

**MEMO# 12997**

January 9, 2001

## **SEC ADOPTS FINAL RULES ON FUND GOVERNANCE**

[12997] January 9, 2001 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 SMALL FUNDS MEMBERS No. 1-01 RE: SEC ADOPTS FINAL RULES ON FUND GOVERNANCE The Securities and Exchange Commission has adopted substantive rule and form changes relating to investment company governance.<sup>1</sup> The changes were proposed in October 1999.<sup>2</sup> While many of the proposed rule and form amendments were adopted essentially as proposed, the final amendments, which are summarized below, reflect several modifications in response to comments submitted by the ICI, independent directors, and others. A copy of the Adopting Release is attached to this memorandum. The release is also available at the SEC's website at [www.sec.gov](http://www.sec.gov). Consistent with the proposal, the 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 in disclosure requirements. A.

**Amendments to Exemptive Rules** The Commission has amended ten commonly used exemptive rules under the Investment Company Act of 1940<sup>3</sup> by adding three new conditions that funds relying on those 1 SEC Release No. IC-24816 (January 2, 2001) ("Adopting Release"). 2 SEC Release No. IC-24082 (October 14, 1999) ("Proposing Release"). 3 The ten rules exempt funds and their affiliates from certain provisions of the Investment Company Act. The Commission selected these rules because they involve inherent conflicts of interest between funds and their managers and therefore shareholders rely on independent directors to monitor these conflicts. The rules 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 2rules must meet.<sup>4</sup> These conditions are generally the same as had been proposed, although some clarifications and modifications have been made, as discussed below. 1) Independent directors must constitute at least a majority of the fund's board of directors, rather than the 40 percent currently required by the Investment Company Act of 1940. As the ICI recommended, the Commission adopted a simple majority independence requirement, rather than a two-thirds supermajority requirement, which had been proposed as an alternative. According to the Adopting Release, a majority independence requirement will permit, under state law, the independent directors to control the "corporate machinery"

(i.e., elect officers, call meetings and solicit proxies) and, as a result, to have a more meaningful influence on fund management and represent shareholders from a position of strength. To allow funds time to implement this provision, compliance is required after July 1, 2002. In connection with this new requirement, the Commission also adopted new Rule 10e-1, which suspends the board composition requirement temporarily in the event of the death, disqualification or bona fide resignation of a director. The final rule provides that if the remaining directors can fill the vacant board position, the suspension is for 90 days; if a shareholder vote is required, the suspension is for 150 days. This time period begins to run when the fund no longer meets the board composition requirement, even if the fund is not yet aware of its non-compliance. The effective date for Rule 10e-1 is February 15, 2001. 2) Independent directors must select and nominate other independent directors. This rule amendment, which the ICI supported, was adopted substantially as proposed. Consistent with the ICI's comments, the Adopting Release clarifies that a fund's adviser may be involved in the nomination process. The Adopting Release specifies that while the independent directors should at all times maintain control of the nomination process, the adviser may suggest candidates at the independent directors' invitation and provide administrative assistance in the selection and nomination process. In addition, the self-nomination requirement is not intended to supplant or limit the ability of shareholders under state law to nominate directors. The Adopting Release emphasizes, however, that the involvement of shareholders or the adviser does not excuse the independent directors from their responsibility to canvass, recruit, interview and solicit candidates. The Adopting Release further clarifies that the self-nomination requirement is prospective only. Current independent directors who were selected through a different process may continue to serve as independent directors but – beginning after July 1, 2002 – all new independent directors must be researched, recruited, considered and formally named by the existing independent directors. 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). 4 In response to concerns raised by the ICI and other commenters, the Commission limited the amendments to Rule 15a-4 so that the new conditions will apply only where the circumstances creating the need for an interim advisory contract were foreseeable. 33) Any legal counsel for the fund's independent directors must be an "independent legal counsel." This rule condition has been modified in response to the large number of comments the Commission received on it. The proposal defined "independent legal counsel" narrowly and, in the opinion of many commenters including the ICI, could have many unintended negative consequences including discouraging independent directors from seeking their own counsel, greatly limiting the pool of eligible counsel and, in some cases, forcing independent directors to terminate longstanding relationships with counsel. The ICI argued that independent directors should select their own counsel in the exercise of their business judgment. The Institute further urged that, if requirements relating to the selection of counsel were to be imposed, they should be process-based. Under the final rule (as under the proposal), independent directors are not required to have counsel but, if they do, that counsel must be an "independent legal counsel," as determined by the independent directors. A person (which is defined to include the lawyer and his firm, partners and employees) is considered an "independent legal counsel" if: (i) the independent directors determine that any representation of the fund's investment adviser, principal underwriter, administrator ("management organizations") or their control persons during the past two fiscal years is or was "sufficiently limited" that it is unlikely to adversely affect the professional judgment of the person in providing legal representation; and (ii) the independent directors have obtained an undertaking from the counsel to provide them information necessary for their

determination and to update promptly that information if the counsel begins, or materially increases, the representation of a management organization or control person. In connection with this analysis and the exercise of their business judgment, directors are entitled to rely on information provided by counsel. The final rule requires that the independent directors determine whether a person is an "independent legal counsel" no less frequently than annually. The basis for the determination must be recorded in the board's meeting minutes. Should the board receive information from counsel concerning representation of a management organization or a control person, the fund can continue to rely on the relevant exemptive rules for up to three months, which is designed to provide time for the independent directors to make a new determination about the counsel's independence under the circumstances or to hire a new independent legal counsel. The Adopting Release states that in making the determination of whether counsel is an "independent legal counsel," the judgment of the independent directors must be reasonable and should include consideration of all relevant factors in evaluating whether the conflicting representations are sufficiently limited. For example, the independent directors should consider factors such as: (i) whether the representation is current and ongoing; (ii) whether it involves a minor or substantial matter; (iii) whether it involves the fund, the adviser, or an affiliate, and if an affiliate, the nature and extent of the affiliation; (iv) the duration of the conflicting representation; (v) the importance of the representation to counsel and his firm (including the extent to which counsel relies on that representation economically); (vi) whether it involves work related to mutual funds; and (vii) whether the individual who will serve as legal counsel was or is involved in the representation. In the opinion of the Commission as reflected in the Adopting Release, this would exclude a lawyer from simultaneously representing the fund's adviser and independent directors in connection with matters such as the negotiation of the advisory contract or distribution plan or other key areas of conflict between the fund and its adviser. As with the board composition and self-nomination requirements discussed above, compliance with the "independent legal counsel" provision will be required after July 1, 2002.

**B. Additional Rule Changes** Other rule changes have been adopted to address: (1) limits on coverage of directors under joint insurance policies; (2) independent audit committees; (3) qualification as an independent director; and (4) recordkeeping requirements. They are described below.

**1) Joint Insurance Policies.** As the Commission had proposed, Rule 17d-1(d)(7) under the Investment Company Act has been amended so that funds will be able to purchase joint "errors and omissions" insurance policies for their officers and directors only if the policy does not exclude bona fide claims brought against any independent director by a co-insured or claims brought by a co-insured in which the fund is a co-defendant with an independent director. This provision becomes effective after July 1, 2002.

**2) Independent Audit Committees.** The Commission has adopted new Rule 32a-4, which is intended to encourage the development of independent audit committees by exempting funds that have audit committees comprised wholly of independent directors from the requirement to seek shareholder approval of the fund's independent public accountant. Consistent with the proposed rule, the final rule provides that a fund is exempt from having to seek shareholder approval if: (i) the fund establishes an audit committee composed solely of independent directors that oversees the fund's accounting and auditing processes; (ii) the fund's board of directors adopts an audit committee charter setting forth the committee's structure, duties, powers and methods of operation, or sets out similar provisions in the fund's charter or bylaws; and (iii) the fund maintains a copy of such an audit committee charter. The final rule thus incorporates the ICI's recommendation for flexibility regarding how the committee's structure and responsibilities may be documented. In addition, in response to the ICI's request for clarification, the Adopting Release specifically notes that the rule does not require that an audit committee perform daily management or supervision of the fund's

operations. The effective date for Rule 32a-4 is February 15, 2001. 3) Qualification as an Independent Director. New Rule 2a19-3 conditionally exempts individuals from being disqualified from serving as independent directors because they invest in index funds that hold shares of the fund's adviser or underwriter or their controlling persons. The rule as proposed would have applied only if the value of securities issued by the adviser or controlling person did not exceed 5% of the value of any index tracked by the index fund. The ICI disagreed that a rule was needed<sup>5</sup> but suggested, if the Commission were to proceed with a rule, that the exemption be applicable to any fund tracking a broad-based index. The Commission has modified the final rule to provide relief if a fund's investment objective is to 5 In its comment letter, the ICI recommended that the Commission clarify in the Adopting Release (as it had done with respect to actively managed funds in the Proposing Release) that a director's ownership of shares of any management investment company does not raise an issue as to independence, regardless of the nature of the fund's portfolio securities. 5replicate the performance of one or more "broad-based" indices. The effective date for Rule 2a19-3 is February 15, 2001. In addition, the Commission has rescinded Rule 2a19-1, which provides relief from Section 2(a)(19) of the Investment Company Act (defining when a fund director is considered to be independent). The Commission had proposed to amend the rule to permit a slightly greater percentage of fund independent directors to be affiliated with registered broker-dealers, under certain circumstances. As the ICI noted in its comment letter, the subsequently enacted Gramm-Leach-Bliley Act amended Section 2(a)(19) to establish new standards for determining independence under the same circumstances, thus making the proposed amendments unnecessary. The rescission will become effective on May 12, 2001. 4) Recordkeeping Requirements. Rule 31a-2 has been amended to require funds to preserve for a period of at least six years any record of: (i) the initial determination that a director qualifies as an independent director; (ii) each subsequent determination of whether the director continues to qualify as an independent director; and (iii) the determination that any person who is acting as legal counsel to the independent directors is an independent legal counsel. According to the Adopting Release, these requirements are designed to permit the Commission's staff to monitor a fund's assessment of director independence. Compliance with this requirement is required after July 1, 2002. C. Disclosure Requirements The Commission has adopted rule and form changes that will require funds to disclose additional director information beyond that currently available in a fund's statement of additional information (SAI) and proxy statements. The amendments were adopted with several modifications, including many suggested by the ICI, to tailor them more closely to the goal of providing shareholders with better information without overburdening directors. All new registration statements and post-effective amendments that are annual updates to effective registration statements,<sup>6</sup> proxy statements for the election of directors, and reports to shareholders filed on or after January 31, 2002 must comply with the new disclosure requirements. The new requirements are summarized below. 1) Disclosure of Basic Information About Fund Directors The Commission has adopted as proposed requirements that basic information about the identity and experience of directors be set forth in tabular form and included in the fund's annual report to shareholders, the SAI and any proxy statement for the election of directors. Specifically, the table must disclose for each director: (i) name, address,<sup>7</sup> and age; (ii) current positions held with the fund; (iii) term of office and length of time served; (iv) principal occupations during the past five years; (v) number of portfolios overseen within the fund 6 The Adopting Release indicates that the Commission will not object if existing funds file their first annual update complying with the amendments pursuant to Rule 485(b), unless information is included in response to the new conflicts of interest disclosure requirements, if the post-effective amendment otherwise meets the conditions for immediate effectiveness under the rule. 7 In response to

privacy concerns raised by some commenters, the Adopting Release clarifies that directors may provide the address of the fund or the fund's adviser and need not provide a personal address. 6complex (as opposed to the current requirement to disclose the number of registered investment companies overseen); and (vi) other directorships held outside the fund complex. The final rule requires disclosure in this table of the relationship, events, or transactions that make each "interested" director an "interested person" of the fund. The annual report also is 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.

2) Ownership of Equity Securities in Fund Complex The proposed requirement to disclose the amount of equity securities of funds in a fund complex owned by each fund director was adopted with certain modifications, as described below.

a) Disclosure of Amount Owned. The Commission was responsive to the views expressed by the ICI and other commenters that the proposal that funds disclose the dollar amount of directors' fund holdings was not necessary to demonstrate alignment of directors' interests with those of shareholders and would impinge on directors' privacy. Thus, as the Institute recommended, the final provision requires disclosure of a director's holdings of fund securities using specified dollar ranges rather than an exact dollar amount. The rule incorporates the following dollar ranges recommended by the ICI: none; 0-\$10,000; \$10,001- \$50,000; \$50,001-\$100,000; over \$100,000.

b) "Beneficial Ownership". The proposed requirement to disclose securities owned beneficially and of record by each director was modified to limit its scope. Based on comments received, the Commission revised this provision to use a narrower definition of "beneficial ownership" than had been proposed and to eliminate the proposed disclosure of record holdings. As a result, disclosure of director holdings will be required only in those instances where the director's economic interests are tied to the securities, and will not be triggered solely by his or her ability to exert voting power or to dispose of the securities.

c) Disclosure of Ownership of Funds Within the Same "Family of Investment Companies". The proposal that directors disclose their aggregate holdings in a fund complex was modified to require disclosure of: (i) each director's ownership in each fund that he oversees; and (ii) each director's aggregate ownership of all funds that he oversees within a fund family. According to the Adopting Release, the ownership in specific funds will demonstrate a director's alignment of interests with shareholders. Recognizing that there may be legitimate reasons why a director may not own shares of a specific fund, however, the Adopting Release states that the requirement to disclose aggregate ownership will help negate any negative inference that otherwise could be drawn. For purposes of determining a director's holdings in a fund complex, the Commission agreed with the ICI's comment that the proposed definition of fund complex was too broad. Instead, the Commission is adopting a narrower definition of "family of investment companies," which includes only funds that share the same investment adviser or principal underwriter and hold themselves out to investors as related companies for purposes of investment and investor services.

7d) Date of Disclosure. The equity ownership disclosure is required in the SAI and proxy statements relating to the election of directors. The equity ownership information in the proxy statement must be provided as of the most recent practicable date and it must be included in the SAI as of the end of the last completed calendar year. The Commission modified this time period to reduce the burdens on directors serving on multiple funds with staggered fiscal years.

3) Conflicts of Interest Consistent with the proposal, fund SAIs and proxy statements will be required to disclose three types of circumstances that, according to the Adopting Release, could affect the allegiance of fund directors to shareholders. These are positions, interests, and transactions and relationships of directors and their immediate family members with the fund and persons related to the fund. The proposal was modified in several significant respects in response to comments by the ICI and others that it was

overbroad. The Commission declined, however, to follow the ICI's recommendation that the information be the subject of a recordkeeping requirement, rather than disclosure requirements, finding that "shareholders have a significant interest in information concerning circumstances that may affect directors' allegiance to shareholders." a) Persons Covered. 1) Interested directors. As suggested by the ICI, the final rule excludes "interested" directors from the conflict of interest disclosure requirements in both the SAI and proxy statement. The Commission agreed with the ICI's comments that applying these requirements to "interested" directors would not advance the goal of evaluating the independence of independent directors. 2) Immediate family members. Consistent with the ICI's recommendation, the Commission narrowed the scope of "immediate family members" covered by the disclosure requirements to a director's spouse, children residing in the director's household (including step and adoptive children) and dependents of the director. The Commission concluded that these are family members from whom directors can reasonably be expected to obtain the required information. Thus, in contrast to the proposal, the final disclosure requirements do not apply to the director's parents, siblings, children not residing with the director, or in-laws. The Commission did not adopt a suggestion made by some commenters to limit disclosure of positions, interests, and transactions and relationships of a director's family members to those of which the director has actual knowledge. 3) Related persons. The Commission followed the ICI's suggestion to exclude administrators from the persons related to the fund that are covered by the requirements. This exclusion is limited to administrators that are not affiliated with the fund's adviser or principal underwriter. Entities (including administrators) that control, are controlled by or are under common control with the adviser or principal underwriter will be covered by the disclosure requirements. Despite these modifications narrowing the disclosure requirements, the Adopting Release encourages funds "to examine any circumstances that could potentially impair the independence of independent directors, whether or not they fall within the scope of [the Commission's] disclosure requirements." b) Other Modifications. 1) Threshold amounts. The Commission adopted a \$60,000 threshold for disclosure of interests, transactions and relationships, which the ICI supported in its comment letter. For purposes of this provision, a director's interest would be aggregated with those of his immediate family members. The Adopting Release cautions funds that the \$60,000 threshold should not be equated with "materiality." In this regard it notes, for example, that "a transaction between a director and a fund's adviser may constitute a material conflict of interest with the fund or its shareholders that is required to be disclosed, regardless of the amount involved, if the terms and conditions of the transaction are not comparable to those that would have been negotiated at 'arm's length' in similar circumstances." 2) Time periods. The Commission also modified some of the proposed time periods for disclosure of conflicts of interest in the proxy statement and SAI. In the proxy statement, disclosure of positions and interests of directors and their immediate family members is required, as proposed, for a five-year period. Disclosure of material transactions and relationships must be provided since the beginning of the last two completed fiscal years. In the SAI, disclosure of positions and interests of directors and their immediate family members, as well as disclosure of material transactions and relationships is required for the two most recently completed calendar years, rather than fiscal years. The ICI pointed out in its comment letter that use of calendar year periods for this purpose would reduce reporting burdens on directors serving multiple funds with staggered fiscal years. 3) Routine, retail transactions and relationships. The Adopting Release clarifies that the exception from the disclosure requirements for routine, retail transactions and relationships, such as credit card or bank or brokerage accounts (unless the director is accorded special treatment), extends to residential mortgages and insurance policies, as well as other routine transactions not specifically enumerated. 4) Board's Role in Fund

Governance The Commission is adopting as proposed disclosure requirements in the proxy rules and SAI relating to board committees. Accordingly, funds must identify each standing committee of the board in both the SAI and any proxy statement for the election of directors. Funds also are 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, if the committee is a nominating committee, state whether the committee would consider nominees recommended by fund shareholders and, if so, describe the procedures for submitting recommendations. Funds must also disclose in the SAI the board's basis for approving an existing advisory contract. In response to comments that this disclosure would become "boilerplate," the Adopting Release specifies that "boilerplate" language is not adequate; funds are required to provide appropriate detail regarding the board's basis for approving an existing advisory contract, including the particular factors forming the basis for this determination. 95) Separate Disclosure The Commission adopted as proposed the requirement that funds present all disclosure for independent directors separately from disclosure for "interested" directors in the SAI, proxy statements for the election of directors and annual reports to shareholders. The Commission believes this will assist shareholders in understanding information about directors and in evaluating the effectiveness of independent directors to oversee fund operations. Marguerite C. Bateman Associate Counsel Attachment (in .pdf format) Note: Not all recipients receive the attachment. To obtain a copy of the attachment to which this memo refers, please call the ICI Library at (202) 326-8304 and request the attachment for memo 12997. ICI Members may retrieve this memo and its attachment from ICINet (<http://members.ici.org>).