

MEMO# 14461

February 14, 2002

SEC STAFF LETTER CONCERNING INDEPENDENT LEGAL COUNSEL FOR INDEPENDENT DIRECTORS

[14461] February 14, 2002 TO: BOARD OF GOVERNORS No. 5-02 CLOSED-END INVESTMENT COMPANY MEMBERS No. 6-02 INVESTMENT COMPANY DIRECTORS No. 2-02 PRIMARY CONTACTS - MEMBER COMPLEX No. 11-02 SEC RULES MEMBERS No. 10-02 SMALL FUNDS MEMBERS No. 4-02 RE: SEC STAFF LETTER CONCERNING INDEPENDENT LEGAL COUNSEL FOR INDEPENDENT DIRECTORS The staff of the SEC's Division of Investment Management has issued a letter to the Institute regarding certain questions that have arisen concerning the "independent legal counsel" provision in the fund governance rule amendments the SEC adopted early last year.¹ According to the letter, it is the staff's understanding that Institute members have raised questions about the provision, based on concerns about: (1) the potential for retroactive loss of exemptive relief if a determination by directors that counsel is independent is overturned; (2) adverse effects on funds if the ability to rely on the exemptive rules is lost as a result of discovery that counsel has performed work for an entity that could affect its status as "independent legal counsel," despite good faith reliance on counsel's representations; and (3) restrictions on the independent directors' ability to retain "special counsel" in matters not involving significant conflicts of interest between funds and fund management. Noting that compliance with the rule amendments is required no later than July 1, 2002, the letter seeks to clarify certain aspects of the independent legal counsel provision to address these questions. Potential for Retroactive Loss of Exemptive Relief The letter points out that Rule 0-1(a)(6) under the Investment Company Act, which defines "independent legal counsel," relies on independent directors to determine whether a person meets the definition. According to the staff's letter, because this determination is a 1 See Memorandum to Board of Governors No. 1-01, Closed-End Investment Company Members No. 1-01, Investment Company Directors No. 1-01, Primary Contacts - Member Complex No. 2-01, SEC Rules Members No. 1-01 and Small Funds Members No. 1-01, dated January 9, 2001. As a result of the amendments, three new conditions must be met in order for funds and their affiliates to rely on certain key exemptive rules under the Investment Company Act. One such condition is that any legal counsel to a fund's independent directors must be an "independent legal counsel." 2 matter of the directors' business judgment, it is entitled to substantial deference. The letter states that "[i]n the absence of facts showing that the independent directors have not acted in good faith or exercised care and diligence in scrutinizing conflicting representations that counsel may have, the staff would not seek to retroactively question their judgments regarding the selection of counsel." In addition, the letter expresses the staff's view that these determinations by independent directors "will and should be given the same deference by courts as other business judgment by directors." Subsequent

Discovery of Representations by Management Organizations The letter asserts that the rule itself answers the question regarding the inadvertent loss of reliance on the exemptive rules where the independent directors discover that their counsel performed work for a management organization or its affiliates. It notes that counsel must undertake to provide the directors with information necessary to make their “independence” determination; that the directors are entitled to rely on information obtained from counsel unless they know or have reason to believe it is false or misleading; and that if counsel fails to inform the independent directors that it has begun or materially increased representation of a fund management organization, the independent directors can rely on counsel’s previous representation. Therefore, according to the letter, counsel’s failure to fully inform the directors about the existence or extent of a conflicting representation would not invalidate the directors’ determination or compromise reliance on the exemptive rules.

Special Counsel The letter indicates that, in the staff’s view, the rule clearly contemplates the possibility of the directors hiring special counsel in a variety of circumstances. According to the letter, after assessing their counsel’s potential conflicts based on a variety of factors, “independent directors could retain as special counsel, in appropriate circumstances, a person who has or is representing a management organization.” The letter goes on to note that the rule does not restrict counsel for a management organization from representing the fund. It states that “the new rule imposes no limits on directors’ ability to engage a lawyer to act as a special counsel to advise, for example, on a director’s retirement plan. In such a matter the lawyer would be acting as special counsel to the fund.” * * * In closing, the letter expresses the staff’s intent to monitor implementation of the independent counsel provision and notes that the fund governance rules will be considered in the context of the planned comprehensive review of all Commission regulations.

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