Interval Fund Governance Considerations

Role of the Interval Fund Board

All interval funds must be governed by a fund board of directors. Like a corporate board of directors, the board of an interval fund registered under the Investment Company Act of 1940 (the "1940 Act") has a fiduciary duty to represent the interests of the fund's shareholders. The operations of the fund, however, are clearly different than those of a corporation. With very few exceptions, 1940 Act registered interval funds have no employees. As such, the fund board relies on various service providers to manage the fund's operations. The primary service provider is the fund's investment adviser. Additional key service providers include fund administrator and accountant (often the same firm), the fund's chief compliance officer, and the fund's independent auditor. As a fiduciary, the fund board should continually assess the performance of the fund's service providers, their respective fee arrangements, and the conflicts of interest that each service provider may have with the fund and its shareholders.

In practice, all registered funds likely have at least one service provider with an inherent conflict—most commonly, the adviser. Due to advisory fees being charged on either net assets or managed assets, the adviser may be incentivized to take risks it would not normally consider. The fund board should consider the potential mitigating factors and the level of conflict it deems acceptable given the fund's structure and goals.

Fund Board Activity Level

The fund board's chief role is to provide oversight for the fund and its shareholders—not to be involved in the fund's day-to-day management. Even still, the fund board oversees the management and operations of the fund, as the ultimate decision-maker on behalf of shareholders. This means that, depending on a fund's investment strategy and structure, the fund board could meet along with the fund's key service providers only once per quarter, or it may need to meet more often. Generally, most registered fund boards have four quarterly meetings with the investment adviser, CCO, administrator and accountant, along with perhaps two additional meetings during the year for "special" or non-regular matters.

Directors oversee the performance of the fund, the agreement with and fees paid to the adviser for its services, conflicts of interest, and the fund's compliance program, among other things.

Portfolio Management and Fund Operations

It is *not* the fund board's role or responsibility to make portfolio management decisions or make recommended investments for the fund or its adviser. The fund board delegates operational responsibility to the fund's officers. The fund's officers oversee the day-to-day operations of the service providers. Officers typically include a President or CEO, Treasurer and CFO, Secretary and/or Chief Legal Officer, CCO, and various assistants to the roles.

1940 Act and Fund Board Independence

The 1940 Act prescribes certain requirements for fund board independence. The 1940 Act requires that at least 40% of directors be "independent" and strictly defines independence. In reality, nearly all registered fund boards are predominantly independent, as various necessary fund board approvals would not be reasonably feasible without a larger number of independent directors.

What qualifies a director as "independent"? For one, they cannot own equity or stock of the investment adviser (or any sub-adviser) or their parent companies, subsidiaries, etc. Additionally, an independent director should not have currently or during the previous two years a significant business relationship with the fund's adviser (including sub-advisers), distributor/underwriter, or their affiliates. A classic example is employment or consulting arrangements—the former is clear, while the latter is subject to counsel review and likely a facts and circumstances test (and to be safe, most counsel would likely find any direct consulting relationship to taint the independence).

A director who is not independent is considered an "interested person" under the 1940 Act. All funds should at least annually consult with their directors (most use an annual questionnaire) to determine whether any independence issues exist.

Key Members on an Interval Fund Board

A fund board will typically have four or five total members, with three to four of those members considered independent. Each fund board member may vote on matters (although interested directors may not vote on certain matters). All fund board members have equal votes. With that said, certain fund board members may fill specific roles, including the following:

- Chairman of the Board
- Chair of the Audit Committee
- Chair of the Nominating & Governance Committee
- Chair of ad hoc or other committees

Fund Board Committees

Most fund boards have established committees that focus on specific subject matters. The most common are the audit committee and nominating & governance committee. Fund board members can expect to provide additional time and effort to their committee assignments. Additionally, fund boards may often establish ad hoc committees for various unique or irregular operational matters such as capital transactions, investigations, etc.

- *Audit Committee*. The audit committee typically oversees the accounting and financial review, audit and reporting process, as well as the internal controls over financial reporting. Additionally, the committee will often oversee the fund's principal financial officer and the fund's independent auditor.
- *Nominating & Governance Committee*. The nominating & governance committee oversees the fund's process and matters related to fund board membership and fund board efficacy, including annual fund board self-evaluation, compensation reviews and recommendations, searches for new fund board members, and nominations of fund board members.

Fund Board Diversity Recommendation

Fund boards and the asset management industry have become increasingly aware of disparities in shareholder representation on fund boards. For example, a recent industry survey showed that 65% of all independent fund board members for registered funds were men, while 86% of independent fund board members for registered funds identified as white. With that in mind, some fund sponsors and fund boards have adopted policies and procedures to encourage more diverse representation in their fund board searches and nominating processes. With that said, there is currently no obligation in the U.S. for a fund board to adopt such procedures or seek to meet any diversity requirements.

Fund Board Formation Options

Interval fund managers may decide to use an existing mutual fund board or stand up a new fund board. Alternatively, management may wish to save time/money by joining a series trust platform which has a shared fund board.

A. Recruit Board Member Candidates for New Fund Board

1. **Candidates recommended by trusted service providers**
   Typically include candidates with expertise in the asset class, finance/accounting, operations, capital markets, and/or the investment management industry. Interval fund board candidates often have alternatives experience as well.

2. **Manager interviews candidates and makes selections**
   Pre-screen or evaluate candidates by determined criteria.

3. **Chosen candidates accept and are appointed at the initial fund board meeting**
   The fund board members will then oversee the fund for as long as they serve.

B. Join an Existing Series Trust Platform

In the mutual fund market, series trusts are commonly used as a way to gain economies of scale for small or new fund managers. While all closed-end funds, including interval funds, require each trust to be a separate legal trust, several fund administrators have created quasi-series trust platforms with shared fund boards and service providers to help reduce costs and speed up the product launch.

Best Practices for Fund Board Formation and Candidate Selection/Election Process

- *Experience.* The learning curve can be steep for interval funds which typically house alternative investment strategies. Interval fund boards will need a level of comfort with valuation policies and procedures for less liquid or illiquid assets. Past experience with alternative investments is a key consideration in the candidate selection process.
- *Fit Is important*. Group fit among members is important to helping with critical and complex decision making.
- *Audit Committee Chair*. It can be difficult to find an audit chair with necessary qualifications, experience and the comfort level to oversee fund audits and the principal financial officer's team. Identify candidates early in the process and determine their ability/desire to serve as an Audit Committee Chair.
- *Trustee Counsel*. Speak with the selected fund counsel and ask for recommendations. Trustee counsel and fund counsel must work closely together, so a good working relationship and experience together can be helpful to the trust and also drive fee efficiencies.
- *Candidate Availability*. Identify fund board candidates that have time to dedicate to the fund board and that can attend in-person meetings. If candidates are still working full-time, scheduling (and potentially independence conflicts) can be a challenge.

Source: XA Investments LLC

- *Geographic Location of Candidates*. Select candidates in the same time zone to ease scheduling of special and ad hoc fund board meetings—this can be especially true for funds that intend to rely on co-investment relief and have high transaction velocity. The fund boards of such funds are often required to have ad hoc meetings that need to be organized quickly.
- *1940 Act Experience*. Identify candidates (at least one) with prior board service experience on a 1940 Act fund board or a candidate with experience serving as an officer of a 1940 Act fund at an asset manager. Experience with the broader 1940 Act rules and regulations can be very helpful.
- *Prestige Is Not Important*. Because the role of the board for a 1940 Act fund is different from an operating company, there's much less (if any) value in having board members that would be seen as prestigious or (e.g., board membership for a Fortune 500 company). Fit and specific experience outlined above are more important than an impressive resume or connections.

Additional Resources for Fund Sponsors and Fund Board Candidates:

- The Informed Board Series (Skadden)
- Understanding the Role of Mutual Fund Directors (ici.org)

Source: XA Investments LLC