

**MEMO# 17126**

February 27, 2004

## **DRAFT INSTITUTE COMMENT LETTER ON SEC'S FUND GOVERNANCE PROPOSALS**

[17126] February 27, 2004 TO: CLOSED-END INVESTMENT COMPANY COMMITTEE No. 9-04 SEC RULES COMMITTEE No. 18-04 SMALL FUNDS COMMITTEE No. 14-04 RE: DRAFT INSTITUTE COMMENT LETTER ON SEC'S FUND GOVERNANCE PROPOSALS Attached is the Institute's draft comment letter on the Securities and Exchange Commission's proposals to enhance the independence and effectiveness of fund boards.<sup>1</sup> The proposed amendments would require funds relying on certain exemptive rules to adopt specified governance practices and to retain records of the written materials the board considers when approving the fund's advisory contract. This memorandum briefly summarizes the draft comment letter and seeks member input on some specific issues. Comments on the proposals must be filed with the SEC by March 10, 2004. Please provide any comments you may have on the Institute's draft letter no later than Friday, March 5 to Jennifer Choi at (202) 326-5810 or [jchoi@ici.org](mailto:jchoi@ici.org) or to Frances Stadler at (202) 326- 5822 or [frances@ici.org](mailto:frances@ici.org). Role of Fund Directors Before commenting on the specific proposals, the draft letter provides a more general discussion of the role of fund directors. This section emphasizes that it is important to recognize that not all problems involving the industry are corporate governance problems or reflect the failure of the director oversight system. In describing the unique role of fund directors, the letter attempts to dispel some common misconceptions about the appropriate role and responsibilities of fund directors. Independent Chairman of the Board The draft letter opposes the proposal to mandate an independent chairman of the board. It argues that the selection of an appropriate person to serve as chairman of the board rightfully is, and should continue to be, a decision made by the directors themselves. <sup>1</sup> See Memorandum to Closed-end Investment Company Committee No. 4-04, SEC Rules Committee No. 10-04, and Small Funds Committee No. 7-04 [17014] (Jan. 28, 2004). <sup>2</sup> In response to the Commission's request for comment on whether there are alternatives to an independent chair requirement that would serve the same or similar purposes, the letter supports requiring that the chairman of the board be elected annually by both a majority of the board as a whole and a majority of the independent directors. The letter suggests that alternatively, or in addition, the Commission could require funds that do not have an independent chair to appoint a "lead independent director" who can pre-approve the agenda for regular meetings to ensure that matters of interest to independent directors are scheduled to be discussed at meetings and/or require that the board's agenda be approved by a majority of independent directors. Do members agree that we should support (as an alternative or in addition to a requirement that the chairman of the board be elected annually) requiring funds that do not have an independent chairman to appoint a lead independent director? Board Composition The draft letter questions the proposal to require at least seventy-five percent of each fund board to be comprised of independent directors

in the absence of any evidence that this proportion would have any tangible benefits over the two-thirds majority standard that most funds meet. The letter recommends that the Commission revise its proposal and require fund boards to have a two-thirds supermajority of independent directors, which would be consistent with industry best practice. Do members agree with this position, or should we support the seventy-five percent proposal?

**Annual Self-Assessment** The draft comment letter supports the Commission's proposal to require fund boards to conduct an annual self-assessment. The letter also supports requiring the directors, as part of this process, to consider the effectiveness of the board's committee structure and evaluate the number of funds on whose boards each director serves. The letter agrees with the Commission's decision not to require written self-assessment reports, noting that a requirement to draft a formal document could result in boards being less critical and candid. In response to the SEC's request for comment on whether it should restrict the number of boards on which a director serves, the letter takes the view that it would not be appropriate for the Commission to dictate the number of fund boards on which a director should serve or the maximum number of directorships (fund or non-fund) any individual should hold. The letter also recommends that the Commission leave to the discretion of individual boards the determination of whether they need to adopt policies regarding service on other boards. We request comment from members on whether we should add a recommendation to our letter that, as part of the annual self-assessment, boards should be required to review the frequency with which they meet and consider whether they need to meet more often.

**3 Separate Meetings of Independent Directors** The letter supports the Commission's proposal to require separate meetings of the independent directors to be held at least once quarterly.

**Independent Director Staff** The letter agrees that independent directors should be able to obtain expert advice to be effective on matters that are beyond their experience and expertise. The letter supports the Commission's approach of not dictating that independent directors must hire their own staff. In response to the Commission's specific request for comment on whether it should require that independent directors have an independent legal counsel, the letter argues that independent directors should not be required to hire independent counsel. The letter takes the view that it is important and sufficient that the option to hire independent counsel is always available to independent directors.

**Recordkeeping for Approval of Advisory Contracts** The letter supports the Commission's proposal to require funds to retain records of the information that their directors consider in approving advisory contracts. It indicates that this is already common practice in the industry and that a formal requirement is appropriate to assist the Commission's examination staff in confirming compliance with Section 15 of the Investment Company Act. Do members agree with supporting the requirement to retain records of information considered by directors in approving advisory contracts? Is the statement in the draft letter about current industry practice accurate?

Jennifer S. Choi Associate Counsel Attachment (in .pdf format)

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