SEC PROPOSES AMENDMENTS TO RULES AND FORMS REGARDING ROLE OF INDEPENDENT DIRECTORS OF INVESTMENT COMPANIES

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NOVEMBER 3, 1999

On October 14, 1999, the Securities and Exchange Commission (the "SEC") proposed for public comment amendments to certain exemptive rules under the Investment Company Act of 1940 to require that, for investment companies that rely on those rules, independent directors constitute at least a majority of their board of directors; independent directors select and nominate other independent directors; and any legal counsel for the independent directors be an independent legal counsel. Funds which do not rely on such exemptive rules need not meet these requirements. The SEC also proposed amendments to rules and forms which would expand the disclosure that investment companies provide about their directors.

The proposed amendments were based in part on discussions at a Roundtable on the Role of Independent Investment Company Directors held by the SEC in February 1999. Participants in the Roundtable included independent directors, investor advocates, executives of fund advisers, academics, corporate governance experts, and experienced legal counsel. After the Roundtable, SEC Chairman Arthur Levitt made comments indicating that the SEC would consider proposing regulatory initiatives to improve the oversight of funds by independent fund directors.

In response to the Roundtable and Chairman Levitt's subsequent comments, a special panel (the "Advisory Group") of the Investment Company Institute was created. The Advisory Group issued a report in which it provided a series of recommendations designed to enhance the role of independent investment company directors and the effectiveness of fund boards generally. This report was summarized in our memorandum dated June 24, 1999, entitled "*ICI ADVISORY GROUP ISSUES REPORT REGARDING BEST PRACTICES FOR FUND DIRECTORS*." Although the SEC did not propose to require funds to follow the recommendations in the Advisory Group report, it did state that funds should give "serious consideration" to such recommendations.

I. PROPOSED AMENDMENTS TO EXEMPTIVE RULES

The SEC proposed amendments to certain exemptive rules under the Investment Company Act. These amendments would require, for funds that rely (or whose affiliated persons rely) on the rules, that: (i) independent directors constitute either a majority or a super majority of their boards; (ii) independent directors select and nominate other independent

directors; and (iii) any legal counsel for the independent directors be an independent legal counsel. Funds which do not rely on the exemptive rules outlined below do not need to comply with these requirements.

These SEC proposals would amend ten rules (the "Exemptive Rules") under the Investment Company Act. In selecting the Exemptive Rules, the SEC sought to identify those rules that exempt funds or their affiliated persons from provisions of the Act, and have as a condition the approval or oversight of independent directors. The Exemptive Rules typically relieve funds or their affiliated persons from statutory prohibitions that preclude certain types of transactions or arrangements that would involve serious conflicts of interest. Accordingly, the SEC proposed to amend the following rules:

- Rule 10f 3 (permits funds to purchase securities in a primary offering when an affiliated broker dealer is a member of the underwriting syndicate);
- Rule 12b 1 (permits use of fund assets to pay distribution expenses);
- Rule 15a 4 (permits fund boards to approve interim advisory contracts without shareholder approval);
- Rule 17a 7 (permits securities transactions between a fund and another client of the fund's adviser);
- Rule 17a 8 (permits mergers between certain affiliated funds);
- Rule 17d 1(d)(7) (permits funds and their affiliates to purchase joint liability insurance policies);
- Rule 17e 1 (specifies conditions under which funds may pay commissions to affiliated brokers in connection with the sale of securities on an exchange);
- Rule 17g 1(j) (permits funds to maintain joint insured bonds);
- Rule 18f 3 (permits funds to issue multiple classes of voting stock); and
- Rule 23c 3 (permits the operation of interval funds by enabling closed end funds to repurchase their shares from investors).

While the SEC recommended that all funds adopt the measures outlined above, it did not propose to require all funds to do so. Funds that do not rely on any of the Exemptive Rules would not be subject to the proposed requirements

A. Independent Directors as a Majority of the Board

The SEC proposed to amend the Exemptive Rules to require funds relying on them to have boards with at least a majority of independent directors. In addition, the SEC requested comment on whether it was sufficient to adopt a simple majority requirement or whether a higher percentage was more appropriate (*e.g.*, the two thirds super majority requirement recommended in the Advisory Group's report).

The SEC noted that if the amendments were adopted as proposed, it expected to delay the compliance date for one year to allow funds to bring their boards into compliance. As of the compliance date, any fund relying on an Exemptive Rule would be required to have a board with the requisite percentage of independent directors.

The SEC proposed new Rule 10e-1 to address those situations where the death, disqualification, or bona fide resignation of an independent director causes the representation of independent directors on the board to fall below that required under the Investment Company Act. Proposed Rule 10e 1 would suspend the board composition requirements of the Act, and of the rules under the Act, for 60 days if the board of directors has the power to fill the vacancy or 150 days if a shareholder vote is required.

B. Selection and Nomination of Independent Directors

The SEC proposed to amend the Exemptive Rules to require funds relying on them to have independent directors selected and nominated by other independent directors. The SEC asserted that if independent directors are selected in this manner, they would be more likely to have their primary loyalty to the fund's shareholders rather than the adviser. Accordingly, they might be more willing to challenge the adviser's recommendations when the adviser's interests conflict with those of the shareholders.

It is important to note that funds that have adopted distribution plans under Rule 12b 1, which already contains this requirement, would not be affected by this proposal. Under the SEC proposal, funds whose independent directors were not nominated in this manner would not immediately lose their ability to rely on the Exemptive Rules. Instead, these funds would be required to adopt the practice before the compliance date for the amendments, and the fund's incumbent independent directors subsequently would select and nominate all independent directors of the fund.

C. Independent Legal Counsel

The SEC proposed to amend the Exemptive Rules to require funds relying on them to have any legal counsel to the independent directors be counsel who does not also represent the fund's adviser, principal underwriter or administrator (collectively, "management organizations") or their control persons. The SEC expressed the view that if such counsel were

independent, it would be better able to "provide zealous representation of independent directors."

The SEC did not propose to require independent directors to retain legal counsel. While it did re-assert its belief that such representation would assist the independent directors, it acknowledged that the retention of legal counsel could entail significant expense. However, if a fund determined to retain legal counsel for its independent directors, the SEC proposal would require that such counsel be independent.

Under the proposed amendments, a person would be an "independent legal counsel" if the fund reasonably believes the person and his or her law firm, partners, and associates have not acted as legal counsel for the fund's management organizations or any of their control persons at any time since the beginning of the fund's last two completed fiscal years. Under the proposed amendments, a person could be an independent legal counsel to a fund's independent directors regardless of the nature and amount of legal services he or she provides to the fund itself.

The proposed amendments would require the fund to have a "reasonable belief" that counsel to the independent directors meets the requirements of the independent legal counsel definition. If, despite the fund's reasonable belief, counsel does not actually meet the requirements, the fund would not lose the ability to rely on any of the Exemptive Rules. A fund could form a reasonable belief based on a representation from counsel. If the fund relies on counsel's representation, the fund also should obtain an undertaking that the counsel will inform the fund and the independent directors if it begins to act as legal counsel to the fund management organizations or any of their control persons.

Under the proposed amendments, the independent directors could make an exception and permit a person to serve as independent legal counsel even if the person has a remote or minor conflict of interest because the person has provided legal advice to management organizations or their control persons. Before retaining such counsel, the independent directors would be required to determine that the counsel's representation was "so limited that it would not adversely affect the counsel's ability to provide impartial, objective, and unbiased legal counsel to the [independent] directors." The SEC noted that relevant factors for this determination could include whether the representation presented a direct and ongoing conflict with the fund, the amount of legal fees generated by the representation, and the nature and the extent of the affiliation between a control person and a fund management organization. The SEC noted that one example of a remote or minor conflict of interest would be where a law firm partner represented an affiliate of the fund's adviser in a minor real estate transaction. The proposed amendments would require that the basis for such a determination be recorded in board meeting minutes.

The SEC requested comment as to the length of the transition period that should be provided to funds that would need to retain new counsel to the independent directors.

II. PROPOSED AMENDMENTS TO OTHER RULES

A. Limits on Coverage of Directors Under Joint Insurance Policies

The SEC proposed to amend Rule 17d 1(d)(7) 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 SEC noted that joint D&O/E&O policies historically have excluded claims in which the parties under the policy sue each other and that without this coverage, independent directors could face substantial personal legal expenses in the event of a lawsuit. The SEC expressed its concern that the exclusion of coverage under joint policies creates a potential threat to directors' personal assets, which in turn can hamper directors' willingness to question management and weaken their resolve to protect fund shareholders in the event of a conflict with the adviser.

B. Exemption from Ratification of Independent Public Accountant Requirement for Funds with Independent Audit Committees

Funds are required to submit to their shareholders for ratification at the next annual meeting the selection of the funds' independent public accountants. The SEC proposed to exempt funds from this shareholder ratification requirement if the auditor is subject to the oversight and direction of an audit committee consisting entirely of independent directors. The SEC expressed its belief that the ongoing oversight provided by an independent audit committee could provide greater protection to shareholders than the current requirement for shareholder ratification of a fund's independent auditors. In order for a fund to rely on the proposed exemption, (i) the audit committee must be responsible for overseeing the fund's accounting and auditing processes, (ii) the fund's board of directors must adopt an audit committee charter setting forth the committee's structure, duties, powers, and methods of operation, and (iii) the fund must maintain of a copy of the charter.

C. Qualification as an Independent Director

The SEC proposed (i) to amend the rule that permits directors to be considered independent directors even if they are affiliated with a broker dealer, and (ii) to adopt a new rule that would prevent directors from being disqualified as independent directors solely because they own shares of index funds that hold limited interests in their fund's adviser or principal underwriter.

Section 2(a)(19) of the Investment Company Act provides that no person can be an independent director unless he is not, or is not affiliated with, a broker-dealer. Rule 2a19 1 under the Investment Company Act provides relief from this provision under certain conditions, but only if no more than a *minority* of a fund's independent directors are broker dealers or affiliated with broker dealers. The SEC proposed to amend Rule 2a19 1 to provide that no more than *one-half* of a fund's independent directors may be broker dealers or their affiliates.

Section 2(a)(19) further disqualifies an individual from being considered an independent director if he knowingly has any direct or indirect beneficial interest in a security issued by the fund's investment adviser or principal underwriter, or by a controlling person of the adviser or underwriter. A fund director, for example, who owns securities issued by the fund's adviser (or its parent company) could not be an independent director. The SEC proposed a new rule that would exempt an individual from being so disqualified merely because he or she owns shares of certain index funds that invest in the adviser or underwriter of the fund (or their control persons).

It is important to note that the SEC did not propose that former officers or directors of a fund's investment adviser, principal underwriter or certain of their affiliates not serve as independent directors of the fund This was one of the Advisory Group's recommendations. Under current guidelines, such former officers or directors could serve as independent directors if sufficient time had elapsed since they left such positions.

D. Recordkeeping Regarding Director Independence

The SEC proposed to amend its rule requiring funds to preserve certain records to enable the SEC to monitor funds' assessments of the independence of their directors. The proposed amendment would require funds to preserve for specified periods any record of the initial determination that a director qualifies as an independent director, and each subsequent determination of whether the director continues to qualify as an independent director.

III. DISCLOSURE OF INFORMATION ABOUT FUND DIRECTORS

Generally, a fund is required to provide basic information about directors in its statement of additional information ("SAI") and proxy statements, including name and age; positions with the fund; principal occupations during the past five years; and compensation from the fund and fund complex.

The SEC asserted that its fundamental approach with respect to disclosure about directors was sound, but it acknowledged that there are gaps in the information that fund shareholders receive. The SEC further noted that the primary vehicle for providing information about mutual fund directors was the proxy statement prepared in connection with shareholder meetings. However, the SEC stated that this approach was problematic in that the proxy statement has become an ineffective vehicle for communicating information to fund shareholders on a regular basis because funds generally are no longer required to hold annual meetings.

The SEC proposed amendments to the disclosure rules which would require mutual funds to:

- Provide basic information about directors to shareholders annually;

- Disclose to shareholders fund shares owned by directors;
- Disclose to shareholders information about directors that may raise conflict of interest concerns; and
- Provide information to shareholders on the board's role in governing the fund.

A. Basic Information about Directors

The SEC proposed to combine in one table certain information currently required for directors in the SAI and proxy statements. This new table would be required in three places: the fund's annual report to shareholders, SAI, and proxy statement for the election of directors. The proposals introduce the requirement that disclosure about fund directors be included in the annual report. The SEC also proposed to require funds to include in the annual report a statement that the SAI includes additional information about fund directors and is available without charge upon request.

The proposed table would require 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; and (6) other directorships held outside of the fund complex. The table also would require for each "interested" director a description of the relationship, events, or transactions by reason of which the director is an interested person.

B. Ownership of Equity Securities in Fund Complex

The SEC proposed to require disclosure of the aggregate dollar amount of equity securities of funds in the fund complex owned beneficially and of record by each director. Funds would provide information on director holdings in a tabular format including: (1) name of director; (2) identity of fund complex; and (3) aggregate dollar amount of equity securities owned of funds in the complex. The SEC did not propose that funds provide information about a director's holdings in each fund; rather information would be required for the fund complex as a whole. The information, as of the most recent practicable date, would be provided in the fund's SAI and in any proxy statement relating to the election of directors.

C. Conflicts of Interest

The proxy rules currently require significant information about conflicts of interest of directors. The SEC proposed to include much of the conflict of interest disclosure in the SAI as well as in proxy statements.

1. General approach to disclosure

The SEC proposed to require disclosure of positions held by a director with the fund and persons related to the fund. It also proposed to require disclosure of directors' interests, including securities holdings, in entities related to the fund. Finally, the SEC proposed to require disclosure of directors' transactions and relationships with the fund and persons related to the fund.

The Commission also proposed to extend the disclosure requirements to the immediate family[1] members of directors.

The SEC proposed to require disclosure in the proxy statement about circumstances involving directors, on the one hand, and the fund and persons related to the fund, on the other. These "Related Persons" would include:

- a fund's investment adviser, principal underwriter or administrator or a person directly or indirectly controlling such an entity;
- a person directly or indirectly controlled by or under common control with the fund's investment adviser, principal underwriter, or administrator;
- any other investment company with the same investment adviser, principal underwriter or administrator as the fund;
- any other investment company with an investment adviser, principal underwriter, or administrator that directly or indirectly controls, is controlled by, or is under common control with an investment adviser, principal underwriter, or administrator of the fund; and
- any officer[2] of the fund or any of the foregoing entities

2. Specific Disclosure in the Proxy Rules and SAI

The SEC proposed to require disclosure of any positions, including as an officer, employee, director, or general partner, held during the past five years by directors and their immediate family members with:

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[1] "Immediate family member" would be defined to mean any spouse, parent, child, sibling, mother or father in law, son or daughter in law, or sister or brother in law, including step and adoptive relationships.

[2] For purposes of this amendment, "officer" would include the president, vice president, secretary, treasurer, controller, or any other officer who performs policy making functions.

- the fund;
- an affiliated person of the fund; or
- any Related Party.

The SEC proposed to require disclosure of securities currently owned, and material direct or indirect interests held during the past five years, by each director and his immediate family members in

- an investment adviser, principal underwriter, or administrator of the fund; or
- a person (other than a registered investment company) directly or indirectly controlling, controlled by, or under common control with an investment adviser, principal underwriter, or administrator.

Information about securities owned would be provided in a table, including the value of the securities and percent of each class owned.

The SEC proposed to require disclosure of transactions and relationships of directors with the fund and Related Parties. The SEC proposed to require disclosure of any material interest, direct or indirect, of any director or his immediate family member in any material transaction, or material series of similar transactions, since the beginning of the last two completed fiscal years (or currently proposed), to which the fund or a Related Party was or is to be a party. Transactions would include loans, lines of credit, and other indebtedness. The SEC also proposed to require disclosure of any material relationship, direct or indirect, of any director or his immediate family member that exists, or has existed at any time since the beginning of the last two completed fiscal years, or is currently proposed, with the fund or a Related Party. Relationships would include payments for property or services, provision of legal or investment banking services, and any consulting or other relationship that is substantially similar in nature and scope to any of the foregoing relationships.

A fund would not be required to disclose routine, retail transactions and relationships between directors or immediate family members and the fund or Related Parties. For example, a mutual fund need not disclose that a director holds a credit card or bank or brokerage account with a fund or Related Party, unless the director is accorded special treatment, such as preferred access to initial public offerings.

Finally, the SEC proposed to require a mutual fund to disclose situations where an officer of an investment adviser, principal underwriter, or administrator of a fund, or an officer of a person directly or indirectly controlling, controlled by, or under common control with an investment adviser, principal underwriter, or administrator of the fund 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 immediate family member is, or was, an officer.

D. Board's Role in Fund Governance

The proxy rules currently require a mutual fund to discuss in reasonable detail the material factors and conclusions the board of directors considered in recommending that the shareholders approve an investment advisory contract, including a discussion of any benefits derived or to be derived by the investment adviser from the relationship with the fund such as soft dollar arrangements. The SEC proposed to require similar disclosure in the SAI so that investors will be able to evaluate the board's basis for approving the renewal of an existing investment advisory contract.

The SEC also proposed to modify disclosure in the proxy rules and the SAI relating to a fund's committees of the board of directors. The proxy rules currently require mutual funds to disclose information about standing audit, nominating, and compensation committees. In the SAI, mutual funds currently are required to identify members of any executive or investment committee, and provide a concise statement of the duties and functions of each committee. The SEC proposed to modify this disclosure to require mutual funds to identify each standing committee of the board in the SAI and proxy statements for the election of directors. As in the current proxy rules, funds 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 its nominating committee will consider nominees recommended by fund shareholders and, if so, describe the procedures for submitting recommendations.

E. Separate Disclosure

The SEC proposed to require funds to 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. For example, when information is furnished in a table, funds should provide separate tables (or separate sections of a single table) for independent directors and for interested directors.

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If you have any questions concerning this report, please do not hesitate to contact Gary S. Schpero (212-455-3665), Sarah E. Cogan (212-455-3575), Cynthia Cobden (212-455-7744) or Brynn Peltz (212-455-2210).

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