

MEMO# 17012

January 28, 2004

SEC PROPOSES RULE AMENDMENTS TO ENHANCE INDEPENDENCE AND EFFECTIVENESS OF FUND BOARDS

[17012] January 28, 2004 TO: DIRECTORS' COMMITTEE No. 3-04 RE: SEC PROPOSES RULE AMENDMENTS TO ENHANCE INDEPENDENCE AND EFFECTIVENESS OF FUND BOARDS The Securities and Exchange Commission (SEC) has proposed amendments to rules under the Investment Company Act of 1940¹ that would enhance the independence and effectiveness of fund boards, thus empowering them to better exercise their oversight responsibilities on behalf of fund investors. The proposed amendments, which are summarized below, would require funds relying on certain exemptive rules to adopt specified governance practices.² In addition, the amendments would impose a recordkeeping requirement on funds.³ Comments on the proposed amendments are due by March 10, 2004. A conference call to discuss the proposal and any comments the Directors' Committee may include in its comment letter will be held on Thursday, February 12th at 11:00 am (EST). The dial-in information for the call is 888-664-9854 and the pass code is 10210. 1 Investment Company Act Release No. 26323 (Jan. 15, 2004) ("Proposing Release"). <http://www.sec.gov/rules/proposed/ic-26323.htm> 2 The rules proposed to be amended 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); Rule 15a-4(b)(2) (permitting fund boards to approve interim advisory contracts without shareholder approval where the adviser or a controlling person receives a benefit in connection with the assignment of the prior contract); Rule 17a-7 (permitting securities transactions between a fund and another client of the fund's investment 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) ("Exemptive Rules"). 3 Proposed amendments to Rule 31a-2 would require that funds retain, for SEC examination, copies of written materials the board considers when approving the fund's advisory contract. 2 Board Composition Pursuant to the proposed amendments, the independent directors of a board that relies on any of the Exemptive Rules would be required to constitute at least 75% of the board. The Proposing Release notes that the objective of this proposal is to strengthen the hand of independent directors when dealing with fund management and to ensure control of the board by the independent directors if an independent director is unable to attend a meeting. The SEC requests comment on

whether this increased percentage is necessary and whether 75% is an appropriate level. In addition, the SEC requests comment on whether the requirement should be stated in terms of a percentage or fraction. Finally, the SEC requests input on the appropriate time frame over which any new requirement should be phased in. In connection with its cost assessment in the Proposing Release, the SEC seeks information on the way in which funds would likely comply with this requirement – decrease board size by having an interested director resign, maintain board size by replacing interested directors with independent directors or increase board size by adding new independent directors.

Independent Chairman of the Board The proposed amendments would require that the chairman of each fund board be an independent director. According to the Proposing Release, this requirement would ensure that an independent director would control the board's agenda and would promote a boardroom culture that is conducive to decisions favoring the long-term interests of fund shareholders. The SEC seeks comment on whether this requirement would strike an appropriate balance between the roles of management and the independent directors. Would it have the result of improving boardroom culture and reducing the advisers' ability to dominate the board? Should the rules require that committee chairman also be independent? Further, the SEC seeks input on whether there are equally effective alternatives, such as a "lead director" or a requirement that the chairman – whether independent or not – be elected annually by the board and a majority of the independent directors. Finally, the SEC asks if, in light of the supermajority requirement, this requirement for an independent board chairman is necessary.

Annual Self-Assessment The proposed amendments would require fund directors to perform an evaluation of the effectiveness of the board and its committees at least annually. According to the Proposing Release, this process would allow the directors to review their performance and consider improvements to their governance practices. This, in turn, would strengthen directors' understanding of their role and improve communication and cohesiveness among board members. This evaluation should focus on the substantive and procedural aspects of the board's operations and, with two exceptions, the board may decide the content of the evaluation. The evaluation must include questions designed to elicit directors' views on the effectiveness of the board's committee structure, as well as an evaluation of the number of boards the directors oversee. The SEC requests comment on whether boards should make written reports of their evaluations, whether the two required areas of evaluation are appropriate and whether committees to address certain matters should be required. The SEC specifically seeks comment on whether the amendments should restrict the number of boards on which a director may serve and, if so, to how many. Alternatively, should boards identify an optimal number of boards on which a director may serve? Further, should rules relating to multiple board service include non-fund boards or dictate an increased number of board meetings each year?

3 Separate Sessions The proposed amendments would require that independent directors meet at least once quarterly in a separate session, without members of management present. The Proposing Release notes that this would promote candid discussion among directors regarding the management of the fund, and the requirement would avoid creating a negative inference from the calling of such executive sessions by independent directors. Comment is requested on whether such sessions should be held more or less frequently than quarterly.

Independent Director Staff The amendments would expressly authorize directors of funds relying on the Exemptive Rules to hire employees and others to assist the independent directors in the performance of their fiduciary duties. While the proposal does not require a board to hire staff, this explicit authority should help ensure that directors are better able to fulfill their role of representing shareholder interests. The SEC requests comment on whether directors are likely to hire staff and whether they should be required to do so (or do so only if they are of a specified asset size). In addition, it asks whether any staff should

be employed by the fund rather than the adviser and whether this authority should extend to committees of the board. The SEC also requests comment on whether it should require that independent directors have an independent legal counsel. This would be an extension of the requirement adopted in 2001 that, if independent directors have counsel, it should be “independent legal counsel.”

Recordkeeping for Approval of Advisory Contracts

The proposal also would amend Rule 31a-2 to require that funds retain copies of the written materials that directors consider in approving an advisory contract. This requirement would allow SEC compliance examiners to determine the sufficiency of materials requested and reviewed in connection with the board’s approval process. The records would be retained by the fund for at least six years, the first two years in an easily accessible place. The Proposing Release notes that the information would not be kept confidential. The SEC seeks comment on whether there are reasons a fund could not keep the documents and whether there are additional documents a fund should maintain that are relevant to the consideration of the advisory contract. In addition, it queries whether the retention period is appropriate. The SEC specifically requests comment on any feasible alternatives to the requirement that would minimize the burdens yet address the need for the records by SEC staff examiners, the costs associated with maintaining the records, and the impact of the requirement on internal compliance policies and procedures. As part of the cost assessment in the Proposing Release, the SEC requests comment on the number of funds that already retain these materials and whether directors are likely to request more written information from the adviser as a result of the proposed requirement.

General Request for Comment

The SEC seeks comment on these specific proposals, and invites suggestions of additional provisions or changes to existing rules or comments on other matters that might have an effect on the proposals in this release. The Proposing Release discusses the respective roles of the adviser and the board and inquires whether the amendments strike an appropriate 4 balance between these roles. In addition, the SEC seeks comment on the effects and cost implications of the proposals, particularly on small funds. It solicits comment on alternatives to the proposed rules that may be less costly for small entities without reducing the effectiveness of the proposed amendments. In connection with all comments, the SEC requests supporting data and analysis where available. The Institute requests copies of any comment letters on these proposals filed with the SEC by ICI members. Letters should be sent to the Investment Company Institute, c/o Jennifer Choi, 1401 H Street, NW, Washington, D.C., 20005 or to jchoi@ici.org. Marguerite C. Bateman Senior Associate Counsel Jennifer S. Choi Associate Counsel