



January 28, 2000

Mr. Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

RE: Role of Independent Directors of
Investment Companies
File No. S7-23-99

Dear Mr. Katz:

The Investment Company Institute¹ is pleased to comment on the Securities and Exchange Commission's proposed rule and form amendments relating to investment company directors.² We commend the Commission and its staff for developing these important and comprehensive proposals so quickly and look forward to working with the Commission on these matters.

The Commission's proposals are the latest in a series of significant developments relating to investment company corporate governance over the past year. In February 1999, the Commission held a Roundtable on the Role of Independent Investment Company Directors, featuring panels that included independent fund directors, members of the industry, outside counsel and other persons with an interest or expertise in this area. Chairman Levitt advanced the discussion in March when he announced several specific initiatives the Commission intended to pursue relating to investment company directors.³ At the same time, the Institute announced the formation of an Advisory Group on Best Practices for Fund Directors ("Advisory Group"), which released a report ("Best Practices Report") in June recommending a series of fund governance policies and practices designed to enhance the independence and effectiveness of fund directors.⁴ It is noteworthy that each of these forums

¹ The Investment Company Institute is the national association of the American investment company industry. Its membership includes 8,004 open-end investment companies ("mutual funds"), 494 closed-end investment companies and 8 sponsors of unit investment trusts. Its mutual fund members have assets of about \$6.404 trillion, accounting for approximately 95% of total industry assets, and over 78.7 million individual shareholders.

² Investment Company Act Release No. 24082 (Oct. 14, 1999), 64 Fed. Reg. 59836 (Nov. 3, 1999) ("Proposing Release").

³ Remarks of Commission Chairman Arthur Levitt at the Mutual Funds and Investment Management Conference, Palm Springs, CA (March 22, 1999).

⁴ In July 1999, the Institute's Board of Governors unanimously approved a resolution strongly endorsing the Best Practices Report and recommending that all Institute investment management company members take appropriate actions to implement the practices recommended in the report.

has confirmed the basic integrity and effectiveness of the current system of investment company governance.⁵ A consensus also has emerged, however, that it is appropriate to explore ways in which this good system might be made even better.

As a general matter, the Institute supports the Commission's goal of strengthening the independence and effectiveness of independent fund directors and supports most of the Commission's specific proposals. The Institute has serious concerns, however, with certain elements of the proposals including, in particular, the proposal relating to independent legal counsel and some of the proposed disclosure requirements. As discussed in more detail below, certain aspects of these proposals would frustrate, rather than promote, the Commission's objectives. In this comment letter, the Institute recommends alternative ways to achieve these objectives that we believe will be more effective and will be more feasible and less burdensome to implement.

Our specific comments on the proposals are set forth below. Our comments address, in turn: (1) the important differences between regulatory requirements and best practices recommendations; (2) the proposed additional conditions for reliance on enumerated exemptive rules under the Investment Company Act of 1940; (3) the proposed rule amendments relating to joint insurance policies, independent audit committees, and investments by directors in index funds; and (4) the proposals concerning disclosure of information about fund directors.

I. REGULATORY REQUIREMENTS AND BEST PRACTICES RECOMMENDATIONS

As noted above, the Institute's Advisory Group released its report on Best Practices for Fund Directors in June of last year. The Best Practices Report includes fifteen recommendations intended to enhance the independence of independent directors and the effectiveness of fund boards as a whole. These fifteen practices were identified after extensive consultation by the Advisory Group with independent directors, industry representatives, counsel to the industry, academics and other persons experienced in the area of corporate governance.

Although these best practices recommendations and the Commission's rule proposals share common goals, "best practices" by definition go beyond what is required by law or regulation. Thus, it is important that the Commission's proposals not be portrayed as alternatives to the best practices recommendations.⁶

⁵ This conclusion is consistent with earlier findings that the current governance system has worked well for investment companies and their shareholders. For example, in its 1992 report on investment company regulation, the Commission's Division of Investment Management concluded: "The oversight function performed by investment company boards, especially the 'watchdog' function performed by the independent directors, has served investors well at minimal cost." SEC Division of Investment Management, Protecting Investors: A Half Century of Investment Company Regulation (May 1992) at 253. In addition, courts that have evaluated independent directors' review of fund advisory fees have consistently found that the independent directors discharged this responsibility diligently and in good faith. See, e.g., Gartenberg v. Merrill Lynch Asset Management, Inc., 694 F.2d 923 (2d Cir. 1982), cert. denied, 461 U.S. 906 (1983); Krinsk v. Fund Asset Management, Inc., 715 F.Supp. 472 (S.D.N.Y. 1988), aff'd, 875 F.2d 404 (2d Cir.), cert. denied, 110 S. Ct. 281 (1989).

⁶ We are pleased that the Commission has recognized this distinction. See Proposing Release at 16; see also "Avoiding Complacency, Advocating Reform: The Commission's Independent Fund Directors Initiative," Remarks of Paul F. Roye, Director, SEC Division of Investment Management, at the Institute's 1999 Investment Company Directors

Likewise, it is inappropriate to compare specific rule proposals to particular best practices recommendations and conclude that one is "stronger" or "weaker" than the other, because they serve different purposes and have different consequences. Thus, the fact that the industry has endorsed these fifteen recommendations as "best practices" does not mean they would be appropriate as rules, or conversely, that Commission rule proposals would be appropriate as best practices.

Significantly, the Advisory Group's best practices recommendations are not *requirements* that carry the force of law. Instead, they represent high industry standards of conduct. In addition, because they are not legal requirements, the best practices recommendations provide important flexibility to fund boards to determine that they can achieve the same goals through other, equally effective practices. This flexibility allows for the distinctive nature of each fund and each board. It should be noted that although they do not carry the force of law, best practices recommendations carry the weight of peer pressure and public scrutiny, which have proved highly effective in motivating adherence to high industry standards.⁷

Commission rules, on the other hand, are necessarily "one-size-fits-all." In effect, such rules mandate a "common denominator" or a minimum standard among funds. Thus, rules are inherently more rigid in their application than best practices recommendations. As a result, funds or other persons who may have good reasons for needing to deviate from the standard set in a rule would have to seek a formal waiver from the Commission or its staff.⁸ This would place additional burdens on the Commission and staff. In addition, noncompliance with Commission rules can lead to enforcement proceedings, private litigation, or other severe consequences.

The Proposing Release seeks comment on whether the recommendations in the Best Practices Report should be incorporated in the Commission's rule proposals, either in whole or in part. We note that some of the Commission's rule proposals overlap with recommendations in the Best Practices Report. With the exception of the independent counsel proposal, we believe that the Commission has generally made the correct judgment as to areas of the best practices recommendations that could be adapted to regulatory requirements and applied in a uniform manner. We do not recommend incorporating any of the other topics addressed in the Best Practices Report into the Commission's rule proposals, because they would not lend themselves to the rigidity of rulemaking. For example, the recommendations that fund boards

Conference (Oct. 28, 1999) at 3. (Mr. Roye expressed his hope that "the boards on which [the directors] are serving are giving serious consideration to the implementation of the best practices.")

⁷ See, e.g., Report to the Division of Investment Management, U.S. Securities and Exchange Commission, "Implementation of the Institute's Recommendations on Personal Investing," Investment Company Institute (April 21, 1995).

⁸ For example, the recommendation in the Best Practices Report that directors own shares of the funds they oversee incorporates flexibility for those circumstances where such ownership would be inappropriate (e.g., because the directors are not eligible investors for those funds or the funds are not suitable investments for the directors). If the Commission were to adopt a rule requiring directors to own shares of the funds they oversee, it would be difficult, if not impossible, to incorporate such flexibility into the rule. As a result, there likely would be many situations in which directors would need to seek relief from the requirement.

adopt policies on retirement of directors and that fund directors evaluate periodically the board's effectiveness do not have any connection with a particular statutory provision and would be difficult to address through rulemaking. The best manner in which to implement these recommendations necessarily will vary from board to board and therefore is more appropriately determined by the directors themselves.

II. ENHANCING THE INDEPENDENCE OF FUND BOARDS OF DIRECTORS

A. Proposed Amendments to Exemptive Rules

The Commission has proposed to amend certain exemptive rules under the 1940 Act to enhance the independence and effectiveness of directors who are charged with overseeing the fund's activities and transactions covered by those rules. Specifically, the proposals would add certain conditions to these exemptive rules that any fund seeking to rely on the rules would have to meet. These conditions are: (1) independent directors would have to constitute a majority of the fund's board of directors;⁹ (2) the fund's independent directors would have to select and nominate any other independent directors; and (3) any legal counsel to the independent directors would have to be independent.

The Institute accepts the Commission's general approach of tying reliance on selected exemptive rules to compliance with conditions designed to enhance the independence of a fund's independent directors.¹⁰ Each of the selected rules relies upon fund boards to approve and oversee arrangements or transactions that may involve conflicts of interest and that otherwise would be prohibited by the 1940 Act.¹¹ We believe these criteria provide an appropriate basis for the Commission's selection of the particular rules covered by its proposal and do not believe that there are additional rules under the 1940 Act that should be made subject to the proposed conditions.

⁹ In the Proposing Release, the Commission has sought comment on whether a higher proportion of independent directors, such as two-thirds, is more appropriate.

¹⁰ Our acceptance of this general approach presumes that the Commission will be receptive to making certain modifications to the conditions as proposed, consistent with our comments set forth below. Absent these changes, the Institute believes the impact of these proposals on funds and their directors would be quite onerous.

¹¹ The ten exemptive rules included in this proposal 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 expenses); Rule 15a-4 (permitting fund boards to approve interim advisory contracts without shareholder approval); Rule 17a-7 (permitting securities transactions between a fund and another client of the fund's 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). Although the Proposing Release indicates that funds that do not rely on any of the selected exemptive rules will not be subject to the proposed conditions, we believe that virtually all funds rely on at least one of the enumerated exemptive rules.

We recommend, however, that one of the ten exemptive rules that would be amended under the Commission's proposals – Rule 15a-4 – be excluded. In contrast to the other exemptive rules identified by the Commission, all of which concern ongoing business practices, the need to rely on Rule 15a-4 only arises on an episodic basis that may be unforeseeable (*i.e.*, when an existing investment advisory contract terminates). Funds that do not rely on any of the other specified exemptive rules would not be in a position to instantaneously make any changes necessary to satisfy the requisite conditions when this situation arises. Furthermore, given the host of other issues the board must consider under these circumstances, it could be quite burdensome to require that it also demonstrate compliance with the enumerated conditions.

Our comments on the specific conditions proposed by the Commission are discussed in more detail below.

1. Independent Directors as a Majority of the Board

The Proposing Release states the Commission's belief that a fund board that has at least a majority of independent directors "is better equipped to perform its responsibilities of monitoring potential conflicts of interest and protecting the fund and its shareholders."¹² Accordingly, the Commission has proposed that, as a condition of reliance on the exemptive rules listed above, independent directors form a majority of the fund's board. The Institute supports this proposal as it advances the objective of strengthening the hands of independent directors.¹³

As an alternative, the Commission has requested comment on whether a two-thirds super-majority of independent directors should be required on each fund board. As indicated in the Proposing Release, the Advisory Group recommended that at least two-thirds of the directors of all investment companies be independent directors.¹⁴ Notwithstanding the Advisory Group's *best practice* recommendation, the Institute does not support increasing the legally *required* percentage of independent directors to this level as a condition for relying on the specified exemptive rules. A majority requirement would accomplish the Commission's objective of ensuring that the independent directors control the voting process, particularly with respect to the arrangements and transactions that are the subject of the specified exemptive rules.

The Institute continues to believe that a two-thirds super-majority of independent directors, as recommended by the Advisory Group, should be a goal for each fund board because it would further enhance the authority of the independent directors. As discussed in Section I above, however, an important characteristic of a best practice recommendation that

¹² Proposing Release at 17 (footnote omitted).

¹³ As noted in the Proposing Release, because many funds already have a majority of independent directors, a majority requirement would not necessitate any change in those cases, but "it would bring those that must change into conformity with the better practice." *Id.* at 19.

¹⁴ *Id.*; Best Practices Report at 11.

distinguishes it from a rule is that it leaves room for a fund's board to determine that a different practice may be more appropriate in a particular case. The Proposing Release observes that an increased percentage of fund directors may change the dynamics of board decision-making in favor of fund investors, but acknowledges that it may require many more funds to change the composition of their boards.¹⁵ We believe that there may be circumstances in which a fund board could reasonably determine that the addition of one or more independent directors, at least at this point in time, would not necessarily be in the interests of fund shareholders after taking into consideration both costs¹⁶ and whether other arrangements may, in the words of the Advisory Group, "be equally or more effective" in achieving the objective of the super-majority recommendation.

For these reasons, the Institute urges the Commission to condition the selected exemptive rules on the presence of a simple majority, and not a two-thirds super-majority, of independent directors on the board. It is highly likely that many fund boards will continue to follow the practice of exceeding the required level both as a precautionary measure (because the consequences of falling below that level could be severe) and in order to satisfy the Advisory Group's recommendation.

The Institute also supports in concept proposed Rule 10e-1, which would temporarily suspend the board composition requirements of the 1940 Act and rules thereunder for prescribed time periods to allow a vacancy caused by the death, disqualification or bona fide resignation of a fund director to be filled.¹⁷ The proposed rule would increase the time periods currently provided under Section 10(e) of the 1940 Act to 60 days if the board of directors may fill the vacancy or 150 days if a shareholder vote is required. As the Commission's proposal recognizes, the importance of these grace periods is amplified because (1) any increase in the percentage of independent directors required on each board may make it less likely that there would be "extra" independent directors to provide a buffer zone, and (2) as noted above, if maintaining the required percentage becomes a condition of reliance on critical exemptive rules, the implications could be severe for a fund that falls below the required percentage.

However, given these circumstances, and because of the time normally involved to properly select, nominate and elect qualified candidates, we believe that the proposed time periods are insufficient. The Institute recommends that they be extended to 120 days if the incumbent directors may name a replacement and 240 days if a shareholder meeting is

¹⁵ Proposing Release at 19.

¹⁶ These costs would include those associated with the possible need to issue a proxy statement and hold a shareholder meeting to elect new independent directors, and/or to compensate additional independent directors, as well as the need to identify and interview suitable candidates. Importantly, the addition of new board members creates an ongoing obligation to pay compensation and possibly provide other benefits. These additional costs could have a disproportionate impact on smaller funds.

¹⁷ Section 10(e) of the 1940 Act suspends the board composition requirements under the 1940 Act in these circumstances for 30 days if the board may fill the vacancy or 60 days if a shareholder vote is required.

required.¹⁸ In the event the Commission declines to expand the time frames as recommended, the Institute anticipates that many funds may seek exemptive relief in order to have sufficient time to replace directors in a prudent and responsible manner.

In addition, the Institute recommends that the Commission clarify in its adopting release that the time periods under Rule 10e-1 will begin to run when a fund becomes aware of a director's disqualification and that, as a result, the board's composition does not meet the requirements of the 1940 Act or rules thereunder.

The Commission has requested comment on an appropriate compliance date for the proposed condition of the selected exemptive rules that would require a majority of independent directors on fund boards. The Proposing Release states that the Commission expects to delay this compliance date for one year if it adopts the proposed amendments. The Institute recommends a transition period of one year from a fund's next fiscal year end after the adoption of the rule amendments. This schedule should permit closed-end funds to comply without the need for and cost of convening a special shareholder meeting. It also should provide sufficient time for any open-end fund that might be required to call a shareholder meeting for the purpose of electing a new independent director (or directors) to do so.

2. Selection and Nomination of Independent Directors

The Institute supports the proposal that would require independent fund directors to select and nominate other independent directors if the fund relies on one or more of the specified exemptive rules. As stated in the Best Practices Report, having the independent directors select and nominate other independent directors "helps dispel any notion that the directors are 'hand picked' by the adviser and therefore not in a position to function in a true spirit of independence."¹⁹

Self-nomination of independent directors is already common practice in the fund industry. Funds that adopt distribution plans pursuant to Rule 12b-1 under the Act are required to provide that independent directors select and nominate their own successors; such funds constitute a majority of the industry. Funds relying on Rule 23c-3, which governs repurchase offers by closed-end funds, must follow this practice as well. The Institute presumes

¹⁸ The proposed 120-day period for board action is intended to correspond with the regular cycle of board meetings for many fund groups (*i.e.*, quarterly), so that it would not be necessary to incur the cost of calling a special meeting of the board. (The 120 days includes the 90 days in a quarter and 30 additional days to prepare for the meeting.) This time frame also allows for quarterly board meeting cycles that may vary beyond a strict 90-day cycle, and for events that may happen too soon before a scheduled quarterly board meeting to complete a search and elect a new or replacement independent director (*i.e.*, find candidates, conduct interviews and hold a vote). The 240-day period seeks to accommodate the regular cycle of board meetings combined with a reasonable period (120 days) to complete a proxy solicitation (again, recognizing the need to allow sufficient time after a board meeting to draft a proxy statement that lists factors the board considered, file such proxy with the Commission, mail the proxies, convene the meeting and obtain the requisite shareholder quorum and vote).

¹⁹ Best Practices Report at 14 (footnote omitted).

that the Commission does not intend by its proposal to change existing procedures followed under these rules; rather, implementation of the proposed requirement would simply extend the procedures to all funds relying on the specified exemptive rules.²⁰

3. Independent Legal Counsel

The Institute supports wholeheartedly the Commission's objective to ensure that independent directors have access to unbiased legal advice in the exercise of their responsibilities to safeguard shareholder interests and monitor conflicts of interest. We believe, however, that the manner in which the Commission has proposed to accomplish this objective is seriously flawed. The Commission's approach would impose a rigid independence standard, thereby supplanting the directors' business judgment. The Institute strongly opposes this approach, as we believe that the selection of counsel is an issue best left to the directors themselves.

The Commission's proposal, which attempts to set forth in a rule standards by which directors should select independent legal counsel, will have a multitude of unintended consequences. Given the effectiveness of restrictions imposed on counsel by the rules of professional conduct and the unnecessary burdens and constraints the Commission's proposal could place on the ability of the independent directors of many fund groups to secure or maintain existing relationships with qualified counsel, a regulatory requirement addressing independent counsel for the independent directors has the potential to be more disruptive and harmful than beneficial.

In the Proposing Release, the Commission has observed that experienced counsel can help independent directors identify potential conflicts of interest and other compliance issues. The proposal seeks to ensure access to such counsel by mandating that, *if* directors have counsel, it must be "independent legal counsel."²¹ A person would qualify as "independent legal counsel" if "[t]he investment company reasonably believes that the person has not acted as legal counsel for the fund's adviser, principal underwriter, administrator. . . , or any of their control persons at any time since the beginning of the company's last two completed fiscal years."²² The rule would cover not only the attorney performing work on behalf of the independent directors, but his or her "partners, co-members or employees."²³ As described in

²⁰ For example, consistent with the Best Practices Report, many fund boards consider it a good practice to seek input into the nomination process from persons associated with the fund's investment adviser and its affiliates. It can be beneficial to have the management company's assistance in identifying persons qualified to serve as independent directors, advising the board of conflicts of interest presented by potential candidates, and otherwise lending support to the independent directors in the selection and interview process. As the Advisory Group noted, the nature and extent of fund management's input into the nomination process is best left to a fund's independent directors to decide, provided that control of the process rests exclusively with the independent directors. See Best Practices Report at 15. The Institute urges the Commission to confirm in its adopting release that the current proposal would not preclude such input.

²¹ The proposal is thus somewhat incongruous in that it places such a high importance on the independence of legal counsel, yet allows that directors are not required to have counsel at all. See Proposing Release at 31-32.

²² Proposed Rule 0-1(a)(6) under the 1940 Act.

²³ *Id.*

the Proposing Release, the independent directors would be permitted to make a limited exception if such representation involved a "remote or minor conflict," such as representing an affiliate in a minor real estate transaction.²⁴

The Institute strongly believes that the Commission's proposal is neither necessary nor advisable. In the first instance, the Commission has not cited, and the Institute is not aware of, any problems that have arisen as a result of current practices of independent directors in retaining counsel.²⁵ Counsel is bound by the rules of professional conduct to identify and disclose potential conflicts of interest and to decline representation if any such conflict renders the counsel incapable of providing impartial, objective and unbiased advice to the independent directors. Independent directors, in the exercise of their business judgment, are in an excellent position to evaluate potential conflicts of interest and determine if their confidence in the ability of counsel to serve the directors is impaired. By appearing to disqualify outright certain experienced legal counsel, the proposed rule is directly at odds with the fundamental premise of the mutual fund governance system—that independent directors can and should be relied upon to make informed decisions regarding what is in the best interests of the fund.

Moreover, the Commission's proposal would have certain perverse effects. The broad definition of "independent legal counsel," covering not only the individual providing advice to the directors but his or her firm, and fellow partners and associates, could have the unintended results of (1) actually discouraging independent directors from seeking their own counsel, and (2) so limiting the pool of eligible counsel that the independent directors of some funds will have difficulty obtaining the advice they need. In an odd twist, the proposal would require independent directors of some fund groups to terminate relationships with counsel that they have relied on for many years, because of work on matters wholly unrelated to the counsel's representation of the independent directors.²⁶ Furthermore, with the increasing consolidation of law firms and the affiliations made possible by the recently enacted financial services reform

²⁴ Proposing Release at 36.

²⁵ Furthermore, current good practices likely will become even more widespread in response to the recommendation in the Best Practices Report concerning qualified independent counsel for independent fund directors. See Best Practices Report at 18-20.

²⁶ We are aware of several situations that likely would result in this outcome. For example, the independent directors of one fund currently are represented by counsel at a large firm. When the fund changed the sub-adviser to its international portfolio, it was discovered that an associate in another office of the law firm had recently done employment work for this new sub-adviser. Under the Commission's proposal, the partner would no longer be eligible to serve as independent counsel to the independent directors. In another example, a law firm has served as counsel to the independent directors of a fund for many years and the management company has consciously avoided the firm for this reason. An internal audit revealed that another attorney in the legal department of the management company contacted a partner in the firm on a retirement product matter. Unless this contact qualifies as "remote or minor," the relationship could call into question the independence of counsel under the Commission's proposal.

More complicated issues may be presented when fund counsel performs work that benefits both the fund and the adviser but is paid for by the adviser (for example, trademark work, proxy statements for mergers, exemptive applications, etc.). While there may be legitimate business reasons for this arrangement – such as fairness to the fund or minimizing fund expenses – under the Commission's proposal, it could disqualify fund counsel from representing the independent directors.

legislation, it is highly likely that many otherwise qualified counsel will be excluded from consideration by the independent directors. Indeed, even counsel or firms that would not be disqualified nevertheless might *choose* not to represent independent directors, as such representation could render the firm and all of its partners and associates ineligible to handle even completely unrelated matters on behalf of any of the fund's related entities. The unfortunate result of this proposal is that the universe of experienced counsel that may be available to independent directors could be severely diminished.²⁷

The limited exception included in the proposal, whereby directors may evaluate potential conflicts and determine that counsel is "independent" if certain conditions are met, is ineffectual to remedy the proposal's defects. First, the exception would apply only in cases where the independent directors determine that "counsel's representation is or was so limited that it would not adversely affect the counsel's ability to provide impartial, objective, and unbiased legal counsel to the directors."²⁸ The commentary in the Proposing Release leaves the clear impression that the exception should be very narrowly drawn.²⁹ Second, and more fundamentally, the establishment of a substantive standard for counsel in a Commission rule would inevitably and inappropriately subject funds and their directors to second-guessing and potential exposure if they were to make use of that standard. The directors, and the fund itself, would face not only the risk of litigation but also the risk that reliance on the various exemptive rules discussed above was misplaced, and the consequences that would flow from such misplaced reliance. Given this uncertainty, it is highly unlikely that directors would be willing to take the risks associated with making this determination. In some cases, they effectively would be forced to replace counsel upon whom they had relied for advice for many years. In other cases, they could well decide to forego seeking counsel's advice altogether to the potential detriment of shareholders.

It is important to note that the Advisory Group recommended that independent directors have *qualified* independent counsel; specifically, counsel with expertise in the regulation of investment companies to advise them as to their responsibilities under both state and federal law.³⁰ The group concluded that having *qualified* counsel was very important to help ensure that the directors understand their responsibilities, ask pertinent questions and receive information necessary to carry out those responsibilities. The Best Practices Report contemplated that the directors themselves should have the discretion to determine if any work performed by the counsel for the adviser or another fund service provider would impair

²⁷ The Commission's proposed definition of "independent legal counsel" would incorporate the meaning of the phrase "acts as legal counsel" currently included in Section 2(a)(19)(B)(iv) of the Act, which defines "interested person." While this parallel may seem logical on its face, its application in this context is overly broad. The Institute believes that it is appropriate to have different standards apply to independent directors, who have the ultimate authority and responsibility for representing shareholders, and to those persons upon whom these directors choose to rely for legal advice.

²⁸ Proposing Release at 36-37.

²⁹ Should directors wish to engage counsel whose independence under the exception is unclear, they may need to seek relief from the Commission. This would place additional burdens on the Commission and staff.

³⁰ See Best Practices Report at 18-20.

counsel's ability to provide impartial, objective and unbiased advice. The Advisory Group's approach highlights the advantage of addressing the issue of counsel for the independent directors through a best practice recommendation instead of a rule. The flexibility afforded by a best practice recommendation allows independent directors to use their judgment in determining the most appropriate way to obtain competent legal advice under the particular circumstances.

The Institute therefore strongly urges the Commission to reconsider its proposal relating to independent counsel. If the Commission remains convinced, however, that a regulatory requirement is needed, we strongly recommend modifying the proposal to incorporate a process-based approach that would give independent directors sufficient latitude in retaining counsel, while still accomplishing the Commission's objectives. Under such an approach, the Commission could require the independent directors, in the exercise of their business judgment, to make a finding annually that their counsel is able to render impartial and objective advice and to reflect that finding in the board minutes.³¹ This finding would be based on disclosure from counsel relating to the nature and extent of any potential conflict.³² If certain relationships appear to raise a potential conflict of interest, the independent directors could assess the ability of the counsel to provide them with impartial advice. The Commission could incorporate in its release adopting the fund governance rule proposals examples of factors that the directors might consider in making this determination.³³ Not only would this approach avoid the many negative consequences of the Commission's proposal, but also it would be more consistent with an important goal of the overall initiative, which is to empower independent directors to make judgments.

B. Coverage of Directors Under Joint Insurance Policies

The Institute supports the proposal to amend Rule 17d-1(d)(7) under the 1940 Act, which permits the purchase of joint directors' and officers' / errors and omissions insurance policies for funds and their affiliates, to make the rule available only for joint insurance policies that do not exclude coverage for bona fide claims against co-insureds. We agree that independent directors should be able to take whatever actions they deem necessary in the interests of shareholders without undue concern over personal liability from litigation, particularly litigation with fund management. The proposed amendment will help eliminate situations where independent directors might be discouraged from acting aggressively in the interests of fund shareholders,

³¹ This approach would eliminate the need for a separate recordkeeping requirement as found in proposed Rule 31a-2(a)(5). The board minutes would be available for Commission inspection. The Institute would oppose public disclosure of the independent directors' deliberations regarding their selection of counsel.

³² This process would be similar to that required annually of accounting firms pursuant to Independence Standards Board Standard No. 1, *Independence Discussions with Audit Committees*.

³³ Factors that independent directors could consider include the nature and types of services counsel performs for the investment adviser or other fund service providers; the amount of fees earned from such services; the importance to the law firm of fees earned from the adviser, distributor, administrator, and/or their affiliates; whether the work done for those entities is substantial in relation to the work performed for the fund board; whether the lawyers providing services to the board receive any financial benefit from work done for those entities; and whether the lawyers serving the directors are effectively screened from the lawyers doing work for those entities.

or where qualified individuals might be discouraged from serving as independent directors, based on concerns about potential personal liability in connection with litigation against a co-insured.

The Commission has asked for comment on whether Rule 17d-1(d)(7) should be further amended to require that insurance policies purchased under it be in an amount adequate to ensure that the independent directors can perform their duties in an independent and effective manner, and what that amount may be. The Institute does not support incorporating such a requirement into the rule. The subjective nature of what amount should be considered "adequate" makes this issue ill-suited to a rulemaking.³⁴ We believe that "adequacy" in this context must be determined on a case-by-case basis. The directors themselves are in the best position to evaluate the need for specific policy features or the total dollar amount of coverage desired, based on the level of risk they are willing to assume. Thus, we agree with the Commission's decision not to incorporate an "adequacy" requirement in the rule, because funds should "have the latitude to determine which arrangements are appropriate for their circumstances."³⁵

C. Independent Audit Committees

The Commission has proposed to exempt funds that have an audit committee meeting certain conditions from the requirement to have shareholders ratify the fund's selection of an independent public accountant. In order to rely on the proposed exemption: (i) the audit committee would have to be responsible for overseeing the fund's accounting and auditing processes; (ii) the audit committee would have to be composed solely of independent directors; (iii) the fund's board of directors would have to adopt an audit committee charter setting forth the committee's structure, duties, powers, and methods of operation; and (iv) the fund would have to maintain and preserve permanently a copy of the charter. The Institute agrees that the ongoing oversight provided by an independent audit committee can provide important protection to shareholders. The conditions in the rule would be consistent with recently adopted standards relating to corporate audit committees³⁶ and would provide the Commission with a method to evaluate the organization and operation of the audit committee. The Institute requests, however, that the Commission confirm that the phrase "oversight of the accounting and auditing processes" found in the first condition of proposed new Rule 32a-4 does not contemplate that the committee would directly supervise a fund's day-to-day management and operations.

³⁴ As indicated in the Proposing Release, the Best Practices Report recommends that fund boards obtain D&O/E&O insurance policies and/or indemnification that is adequate to ensure the independence and effectiveness of independent directors. This is another example of a best practice recommendation that cannot readily be adapted to the form of a regulatory requirement.

³⁵ Proposing Release at 41.

³⁶ Recently, the Commission adopted new rules and rule amendments relating to the functioning of corporate audit committees (Securities Exchange Act Release No. 42266 (Dec. 22, 1999)). Similar rule amendments were recently adopted by the New York Stock Exchange and the American Stock Exchange relating to their audit committee requirements for listed companies (Securities Exchange Act Release Nos. 42233 (Dec. 14, 1999) and 42232 (Dec. 14, 1999)). These rules apply to closed-end investment companies.

The Institute does not support imposing additional requirements for the exemption relating to the filing and review of the audit committee charter. Specifically, the Institute does not see any reason to require that the audit committee charter be filed as an exhibit to the fund's registration statement, nor does the Proposing Release mention any. Instead, the charter should be retained with other fund records. The Institute likewise would not support a requirement that the board annually review the charter. Rather, similar to the requirements of several other rules under the 1940 Act, the Institute recommends that the board approve such changes to the charter as it deems necessary.³⁷

Finally, the Commission has requested comment on whether the rule should recognize that audit committee provisions could be included in a document other than the charter. The Institute would support a provision providing flexibility as to the form of instrument governing the audit committee. In our view, it should be permissible for the audit committee provisions to be set forth in a charter or the by-laws or some other document (*e.g.*, articles of incorporation or declaration of trust).

D. Qualification as an Independent Director

The Commission has proposed to adopt Rule 2a19-3 under the 1940 Act to conditionally exempt an individual from being disqualified as an independent director merely because he or she knowingly has any direct or indirect beneficial interest in a security issued by the fund's investment adviser or principal underwriter or their controlling persons through ownership of shares of an index fund.³⁸ The exemption would be available only if the value of the securities issued by the adviser or underwriter or controlling person does not exceed 5 percent of the value of any index tracked by the index fund.

The Institute appreciates that the Commission has sought to clarify a potential issue under the 1940 Act. We disagree, however, with the Commission's apparent conclusion that an independent director's ownership of shares of an index fund might result in his or her beneficial ownership of the fund's underlying portfolio securities and strongly oppose the promulgation of a rule that would have this implication. We believe the Commission's proposal suggests a novel, and inappropriate, basis upon which to attribute beneficial ownership of securities, and we are concerned that it could promote confusion in this area. As an alternative to the Commission's proposal, the Institute recommends that the Commission simply clarify (*e.g.*, in

³⁷ See, *e.g.*, Rules 10f-3, 17a-7 and 17e-1 under the 1940 Act, requiring that fund boards make and/or approve such changes to the procedures required under those rules as they deem necessary. Alternatively, the charter and any changes thereto could be adopted by a resolution of the audit committee pursuant to a delegation of authority from the full board, where permissible under state law.

³⁸ The Commission also proposed to amend Rule 2a19-1 to provide that an independent director's affiliation with a broker-dealer would be permitted under certain conditions if no more than one-half of a fund's independent directors are broker-dealers or their affiliates. We have no comments on this proposal, as it has become moot with the recent enactment of financial services reform legislation. See Section 213 of S. 900, the Gramm-Leach-Bliley Act.

the adopting release), just as it did with respect to actively managed funds,³⁹ that a director's ownership of shares of *any* management investment company does not raise an issue as to independence, regardless of the nature of the fund's portfolio securities.

If the Commission determines, however, that a rule specific to index funds is needed, the Institute recommends that the Commission revise proposed Rule 2a19-3 to eliminate the percentage limitation. Instead, the Institute recommends that the exemption for directors' ownership of shares of an index fund apply in any case where the index fund tracks a broad-based securities market index. Like the proposed percentage limitation, a requirement that the fund track a broad-based index would address the concern that the index fund not be heavily concentrated in securities issued by the fund's adviser or underwriter. A broad-based index requirement would have the added benefit of not imposing undue compliance burdens on funds and directors. In contrast, under the Commission's proposal, it would be necessary to ascertain the percentage of securities of the adviser or underwriter held by an index fund in which an independent director invested, and possibly to monitor this percentage on an ongoing basis.

The Institute further recommends that the Commission's final action in this area treat investments in unit investment trusts in a manner similar to investments in index funds. There seems to be no justification for evaluating director independence differently depending upon whether the director owns shares of an actively managed fund, index fund or unit investment trust.⁴⁰

III. DISCLOSURE OF INFORMATION ABOUT FUND DIRECTORS

A. Introduction and Summary

Consistent with our longstanding support of effective communications between funds and their shareholders,⁴¹ the Institute supports the general proposition of requiring funds to provide additional disclosure about their directors. Various commentators have urged the Commission to increase the amount and accessibility of information about fund directors that is available to shareholders. We agree that there may be benefits to providing certain additional, useful information about directors to shareholders, although such information should not be required in the fund prospectus, where it would undermine the goal of the Commission's recent prospectus simplification initiative.

³⁹ See Proposing Release at 49, n. 140.

⁴⁰ If the Commission declines to adopt the approach recommended by the Institute, it should, at a minimum, increase the percentage of securities of the adviser, principal underwriter or a controlling person necessary to trigger the presumption that a director is "interested" from 5% (as proposed) to 25% of the value of the index, measured at the time of purchase. We do not believe that ownership of a fund that invests as little as 5% of its portfolio in shares of an adviser or underwriter amounts to a meaningful investment in the adviser or underwriter. In the case of unit investment trusts, the relevant percentage would be 25% of the value of the trust's portfolio instruments.

⁴¹ See, e.g., Letter from Paul Schott Stevens, General Counsel, Investment Company Institute, to Mr. Jonathan G. Katz, Secretary, Securities and Exchange Commission, dated June 9, 1997 (commenting on the Commission's proposed amendments to Form N-1A) ("N-1A Comment Letter").

Thus, as discussed further below, the Institute generally supports the Commission's proposals concerning disclosure of basic information about directors, and disclosure of directors' ownership of shares of funds in their complex. We also support making available to the Commission information about certain positions, interests, transactions and relationships of directors that a fund has designated as "independent" with the fund and various related parties.⁴² We do not support, however, the Commission's proposals to require disclosure about directors' positions, interests, transactions and relationships in fund SAIs, and to require additional disclosure of such information in fund proxy statements beyond that currently required.

Additionally, the Institute opposes the proposed SAI disclosure concerning the board's approval of the fund's investment advisory contract. We also oppose the proposal to require physically separate disclosure concerning independent and "interested" directors. We recommend that the Commission not adopt one of its proposed technical and conforming amendments and, finally, we suggest an appropriate compliance date for any disclosure changes that the Commission ultimately may adopt.

In considering any new disclosure requirements, the needs of shareholders and the Commission for additional information about directors must be carefully balanced with directors' legitimate privacy interests and the need to avoid unreasonably burdensome requirements. In our view, some of the Commission's proposals do not reflect due consideration for these important concerns. Our recommendations below seek to achieve an appropriate balance.

B. Basic Information

1. General Comments

The Institute generally supports the Commission's proposal to require disclosure of certain basic information about all fund directors in a tabular format in the annual report to shareholders, SAI and proxy statement.⁴³ We believe that this proposed disclosure would generally ensure that fund shareholders receive basic information about the identity and experience of their directors on a regular basis.⁴⁴

⁴² This information would assist the Commission in evaluating whether it should exercise its authority to determine that a director is an "interested person" under Section 2(a)(19)(A)(vi) or (B)(vi) of the 1940 Act.

⁴³ The table would disclose for each director: (1) name, address and age; (2) current positions(s) 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.

⁴⁴ We recommend that the Commission permit funds to update this information on an annual basis. Otherwise, fund groups with boards serving multiple funds with staggered fiscal year ends would have to update the information as frequently as monthly, which would be costly and burdensome. Our recommendation is consistent with the approach the staff has permitted for disclosure of complex-wide director compensation. See Letter from Carolyn B. Lewis, Assistant Director, Division of Investment Management, Securities and Exchange Commission, to Investment Company Registrants, dated February 3, 1995, at 3.

In addition, we strongly support the Commission's decision *not* to propose requiring disclosure about fund directors in the prospectus. Including disclosure about directors in the prospectus would be inappropriate because such information is not essential to an investment decision and therefore would be totally inconsistent with the Commission's recent initiative to simplify and improve mutual fund prospectus disclosure,⁴⁵ which the Institute strongly supported.⁴⁶

As discussed in the Proposing Release, in the course of this recent, sweeping fund prospectus disclosure initiative, the Commission thoroughly considered and ultimately decided against requiring information about directors to be included in the prospectus.⁴⁷ The Commission's prospectus disclosure proposal received an unprecedented number of comments from investors and others who overwhelmingly argued that information about directors "is not essential to a typical investor in making a decision about investing in a fund and would only serve to lengthen the prospectus."⁴⁸ These commenters recommended that the SAI or the annual report to shareholders would be more appropriate places for disclosure about fund directors.⁴⁹ The Commission's current proposals are consistent with those recommendations.

Consequently, while we understand that there are some calls for the Commission to consider requiring disclosure about fund directors in the prospectus, we urge the Commission to adhere to the disclosure principles it established in the recent N-1A Release and stand firm on its well-reasoned and widely-supported decision not to do so. As the Commission itself noted in the N-1A Release, "achieving the goals underlying the amendments to Form N-1A . . . necessitates discipline on the part of the Commission and its staff, as well as on the part of funds and their advisers."⁵⁰ A perfect opportunity for the Commission to exercise this discipline has presented itself. We stand firmly behind the Commission's resolve, as reflected in its proposal, because it is critical to the ongoing achievement of the fundamental goals of the disclosure initiatives. It would be a sadly ironic, self-inflicted blow if Commission reforms in the area of fund governance unnecessarily reversed the Commission's recent reforms in the area of disclosure.

⁴⁵ See Investment Company Act Release No. 23064 (Mar. 13, 1998), 63 Fed. Reg. 13916 (Mar. 23, 1998) ("N-1A Release"). As stated in the N-1A Release, the amendments to Form N-1A were intended to "improve fund disclosure by requiring prospectuses to focus on information central to investment decisions." *Id.* at 13917.

⁴⁶ See N-1A Comment Letter.

⁴⁷ See Proposing Release at 56.

⁴⁸ N-1A Release at 13931.

⁴⁹ *Id.*

⁵⁰ N-1A Release at 13941.

2. Specific Information Requirements

As noted above, the Commission has proposed that funds disclose, among other things, the total number of portfolios overseen by each director. The Institute agrees that disclosure of the total number of portfolios that a director oversees will provide shareholders with a more accurate picture of the director's responsibilities than the currently required disclosure of the number of registered investment companies overseen by a director.

We oppose, however, the proposed requirement to describe the relationship, events or transactions that make certain directors "interested persons" of the fund, because it is unnecessary. As long as those directors are clearly identified as "interested persons," the reason *why* they are "interested" is irrelevant. Moreover, as currently required in the SAI and proxy statements,⁵¹ column (4) of the proposed table would require directors to disclose their principal occupations during the past 5 years. In most cases, this information would clearly illustrate the reason why a particular director is "interested" (*e.g.*, because he or she is an officer of the investment adviser). We therefore recommend that the Commission not impose a separate requirement to disclose the relationship, events or transactions that make certain directors "interested persons" of the fund in annual reports, SAIs or proxy statements.⁵²

C. Fund Ownership Information

1. Ownership in Fund Complex

The Commission has proposed to require disclosure in fund SAIs and proxy statements of the aggregate dollar amount of equity securities of funds in the fund complex owned beneficially and of record by each director. The Institute generally supports the Commission's proposal. In particular, we strongly support the Commission's proposal to require disclosure of a director's aggregate ownership of all funds in the complex, as opposed to his or her holdings on a fund by fund basis. As the Commission acknowledged in the Proposing Release, there are many reasons a director could have for not investing in a given fund (*e.g.*, the fund's investment objectives are not aligned with the director's investment goals) and, as a result, such disclosure would have limited value.⁵³ It also could cause investors to erroneously assume a problem with a given fund simply because one or more directors did not hold shares of that fund. It is important to remember that each director has a fiduciary duty to fund shareholders, regardless of the nature or amount of his or her personal investments.

⁵¹ See current Instruction 2 to Item 13(b) of Form N-1A and current Item 401(e) of Regulation S-K, through Item 22(b)(11) of Schedule 14A.

⁵² See Proposed Instruction 4 to Item 22(b)(1) of Schedule 14A, proposed Instruction 2 to Item 13(a)(1) and Item 22(b)(5) of Form N-1A, and proposed Instruction 2 to Item 18.1 of Form N-2; *see also* current Instruction 1 to Item 22(b)(4) of Schedule 14A.

⁵³ See Proposing Release at 59.

We recognize that disclosure of a director's fund ownership by fund complex may not perfectly illustrate alignment of director interests with those of shareholders of a particular fund. Given the limited probative value and potential erroneous negative implications of fund by fund disclosure, however, we believe that the approach taken in the Commission's proposal is the correct one.

For the purpose of disclosing fund ownership by fund complex, the Commission has proposed to use the definition of "fund complex" currently in the proxy rules.⁵⁴ The Proposing Release requests comment, however, on whether this is an appropriate definition, or whether another definition, such as the definition of "family of investment companies" in Form N-SAR,⁵⁵ would be more appropriate.⁵⁶ We recommend using the Form N-SAR definition of "family of investment companies" for disclosure of fund ownership information in both fund SAIs and proxy statements. That definition would require directors to disclose ownership interests in funds that are held out to investors as related companies, which would be relevant to demonstrate that directors' interests are aligned with the interests of fund shareholders.

In contrast, the "fund complex" definition is too broad because it would require, for example, inclusion of a director's holdings in a fund that is completely unrelated to the fund(s) on whose board the director serves, except that it shares the same subadviser. Not only would this information have the potential to inappropriately inflate the ownership amounts to be disclosed, but also, requiring directors to provide information about their ownership of funds that are related to the fund(s) on whose board(s) they serve only by reason of sharing a common subadviser (for example) would intrude upon directors' privacy and would involve undue administrative burdens.⁵⁷

⁵⁴ See Item 22(a)(1)(v) of Schedule 14A (defining "fund complex" as two or more funds that (1) hold themselves out to investors as related companies for purposes of investment and investor services; or (2) have a common investment adviser or an investment adviser that is an affiliated person of the investment adviser of any of the other funds).

⁵⁵ See General Instruction H of Form N-SAR (defining "family of investment companies" to mean any two or more registered investment companies 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).

⁵⁶ See Proposing Release at 60.

⁵⁷ Similar anomalous results may occur from using this overly broad definition in other contexts (e.g., disclosure of director compensation). For example, the current definition of "fund complex" requires Fund A in fund group ABC, when disclosing compensation received by each director from the "fund complex," to include the compensation one of its directors earned for service as a director of Fund X in fund group XYZ, where fund groups ABC and XYZ are completely unrelated except that Fund A and Fund X share the same subadviser. Although this set of circumstances may be unlikely to arise, we believe this is an inappropriate result. For this reason, and for consistency throughout proxy statement and registration statement disclosure requirements, the Commission should consider applying the "family of investment companies" definition in lieu of the definition of "fund complex" for all purposes in fund proxy and registration statements.

2. Disclosure of Dollar Ranges

Under the Commission's proposal, funds would be required to disclose the aggregate dollar amount of equity securities of funds in the fund complex owned by each director. In lieu of requiring disclosure of specific dollar amounts of fund ownership, the Institute strongly recommends that the Commission require disclosure of ownership within specified dollar ranges. Disclosure of a specific dollar amount of assets in the fund complex is not necessary to demonstrate alignment of directors' interests with those of shareholders. Moreover, specific dollar amount disclosure would impinge on directors' privacy. Requiring disclosure of fund ownership within dollar ranges would provide investors with sufficient information to assess directors' economic stakes in funds in the complex without unduly invading directors' privacy.

For this purpose, we suggest the following dollar ranges: None; \$1-\$10,000; \$10,001-\$50,000; \$50,001-\$100,000; and Over \$100,000. We believe that it is particularly important to avoid requiring more detailed disclosure regarding ownership amounts exceeding \$100,000. Such disclosure essentially would require directors to reveal whether they are high net worth individuals, which is an invasion of privacy neither justified nor necessitated by the underlying purpose of the disclosure. Forcing directors to disclose indications of high net worth could make them targets for plaintiffs' attorneys, or for sales schemes or persons who prey on high net worth individuals. To subject directors to such risks not only would be unjustified, but also could have the unintended effect of discouraging directors from investing large amounts in funds on whose boards they serve specifically because they do not want to disclose indications of high net worth. Worse yet, it could discourage qualified individuals from serving as independent directors. We therefore recommend that the Commission revise its proposal to require directors to disclose fund ownership within the above-proposed dollar ranges.

D. Information About Certain Positions, Interests, Transactions and Relationships of Directors

1. General Comments

The Commission has proposed to require disclosure in fund SAIs and proxy statements about certain positions, interests, transactions and relationships of directors and their "immediate family members" with the fund and various related persons and entities.⁵⁸ This proposed disclosure would be entirely new in fund SAIs and would *significantly* expand disclosure of this type that is currently required in fund proxy statements.⁵⁹ For the reasons

⁵⁸ These persons and entities would include, among others, the fund's investment adviser, principal underwriter and administrator, and any person controlling, controlled by or under common control with any of those entities.

⁵⁹ For example, with respect to positions, the current proxy rules require funds to identify any director or nominee for election as director who is, or was during the past five years, an officer, employee, director or general partner of the investment adviser. See Item 22(b)(1) of Schedule 14A. By contrast, the Commission's proposal would require funds to describe any positions, including as an officer, employee, director or general partner, held by a director, nominee, or an immediate family member of a director or nominee, during the past five years, with *any* of the following: (i) the fund; (ii) an investment company, or person relying on the exclusions in Sections 3(c)(1) and 3(c)(7) of the Investment Company Act, having the same investment adviser, principal underwriter, administrator or sponsoring insurance company as the fund, or having an investment adviser, principal underwriter, administrator or sponsoring insurance

detailed below, the Institute strongly opposes the proposed disclosure of positions, interests, transactions and relationships of directors and their family members in fund SAIs and proxy statements, and recommends an alternative approach to making such information available to the Commission.

First, we believe that the current proxy rule requirements provide shareholders with sufficient information about positions, interests, transactions and relationships of directors and their family members.⁶⁰ Given the strict standards for independence of independent directors under the 1940 Act, and considering that a fund and its counsel examine a director's independence before placing that director before shareholders for a vote, the disclosure of any further such information in fund proxy statements is unnecessary. Moreover, while information of this type arguably might be considered relevant in the proxy statement context (when shareholders are asked to evaluate candidates for election to the board of directors), we do not believe it would provide any benefits to shareholders if disclosed in the SAI. Notably, we are unaware of any widespread demand from shareholders for the information proposed by the Commission.

Second, the scope of the Commission's proposal is so broad that it likely would result in disclosure in proxy statements and SAIs that is of questionable or no relevance to fund shareholders, and that could cause confusion or be subject to misinterpretation. For example, what conclusion should shareholders draw if they learn that, four years ago, a company under common control with the fund's administrator, or a company that at that time owned 5% of the fund's outstanding voting securities, employed the son-in-law of a fund director? Even if one could manage to conjure up a scenario under which shareholders might derive some minor benefit from the availability of this information, any such benefit would be far outweighed by the extreme burden that would be placed on funds, and especially on their directors, who would have to compile and update the required information concerning not only themselves but also a potentially broad range of other people.⁶¹ Particularly for fund groups with boards that serve multiple funds with staggered fiscal year ends, an SAI disclosure requirement would necessitate asking for updated director information as frequently as monthly. These burdens, along with the potential liability for material omissions that registration statement disclosure would entail, could well discourage directors from continuing to serve on fund boards or from joining such boards in the first place.

Third, the proposed disclosure is not an appropriate way to achieve the Commission's stated goals. According to the Proposing Release, the Commission believes that "the proposed disclosure would give shareholders the tools to determine how effectively the directors serve

company that directly or indirectly controls, is controlled by, or is under common control with an investment adviser, principal underwriter, administrator or sponsoring insurance company of the fund; (iii) an investment adviser, principal underwriter, administrator, or affiliated person of the fund; or (iv) any person directly or indirectly controlling, controlled by, or under common control with an investment adviser, principal underwriter, administrator, or sponsoring insurance company of the fund. See proposed Item 22(b)(3) of Schedule 14A.

⁶⁰ See Items 22(b)(1) through (4) of Schedule 14A.

⁶¹ The Commission's Cost-Benefit Analysis did not take into account any of the time that fund directors themselves would have to spend tracking down, compiling and submitting such information. See Proposing Release at 99-104.

their interests and encourage the selection of directors that are independent in the spirit intended by Congress.”⁶² The Institute disagrees with the first part of this statement, and believes there are better ways to accomplish the objective described in the second part.

Contrary to the Commission’s assertion, the proposed information would *not* equip shareholders to determine how effectively directors are serving their interests. Indeed, in many cases, the positions, interests, transactions or relationships that would have to be disclosed under the Commission’s proposal would have no bearing whatsoever on a particular director’s effectiveness in serving shareholder interests.⁶³ Yet, disclosure of this information would have negative connotations. It would imply that the information provides a legitimate and adequate basis for shareholders to assume some impropriety or lack of objectivity on the part of the director. This result would be inappropriate and unfair.

Moreover, public disclosure of the various positions, interests, transactions and relationships of directors, as proposed by the Commission, is not necessary to achieve the objective of encouraging the selection of directors that are “independent in the spirit intended by Congress.” For example, with this same goal in mind, the Advisory Group recommended 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.⁶⁴ As stated in the Best Practices Report, this recommendation goes far beyond current law. The industry’s record of embracing best practices suggests that most fund boards either already do, or in response to the Advisory Group’s recommendation will, adhere to this high standard.

Based on the foregoing, the Commission should not adopt its proposal to require the proposed information about positions, interests, transactions and relationships of fund directors and their family members in fund SAIs or proxy statements. Instead, we recommend that the Commission require funds to: (1) keep records reflecting this information (subject to the modifications we suggest below); and (2) maintain copies of such records for six years, the first two in an easily accessible place. The records, which could be in the form of a questionnaire or other document, would be available to the Commission to assist in a determination of whether a “material business or professional relationship” exists for purposes of Section 2(a)(19) of the 1940 Act.

This approach to monitoring various positions, interests, transactions and relationships of directors and their family members is consistent with, but actually would go further than, the Commission’s proposed recordkeeping requirement.⁶⁵ Our proposal would require a very thorough examination of independence by requiring funds to keep records of specific information concerning positions, interests, transactions and relationships of independent

⁶² Proposing Release at 65.

⁶³ The examples set forth above concerning the employment four years ago of a director’s son-in-law by a company under common control with the fund’s administrator, or a company that owned 5% of the fund’s outstanding voting securities at that time, are but two of the countless scenarios that could be used to illustrate this point.

⁶⁴ Best Practices Report at 12-14.

⁶⁵ See proposed Rule 31a-2(a)(4). We suggest that the Commission implement our recommendation by revising proposed Rule 31a-2(a)(4).

directors and their family members with the fund and related entities. Prescribing the content of the required records would accomplish the goal of providing the Commission with information to monitor funds' assessments of their directors' independence. It also would bolster existing incentives for funds to select directors whose independence is unimpaired.

2. Scope of Information Required

As discussed below, we recommend several modifications to the scope of the information about positions, interests, transactions and relationships of directors and their family members to be covered by our proposed recordkeeping requirement. Our proposed modifications are intended to avoid both encompassing situations that are unlikely to have any significant relevance to a director's independent status and placing unreasonable burdens on funds and their directors. Our recommendations address: (a) "interested" directors; (b) "immediate family members;" (c) fund administrators; (d) control persons; (e) *de minimis* thresholds; (f) cross-directorships; and (g) time periods to be covered.

a. *"Interested" Directors*

The Commission has proposed to "follow the approach taken in the current proxy rules" and require disclosure of positions, interests, transactions and relationships of both "interested" and independent directors.⁶⁶ We believe that the approach currently taken in the proxy rules is inappropriate, given the purpose of the information. Information about circumstances that potentially could affect the status of directors who are not considered to be "interested persons" of the fund serves no purpose in the case of admittedly "interested" directors. We therefore recommend that information concerning positions, interests, transactions and relationships of "interested" directors not be required either in the records we propose or in fund proxy statements.⁶⁷

b. *Immediate Family Members*

The Commission has proposed to require disclosure of various positions, interests, transactions and relationships of directors and their "immediate family members." The Commission's proposed definition of "immediate family member" is exceedingly broad and includes family relationships that often may be attenuated for a variety of reasons.⁶⁸ For instance, an independent director simply may be unaware of a daughter-in-law's or stepson's involvement with a person or entity related to the fund, and such involvement is unlikely to cause a conflict even if known by the director. Moreover, given the sensitivities and nuances of

⁶⁶ Proposing Release at 67.

⁶⁷ This recommendation is consistent with the Commission's proposed recordkeeping requirement, proposed Rule 31a-2(a)(4), which is limited by its terms to independent directors.

⁶⁸ As proposed, the term "immediate family member" would include "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." See proposed Instruction 1(b) to Item 13 of Form N-1A.

family relationships, it could be quite difficult, and in some cases impossible, for independent directors to obtain such information from certain relatives (*e.g.*, if a relative lives overseas or his or her location is unknown, or where the director is not on speaking terms with the relative).

Not only does the Commission propose to adopt a very broad definition of “immediate family member,” but also the universe of positions, interests, transactions and relationships of such persons that would be covered is extremely expansive.⁶⁹ This would result in a tremendous burden on fund directors to seek information that in many cases would not be relevant to their “independent” status. We therefore recommend that “immediate family member” be defined for this purpose to include any family member residing in the same household as the independent director and any dependents of the director.⁷⁰ The Institute believes that modifying the scope of the definition of “immediate family member” in this manner will better capture situations that realistically might raise potential conflict of interest concerns, without unduly burdening fund directors or invading their privacy.

We recognize that our proposed definition of “immediate family member” would be narrower than the definition of “member of the immediate family” in Section 2(a)(19) of the 1940 Act.⁷¹ Significantly, however, the Commission’s authority under Section 2(a)(19)(A)(vi) and (B)(vi) to determine that a director is an “interested person” of a fund (or its investment adviser or principal underwriter) on the basis of a “material business or professional relationship” does not encompass relationships involving the director’s family members.⁷² Thus, our proposed definition still would require funds to provide information about relationships that go beyond the scope of Section 2(a)(19)(A)(vi) and (B)(vi). We believe it would strike a fair balance between the need to identify relationships that potentially could present conflicts of interest and the burdens that would be imposed on directors if an overly broad definition of “immediate family member” were adopted.

c. Fund Administrators

The Institute also recommends that information about positions, interests, transactions and relationships covered in the records not include those involving fund administrators. While we recognize that the Commission based this aspect of its proposals on the current proxy rules,⁷³ we disagree with the Commission’s assessment that independent directors’ interactions

⁶⁹ See, *e.g.*, note 59, *supra*.

⁷⁰ A “dependent” should be defined as any person whom a director may claim as a dependent on his or her federal income tax return.

⁷¹ Section 2(a)(19) of the 1940 Act defines “member of the immediate family” to mean any parent, spouse of a parent, child, spouse of a child, spouse, brother or sister, and includes step and adoptive relationships. It does not include, however, a mother- or father-in-law or brother- or sister-in-law.

⁷² Under these provisions, the Commission is authorized to issue an order determining that a natural person is an “interested person” of a fund, or its investment adviser or principal underwriter, “by reason of having had, at any time since the beginning of the last two completed fiscal years of [the fund], a material business or professional relationship” with the fund, its investment adviser or principal underwriter, or certain related persons or entities.

⁷³ See Proposing Release at 69. See also Item 22(b)(3) of Schedule 14A.

with fund administrators may affect their "ability to safeguard the interests of fund shareholders."⁷⁴ Where a fund's administrator and its adviser are not part of the same business organization, the fund board typically negotiates the administrative contract through the fund's sponsor or adviser, who acts at arm's length with the administrator.⁷⁵ The directors' interactions with administrators normally are very limited and thus do not raise the types of conflicts that the Commission seeks to uncover in its disclosure proposals. We further note that requiring records concerning directors' positions, interests, transactions or relationships with fund administrators would not assist the Commission in determining whether it should exercise its authority to determine that a director is an "interested person" under Section 2(a)(19)(A)(vi) or (B)(vi) of the 1940 Act, because those provisions do not cover relationships with fund administrators.

d. Control Persons

Additionally, we recommend that the information required in the records we propose be limited to directors' positions, interests, transactions and relationships that involve the fund's investment adviser and principal underwriter, or their parents or subsidiaries, and not include all entities under common control with the adviser or principal underwriter, as the Commission has proposed. Information concerning entities under common control with the fund's adviser or principal underwriter would be of limited value to assessing a director's independence, because the attenuated nature of the relationship between a sister company of the adviser or underwriter and the fund makes any conflict of interest unlikely.⁷⁶ For example, in the case of funds that are part of large financial services firms, the funds' adviser and/or underwriter may have "common control" affiliates throughout the world that are involved in a wide range of businesses unrelated to mutual funds. It is unlikely that a conflict would exist in this situation, where the affiliates are involved in completely different businesses.

Moreover, even where an adviser or underwriter is under common ownership with another entity involved in the mutual fund business, the adviser or underwriter and such other entity are unlikely to be in a position to control or influence one another. In some circumstances, they may view each other as competitors. Given the small likelihood that a conflict would arise in the case of an entity under common control with the fund's adviser or principal underwriter, the increased burden that requiring such information would place on funds and their independent directors simply is not justified.

⁷⁴ See Proposing Release at 69.

⁷⁵ For example, a fund might enter into a contract with a third-party administrator to perform certain administrative functions that the administrator can perform more efficiently than the adviser. In this case, the adviser's interests are aligned with those of the fund's shareholders, because the adviser and fund shareholders have a common interest in ensuring that administrative fees are kept to a minimum.

⁷⁶ In its recent interpretive release concerning issues related to independent fund directors, the Commission provided several examples of transactions or relationships that might be viewed as "material business or professional relationships" for purposes of Section 2(a)(19)(A)(vi) and (B)(vi). See Release No. IC-24083 (Oct. 14, 1999). We note that none of the examples involved transactions or relationships with an entity under common control with the fund's investment adviser or principal underwriter.

e. De Minimis Thresholds

The Institute further recommends establishing a \$60,000 threshold to trigger a requirement to keep records of interests of independent directors and their immediate family members in specified parties related to the fund, rather than covering any "material" interest, as proposed by the Commission.⁷⁷ Similarly, the Institute recommends that a \$60,000 threshold apply to determine whether any interest of a director or an immediate family member in a transaction or relationship would have to be reflected in fund records. The \$60,000 threshold is consistent with current requirements under the proxy rules⁷⁸ and would appropriately focus the information required on significant interests that may give rise to potential conflicts of interest, without unduly burdening independent directors and their immediate family members. Moreover, in contrast to a "material" standard, it would provide an objective, bright-line test for when records are required, which would promote consistency across different fund groups.

f. Cross-Directorships

The Commission has proposed to require disclosure of 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. The Proposing Release indicates that the Commission believes such cross-directorships could potentially create conflicts of interest for directors, but requests comment on whether the Commission has appropriately defined the scope of the circumstances to be disclosed.

The Institute agrees that there are some situations in which cross-directorships potentially could create conflicts of interest for directors. We are concerned, however, that the Commission's proposal would extend to many situations that would not raise potential conflicts and that the requirement would be very burdensome to administer in its current form.⁷⁹ We recommend that the Commission address these issues by modifying the scope of information proposed to be required concerning cross-directorships in much the same way as we propose modifying the scope of other proposed information concerning directors' positions, interests, transactions and relationships.

Thus, cross-directorship information should not be required with respect to "interested" directors, given the purpose of the information. In addition, the cross-directorship information should cover independent directors and their "immediate family members," defined in the

⁷⁷ See proposed Items 22(b)(7) and (8) of Schedule 14A and proposed Items 13(b)(7) and (8) of Form N-1A.

⁷⁸ See Item 404(a) of Regulation S-K, referenced in Item 22(b)(4) of Schedule 14A. The Commission may want to consider adjusting the \$60,000 threshold upward to account for inflation.

⁷⁹ For example, in some instances the proposed requirement would require fund groups to survey thousands of people to determine whether any cross-directorships exist that, under our proposal, would have to be reflected in fund records. The proposal would be particularly burdensome for companies with a large number of affiliated entities, which has and may continue to become increasingly common as a result of consolidation within the financial services industry.

narrower manner we suggest above. Finally, funds should not be required to keep records concerning cross-directorships involving the fund's administrator or its control persons, or an entity under common control with the fund's investment adviser or principal underwriter.

g. Time Periods

The Commission has requested comment on the appropriate time period to be covered by the information concerning positions, interests, transactions and relationships of directors and their immediate family members with the fund and related parties. The Institute recommends that the Commission require a fund's records to provide this information for the two most recently completed calendar years. We recognize that a fiscal year time period coincides with the time period specified under Section 2(a)(19)(A)(vi) and (B)(vi) of the 1940 Act.⁸⁰ For fund groups with boards that serve multiple funds with staggered fiscal year ends, however, a fiscal year time period would require funds to obtain updated information from their directors as frequently as monthly. Therefore, to ensure that the administration of this recordkeeping requirement is not overly burdensome for funds and their directors, we strongly recommend a time period based on calendar year ends. In addition, the Commission should permit funds a certain period of time to comply with the recordkeeping requirement (*e.g.*, 90 days following year end).

3. Board's Role in Fund Governance

The Commission has proposed to require in the SAI disclosure of the factors and conclusions that formed the basis for the board's approval of the fund's existing investment advisory contract.⁸¹ The Institute questions the potential usefulness of this proposed disclosure. Despite the Commission's desire to ensure that information provided in response to this requirement does not result in "boilerplate" disclosure, we are skeptical that this goal will be achieved. We note, for example, that in contrast to the proposed disclosure in the SAI of the routine, annual approval of the advisory contract, when advisory contract disclosure is provided in proxy statements, it is because a material change that directly impacts shareholders is being considered (*e.g.*, a proposed fee increase or new adviser). These circumstances tend to result in more useful information than a description of the annual approval of the advisory contract likely would provide. Thus, we recommend that the Commission not adopt the proposed SAI disclosure requirement.

4. Separate Disclosure

The Institute opposes the Commission's proposal that funds present disclosure concerning independent directors separately from disclosure about "interested" directors in annual reports, the SAI, and proxy statements. We believe that the use of an asterisk to identify "interested" directors, as is currently required for SAIs and proxy statements, clearly indicates to investors which directors are not independent. Given that all fund directors, whether

⁸⁰ See n. 72, *supra*.

⁸¹ Similar disclosure is currently required in fund proxy statements. See Item 22(c)(11) of Schedule 14A.

"interested" or independent, have a fiduciary duty to act in the best interests of shareholders, we believe the proposal for physically separate disclosure is misguided and should therefore be dropped. Physically separate disclosure could imply that "interested" directors do not have the same fiduciary duty as independent directors to act in shareholders' best interests, and it could even leave shareholders with the erroneous impression that a divisive or antagonistic relationship exists between the two groups of directors.

5. Technical and Conforming Amendments

The Commission has proposed to require in the SAI "a brief description of any arrangement or understanding between a director or officer and any other person pursuant to which he was selected as a director or officer." This proposal is described as a conforming change because such disclosure is currently required under the proxy rules. The Institute opposes this proposed change. First, the purpose and scope of this proposed requirement are unclear. Moreover, in light of the Commission's proposal to condition reliance on key exemptive rules on self-nomination of independent directors, this disclosure requirement seems both unnecessary and unlikely to produce disclosure of any value to shareholders. Therefore, we recommend that the Commission delete this requirement from the proxy rules and not require such disclosure in the SAI, at the very least for funds whose independent directors are self-nominated.

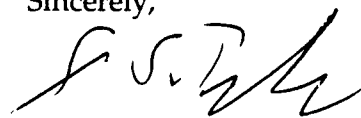
6. Compliance Date

To give funds sufficient time to comply with any amendments that would revise fund disclosure requirements, we recommend that the Commission provide a transition period of one year after the effective date of the amendments. Following the transition period, annual reports, new registration statements, post-effective amendments that are annual updates to registration statements and proxy statements filed with the Commission would have to comply with the new disclosure requirements. We further recommend that the Commission clarify in its release adopting any new disclosure requirements that post-effective amendments filed to comply with such requirements will be permitted to be 485(b) filings, if otherwise eligible under that rule. The Institute also recommends that the compliance date for our proposed recordkeeping requirement be one year from the effective date of the amendments.

* * *

We appreciate the Commission's consideration of our comments on these important and far-reaching proposals. If you have any questions or need additional information, please contact me at (202) 326-5815, Frances Stadler at (202) 326-5822 or Marguerite Bateman at (202) 326-5813.

Sincerely,



Craig S. Tyle
General Counsel

Mr. Jonathan G. Katz
January 28, 2000
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cc: Arthur Levitt, Chairman
Paul R. Carey, Commissioner
Isaac C. Hunt, Jr., Commissioner
Norman S. Johnson, Commissioner
Laura S. Unger, Commissioner

Paul F. Roye
Director, Division of Investment Management