SEC ADOPTS AMENDMENTS REGARDING THE ROLE OF INDEPENDENT DIRECTORS OF INVESTMENT COMPANIES

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On January 3, 2001, the Securities and Exchange Commission (the "Commission") adopted amendments to several widely-used rules that exempt funds and their affiliates from certain prohibited activities under the Investment Company Act of 1940, as amended (the "1940 Act"). The amendments are designed to reinforce the role that independent directors play in protecting fund investors, enhance their ability to deal with fund management and provide investors with greater information to assess the independence of those directors. Funds relying on any of the exemptive rules listed on Schedule A (the "Exemptive Rules") of this memorandum will be required to comply with these amendments. Unless otherwise indicated below, these amendments are generally scheduled to become effective on February 15, 2001. All new registration statements, post-effective amendments, proxy statements for the election of directors, and reports to shareholders that are filed on or after January 31, 2002 must comply with the new disclosure amendments.

1. FUND GOVERNANCE CHANGES

a) Independent Directors as a Majority of the Board. The amendments impose a new board composition requirement for funds relying on only the Exemptive Rules, namely that the board of directors consist of a majority of independent directors. Prior to the adoption of the amendments, the 1940 Act generally required that independent directors constitute at least 40 percent of the board. The compliance date for this requirement is July 1, 2002.

As a practical matter, many funds boards already consist of a majority of independent directors and are not affected by this amendment. Bank-sponsored funds which recently obtained the ability to put affiliates of the bank on their boards as interested directors (through the repeal of the Glass-Steagall Act), will be limited, however, because of the increased percentage of independent directors required.

If a fund fails to maintain a majority because of the death, disqualification, or bona fide resignation of a director, compliance may be temporarily suspended under newly-adopted Rule 10e-1. Rule 10e-1 provides relief if a fund no longer has a majority of independent directors because of the sudden loss of one or more directors. Rule 10e-1 temporarily suspends the board composition requirements for 90 days if the board can fill a director vacancy, or 150 days if a shareholder vote is required to fill a vacancy.

b) Selection and Nomination of Independent Directors. The amendments require that the independent directors of funds relying on the Exemptive Rules select and nominate any other independent directors. The investment adviser may suggest independent director candidates if the independent directors invite such suggestions, and the investment adviser may provide administrative assistance in the selection and nomination process. Funds with Rule 12b-1 plans are already subject to this requirement, and, accordingly, are unaffected by this amendment.

c) Independent Legal Counsel. The amendments do not require independent directors to retain legal counsel, but provide that if legal counsel is retained, it must be "independent legal counsel." The compliance date for this provision is July 1, 2002. A person[1] is an "independent legal counsel" if:

- a majority of the independent directors reasonably determine in the exercise of their judgment (and record the basis for that determination in the minutes of their meeting) that any representation by the person of the fund's investment adviser, principal underwriter, administrator ("management organizations"), or any of their control persons,[2] since the beginning of the fund's last two completed fiscal years, is or was sufficiently limited that it is unlikely to adversely affect the professional judgment of the person in providing legal representation to the independent directors; and

- the independent directors have obtained an undertaking from the person to provide them information necessary for their determination, and to update promptly that information if and when the counsel begins, or materially increases, the representation of a management organization or control person.

In the release adopting the amendments (the "Adopting Release") the Commission used the following examples as guidance for when counsel to the independent directors, if any, should be "independent":

- approving a fund's advisory contract or a distribution plan;

- approving a merger;

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[1] The Commission adopted as proposed the definition of "person" as any natural person or a company (including a partnership or other association) as well as a partner, co-member, or employee of any person. Thus, the independent directors must examine any conflicting representations of their individual attorney, as well as conflicting representations of that attorney's law firm, partners, and employees.

[2] The Commission amended Rule 0-1 of the 1940 Act to define "control person" as any person (other than a registered investment company) directly controlling, controlled by or under common control with a fund's investment adviser, principal underwriter, or administrator.

- monitoring the allocation of fund brokerage;
- valuing fund securities; and
- considering the appropriateness and legality (under Sections 17(a) and 17(d) of the 1940 Act) of proposed transactions between the fund and its promoter, investment adviser, or principal underwriter (or any other affiliated person).

The Commission noted that, in these instances, counsel who simultaneously represents the investment adviser or its affiliates would not be considered "independent."

According to the Adopting Release, the following factors should be considered in determining whether conflicting representations are "sufficiently limited":

- whether the representation is current and ongoing;
- whether it involves a minor or substantial matter;
- whether it involves the fund, the investment adviser, or an affiliate, and if an affiliate, the nature and the extent of the affiliation;[3]
- the duration of the conflicting representation;
- the importance of the client (including the extent to which counsel relies on that representation economically);
- whether the representation involves work related to mutual funds; and[4]
- whether the individual who will serve as legal counsel to the independent directors was or is involved in the representation.

These factors, however, are not intended to be exhaustive. The Commission also referenced the following factors cited by the Task Force on Independent Director Counsel of the American Bar Association:

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[3] The Commission noted that counsel's representation of a fund's administrator or sub-adviser may not impede its ability to be independent and that a board could differentiate between an administrator and/or sub-adviser that just performs ministerial functions and one that has sponsored, organized or promoted the fund.

[4] Whether counsel's representation of a management organization or control person is unrelated to a fund, although relevant, is not conclusive. The Commission believes that even if legal services are unrelated to a fund, those services may be so substantial, significant, or integral to the business of the management organization (or control person) that the independent directors could determine that the counsel is not independent.

- factors for determining qualifications of the firm
  - experience of firm in mutual fund, service provider and independent director representation
  - firm size and resources
  - industry reputation
  - attorney credentials
  - other related practice areas such as tax, ERISA and securities litigation
  - firm's other clients
- factors for evaluating conflicts of interest
  - nature of other client relationships and relative importance to law firm including economic importance
  - benefits of joint representation (cost saving because of counsel's knowledge of matters) versus disadvantages (chances of adversarial situation arising)
  - formal firm procedures such as Chinese Walls
  - informal procedures (agreement to resign from representation should conflict develop)
  - other effective protections such as hiring other counsel only in specific situations (*e.g.*, adversarial situations)
  - identity of other clients (fund sponsor, investment adviser, underwriter, custodian, other service provider)
  - geographic proximity of lawyers involved

Independent directors are entitled to rely on information provided by counsel in forming a judgment. Independent directors must make at least an annual determination about whether a person is an independent legal counsel. If the independent directors obtain information that their counsel has begun to represent a management organization or control person, they must determine whether this new representation, together with any other representations of management organizations and control persons, is unlikely to adversely affect the counsel's professional judgment.[5]

In order to prevent the fund from losing the availability of the exemptions in these circumstances, the rule provides that counsel can still be considered "independent legal

[5] This provision also would apply when conflicts arise as a result of a law firm merger, the hiring of a new partner or associate, the merger of two financial services firms, or as a result of a material increase in the scope or nature of the legal counsel's representation of a management organization.

counsel" for up to three months, which will provide time for the independent directors to make a new determination about the counsel or to hire a new independent legal counsel.

2. FUND DISCLOSURE CHANGES

*a) **Basic Information about the Identity and Experience of Directors.*** The amendments require funds to provide basic information about directors to shareholders annually. The amendments require the information to be presented in an easy-to-read tabular format. The table will be required in three places: the fund's annual report to shareholders, the statement of additional information (the "SAI"), and the proxy statement for the election of directors. The table will require for each director:

- name, address, and age;
- current positions held with the fund;
- term of office and length of time served;
- principal occupations during the past five years;
- number of portfolios overseen within the fund complex; and
- other directorships held outside of the fund complex.

The amendments further require funds to describe in the table the relationships, events or transactions that make certain directors "interested persons." All disclosure for independent directors must be presented separately from disclosure for interested directors. Funds may present this information in a single table or chart, so long as the information for independent and interested directors is provided in separate sections within the table or chart.

*b) **Fund Shares Owned by Directors.*** The amendments require the disclosure of the dollar amount of equity securities in each fund and in all funds in a fund complex owned by each director in the SAI and any proxy statement relating to the election of directors. Directors will be required to disclose their holdings of securities using dollar ranges rather than a dollar amount to provide shareholders with sufficient information to assess whether directors' interests are aligned with their own. This information must also be presented in tabular form. The amendments further require the disclosure of fund securities owned beneficially and of record by each director in accordance with a definition of "beneficial ownership" which focuses on economic ownership rather than voting and investment power. For purposes of determining a director's holdings in a fund complex, the Commission has adopted the 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. This definition is more narrow than the current definition of "fund complex" in the proxy rules and clarifies that share ownership of funds remotely related (e.g., funds with the same sub-advisers that are not otherwise related) is not required.

c) ***Conflicts of Interest.*** The amendments require the disclosure of conflicts of interest of independent directors in the SAI and the proxy statement regarding positions, interests and transactions and relationships of directors and their immediate family members with the fund and persons related to the fund. The "immediate family members" covered by the disclosure requirements extend to a director's spouse, children residing in the director's household and dependents of the director. Administrators not affiliated with the fund's investment adviser or principal underwriter are excluded from the persons related to the fund that are covered by the requirement. Entities (including administrators) that control, are controlled by or are under common control with the investment adviser or principal underwriter are covered by the requirement.

The amendments require that the threshold amount for disclosure of interests, transactions and relationships is $60,000. The conflicts of interest provisions will not require a fund to disclose routine, retail transactions and relationships such as a credit card, bank or brokerage accounts, residential mortgages or insurance policies, unless the director has been accorded special treatment.

d) ***The Board's Role in Fund Governance.*** The amendments require disclosure relating to committees of the board of directors in the SAI and the proxy statement disclosure in the SAI describing the board's basis for approving an existing investment advisory contract.

3. OTHER CHANGES

a) ***Qualification as an Independent Director.*** The Commission adopted a new rule to prevent certain qualified individuals from being unnecessarily disqualified from being considered an independent director. Rule 2a19-3 conditionally exempts an individual from being disqualified as an independent director solely because he or she owns shares of a broad-based index fund[6] that invests in securities issued by the investment adviser or principal underwriter of the fund, or their controlling persons.

b) ***Limits on Coverage of Directors under Joint Insurance Policies.*** Rule 17d-1(d) permits funds to purchase "errors and omissions" joint insurance policies for their officers and directors. Currently, many of these policies contain exclusions when these parties sue each other resulting in the lack of coverage of independent directors against lawsuits by the investment adviser and possibly resulting in an independent director's reluctance to take actions necessary to protect fund investors out of a concern for personal liability. Under the amendments, Rule 17d-1(d) is available only if the joint insurance policy does not exclude coverage for litigation between the investment adviser and the independent directors. The compliance date for this provision is July 1, 2002.

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[6] A broad-based index is an index that provides investors with a performance indicator of the overall applicable stock or bank markets, as appropriate.

c) ***Independent Audit Committees.*** Under new Rule 32a-4, funds are exempted from the 1940 Act's requirement that shareholders vote at each annual meeting on the selection of the fund's independent public accountant if the fund has an audit committee composed wholly of independent directors. The rule permits continuing oversight of the fund's accounting and auditing processes by an independent audit committee in place of the shareholder vote. Many funds have established audit committees. Funds that have not set up audit committees may want to reconsider the situation in light of the amendments. However, because most open-end funds are not required to have annual meetings, shareholders rarely ever vote on the selection of independent accountants. The compliance date for this provision is July 1, 2002.

d) ***Records on Independence of Independent Directors and their Counsel.*** The amendments now 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. We recommend that [ ] follow the Report of the Advisory Group or Best Practices For Fund Directors (June 24, 1999) which requires independent directors to complete a questionnaire each year on business, financial, and family relationships that could affect their independence and to preserve those questionnaires as part of their records.

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SCHEDULE A

THE EXEMPTIVE RULES

• Rule 10f-3	permitting purchase of securities for a fund during the course of an underwriting in which an affiliated underwriter participates
• Rule 12b-1	permitting use of mutual fund assets to pay for distribution-related activities
• Rule 15a-4(b)(2)	permitting interim investment advisory contract for a fund after termination of previous contract because of assignment for compensation
• Rule 17a-7	permitting trading among funds with common or related investment advisers, common directors and/or common officers
• Rule 17a-8	permitting merger of funds with common or related investment advisers, common directors and/or common officers
• Rule 17d-1(d)(7)	permitting joint liability insurance policies among affiliates
• Rule 17e-1	producing a safe harbor for brokerage transactions with affiliates on an exchange
• Rule 17g-1(j)	permitting joint insured fidelity bond among affiliates
• Rule 18f-3	permitting issuance of multiple classes of voting stock
• Rule 23c-3	permitting repurchase offers by closed-end companies