K&L GATES

CONTRACTUAL RELATIONSHIPS

INVESTMENT COMPANY SERVICE PROVIDERS AND THE BASIC AGREEMENTS

Most mutual funds are externally managed and do not have employees of their own. Instead, their operations are conducted by various affiliated organizations and by independent contractors.

I. INVESTMENT ADVISERS AND INVESTMENT ADVISORY CONTRACTS

A. **General Responsibilities.** The investment adviser typically is responsible for selecting portfolio investments in accordance with the objective(s) and policies established in the fund's registration statement. Investment advisers also place portfolio orders with broker-dealers and usually are responsible for seeking to obtain best price and most favorable execution for fund orders. The adviser's precise responsibilities are defined by its contract with the fund.

B. **Written Contract.** The investment adviser performs its services pursuant to a written contract with the fund.

1. Section 15 of the Investment Company Act, as amended ("1940 Act"), requires that each investment advisory contract with a registered investment company be approved initially by a majority of the fund's outstanding voting securities and by a majority of the board of directors, including a majority of the directors who are not parties to the contract or interested persons of any such party ("disinterested directors").

   a) For series funds, each series has its own advisory contract, whether in a master agreement covering other series or in a separate agreement covering only that series, and shareholder approval is by series.[1]

   b) Approval of the disinterested directors must be in person, at a meeting specifically called for the purpose of voting on the advisory contract. Voting by telephone, closed-circuit television conference or proxy does not constitute "in person" for this purpose.[2]

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[1] Rule 18f-2 under the 1940 Act.

[2] Investment Company Act Release No. IC-6336 (Feb. 2, 1971).

c) Rule 15a-4 provides relief from the shareholder approval requirement and permits an investment adviser to serve, pursuant to an advisory contract that has not been approved by shareholders, for up to 150 days after certain types of termination of an advisory contract, subject to certain further conditions. The rule treats terminations resulting from assignments in which the advisory firm or an interest in the advisory firm was sold differently from terminations resulting from an involuntary assignment (*e.g.*, one resulting from death of the controlling shareholder) or a non-renewal by the independent directors.

2. Section 15(a) requires that each investment advisory contract:

a) Precisely describe the compensation to be paid under the contract.

(1) Typically, advisory contracts provide for an annual fee rate, expressed as a percentage of the fund's average daily net assets under the investment adviser's management.

(2) An advisory contract may provide for a fee based on the fund's performance in relation to an appropriate index if it is a "fulcrum fee," *i.e.*, a fee that varies equally up and down as the fund's performance exceeds or lags the designated index.

b) Provide that it may continue after its initial term (which may be up to two years) only if its continuance is approved at least annually by the board of directors or the shareholders. Section 15(c) further requires that the continuance also be approved by the disinterested directors in person, at a meeting specifically called for the purpose of voting on continuance of the advisory contract.

c) Permit its termination by the board of directors or the shareholders at any time, without penalty, on not more than 60 days' prior written notice to the investment adviser.

d) Provide for its automatic termination in the event of its assignment.

(1) An assignment, as defined in Section 2(a)(4) of the 1940 Act, generally includes any direct or indirect transfer or hypothecation of a contract, or of a controlling block of the assignor's outstanding voting securities by a security holder of the assignor.

(a) A transfer of a "controlling block" is presumed to occur if a person who owns more than 25% of the voting securities of the adviser ceases to do so and the transfer results in another person owning more than 25% of the voting securities of the adviser.[3]

(b) However, a transaction that does not result in a change of actual control or management of the investment adviser (*e.g.*, a transfer of the current adviser's contract and its management personnel to a new entity under common control with that adviser) is not an assignment.[4]

(2) If there is an assignment, Rule 15a-4 may provide interim relief to the investment adviser and permit it to operate under a new contract prior to shareholder approval. The conditions imposed by the rule are different depending on whether the assignment involved the receipt of consideration by the adviser or a controlling person of the adviser. A fund wishing to rely on Rule 15a-4 in a case where consideration was paid must comply with the SEC's rules on director independence.

3. The advisory contract typically also addresses:

a) The investment adviser's authority in general. Particularly if the adviser may retain one or more subadvisers, the advisory contract should grant the investment adviser full authority to manage the fund so that the adviser may take over without obtaining shareholder approval of a revised agreement if a subadvisory contract terminates.

b) The investment adviser's authority to engage in soft dollar transactions. The investment advisory agreement typically authorizes the investment adviser to use brokers and dealers who provide the adviser with research, analysis and similar services and to pay such brokers and dealers a higher commission than may be charged by other brokers.

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[3] Section 2(a)(9) of the 1940 Act.

[4] Rule 2a-6 under the 1940 Act.

c) The investment adviser's standard of care. Section 17(i) of the 1940 Act prohibits an advisory contract from containing any provision that would exculpate the investment adviser from liability to the fund or the fund's shareholders for which the adviser "would otherwise be subject by reason of willful misfeasance, bad faith, or gross negligence, in the performance of his duties, or by reason of his reckless disregard of his obligations and duties under such contract … ."

d) Ownership of the fund's name. The advisory agreement may contain a provision that specifies which of the parties has rights to the name of the fund (or a portion of the name similar to that of the investment adviser) in the event the adviser ceases to provide advisory services to the fund.

4. The 1940 Act does not distinguish between contracts with investment advisers and contracts with investment subadvisers. The contract of any person who is an "investment adviser" as defined in Section 2(a)(20) of the 1940 Act is subject to the same requirements of the Act.

a) In 2003, the SEC proposed new Rule 15a-5 that would, under certain conditions, permit an investment adviser to serve as a subadviser to a fund without approval by the shareholders of the fund. The rule would eliminate the need to obtain an SEC exemptive order to facilitate so-called "manager of managers" arrangements, under which one or more subadvisers manage a fund's assets subject to the supervision of an investment adviser whose advisory contract has been approved by fund shareholders. The proposed rule would require a fund to inform investors of the identity of the current subadviser(s) managing its assets and the ability of the fund to add or replace the subadviser(s) without shareholder approval. The rule also would require the fund's investment adviser to supervise and oversee the fund's subadvisers, and that the hiring of a new or different subadviser not increase the fees charged to the fund.

b) An advisory contract with a subadviser should address the investment adviser's responsibility for an act or omission of the subadviser.

5. Apart from the more general duties that the board of directors may have under federal and state law with respect to approval of an investment advisory contract, Section 15(c) of the 1940 Act requires the board to "request and evaluate … such information as may be reasonably necessary

to evaluate the terms" of the advisory contract at issue. See "Role of Fund's Board of Directors" about directors' responsibilities regarding advisory contract approval.

II. PRINCIPAL UNDERWRITERS AND UNDERWRITING CONTRACTS

A. **General Responsibilities.** Most funds engage a separate organization, registered as a broker-dealer under the 1934 Act, as principal underwriter to distribute the fund's shares to the public. There are, however, some funds that are self-distributing.

B. **Types of Underwriting Arrangements.** Distribution arrangements with principal underwriters take several forms.

1. Some principal underwriters distribute fund shares through independent broker-dealers with which the underwriter has selling agreements.

2. Some principal underwriters employ their own sales force to distribute fund shares.

C. **Written Contract.** The principal underwriter performs its services pursuant to a written contract with the fund.

1. Section 15 of the 1940 Act requires that each underwriting contract with a registered investment company be approved initially by the board of directors, including a majority of the disinterested directors.

   a) Unlike advisory contracts, underwriting contracts need not be approved by shareholders.

   b) As with advisory contracts, approval of the disinterested directors must be in person, at a meeting specifically called for that purpose.

2. Section 15(b) requires that each underwriting contract provide:

   a) That it may continue after its initial term (which may be up to two years) only if its continuance is approved at least annually by the board of directors or the shareholders. Section 15(c) further requires that the continuance also be approved by the disinterested directors in person, at a meeting specifically called for that purpose.

   b) For its automatic termination in the event of its assignment.

(1) As with advisory contracts, an assignment is determined by reference to Section 2(a)(4) of the 1940 Act, which defines the term to include any direct or indirect transfer or hypothecation of a contract, or of a controlling block of the assignor's outstanding voting securities by a security holder of the assignor.

(a) A transfer of a "controlling block" is presumed to occur if a person who owns more than 25% of the voting securities of the adviser ceases to do so and the transfer results in another person owning more than 25% of the voting securities of the underwriter.[5]

(b) However, a transaction that does not result in a change of actual control or management of the underwriter (*e.g.*, a transfer of the current underwriter's contract and its management personnel to a new entity under common control with that underwriter) is not an assignment.[6]

(2) Rule 15a-4 does not apply to underwriting contracts.

3. The underwriting contract typically also addresses:

a) The scope of services provided. The contract typically obligates the underwriter to sell fund shares on a "best efforts" basis (rather than being obligated to sell any particular number of shares). The contract may also address other matters such as: which party (typically, the fund) is responsible for registering the fund's shares with the SEC and making required notice filings with the states; and the responsibilities delegated to the underwriter under the fund's Anti-Money Laundering ("AML") Program.

b) Expenses and compensation.

(1) Because the SEC takes the position that a fund may not use its own assets to support distribution, except pursuant to a plan adopted in accordance with Rule 12b-1 under the 1940 Act, the underwriting contract typically provides that the

5 Section 2(a)(9) of the 1940 Act.

6 Rule 2a-6 under the 1940 Act.

fund will bear the costs of preparing and distributing the fund's prospectus and statement of additional information to existing shareholders and that the underwriter will pay all distribution-related expenses, including the costs of printing and distributing the fund's prospectus, statement of additional information and other sales literature to prospective shareholders.

(2) The underwriting contract may specifically authorize the underwriter to receive all or a portion of the sales load paid by the investor, upon either the purchase or redemption of fund shares. The contract may also authorize the underwriter to receive payments pursuant to the fund's 12b-1 plan, if any.

c) Liability considerations. Both the fund and the underwriter are subject to liability under Section 12(a)(2) of the 1933 Act if fund shares are sold by means of false or misleading statements. Accordingly, underwriting contracts typically:

(1) Provide for cross-indemnification between the fund and the underwriter, depending on which party provided the information found to be false or misleading.

(2) Prohibit the underwriter from making any statements in advertising or sales literature that are not contained in the fund's prospectus or statement of additional information (or otherwise approved by the fund).

d) The underwriter's standard of care. Section 17(i) of the 1940 Act prohibits an underwriting contract from containing any provision that would exculpate the underwriter from liability to the fund or the fund's shareholders for which the underwriter "would otherwise be subject by reason of willful misfeasance, bad faith, or gross negligence, in the performance of his duties, or by reason of his reckless disregard of his obligations and duties under such contract . . . ."

e) Use of shareholder lists for purposes other than marketing of fund shares. To avoid potential questions as to whether the underwriter may use shareholder lists for non-fund purposes and whether such use may constitute an affiliated transaction under Section 17 of the 1940 Act, some underwriting agreements specify that the underwriter has an interest in and right to use the shareholder list.

f) Ownership of the fund's name. Where the fund bears the underwriter's name or other name with which the underwriter is associated, the underwriting contract may contain a provision that specifies which of the parties has rights to the name of the fund (or a portion of the name similar to that of the underwriter) if the underwriting contract is terminated.

III. ADMINISTRATORS AND ADMINISTRATION ARRANGEMENTS

A. General Responsibilities. Funds typically contract for various administrative services. These may include one or more of the following: overseeing the performance of certain other service providers to the fund; ensuring that the fund's operations comply with applicable state and federal requirements; providing support for the board of directors; providing general accounting services and internal controls; and responsibility for preparing and filing SEC, tax, shareholder and other reports.

B. Combined with Advisory Contract. In many cases, these administrative services are provided by the fund's investment adviser or an affiliate of the adviser, either as part of the investment advisory contract that is subject to the requirements of Section 15 of the 1940 Act or under a separate administrative services agreement that is not directly regulated as such by the 1940 Act. These services are also commonly provided by third parties not affiliated with a fund's investment adviser.

C. Application of Section 15. Section 15 of the 1940 Act does not apply to separate administration contracts. Accordingly, although an advisory contract may provide for other services (most commonly, administrative services), many funds enter into separate contracts for non-advisory services to avoid the application of Section 15 to these non-advisory arrangements and fees.

IV. TRANSFER AGENTS AND RELATED SERVICING ARRANGEMENTS

A. General Responsibilities. Funds typically contract with one or more persons, who may or may not be affiliated with the fund's investment adviser or principal underwriter, to provide transfer agency, dividend disbursing and shareholder servicing services.

1. A transfer agent maintains records concerning the fund's shareholder accounts, which include records of daily investor purchases, redemptions, account balances and non-financial transactions. Transfer agents typically prepare and mail to shareholders periodic account statements, federal income tax information and other shareholder notices, and frequently prepare and mail on behalf of the fund, its principal underwriter and the

broker involved, daily confirmations of transactions in fund shares. Transfer agents are regulated under Section 17A of the 1934 Act.

2. A dividend disbursing agent typically calculates dividends, directs their payment by the fund's custodian and maintains dividend payment records.

3. A shareholder servicing agent typically handles shareholder correspondence and responds to shareholder inquiries regarding the status of their accounts.

B. <u>Contracts</u>. Contracts for transfer agency, dividend disbursing and/or shareholder services are not directly regulated as such by the 1940 Act. Although the precise scope of these services is established by the applicable contract, the contracts typically require the agent to maintain the records relating to the prescribed services to the extent and in the manner required of the fund under the 1940 Act. Contracts for transfer agency and/or shareholder services also typically address responsibilities delegated to the agent under the fund's AML Program.

V. CUSTODIANS AND CUSTODY ARRANGEMENTS

The 1940 Act requires each registered investment company to maintain its "securities and similar assets" in the custody of either: one or more banks; a member firm of a national securities exchange; or the fund itself. Most funds use banks as custodians. Special rules, discussed below in Sections D., E. and F., respectively, apply to the use of central depositories and book-entry systems, margin for futures contracts and foreign custody of fund assets.

A. Bank Custody

1. To be eligible as a custodian, a bank must have aggregate capital, surplus and undivided profits of at least $500,000.

2. The SEC staff has stated that the custody contract must include provisions as to: maintenance of cash and securities in separate accounts in the name of the fund; the circumstances under which cash may be disbursed or securities delivered; the obligations of the custodian to ensure that the fund has the opportunity to vote proxies with respect to securities of portfolio companies; and care of fund assets if the custody contract is terminated.[7]

3. In addition, the custody agreement typically addresses:

[7] Appendix A to Investment Company Act Release No. IC-7221 (June 9, 1972).

a) The custodian's liability and standard of care. As required by the SEC staff position, the custody contract specifies the circumstances under which the custodian may deliver fund assets, and contracts typically hold the custodian liable for losses resulting from its failure to adhere to this standard. For other actions, the custodian typically has a negligence standard. The contract should also address the custodian's liability for acts of its agents or sub-custodians.

b) The custodian's payment of taxes, penalties or advances on behalf of the fund. Custody contracts frequently create a lien in favor of the custodian to ensure the fund's repayment of these amounts. Lien provisions should be examined carefully to be sure that they are permissible under the fund's policies and, even if so, that they do not create senior securities under Section 18 of the 1940 Act and afford the fund the flexibility to substitute assets for those subject to the lien.

4. The 1940 Act does not require that the fund's board of directors approve the custody contract, although boards commonly do so.

5. If a fund uses a bank custodian for its assets, it must also maintain its cash assets in the custody of a bank, with the exception of a checking account that does not exceed the amount of the fund's fidelity bond and a petty cash account that does not exceed $500.[8] Only the first $100,000 of fund cash held at a bank is covered by federal deposit insurance.

B. Custody with a Member of a National Securities Exchange

1. If a fund uses a broker-dealer that is a member of a national securities exchange for custody, the arrangement must be approved initially, and thereafter at least annually, by the fund's board of directors. This arrangement is rarely used.

2. Special SEC rules apply to this arrangement, including those which restrict the broker-dealer's access to fund assets and require independent audits.

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8 Section 17(f) and Rule 17f-3 under the 1940 Act.

C. Self-Custody

1. A fund may maintain custody of its assets if it meets the requirements designed to control access to fund assets and provide independent verification of their safekeeping.[9]

2. Use of an affiliated person of the fund to provide custody is treated as self-custody by the SEC staff.

D. Central Depositories and Book-Entry Systems

1. A fund's use of central depositories, such as the Depository Trust Company, and book-entry systems, such as those for Treasury securities that are operated by the Federal Reserve Banks.[10]

2. Rule 17f-4 under the 1940 Act regulates the circumstances under which fund assets may be deposited with a securities depository. Rule 17f-4 requires that a fund's custodian, when using a depository, exercise due care in accordance with reasonable commercial standards.

E. Margin for Futures Transactions

1. Margin provided by a fund for its futures contracts and options on futures contracts may be held in an account with the fund's custodian and subject to an agreement specifying the rights of the futures commission merchant ("FCM") to that margin in the event of default.

2. Alternatively, margin may be held with the FCM in accordance with Rule 17f-6, the requirements of which include:

    a) The FCM must be registered under the Commodity Exchange Act and meet certain net capital requirements and, further, may not be an affiliated person of the fund, or an affiliated person of such a person.

    b) The arrangement must be governed by a written agreement that contains certain provisions as to the FCM's compliance with segregation requirements, placement of the fund's assets with third parties, and provision of information to the SEC.

F. Foreign Custody

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9 Rule 17f-2 under the 1940 Act.

10 Rule 17f-4 under the 1940 Act.

1. The 1940 Act generally defines "banks" to include only those institutions that are organized as banks under U.S. law or otherwise subject to domestic bank regulatory authority.[11] However, a fund may maintain certain of its assets in the custody of an "eligible foreign custodian" if the other requirements of Rule 17f-5 are met and may maintain assets with an "eligible securities depository" if the requirements of Rule 17f-7 are met.

    a) Any foreign bank or trust company subject to foreign bank or trust company regulation, and any majority-owned subsidiary of a U.S. bank or bank holding company, may be an eligible foreign custodian. Generally, an eligible securities depository is a system for the handling of securities or book-entries that is regulated by a foreign financial authority, holds assets for custodians participating in its system, maintains records identifying and segregating the assets of each participant and provides periodic reports to its participants regarding its safekeeping of assets.

    b) A fund's board of directors must determine, or may delegate responsibility to a foreign custody manager (typically, the fund's custodian) to determine, that the fund's assets will be subject to "reasonable care" if maintained with a foreign bank, based on standards applicable to custodians in the relevant market. The factors that the board or foreign custody manager must consider include:

        (1) the custodian's practices, procedures and internal controls (including the physical protections available for certificated securities, the method of keeping custodial records and the security and data protection practices);

        (2) the custodian's financial strength;

        (3) the custodian's general reputation and standing; and

        (4) whether the fund can obtain jurisdiction over and enforce judgments against the custodian.

    c) A fund's board of directors must also determine, or may delegate responsibility to the foreign custody manager to determine, that the contract governing the custody relationship will provide "reasonable care" for fund assets. Generally, the contract must contain the following:

[11] Section 2(a)(5) of the 1940 Act.

(1) indemnification or insurance arrangements (or a combination of them) such that the fund will be adequately protected against the risk of loss of assets held in accordance with the contract;

(2) terms that provide that the fund's assets will not be subject to any right, charge, security interest, lien or claim in favor of the custodian or its creditors except a claim for payment for their safe custody or administration, or with respect to cash deposits, liens or rights in favor of creditors of the custodian arising under bankruptcy, insolvency or similar laws; and

(3) a provision requiring adequate records to be maintained identifying the assets as belonging to the fund or as being held by a third party for the benefit of the fund.

d) The contract may contain alternative provisions to the foregoing if the fund's board of directors or the foreign custody manager determines that those provisions, in their entirety, provide at least the same level of care and protection for fund assets as the foregoing.

e) With respect to maintaining fund assets with a foreign securities depository, the fund's contract with its foreign custody manager (or other bank engaged by the fund to provide foreign custody services) must provide that such bank or its agent will:

(1) provide the fund or its investment adviser with an analysis of the custody risks associated with use of the particular depository, before the fund places assets with the depository;

(2) monitor these risks and promptly notify the fund or its investment adviser of any material change in the risks; and

(3) exercise at least reasonable care, prudence and diligence in performing the risk analysis and monitoring specified above (and in all other conduct relating to custody arrangements).

2. In assessing foreign custody arrangements, prevailing country risks are treated as investment, not custodial, risks to be evaluated by a fund fiduciary (either the board or the investment adviser) in connection with

the decision to invest in a particular country. Recognizing the role of global custodians (typically, U.S. custodian banks that have organized networks of foreign sub-custodians) as a primary source of information concerning foreign financial systems and market practices, funds typically expect their global custodians to provide investment advisers with information to assist them in making foreign investment decisions (and, under Rule 17f-7, global custodians are required to do so with respect to foreign depositories).

VI. INSURANCE CONTRACTS

A. Fidelity Bonding

1. Rule 17g-1 requires every registered management investment company to have a bond against "larceny and embezzlement" that covers all of its officers and employees who may have access to fund assets.

    a) Because most funds do not have employees but conduct their operations through their respective investment advisers, administrators and principal underwriters, employees of these entities should be covered by an appropriate fidelity bond.

    b) Although each fund in a complex may obtain its own separate bond, they typically have joint bonds that also cover certain other affiliates.

        (1) The joint bond may include only: (i) the fund's investment adviser(s) and principal underwriter; (ii) other funds managed, or whose shares are distributed, by the same persons, or affiliates of such persons; (iii) the investment adviser(s) and principal underwriter(s) of the funds described in (ii); (iv) affiliated persons of any fund named in the bond or of a person included in (i) or (iii); and (v) certain in-house employee benefit plans.

        (2) The funds under a joint bond must enter into a written agreement with the other named insureds that provides that each fund will receive an "equitable and proportionate" share of any recovery under the bond, at least equal to what the fund would have received under a single bond of the minimum required amount.

        (3) Joint bonds must provide that the insurer will notify each other insured if an insured makes or settles a claim.

c) Rule 17g-1 prescribes the minimum amount of fidelity bond coverage required, based on the fund's assets.

(1) The minimum under a joint bond must at least equal the aggregate of the applicable minimum for each fund included.

(2) The minimum for a series investment company is determined on the basis of the company as a whole, rather than separately for each series.

(3) The SEC staff takes the position that deductibles are not permitted under Rule 17g-1; however, the staff has allowed deductibles if the investment adviser agrees to indemnify the fund(s) for any losses that, but for the deductible, would have been covered and places cash and/or cash items in an amount equal to the deductible in escrow.[12]

d) Bonds must provide that they may be canceled, terminated or modified by a party only upon at least 60 days' prior written notice to the other(s) and to the SEC.

2. At least annually, the form and amount of the fidelity bond must be approved by the disinterested directors of the fund.

a) Directors must consider all relevant factors, including: the value of the assets to which any covered person may have access; the type and terms of the safekeeping and custody arrangements for those assets; and the nature of the securities in the fund's portfolio.

b) In evaluating a fund's portion of a joint bond, directors must also consider the number of other insureds, the nature of the business activities of those insureds, the amount of the joint bond, the amount of the premium and its ratable allocation, and the amount of premium the fund would have paid under a separate bond.

3. Each fund must file with the SEC: a copy of its fidelity bond; a copy of the board resolution approving the bond; a statement of the period for which premiums have been paid; and, for a joint bond, a copy of the requisite agreement among the insureds and a statement showing the amount of the single bond the fund would have been required to maintain were it not jointly covered.

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12 See United Service Funds (pub. avail. Dec. 8, 1986).

4. Each fund must notify the SEC and all board members when it makes or settles a claim under the bond.

5. Each fund must notify all board members at least 45 days before the cancellation, termination or modification of the bond.

B. Directors and Officers/Errors and Omissions ("D&O/E&O") Liability Insurance

1. Unlike fidelity bond coverage, D&O/E&O coverage is not required by the 1940 Act; however, virtually all funds have this coverage to protect fund assets and supplement the indemnification funds otherwise typically provide to their directors and officers.

2. Under a long-standing SEC staff position, a fund may not purchase D&O/E&O insurance that would protect a director or an officer of the fund against liability to the fund or its shareholders for willful misfeasance, bad faith, gross negligence or reckless disregard of his or her duties. See Section 17(h) of the 1940 Act.

3. Many fund groups, their investment advisers, and distributors purchase insurance jointly. Joint transactions among funds and their affiliates are generally prohibited by Section 17(d) and Rule 17d-1 under the 1940 Act. However, Rule 17d-1(d)(7) permits joint liability insurance, provided certain conditions are met. Among these are review and approval by the fund board, including the disinterested directors, and coverage for the directors in good faith suits between the disinterested directors and the adviser. A fund wishing to rely on this provision also must comply with the SEC's rules on director independence.

VII. INDEPENDENT AUDITORS

A. Selection of Accounting Firm. Each fund's financial statements must be audited at least annually by an independent registered public accounting firm (the "auditor") selected in accordance with Section 32 of the 1940 Act and the rules thereunder.

1. The auditor must be selected by a majority of the fund's disinterested directors, voting in person at a meeting. Generally, the meeting must be within 30 days before or 90 days after the end of the fund's fiscal year or, for a fund within a complex of funds having different fiscal year-ends, 90 days before or after the end of the fund's fiscal year.

2. The board's selection of an auditor must be submitted to fund shareholders for their ratification at the next annual meeting. Because most open-end funds do not have annual meetings, the SEC staff generally requires a fund to submit the selection of its auditor for shareholder approval when the fund has a special shareholder meeting. Rule 32a-4 exempts funds from this requirement if they have an audit committee, composed entirely of independent directors, charged with overseeing the fund's accounting and auditing processes and operating under a written charter that sets forth the committee's structure, duties, powers and methods of operation.

3. The appointment of the auditor must be conditioned upon the fund's right, by vote of a majority of the fund's outstanding voting securities, to terminate the appointment immediately and without penalty.

B. **Defining the Scope of Services.** Although a fund's board may not review the actual agreement or engagement letter with the proposed auditor, the fund's audit committee typically receives a presentation from the auditor as to the proposed scope of services and corresponding fees and, thereafter, may meet periodically with the auditor during the course of its engagement.