ICI ADVISORY GROUP ISSUES REPORT REGARDING BEST PRACTICES FOR FUND DIRECTORS

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On June 24, 1999, a special panel (the "Advisory Group") of the Investment Company Institute issued a report in which it provided a series of recommendations designed to enhance the role of independent investment company directors and the effectiveness of fund boards generally. Although a number of the practices recommended by the Advisory Group go beyond what is required by law and regulation, the Advisory Group recommended that the specific practices outlined in the Report be considered for adoption by all fund boards.

The Advisory Group was created in response to a Roundtable on the Role of Independent Investment Company Directors held by the Securities and Exchange Commission in February 1999 and to subsequent comments by SEC Chairman Arthur Levitt indicating that the SEC would consider proposing regulatory initiatives to improve the oversight of funds by independent fund directors. The Advisory Group released the Report following consultations with a variety of experts in the fund area

Listed below are the specific recommendations outlined in the report, along with a brief discussion.

1. The Advisory Group recommended that at least two-thirds of the directors of all investment companies be independent directors.

The Advisory Group believed that this requirement would help assure that independent directors control the voting process, particularly on matters involving potential conflicts of interest with the fund's investment adviser or other service providers.

2. The Advisory Group recommended that former officers or directors of a fund's investment adviser, principal underwriter or certain of their affiliates not serve as independent directors of the fund.

The Advisory Group acknowledged that former officers and directors of the fund's investment adviser or principal underwriter often may be desirable candidates for board membership because of their knowledge of the industry, the fund complex and the operations of the adviser and/or underwriter. However, the Advisory Group stated that such prior service may affect the director's independence, both in fact and in appearance.

The Advisory Group did not apply the standard to former directors and officers of all affiliates of the fund's adviser and underwriter; however, it did note that the board's nominating committee should carefully consider any such relationships in assessing a candidate's independence.

3. The Advisory Group recommended that independent directors be selected and nominated by the incumbent independent directors.

The Advisory Group stated that independent directors are uniquely qualified to evaluate a present or prospective director's independence. Moreover, the Advisory Group indicated that control of the nominating process by the independent directors would help dispel any notion that the directors are "hand picked" by the adviser and therefore not in a position to function in a true spirit of independence. It is important to note that funds that adopt distribution plans pursuant to Rule 12b-1 under the Act are already required to provide that independent directors select and nominate their own successors.

4. The Advisory Group recommended that independent directors establish the appropriate compensation for serving on fund boards.

The Advisory Group stated that placing control over compensation in the hands of the independent directors and not with fund management would help ensure the independence and effectiveness of the board.

5. The Advisory Group recommended that fund directors invest in funds on whose boards they serve.

The Advisory Group felt that share ownership by fund directors serves to align their interests with those of fund shareholders. The Advisory Group noted that, in particular, directors could learn more about the quality of shareholder services provided by a fund group if they personally experience those services from a shareholder's perspective. As a result, the Advisory Group recommended that investment company boards in each complex adopt a policy requiring fund directors to invest in one or more (though not necessarily all) funds on whose boards they serve.

6. The Advisory Group recommended that independent directors have qualified investment company counsel who is independent from the investment adviser and the fund's other service providers. The Advisory Group also recommended that independent directors have express authority to consult with the fund's independent auditors or other experts, as appropriate, when faced with issues that they believe require special expertise.

The Advisory Group noted that experienced counsel can help ensure that directors understand their responsibilities, ask all pertinent questions and receive the information necessary to carry out their responsibilities. The Advisory Group stated that counsel to the independent directors must be independent from the adviser and other fund service providers in order to render objective advice on areas of potential conflict between the fund and its service providers.

The Advisory Group also noted that use of independent consultants may be necessary if the directors are to be effective on matters that are beyond their experience and the expertise of their counsel. The Advisory Group indicated that consultants also may give the directors a sense of common practices in the industry.

7. The Advisory Group recommended that independent directors complete on an annual basis a questionnaire on business, financial and family "relationships, if any, with the adviser, principal underwriter, other service providers and their affiliates.

8. The Advisory Group recommended (1) that investment company boards establish Audit Committees composed entirely of independent directors; (2) that the Audit Committee meet with the fund's independent auditors at least once a year outside the presence of management representatives; (3) that the Audit Committee secure from the auditor an annual representation of its independence from management; and (4) that the Audit Committee have a written charter that spells out its duties and powers.

9. The Advisory Group recommended that independent directors meet separately from management in connection with their consideration of the fund's advisory and underwriting contracts and otherwise as they deem appropriate.

The Advisory Group believed that separate meetings of the independent directors, outside the presence of management representatives, can enhance independence and effectiveness. It added that separate meetings would be especially important on such matters as a management proposal for a fee increase or other significant change in the terms of the arrangement between the fund and its affiliated service providers, or questions involving claims against the adviser or its affiliates.

10. The Advisory Group recommended that independent directors designate one or more "lead" independent directors.

The Advisory Group noted that a lead director could help coordinate activities of the independent directors, such as by chairing separate meetings of the independent directors (see Recommendation 9 above) and by raising and discussing issues with counsel. This lead director also could act as a spokesperson for the independent directors in between meetings of the board since, from fund management's perspective, it can be useful to have a contact person among the independent directors with whom management can discuss ideas informally. The Advisory Group noted that there may be less need for a lead director in the case of smaller boards. The Advisory Group emphasized that the designation of one or more persons as lead director would not in any way diminish the obligations or commitment of the other directors.

11. The Advisory Group recommended that fund boards obtain directors' and officers'/errors and omissions insurance coverage and/or indemnification from the fund that is adequate to ensure the independence and effectiveness of independent directors.

The Advisory Group noted two recent situations where fund management sought to resolve serious differences with the independent directors through litigation. The Advisory Group noted that these scenarios showed the importance of ensuring that independent directors be able to take whatever action they believe in good faith to be necessary for the protection of shareholders without concern over personal liability from litigation, particularly litigation with fund management. Since such litigation can be extremely expensive, the Advisory Group felt that the lack of adequate insurance coverage or indemnification might discourage independent directors from acting aggressively in the interests of fund shareholders and even discourage qualified individuals from serving as independent directors.

The Report outlined a number of factors to be considered in determining whether such coverage is adequate. These include: (i) whether the insurance policy would provide coverage in instances in which a fund's independent directors and its investment adviser are opposing parties in litigation, (ii) whether the insurance policies and/or indemnification provisions in fund charters or bylaws provide continuing coverage for claims arising in connection with their service as directors after the directors stop serving on the board and (iii) whether directors would have adequate coverage if the policy subsequently is terminated or modified.

12. The Advisory Group recommended that investment company boards of directors generally be organized either as a unitary board for all the funds in a complex or as cluster boards for groups of funds within a complex, rather than as separate boards for each individual fund.

The Advisory Group stated that it did not believe that service on more than one board within the same fund complex would compromise the independence of directors, particularly where independent directors control the nominating process and set their own compensation. To the contrary, the Advisory Group stated that service on multiple boards enables independent directors to become more familiar with the aspects of fund operations that are complex-wide in nature. Such service also could give independent directors greater access to the fund's adviser and greater influence with the adviser than if there were a separate board for each fund in the complex.

13. The Advisory Group recommended that fund boards adopt policies on retirement of directors.

The Advisory Group stated that boards should provide for administration of retirement policies by independent directors or a committee of independent directors in order to prevent fund management from having control over their implementation. The Advisory Group added that the board should consider whether setting a specific mandatory retirement age would enhance the board's effectiveness. It noted that the board should balance the need for fresh perspectives against the benefits that the experience and institutional memory of existing directors can provide. The Advisory Group noted that some boards have instituted retirement policies that require board members to step down upon reaching a designated age. The Advisory Group noted that, as an alternative, boards may wish to consider setting specific term limits on the service of fund directors.

14. The Advisory Group recommended that fund directors evaluate periodically the board's effectiveness.

The Advisory Group stated that it can be helpful for boards to step back periodically and review their overall performance. While the Advisory Group did not think it feasible to list specific criteria against which a board should measure its effectiveness, it did list several examples of issues that directors might consider, including: (i) whether the frequency of board meetings is appropriate, (ii)whether the materials provided to the board are useful, sufficient, and properly focused and whether such materials are received far enough in advance of the meeting to allow for a thorough review, (iii) whether the board focuses on the most important matters and whether an appropriate amount of meeting time is devoted to issues that the independent directors consider to be most important, (iv) whether there is sufficient opportunity for the independent directors to meet separately from management to consider agenda and other issues, (v) whether board members participate actively, ask pertinent questions and contribute meaningfully to the board's deliberations, (vi) whether the board's ability to handle its workload efficiently and effectively would be enhanced by a different form of organization, (vii) whether the board has the right mix of backgrounds, skills and experience, and (viii) whether the board understands and is in agreement with fund management's objectives and criteria for evaluating whether those objectives have been achieved.

15. The Advisory Group recommended that new fund directors receive appropriate orientation and that all fund directors keep abreast of industry and regulatory developments.

The Advisory Group noted that such orientation can be conducted by fund management or fund counsel, for example, at a special meeting. It added that this can be done in many ways, including by regularly reviewing written materials that address industry and regulatory topics, by holding special sessions of the board that focus on particular topics or by attending conferences and educational seminars.

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If you have any questions concerning this report, please do not hesitate to contact Gary S. Schpero (212-455-3665), Sarah E. Cogan (212-455-3575) or Cynthia Cobden (212-455-7744).

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