Report
of the
Mutual Fund Directors Forum

Practical Guidance for Directors on Board Self-Assessments

January 2008

I. Introduction

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

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

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

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

---

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

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

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

4 This report was developed by leaders in the independent director community with advice given by members of the Forum's Advisory Board, with extensive assistance from PricewaterhouseCoopers LLP. Members of the working group participated in the report in their individual capacities, and not as representatives of their organizations, the fund boards on which they serve, or the funds themselves. Drafts of this report were reviewed by the Forum's Board of Directors and Steering Committee, and their comments have been integrated into this document. The report does not necessarily represent the views of all Forum members in every respect.

II. Regulatory Requirements

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

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

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

---

5 *See* Adopting Release.

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

7 *See id.* at 3.

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

9 *See id.*

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

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

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

13 *See* Adopting Release at 9.

14 *See id.*

III. Board Accountability

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

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

IV. Asking the Right Questions

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

Number of Funds Overseen by the Board

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

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

Board Composition

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

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

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

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

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

Board Information

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

- The overall quality and timeliness of information received prior to board meetings;

- The quality of information provided to the Board related to specific areas of responsibility, including the advisory contract renewal process, fund performance, compliance, and approval of fund distribution arrangements;

- The quality of information that the board receives about service providers;

- Whether the board receives sufficient information about important issues and trends in the mutual fund industry and how those areas impact the funds;

- Whether the information addresses matters that are important to fund shareholders;

- Whether the board has sufficient access to fund officers between meetings; and

- Whether the board has sufficient access to resources, including counsel, outside auditors, and others outside of board meetings.

Meeting Process

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

- Whether the number, frequency, and locations of board meetings are appropriate;

- Whether the length of meetings is appropriate to cover all necessary information;

- Whether agenda items are appropriate and whether independent directors have sufficient input as to those items;

- Whether the meetings foster open communication, meaningful participation, and timely action; and

- Whether sufficient executive sessions are scheduled and whether they are constructive and encourage open discussion even in areas where directors may disagree.

Committee Structure

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

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

- o Whether the board has established the appropriate committees, given the fund complex's particular structure;
- o Whether the number, frequency, and length of committee meetings are appropriate; and
- o Whether the governing charters for each committee provide adequate guidelines for the operation of each committee.

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

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

Board Accountability

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

- o Whether board members are sufficiently prepared for meetings;
- o Whether directors have an appropriate understanding of the mutual fund business in order to provide adequate oversight;
- o Whether the board has a sufficient understanding of industry and fund performance data;
- o Whether the board spends its time on the appropriate items by focusing on board issues and delegating other items to management;
- o Whether the board effectively uses its chief compliance officer to provide appropriate oversight;
- o Whether the board appropriately follows up on action items from prior meetings;
- o Whether each board member understands a director's fiduciary responsibilities and adequately discharges those duties;
- o Whether there is open and honest communication between the board and management and other service providers; and

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

Other

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

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

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

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

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

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

V. Process for Board Self-Assessments

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

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

Discussion

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

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

- Pros and Cons of the Discussion Method

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

Questionnaire

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

- Pros and Cons in the Use of Questionnaires

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

Interview

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

- Pros and Cons of the Interview Method

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

---

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

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

VI. Use of Third Parties

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

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

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

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

---

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

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

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

VII. Individual Director Evaluations

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

Questions to Ask When Conducting Individual Director Evaluations

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

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

Individual Self-Assessments

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

Peer Evaluations

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

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

VIII. Follow-Up

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

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

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

IX. Conclusion

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

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