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BEFORE THE

INVESTMENT COMPANY INSTITUTE
ADVISORY GROUP

ON

BEST PRACTICES FOR FUND DIRECTORS

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Good afternoon. My name is David A. Sturms. I am a partner of the Chicago-based law firm of Vedder, Price, Kaufman & Kammholz.

I am pleased to appear before this Advisory Group today to discuss the subject of independent investment company directors and the various ways to enhance their effectiveness. I wish to thank the members of the Advisory Group and the Investment Company Institute for this opportunity to address you.

In my practice, I represent independent directors, investment companies and investment management firms. Prior to the private practice of law, I was a principal of an investment management firm (Stein, Roe & Farnham) for close to ten years. As a result, I have been fortunate to see the mutual fund industry from a variety of perspectives.

Your mission, as I understand it, is to prepare a report on the best practices of mutual fund boards, focusing, in particular, upon the role of the independent directors. Inherent in such an undertaking is finding ways to enhance the effectiveness of independent directors in performing their duties under the Investment Company Act. However, as I'm sure you know, that is a difficult task. One of the most important elements of effective mutual fund governance is board independence and, as SEC Chairman Levitt has appropriately recognized, "independence is a state of mind." There is nothing you, I or the Securities and Exchange Commission can do to change that. We can, though, help deliver to independent directors the tools to enable them to serve adequately and effectively as "watchdogs" over the interests of fund shareholders. Unfortunately, I believe that the SEC's initiatives, to date, have been less than revolutionary. This Group, however, has the golden opportunity to deliver the blueprint for an effective and enhanced corporate governance scheme to serve the industry and shareholders even better for years to come.

At the outset, I would like to emphasize that most of the independent directors that I have had the pleasure of working with seek to perform their duties conscientiously, with dedication and with independence. It is also important to note that, in my experience, the relationship between the independent directors and management works best when it is a cooperative one, not an adversarial one. As an industry leader once told me, an "ideal" independent director is "management's best friend — the type of friend that will take the keys away when you've had too much to drink."

Nevertheless, the Investment Company Act places a unique statutory burden on independent directors to serve as "watchdogs," a role that can only be performed if such directors are and act independent from management. Towards that end, I submit my "Top Ten List" of best practices for fund directors. If some of my comments sound like they have been borrowed from luminaries such as Ira Millstein and organizations such as CalPERS, it's because they have been.

I. A ***significant*** majority of the board should be independent directors.

SEC Chairman Levitt has recommended that independent directors constitute a majority of the board. That's all right as a minimum threshold, but as a "best practice" I would suggest that independent directors should constitute a *substantial* majority of the board — two-thirds or perhaps 75 percent. This is the growing trend in corporate America; investment companies should follow suit. I would not, however, go so far as to suggest that all the directors should be independent (even though it works well for bank-sponsored funds). A number of independent directors that I've talked to invite and appreciate management participation on the board — in part because, as a fellow directors, they share liability and vote in tandem with the independent directors.

II. Independent directors should be self-nominating.

This does not mean that management could not or should not be able to suggest or meet potential candidates. They should. But, the process and ultimate selection should

be under the control of the independent directors. It would be troubling if, for example, the independent directors only considered and selected from management's nominees.

III. The board should have an audit and a governance committee, each of which should consist of *only* independent directors.

First, most publicly traded companies are required to have audit committees comprised of independent directors. Moreover, this "best practice" has been emphatically embraced by the recent report of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees. This, along with many of the other recommendations contained in that Report, is equally applicable to investment companies.

Second, if independent directors were self-nominating, a nominating committee comprised of independent directors would logically follow. But I've suggested more: a governance committee responsible for the overall governance of the board, which would include nominating directors for board membership, and, as I'll discuss later, much more.

IV. Independent directors should have counsel that is separate and independent from management.

This practice, while commonly cited, is often confused. There are three common models of legal representation that provide for counsel to the independent directors that is separate from counsel to the adviser.

In the first model, the independent directors, the investment company and the adviser each retain their own separate counsel. This is the ultimate degree of separateness.

In the second model, one counsel represents the investment company and the adviser, while the independent directors retain their own separate counsel. This model is premised on the notion that the fund and the adviser are essentially synonymous and, therefore, one counsel represents those parties while another counsel represents the independent directors.

In the third model, one counsel represents the investment company and the independent directors and another counsel represents the adviser. This model is premised on the belief that the fund and the independent directors are essentially synonymous, and that any conflict is with the adviser, which retains its own counsel.

Although any of the three models can, depending upon the circumstances, achieve the goal of giving the independent directors adequate counsel, the type of structure employed can affect the access to information and the influence that the independent directors have over fund matters. In my experience, the third model (where one firm represents the independent directors and the fund) is by far the most efficient and logically consistent with the goals of the 1940 Act. I have yet to see an instance where the interests of the independent directors and the fund shareholders were not aligned, yet I have seen many instances in which counsel representing only the independent directors has less access to information, which in turn, dilutes or even blocks the information flow to the independent directors. As the Fund Director's Guidebook of the American Bar Association notes:

> Whether to retain separate counsel for the independent directors is dependent on a number of factors. Counsel with no material relationship with the investment adviser or its affiliates frequently acts both as fund counsel and counsel for the independent directors. In other cases, the relationship of fund counsel to management warrants having the directors retain separate counsel. The size and complexity of a fund group may also warrant retaining separate counsel who can focus on the needs of the independent directors. In lieu of regular, separate counsel, the board might consider independent counsel on an *ad hoc* basis with respect to specific matters. The decision to retain separate counsel may be a question of economics as smaller fund groups may not have the asset base to afford regular separate representation. There is no "bright line" test, but generally it is important that the independent directors have ready access to counsel who views the board and the fund, not the adviser, as the client. (emphasis added).

No matter what structure is employed, however, the decision on counsel selection should rest with the independent directors, who can determine which structure and which counsel best serves the interests of the independent directors, the fund and the fund's

shareholders. This would place the selection of counsel to the fund and, if determined appropriate, separate counsel for the independent directors on a par with the selection of independent public accountants for the fund, which must be approved by a majority of the independent directors.

V. The independent directors should meet periodically alone, without management present.

These meetings should be scheduled and should be held away and separate from full board meetings.

Separate meetings provide independent directors the opportunity to react to management proposals and/or actions in an environment free from formal or informal constraints. They also provide an opportunity for dialogue between and among independent directors that facilitates a more open and timely exchange of ideas, perspective and beliefs.

As the National Association of Corporate Directors Blue Ribbon Commission on Director Professionalism stated: "Regularly scheduled executive sessions set an expectation that private discussions among independent directors will be held as a matter of course, thus disarming concern over an action that may otherwise be perceived as unusual or threatening."

Having separate meetings of independent directors away and apart from full board meetings also avoids the awkward experience of having management "cooling its heels" outside in the hallway.

VI. The board should have a "lead" independent director.

An independent board needs independent leadership. As is true of corporate boards, however, the role of chairman is typically filled by a "management" director, often the chief executive officer of the investment adviser. While in some cases the role of a non-executive chairman has developed, an independent lead director concept seems to fill the void and is an effective way to enhance the role of the independent directors.

The purpose of creating a lead independent director position is not to add another layer of power, but to ensure thoughtful organization of, and accountability for, the execution of certain critical independent director functions. These functions could include, among other things: (i) delegating the appointment of committees and committee chairpersons to the independent directors; (ii) allowing for periodic meetings of the independent directors to review performance of the investment adviser and other matters; (iii) providing independent directors with a greater voice in the establishment of the meeting agenda; (iv) serving as the principal contact for the engagement of independent service providers working for the fund, and (v) facilitating communications between the independent directors and other constituencies, such as the investment adviser and other service providers.

VII. The interests of independent directors and shareholders should be aligned through a formal stock ownership program.

It is widely recognized that it is important to align the interests of directors and shareholders both in fact and in appearance. Again, looking to corporate America, many institutional investors and corporate governance groups have set forth guidelines on director stock ownership, and many companies have adopted plans whereby they pay directors partly or completely in company stock.

Application of general corporate governance standards to investment companies, however, is not without difficulties. Ownership of shares in every fund governed may be onerous because fund investment objectives may not be appropriate for each director (e.g., a state specific tax-exempt fund). Further, for regulatory reasons, stock options and other such traditional forms of equity ownership are not available for investment company directors. Nevertheless, a significant ownership stake in each of the funds subject to a director's purview can lead to a stronger alignment of interests between that director and the shareholders he or she represents.

Each board should determine the levels and time periods for stock ownership requirements. As a starting point, though, I suggest you look at the recommendation of Management Practice, Inc. that (i) at least 50 percent of director compensation be paid in

shares of the funds served and (ii) directors must own shares in each fund governed in an amount equal to at least one year's compensation accumulated over no more than a three-year period. Others have suggested stock ownership guidelines that require total amounts for a fund complex, while allowing each director to allocate assets among the various funds. While this may better fit the director's investment needs—and mailbox—it does not directly align director and shareholder interests. Perhaps, at a minimum, the directors should have a meaningful investment in each major type of fund in the complex.

A final and important benefit of director stock ownership is that directors become more aware of customer service issues, having an opportunity to read routine mailings and interacting, as a shareholder would, with the fund's various service providers. Indeed, rather than the monetary linkage, this may be a more important thread that ties together the interests of directors and shareholders. This benefit is diluted, however, if the directors are given a special number to call, or if their accounts are coded for "kid glove" handling.

VIII. The independent directors should adopt guidelines that address the competing time commitments they face when directors serve on multiple funds and/or other boards.

Board membership, for an investment company or otherwise, requires an appropriate amount of time and effort. In addition to near-perfect attendance at board and committee meetings, board membership requires rigorous preparation, undivided attention and active participation.

We are all familiar with the spate of recent lawsuits that have challenged board independence on the basis of multiple interlocking directorships. While I believe that these attacks on independence were not well founded, these suits do bring to our attention the subject of how many mutual funds any one person can reasonably oversee. I am a strong believer in the so-called "pooled" board structure. It offers administrative economies for the funds, the directors and the adviser. It broadens the knowledge and experience of each director and allows for consistent policies and procedures within a fund complex. It may also put a board in a more effective bargaining position. But, at some point, there has to be a limit. Each fund that a director oversees increases that

director's workload and responsibility. At some point, administrative economies are offset by the lack of attention that can effectively be given to each and every fund. Where that limit must be drawn will vary among fund groups, but it must be recognized and addressed. As the National Association of Corporate Directors notes (albeit in a much different context): "In addition to limitations of the calendar, which restrict the amount of time available for thinking, advising, and preparing for and attending meetings, there are limitations of the mind, which restrict the number of companies for which a director can maintain current knowledge."

More significant than focusing on the number of funds a director oversees, boards need to address the time commitments necessary to prepare for, attend and constructively participate in board meetings for those that they do oversee. Board members should be given the agenda and meeting materials as far in advance of the meeting as possible. Board meetings should be structured so that agenda items can be given proper attention without the burden of "watching the clock." Nothing is more stifling than a group of men and women with flights to catch or other pressing commitments. The board should determine the number, length and location of its meetings. While the number of meetings that a board finds necessary will vary, anything less often than quarterly is insufficient. For larger complexes, six to eight meetings per year, or even monthly meetings, may be required. Two- or three-day meetings may also be appropriate. In my experience, shorter, more frequent meetings are more productive than fewer, lengthier meetings.

Finally, while they are not universally accepted, I find multi-day offsite meetings particularly helpful (away from the distractions of the corporate office environment).

IX. The independent directors should establish written performance criteria for the investment adviser and regularly review the adviser's performance against those criteria.

The Investment Company Act is unique in that it requires the independent directors to annually review and renew the service contract for the fund's most important service provider, the investment adviser. I know of no other regulatory scheme that requires such a periodic and formalistic review.

The press and others, however, have alleged that this annual review is nothing more than a rote process. They point to the lack of action by independent directors in holding down management fees or replacing poorly performing advisers as *prima facie* evidence that independent directors are not looking after shareholders' interests.

We all know, as I discussed at the recent SEC Roundtable on Independent Investment Company Directors, that as a practical matter independent directors lack an essential element of arm's-length bargaining: the freedom to terminate the negotiations and to bargain with other parties for investment advisory services. But maybe that's OK. Many independent directors believe that investors buy the adviser, not the directors, fully cognizant of the adviser's investment capabilities, track record and the fees charged, and that the directors should not substitute their judgment for that of the investors *so long as* the adviser continues to provide the product chosen by the investors, the fees are not excessive and the adviser is not in violation of the law.

The key, then, is to establish a written, structured program to measure whether the investment adviser is delivering on its promise to shareholders and, if it is not, how to deal with poor performance. All too often these issues are addressed in an ad hoc manner, leaving independent directors with the choice of a pea-shooter or the nuclear bomb, neither of which is usually productive or beneficial to shareholders.

Rather, the independent directors, working with the adviser, should establish written performance criteria and regularly review the adviser's performance against those criteria. Most importantly, there should be an agreed upon process for addressing poorly performing funds. This process should not be left to "15(c) meetings," with merely an "approve" or "disapprove" decision.

X. The board should adopt its own written statement of its own governance principles, and regularly re-evaluate those principles.

As articulated in the National Association of Corporate Directors Report on Director Professionalism, adopting a written statement of governance principles serves two purposes: first, it shows that directors understand their role and the importance of independence, and second, it demonstrates that directors have taken steps to exercise their

authority in this role. In addition to being adopted, governance principles should be formally reviewed on a periodic basis (at least every two years). In addition, the directors should consider periodically reviewing and evaluating the performance of the board. This is not an easy task and if not undertaken in a cooperative spirit could threaten collegiality. But it is perhaps one of the most important steps towards increasing the effectiveness of the board.

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Again, I wish to thank you for the opportunity to appear before this Advisory Group. The mutual fund industry has been a tremendous success for the investing public and mutual fund sponsors. Despite some recent criticisms, the corporate governance structure, including the requirement of independent directors, has served this industry remarkably well for nearly 60 years. The efforts of this Group will surely contribute to making a good structure even better. I look forward to your report, urging you to be aggressive, and perhaps even controversial, as you lay the groundwork for the next 60 years and beyond.

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