

**SEC ADOPTS FINAL RULES ON
INVESTMENT COMPANY GOVERNANCE**

On June 23, 2004, the Securities and Exchange Commission (the “SEC”), by a three-to-two vote, adopted amendments to ten exemptive rules (the “Exemptive Rules”) under the Investment Company Act of 1940, as amended (the “Investment Company Act”), to require investment companies (“funds”) that rely on those rules to adopt certain governance practices.¹

The amendments require that any fund that relies upon any of the Exemptive Rules² satisfy the fund governance standards set forth in new Rule 0-1(a)(7) of the Investment Company Act (the “fund governance standards”),³ which include the following:

- **Board Composition.** At least 75 percent of the directors of the fund must be independent directors or, if the fund board has only three directors, all but one of the directors must be independent directors;
- **Independent Chair of the Board.** The chair of the board must be an independent director;
- **Annual Self-Assessment.** The board must perform a self-assessment at least once annually;
- **Separate Sessions.** The independent directors must meet separately at least once per quarter; and
- **Independent Director Staff.** The independent directors must be affirmatively authorized to hire their own staff.

¹ SEC Release No. IC-26520 (July 27, 2004) (the “Adopting Release”). The Adopting Release includes the written dissent of Commissioners Cynthia A. Glassman and Paul S. Atkins to the adoption of the amendments requiring that 75 percent of board members and the chair of a board be independent (the “Dissent”).

² The amendments would apply to most funds because almost all sizeable fund groups rely on one or more of these Exemptive Rules. The Exemptive Rules are the following: Rule 10f-3, Rule 12b-1, Rule 15a-4(b)(2), Rule 17a-7, Rule 17a-8, Rule 17d-1(d)(7), Rule 17e-1, Rule 17g-1(j), Rule 18f-3, Rule 23c-3 and proposed Rule 15a-5 (if adopted).

³ New Rule 0-1(a)(7), which defines the term “fund governance standards,” incorporates the following fund governance requirements with which funds have had to comply since 2001 in order to rely upon any of the Exemptive Rules: (i) a fund’s board must have a majority of independent directors; (ii) the fund’s independent directors must select and nominate any other independent directors; and (iii) the fund’s independent directors, if they hire counsel, must hire only counsel that does not have substantial ties to fund managers (“independent counsel”). See SEC Release No. IC-24816 (Jan. 2, 2001) (the “2001 Adopting Release”). After January 15, 2006, the compliance date for the amendments, the majority independence condition will be revised to the 75 percent independence condition discussed in this memorandum.

In the Adopting Release, the SEC also amended Rule 31a-2 of the Investment Company Act, the fund recordkeeping rule, to require that a fund retain copies of written materials that the board considers when approving the fund's advisory contract.

Effective Date; Compliance Date

The amendments to the Exemptive Rules will become effective on September 7, 2004. After *January 15, 2006*:

- persons may rely upon any of the Exemptive Rules only if they comply with all of the fund governance standards; and
- funds must comply with the recordkeeping requirements of amended Rule 31a-2.

After the effective date but before the compliance date of the amendments, a person that relies on an Exemptive Rule must continue to meet the current fund governance requirements in that Rule.

Rationale for the Amendments

The SEC proposed the rule amendments in the wake of a series of enforcement actions involving late trading of mutual fund shares, inappropriate market timing activities and misuse of nonpublic information about fund portfolios. In the SEC's view, these enforcement cases reflected a breakdown in fund management and compliance controls that raised questions about the ability of many fund boards, as presently constituted, to effectively oversee the management of funds. According to the SEC, the objectives of the amendments are to enhance the independence and effectiveness of fund boards and to improve their ability to protect the interests of the funds and fund shareholders they serve and to effectively oversee management of the fund.

I. Board Composition

The Investment Company Act required that at least 40 percent of a board be independent.⁴ However, prior to the adoption of the amendments, a fund that relied on the Exemptive Rules was required to have a majority of independent directors on its board.⁵ Under new Rule 0-1(a)(7)(i), each fund relying on any Exemptive Rule must have a board of directors whose independent directors constitute at least 75 percent of the board or, if the fund has only three directors, all but one of the directors must be independent. The exception for three-director boards, which was not included in the proposed rule,⁶ was adopted to address concerns from funds with small boards about the costs of hiring new directors to meet the 75 percent independence requirement. A fund that does not already meet the 75 percent standard may (i) seek the resignation of one or more interested directors and decrease the size of its board;

⁴ See Rule 10(a).

⁵ See the 2001 Adopting Release.

⁶ See SEC Release No. IC-26323 (Jan. 15, 2004) (the "Proposing Release").

(ii) maintain the current size of its board and replace some interested directors with independent directors; or (iii) increase the size of its board and elect new independent directors.

The SEC adopted the 75 percent standard to address its concerns that, under the existing independence requirements, boards continue to be dominated by their management companies.⁷ In the view of the majority of the SEC Commissioners, because management controls the day-to-day activities of the fund and has significantly greater access to information about the fund than do the independent directors, the management directors have a significant advantage over the independent directors in setting the board's agenda and potentially dominating board deliberations.⁸

Under the amendments, an "independent director" refers to a director who is not an "interested person" of the fund as defined in Section 2(a)(19) of the Investment Company Act. The SEC, however, indicated in the Adopting Release that independent directors, when selecting and nominating new independent directors, should look beyond the minimum statutory requirements and examine whether a candidate's personal or business relationships suggest that the candidate will not aggressively pursue the interests of fund investors. The SEC expressed that former executives of the fund adviser or close family members of employees of the fund, its adviser or principal underwriter would be "poor choices for candidates, although they may meet the minimum statutory requirements."

In the Proposing Release, the SEC estimated that nearly 60 percent of all funds currently meet the 75 percent independence requirement.

II. Independent Chair of the Board

Under new Rule 0-1(a)(7)(iv), any fund that relies on an Exemptive Rule is required to have a chair of its board who is an independent director. Under this requirement, the independent chair must preside over meetings of the board and have substantially the same responsibilities as a typical chair of the board. The role of the independent chair is not entirely clear from the Adopting Release, but, at a minimum, it appears to consist of the following:

- setting the board meeting agenda;
- leading the board through its various tasks;
- fostering a boardroom culture that promotes dialogue between the fund management and the independent directors;
- participating in determining what information is provided to the board;

⁷ The SEC analogized the higher percentage requirement to the 75 percent requirement set forth in Section 15(f) of the Investment Company Act. Section 15(f) requires funds to maintain boards comprising at least 75 percent independent directors for the three-year period after an adviser has sold its advisory business to another entity.

⁸ The Dissent argued that the existing independence requirements already enable independent directors to set the agenda and determine the outcome of decisions made by the board. See the Dissent at 49.

- providing a “check” on the adviser in connection with the advisory contract review; and
- providing leadership to the board that focuses on the long-term interests of fund shareholders.

The Adopting Release makes clear that the independent chair is not expected to become part of the day-to-day management of the fund.

A fund may not designate an interested director to preside over meetings or set meeting agendas or name an interested director as a “co-chair” of the board. An interested director (e.g., a vice chair) may, however, temporarily perform a chair’s duties under certain circumstances (e.g., due to a chair’s illness or inability to attend a meeting).

The Dissent recognized that the independent chair requirement may result in added costs to fund investors: (i) increased compensation to a sitting independent director for service as chair; (ii) costs of an executive search for an independent chair if none of the sitting independent directors wishes or is qualified to serve; and (iii) costs of a staff for the independent chair.

Funds may need to amend their by-laws to modify the role of the chair of the board, which currently may be described as including being chief executive officer of the fund.

III. Annual Self-Assessment

Under new Rule 0-1(a)(7)(v), fund directors are required to evaluate at least once annually the performance of the fund board and its committees. The precise contents of the self-assessment is not prescribed in the new Rule, except in two areas: the evaluation must include a consideration of the effectiveness of the committee structure of the fund board and the number of funds on whose boards each director serves. The latter inquiry would focus on whether a director is overseeing too many funds. The Proposing Release recognized that it is a common practice in the fund industry for directors to serve on multiple boards and that many issues that arise in a fund family are common to many funds in the family. Nevertheless, the SEC stated that they are “sufficiently concerned” about the ability of a director to pay adequate attention to his or her obligations to each fund when the director serves on multiple boards to require boards to evaluate this matter annually.

The self-assessment requirement is intended to focus the board’s attention on the need to create, consolidate or revise the various board committees, such as the audit, nominating or pricing committees, and to facilitate a critical assessment of the effectiveness of current board committees. The annual self-assessment is also intended to enable independent directors to identify subject areas, such as valuation of portfolio securities, in which the board may need future independent directors to have expertise.

The board’s self-assessment need not be in writing, but the SEC expects that the minutes of the board would reflect the substance of the matters discussed during the board’s annual self-assessment.

IV. Separate Sessions

Under new Rule 0-1(a)(7)(vi), the independent directors are required to meet at least once quarterly in a separate session at which no directors who are interested persons of the fund are present. This requirement is intended to give independent directors the opportunity for a frank and candid discussion among themselves regarding the management of the fund, including its strengths and weaknesses. The rule does not specify the matters that should be discussed by the independent directors at the separate executive sessions, although the SEC expects that the independent directors would use this forum to discuss, among other things, their views on the performance of the fund adviser and other service providers and the fund's activities pursuant to the Exemptive Rules (e.g., the use of fund assets to pay for the distribution of fund shares under Rule 12b-1 and the fund's 12b-1 plan adopted by the board).

The SEC believes that most funds would choose to satisfy this requirement by having directors meet at a breakout session of regularly scheduled board meetings.

V. Independent Director Staff

Under new Rule 0-1(a)(7)(vii), funds are required to explicitly authorize the independent directors to hire employees and to retain advisers and experts necessary to carry out their duties without the consent of management. Under this amendment, independent directors are not required to hire employees or retain advisers or experts. If a fund's independent directors do retain their own legal counsel, such counsel must be an independent counsel in order for the fund to be able to rely on any of the Exemptive Rules.⁹

The SEC expects that the amendment should help independent directors address complex matters and provide them with an understanding of the practices of other mutual funds.

By its terms, the new Rule does not require that Board committees similarly be authorized to retain experts without the consent of management. However, pursuant to Rules 10A-3(b)(4) and (5) under the Securities Exchange Act of 1934, audit committees of exchange-listed funds are explicitly authorized to do so.

VI. Recordkeeping for Approval of Advisory Contracts

In addition to the amendments to the Exemptive Rules, the SEC also amended Rule 31a-2, the fund recordkeeping rule. Under new Rule 31a-2(a)(6), funds are required to retain copies of the written materials that directors consider in approving an advisory contract under Section 15 of the Investment Company Act. The amendment requires funds to retain the materials for at least six years, the first two years in an easily accessible place.

⁹ See Rule 0-1(a)(7)(iii).

The recordkeeping amendment is intended to improve the documentation of a fund board's basis for approving an advisory contract, which the SEC believes would assist its examination staff in determining whether fund directors are fulfilling their fiduciary duties when approving advisory contracts. According to the SEC, the amendment underscores the importance of the information requests that precede the directors' consideration of the advisory contract. The SEC believes that the amendment may encourage independent directors to request more information, and this information may enable them to obtain more favorable terms in advisory contracts.

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