The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

MEMO# 11320

October 19, 1999

SEC PROPOSES RULE CHANGES AND ISSUES INTERPRETIVE RELEASE RELATING TO INVESTMENT COMPANY DIRECTORS

1 SEC Release No. IC-24082 (October 14, 1999) (“Proposing Release”). 2 SEC Release No. IC-24083 (October 14, 1999) (“Interpretive Release”). [11320] October 19, 1999 TO: BOARD OF GOVERNORS No. 63-99 CLOSED-END INVESTMENT COMPANY COMMITTEE No. 35-99 DIRECTOR SERVICES COMMITTEE No. 25-99 SEC RULES COMMITTEE No. 79-99 RE: SEC PROPOSES RULE CHANGES AND ISSUES INTERPRETIVE RELEASE RELATING TO INVESTMENT COMPANY DIRECTORS

_____ The Securities and Exchange Commission has proposed substantive rule and form changes designed to enhance the independence and effectiveness of fund directors and provide investors with greater information about fund directors.1 The SEC also has issued an interpretive release addressing the SEC’s role in disputes involving directors and fund management, as well as other issues relating to independent directors.2 Copies of the Proposing Release and Interpretive Release are attached to this memorandum and are summarized below. The releases are also available at the SEC’s website at www.sec.gov. Comments on the rule proposals are due on January 28, 2000; the staff views expressed in the Interpretive Release became effective on October 14, 1999. If you have comments you would like to be considered for the Institute’s comment letter on the rule proposals, please submit them to Marguerite Bateman at 202- 326-5813 or bateman@ici.org, or Frances Stadler at 202-326-5822 or frances@ici.org, no later than November 22, 1999. Proposed Rule Amendments The proposals for rule and form changes fall into three categories: 1) conditions for reliance on certain exemptive rules; 2) other rule amendments relating to directors; and 3) changes designed to provide better information to investors concerning the directors of their funds. A. Exemptive Rules A large number of funds currently rely on exemptive rules under the Investment Company Act of 1940 that require fund boards to approve and oversee activities that involve 3 The rules the SEC proposes to amend are: Rule 10f-3 (permitting funds to purchase securities in a primary offering when an affiliated broker-dealer is a member of the underwriting syndicate); Rule 12b-1 (permitting use of fund assets to pay distribution expenses); Rule 15a-4 (permitting fund boards to approve interim advisory contracts without shareholder approval); Rule 17a-7 (permitting securities transactions between a fund and another client of the fund’s adviser); Rule 17a-8 (permitting mergers between certain affiliated funds); Rule 17d-1(d)(7) (permitting funds and their affiliates to purchase joint liability insurance policies); Rule 17e-1 (specifying

conditions under which funds may pay commissions to affiliated brokers in connection with the sale of securities on an exchange); Rule 17g-1(j) (permitting funds to maintain joint insured bonds); Rule 18f-3 (permitting funds to issue multiple classes of voting stock); and Rule 23c-3 (permitting the operation of interval funds by enabling closed-end funds to repurchase their shares from investors). 2 potential conflicts of interest. The proposed rule amendments would require that funds relying on any of ten commonly used exemptive rules3 meet the following additional conditions designed to enhance director independence and effectiveness: ! Independent directors must constitute at least a majority of the fund's board of directors. The Proposing Release states the SEC's belief that a fund board that has at least a majority of independent directors "is better able to perform its responsibilities of monitoring potential conflicts of interests and protecting the fund and its shareholders." The SEC seeks comment, however, on whether an even higher proportion of independent directors (e.g., a two-thirds supermajority) should be required. In addition, in a related change, the SEC proposes to temporarily exempt funds from the percentage requirement for independent directors in the event of the death or resignation of an independent director. ! Incumbent independent directors must select and nominate new independent directors. According to the Proposing Release, selection and nomination refers to the process by which candidates are researched, recruited, considered and formally named. If adopted, the proposal would apply prospectively only and funds would be required to adopt the practice before the compliance date for the amendments. The Proposing Release indicates that the proposal would not impact on the initial selection of an organizing fund's directors and would not limit the ability of public shareholders to nominate independent directors. ! Legal counsel to the independent directors must be independent. Under the proposal, a person would qualify as "independent legal counsel" if the independent directors reasonably believe that the person and his law firm, partners and associates have not acted as legal counsel for the fund's adviser, principal underwriter, administrator (collectively, "management organizations"), or any of their control persons at any time since the beginning of the fund's last two completed fiscal years. The independent directors would be permitted to make an exception if such representation was limited (e.g., it involved a "remote or minor conflict"). The provision would not preclude counsel from also representing the fund itself or the independent directors of multiple funds affiliated with the same management organization. Also, the proposal would not require independent directors to retain legal counsel. Independent directors required to seek new independent legal counsel under the proposal would not be required to do so until the compliance date set in the adopting release. B. Additional Rule Changes Other rule changes included in the proposal would: 3! Amend Rule 17d-1(d)(7) under the 1940 Act, which permits the purchase of joint D&O/E&O policies by funds and their affiliates, to make the rule available only for joint liability insurance policies that do not exclude coverage for litigation between the independent directors and the fund's adviser. The proposed amendments also would prohibit the exclusion of coverage for the fund if it is a co-defendant with an independent director in a claim brought by a co-insured. The proposal would not require that funds obtain insurance coverage or indemnification for independent directors, based on the SEC's judgment that it is appropriate to allow funds the latitude to determine which arrangements are appropriate for their circumstances. ! Exempt funds that have an independent audit committee from the requirement to have shareholders approve the fund's selection of an independent public accountant. In order to rely on the proposed exemption: (i) the audit committee would have to be responsible for overseeing the fund's accounting and auditing processes; (ii) the fund's board of directors would have to adopt an audit committee charter setting forth the committee's structure, duties, powers, and methods of operation; and (iii) the fund would have to maintain a copy of the charter. ! Amend Rule 2a-19 to prevent unnecessary disqualification of independent directors. The proposals would amend Rule

2a-19 under the 1940 Act to provide that an independent director's affiliation with a broker-dealer would be permitted under certain conditions if no more than one-half (as opposed to a minority, as currently required) of a fund's independent directors are broker-dealers or their affiliates. In addition, Rule 2a-19 currently prevents a person from serving as an independent director if he or she knowingly has any direct or indirect beneficial interest in a security issued by the fund's investment adviser or principal underwriter, or by their controlling persons. The proposal would add a new rule that would conditionally exempt an individual from being disqualified as an independent director merely because he or she owns shares of an index fund that invests in the adviser or underwriter of the fund or their controlling persons. The exemption would be available only if the value of securities issued by the adviser or underwriter or controlling person does not exceed 5 percent of the value of any index tracked by the index fund. ! The SEC also proposes to require funds to preserve any record of the initial determination that a director qualified as an independent director, and each subsequent determination of whether the director continues to qualify as an independent director. According to the Proposing Release, this requirement would permit the SEC to more effectively monitor director independence. The records would need to be preserved for a period of six years, the first two in an easily accessible place. 4C. Disclosure Requirements In an effort to improve the information available to investors about fund directors, the proposed amendments would require funds to disclose the following to supplement the information currently available in a fund's statement of additional information (SAI) and in proxy statements: ! Basic information about the identity and business experience of directors. This information would be set forth in tabular form and would combine the current disclosure found in the SAI and proxy statements. Specifically, the table would disclose for each director: (1) name, address, and age; (2) current positions held with the fund; (3) term of office and length of time served; (4) principal occupations during the past five years; (5) number of portfolios overseen within the fund complex (as opposed to the current requirement to disclose the number of registered investment companies overseen); and (6) other directorships held outside the fund complex. The table also would require that "interested" directors describe the relationship, events, or transactions that make the director an interested person. The table would be required in the fund's annual report to shareholders, the SAI and any proxy statement for the election of directors. The annual report also would be required to include a statement that the SAI has additional information about the fund's directors and is available without charge upon request, along with a toll-free or collect number to call for additional information. The SEC does not propose to require additional information about fund directors in the prospectus, although the Proposing Release requests comment on the appropriate content of and location for basic information about fund directors. ! The aggregate dollar amount of equity securities of funds within the fund complex owned beneficially and of record by each director. This information also would be presented in a tabular format and would include: (1) the name of the director; (2) the identity of the fund complex; and (3) the aggregate dollar amount of equity securities in the complex owned. The information would be included in the SAI and in any proxy statement relating to the election of directors. The proposal would not require disclosure of a director's holdings of equity securities in the fund itself. The SEC seeks comment, however, on whether the disclosure should be limited to holdings in the fund itself, the group of funds overseen by the director or some other group of funds. ! Information about interested and independent directors' potential conflicts of interest as a result of positions, interests, and transactions and relationships. According to the Proposing Release, this disclosure would permit shareholders to assess for themselves the directors' allegiances; would facilitate wider dissemination of the information to the public, media and other interested third parties; and would assist the SEC in evaluating whether it should deem the person an "interested

person” under Rule 2a-19. First, the SEC is proposing to require disclosure of positions held by a director and his or her immediate family members with the fund and certain related entities during the past five years. Second, the proposal would require disclosure concerning interests, including securities holdings, in entities related to the fund held during the past five years by the director and his or her immediate family members. Third, the proposal would require disclosure of any current or proposed transactions and the relationships of any director or his or her immediate family members with the fund and related entities since the beginning of the last two completed fiscal years. Finally, the SEC is proposing to require a fund to disclose cross- directorships, i.e., those situations where an officer of an investment adviser, principal underwriter or administrator of a fund or certain related entities serves or has served since the beginning of the last two completed fiscal years of the fund, as a director of a company of which a fund director or his or her immediate family member is or was an officer. The disclosure would include the persons or entities involved, the positions held, and the relevant period. 5! The board’s role in governing the fund’s operations. The SEC proposes to require that the factors and conclusions that formed the basis for the board's approval of the existing investment advisory contract be included in the SAI. In addition, funds would have to identify each standing committee of the board in both the SAI and any proxy statement for the election of directors. Funds also would be required to provide a concise statement of the functions of each committee; identify the members of the committee; indicate the number of committee meetings held during the last fiscal year; and state whether the nominating committee would consider nominees recommended by fund shareholders and, if so, describe the procedures for submitting recommendations. The proposed amendments would require that the information relating to independent directors, either in chart or narrative form, be presented separately from that for “interested” directors. Interpretive Release In addition to the rule proposals described above, the SEC issued a companion release that, after providing general background information: (1) expresses the views of the Commission and the staff on certain interpretive issues related to independent fund directors; and (2) briefly describes the role of the SEC with respect to disputes between independent fund directors and fund management. A. Interpretive Guidance The release provides interpretive guidance in four areas, as summarized below. ! Commission orders under Section 2(a)(19) of the Act. Section 2(a)(19)(A)(vi) and (B)(vi) of the 1940 Act authorize the SEC to issue an order finding that a person is “interested” by reason of having a “material business or professional relationship” with certain persons and entities within the fund’s preceding two fiscal years. The release discusses how the staff analyzes this issue and provides examples of the types of positions and transactions of a fund director that might result in a finding by the SEC that he or she is an “interested person” of the fund and thus ineligible to serve as an independent director. ! Independent directors and Section 17(d) and Rule 17d-1. Section 17(d) of the 1940 Act and Rule 17d-1 thereunder generally prohibit an affiliated person of a fund (which includes a fund director) or an affiliated person of such person, acting as principal, from participating in or effecting any transaction in connection with any joint enterprise or other joint arrangement or profit-sharing plan in which the fund is also a participant, unless authorized by a SEC order. Noting that it is common for fund directors to authorize the use of fund assets to make payments from which the directors may personally benefit (e.g., director salaries, board meeting expenses, proxy expenses, and legal fees of counsel to the independent directors), the release indicates that interpreting Rule 17d-1 as encompassing such actions could impede or prevent fund directors from taking actions that are in the best interests of shareholders. The release expresses the staff’s view that generally, “the actions of fund directors taken in their capacities as directors would not constitute joint arrangements for purposes of rule 17d-1,” because such actions lack the requisite element of combination between the fund

and its affiliate. ! Advances of legal expenses to independent directors. The release also clarifies when funds may advance legal fees to their independent directors. It discusses a recent staff position stating that it would be consistent with Section 17(h) of the 1940 Act and previous staff positions if legal counsel, in providing an opinion as to whether a fund should advance legal fees either to its independent 6directors or to any directors who are interested persons solely by reason of serving as fund officers, afforded the directors a rebuttable presumption that they had not engaged in "disabling conduct" for purposes of Section 17(h). According to the release, the staff believes that this rebuttable presumption should also apply when the independent, non-party fund directors, rather than independent legal counsel, make the required determination that there is a reasonable belief that a director has not engaged in disabling conduct and ultimately will be entitled to indemnification. The release also provides guidance on the degree of due diligence that the independent, non-party directors or independent legal counsel should engage in to form the basis for such a reasonable belief determination. ! Compensating fund directors with fund shares. Section 22(g) of the 1940 Act generally provides that an open-end fund may not issue any of its securities for services, or for property other than cash or securities. Noting that effective fund governance can be enhanced when funds align the interests of their directors with the interests of their shareholders, the release indicates that policies encouraging or requiring independent fund directors to invest their compensation in shares of the funds they oversee -- and under which a fixed dollar value is assigned to services provided by fund directors prior to the time that the directors perform any services or purchase fund shares -- are consistent with Section 22(g) because the directors' fees cannot be inflated under these circumstances. In addition, the release states that the staff would not recommend enforcement action to the Commission under Section 22(g) if funds directly compensate their directors with fund shares, rather than with cash that the directors subsequently are required to invest in fund shares, provided that a fixed dollar value is assigned to the directors' services prior to the time that the compensation is payable. B. Role of the SEC in Disputes Between Independent Directors and Management The interpretive release notes that the SEC has been criticized in recent years for not taking certain actions in connection with disputes between independent fund directors and fund management. It explains that the SEC's role in such disputes generally is to provide guidance regarding the requirements of the federal securities laws, investigate possible violations of these laws, and institute enforcement proceedings in appropriate circumstances when the SEC believes these laws have been violated. It also describes the procedures followed by the SEC and the staff in connection with internal fund disputes. The release states that the SEC and the staff "are committed to carefully reviewing all allegations of violations of the federal securities laws, and taking appropriate action when a violation has occurred." It further indicates that the SEC's and staff's actions, and any decisions not to act, will not necessarily be explained to the public, noting that these positions are necessary to ensure the fairness and integrity of the examination and investigative process. Craig S. Tyle General Counsel Attachments

---