



January 25, 2004

Proposed SEC Rule Concerning Investment Company Governance

The Securities and Exchange Commission (the “SEC”) has proposed amendments to certain rules promulgated under the Investment Company Act of 1940, as amended (the “1940 Act”): “Investment Company Governance” (the “Proposed Rule”).¹ Comments on the Proposed Rule must be submitted to the SEC by March 10, 2004. This memorandum outlines the requirements of the Proposed Rule.

A. Introduction

Under the 1940 Act, all investment companies (“funds”) must have a board of directors that is elected by shareholders to represent shareholder interests.² While fund boards are empowered to manage all of the fund’s affairs, most boards delegate management responsibility to the fund’s investment adviser. However, the 1940 Act relies heavily on fund boards to manage conflicts of interest between the fund adviser and the fund. As such, the effectiveness of fund boards and fund independent directors depends heavily on the quality of the fund directors and adopted governance practices when addressing these management issues.³

The SEC believes that the failure of a fund board to play its appropriate role can result in serious compliance breakdowns, excessive fees and brokerage commissions, inadequate disclosures, mispricing of portfolio securities, and inferior investment performance.⁴ In order to prevent additional such failures, the SEC is proposing to require

¹ Proposed Rule: Investment Company Governance, 17 CFR Part 270; Release No. IC-26323, File No. S7-03-04; RIN: 3235-AJ05 (January 15, 2004).

² *Id.* at Section I.

³ *Id.*

⁴ *Id.*

funds to adopt better governance practices and thereby empower independent directors to be a check on fund management. Specifically, the Proposed Rule would require funds relying on any of ten specific exemptive rules to adopt certain fund governance standards.⁵ In proposing these rule amendments, the SEC is cognizant of the tension between the role of the fund board and that of the investment adviser. The SEC believes however that the Proposed Rule strikes an appropriate balance between management and oversight.⁶

B. Board Composition

The Proposed Rule would require that any fund relying on exemptive rules have a board of directors whose independent directors constitute at least seventy-five percent of the board.⁷ The 1940 Act currently requires at least forty percent of the board to be independent, and recent amendments require that a majority of the board be independent.⁸

C. Independent Chairman of the Board

The SEC's Proposed Rule would also require an independent director to be the fund board chairman.⁹ The SEC notes that often times an officer of the fund's investment adviser serves as chairman of the fund board. Since the chairman can control the board's agenda, the SEC believes that an independent chairman would enhance the degree to which shareholder interests are represented in fund management as well as general fund governance.¹⁰ Moreover, the SEC believes that a fund board will be more effective when

⁵ *Id.* at Section II. These exemptive rules are routinely relied upon by many funds. Proposed Rule: Release No. IC-26323 at Section II.

⁶ Proposed Rule: Release No. IC-26323 at Section II.

⁷ *Id.* at Section II.A.

⁸ *Id.*

⁹ *Id.* at Section II.B.

¹⁰ *Id.*

negotiating with the fund adviser if the board is led by an independent chairman.¹¹ In this respect, the SEC notes that shareholders would stand to benefit substantially if such negotiations lead to lower advisory and other fees.

D. Annual Self-Assessment

The Proposed Rule would require fund directors to conduct an annual evaluation of the effectiveness of the board and its committees.¹² The SEC states that the self-evaluation would focus on such substantive and procedural aspects of the board's operations as the board decides upon, in its discretion. However, the Proposed Rule would require fund boards to consider two specific matters.

First, the Proposed Rule would require directors to consider the effectiveness of the board's committee structure.¹³ This requirement would focus fund boards on the need to create, consolidate or revise various committees, such as the audit, nominating or pricing committees.¹⁴ The requirement also would facilitate a critical assessment by fund boards of their current committees.¹⁵

Second, the Proposed Rule would require fund directors to carefully evaluate whether the directors have taken on the responsibility for overseeing too many funds.¹⁶ The SEC believes that directors often serve on a large number of fund boards within a fund complex. The SEC notes however that it is difficult to determine the maximum number of funds that a particular director or group of directors can adequately serve.

¹¹ *Id.*

¹² *Id.* at Section II.C.

¹³ *Id.*

¹⁴ *Id.*

¹⁵ *Id.*

¹⁶ *Id.*

E. Independent Directors: Separate Meetings and Staff

The SEC's Proposed Rule would require independent directors to meet at least once quarterly, in a separate session, at which no other persons from the fund are present.¹⁷ The SEC believes that such meetings would give independent directors the opportunity for a candid discussion regarding the management of the fund. The Proposed Rule also would authorize independent directors to hire employees and others to help the directors fulfill their fiduciary duties.¹⁸ The SEC believes that such use of staff and experts is important in helping independent directors address matters beyond their expertise.

F. Recordkeeping for Approval of Adviser Contracts

Finally, the SEC proposes to require that funds retain copies of the written materials reviewed by directors when the directors consider approving an advisory contract.¹⁹ Currently, the SEC requires that fund directors, including a majority of independent directors, approve the fund's advisory contract annually.²⁰ The SEC also currently requires that directors first obtain from the adviser information reasonably necessary to evaluate the contract. It should be noted that the Mutual Fund Directors Forum is preparing best practices recommendations for the types of information that directors should request and consider when reviewing advisory contracts.²¹

¹⁷ *Id.* at Section II.D.

¹⁸ *Id.* at Section II.E.

¹⁹ *Id.* at Section II.F. To implement this requirement, the Proposed Rule would amend Rule 31a-2: the fund recordkeeping rule. Proposed Rule: Release No. IC-26323 at Section II.F.

²⁰ Proposed Rule: Release No. IC-26323 at Section II.F.

²¹ *Id.* The Mutual Fund Directors Forum is an independent organization that advises fund directors.

The Proposed Rule states that SEC examiners have found that the nature and quality of the materials directors review varies widely among funds.²² The SEC therefore proposes to address this problem by amending the recordkeeping rules. Under the Proposed Rule, funds would be required to retain the materials on which the board relied in approving the advisory contract for at least six years, the first two of which would be in an easily accessible place.²³

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If you have any questions about the Proposed Rule or would like to consider submitting a comment on any part of the Proposed Rule, please do not hesitate to contact us.

This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its contents.

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²² Proposed Rule: Release No. IC-26323 at Section II.F. Some fund boards have failed to request the materials they need to make an informed assessment of the advisory contract. In one case, the SEC brought an enforcement action against directors who neglected to request and evaluate sufficient information under section 15(c). Proposed Rule: Release No. IC-26323 at Section II.F.

²³ Proposed Rule: Release No. IC-26323 at Section II.F.