The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

FAQ

April 18, 2021

Overview of Mutual Fund Governance

A. Fund Boards Follow Strong Governance Practices to Best Serve Shareholders

- Fund boards are robustly independent. Federal securities laws require that at least 40 percent of the directors on a fund board be "independent," as defined by SEC rule. In practice, the proportion of independent directors is significantly higher throughout the industry. In more than 90 percent of fund complexes, 75 percent or more of fund directors are independent. Moreover, 97 percent of independent directors have never been employed by the fund complex.
- Eighty-eight percent of fund boards have an independent director serving as the board's chair or as lead independent director. There is no legal requirement for a board to have an independent chair or independent lead director.
- New independent directors of a fund board are selected and nominated by the existing independent directors on the board, not by the fund's adviser.
- A fund's adviser cannot "fire" or otherwise remove an independent director.
- Independent directors—not the fund's adviser—set their own compensation.

B. Independent Directors Protect the Interests of Fund Shareholders by Serving as "Independent Watchdogs"

In broad terms, independent directors oversee the management and operations of the fund and are not involved in its day-to-day management.

A critical component of a board's oversight responsibility is to protect the fund's shareholders against potential conflicts of interest between the fund and its service providers, including the adviser.

Independent directors have a fiduciary duty to protect the interests of fund shareholders. In addition, directors must perform all their duties in "an informed and deliberate manner." Directors devote substantial time and consider large amounts of information related to various aspects of fund operations and management. This process provides fund directors with the depth of understanding that ultimately allows them to make informed decisions and fulfill their duties and responsibilities.

C. Independent Directors Rigorously Review the Advisory Contract Every Year

- In addition to their general oversight responsibilities, fund directors have specific and significant responsibilities under the federal securities laws, ranging from overseeing the fund's compliance program to approving the fees paid to the fund's adviser.
- Independent directors are required to approve the fund's advisory fees annually.

Directors exercise this responsibility with the utmost diligence and care, often consulting with independent counsel and third party consultants, reviewing hundreds if not thousands of pages of detailed information, and participating in numerous meetings throughout the year.
- Directors are not required to negotiate for the absolute lowest rate with the adviser. Instead, there is broad recognition by regulators and the courts that directors must balance a number of considerations, including the nature, extent, and quality of the services provided by the adviser. Good performance, which is ultimately what shareholders are seeking, may best be achieved by paying the adviser a competitive rate, rather than the lowest possible fee. In the fee approval process, however, directors do often require the adviser to take steps to bring fees down—steps such as breakpoints at specified asset levels, fee waivers, outright fee reductions, or service enhancements.
- Fund performance is an important component and focus of extensive board oversight. In fulfilling their oversight responsibilities, directors seek to ensure that the adviser is managing the fund in a manner consistent with the fund's stated investment objectives. Quarterly reviews with the adviser keep attention focused on performance issues until they are resolved.
- Directors have many means to carry out their duty to forcefully represent shareholders' interests and effect changes in their funds' best interests. For example, directors can require the adviser to increase the quality of its services or to take appropriate steps to improve its performance, such as by hiring a new portfolio manager for the fund, increasing the adviser's investment research capability, retaining a subadviser, or merging the fund.
- The fact that directors typically do not "fire" the fund's adviser does not indicate that directors do not forcefully represent shareholders' interests. Such a drastic step would be costly, disruptive, and, importantly, contrary to the fund's shareholder's express intention to invest with a particular money manager. Replacing the adviser is not comparable to replacing a CEO and one or two other top members of management at an operating company—it is more like replacing an operating company's entire operational staff. Because a fund's shareholders have deliberately chosen that fund on the basis of its adviser and the other reasons noted above, directors should consider replacing a fund's adviser only as a last resort, as in the case of fraud.

D. Mutual Funds Boards are Uniquely Different from Corporate Boards

- Directors of mutual fund boards and corporate boards both oversee management and operations and have a fiduciary duty to protect the interests of shareholders. The focus of fund directors, however, is different, due to the unique structure of mutual funds. Because a fund has no employees and relies on the adviser and other service providers to carry out the fund's day-to-day operations, the board focuses on the performance of these entities under their respective contracts and monitors the potential conflicts of interest that can arise between them and the fund.
- A mutual fund board is not the board of the fund's adviser. Thus, while the fund board oversees the services the adviser provides to the fund, it does not oversee the management or operations of the adviser. Decisions regarding, for example, the hiring, firing, and compensation of the adviser's employees should be left solely to the adviser.
- Most mutual fund boards employ governance models that reflect the unique structure of funds and fund complexes. Because all of the funds within a fund complex usually

receive necessary services from the same entities, are served by common personnel, and are organized around common operating features, fund boards employ a "unitary" board model (a single board overseeing all funds in the complex) or a "cluster" board model (two or more separate boards each overseeing a group of funds with the complex) to oversee multiple funds. These governance models allow directors to provide efficient and effective oversight on behalf of fund shareholders.

For more information on fund governance, please see IDC's [Frequently Asked Questions About Mutual Fund Directors].
