004).

46 Testimony of Paul F. Roye, Before the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, House Committee on Financial Services Concerning the Mutual Funds Integrity and Fee Transparency Act of 2003, H.R. 2420 (June 18, 2003) (citing, *Bear Stearns, Brokers and Asset Managers* (June 2003)). *See also* SEC Soft Dollar Report, *supra* note 25.

When an adviser receives a benefit in the form of a research service or product from a transaction for the fund, the arrangement gives rise to a potential conflict of interest between the adviser and the fund. Soft dollar arrangements raise the following questions:

- Whether a transaction has been allocated to a broker-dealer on the basis of the research provided to the adviser rather than the quality of the execution provided to the fund;
- Whether a lower commission could have been paid for a transaction or whether a fund could have recaptured a portion of the brokerage commissions if the adviser had not received research;
- Whether other funds in the complex or other clients of the adviser are benefiting from the research an adviser receives in connection with a trade for a fund;
- Whether the value of the research provided by a broker-dealer 1s reasonable in relation to the commissions paid;
- Whether the need for research has motivated the adviser to place trades that it might not otherwise place; and
- Whether the adviser should reimburse the fund for the value of the research.

Soft dollar arrangements benefit a fund's adviser because it is spared the expense of purchasing or obtaining on its own the research provided by the broker-dealer.[47] The effect of this savings to an adviser may not be transparent to the fund's independent directors when they examine an adviser's income and expenses in connection with their annual review of the fund's investment advisory contract.[48] Further, it may be very

[47] The SEC staff has stated: "Research and other services purchased by the adviser with the fund's brokerage bear upon the reasonableness of the advisory fee because the research and other services would otherwise have to be created by the adviser itself or be purchased with its own money." SEC Soft Dollar Report, *supra* note 25. In this connection, it is of interest that the securities authorities in the United Kingdom have stated that commission arrangements in which the adviser receives a research benefit create powerful incentives that have a strong influence on fund managers' trading decisions, and that control over these incentives exerted by normal market disciplines is weak and uneven. FSA Consultation Paper, *supra* note 28, at§ 1.5. *See also* FSA Policy Statement, *supra* note 28, at§ 2.27 ("We conclude that the size of the market is significant, in that a significant amount of commission payments made from clients' funds return opaquely to the manager in the form of bundled and softed goods and services. The magnitude of these figures supports our view that fund managers may be unduly influenced by the availability of bundled and softed goods and services, to the detriment ofbest execution.")

[48] Under Section 15(c) of the 1940 Act, it is the duty of fund directors to request and evaluate, and the duty of the investment adviser to furnish, such information as may reasonably be necessary to evaluate the terms of an investment advisory contract. *(See* Part V, *infra,* Recommendations for

difficult to quantify the benefit an adviser obtains from a soft dollar arrangement and to confirm that best execution is the sole criterion in allocating brokerage transactions.[49]

Accordingly, the Forum recommends that a fund board, under the leadership of its independent directors, not permit the fund's adviser to participate in soft dollar arrangements in trades for the fund. Ideally, this prohibition regarding soft dollar arrangements should extend to both formal and informal soft dollar arrangements and to both proprietary research and third-party research.[50]

In reaching this conclusion, the Forum is aware of the prevalence of soft dollar practices and that implementation of this recommended best practice would likely have an economic effect on fund advisers and on trading practices.[51] Fund advisers may have

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Management Agreements and Management Fees.) In evaluating the terms of an investment advisory agreement, boards should consider the factors set forth in *Gartenberg v. Merrill Lynch Asset Mgmt., Inc.,* 694 F.2d 923, 928 (2d Cir. 1982). The SEC Soft Dollar Report noted in 1998 that the boards of most funds examined by the SEC staffhad not received sufficient information to permit the directors to evaluate the adviser's benefits from soft dollar arrangements. SEC Soft Dollar Report, *supra* note 25, at 46. *See also* Testimony of William F. Galvin, Secretary of the Commonwealth of Massachusetts, Before the Subcommittee on Financial Management, the Budget and International Security, Senate Governmental Affairs Committee (Nov. 3, 2003) (commenting that soft dollar costs are often hidden from consumers and should be banned as shareholders do not benefit from the practice).

49 *But see* Letter from The Alliance in Support of Independent Research, to William H. Donaldson, Chairman, U.S. Securities and Exchange Commission (Jan. 27, 2004) (stating that "virtually all broker-dealers providing third party research services in the U.S. indicate on their customers' statements the dollar value of research provided to the customer, the aggregate commissions used to pay for the research, and an identification of the research. This method of accountability has made the independent research dissemination process precise and transparent....").

50 At least one investment adviser has called for the adoption of a uniform methodology to value proprietary research. *See* Fidelity Comment Letter, *supra* note 28, at 3 ("We encourage the Commission to consider the use of its rulemaking powers to foster comparability in the disclosure of soft dollar research expenses by adopting recordkeeping rules requiring brokers to account separately for their expenses in preparing internal research.")

51 Various arguments have been advanced that support soft dollar arrangements, including: (1) that soft dollar arrangements encourage more and better research, and better research can improve investment performance; and (2) that it ultimately is cheaper for fund shareholders if a fund's brokerage allocation is used to help obtain research. *See* Lemke & Lins, *supra* note 45, §1.06[A] (better management of client accounts, unbiased research, competition among broker-dealers, and competition among money managers, among others, are arguments supporting the use of commission dollars to obtain research and brokerage services.) Indeed, both Congress and the SEC have, at times, expressed support for the benefits of soft dollar research. SEC Statement on the Future Structure of the Securities Markets, 37 Fed. Reg. 5286, 5290 (Feb. 4, 1972); *SEC Report on Public Policy Implications of Investment Company Growth,* H.R. Rep. No. 2337, 89th Cong. 2d Sess. 175 (1966) ("In our view, the providing of investment research is a fundamental element of the brokerage function for which the bona fide expenditure of the beneficiary's funds is completely appropriate..."). *See also* FSA Consultation Paper, *supra* note 28, at§§ 3.29 and 3.31 (other arguable benefits include ease of market entry by smaller fund managers and brokers, increasing competition and choice); FSA Policy Statement, *supra* note 28, at § 2.92, acknowledging that proposed reforms could.... "have a disproportionately severe impact on the

to enhance their own research capabilities or spend more money on research[52] and long-established patterns in brokerage practices may come under pressure.[53] The Forum also recognizes that although some fund boards may embrace the recommended best practice, and, along with their advisers, eschew soft dollar arrangements, others may not, which could place the adviser at a competitive disadvantage to its peers.[54]

Still, the Forum's guiding principles-- that brokerage commissions are an asset of a fund, that best execution is the most important factor and that transparency is important

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smaller sectors of the fund management market, particularly the less profitable firms."); Stephen M. Horan and D. Bruce Johnsen, *Soft Dollar Brokerage, Portfolio Management, and Private Information: Agency Theory and Evidence* (July 11, 2000) in Alternative Perspectives in Finance and Accounting, Alternative Perspectives in Finance 6, University of Hamburg (August 4-6, 2002) (conference paper) (finding that "the use of soft dollars increases competition by reducing the cost to managers [by] establishing trust and allowing them to use a larger pool of brokers than otherwise [available] ....[The abolition of soft dollars] could easily compromise the informed manager's anonymity, leading to leakage, price impact, poor execution quality, and reduced portfolio performance.")

52 The FSA acknowledged this in its study. FSA Consultation Paper, *supra* note 28, at § 4.26. Indeed, some fund advisers may seek to increase their investment advisory fees to offset their greater research costs. In some instances, funds themselves could incur expenses for research. This result would still provide greater transparency of an adviser's true operating expenses.

53 *See* FSA Consultation Paper, *supra* note 28, at §§ 4.26 – 4.28 (in light of recommendations to limit "bundled brokerage and soft commission arrangements," in the United Kingdom, brokers may develop more flexible service arrangements). *But see Transcript of The Conference on the Role of Independent Investment Company Directors,* U.S. Securities and Exchange Commission, Washington, D.C. (Feb. 23, 1999) (A representative of a major broker-dealer stated that it was company practice for there to be different prices associated with different brokerage services, and that flexibility will be imperative for future competition.) Representatives of a major fund group have said "the time has come for the Commission to introduce dramatic change in disclosure rules relating to soft dollars," noting the "mutual fund industry will emerge better able to serve its investors." Fidelity Comment Letter, *supra* note 28, at 2.

54 The reform contemplated by this recommended best practice would be more equitably instituted if achieved through a change in applicable law, after study of the economic impact and an opportunity for interested parties to comment. The recommended reform would then apply equally to all fund boards and fund advisers. In this regard, a Directors Committee of the ICI commented that it would support a legislative effort to repeal in its entirety Section 28(e) of the Exchange Act. Letter from James H. Bodurtha, Chairman, ICI Directors Committee, to William H. Donaldson, Chairman, U. S. Securities and Exchange Commission, at 8 (Dec. 31, 2003). In a similar vein, authorities in the United Kingdom have announced the following future policy direction and outcomes relating to sweeping changes to bundled brokerage (execution and in-house research from a broker-dealer) and soft commissions (execution and research from a third-party): (1) limiting the range of goods and services that fund managers can buy with their clients' funds through commissions to execution and research; (2) requiring that fund management clients should be given, through enhanced disclosure, clear information about the respective costs of execution and research paid for on their behalf by the their manager, and the overall expenditure on these services; and (3) encouraging fund managers to seek, and brokers to provide, clear payment and pricing mechanisms that enable individual services to be purchased separately. *FSA Policy Statement*, *supra* note 28 at Section 3.3.

--weigh strongly in favor of abandoning soft dollar arrangements involving fund assets.[55] The enhanced transparency and clearer focus on best execution that would result from the Forum's recommendation would be in the long-term best interests of fund shareholders. Indeed, some Forum members reported that the advisers of their funds have achieved success in obtaining best execution through brokerage commissions that are lower than usual and customary rates in circumstances in which the advisers did not engage in soft dollar arrangements and instituted affirmative measures to pay low commissions. Fund managers should be able to adapt to a loss in research services and products attributable to trades by the funds, particularly if the use of soft dollars is discouraged for all funds.[56]

Fund boards that determine to allow their advisers a transition period before prohibiting further soft dollar arrangements on trades for their fund should set deadlines and implement the recommended best practice as soon as practicable.

Fund boards that permit their advisers to use soft dollar arrangements on an interim basis - or that do not adopt the Forum's recommended best practice - should nonetheless insist that the fund receive best execution on "soft dollar" trades. Independent directors should review the quality of the execution their fund receives on transactions in which its adviser receives research or products and compare the quality of the execution on "soft dollar" trades to the execution quality of other trades (without giving a value to the research provided), with a view to assessing whether the fund is receiving best execution on its trades. The Forum also recommends that independent

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55 It should be noted that others have called for different types of reform of soft dollar practices. The ICI has called upon the SEC to narrow the definition of permissible research and to eliminate payment for third-party research. *See* ICI Proposals, *supra* note 42. In addition, SEC officials have also indicated that the Commission will continue to review and consider the use of soft dollars by fund investment advisers. *See* Paul F. Roye, Director, Division of Investment Management, Remarks Before the American Law Institute/American Bar Association (June 19, 2003) (stating, in response to Congressional inquiries, "we expressed concern about the growth of soft dollar arrangements and the conflicts they may present to fund advisers. Certain soft dollar arrangements are protected by Section 28(e) under the Securities and Exchange Act. However, the general effect of Section 28(e) is to suspend the application of otherwise applicable law, including fiduciary principles, and to shift the responsibility to fund boards to supervise the adviser's use of soft dollars and the resulting conflicts of interest, subject to best execution and disclosure requirements."); Testimony of William H. Donaldson, Chairman, U.S. Securities & Exchange Commission, Concerning Regulatory Reforms To Protect Our Nation's Mutual Fund Investors (Nov. 18, 2003) ("The Commission must engage in a reassessment of how fund commission dollars are used, including various soft dollar arrangements and the lack of transparency to investors of these payments.") Nonetheless, the Forum believes that its position described above would best address the guiding principles of best execution and transparency.

56 In this regard, the FSA noted that under its proposed reforms, advisers would have stronger incentive to scrutinize expenditures for services more carefully, and the agency predicted downward pressure on demand and cost for research. Recently, large investment advisers, such as MFS Financial Services, Morgan Stanley, Putnam, Janus and One Group, have joined the growing list of fund complexes that have curtailed or reformed their use of soft dollars. These firms all have announced that they will no longer use soft dollars to obtain third-party research. *See generally* Board IQ, *Soft Dollar Spending Drops Sharply* (June 8, 2004).

directors request that the adviser quantify soft dollar benefits in the reports submitted to the board in connection with the annual renewal of investment advisory agreements.[57]

Transactions with Affiliates

12. Independent directors should require that any trades placed with an affiliated broker-dealer receive the most favorable commission rates that the broker-dealer gives to comparable clients.

Some fund advisers are also broker-dealers that have execution capabilities or are affiliated with broker-dealers that have execution capabilities (an "affiliated broker-dealer") and effect a portion of their fund's agency trades with the affiliated broker-dealer. Under SEC rules, trades with an affiliated broker-dealer are permissible provided that the commissions paid to the affiliated broker-dealer are reasonable and fair compared to commissions received by other broker-dealers in comparable transactions.[58]

In addition to this standard, the Forum recommends that fund boards require that their funds be well served by an affiliated broker-dealer. In this regard, the Forum recommends that funds be charged commission rates at least as favorable as the affiliated broker-dealer charges other comparable clients -- *i.e.* enjoy a "most favored nation" status.

13. Independent directors should review the quality of the execution a fund receives on any transactions placed with an affiliated broker-dealer.

The Forum also recommends that independent directors review the quality of the execution the funds receive on transactions placed with an affiliated broker-dealer. The directors should compare the quality of the execution on these trades to the quality on trades placed with unaffiliated broker-dealers, with a view to verifying that the fund receives best execution on its trades.

Revenue Sharing

14. Independent directors should require that fund management disclose revenue sharing arrangements to the board, should review any revenue sharing arrangements annually, and should consider revenue sharing arrangements to be part of the contract renewal process, where applicable.

"Revenue sharing," for purposes of this recommendation, means arrangements under which a fund's adviser, distributor, administrator, or other agent intending to directly or indirectly promote the distribution of fund shares makes payments to others that exceed the amount of commissions normally associated with sales loads or normally

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57 *See* Part V, *infra,* Recommendations for Management Agreements and Management Fees.

58 Rule 17e-1 under the 1940 Act.

derived from Rule 12b-l plan proceeds.[59] For example, a fund distributor or adviser may pay: (1) a broker-dealer that has included the fund on the list of funds that may be sold or are preferred for sale; (2) an insurance company that has included the fund as an underlying investment option in a variable contract; or (3) a retirement plan sponsor or administrator that has included the fund as an available option for one or more retirement plans.[60] "Revenue sharing" includes payments that are characterized as compensation for promoting the sale of the fund's shares (often referred to as paying for "shelf space"), as well as payments made for other purposes such as services.[61]

The Forum's recommendation should not be taken as suggesting that revenue sharing arrangements are inappropriate, but rather that transparency is important for revenue sharing arrangements. Transparency may help a fund's board understand the expenses borne by the fund's service providers in distributing the Fund's shares, and may aid the board in its assessment of the reasonableness of fees paid for services rendered under advisory and other agreements.[62] An understanding of revenue sharing

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59 The SEC has recently proposed to define revenue sharing to mean "any arrangement or understanding by which a person within a fund complex, other than the issuer of the covered security, makes payments to a broker, dealer or municipal securities dealer, or any associated person of the broker, dealer or municipal securities dealer, excluding amounts earned at the time of the sale that constitutes a dealer concession or other sales fee and that are disclosed [pursuant to certain disclosure requirements]." *Confirmation Requirements and Point of Sale Disclosure Requirements for Transactions in Certain Mutual Funds and Other Securities, and Other Confirmation Requirement Amendments, and Amendments to the Registration Form for Mutual Funds,* Securities Act Rel. No. 8358 (Jan. 29, 2004) ("Proposed Confirmation Rules"). Proposed Rule 15c2-2 under the Securities Exchange Act would require specific confirmation disclosure of information about front-end and deferred sales fees ("loads") and other distribution-related costs that directly impact the returns earned by investors in mutual fund shares, unit investment trust interests (including certain insurance company separate accounts that issue variable insurance products such as variable annuity contracts and variable life insurance policies) and 529 plan securities. The NASD has recently submitted comments to enhance the SEC Proposed Rule. Letter from Mary L. Shapiro, Vice Chairman, NASD, and President, Regulatory Policy and Oversight, NASD, to Jonathan G. Katz, Secretary, U.S. Securities and Exchange Commission, (May 4, 2004).

60 The latter two scenarios may go beyond the arrangements captured in the SEC definition of "revenue sharing," discussed in the prior footnote.

61 This list is intended to include payments made to an entity that directly or indirectly helps distribute the sale of the fund's shares, even though the fund or its management receives services.

62 The SEC has taken the position, supported in court cases, that distribution expenses cannot be taken into account to justify an advisory fee as reasonable. Moreover, Section 12(b) of the 1940 Act, as amplified by Rule 12b-l under the 1940 Act, make it unlawful for a fund to pay directly or indirectly (e.g., through its advisory fees) to finance the distribution of its shares except in accordance with Rule 12b-l. However, the SEC recognizes that an adviser may finance fund distribution out of its "legitimate profits." Investment Co. Act Rel. No. 16431 (June 13, 1988). Thus, a fund's board is not precluded from looking at an adviser's distribution expenses to help it assess whether the advisory fee was likely to have been one that would have been negotiated in an arms-length bargaining. *See, e.g. Bearing of Distribution Expenses by Mutual Funds,* Investment Co. Act Rel. No. 11414 (Oct. 28, 1980); Schuyt, *supra* note 18, 663 F. Supp at 965.

arrangements can help a board assess how much in total is being paid to finance the distribution of fund shares or to support platforms through which fund shares are offered.

To provide adequate information to the independent directors, the Forum recommends, at a minimum, that:

- Revenue sharing arrangements be presented annually to the board.

- If the entity involved in revenue sharing arrangements is subject to annual contract renewal (such as an investment adviser), the information should be considered as a part of the contract renewal process in order to enable the board to better focus on the reasonableness of the fees under the agreement at the time of renewal.

- The information presented should include the types of entities to which revenue sharing payments are made, the structure of the payments made under each type of arrangement, the services received for the payments and the total amount paid, both in dollars and basis points.

15. Independent directors should require that pertinent revenue sharing information be disclosed to shareholders.

The SEC recently proposed rules that would increase disclosure to shareholders with respect to revenue sharing arrangements.[63] Notably, the proposed disclosures would be included in transaction confirmation statements Erovided after the purchase of fund shares as well as certain point-of-sale disclosure.[4] A fund's prospectus would be required to indicate whether a person in the fund complex makes revenue sharing payments, and if so, to provide cross references to confirmations on the sale of shares and in point-of-sale disclosures.

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63 *See* Proposed Confirmation Rules, *supra* note 59.

64 Proposed paragraph (c)(5) of Rule 15c2-2 would require disclosure of information related to revenue sharing payments and portfolio securities transaction commissions received by the broker, dealer or municipal securities dealer. The proposed rule specifically would require disclosure of information about two types of arrangements: (i) revenue sharing payments from persons within the fund complex; and (ii) commissions, including riskless principal compensation, associated with portfolio securities transactions on behalf of the issuer of the covered security, or other covered securities within the fund complex. The SEC has also proposed Rule 15c2-3 of the Exchange Act which would provide information to investors at the time they make their investment decisions with respect to transactions in mutual fund shares, unit investment trust interests and 529 plan securities. The rule specifically is intended to give investors timely access to information about sales loads and other distribution-related costs associated with transactions in those securities, as well as distribution arrangements that pose conflicts of interest for the brokers, dealers or municipal securities dealers, or their associated persons, that effect those transactions. *See* Proposed Confirmation Rules, *supra* note 59.

The Forum supports the SEC's proposal for providing specific information to shareholders. Until measures such as those proposed by the SEC are adopted, the Forum recommends that a fund's directors discuss with management:

a. Having the fund's prospectus and annual report include a general description of existing revenue sharing arrangements and the range of any regular payments made (in basis points), and referring the reader to the Statement of Additional Information for more information.

b. The desirability of the fund's Statement of Additional Information providing more specific information about revenue sharing practices, including a description of the types of entities that are paid, information about the types of services and marketing or distribution benefits received or anticipated for such payments, and the range of payments made (in basis points) for each type of arrangement.[65]

V. RECOMMENDATIONS FOR REVIEW OF MANAGEMENT AGREEMENTS AND MANAGEMENT FEES

Introduction

The obligation of independent directors to conduct a formal annual review of their fund's advisory agreement was established by Congress in the 1940 Act, which provides, in effect, that any fund advisory agreement will lapse unless either a majority of the fund's full board or its shareholders approve its continuance annually (after the first two years from execution). In addition, in order to limit the influence of interested members of the board, a majority of the independent directors must approve each advisory agreement initially and upon its renewal. The 1940 Act mandates certain additional procedures in this connection, including requirements (1) that the annual renewal process occur at an "in person" meeting, (2) that the board request "such information as may reasonably be necessary to evaluate" the terms of the advisory agreement and (3) that the investment adviser furnish that information.[66] To reinforce the investment adviser's

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65 *See also* NASD Rule 2830(1)(4) (requiring disclosure of special cash compensation arrangements in a fund's statement of additional information, including the name of the broker-dealer to whom the compensation is paid and the details of the arrangement). The NASD has also proposed amendments to Rule 2830 that would require a broker-dealer to disclose revenue sharing and differential cash compensation arrangements relating to the sale of investment company securities, in writing, when a customer first opens an account or purchases fund shares. The proposal would also require this information to be updated twice a year and made available to customers. NASD Notice to Members 03-54 (Sept. 17, 2003). Although the comment period on this proposal has expired, it has not been acted upon as of the date of this Report.

66 Board members, including independent directors, are also subject to duties arising under state law concepts, involving primarily duties of care and loyalty that require the members to obtain all material information reasonably available on the matter under consideration and to act in a manner they believe to be in the best interests of the fund. Boards that fulfill their duties of care and loyalty in making decisions generally are given deference by courts under the "business judgment

obligation in this regard, as noted in recommendation number 20 *infra*, the Forum recommends that funds require their investment adviser specifically to agree to provide such information.

Typically, fund boards and independent directors monitor fund management continuously throughout the year. Directors generally receive information in connection with each board meeting that is relevant to the annual consideration of renewal, and independent directors consider on an on-going basis management's performance of the various services it provides to the fund. Thus, the analysis and actions taken at the annual renewal meeting will reflect information exchanged over the course of the year (and over several years) and will include an overall assessment by the independent directors of the adviser's performance and its responsiveness to concerns or questions that the independent directors have raised over time.[67]

Case law[68] and statements by the SEC and its staff traditionally have influenced the types of information that boards and independent directors request and evaluate and have emphasized their responsibilities in monitoring the fees and expenses of the funds they oversee, particularly in light of the quality of services provided and the overall fairness of the agreements to the funds and their shareholders. More recently, state regulators and others have influenced the process.

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rule." For an example of directors vigorously engaged in the evaluation of an advisory contract, *see* Schuyt, *supra* note 18, 663 F. Supp at 985-986 ("[T]hroughout the 1981 [advisory contract] renewal process, the independent directors continued to request information and actively debate with the Adviser . . . . Certainly this series of events indicates that the directors were extremely able and conscientious. This is not a case where a contract was rubber-stamped by docile individuals; this is a case where competent, aggressive individuals analyzed the facts and actively bargained to obtain a better deal for the Funds.").

67 "Perhaps no other issue addressed by independent directors has as much impact on investors' returns than the level of fund fees . . . . Now, we all understand that directors aren't required to guarantee that their fund will be able to employ the lowest fees, but they are required to ask whether fund investors are really getting their money's worth." Arthur Levitt, Chairman, U.S. Securities and Exchange Commission, Remarks at *Roundtable on the Role of Independent Investment Company Directors, Part I* (Feb. 23, 1999).

68 The case law has developed under Section 36(b) of the 1940 Act, which is directed to fund advisers, as opposed to fund directors or the funds themselves, and imposes on advisers a fiduciary duty with respect to the compensation they receive. Nevertheless, these cases typically recognize that the 1940 Act assigns to the directors primary responsibility for approving an appropriate fee structure with fund management. Historically, courts have looked to whether the advisory fee is considered to be "within the range of what would have been negotiated at arm's-length in the light of all the surrounding circumstances." *See, e.g., Kalish v. Franklin Advisers, Inc.*, 742 F. Supp. 1222, 1227 (S.D.N.Y. 1990), *aff'd,* 928 R.2d 590 (2d Cir. 1991). Another court concluded that the test should be whether the compensation is "so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been the product of arm's length bargaining." *Gartenberg v. Merrill Lynch Asset Mgmt., Inc.,* 694 F.2d 923, 929 (2d Cir. 1982), *cert. denied,* 461 U.S. 906 (1983). *See also Gartenberg v. Merrill Lynch Asset Mgmt., Inc.,* 740 F.2d 190 (2d Cir. 1984).

Investment advisers are fiduciaries and have continuing responsibilities with respect to the funds they advise. An adviser's reputation and the fund's investment objectives, style and performance history are typically the most significant factors in a shareholder's decision to choose the particular adviser and fund. In addition to providing investment advice, the adviser must maintain shareholders' trust and confidence. The oversight function of the independent directors with respect to the investment management agreement can therefore be characterized as a continual review and discussion with the adviser concerning matters of interest to the fund and its shareholders. The annual review of the advisory relationship, including the contract terms and advisory fees, is an integral part of this ongoing dialogue between the independent directors and the adviser.

Depending on all the circumstances, a fund's board, and the independent directors in particular, must determine the standards against which the adviser is to be measured and the nature of the information to be considered in evaluating the advisory agreement and related fees. Generally speaking, the basic objectives in approving or continuing an investment advisory relationship are to (1) assess the quality of the adviser's services in relevant areas, usually in comparison to performance of a relevant peer group and the degree of risk undertaken on behalf of the funds by the adviser; (2) determine the fairness of the advisory contract, principally in terms of its fee structure, in relation to the services provided and the adviser's profitability; and (3) consider whether the adviser can achieve economies of scale at higher asset sizes due to the spreading of fixed costs over a larger asset base, or other possible economies, that should be shared with fund shareholders.

The fiduciary duties of directors in connection with their annual review of management contracts extend beyond evaluation of fund investment performance and the fees for advisory services. Typically, advisers and their affiliates perform other services that may be specified in a combined advisory and management contract, or other separate contracts. These services may include transfer agent services, custody of fund assets, recordkeeping and fund accounting, shareholder services, proxy voting and other services. Many of the criteria discussed above with respect to contracts for advisory services also apply to contracts for these services, whether with the adviser or its affiliates or others.

The directors' fiduciary duties in these areas stem in part from Section 36(a) of the 1940 Act, which authorizes the SEC to bring suits against fund directors for "any act or practice constituting a breach of fiduciary duty involving personal misconduct."[69] In

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69 *See* Alan Rosenblat and Solomon Freedman, *Duties to Mutual Funds*, in 4 The Review of Securities Regulation 932 (1971). There is no definition of "personal misconduct" in the 1940 Act. However, the legislative history of Section 36 (a) indicates that a failure to act when there is a duty to act may constitute personal misconduct for these purposes. That is, liability under Section 36(a) is not limited to situations where an actual intent to violate the law can be shown or to acts of affirmative misconduct. In appropriate cases, "nonfeasance of duty or abdication of responsibility would constitute a breach of fiduciary duty involving personal misconduct." H.R. Rep. No. 1382,91[51] Cong., 2d Sess. (1970).

addition, Section 36(b) of the 1940 Act imposes a fiduciary duty on a fund's investment manager "with respect to the receipt of compensation for services, or of payments of a material nature" made by a fund to its investment manager or to an affiliated person of the investment manager (including a director who is an affiliated person of the investment manager). Accordingly, the best practices recommended below are applicable to all services provided to a fund by its affiliates.

RECOMMENDATIONS

The Forum recommends that, depending on all the circumstances, a fund's board and its independent directors adopt the following procedures in connection with their consideration of the renewal of the fund's advisory relationship.

16. A fund's board should designate a committee, consisting of some or all of the fund's independent directors, to oversee the contract review process and the committee should have a written charter.

The board should assign responsibility for managing the process by which a fund's board reviews the fund's advisory contract and, as appropriate, contracts with other service providers, to a contract review committee of the board consisting of some or all of the fund's independent directors. The board could assign this role to a separate board committee or add this responsibility to an existing board committee. The board should adopt a written charter for the committee, determining the scope of the committee's duties in the advisory contract review and fee negotiation process and authorizing it to use independent counsel and other experts. The board should assure that provision is made for adequate resources to be made available for the committee's activities. The written charter also should define the committee's responsibilities to include a report to the full board regarding its review of the advisory agreement and its recommendations regarding adoption or continuation of the advisory agreement, with or without modifications to its terms.

17. Independent directors and the contract review committee should consult with independent legal counsel as needed.

Advice of independent legal counsel is particularly important in the contract review process. Accordingly, whether or not the independent directors have determined to retain independent legal counsel on an ongoing basis, the Forum recommends that the independent directors and the contract review committee consult with independent counsel on contract review.[70] At least one court, as well as SEC rules, have highlighted the value of independent legal counsel.[71] Although not required by SEC rules, independent legal counsel can advise independent directors of their legal obligations,

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70 See Recommendation 5 recommending retention of independent legal counsel.

71 Schuyt, *supra*, 663 F. Supp at 965; Independent Directors Release, *supra* note 7 ("We believe that the conflicts involved in the transactions and arrangements permitted by the Exemptive Rules

provide perspective on industry practices, particularly when difficult judgments must be made, and assist the independent directors in protecting shareholders from conflicts of interest.

18. Independent directors and the contract review committee should consider retaining unaffiliated third party consultants.

Unaffiliated third party consultants provide a source of objectivity for independent directors on certain economic matters, such as establishing comparative peer groups, analyzing the advisory fees, review of procedures related to profitability methodologies, providing a profitability framework or comparing services and performance.

Independent directors should consider whether independent consultants would be helpful to them in fact gathering or providing analysis. In some situations, the Forum recognizes, the costs associated with unaffiliated third party consultants may outweigh the anticipated benefits.

19. The contract review committee should establish a structured process for the consideration of the advisory agreement.

The Forum recommends that the contract review committee establish a structured process for obtaining and processing information relevant to contract approvals. This process might include a timeline providing for: (1) preparation of a written request to the adviser on behalf of the contract review committee, requesting information that the committee believes is necessary or desirable to evaluate the advisory agreement ("15(c) request"); (2) receipt of the adviser's report to the committee and the full board in response to the Section 15(c) request and including any other information the adviser believes may be helpful ("Section 15(c) report"); (3) review and deliberation of the response by the committee and the independent directors, and further requests to the adviser, if necessary; (4) discussion with the adviser, if desired; and (5) a final board decision.

20. A fund's board should require the investment adviser to commit by contract to provide the independent directors with all relevant information and the contract review committee should prepare a formal written 15(c) request to obtain that information.

Independent directors generally receive a wealth of information about the fund's investment adviser throughout the year. However, Section 15(c) of the 1940 Act specifically requires, in connection with the adoption or continuation of an advisory contract, that a fund's board request the adviser to provide it with information reasonably necessary to evaluate the contract. The Forum recommends that the board's request for information be in the form of a formal written request, prepared with the assistance of

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make it critical that independent directors, when they seek legal counsel, be represented by persons who are free of significant conflicts of interest that might affect their legal advice.").

counsel.[72] The Section 15(c) request is not the exclusive method by which the directors obtain information relevant to the contract renewal process. Section 15(c) of the 1940 Act obliges the adviser to furnish information that is reasonably necessary to permit the board to evaluate the contract, whether or not the information is referred to in the section 15(c) request. To emphasize this responsibility, the Forum recommends that fund investment advisers be required to commit by contract to provide all information reasonably relevant to the board's review.

A draft Section 15(c) request may be submitted to the adviser in advance to give the adviser an opportunity to clarify questions or ambiguities before the final Section 15(c) request is delivered. The content of the Section 15(c) request should be tailored to address the particular advisory arrangement. For example, if the contract covers services in addition to investment advice, such as fund administration, the Section 15(c) request should add appropriate questions regarding those other services. Additionally, if the fund uses sub-advisers, the information sought regarding the investment adviser should also be requested regarding any sub-advisers, to the extent relevant. Whether a particular item of information would be relevant to a sub-advisory relationship will depend on the terms of that relationship. Information that might be sought in a Section 15(c) request is included in Appendix I.

21. Independent directors should ask counsel for a memorandum describing their legal obligations in reviewing an investment advisory agreement.

The directors' responsibilities under the 1940 Act have been examined and explained in numerous court decisions. It is important for directors to be fully informed in writing, by qualified legal counsel, about applicable judicial and regulatory guidance regarding their responsibilities, including factors they should consider in evaluating an investment advisory agreement. Before the independent directors complete their review of an investment advisory contract, independent counsel should provide them with a memorandum describing their legal obligations.

22. The contract review committee, and preferably all independent directors, should meet in person at least once, with no representatives of the adviser, including adviser affiliated directors, in attendance, to review the Section 15(c) report and to formulate a recommendation for the board regarding adoption or continuation of the advisory contract.

Before the board meeting at which adoption or continuation of the advisory contract will be considered, the contract review committee should meet at least once in person, with no representatives of the adviser, including adviser affiliated directors, in attendance, to review the Section 15(c) report. The contract review committee should consider whether legal counsel and other consultants should participate in this meeting.

[72] *See* discussion *infra* Appendix I.

If a fund's contract review committee does not include all the independent directors, the Forum suggests that they be included in the in-person meeting.

The purpose of the meeting should be to consider the adequacy of the Section 15(c) report and any questions raised by the report and to consider and agree upon the committee's recommendation to the board regarding adoption or continuation of the advisory contract. In particular, the adviser's response to the Section 15(c) request should demonstrate that the adviser has met the expectations of investors both in terms of the investment experience of the fund and in the services provided by the adviser, including services performed under separate contracts (such as administrative, fund accounting and shareholder servicing arrangements).

If, based on an analysis of all of the factors, the independent directors believe that the proposed advisory fees are not reasonable, or that the overall cost structure for the fund is not appropriate, the independent directors should not approve the arrangement without first negotiating, as necessary or appropriate, alternatives for reducing the fund's investment advisory fees or total expenses or addressing performance, service or compliance concerns. Guidance on matters that might be negotiated is included in Appendix II.

Once the contract review committee presents its recommendations to the full board, the board should take action to approve or disapprove the advisory contract at its "in-person" board meeting.[73] The board should discuss in reasonable detail the material factors and the conclusions that form the basis for its decision regarding the agreement.[74]

SEC rules, as recently amended, require funds to disclose in public filings the material factors and the conclusions with respect to those factors that formed the basis for the board's decision to approve or recommend that shareholders approve an investment advisory agreement.[75] Thus, records should be kept of the board's deliberations, the factors it considered and the basis for its conclusions with respect to the advisory contract. These records would also provide a basis for supporting a conclusion that the board's decision was appropriate under state law business judgment rules.

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73 Section 15 of the 1940 Act requires the directors to approve or continue the advisory agreement at an "in-person" board meeting called for the express purpose of approving or continuing the contract.

74 *See Disclosure Regarding Approval of Investment Advisory Contracts by Directors of Investment Companies,* Investment Co. Act Rel. 26486 (June 23, 2004) ("Advisory Contract Disclosure") ("These enhancements clarify and reinforce a fund's obligation under the existing proxy disclosure requirement to discuss the material factors and the conclusions with respect thereto that formed the board's basis for recommending that the shareholders approve an advisory contract. They are intended to address [SEC] concerns that some funds do not provide adequate specificity regarding the board's basis for its decision.").

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VI. RECOMMENDATIONS WITH RESPECT TO VALUATION AND PRICING

Introduction

Proper valuation of a fund's portfolio secuntles is critical for the accurate calculation of daily net asset value per share. Rule 22c-1 under the 1940 Act provides that a fund may sell, redeem or repurchase its shares only at a price based on the net asset value of its shares next determined after the purchase, redemption or repurchase order is received. Section 2(a)(41) of the 1940 Act and Rule 2a-4 thereunder provide that the "value" of fund assets is (a) "market value" for securities for which market quotations are readily available, and (b) for other securities and assets, "fair value as determined in good faith by the board of directors." Under recent amendments to disclosure requirements for non-money market open-end funds and managed variable annuity separate accounts, the SEC has clarified that these funds and accounts must "fair value" their portfolio securities when market quotations for those securities are not readily available or are unreliable.[76]

The SEC and its staff provide guidance on valuation and pricing, and fund directors responsible for oversight of fund management's valuation and pricing policies, procedures and practices should be familiar with the guidance as it evolves. A brief summary of the guidance that is available as of June 2004 is set forth in Appendix III.

In considering recommended best practices relating to directors' oversight of funds' valuation and pricing procedures, including fair valuation, the Forum did not focus on current industry issues related to late trading of fund shares and abusive market timing. Nevertheless, the guidance provided below can be expected to provide collateral benefits with respect to these matters. The Forum emphasizes that, while using current market prices and fair valuations may help to reduce the incentive for market timing, valuation and pricing techniques, procedures, policies and practices cannot by themselves prevent abusive market timing and late trading of fund shares.[77] The new fund chief

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[76] *See Disclosure Regarding Market Timing and Selective Disclosure of Portfolio Holdings,* Investment Co. Act Rel. No. 26418 (April 16, 2004) ("Market Timing Disclosure"). The amendments are effective August 5, 2004, except that the amendments to Item 12 of Form N-1A, Item 18 ofFormN-2 andltem20 ofFormN-3 are effective as ofJanuary 31,2006.

[77] *See* Market Timing Disclosure, *supra* note 76 (among other things, adopting rules to deter market timing and requiring disclosure of fair value pricing procedures).

> Our amendments will require the fair value pricing disclosure to be included in a fund's prospectus, as proposed. Some commenters suggested that the required information about fair value pricing may be more appropriately included in a fund's SAL In addition, some commenters suggested that the location of the disclosure should depend on the significance of market timing as a potential problem for the fund; thus, in cases where market timing is a more important concern, such as foreign stock funds that are subject to time-zone arbitrage, the information should be included in the prospectus itself. We continue to believe, however, that information about the circumstances under which a
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> included in the prospectus together with other key information about a fund. We also

compliance officer as required by Rule 38a-1 under the 1940 Ace[8] will be an important resource to enable fund directors to monitor for abusive market timing and late trading of fund shares in the future.

There are a number of relevant best practice recommendations, discussed below, and the Forum recognizes that each fund's board is in the best position to determine how best to implement these themes and recommendations, giving careful consideration to the culture and size of the fund family and the complexities of a fund's portfolio. The basis for all of the following recommendations is the exercise by all fund directors of independent and objective oversight and judgment with respect to their fund's valuation and pricing procedures. Directors cannot be expected to have studied the financial statements and market indicators for every security in a fund's portfolio. Rather, a fund's board of directors has the responsibility to assure that the adviser has developed and implemented reasonable and effective valuation and pricing procedures and that the procedures are applied fairly and consistently. The board should review the procedures for appropriateness on an ongoing basis.

RECOMMENDATIONS

23. A **fund's board should establish a standing valuation and pncmg committee to provide objectivity and the committee should have a written charter.**

Directors who provide oversight of fund management's valuation and pricing policies, procedures and practices should determine how they can best organize themselves to evaluate effectively and efficiently fund management's valuation and pricing activities.

As a general rule, the Forum recommends that a fund's board establish a standing valuation and pricing committee with an appropriate charter. Members of this committee generally should - but need not - include independent directors, but the structure should be designed to assure that directors can provide objectivity in their oversight of fund management's valuation and pricing policies, procedures and practices. Directors who perform this oversight role should be separate from the members of the fund management's valuation and pricing committee.

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believe that it is preferable for investors if the information is uniformly located in one document, rather than located in the prospectus for some funds and the SAl for others. In addition, the instruction requires the disclosure regarding fair value pricing to be brief, and, as noted above, funds will not be required to provide detailed information about their fair value pricing methodologies and formulas.

The new Rules became effective May 28, 2004. All initial registration statements on Forms N-lA, N-3 N-4, and N-6, and all post-effective amendments to effective registration statements on these forms, filed on or after December 5, 2004, must include the disclosure required by the amendments.

78 See Compliance Programs, *supra,* note 37.

Although directors are not required to be experts in portfolio valuation, the board should strive to be familiar with the varieties of portfolio valuation techniques in order to enhance their ability to determine objectively that fund management's fair valuation proposals are reasonable. Examples of considerations that directors may use to assist them to organize, operate and evaluate fund management's valuation and pricing activities are set forth in Appendix IV.

24. A fund's board should assure that factors and decisions it used in determining any fair valuations are documented in detail.

Where valuation procedures require boards to consider fair valuing[79] certain holdings (typically where reliable market valuations are not otherwise readily available), the Forum recommends that boards require detailed documentation of the factors and decisions used in the valuation process. Additionally, directors should determine whether the methodology applied is consistent with previous similar situations. Any deviations should be supported and documented.

25. A fund's board should request that the adviser identify new situations that may require fair valuations.

Because global securities markets are dynamic and volatile it is incumbent on a fund's adviser and its directors to recognize that securities that trade infrequently, as well as securities that are restricted or illiquid, may create situations that require fair valuation of securities. Therefore fund directors should request fund management to identify new situations that may require fair valuations. Fund management and directors may wish to utilize triggering events to help in determining when fair valuation models or tools should be considered. They may also wish to consider what assistance may be available from commercial pricing services.

26. A fund family's valuation and pricing procedures should assure that, in general, the same valuation is used consistently for a security throughout the fund family, including its public and private funds.

In cases where no readily available market quotations for a security exist, it is probable that different fund management personnel and directors using proprietary models or other techniques will, in good faith, derive different security valuations that they believe are appropriate under the circumstances. Within fund families, however, fund management and fund directors should have policies, procedures and practices in place so that, in general, the same valuation is used consistently for a security throughout the fund family, including public and private funds, to ensure consistent and equitable treatment for all investors. Where more than one valuation is used for a security, the reasons for doing so should be documented by fund management and shared with the fund directors.

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[79] To "fair value" refers to the practice of determining a value for securities in situations in which market values do not exist or are unreliable.

27. A fund's board, or the board valuation and pricing committee, should establish valuation and pricing procedures that are consistent with current regulatory guidance and the fund's public disclosures.

Valuation and pricing policies, procedures and practices should comply with applicable regulatory guidance and registration statement disclosure and should be appropriate for the fund and fund family. Fund directors who oversee the adviser's pricing policies, procedures and practices should establish procedures to assure that they are regularly informed of applicable regulatory developments and guidance. These directors should also develop methods to assure that regulatory developments and guidance are reflected in the fund's valuation and pricing procedures, as well as in the fund's public disclosures. The adviser and the directors need to receive current information about regulatory requirements and should determine that fund management will assure that disclosures in shareholder reports are consistent with regulatory guidance and registration statement disclosure.

In addition, the board or its valuation and pricing committee should review the fund's pricing and valuation procedures periodically to assure that they continue to be appropriate for the fund and fund family.

VII. RECOMMENDATIONS TO ENHANCE THE EFFECTIVENESS OF FUND INDEPENDENT DIRECTORS WITH RESPECT TO CONFLICTS OF INTEREST

Parts IV, V and VI, above, deal with specific areas of obvious potential conflict between a fund and its adviser. Fund boards should be attentive to other types of conflicts that can arise, for example, from other business activities of the adviser and its affiliates and, to the extent practical, also seek to align directors' economic interests with that of fund shareholders. Additionally, board members should regularly evaluate their performance as a board and the independent directors should actively participate in educational and informational programs.

RECOMMENDATIONS

28. A fund's board should establish a process for identifying and reviewing conflicts of interest.

The structure of the investment management business has changed significantly in recent years. Today, many investment advisers are part of financial institutions engaged in a number of businesses other than the fund business. The 1940 Act addressed the obvious conflicts that were present in the traditional external management structure, but was enacted before full service financial institutions became possible. In light of these changes and the complexities they have introduced, the Forum recommends that directors consider assigning to a committee of the board the express responsibility for addressing potential conflicts of interest that may arise between the fund and its adviser or affiliates due to other business activities of the adviser or affiliates. The committee may be an existing committee, such as a fund's audit or governance committee, and should have express responsibility for addressing conflicts as reported to the committee by the adviser as part of the adviser's conflicts review process.

The board should require that conflicts arising from the adviser's other business activities be identified by the adviser and others and reported periodically to the committee by (i) the adviser or (ii) other persons having knowledge or experience with respect to the operations of the fund, its adviser or entities affiliated with the adviser.[80] In this regard, the board should require that the adviser establish a review process to identify potential conflicts of interest that may arise between the fund and the adviser or between the fund and any affiliated person of the adviser as a result of, among other things: (i) the operation of a non-investment management business in which the adviser or an affiliated person of the adviser engages; (ii) the adviser engaging in a new business; (iii) the adviser making available new investment products or services; or (iv) the adviser changing significantly the manner in which it operates its investment management business. Ongoing identification of potential conflicts of interest will assist the board and the adviser in addressing situations that could have a significant negative effect on the interest of the fund's shareholders.

29. A fund's independent directors should establish guidelines for ownership of fund shares by directors.

Ownership of fund shares by fund directors helps to align the directors' economic interests with those of shareholders of the fund or fund complex. The Forum recommends that the independent directors of a fund develop a policy relating to director ownership of fund shares that seeks to meet this goal.[81] The policy could require a fund director to own shares in each fund for which he or she is a director or, in the case of a large fund complex, of a number of funds in the complex. Because it may not be appropriate for a director of multiple funds to own shares in every fund the director oversees, the policy should permit fund directors to determine the appropriate level of share ownership in the funds they serve.

30. Independent directors should make disclosure of their fund share ownership easily accessible.

The Forum recommends that funds identify their independent directors and publicly disclose, in a manner approved by a fund's independent directors, all director

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80 The Forum believes that any process for the review and management of conflicts should be carried out in conjunction with the fund's compliance program and the appointment of its chief compliance officer as required by recently adopted Rule 38a-l. See Compliance Programs, *supra* note 37.

81 *See Interpretative Matters Concerning Independent Directors of Investment Companies* Investment Co. Act Rel. No. 24083, (Oct. 14, 1999) ("The Commission staff believes that effective fund governance can be enhanced when funds align the interests of their directors with the interests of their shareholders. Fund directors who own shares in the funds that they oversee have a clear economic incentive to protect the interests of fund shareholders.").

ownership of shares of the fund as well as ownership of shares of other funds in the fund complex.[82] Disclosure of director ownership of fund shares should be easily available to fund shareholders.

31. A fund's board should conduct an annual self-evaluation review.

The Forum recommends that a fund's directors conduct an annual self-evaluation review designed to enable each member of the board to evaluate (1) his or her effectiveness as a director of the fund, (2) the effectiveness of the committee structure implemented by the board, and (3) the effectiveness of the board as a whole. A rigorous annual review by the board will enable each director to consider carefully his or her own performance and that of the board and its committees.[83]

The annual review should be designed to cause the fund's directors to assess at least the following topics regarding the board's committee structure and the board of directors as a whole:

a. The process for nominating directors.

To enhance the board's independence and expertise, a fund's independent directors should control the process for nominating all additional directors.[84] Independent directors of a fund, by virtue of having no close connection to the fund's adviser or entities affiliated with the adviser, are well-positioned to judge the manner in which a potential director can contribute to effective oversight of a fund.

b. Retirement policies and term limits for directors.

The Forum recommends that a fund's directors annually assess the fund's retirement policy, if it has one, as well as the effectiveness of that policy, or consider whether to adopt a retirement policy. The directors should determine what factors, such as age, years of service, or other criteria, are relevant to a retirement policy. If a fund has adopted policies on director service term limits, those policies should be assessed for

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[82] This best practice contemplates disclosure of this information in a more accessible manner than that required by SEC disclosure forms applicable to mutual funds. The directors of a fund may determine to disclose director fund share ownership on the fund's website or through other means providing for easy accessibility for the fund's shareholders.

[83] *See* Governance Proposing Release, *supra* note 12. ("The self-assessment process can improve fund performance by strengthening directors' understanding of their role and fostering better communications and greater cohesiveness. It gives directors the opportunity to step back and review their own performance, so that they can best consider any changes in their governance practices.").

[84] As noted above, funds relying on certain widely used SEC rules are already required to have their independent directors nominate additional independent directors. *See* Independent Directors Release, *supra* note 7.

effectiveness. A fund's policies regarding director retirement should be flexible in nature and may, but need not, specify mandatory retirement ages for directors or term limits.

c. The frequency with which the directors should be considered for election by shareholders.

Under applicable state and federal laws, fund directors are generally not required to be re-elected periodically by fund shareholders. Because consideration by a fund's shareholders of whether the term of a director should be affirmed or extended is consistent with the interests of the fund's shareholders, the Forum recommends that, as part of an annual self-assessment process, directors consider whether standing for periodic re-election would assist their board in carrying out its responsibilities to the fund's shareholders, taking into account the significant cost involved.[85]

d. The amount and form of compensation received by the directors from a fund individually and in the aggregate from the fund complex.

Directors of a fund should evaluate annually the compensation they receive from the fund as well as from all other funds in the complex. In undertaking this evaluation, a fund board should consider comparing the compensation received by directors for similar services on similar fund boards or for similar fund complexes to the compensation they receive from the fund and the other funds in the complex, as well as any other relevant factors.

e. The degree to which directors are informed about fund matters and the effectiveness of their participation in board and committee meetings.

Directors should annually consider the ways in which they are informed about fund matters and the quality and sufficiency of this information. Directors should consider ways in which this information could be improved, as well as other sources of information that could be made available to them. Directors also should be asked to comment on the effectiveness of the board and offer suggestions for improving director participation in board meetings.

f. Other factors.

A fund's board, in instituting the self-evaluation review, should set out in writing the factors each director should consider when evaluating his or her own personal performance, including meeting attendance, committee membership, participation in educational activities and industry knowledge. When evaluating the committee structure of their board and the board's effectiveness in promoting the best interests of the shareholders of a fund, the fund's directors should evaluate criteria such as: the frequency of board meetings; the substance of the agendas of meetings and how those

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85 Funds - generally closed-end funds - listed on the major U.S. stock exchanges are required by the rules of those exchanges to elect directors annually.

meeting agendas are created; the usefulness of the materials provided to the board and the ways in which they can be enhanced; and the experience and background of the directors.

In their self-evaluation, directors also should consider the number of funds they oversee and the effectiveness of their commitment to each fund. Regular review of these questions can serve as an appropriate alternative to the establishment of an arbitrary limit on the number of funds for which a person can serve as director.[86] The Forum recognizes that many funds in a fund complex have common boards and that this organizational structure can provide significant efficiencies in handling matters affecting multiple funds in the same complex. Nonetheless, it is important that a director personally evaluate annually his or her own success in meeting commitments to each fund the director oversees.[87]

32. Each independent director of a fund should participate in ongoing educational and informational programs designed to enhance knowledge of issues relating to fund oversight.

In light of the extensive and evolving nature of fund regulation, directors should regularly participate in educational or informational programs that may be useful to the directors in fulfilling their fiduciary duties to the fund's shareholders. It is especially important for the independent directors, as stewards of the fund's shareholders, to have a working knowledge of matters related to fund oversight and to gain that knowledge through participation in educational activities.[88] These activities can include, by way of example, participation in or attendance at presentations, seminars or discussion groups conducted by personnel of the fund or the fund's adviser, outside experts, industry groups, representatives of the fund's various service providers and educational organizations and institutions.

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86 *See* Governance Proposing Release, *supra* note 12. ("It would be difficult to detennine the optimum number of funds that a particular director or group of directors can serve, which should depend upon a number of factors.").

87 *!d.* ("Directors often serve on a large number of fund boards within a fund complex. This practice has over the years generated some criticism that directors are unable to pay adequate attention to their obligations to each fund. Others, however, strongly support the practice as a necessary recognition that many issues facing a particular fund in a fund group are common to all of the funds, and argue that it may actually give directors greater leverage when dealing with the common adviser.").

88 *See* Donaldson Remarks, *supra* note 9. ("Some have questioned whether mutual fund directors...lack the knowledge to keep apprised of the fund's activities....").

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

THE CHAIRMAN

November 17, 2003

Professor David S. Ruder
Chairman
Mutual Fund Directors Forum
c/o Northwestern University School of Law
357 East Chicago Avenue
Chicago, Illinois 60611-3069

Mr. Allan S. Mostoff
President
Mutual Fund Directors Forum
1775 Eye Street, N.W.
Washington, DC 20006

Dear Professor Ruder and Mr. Mostoff:

As you know, the Securities and Exchange Commission is scheduled to consider package of rulemaking reforms designed to combat late trading and market timing abuse involving a number of mutual funds. This package of reforms represents the first step in the Commission's plan to address these issues. As we learn more from our investigation we will consider other reforms that might be necessary, including fund governance and board composition issues.

However, because mutual fund directors, particularly independent directors, play such a critical role in protecting the interests of mutual fund shareholders and the funds themselves, I would like to call upon the Mutual Fund Directors Forum to develop guidance and best practices in areas where director oversight and decision-making is critical for the protection of fund shareholders. Such areas include board review of management contracts and management fees; soft dollar, directed brokerage and revenue sharing arrangements; rule 12b-l payments; valuation and pricing; and conflicts of interest between funds and their managers. As you know, statutory provisions and regulations can only go so far. While the Commission can remind directors of their obligations, I would welcome your help in providing practical guidance to fund directors as to how they can fulfill their obligations to fund investors. You and your organization are in a unique position to educate fund directors and provide them with information and insights to carry out their fiduciary obligations.

I would ask that you keep me apprised of your progress as you develop this guidance and the best practices. Mutual funds directors are the watchdogs for the millions of mutual fund shareholders and must help ensure that all mutual fund shareholders are protected. I urge your organization to assist mutual fund directors in this crucial task.

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MUTUAL FUND DIRECTORS FORUM

"THE FORUM FOR FUND INDEPENDENT DIRECTORS"

November 21,2003

By Hand Delivery

Hon. William H. Donaldson
Chairman
United States Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, DC 20549

Dear Mr. Chairman:

The matters that you address in your letter ofNovember 17, 2003 are clearly of vital concern to the Mutual Fund Directors Forum. We share the Commission's concern regarding the need to protect the interests of mutual fund shareholders and mutual funds themselves.

In response to your request, the Forum will undertake a program to develop guidance and best practices to fund independent directors in critical areas, including the five areas you identified: board review of management contracts and management fees; soft dollar, directed brokerage and revenue sharing arrangements; Rule 12b-1 payments; valuation and pricing; and conflicts of interest between funds and their managers. We anticipate that our independent director members, assisted by our Advisory Board, will be active participants in this effort.

We note that the Forum's forthcoming Policy Conference "Critical Issues for Investment Company Directors," which will be held in Washington, DC on January 7-8, 2004, will deal with many of the issues addressed in your letter. Specifically, panels will focus on Independent Director Best Practices; Director Responsibilities with respect to Fund Distribution; and Current Developments related to Rule 22c-1, including market timing, late trading, redemption fees and fair value pricing. The Conference also will have an important session on Educating the Independent Director, which will focus on the importance of vigilant, dedicated and well-informed directors.

As you requested, we will keep you apprised of our progress.

1775 I Street, NW, Washington, DC 20006 *(202)261-3399*
Website: mfdf.com

Please do not hesitate to call on us in the future to address other matters that may be of concern to the Commission.

Sincerely,

DavidS. Ruder
Chairman

Allan S. Mostoff
President

Appendix I

Practical Guidance For Fund Independent Directors

Suggested Information to Seek in a Section lS(c) Request

Recognizing that information is available and provided throughout the year, the Section 15(c) request might ask the investment adviser to provide, among other things:

- a description of the services it provides to the fund, including services under the advisory contract and any other services provided by the adviser or any of its affiliates;[89]

- a discussion of its philosophy for setting fees of a fund, its profitability goals, and its rationale for setting the fund's advisory fees. The adviser should also provide meaningful criteria against which the fees can be evaluated initially and measured over time, including the guidelines it uses to set fees;

- a detailed analysis of the adviser's cost structure, identifying amounts spent on portfolio management decisions, research, trading, product development, cash management, access to distribution (including "revenue sharing arrangements"), compliance, accounting, proxy voting, and other fund-related significant activities, and the proportions those items bear to its overall costs. Sufficient information should be provided so that the independent directors can also consider the size of the adviser's staff, and their functions, qualification and compensation, in evaluating whether the adviser invests its capital in personnel and technology to the fund's benefit;

- information on the adviser's profitability, including whether the adviser's profits attributable to the fund are appropriate and not unreasonable in view of the fund's performance over time, and the adviser's long-term financial ability to continue delivering services to the fund;[90]

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89 For example, services provided by the adviser could include fund administration, corporate and secretarial services; public relations; shareholder servicing; financial and other reporting services; and other regulatory services. The independent directors have the ability to discuss with the adviser whether any expenses regarding these items will be treated as fund expenses or as adviser overhead.

90 The independent directors should endeavor to evaluate the adviser's profitability over time, considering both profitability to the adviser of the advisory contract alone for each fund, and the adviser's overall profitability in managing all of the funds in the complex after taking into account distribution and affiliated contracts. In assessing profitability, independent directors should satisfy themselves that fees charged are reasonable in light of the services provided and that they are not being used improperly to indirectly finance fund distribution. Independent directors will also want to inquire whether the adviser has sufficient financial strength and stability to serve the fund for the long term and is investing its capital in personnel and technology that enable quality performance in the services the adviser renders to the funds and their shareholders.

- information on fund transaction costs and the adviser's portfolio brokerage allocation policies, including information on the use of fund brokerage to obtain non-execution services;[91]

- meaningful information on the adviser's fee structures for any other comparable investment vehicles, both public and private, and an explanation of any differences from fees charged to the fund;

- a discussion of the criteria for the selection of all comparative information presented, including comparative information regarding fees, costs and performance;[92]

- a discussion, through the use of comparisons from creditable sources, of the appropriateness of the fees charged, supported in part by comparisons of the adviser's cost and expense structure with the cost and expense structure of other firms where meaningful comparative information is available;

- as applicable, information on the relevance and impact of fund structure such as the use of sub-advisers[93] the allocation of advisory expenses among multiple funds and other advisory clients in the complex (such as hedge funds), distribution channels, etc;

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91 Independent directors should review the adviser's brokerage policies, including objective analyses of best execution, commission rates, and affiliated brokerage. Independent directors should also review dollar amounts of commissions paid, and the amount of commissions paid to brokers affiliated with the adviser. *See* discussion of soft dollars, *supra,* pp. 17-22.

The Forum believes that directed brokerage and soft dollar practices should be reformed as discussed in Section IV *supra.* Boards that decline to follow the Forum's recommendation in this regard should review information on directed brokerage and soft dollars, with particular emphasis on conditions under which a selling broker or its affiliate is designated to provide brokerage or execution services, and should consult with independent legal counsel to confirm acceptable practices in this area.

92 In most cases, independent directors will consider whether each fund's investment performance on a long-term basis has satisfied investor expectations, the adviser's services and expenses related to the fund, the adviser's profitability with respect to the fund, other fund expenses, and information regarding fees and expenses of other comparable funds, other comparable clients of the adviser, and how a fund's performance compares to an objectively identified peer group. Fund performance should be judged in comparison to industry performance, taking into consideration the specific category and classes of shares, and cost and expense levels. Independent directors should receive information about sales and redemptions that may reflect investor reactions to fund or adviser performance. Independent directors should assess the adviser's identification of underperforming funds, the reasons for their poor performance and the adviser's efforts to improve performance. These could include action steps and procedures, a timeline and alternative actions or procedures should the initial plan not produce satisfactory results.

93 *See* Advisory Contract Disclosure, *supra* note 74, (adopting rules requiring enhanced disclosure of directors' process in selecting sub-advisers).

- information on the allocation of aggregated secuntles transactions, including initial public offerings, between the fund and other accounts managed by the adviser;

- information on the fund's performance for specified time periods, compared with performance of an appropriate peer group, with explanations of any material differences in performance relative to the fund's peers;

- information on any "ancillary benefits" the adviser may realize from its association with the fund;[94]

- information on the adviser's compliance structure, including the results of any regulatory, internal or self-audits of the adviser, deficiencies found and steps taken to correct deficiencies;[95]

- information concerning any significant pending or anticipated legal actions involving the fund or the adviser;

- a copy of the adviser's Form ADV, Parts I and II;

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94 This would include, among other things, information on service contracts between the fund and adviser affiliates, and the fees paid and services provided under those contracts. Independent directors also should consider other costs or benefits that might accrue to the adviser and its affiliates in determining whether the advisory fee is reasonable. *See* discussion of soft dollars *supra,* pp. 17-22. Such benefits could include research services the adviser receives as a result of the brokerage generated by each fund; and any float income realized by a free credit balance or by using redemption proceeds during the period between the time a redemption check is written and the time it is presented for payment, or the development of client relationships as well as any additional business that the adviser or its affiliates may acquire as a result of their relationships with shareholders.

95 In particular, independent directors should obtain appropriate assurances from management that the compliance procedures approved by the independent directors are in place, that there is adequate staff administering the provisions in accordance with their terms, and that there have been no violations about which the independent directors should be informed. In considering the efficacy of the compliance program, the independent directors should consider the adviser's historical compliance record, including any deficiencies that may reflect upon the adviser's capability, resources and commitment to compliance efforts for the fund and the adviser. Independent directors should also request reports from the adviser about pending regulatory examinations involving the fund, the fund complex and the adviser, and request copies of any deficiency letters and the adviser's responses. New Rule 38a-l under the 1940 Act, which requires funds to adopt written compliance policies and procedures and to hire a chief compliance officer, provides the independent directors with a new set of issues to discuss with the adviser concerning how the adviser will comply with the rule and whether any or all of the expenses of compliance with the new rule should be paid by the adviser or the fund. *See* Compliance Programs, *supra* note 37. Independent directors should also obtain assurances that the adviser can perform the required oversight obligations with respect to compliance issues affecting the funds' service providers.

- a copy of the adviser's balance sheet and income statements for its last fiscal year; and

- other information determined to be relevant, such as developments in the industry, trends in fee levels, competitive products, general levels of sales or profitability in the industry, technological advances and other factors.

Appendix II

Practical Guidance for Fund Independent Directors

Matters for Consideration During Negotiation of the Renewal of an Investment Advisory Relationship

Matters that may be considered for negotiation include, but are not limited to, the following:

Fee and Expense Reductions

Advisory Fee Reductions/Fee Waivers[96] /Breakpoints.[97] If the contractual fee rate is reduced, original fee rates cannot be restored or otherwise increased without shareholder approval. Advisers may be more responsive to fee waivers, which could be either contractual or informal. Fee breakpoints may be appropriate if it appears that significant economies of scale occur at higher asset levels of the fund, due to the spreading of certain costs over a larger asset base. If a breakpoint arrangement is negotiated, the independent directors should determine that the benefits of the breakpoints inure to the shareholders of the fund.[98]

Expense Limits[99] /Expense Reductions. The directors could request the adviser to agree to an expense limit or cap, under which the adviser would waive fees, or reimburse fund fees or expenses, if, or to the extent that, fund expenses exceed a specified percentage. These agreements may permit the adviser to recover waived or reimbursed amounts if total fund expenses decline. If an expense limit is in place, independent directors should be aware that other arrangements made by the fund to reduce its own expenses may inure to the benefit of the adviser. Alternatively, if an affiliate of the adviser receives fees from the fund under another service contract, such as a custodial or transfer agency contract, the independent directors may seek a reduction in those service fees. If the fund uses service providers that are not affiliated with the adviser, the

96 The adviser could waive a portion of the fees due under the advisory contract for a definite or indefinite period.

97 A fund's fee rate could be reduced by lowering the contractual rate provided in the advisory contract, or through the introduction of fee breakpoints, which are reduced advisory fee rates that automatically apply under the investment advisory contract as the fund's assets under management reach pre-determined higher levels.

98 Two common breakpoint arrangements often benefit primarily the adviser: (i) when breakpoints are in a sub-advisory agreement only, and (ii) when the fund has a total expense cap (such that the reduction in advisory fees only increases the amount of expenses under the total expense cap and therefore, shareholders receive no benefit from the advisory fee breakpoint).

99 The adviser could enter into a separate agreement, which could be for a fixed contractual term or voluntarily terminable at the adviser's discretion, under which the adviser agrees to limit fund expenses to a specified percentage of assets.

independent directors should consider requesting the adviser to seek to negotiate more favorable terms from those service providers.

Performance/Service/Compliance Concerns

If a review of the fund's performance and services indicates areas of weakness, the fund's independent directors may consider some of the following measures:

Retain Consultants. Independent directors could request the adviser to engage a consultant to review the disappointing services -- such as, portfolio management, shareholder servicing or compliance. A third-party review may identify specific areas of improvement. In making this request, the independent directors should consider the cost involved in hiring a consultant. As a practical matter, the consultant must be able to work with the adviser and applicable service providers to achieve better performance in the area identified as needing improvement.

Sub-advisers. Independent directors could ask the adviser to retain a sub-adviser to tum around an underperforming fund. The independent directors might negotiate a sub-advisory arrangement for a particular fund as an alternative to replacing the adviser.

Outsourcing. Independent directors could suggest that administrative or shareholder services be performed by an entity unaffiliated with the adviser.

Cancellation. Ultimately, the independent directors may conclude that they should refuse to continue an advisory contract and seek a new adviser. In considering cancellation, directors should be mindful that shareholders implicitly choose the adviser or fund family when deciding to invest in a fund, and not the fund's directors.[100] Transferring the management of a fund from one adviser to another imposes costs on shareholders, including costs of a shareholder meeting to approve a contract with a new investment adviser, potential proxy contests and legal costs, administrative costs, portfolio management and distribution disruption (including systems changes and,

[100] To some extent, this view is supported by two recent instances where independent directors' decisions to discontinue particular advisory relationships were effectively reversed by shareholder vote. In a situation involving the Yacktman Funds, management called a shareholder meeting to replace the independent directors because management felt they did not support management's goals for the fund; the independent directors opposed the action in a proxy contest, and were essentially "fired" by shareholders. Jeffrey M. Laderrnan, *A Battle Investors Can't Win,* Bus. WK., Oct. 19, 1998, at 150; Rick Miller, *Despite Reforms, War for Independence Far From Over,* INV. NEWS, May 20, 2002, at 16. In a situation involving the Navellier Funds, the independent directors terminated the fund's advisory agreement because management had failed to provide requested financial information in connection with the fund's contract renewal meeting and had proposed that the board approve a merger agreement on short notice. The independent directors viewed the merger proposal as insufficiently supported and placed the merger proposal and a new investment advisory agreement with a different investment adviser before shareholders. Shareholders voted to restore Navellier. *Nave/tier v. Sletten,* 262 F. 3d 923 (9th Cir. 2001). In both instances, it appears that by the time of the shareholder votes the majority of the remaining shareholders approved of their fund's current management.

potentially, interrupted advisory services if the fund requires continuous management), as well as subsequent brokerage commission costs incurred in connection with portfolio changes likely to be made by the new adviser and possible income tax ramifications of those changes.

Appendix III

Practical Guidance for Fund Directors

Valuation and Pricing

Set forth below are suggested sources directors may consult for guidance in considering pricing and valuation matters. These sources are not intended to be exhaustive and there is a broad range of SEC guidance on valuation and pricing. Directors should seek advice from legal counsel and other experts regarding specific pricing and valuation issues and concerns and interpretation of the relevant SEC guidance.

<u>The 1940 Act</u>

Section 22 of the 1940 Act and Rule 22c-1 thereunder govern the pricing of securities and calculation of net asset value. Section 2(a)(41) contains the definition of "value" under the 1940 Act and Rule 2a-4 thereunder states that "Portfolio securities with respect to which market quotations are readily available shall be valued at current market value, and other securities and assets shall be valued at fair value as determined in good faith by the board of directors of the registered company." The pricing of securities and calculation of net asset value for money market funds is governed by Rule 2a-7 under the 1940 Act.

There are numerous SEC no-action letters and exemptive orders and releases regarding a wide variety of specific pricing issues.

<u>Form N-1A</u>

Item 7 of Form N-1A, the form governing prospectuses and statements of additional information for mutual funds, requires disclosure of a fund's policies for pricing and valuation. An instruction to this item states specifically:

> If a Fund has a policy that contemplates using fair value pricing under special circumstances (e.g., when an event occurs after the close of the exchange on which the Fund's portfolio securities are principally traded that is likely to have changed the value of the securities), provide a brief explanation of the circumstances and the effects of this policy.

<u>Disclosure Rule Regarding Fair Value Pricing Policies</u>[101]

On April 16, 2004, the SEC adopted rules that expand the disclosure requirements for fund pricing and valuation policies, including fair value pricing procedures. The adopting release stated:

> The required disclosure regarding the circumstances under which a fund will use fair value pricing should be specific to the fund. For example, if a

[101] Disclosure Regarding Market Timing and Selective Disclosure of Portfolio Holdings, Investment Co. Act Rel. No. 26418 (April16, 2004).

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 pncmg.

ASR No. 113[102]

ASR No. 113 was the first attempt by the SEC to provide guidance to mutual funds regarding pricing methodology. While the stated purpose of ASR No. 113 is to address the valuation of restricted securities, it is important for mutual fund pricing and valuation procedures generally. ASR No. 113 articulates two important principles: first, it distinguishes between securities for which market quotation are readily available and those which must be valued using fair value procedures and second, it recognizes the general principal that fair value pricing is a flexible concept and that directors should take into account "all indications of value available to them." ASR No. 113 defines fair value as "the amount which the owner might reasonably expect to receive for [the securities] upon their current sale."

ASR No. 118[103]

ASR No. 118 emphasizes the requirement that a board fair value securities when market quotations are not readily available. The release identifies several general factors that a board should consider in selecting a valuation method, including: (1) the fundamental and analytical data relating to an investment; (2) the nature and duration of any restrictions on disposition of the securities; and (3) an evaluation ofthe forces which influence the market in which the securities are purchased and sold. ASR No. 118 also discussed more detailed factors involved in the fair valuation process, including: (1) the type of security; (2) the financial statements of the issuer; (3) the cost of the security at the date of purchase; (4) the size of the fund's holdings; (5) the discount from market value of restricted securities from that of similar unrestricted securities at the date of purchase; (6) 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

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

103 *Accounting for Investment Securities by Registered Investment Companies,* Accounting Series Rel. No. 118, Investment Co. Act Rel. No. 6295, SEC Accounting Rules (CCH) 3750-57 (Dec. 23, 1970).

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 factors.

Revenue Ruling 59-60[104]

Revenue Ruling 59-60 of the Internal Revenue Service provides detailed guidance regarding the valuation of securities of closely held corporations and other corporation for the securities of which market quotes are not readily available. While the ruling applies primarily to valuation for estate and gift tax purposes, the factors discussed in the Revenue Ruling are relevant to valuation of similar securities by mutual funds.

Letters from the Division oflnvestment Management [105]

On December 8, 1999 and again on April 30, 2001, the Division of Investment Management of the SEC issued letters to the Investment Company Institute regarding valuation issues. The 1999 letter focuses fairly generally on pricing and valuation issues and the obligation of a board to fair value securities when market quotations are not "readily available." Discussing the Division's views regarding the "good faith" obligation of the board of directors, that letter states:

> We also recognize that different fund boards, or funds in the same complex with different boards, when fair value pricing identical securities, could reasonably arrive at prices that were not the same, consistent with the boards' obligation to fair value price in good faith. We believe that "good faith" is a flexible concept that can accommodate many different considerations, including the incorporation of a variety of sources of information. Finally, we believe that the specific actions that a mutual fund board must take in order to satisfy its good faith obligation under Section 2(a)(41) of the 1940 Act will vary, 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.
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> * * *
>
> A mutual fund board can take significant steps toward satisfying its good faith obligations prior to an emergency or unusual situation. We believe that, in general, the degree of involvement required of a board during emergencies will depend heavily on the comprehensiveness of the pricing procedures adopted for the fund and the degree of discretion vested in fund management. If, for example, a board has approved comprehensive procedures which provide methodologies for how fund management

[104] 1959-1 C.B. 237.

[105] Letter from Douglas Scheidt, Associate Director and Chief Counsel, Division of Investment Management, to Craig S. Tyle, General Counsel, Investment Company Institute (Dec. 9, 1999); *Investment Co. Institute,* SEC No-Action Letter (publ. avail. Apr. 30, 2001).

should fair value price portfolio secuntles, including procedures which would be appropriate for that particular emergency situation, a board would need to have comparatively little involvement in the valuation process in order to satisfy its good faith obligation. This necessitates, of course, that the board 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 that it make changes when appropriate.

When the board has vested a comparatively greater amount of discretion in fund management, or when pricing procedures are relatively vague, we believe that the board's involvement must be greater and more immediate. In these instances, a fund board may be required to evaluate how emergency conditions are affecting the fund's pricing mechanisms, whether the pricing procedures are appropriate, what inquiries fund management is making, and what factors management is considering when making valuation recommendations. Depending on the particular circumstances, the board may need to evaluate how particular portfolio securities are being priced, or, when the fund has limited or no fair value pricing procedures, authorize the specific pricing methodology used. In any event, given that the fund's board retains oversight responsibility for the valuation of the fund's assets, the board should receive periodic reports from fund management that discuss the functioning of the valuation process and that focus on issues and valuation problems that have arisen.

The 2001 letter expands on the Division's 1999 letter and specifically discusses issues relating to the valuation of foreign securities and valuation in case of significant events.

Appendix IV

Practical Guidance for Fund Directors

Considerations For Directors to Assist Them To Organize, Operate and Evaluate Fund Management's Valuation and Pricing Activities

The examples set forth below are intended as guidelines. Each fund board should follow the examples that make sense in view of the board's size, management structure and the type of fund or funds.

How can fund directors organize themselves to oversee fund valuation and pricing?

Among other things:

- Consider a committee charter or policy statement that clearly articulates the separation of the directors' oversight responsibilities from the daily fund management valuation and pricing responsibilities.
- Consider whether it is desirable and practical, and, if so, the extent to which independent directors should serve on fund management's valuation and pricing committee.
- Consider whether there should be special qualifications for directors to serve on the board's valuation and pricing committee
- Consider whether more than one board valuation and pricing committee should be established. For example, are the valuation issues for equity securities sufficiently different from valuation issues for fixed income securities to warrant separate committees? Or for domestic versus foreign securities?
- Consider whether, in the absence of a board valuation and pricing committee, the independent directors as a group should provide valuation and pricing oversight to fund management.
- Consider whether there needs to be a director liaison position that fund management's valuation and pricing committee can contact when difficult valuation situations arise.
- Consult with management directors who have responsibility for portfolio management when assessing the performance of management's valuation and pricing committee. However, the independent directors need to reach their own conclusions regarding the sufficiency of the valuation and pricing policies and procedures followed by management's valuation and pricing committee.
- Consult with legal counsel regarding compliance with legal and regulatory standards and with relevant public disclosures in registration statements and shareholder reports, including financial statements.

How can fund directors oversee fund management's valuation and pricing process?

The Forum recognizes that a fund's directors must rely on fund management to provide day-to-day pricing of the fund's portfolio securities and other assets. The Forum offers directors the following guidance in overseeing the pricing and valuation process, either directly or through a board committee:

- Understand the composition of fund management's valuation and pricing committee and be informed of the potential for conflicts of interest should portfolio management serve on the committee.
- Assure that the valuation and pricing policies, procedures and practices adopted are regularly reviewed and updated to be in compliance with regulatory requirements, guidance and relevant public disclosures in registration statements and shareholder reports, including the valuation policy footnote disclosures in the funds' financial statements.
- Understand the valuation process, and in particular the alternatives to a market price, such as quantitative models and dealer bid prices.
- Understand how relevant fundamental information on securities issuers is communicated to the pricing services for purposes of their determining market, matrix and fair valuations. Determine that fund management regularly reviews pricing services practices that provide market, matrix or fair valuations and that disclosure related to their services continues to be appropriate.
- Periodically review the pricing services' practices and the consistency of results with the market. Fund management and the board's valuation and pricing committee can delegate daily responsibilities for valuation to a third party, but they should consider whether it is reasonable to rely solely on the fact that valuations are provided by a third party.
- Assure that the policies, procedures and practices covering the valuation of restricted securities, thinly traded and illiquid securities, and foreign securities including foreign currencies conversion rates are regularly reviewed for continued appropriateness. Consider whether any of such valuation and pricing situations is deserving of separate policies, procedures and practices. If so, require that they be reviewed and approved by the board's valuation and pricing committee.
- Review regularly the fund management's valuation and pricing committee's actions including prices for subsequent security transactions and relevant market price movements. This review may involve presentations from fund management or the review of fund management's committee's minutes.
- Understand procedures permitting management override of valuations received from independent sources and provide for the board's valuation and pricing committee's review of such actions.
- Understand the frequency and comprehensiveness of fund management's review of the valuation of portfolio securities including the extent of the review of the

integrity of prices used in the daily net asset value determination (e.g. large change investigations and identification of stale prices).

- Understand the extent of use of valuation models for derivatives, asset-backed securities and other investments and degree to which model valuations are (or can be) compared to market transactions. Also consider the results of fund management's comparisons of model valuations to actual trades.

- Understand the extent to which security valuations are obtained from selling broker-dealers and management's efforts to confirm valuations with independent sources. Also consider who is obtaining the broker quotations; if it is the portfolio manager, additional oversight procedures may be necessary.

- Understand whether there are regular occurrences that need fair valuations and whether a policy is warranted to aid fund management in addressing the need for fair valuations.

- Understand whether management has information covering the types of events such as national, international, economic or market events that are likely to call for fair valuations.

- Understand the procedures used to determine when the market value of an investment is not readily available or deemed not reliable and that fair value should be used.

- Understand procedures employed to determine fair value when the market value of a security is not readily available, and to evaluate those determinations against any subsequently available market values or transactions.

- Understand procedures employed to monitor and adjust valuations for "significant events" such as those which indicate that closing prices in foreign markets no longer represent current value, and to compare any adjusted values to subsequent market openings values.

- Understand valuation considerations arising from restrictions on repatriation of assets from foreign countries.

- Understand procedures used by money market funds for assessing minimal credit risk and monitoring security market values to comply with Rule 2a-7 of the 1940 Act.

- Assure that valuation and pricing policies and procedures address the impact of market volatility (both domestic and foreign).

- Assess the impact of any new regulatory or standard-setter guidance (for example valuation guidance issued by the IRS) on valuation policies and procedures.

How may directors determine that valuation and pricing policies, procedures and practices are resulting in an appropriate net asset value determination to be used for mutual fund share transactions?

- Coordinate with the board's audit committee to determine the independent auditor's assessment of the valuation procedures and the appropriateness of documentation supporting the fair valuation of securities for which market quotations are not readily available and internal controls surrounding the fund's daily net asset value per share calculations.
- Discuss with the fund's chief compliance officer the results of the work performed under his direction to determine that the fund's valuation and pricing policies, procedures and practices comply with federal securities laws and regulations and the fund's disclosure statements.
- Obtain from fund management comparisons of portfolio valuations and net asset value movements for other funds known to have the same or comparable portfolio valuation and net asset value calculation issues to determine whether movements are directionally the same and if not, why not.
- Consider whether other fund families have policies, procedures and practices that produce valuations that better track with subsequent market prices and whether changes in policies, procedures and practices may improve portfolio valuations and net asset valuation calculations.
- Where fair value securities are subsequently sold, compare actual transaction prices with the earlier valuation determinations for the securities.