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MUTUAL FUND DIRECTORS FORUM

The FORUM for FUND INDEPENDENT DIRECTORS

Report of the
Mutual Fund Directors Forum

Practical Guidance for Mutual Fund Directors

Board Governance and Review of Investment Advisory Agreements

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Table of Contents

The Forum's first report, *Best Practices and Practical Guidance for Mutual Fund Directors*, was published in July 2004. The "best practices" described in that report were developed at the request of then-SEC Chairman William Donaldson and covered board review of management agreements; soft dollars, directed brokerage, and revenue sharing arrangements; valuation and pricing; and conflicts of interest between funds and advisers. Since that initial report, the Forum has published reports on more discrete topics, including risk oversight, proxy voting, securities lending, and oversight of Rule 12b-1 (which was included in the original request from the SEC, but not addressed until 2007).

The material contained in the original report contains much information that remains useful to directors today. Last year, given directors' intense interest in valuation, we updated the valuation section and published guidance in a stand-alone report. In reviewing the rest of the report, the general board governance items as well as board review of fund advisory contracts seemed the most logical next steps for an update. What follows retains much of what remains useful in the original report supplemented with new legal developments and the evolution we have witnessed in board practices.[1]

RECOMMENDATIONS TO ENHANCE THE EFFECTIVENESS OF INVESTMENT COMPANY INDEPENDENT DIRECTORS

- ***In fulfilling their duties, fund directors must act in a manner they reasonably believe to be in the best interests of the fund and its shareholders.***

  "The structure and purpose of the Investment Company Act (the "1940 Act") indicate that Congress entrusted to the independent directors of investment companies . . . the primary responsibility for looking after the interests of the fund's shareholders."[2] A number of SEC regulations focus on strengthening boards, emphasizing their independence from the adviser and its affiliates, and giving them the tools necessary to represent the interests of fund shareholders more effectively.[3] Because of their familiarity with the funds they oversee, mutual fund independent directors are well positioned to respond quickly as issues arise and satisfy themselves that the adviser acts in the best interest of the funds.

  All directors of a fund, separate and apart from their independent relationship to the fund's adviser and its affiliates[4], are fiduciaries of the fund under state law,[5] and are thus required always to place the interests of the fund first in any action they take. Due to the structure of investment companies, fund independent directors must apply these fiduciary duties in unique ways dictated by the 1940 Act.[6]

- ***Independent directors are most effective when they focus on oversight, rather than involvement in day-to-day management.***

  Directors should be aware of the inherent tension between a board's appropriate oversight role and the responsibility of fund management and service providers for day-to-day management and operations of the fund. Fund boards can best serve shareholders by providing effective oversight, such as in monitoring investment performance and the quality of the services provided by the fund's adviser and other service providers, carefully considering advisory and other fees and expenses necessary for fund operations, and protecting shareholders from conflicts that are inherent in investment management by third parties. Although the regulatory structure of mutual funds requires that directors focus on certain specific details of fund operations in order to monitor an adviser's potential conflicts of interest, directors should not use these requirements as an invitation to become involved in active day-to-day fund management.

- ***A broad and current understanding of the securities markets, the fund industry, and the practices of other fund boards can help directors fulfill their oversight role.***

  Fund independent directors often seek to maintain a broad, strategic perspective of the fund industry. Market developments such as new trading venues, increasingly complex portfolio investments, the growth of new types of funds, and regulatory changes require fund independent directors to educate themselves on these new developments in order to fulfill their oversight role. In addition, because there is no one path to becoming a mutual fund director, board members often have diverse backgrounds and can benefit from the experiences of other fund directors. As a result, directors should consider taking advantage of educational opportunities available to them, particularly with respect to important areas of responsibility with which they are less familiar.

  Boards may choose from a variety of options to gain insight into fund industry developments and governance practices of other fund boards. Directors can gain valuable knowledge about the fund industry by reading both the broad financial industry press and mutual fund and board specific publications. In addition, a variety of organizations offer formal educational programs targeted at fund directors. Finally, effective learning opportunities, especially for insight into board governance practices, often arise from fund directors' interactions with directors at other fund complexes.

  As further encouragement for directors to stay abreast of industry issues, boards may wish to require directors to attend at least one educational event per year as part of the board's self-assessment process. Board members who attend educational meetings or conference should be encouraged to report to the full board on topics of interest.

- ***Fund specific educational sessions can help fund boards better understand issues affecting their funds.***

  Many fund complexes offer periodic educational sessions to their directors on current issues. Often, the board approaches the adviser expressing a desire to learn more about a particular issue affecting the funds in the complex. These education sessions are often conducted in connection with regular board meetings. The goal of this education is not to turn fund directors into traders, risk or compliance officers, or other specialists. Rather, it can help the board understand the issues and ask better questions of the professionals who provide services to the funds in the complex.

Board Structure

- ***A fund board's leadership structure should be designed to enhance the board's ability to act independently and in a manner the directors reasonably believe to be in the best interests of the fund.***

  The independent directors should choose a structure that fosters a culture that encourages free and open dialogue among the board members and with fund management, and that enhances the role of the board and its independent directors. Selecting either an independent chair or a lead independent director may enable the board to further foster its independence.[7]

  A fund, in its statement of additional information, must describe its leadership structure, including whether the chairman of the board is an interested person of the fund. Funds with interested chairs must disclose whether there is a lead independent director and, if so, what specific role the lead independent director plays in the leadership of the board. Additionally, the fund must disclose whether its leadership structure is appropriate given the characteristics of the fund.[8] Periodic review of the required disclosure gives the board an opportunity to revisit the appropriateness of its leadership structure each time the fund's registration statement is updated. Boards typically also review the appropriateness of their structure at the time of their annual self-assessment.[9]

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

  While the 1940 Act rules require virtually all funds to be composed of a majority of independent directors,[10] most boards would benefit from a board composed of at least 75 percent independent directors to facilitate the board's independence. Having a super-majority of independent directors may prove particularly beneficial when voting on matters where the adviser's interests may conflict with those of fund shareholders.

  While a constructive relationship with management typically helps independent directors better serve their shareholders, the critical role of the fund independent directors is to serve as an independent check on management for the benefit of shareholders. Therefore, maintaining independence in substance and appearance is vital to building an effective, independent board. In addition to meeting the legal definition of independence, directors should consider whether third parties could consider the board "too close" to management – and whether, in fact, the close relationship is impairing the board's independent decision-making. By maintaining an awareness of the importance of independence, independent directors can feel confident that they have used their unconstrained judgment in their decision-making, a fact that may be critically significant in numerous contexts, including litigation.

  Although having an independent board is important, inside directors contribute insights into the fund's day-to-day operations and inside industry knowledge not generally available to fund independent directors and can make important contributions to the governance of a fund. Inside directors and fund officers, sharing their perspectives both with the board and within the adviser's or administrator's organization, enhance the recognition of the parallel fiduciary obligations of the board and the fund's service providers to the fund and its shareholders.

- ***Board size is an important consideration for fund boards, as size can directly influence the ability to function effectively as a group.***

  Choosing the appropriate size for a board is a balancing act between having enough members to represent a broad range of expertise relevant to the funds in the complex, and small enough to allow independent directors to work together efficiently as a unit. The optimal size for a board may change from time to time. For example, a board may periodically be larger in order to facilitate the transition of newer members who will ultimately replace members who are approaching retirement, or to help with the integration of a new fund complex. Adding more directors to a board also may be necessary as a complex grows and the board oversees more funds. Periodically reevaluating the board's size will help directors maintain an optimal size for the board depending on a fund's circumstances at different points in time.

- ***Many boards find that standing committees help boards fulfill their responsibilities to fund shareholders.***

  In an environment of expanding responsibilities of fund boards, both due to industry growth and increased regulatory expectations, many boards find that standing committees can help a board work effectively on behalf of fund shareholders and can greatly streamline a board's workflow. Committees may be especially helpful to large boards or those boards that oversee a large number of funds. Once the board has identified the committees that will facilitate its oversight responsibilities, care should be taken in making committee assignments to capitalize on each director's expertise and experience. In order to give all directors exposure to all board committees, some boards may choose to rotate committee assignments. In addition, boards should consider the optimal size of the committee.

  Care should be taken when establishing committees and setting the parameters of their activities is particularly important. As part of the process, directors should consider which issues will be assigned to a particular committee and how a committee's recommendations will be reported to the board. Committee charters are one effective way of specifying the roles and responsibilities of a particular committee.

  While relevant committees will vary from board to board, virtually all boards have established an audit committee that oversees the fund's financial reporting and audit process. The audit committee is typically composed entirely of independent directors, in part to avoid the requirement that fund shareholders ratify the selection of the fund's independent accountants.[11] The Sarbanes-Oxley Act requires an audit committee to disclose whether it has a "financial expert," and whether that expert is independent. Further, Sarbanes-Oxley also requires the committee to pre-approve all of the audit and non-audit services the fund's independent auditor performs for the fund. As such, the audit committee typically takes the lead in working with the fund's outside auditor. In addition, some funds have made the audit committee the primary contact for valuation issues that must be addressed by the board.

In addition to an audit committee, many funds also have a nominating committee. Funds must disclose in their proxy statements whether they have a nominating committee.[12] Because funds generally do not nominate new directors frequently, some boards choose to combine the nominating committee with a governance committee or convene an ad hoc committee when the board intends to add new directors.[13] Other relatively common board committees include compliance and/or governance committees, investment committees, contract committees, and pricing and valuation committees. Boards also may find risk committees, either a stand-alone committee or combined with another existing committee, to be useful.

In addition to standing committees, boards may find the use of ad hoc committees helpful. These types of committees typically are established to accomplish a particular purpose, and may be more helpful than standing committees for relatively short-term issues that will not persist. In addition to director nominations, ad hoc committees may be useful to address litigation matters, regulatory investigations, fund mergers or changes in control, or accounting or tax issues.

- ***Boards can explore a variety of options to facilitate turnover, encourage succession planning, and provide opportunities to review the expertise and diversity of board members.***

  Board retirement policies are another important consideration for boards. Establishing a mandatory retirement age may help facilitate board turnover, encourage succession planning, and provide a built-in opportunity to review the expertise and diversity of board members. Exceptions to a mandatory board retirement policy should be carefully considered on a case by case basis.

  Some boards choose not to establish a formal policy because they are reluctant to lose valuable experienced directors who may have many additional productive years on the board, and use other methods to facilitate board turnover. For example, some boards have established term limits. Term limits may be particularly effective when directors are added to boards while still relatively young – without them a director could potentially spend many years on the board before reaching the board's retirement age. Some boards use the board self-assessment and/or peer review process to identify underperforming directors to avoid waiting for a director to reach a particular age.

- ***Board diversity policies can consider all types of diversity that a board may find helpful.***

  Boards should also consider whether to adopt a diversity policy. Such a policy need not focus solely on traditional diversity concepts, such as race, gender, or national origin. Instead, boards adopting such a policy can consider characteristics designed to encourage a diversity of thought on a fund board – such as education, professional background, and other similar qualities. Proxy statements for the election of directors are required to include disclosure regarding whether and how a nominating committee considers diversity in recommending board candidates.[14] While the disclosure does not require a board to adopt a diversity policy, if the board or nominating committee has one, disclosure about "how the policy is implemented as well as how the nominating committee or board assesses the effectiveness of its policy" is required.

- ***The board's structure and processes should facilitate appropriate oversight of the adviser's management of the investment, operational, and other risks associated with the fund.***

  Though the diversity of funds and fund families as well as the constantly evolving universe of market risks make it impossible to develop a one size fits all approach to risk governance, all directors should consider the adviser's culture and risk awareness.[15] Fund directors are not responsible for designing and implementing the systems and procedures that are used to identify, analyze, and track risks. Instead, boards consider such policies adopted by the adviser or other service providers with an eye toward understanding whether service providers have appropriate policies in place and are implementing those policies.

  Directors should develop a foundational understanding of the risks that arise as part of the investment management process and how their fund's adviser's (and other service providers') risk management systems are designed to operate. At a threshold level, directors should understand that the adviser has established the proper tone at the top – that is, that risk management is an important issue and that effective risk management is important to fund shareholders.

Board Communication

- ***An effective relationship between the independent chair/lead independent director and senior executives from the adviser can help foster an effective fund governance process.***

  In order to be effective, the board should strive to develop a productive relationship with fund management. Although the SEC encouraged boards to have a "healthy skepticism"[16] when dealing with fund advisers, the relationship does not have to be adversarial. In most circumstances the board and management have aligned interests in serving shareholders, and a governance process guided by an attitude of mutual respect between management and the board can better serve fund shareholders.

  The independent board leader may be in the best position to facilitate the relationship between the board and management. The independent board leader should be able to communicate with the adviser's CEO (or the most senior U.S. executive) outside of board meetings. This communication will allow the independent leader to understand issues the fund faces in a timely manner and avoid surprises at board meetings. The fund leader and adviser's senior executive can together determine the best method for communication. In addition, they can discuss how to get the most out of the meetings by determining who should attend and the types of information they plan to cover. The board should then determine if and how information provided to the independent leader would then be shared with all directors between meetings to help all board members better serve fund shareholders.

- ***Input into the board meeting agenda allows independent directors to put forth the issues that they see as most important.***

  A key responsibility of the independent chair or lead independent director is input into board meeting agendas. By having input into the agenda and facilitating discussion, the independent chair or lead independent director can focus the board's efforts on those issues important to the independent directors.[17] Fund independent chairs also may influence board meeting agendas by determining during the meeting how long the board should discuss particular agenda items.

- ***Working with the adviser over time on board materials can help boards get more usable information from the adviser, and therefore make better decisions on behalf of fund shareholders.***

  Independent board members will not be able to make valuable contributions during board discussions without sufficient information, prepared and organized in an understandable manner, about the funds and any issues they encounter. Determining the amount and type of information is a particularly important aspect to the board/adviser relationship. Fund independent directors work with their counsel and adviser to strike the appropriate balance for the types of information they receive and the presentation of that information. Standing committee chairs also can play an important role in this process. Given the increasing use of electronic board materials, some fund advisers may be inclined to provide more information than the board can practically and effectively review. The independent fund leader can become the point person with the adviser to develop board materials that provide the directors with the necessary and clearly presented information they need to oversee the funds in the complex, taking into account the adviser's capabilities to produce the reports requested by the board.

- ***Active participation in board meetings by each independent director helps the board achieve maximum benefit of each board member's experience.***

  One of the great benefits of building a board that represents a diversity of thought is that each director can bring his or her unique perspective to board meetings. By fostering active participation by each independent director both during and in between meetings, the resulting dialogue can benefit shareholders as each director is likely to approach an issue from a slightly different angle. One way to promote a culture that encourages effective communication on the board is to provide time for informal interactions among the independent directors, such as over dinner. These opportunities can help the board work together and maximize the contribution of each individual director when conducting formal business.

- ***A fund board should meet in executive session in conjunction with every board meeting.***

  SEC rules require most fund independent directors to meet at least quarterly without the interested board members.[18] As discussed more fully below with respect to the CCO and the advisory contract renewal process, these sessions encourage independent directors to speak more freely than may be possible with members of management present. By mandating the sessions, the SEC wanted to prevent any "negative inferences from attaching to the calling of such executive sessions."[19] Executive sessions provide independent directors invaluable opportunities to build a collaborative relationship that facilitates the development of a strong, more effective board than would likely be possible if the independent directors met only during regularly scheduled board meetings. The sessions also provide independent directors and their counsel the chance to discuss their views on the more sensitive issues before the board. Having these sessions prior to a board meeting can make the full board meetings more productive by identifying those issues of most concern to fund independent directors which can then be addressed during the meeting. Other boards may choose to conduct the executive session during or after the board meeting to review matters that may arise during the meeting and/or to develop "next steps," including requesting additional information on sensitive matters.

Board Use of Third Parties

- ***A fund's independent directors should employ other independent advisors and consultants when necessary to assist them in carrying out their duties.***

  Directors have authority both under applicable state law and the 1940 Act to retain experts as deemed advisable.[20] Independent directors should reevaluate from time to time whether hiring outside experts will assist the board in carrying out its fiduciary duties to the fund's shareholders. The costs of any expert assistance should generally be borne by the fund to make it clear that the consultant is responsible to the board, though the independence of a consultant should not automatically be called into question if the adviser pays for those services. When considering whether to retain an outside expert, directors should consider whether the anticipated benefits of the expert exceed the cost to retain the expert.

- ***A fund's independent directors should retain knowledgeable counsel to advise and assist them in carrying out their duties.***

  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 continual changes and reinterpretation. At least one court as well as SEC rules have highlighted the value of independent counsel.[21] Independent legal counsel can advise independent directors of their legal obligations, provide perspective on industry practices, particularly when difficult judgments must be made, and assist the independent directors in protecting shareholders from conflicts of interest.

  Should the independent directors of a fund determine not to use the services of independent legal counsel on a regular basis, the board periodically may wish to reconsider that decision, particularly if a specific conflict arises and is reported to the board. In addition, as discussed more fully below, many boards find independent counsel especially helpful during the 15(c) advisory contract renewal process.

  If independent directors determine to hire independent counsel, that counsel needs to be independent under SEC rules.[22] 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.

Counsel for the independent directors may also serve as counsel to the fund. For most purposes, the interests of the fund are aligned with those of independent directors who oversee the fund on behalf of shareholders. The decision to engage counsel to serve independent directors and the fund simultaneously is left to the board's discretion, and directors can consider its comfort level with sharing counsel with the funds, the cost and likely benefits of the arrangement, and any other factors necessary to make the decision.[23]

- ***A fund's board should seek to ensure that it uses the fund's chief compliance officer effectively, especially with respect to identifying and resolving conflicts.***

  One of the most transformative changes to the mutual fund industry in recent years, particularly for the day-to-day functioning of mutual fund boards, is the requirement that funds have a chief compliance officer (CCO). Seeking to provide fund boards with additional insight into compliance issues, in 2003 the SEC adopted Rule 38a-1. The rule requires funds, among other things, to appoint a CCO who is "competent and knowledgeable regarding the federal securities laws" and "empowered with full responsibility and authority to develop and enforce appropriate policies and procedures for the fund."[24]

  The fund board appoints the CCO and approves the CCO's compensation. In addition, the board may fire the CCO at any time, and further, may prevent the adviser (or other service provider) from doing so. Through the CCO, fund boards now have "direct access to a single person with overall compliance responsibility for the fund who answers directly to the board."[25]

  The CCO annually must report to the board regarding the operation of the fund's policies and procedures and those of its service providers. The report must, at a minimum, address: the operation of the policies and procedures of the fund and each service provider since the last report; any material changes to the policies and procedures since the last report; any recommendations for material changes to the policies and procedures as a result of the annual review; and any material compliance matters since the date of the last report.[26] Should any serious issues arise in the interim, the CCO should notify the board promptly. In addition to receiving the CCO's report, directors must meet in executive session with the CCO at least once a year, giving the CCO the opportunity to speak freely regarding any "sensitive compliance issues of concern, including any reservations about the cooperativeness or compliance practices of fund management."[27]

  While the CCO is required to provide a formal report and meet in executive session with the board once a year, most boards find more frequent communication useful. Many fund boards meet separately with the CCO during each regular board meeting. Because the CCO works with the adviser daily, he or she has direct insight into how the adviser is carrying out the fund's compliance policies. In addition, the CCO can identify problematic patterns in the implementation of procedures.

To facilitate communication between meetings, some boards find it helpful to establish a compliance committee, give an existing committee responsibility for compliance matters, or identify a particular board member to confer with the CCO. By doing so, the board and CCO agree on how information between meetings should be conveyed to the board.

When employing a CCO, boards should consider whether it would be appropriate for the CCO to also serve as the CCO, or other member of the compliance staff, for the fund's adviser (or other service provider). Although a CCO's complete independence from the adviser may enhance objectivity, a board may find that a CCO with dual roles is better integrated with fund operations and less dependent on the adviser for information.

- ***Compensation is a key consideration in attracting and retaining qualified personnel to serve as the CCO to a fund.***

  Compensation is a key consideration as fund complexes try to attract and retain qualified personnel to serve as CCO. The board must approve the CCO's compensation and any changes to that compensation. The board's role in approving the CCO's compensation is designed to alleviate the concern expressed by the SEC that the adviser could use changes in compensation to punish a CCO for sharing adverse information with the board.[28] Despite the board's approval, however, making compensation decisions can be challenging because CCOs often serve in the role both for the fund and the fund adviser (or in some capacity as a member of the adviser's compliance staff). The board may wish to consider how the CCO's compensation compares with compensation of other employees of the adviser; pay parity with other employees may be particularly important given that the CCO's success is partly driven by the relationships with other employees of the adviser. While the compensation structure should be sufficient to attract and retain qualified candidates, boards also may be concerned that a CCO's compensation could create an incentive for the CCO to favor the adviser at the expense of the fund. There is no one formula to determine the CCO's compensation, and different boards will reach different conclusions as they weigh these important considerations.

- ***A fund's independent auditor can serve as a valuable resource to fund boards.***

  In addition to the CCO, another third party that all boards have access to is their independent auditor. Independent auditors must certify the fund's financial statements and review certain items in other periodic fund filings.[29] The fund's independent directors select the fund's independent auditor.[30] The audit committee approves the scope of the fund audit, as well as its anticipated cost. Because of the direct relationship between the board and the independent auditor, the auditor can serve as another resource to the board. The auditor will typically discuss the results of the audit in an executive session, allowing a free exchange of ideas. Further, the auditors' experience with other clients can help provide a broad perspective on industry practices.

Compensation Issues

- ***Compensation levels and structure can be important in attracting and retaining highly qualified directors.***

  Director compensation is important in attracting and retaining highly qualified directors. Some factors that a board may consider when setting compensation include: (i) 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; (ii) the number of funds in the complex and the complexity of each fund and the fund complex as a whole; and (iii) each fund's investment strategies, policies, and objectives. In addition, as workloads increase, more directors may find it difficult if not impossible to maintain other employment, increasing the opportunity cost of serving on a fund board. In order to avoid undue adviser influence, a fund's independent directors should have sole responsibility either acting as a group or as a committee, for determining their compensation.

  When setting director compensation, the independent directors should consider the aggregate amount of compensation as well as the appropriate split between a retainer and per meeting fee. In some cases, board members may receive an all-inclusive fee combining a retainer and meeting attendance, independent of additional fees paid to board or committee chairs. Boards may find comparison to broad industry compensation data helpful in setting compensation amounts.

- ***A routine schedule for reevaluating director compensation can help a board stay competitive in attracting and retaining qualified board members.***

  Like most governance issues, compensation decisions should be revisited periodically in light of changes in the fund complex (such as increases or decreases in assets under management, changes in the complexity of funds offered in the complex, etc.). In addition to reviewing the aggregate compensation, reevaluating the split between the retainer and per meeting fees is important to understand whether the current structure remains appropriate in light of changes to the board's operations, whether with respect to board participation as a whole or with respect to a director's role on board committees.

- ***Boards may wish to encourage or require fund independent directors to use a portion of their compensation to invest in funds in the complex.***

  Ownership of fund shares by fund directors may help further align the directors' economic interests with those of shareholders of the fund or fund complex.[31] Directors' share ownership is required to be disclosed in the fund's SAI.[32] Boards may wish to consider developing a policy relating to director ownership of fund shares. Some complexes require that directors invest in all funds in the complex while others specify a minimum investment in one or more funds in the complex. A board should consider the type of funds in its complex when determining the appropriate investment policy as certain specialized funds may not be appropriate investments for all directors.

Board Self-Assessments[33]

- ***Boards should ensure that every director participates fully in the board's annual self-assessment.***

  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.

- ***The board should plan follow-up action based upon the conclusions of the self-assessment process.***

  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 opportunity to improve their processes over time. Where change is indicated, 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 CCO, management, or other appropriate parties. Boards may find it useful to review the action plan at each meeting to ensure that the board continues to monitor its progress throughout the year.

Board Oversight of Valuation[34]

- ***Independent directors have a statutory obligation to determine the fair value of securities for which market quotations are not readily available.***

  Fund directors have a statutory obligation to determine the fair value of securities for which market quotations are not readily available; however, boards can and do delegate the day-to-day responsibility for determining the valuation of particular securities to the fund's adviser. Delegating the day-to-day task of valuing portfolio securities to the adviser does not absolve boards of responsibility for the process; directors should develop an understanding of the adviser's process and valuation resources in order to provide adequate oversight. Further, boards should determine the form and frequency of reporting on valuation in light of the portfolio investments in the complex. By providing oversight of the valuation process, fund directors not only fulfill their statutory valuation responsibilities, but also provide a valuable risk oversight function for the funds they oversee.

RECOMMENDATIONS FOR THE REVIEW OF MANAGEMENT AGREEMENTS AND MANAGEMENT FEES

- ***Independent directors play a fundamental role in the contract renewal process.***

  Reviewing and approving a fund's advisory contract is a core duty of independent fund directors. As the Supreme Court has said, "scrutiny of investment adviser compensation by a fully informed mutual fund board is the cornerstone of the effort to control conflicts of interest within mutual funds."[35] However in spite of the importance of the board's approval of the advisory contract, the 1940 Act itself provides little guidance on what directors are to do or on what basis they should approve the contract.

  To be specific, the 1940 Act provides that any fund advisory contract will lapse unless either a majority of the fund's full board or its shareholders approve its continuance annually (following the initial two-year term of the contract). In addition, in order to limit the influence of interested members of the board, a majority of the independent directors also must approve each advisory contract annually. The 1940 Act mandates certain additional procedures for the annual review, including

  - that the annual review process occur at an "in-person" meeting,
  - that the board request "such information as may be reasonably necessary to evaluate" the terms of the advisory contract, and
  - that the investment adviser furnish that information.[36]

  While the 1940 Act requires an in-person meeting to approve the contract, directors generally do not review the advisory contract solely at a single point in time. Directors generally receive at each board meeting information that is relevant to the annual consideration of renewal. 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.

  The oversight provided by independent directors is, in part, a continual review and discussion with the adviser concerning matters of interest to the fund and its shareholders. Apart from the adviser's legal obligations as a fiduciary, its 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.

  For most boards, the formal 15(c) meeting process begins with a formal request for information from the adviser and others who provide services to the fund. Case law[37] and statements by the SEC and its staff traditionally have influenced the types of information that independent directors request and evaluate. More important, however, is the independent directors' assessment of what information they need to effectively review the contract and the adviser's performance. Normally, counsel to the independent directors will provide directors with a memorandum outlining the board's legal obligations, relevant case law, and key factors to take into account as they consider approval or renewal of the agreement with the adviser. The decision whether to renew the contract (in either identical or amended form) is committed to the business judgment of the board. In designing and conducting the 15(c) process, directors should therefore seek information regarding those issues they see as relevant or potentially relevant to their decision about the contract.

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

- assess the quality of the adviser's services in relevant areas and
- determine whether the advisory contract, principally in terms of its fee structure in relation to the services provided, is in the best interests of fund shareholders.

In describing the contract renewal process, both the courts and the SEC have emphasized directors' 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. Precisely how the SEC and the courts discuss directors' obligations has, however, evolved over time. For example, recent court decisions, including the Supreme Court's decision in *Jones v. Harris Associates* have noted the potential relevance of factors including:

- The quality and nature of the services provided by the adviser to the fund;
- The fund's investment performance;
- The profitability of the adviser and its ability to achieve economies of scale as the size of the fund grows;
- Fees charged by the fund's adviser to other clients for similar services;
- Fees charged by other advisers to similar funds.

Moreover, the importance of many of these factors is highlighted by the requirement that the board annually describe to shareholders why it renewed the advisory contract, and in doing so note its consideration of certain of these factors specifically.[38]

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."[39] In 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 guidance provided below is applicable to all services provided to a fund by its affiliates.

- ***Independent directors should be fully informed about their responsibilities in reviewing a fund's investment advisory contract.***

  The directors' responsibilities under the 1940 Act during the advisory contract review process have been examined and explained in numerous court decisions. It is important for directors to be fully informed about applicable judicial and regulatory guidance regarding their responsibilities, including factors they should consider in evaluating an investment advisory agreement.[40] Before the independent directors complete their review of an investment advisory contract, independent counsel should provide them with a memorandum describing their legal obligations.

  Because the advisory contract renewal process is highly technical, even boards who do not have independent legal counsel on an ongoing basis may find consultation with independent counsel helpful during the process. Legal guidance by independent counsel also can aid directors in conducting their process so as to facilitate compliance with the fund's disclosure responsibilities. The SEC requires that fund shareholder reports and proxy statements contain details about the board's deliberations during the advisory contract renewal process.[41] While the disclosure is similar to the factors laid out in Gartenberg, independent counsel can help boards structure a process that will create a record that includes the mandatory disclosure items, or provide sufficient information regarding why a particular factor is not relevant for a particular fund.[42]

- ***Independent directors should review the fund's advisory contract in accordance with a defined process.***

  A thorough process of reviewing relevant documentation during the advisory contract renewal process helps to protect the fund and the adviser from claims that the adviser violated its duty to the fund's shareholders.[43] This protection is not available, however, if the independent directors did not receive complete information or did not carefully consider the information that was provided.

  This process might include:

  - preparation of a written request to the adviser requesting information that the board or committee believes is necessary or desirable to evaluate the advisory agreement;
  - receipt of the adviser's report in response to the board or committee's request and including any other information that the adviser believes may be helpful;
  - review and deliberation of the response and further requests to the adviser, if necessary;
  - discussion with the adviser; and
  - a final board decision.

- ***A fund's board may find that a contract review committee, consisting of some or all of the fund's independent directors, is helpful in overseeing the contract review process.***

  Boards may find that a contract review committee, consisting of some or all of the board's independent directors, is an effective way to manage the process of reviewing a fund's advisory contract, and potentially contracts with other service providers as well. The board may assign this role to a separate board committee or add this responsibility to an existing board committee.

  As part of the decision-making process, the board should consider the appropriate role of that committee within the board's governance structure. The committee's charter should define the scope of the committee's duties in the advisory contract renewal and fee negotiation process. In addition, boards may wish to authorize expressly the committee in the charter to use outside experts, including independent counsel, to facilitate the committee's work. Because the contract review process is such an integral duty for fund independent directors, the written charter also should require that the committee report to the full board regarding its deliberation of and recommendation for adoption or continuation of the advisory agreement, with or without modification of its terms.

- ***Fund directors can reach a more informed conclusion regarding a fund's advisory contract by understanding both the adviser's business as well as the asset management business generally.***

  Familiarity with the fund adviser's business may help directors evaluate the fundamental question of whether the adviser has adequate resources to remain in the fund business. Additionally, a board may gain insight as to whether to adviser's resources are sufficient to allow investment in the fund business which, over time, has a direct impact on shareholders' experiences with the fund. Further, a deeper understanding of the adviser may help directors identify conflicts that may arise as a result of the adviser's other business activities.

  One important aspect of the adviser's business for boards to consider is the adviser's services to non-fund investment advisory clients. The fees the adviser charges to non-fund clients, particularly those that employ a similar investment strategy to the fund, may be relevant to the board's review of the fund's advisory contract. Directors must use their business judgment regarding whether and how to weigh any factor including fees charged to other clients of the adviser.

  While an adviser's services to non-fund clients may be a factor in the board's decision of whether to approve the advisory contract, the fee the adviser charges for these services is not determinative nor even necessarily relevant to a board's decision on a fund's advisory contract. For example, a board may decide that the services provided to other clients are so dissimilar that comparison of the fees charged to those clients with the fund's fee is not helpful.[44] Even if a board decides that such comparisons are relevant to its evaluation of the reasonableness of the fees in the advisory contract, the board has discretion to evaluate similarities and differences in the services provided, and fee parity is not required. Boards are therefore able to use their familiarity with the funds they oversee to evaluate the appropriateness of an adviser's services and fees.

- ***The decision regarding whether to approve a fund's advisory contract is committed to the business judgment of the board.***

  The 15(c) process is not intended to be formulaic; neither is it intended to be a "check the box" process. The decision whether to approve the advisory contract is one that is committed to the business judgment of the board; indeed, as the Supreme Court has noted, when independent directors have conducted a fully-informed review process, "their decision to approve a particular fee agreement is entitled to considerable weight, even if a court might weigh the factors differently."[45]

  While the Gartenberg case laid out the factors that directors may find helpful in approving an advisory contract (and the Supreme Court reaffirmed those factors in Jones v. Harris Associates), a board is not required to consider those, or only those, factors. A board is always free to identify those and any other factors that it considers relevant and include them in its consideration of the advisory contract, determine that the circumstances they face render other factors less relevant, and weigh the factors in their analysis as they see fit. Doing so allows directors to determine whether renewing the investment contract is in the interests of the fund's shareholders. Because independent directors are free to weigh different factors as they see fit, deliberations by fund boards may vary significantly from fund complex to fund complex. Similarly, boards make decisions on a fund-by-fund basis, so the same board may view factors differently across all the funds in a particular complex.

- ***Independent directors, working in conjunction with their counsel, should seek to obtain all information reasonably necessary to review the contract from the fund's investment adviser and should prepare and submit to the adviser a formal written request seeking this 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 provide it with information reasonably necessary to evaluate the contract. The request should be in writing, generally prepared with the assistance of counsel. In addition, the adviser is obligated 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 15(c) request can include a question requiring the adviser to state whether there is any information that has not otherwise been requested that the adviser believes the board should know about as part of the board's evaluation of the advisory contract.

  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 agreement. For example, if the adviser provides investment advice to non-fund clients, the request might seek information concerning the fees charged to those other accounts. Further, the Section 15(c) request should include appropriate questions about any services other than investment advice (such as fund administration) included under the advisory contract. 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 the sub-advisory relationship will depend on the terms of that relationship.[46] As with other aspects of a fund's relationship with the adviser, the 15(c) request is likely to evolve over time as both the board and the adviser gain experience surrounding the process.

- ***The ability to review a fund's performance track record provides directors with meaningful information necessary in the board's evaluation of the fund's advisory contract.***

  Fund performance is one of the most significant factors in a shareholder's decision to invest in a particular fund offered by a particular adviser; therefore, directors and advisers both have a keen interest in examining a fund's performance relative to its benchmark and/or peer group as well as the drivers of that performance. Given its importance, directors do not review performance only in connection with the advisory contract renewal process, but rather regularly throughout the year. The ability to review a fund's track record provides directors with meaningful information necessary to evaluate a fund's advisory contract.

  Directors may use a variety of tools to evaluate fund performance. In addition to comparing the fund's performance to its benchmark and/or peer group, directors may wish to use performance attribution, review risk adjusted returns, and other common risk metrics as appropriate. The types of metrics a board uses to evaluate its performance will vary based on the types of investments that are held by the fund as well as the strategies employed. Expanding performance review to include risk-based factors can provide boards with a picture of how a particular fund portfolio is being managed, and therefore give the board additional information on which to base its consideration of the fund advisory contract.[47]

  In addition to providing reports to the board, meetings with portfolio managers can provide additional insight into fund performance. The portfolio manager can provide information about the composition of the portfolio, as well as the manager's plans for the fund going forward. The board would then have an opportunity to ask questions directly of the individual in charge of the fund's investment decisions. Operational efficiency may require that boards that oversee large complexes develop a schedule regarding how often a portfolio manager from a particular fund participates directly in a board meeting.

- ***Factors other than performance are helpful in evaluating the quality of the service that the adviser provides to a fund.***

  While investment performance is a significant in a board's review of the adviser's performance with respect to a particular fund, other factors also can help a board assess the quality of the services the adviser provides the fund. In addition, the board may wish to consider the adviser's record regarding its administrative and compliance services. For example, the board may wish to consider the number of issues raised by the SEC staff during SEC inspections as well as the board's view of the adviser's follow-up; the independent auditor's assessments of systems and operations evidenced by SOC 1 reports; or similar items. While these sorts of metrics may be more difficult to evaluate than the objective performance numbers, the alternatives can provide independent directors with valuable insight into the adviser's performance.

- ***Before approving a proposed contract, the independent directors should meet in executive session without any interested directors or other representatives of the adviser and its affiliates present to discuss the factors they find relevant to their decision to approve a proposed contract.***

  An executive session without any representatives from management can provide the independent directors a valuable opportunity to consider a fund's advisory contract. Directors may feel more free to discuss any reservations about the contract when no management representatives are present. Further, funds are required to disclose the material factors and conclusions that formed the basis for the board's decision regarding whether to renew the advisory contract. The executive session can help directors focus on these factors as well as establish a record to support the board's conclusions.

ENDNOTES

1 This publication has been reviewed by the Forum's Steering Committee and approved by the Forum's Board of Directors, although it does not necessarily represent the views of all members in every respect. One representative from each member group serves on the Forum's Steering Committee. The Forum's current membership includes over 758 independent directors, representing 121 independent director groups. Nothing contained in this report is intended to serve as legal advice. Each fund board should seek the advice of counsel for issues relating to its individual circumstances.

2 Burks v. Lasker, 441 US 471, 484-485 (1979).

3 *See, e.g.*, Compliance Programs of Investment Companies and Investment Advisers, IC- 26299 (August 20, 2008) requiring that funds designate a chief compliance officer who reports directly to the fund's board. See also Role of Independent Directors of Investment Companies, IC-24816 (February 27, 2001) requiring funds who rely on commonly used exemptive rules to have a board composed of a majority of independent directors, independent directors to be selected by current independent members of the board, and any counsel to the fund board be independent of the fund's investment adviser. See also Investment Company Governance, IC-26520 (July 27, 2004) requiring boards to meet in sessions separate from management, conduct annual board self-assessments, and giving boards the ability to hire employees and experts necessary to carry out their duties.

4 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 "independent" or "disinterested directors." The definition of "interested persons" is set out in Section 2(a)(19) of the 1940 Act.

5 *See* Jean Gleason Stromberg, *Governance of Investment Companies*, in *Investment Company Regulation Deskbook* Section 4.1-2 (Amy L. 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.

6 *See, e.g.,* Robert Robertson, *Fund Governance: Legal Duties of Investment Company Directors*, Section 2.01 (Law Journal Press 2007).

7 Most fund boards have determined that an independent chair or lead independent director is the appropriate board structure. *See Overview of Fund Governance Practices 1994-2010*, Investment Company Institute and Independent Directors Council, available at http://www.ici.org/pdf/pub_11_fund_governance.pdf ("Overview of Fund Governance Practices"). In 2010, 88 percent of survey participants had either an independent chair or lead independent director. The Forum's original report, *Best Practices and Practical Guidance for Mutual Fund Directors* (July 2004) recommended that "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."

8 *See* Item 17(2)(b) of Form N-1A.

9 Board self-assessments are discussed more fully below in the section "Board self-assessments."

10 Rule 0-1(a)(7)(i) requires that funds relying on a number of exemptive rules under the 1940 Act (including Rules 12b-1, which allows fund assets to be used for distribution and Rule 18f-3 which permits funds to offer multiple classes) have a board composed of a majority of independent directors (as defined by the 1940 Act). In 2010, 91% of complexes had boards comprised of at least 75% independent directors. *See* Overview of Fund Governance Practices at 6.

11 *See* Rule 32a-4 under the Investment Company Act. Further, exchange traded closed-end funds are required to have audit committees consisting solely of independent directors.

12 Because independent directors of funds that rely on several common exemptive rules must select and nominate other independent directors, many funds choose to create a nominating committee even though the disclosure requirement does not require them to do so.

13 Rule 0-1(a)(7)(ii) requires that independent directors select and nominate other independent directors if the fund relies on certain common exemptive rules.

14 *See* Item 407(c) of Regulation S-K.

15 For more information about a board's duty in risk oversight, *see* the Forum's report, *Risk Principles for Fund Directors* (April 2010).

16 *See Investment Company Governance*, Release No. IC-26343 (January 15, 2004) ("Fund Governance Proposing Release").

17 See *e.g. Fund Governance Proposing Release*. The release states, "The chairman of a fund board can largely control the board's agenda, which may include matters not welcomed by the adviser. The board is required to consider some matters annually in connection with the renewal of the advisory contract, but other matters, the board considers at its discretion . . ."

18 *See* Rule 0-1(a)(7)(vi) under the 1940 Act.

19 *See* Fund Governance Proposing Release at n.15.

20 *See* 1940 Act Rule 0-1(a)(7)(vii).

21 *See Schuyt v. T. Rowe Price Primer Reserved Fund*, 663 F. Supp 962 (S.D.N.Y. 1987), *aff'd* 835 F.2d 45 (2d Cir. 1987), *cert. denied*, 485 U.S. 1034 (1988). *See also Role of Independent Directors of Investment Companies*, Investment Co. Act Rel. No. 24816 (Jan. 2, 2001).

22 *See* Rule 0-1(a)(6)(i).

23 A recent study suggests that virtually all (91%) of boards have independent representation. Of those boards, 56% have their own counsel and 35% rely on fund counsel. See Overview of Fund Governance Practices at 16-17.

24 Compliance Programs of Investment Companies and Investment Advisers, Release No. IC-26299, 68 FR 74714, 74721 (December 24, 2003) ("CCO Adopting Release").

25 Id. at 74722

26 *See* id. at 74721.

27 Id. at 74721.

28 *See* CCO Adopting Release, footnote 77, stating "In approving a change in compensation, the board should assure itself that the chief compliance officer is not denied any customary cost of living increase or any full and customary bonus and that fund managers are not otherwise retaliating against the chief compliance officer for having taken aggressive actions to ensure compliance with the federal securities laws."

29 *See, e.g.* Section 30(g) of the 1940 Act.

30 *See* Section 32(a) of the 1940 Act.

31 *See* Interpretive Matters Concerning Independent Directors of Investment Companies, Investment Co. Act Rel. No. 24083 (October 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.")

32 *See* Item 17(b)(4) of Form N-1A.

33 For a more thorough discussion of the board self-assessment process, *see* the Forum's report, Practical Guidance for Directors on Board Self-Assessments. *See also* Board Self-Assessments: Seeking to Improve Mutual Fund Board Effectiveness, IDC Task Force Report, February 2005.

34 For a more thorough discussion of directors' valuation responsibilities, *see* the Forum's report, Practical Guidance for Fund Directors on Valuation Oversight (June 2012).

35 Jones v. Harris, slip op. at 11 (internal quotation marks and citations omitted).

36 *See* Section 15(c) of the 1940 Act.

37 The case law has developed under Section 36(b) of the 1940 Act, which is directed to the fund adviser, 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. The court in Gartenberg v. Merrill Lynch Asset Management concluded that the appropriate test is 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." 694 F.2d 923, 929 (2d Cir. 1982). The Supreme Court in Jones v. Harris Associates agreed that Gartenberg "applied the correct standard."

38 *See* Item 27(d)(6) of Forum N-1A and Item 22(c)(11) of Schedule 14A.

39 *See* Alan Rosenblat and Solomon Freedman, Duties to Mutual Funds, in 4 The Review of Securities Regulation 932 (1971).

40 The Supreme Court's decision in Jones v. Harris Associates upholds the factors outlined in Gartenberg v. Merrill Lynch Asset Management, Inc., 694 F.2d 923 (2d Cir.1982), regarding considerations that directors may find helpful in determining whether an advisory fee is reasonable. These factors include: the nature and quality of the services provided, profitability of the fund to the adviser, economies of scale, fee structures of comparable funds, and fall out benefits.

41 *See* Disclosure Regarding Approval of Investment Advisory Contracts by Directors of Investment Companies, Investment Company Act Rel. No. 26486 (June 30, 2004). Disclosure is required regarding: the nature, extent and quality of the services to be provided by the investment adviser; the investment performance of the fund and the investment adviser; the costs of the services to be provided and profits to be realized by the investment adviser and its affiliates from the relationship with the fund; the extent to which economies of scale would be realized as the fund grows; and whether the fee levels reflect these economies of scale for the benefit of fund investors.

42 The SEC has held fund independent directors responsible for inaccurate disclosure regarding a board's consideration of a fund's advisory contract. In May 2013, the trustees of the Northern Lights Fund Trust and Northern Lights Variable Trust settled SEC charges related to misleading disclosure about the board's considerations during the advisory contract renewal process. The SEC's order found that the funds' shareholder reports contained boilerplate disclosures about the advisory contract approval process that were materially untrue or misleading in violation of the 1940 Act. The trustees were charged with causing this violation because the disclosures were based on board minutes that were reviewed and approved by the trustees. See In the Matter of Northern Lights Compliance Services, LLC, Gemini Fund Services, LLC, Michael Miola, Lester M. Bryan, Anthony J. Hertl, Gary W. Lanzen, and Mark H. Taylor, Investment Company Act Release No. 30502 (May 2, 2013).

43 *See, e.g.* Jones v. Harris Associates. The Supreme Court stated "Where a board's procedure for negotiating and reviewing investment adviser compensation is robust, a reviewing court should afford commensurate deference to the outcome of the bargaining process . . . In contrast, where a board's process was deficient or the adviser withheld information, the court must take a rigorous look at the outcome."

44 As the Supreme Court cautioned in Jones v. Harris Associates, courts "must be wary of inapt comparisons."

45 Jones v. Harris Associates

46 Sub-advisory contracts are subject to the same board review and approval requirements under Section 15(c) of the 1940 Act. For more information on oversight of sub-advisers, *see* the Forum's report, <u>Practical Guidance for Directors on the Oversight of Sub-Advisers</u> (October 2009).

47 For a more complete discussion of board oversight of risk, *see* the Forum's report, <u>Risk Principles for Fund Directors: Practical Guidance for Fund Directors on Effective Risk Management Oversight</u> (April 2010).