SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 270

[Release No. IC–26323; File No. S7–03–04]

RIN 3235–AJ05

Investment Company Governance

AGENCY: Securities and Exchange Commission.

ACTION: Proposed rule.

SUMMARY: The Securities and Exchange Commission (''Commission'') is proposing amendments to rules under the Investment Company Act of 1940 to require registered investment companies (''funds'') to adopt certain governance practices. The proposed amendments, which apply to funds relying on certain exemptive rules, are designed to enhance the independence and effectiveness of fund boards and to improve their ability to protect the interests of the funds and fund shareholders they serve.

DATES: Comments must be received on or before March 10, 2004.

ADDRESSES: To help us process and review your comments more efficiently, comments should be sent by one method only. Comments in paper format should be submitted in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street NW., Washington, DC 20549–0609. Comments in electronic format should be submitted to the following E-mail address: *rule-comments@sec.gov*. All comments should refer to File No. S7–03–04; if E-mail is used, this file number should be included on the subject line. Comment letters will be available for public inspection and copying in the Commission's Public Reference Room, 450 Fifth Street NW., Washington, DC 20549. Electronically submitted comment letters will be posted on the Commission's Internet web site (*http://www.sec.gov.*) [1]

FOR FURTHER INFORMATION CONTACT: Catherine E. Marshall, Attorney, Office of Investment Adviser Regulation, (202) 942–0719; C. Hunter Jones, Assistant Director, Office of Regulatory Policy, (202) 942–0690, Division of Investment Management, Securities and Exchange Commission, 450 Fifth St. NW., Washington, DC 20549–0506.

SUPPLEMENTARY INFORMATION: The Commission is proposing amendments to: rules 0–1(a) [17 CFR 270.0–1(a)]; 10f–3(c)(11) [17 CFR 270.10f–3(c)(11)]; 12b–1(c) [17 CFR 270.12b–1(c)]; 15a–4(b)(2)(vii) [17 CFR 270.15a–4(b)(2)(vii)]; 17a–7(f) [17 CFR 270.17a–7(f)]; 17a–8(a)(4) [17 CFR 270.17a–8(a)(4)]; 17d–1(d)(7)(v) [17 CFR 270.17d–1(d)(7)(v)]; 17e–1(c) [17 CFR 270.17e–1(c)]; 17g–1(j)(3) [17 CFR 270.17g–1(j)(3)]; 18f–3(e) [17 CFR 270.18f–3(e)]; 23c–3(b)(8) [17 CFR 270.23c–3(b)(8)]; and 31a–2 [17 CFR 270.31a–2] under the Investment Company Act of 1940 [15 U.S.C. 80a] (the ''Investment Company Act'' or the ''Act'').[2]

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I. Background

Investment companies typically are formed as corporations or business trusts under state law and, like other business organizations, must be operated for the benefit of their shareholders. Under the Investment Company Act, each fund must have a board of directors, which is elected by shareholders to represent their interests. Fund boards are fully empowered with authority to manage all of the fund's affairs, although most delegate management responsibility to the fund adviser over whom they retain oversight responsibility.

In 2001, we recognized the need to improve governance standards and adopted rules to improve the effectiveness of the independent directors [3] and their ability to deal with fund managers.[4] These rules, which apply to funds relying on certain of our exemptive rules, require that boards have a majority of independent directors, that independent directors select and nominate independent directors, and that independent directors, when they hire counsel, hire only counsel that does not have substantial ties to fund managers.[5] The rules required funds to make modest improvements to their governance practices.

Recent events, however, suggest we need to revisit the governance of funds. We and state regulators have brought a number of enforcement actions involving late trading, inappropriate market timing activities and misuse of nonpublic information about fund portfolios.[6] These enforcement actions reflect a serious breakdown in management controls in more than just a few mutual fund complexes. In each case, the fund was used for the benefit of fund insiders rather than fund shareholders. In this respect, the enforcement cases bear a striking similarity to the abuses that led to the enactment of the Investment Company Act.[7]

The Investment Company Act relies heavily on fund boards of directors to manage conflicts of interest that the

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[1] We do not edit personal, identifying information, such as names or E-mail addresses, from electronic submissions. Submit only information you wish to make publicly available.

[2] Unless otherwise noted, all references to statutory sections are to the Investment Company Act of 1940.

[3] We refer to directors who are not ''interested persons'' of the fund as ''independent directors'' or ''disinterested directors.'' The term ''interested person'' is defined in section 2(a)(19) [15 U.S.C. 80a–2(a)(19)] of the Investment Company Act.

[4] Role of Independent Directors of Investment Companies, Investment Company Act Release No. 24816 (Jan. 2, 2001) [66 FR 3734 (Jan. 16, 2001)] (''2001 Adopting Release'').

[5] *See, e.g.,* rule 12b–1(c) [17 CFR 270.12b–1(c)].

[6] *See, e.g.,* In the Matter of Alliance Capital Management, L.P., Investment Company Act Release No. 26312 (Dec. 18, 2003) (''Alliance Capital Management'') (finding that an investment adviser violated its fiduciary duty to the fund by failing to disclose agreements, and making special accommodations, to permit select investors to engage in market timing transactions in exchange for the maintenance of ''sticky assets,'' and finding that the investment adviser divulged material nonpublic information about portfolio holdings); In the Matter of Putnam Investment Management, Investment Company Act Release No. 26232 (Nov. 13, 2003) (''Putnam Investment Management'') (finding that an investment adviser failed to disclose potentially self-dealing transactions in shares of funds managed by several of its employees, failed to have procedures reasonably designed to prevent misuse of material nonpublic information, and failed to reasonably supervise the employees who committed violations); In the Matter of Connelly, Investment Company Act Release No. 26209 (Oct. 16, 2003) (finding that a former executive of an investment adviser to a fund complex approved agreements that permitted select investors to engage in market timing transactions in certain funds in the complex, in exchange for the maintenance of sticky assets); In the Matter of Markovitz, Investment Company Act Release No. 26201 (Oct. 2, 2003) (finding that a former hedge fund trader violated the federal securities laws and defrauded investors by engaging in late trading of mutual fund shares).

[7] *See* Sen. Rep. No. 76–1775, at 6 (1940) (''[C]ontrol of [investment companies] offers manifold opportunities for exploitation by the unscrupulous managements of some companies. [Investment company] assets can and have been easily misappropriated and diverted by such types of managements, and have been employed to foster their personal interests rather than the interests of the public security holders.''). *See also* section 1(b)(2) [15 U.S.C. 80a–1(b)(2)] (finding that the interests of investors are adversely affected when funds are organized, operated and managed in the interest of fund insiders).

fund adviser inevitably has with the fund. The effectiveness of a fund board and the influence of its independent directors depend on both the quality of the directors and the governance practices they adopt. Our concern is that in many fund groups, including some of the fund complexes that have been the subject of our enforcement cases, the fund adviser exerts a dominant influence over the board. Because of its monopoly over information about the fund and its frequent ability to control the board's agenda, the adviser is in a position to attempt to impede directors from exercising their oversight role. In some cases, boards may have simply abdicated their responsibilities, or failed to ask the tough questions of advisers;[8] in other cases, boards may have lacked the information or organizational structure necessary to play their proper role.[9]

Management-dominated boards may be less likely to effectively undertake the many important responsibilities assigned to them.[10] The breakdown in fund management and compliance controls evidenced by our enforcement cases raises troubling questions about the ability of many fund boards, as presently constituted, to effectively oversee the management of funds.[11] The failure of a board to play its proper role can result, in addition to serious compliance breakdowns, in excessive fees and brokerage commissions, less than forthright disclosure, mispricing of securities, and inferior investment performance.

We believe that a fund board must be "an independent force in [fund] affairs rather than a passive affiliate of management." [12] Its independent directors must bring to the boardroom "a high degree of rigor and skeptical objectivity to the evaluation of [fund] management and its plans and proposals," particularly when evaluating conflicts of interest.[13] To empower independent directors to better serve as an effective check on fund management, we are proposing to require funds to adopt better governance practices. Publicly traded companies now are required by exchange listing standards to have similar practices in place.[14] Many have been adopted voluntarily by some fund complexes.[15]

II. Discussion

The Commission is proposing to amend ten of our exemptive rules to require any fund that relies on any of them to adopt certain fund governance standards, which we discuss below, in addition to those adopted by the Commission in 2001. Each of these rules, which we have listed in the margin below,[16] (i) exempts funds or their affiliated persons from a provision of the Act, and (ii) has as a condition the approval or oversight of independent directors. For convenience, we will refer to these rules as the "Exemptive Rules." The Exemptive Rules typically relieve funds from statutory prohibitions that preclude certain types of transactions or arrangements that would involve serious conflicts of interest. We are also proposing to require that funds retain, for our examination, copies of written materials that the board considers when approving the fund's advisory contract.

In proposing these rules, we recognize that there is a tension between the role

[8] *See, e.g.*, In the Matter of Hammes, Investment Company Act Release No. 26290 (Dec. 11, 2003) (directors of Heartland Funds negligently failed to adequately monitor the liquidity of the Funds and to take adequate steps to address the Funds' pricing deficiencies, and failed to inquire beyond the self-serving answers and misrepresentations they received from the advisers regarding the board's concerns). One Commissioner believed that the Heartland Funds directors' conduct was reckless or knowing. *See* In the Matter of Hammes, Investment Company Act Release No. 26290A (Jan. 7, 2004). (Commissioner Roel C. Campos dissenting as to the Commission's acceptance of the Heartland Funds directors' settlement offer, on the basis that it charged only negligence or non-scienter based fraud and because imposition of a cease-and-desist order was insufficient to address the conduct).

[9] In order to get fund boards the information they need to oversee fund compliance, we recently adopted rules requiring appointment of a chief compliance officer reporting directly to the fund board. New rule 38a–1 will require fund boards (including independent directors) to (i) approve the compliance policies and procedures of the fund and its service providers; (ii) designate, and approve the compensation of, the compliance officer; (iii) approve the removal of the chief compliance officer; and (iv) review the compliance officer's annual report and meet separately with the compliance officer. Compliance Programs of Investment Companies and Investment Advisers, Investment Company Act Release No. 26299 (Dec. 17, 2003) [68 FR 74714 (Dec. 24, 2003)] ("Compliance Adopting Release").

[10] The Investment Company Act places specific responsibilities on fund boards and the independent directors, including evaluating and approving a fund's advisory contract (sections 15(a) and 15(c) [15 U.S.C. 80a–15(a) and 80a–15(c)]), approving the fund's principal underwriting contract (sections 15(b) and 15(c) [15 U.S.C. 80a–15(b) and 80a–15(c)]), selecting the fund's independent accountant (section 32(a)(1) [15 U.S.C. 80a–31(a)(1)]), and valuing certain securities held by the fund (section 2(a)(41) [15 U.S.C. 80a–2(a)(41)]). In addition, state law generally places responsibility on directors to oversee all operations of a fund. *See* Jean Gleason Stromberg, *Governance of Investment Companies*, *in* The Investment Company Regulation Deskbook §§ 4.1–2 (Amy L. Goodman ed., 1997). Many of our exemptive rules rely heavily on independent directors to approve transactions and review practices involving conflicts of interest that otherwise would be prohibited by the Act.

[11] In some cases, fund boards appear to have been deceived, misled or not informed as to the existence of serious compliance lapses. Our new compliance rule, which requires each fund to designate a chief compliance officer who reports directly to the board of directors, should get boards the information they need about compliance matters. *See* Compliance Adopting Release, *supra* note 9.

[12] Division of Corporation Finance, Securities and Exchange Commission, *Staff Report on Corporate Accountability* (Sept. 4, 1980) (printed for the use of Senate Committee on Banking, Housing, and Urban Affairs, 96th Cong., 2d Sess.) at F2.

[13] Donald C. Langevoort, *The Human Nature of Corporate Boards: Law, Norms, and the Unintended Consequences of Independence and Accountability*, 89 Geo. L.J. 797, 798 (2001). "[T]here are industries where the case for independence is compelling. The best example here is the mutual fund industry, where conflicts of interests are commonplace and traditional checks on managerial overreaching, such as vigorous shareholder voting and hostile tender offers do not exist." *Id.* at 814.

[14] We recently approved amendments to the corporate governance listing standards of the New York Stock Exchange ("NYSE") and NASD. Although many closed-end funds are listed on the NYSE, several of the corporate governance listing standards recently adopted are not applicable to closed-end funds. *See* Securities Exchange Act Release No. 48745 (Nov. 4, 2003) [68 FR 64154 (Nov. 12, 2003)]. We also approved proposed changes to the corporate governance standards of the NYSE itself. *See* Securities Exchange Act Release No. 48764 (Nov. 7, 2003) [68 FR 64380 (Nov. 13, 2003)].

[15] *See* Investment Company Institute, *Report of the Advisory Group on Best Practices for Fund Directors: Enhancing A Culture of Independence and Effectiveness* (June 24, 1999) ("ICI Advisory Group Report"); Richard M. Phillips, *Mutual Fund Independent Directors: A Model for Corporate America?, in* Investment Company Institute Perspective, Aug. 2003, at 1, 3 (stating that a significant portion of mutual funds have followed all or most of the recommendations in the ICI Advisory Group Report).

[16] The rules proposed to be amended 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(b)(2) (permitting fund boards to approve interim advisory contracts without shareholder approval where the adviser or a controlling person receives a benefit in connection with the assignment of the prior contract);

Rule 17a–7 (permitting securities transactions between a fund and another client of the fund investment 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).

Last October we proposed a new exemptive rule, rule 15a–5, that would also be conditioned on meeting the fund governance standards that are currently included in these ten exemptive rules. *See* Exemption from Shareholder Approval for Certain Subadvisory Contracts, Investment Company Act Release No. 26230 (Oct. 23, 2003) [68 FR 61720 (Oct. 29, 2003)]. If we adopt the fund governance standards proposed in the current Release, we also intend to adopt those standards as a condition of rule 15a–5.

of the board and that of the investment adviser, and that our rules need to strike the proper balance between management and oversight. Funds meet the investment needs and fulfill the expectations of their shareholders because of the efforts and skill of their investment advisers. Investors do not generally invest in a fund because of the skill or reputation of its board of directors. Nonetheless, the ultimate responsibility for the fund lies with its board of directors, whose oversight is critical because of the unique set of conflicts the investment adviser has with the fund. We ask commenters to address whether our proposals strike the proper balance.

A. Board Composition

We propose to require that any fund relying on any of the Exemptive Rules [17] have a board of directors whose independent directors constitute at least seventy-five percent of the board.[18] The Investment Company Act currently requires that at least forty percent of the board be independent,[19] and our 2001 amendments to the Exemptive Rules require that a majority of the board be independent.[20] These 2001 amendments largely codified current mutual fund practices at the time we adopted them.[21]

When we proposed the 2001 amendments, we considered requiring that independent directors comprise a supermajority of the fund boards, and observed that such a requirement ''could change the dynamics of board decision making in favor of the interests of investors.''[22] Commenters supporting a supermajority independence requirement asserted that a greater proportion of independent directors would help to strengthen the hand of independent directors when dealing with fund management, and would help assure that independent directors maintain control of the board in the event of the illness or absence of other independent directors.[23]

We request comment on the proposed seventy-five percent requirement. Is any change from the current requirement necessary? Should the requirement be higher? Should it be lower? Should it be phrased in terms other than a fraction or percentage, *e.g.,* that all directors, or all directors but one, must be independent? We also request comment on the appropriate period of time over which, if we adopt the new requirement, it should be phased in.[24] Would eighteen months be sufficient? [25]

B. Independent Chairman of the Board

We propose to require that the chairman of the fund board be an independent director.[26] The Investment Company Act and state law are silent on who will fill this important role on fund boards. Today, a director who is also an officer of the fund's investment adviser serves as chairman of most, but not all, fund boards. In many cases, he (or she) also is the chief executive officer of the adviser. This practice may contribute to the adviser's ability to dominate the actions of the board of directors.

The chairman of a fund board can largely control the board's agenda, which may include matters not welcomed by the adviser. The board is required to consider some matters annually in connection with the renewal of the advisory contract, but other matters the board considers at its discretion, such as termination of service providers, including the adviser.[27] Perhaps more important, the chairman of the board can have a substantial influence on the fund boardroom's culture. The boardroom culture can foster (or suppress) the type of meaningful dialogue between fund management and independent directors that is critical for healthy fund governance. It can support (or diminish) the role of the independent directors in the continuous, active engagement of fund management necessary for them to fulfill their duties.

[17] As discussed above, our proposal would apply only to funds that rely on one or more of the Exemptive Rules. Because almost all funds either rely or anticipate someday relying on at least one of the Exemptive Rules, we expect they would apply to most funds. For convenience, the remainder of this Release assumes that they will apply to all funds registered with the Commission.

[18] We note that section 15(f)(1) of the Act, which provides a safe harbor for the sale of an advisory business, requires that directors who are independent of the adviser constitute at least 75 percent of a fund board for at least three years following the assignment of the advisory contract. 15 U.S.C. 80a–15(f)(1). *See also* Alliance Capital Management, *supra* note 6 (Dec. 18, 2003) (including voluntary undertaking to have independent directors constitute at least 75 percent of board); Putnam Investment Management, *supra* note 6 (same).

[19] *See* section 10(a) of the Act [15 U.S.C. 80a–10(a)].

[20] *See, e.g.,* rule 10f–3(b)(11)(i) [17 CFR 270.10f–3(b)(11)(i)].

[21] Role of Independent Directors of Investment Companies, Investment Company Act Release No. 24082 (Oct. 14, 1999) [64 FR 59826 (Nov. 3, 1999)] (''1999 Proposing Release'') at n. 39 and accompany text (''Today, most, but not all, mutual funds have boards with at least a simple majority of independent directors.'').

[22] *See* 1999 Proposing Release, *supra* note 21, at text following n. 44. Some economic studies of funds find that boards with a higher proportion of independent directors are more effective. *See, e.g.,* Peter Tufano and Matthew Sevick, *Board Structure and Fee-Setting in the U.S. Mutual Fund Industry,* 46 J. Fin. Econ. 321, 350 (1997) (''Tufano and Sevick'') (''We find that funds whose boards have a larger fraction of independent directors tend to charge investors lower fees.''); *Mutual Funds: Who's Looking Out for Investors?: Hearings Before the Committee on Financial Services, Subcomm. on Capital Markets, Insurance and Government Sponsored Enterprises on the Committee on Financial Services,* 108th Cong., 1st Sess. (2003) (prepared testimony of Eric W. Zitzewitz, Assistant Professor of Economics, Stanford Graduate School of Business) (*http://financialservices.house.gov/media/pdf/110603ez.pdf*) (''My research suggests that boards with more independent directors perform better in limiting arbitrage; earlier research has shown that these boards negotiate lower expense ratios on behalf of their investors.''); Diane Del Guercio, Larry Y. Dann and M. Megan Partch, *Governance of Boards of Directors in Closed-End Investment Companies,* 69 J. Fin. Econ. 111, 148 (2003) (''[W]e find reasonably strong evidence of an association between [closed-end fund] board decisions in shareholders' interests and greater nominal independence. Funds with more nominally independent boards have lower expense ratios * * *.''). However, we note that the authors of these studies concede that fewer independent directors may be a symptom rather than the cause of ineffective governance and that studies of operating companies have failed to find a correlation between the proportion of independent directors and performance. *See* Tufano and Sevick, *supra,* at 353 (''[W]e must be very cautious about attributing causality to empirical results of this type.''); Sanjai Bhagat and Bernard Black, *The Uncertain Relationship Between Board Composition and Firm Performance,* 54 Bus. Law. 921, 922 (1999) (''studies of overall firm performance have found no convincing evidence that firms with majority-independent boards perform better than firms without such boards'').

[23] *See, e.g.,* Letter from W. Allen Reed, Chair, Financial Executives Institute Committee on Investment of Employee Benefit Assets (Jan. 24, 2000) (expressing support for two-thirds majority requirement by noting that ''the more independent a board is, the less likely it will be to have conflicts and, therefore, in a better position to serve the needs of the fund's shareholders''); Letter from C. Meyrick Payne, Senior Partner, Management Practice Inc. (Nov. 3, 1999) (''independent directors are markedly more powerful with a 67% majority than they would be with only a 51% majority''); Letter from Gerald C. McDonough, Independent Trustee, Fidelity Funds (on behalf of the Independent Trustees) (Jan. 28, 2000) (''A two-thirds super majority of independent directors is necessary to maintain an adequate cushion above a bare majority requirement in order to assure that independent directors control the corporate machinery at all times.''); Letter from Peter W. Gavian, Independent Trustee, Calvert Group (Jan. 5, 2000), (welcoming ''a supermajority requirement, perhaps even the 100% standard that has apparently proven quite successful with bank funds.''). These letters are available in the public comment file on that rulemaking, File No. S7–23–99. In addition, the ICI Advisory Group Report recommends that independent directors constitute at least two-thirds of the fund board. The ICI's Board of Governors endorsed these best practices in 1999. ICI Advisory Group Report, *supra* note 15.

[24] Proposed rule 0–1(a)(7) would include the requirement that currently appears in the Exemptive Rules, that the fund's independent directors must select and nominate other independent directors. *See* proposed rule 0–1(a)(7)(i).

[25] *See* 2001 Adopting Release, *supra* note 4, at Section III.B (permitting funds 18 months to comply with fund governance amendments to Exemptive Rules).

[26] *See* proposed rule 0–1(a)(7)(iii).

[27] Under section 15(a)(3) of the Act [15 U.S.C. 80a–15(a)(3)], the advisory contract must permit the fund board to terminate the advisory contract on no more than 60 days' notice.

A boardroom culture conducive to decisions favoring the long-term interest of fund shareholders may be more likely to prevail when the board chairman does not have the conflicts of interest inherent in his role as an executive of the fund adviser.[28] Moreover, a fund board may be more effective when negotiating with the fund adviser over matters such as the advisory fee if it were not at the same time led by an executive of the adviser with whom it is negotiating.[29] If such negotiation leads to lower advisory and other fees, shareholders would stand to benefit substantially.[30]

We request comment on this proposed amendment. Would it strike the correct balance between management of the fund and the proper role of independent directors? Could it improve the boardroom culture we discussed above? Would it reduce the ability of the fund adviser to dominate the board? Or, as some have asserted, would an independent board chairman actually weaken fund governance because an independent director could not effectively lead the board through a discussion of a detailed and, in some respects, complex agenda? [31] Comment is specifically requested on this point from members of those fund boards currently chaired by independent directors.

Are there alternatives that would serve the same or similar purposes? For example, should we instead require independent directors to appoint a ''lead director,'' who would chair separate meetings of the independent directors, act as their spokesperson and interact with their independent legal counsel? [32] Should the chairman of all board committees, or certain board committees, also be required to be an independent director? Should we require instead that the chairman—whether or not independent—be elected annually by both a majority of the board as a whole *and* by a majority of the independent directors? Is a requirement mandating an independent chairman necessary if the Commission adopts a supermajority requirement, as discussed in Section II.A, *supra,* since a majority may empower the independent directors to select the appropriate person to serve as chairman, whether or not independent? Similarly, is a requirement mandating an independent chairman even necessary under current standards that generally mandate a majority of independent directors?

C. Annual Self-Assessment

We also propose to require fund directors to perform an evaluation, at least once annually, of the effectiveness of the board and its committees.[33] The self-assessment process can improve fund performance by strengthening directors' understanding of their role and fostering better communications and greater cohesiveness.[34] It gives directors an opportunity to step back and review their own performance, so that they can best consider any changes in their governance practices.[35]

The self-evaluation should focus on both substantive and procedural aspects of the board's operations. Our proposed rule would leave for the directors to decide those aspects of board operations they should address in their evaluation, except for two procedural matters. First, we propose to require the directors to consider the effectiveness of the board's committee structure. Fund boards, like corporate boards, often designate board committees to which they delegate certain functions and activities.[36] The proposed requirement is designed to focus the board's attention on the need to create, consolidate or revise the various board committees, such as the audit, nominating or pricing committees. The requirement also is designed to facilitate a critical assessment of the current board committees.[37]

Second, we would have the directors carefully evaluate whether they have taken on the responsibility for overseeing too many funds.[38] Directors often serve on a large number of fund boards within a fund complex.[39] This

[28] *See* Ira M. Millstein and Paul W. MacAvoy, *Proposals for Reform of Corporate Governance,* in The Recurrent Crisis in Corporate Governance 95, 119 (2003) (''Millstein and MacAvoy'') (''The first important initiative is for the [corporate] board * * * to develop an identified independent leadership, by separating the roles of chairman of the board and CEO and appointing an independent director as chairman. Independent leadership is critical to positioning the board as an objective body distinct from management. * * * The board cannot function without leadership separate from the management it is supposed to monitor. On behalf of the shareholders, the board must be enabled to obtain the information necessary to monitor * * * the performance of management. * * *'').

[29] We recognize that neither the Investment Company Act nor any state law (of which we are aware) requires a fund to appoint a chairman of the board. The proposed rule would apply to any person designated as chairman of the fund board of directors, or who otherwise presides over board meetings and has substantially the same responsibilities as a chairman of a board of directors. *See* proposed rule 0–1(a)(7)(iii).

[30] In some of our recent settled enforcement cases against fund advisers, the funds have undertaken voluntarily to have an independent director chair the fund board. *See* Alliance Capital Management, *supra* note 6; Putnam Investment Management, *supra* note 6. We note that the National Association of Corporate Directors (''NACD'') recommends an independent director be designated chairman of the board. *See, e.g.,* National Association of Corporate Directors, *Recommendations from the National Association of Corporate Directors Concerning Reforms in the Aftermath of the Enron Bankruptcy* (May 3, 2002) (*http://www.nacdonline.org/nacd/enron_recommendations.asp*) (''NACD Recommendations'') (recommendations include: designation of an independent director as chairman or lead director; regular and formal evaluation of the performance of the board as a whole; and periodic executive sessions for independent directors).

[31] *Hearings on H.R. 2420, the Mutual Funds Integrity and Fee Transparency Act of 2003, Before the Subcomm. on Capital Markets, Insurance and Government Sponsored Enterprises of the Committee on Financial Services,* 108th Cong., 1st Sess. (''Executive Summary'') (2003) (prepared testimony of Paul G. Haaga, Vice President, Capital Research and Management Company, and Chairman, Investment Company Institute) (*http://financialservices.house.gov/media/pdf/061803ph.pdf*) (''It is neither necessary nor appropriate to require mutual funds to have an independent chairman of the board. In many cases, a person needs to be intimately familiar with the operations of a company in order to be an effective chairman, and a management representative is often in the best position to do this.'').

Similar criticisms also have been raised of proposals to split the roles of the chairman and the chief executive officer of operating companies. *See, e.g.,* The Conference Board, *The Commission on Public Trust and Private Enterprise: Findings and Recommendations 2003* (''Conference Board Recommendations'') at 1, 35 (dissenting opinion of John H. Biggs) (*http://www.conference-board.org/knowledge/governCommission.cfm*) (''If [organization of the board meeting] is done in a perfunctory way, say the day before the meeting, it is probably irrelevant. However, to do this competently, [the chairman] would have to devote substantial extra time to understanding the company's operations, discussing with the CEO and others in senior management the issues currently confronting the company, and probably ''rehearsing'' the meeting to be sure those issues can be discussed adequately.'').

[32] *See* ICI Advisory Group Report, *supra* note 15, at 25 (recommending as a best practice that the independent directors of a fund appoint a lead independent director).

[33] *See* proposed rule 0–1(a)(7)(iv). The ICI, NACD, Business Roundtable, and Conference Board all recommend that boards evaluate their performance and effectiveness. *See* ICI Advisory Group Report, *supra* note 15, at 29; NACD Recommendations, *supra* note 30; The Business Roundtable, *Principles of Corporate Governance* (May 2002), at 28–29 (*http://www.businessroundtable.org/pdf/704.pdf*) (''Business Roundtable Principles''); Conference Board Recommendations, *supra* note 31, at 31.

[34] See Katherine McG. Sullivan and Holly J. Gregory, *Creating a Board Self-Evaluation Methodology*, The Metropolitan Corporate Counsel, Mar. 1996, at 1, 12.

[35] *See* ICI Advisory Group Report, *supra* note 15, at 29–31 (recommending periodic self-evaluation by fund board).

[36] *See* American Bar Assoc., *Fund Director's Guidebook*, 59 Bus. L. 201, 212–17 (2003).

[37] We would expect that the minutes of the board of directors would reflect the substance of the matters discussed during the board's annual self-assessment.

[38] *See* proposed rule 0–1(a)(7)(iv).

[39] *See, e.g.*, Tufano and Sevick, *supra* note 22, at 333–334 (for the 50 largest funds sampled, the average number of boards on which a director serves is 16, with the highest being 151); Raj Varma, *An Empirical Examination of Sponsor Influence Over the Board of Directors*, 38 Fin. Rev. 55 (2003)

Continued

practice has over the years generated some criticism that directors are unable to pay adequate attention to their obligations to each fund.[40] Others, however, strongly support the practice as a necessary recognition that many issues facing a particular fund in a fund group are common to all of the funds, and argue that it may actually give directors greater leverage when dealing with the common adviser.[41] It would be difficult to determine the optimum number of funds that a particular director or group of directors can serve, which should depend upon a number of factors.[42] We are, however, sufficiently concerned that we are proposing to ask directors to evaluate each year this aspect of their service on fund boards.

We request comment on our proposed self-evaluation requirement. Should we require boards to make written reports of their self-assessment? We also request comment on whether we should ask directors to evaluate their committee structures and the number of boards on which they serve. Should we require that boards form committees to address certain matters? Should we restrict the number of fund boards on which a director serves? If so, what should be the maximum number of fund directorships any individual should hold? Alternatively, should boards be required to adopt policies on the number of other boards that directors may serve? Should service on non-fund boards factor into any limitation? Should we require that boards also consider how frequently they meet, in light of the number of funds that they oversee?

D. Separate Sessions

We propose that independent directors be required to meet at least once quarterly in a separate session at which no interested persons of the fund are present.[43] Such meetings, which we understand are held by many fund boards, would afford independent directors the opportunity for a frank and candid discussion among themselves regarding the management of the fund, including its strengths and weaknesses. Regularly required sessions would prevent any ''negative inferences from attaching to the calling of such executive sessions.'' [44] The requirement is also designed to help strengthen the collegiality and cohesiveness of the independent directors. We request comment on this proposed amendment. Should separate sessions be held more or less frequently than quarterly?

E. Independent Director Staff

We are proposing that any fund relying on any Exemptive Rule explicitly authorize the independent directors to hire employees and others to help the independent directors fulfill their fiduciary duties.[45] Use of staff and experts may be important to help independent directors deal with matters that are beyond the level of their expertise, or help give them an understanding of better practices among mutual funds.[46]

We request comment on this proposed amendment. If independent directors receive this explicit authority, are they likely to hire their own staff? Should the rule *require* independent directors to hire their own staff? [47] If so, should such a requirement be limited to funds with a certain minimum amount of assets under management? Should the staff be employed by the fund rather than the fund adviser? Should we also require that committees of the board be explicitly authorized to hire their own staff or experts? [48]

We also request comment on whether we ought to *require* that independent directors have an independent legal counsel. In 2001, we began to require that independent directors, if they retain counsel, retain ''independent legal counsel,'' *i.e.,* counsel who the independent directors determine at least annually is free of significant conflicts

(for the closed-end funds sampled, the average number of board seats held by independent directors for a given sponsor is 32.4, with the highest being 99).

[40] *See, e.g., Mutual Funds: Trading Practices and Abuses That Harm Investors: Hearings Before the Subcomm. on Financial Management, the Budget, and International Security of the Senate Governmental Affairs Committee*, 108th Cong., 1st Sess. (2003) (statement of Senator Susan M. Collins) (webcast: *http://govt-aff.senate.gov/index.cfm?Fuseaction=Hearings.Detail&HearingID=124*) (''There are, in fact, plenty of fund family directors who serve on the boards for 80 or even 90 different funds, which seems too many to me. The chairman of Bank of America's Nations Fund sits on the boards of 85 funds. The chairman at Janus sits on 113 fund boards. Now, I realize that many of the funds have similar structures and approaches so there may be some economies of scale, if you will. But it's hard for me to see how anyone, any one director could effectively monitor the activities of so many different entities.''); Tufano and Sevick, *supra* note 22, at 329 (''The potential for conflicts of interest may be compounded when the independent directors serve on multiple boards for a single fund sponsor. * * * By seeking to protect the current and future stream of compensation from existing and new board membership, an independent director's interests could become more closely aligned with the fund sponsor than with the shareholders of the fund, leading to less vigilant oversight and higher fees.''); Varma, *supra* note 39 (''a more important factor that can weaken director independence is multiple board service for the sponsor''); Geoffrey Smith, *Mutual Funds: Investors Are Still in the Dark*, Bus. Wk., Apr. 29, 2002, at 90 (''the independent directors are often on the boards of so many of the funds in the same family that it's hard to distinguish them from full-time employees''); Anna Robaton, et al., *Is There a Cushier Part-Time Job? Board Stiffs: Pay Swell for Fund Directors*, Investment News, Feb. 22, 1999, at 1 (quoting Barry Barbash, ''What troubles me more is the number of fund boards on which a director serves.'').

[41] *See* ICI Advisory Group Report, *supra* note 15, at 28 (''[S]ervice on multiple boards can provide the independent directors of those boards with an opportunity to obtain better familiarity with the many aspects of fund operations that are complex-wide in nature. It also can give the independent directors greater access to the fund's adviser and greater influence with the adviser than they would have if there were a separate board for each fund in the complex.'').

[42] Funds must disclose to shareholders in their statements of additional information and proxy statements the number of fund boards on which each director serves. Form N–1A (Item 13(a)(1)) [17 CFR 274.11A] (requiring disclosure of the number of portfolios in the fund complex overseen by each director); Schedule 14A, Item 7 [17 CFR 240.14a–101 (Item 7); 17 CFR 229.401 (Item 401)(a)] (requiring disclosure of all positions and offices held by each director).

[43] *See* proposed rule 0–1(a)(7)(v). Under the compliance rule that we recently adopted, the fund's chief compliance officer and the independent directors must meet separately at least once a year. *See* rule 38a–1(a)(4)(iv), to be codified at 17 CFR 270.38a–1(a)(4)(iv). NYSE and NASD listing standards require that independent directors meet without management, and the ICI, NACD, Conference Board, and Business Roundtable also recommend that independent directors meet without the presence of management. *See* Securities Exchange Act Release No. 48745 (Nov. 4, 2003) [68 FR 64154 (Nov. 12, 2003)]; ICI Advisory Group Report, *supra* note 15, at 24; NACD Recommendations, *supra* note 30; Conference Board Recommendations, *supra* note 31, at 41, and Business Roundtable Principles, *supra* note 33, at 26 (''Independent directors should have the opportunity to meet outside the presence of the CEO and any other management directors.'').

[44] Report of the New York Stock Exchange Corporate Accountability and Listing Standards Committee (June 6, 2002) at 8 (recommending that independent directors meet at regularly scheduled sessions without management).

[45] *See* proposed rule 0–1(a)(7)(vi).

[46] *See* Millstein and MacAvoy, *supra* note 28, at 115, 116 (recommending that ''[b]oards should feel free, without the consent of management, to retain such consultants and advisers as they deem necessary to carry out their responsibilities * * *. In order to monitor management effectively—and sufficiently, in light of emerging legal responsibilities—directors must know more, and understand more, about how the company functions.''). *See also* ICI Advisory Group Report, *supra* note 15, at 20.

[47] *See* Alliance Capital Management, *supra* note 6 (voluntarily undertaking to hire compliance staff and to give notice and invitations to independent staff of directors to attend and participate in meetings of Internal Compliance Controls Committee); Putnam Investment Management, *supra* note 6 (voluntarily undertaking to designate independent administrative staff of the trustees to assist the board in monitoring compliance with federal securities laws, fiduciary duties and the funds' codes of ethics; to review compliance reports; and to attend meetings of the Internal Compliance Controls Committee).

[48] *See, e.g.,* Exchange Act rule 10A–3(b)(4) and (5) [17 CFR 240.10A–3(b)(4) and (5)] (rules of securities exchanges and associations must provide that a listed company's audit committee must have authority to engage independent legal counsel and other advisers as it determines are necessary to carry out its duties, and that the company must provide for appropriate funding for the audit committee as determined by the committee).

of interest that might affect their legal advice.[49] At that time, we did not require that independent directors retain independent legal counsel. We noted, however, that the likely result of our rule amendments would be that many fund directors would seek independent legal counsel. We also cited with approval an American Bar Association Report stating that ''[t]he complexities of the Investment Company Act, the nature of the separate responsibilities of independent directors and the inherent conflicts of interest between a mutual fund and its managers effectively require that independent directors seek the advice of counsel in understanding and discharging their special responsibilities.'' [50] Should we take the next step and require independent legal counsel?

F. Recordkeeping for Approval of Advisory Contracts

Finally, we propose to amend rule 31a–2, the fund recordkeeping rule, to require that funds retain copies of the written materials that directors consider in approving an advisory contract under section 15 of the Investment Company Act. Section 15 requires that fund directors, including a majority of independent directors, approve the fund's advisory contract each year.[51] It also requires that the directors first obtain from the adviser the information reasonably necessary to evaluate the contract.[52]

The information request requirement in section 15 provides fund directors, including independent directors, a tool for obtaining the information they need to represent shareholder interests.[53] Careful consideration of the information enables them to better negotiate the amount of the advisory fee.[54] Conversely, the failure of a board to acquire information sufficient to scrutinize the advisory fee and other fund expenses can suggest an inability or lack of interest on the part of the board in negotiating on behalf of the fund. In this regard, the Mutual Fund Directors Forum, an independent organization that advises fund directors, is preparing best practices recommendations for directors on the types of information that they should request and consider when reviewing advisory contracts.[55]

As part of our examinations of funds, our staff has reviewed the materials that directors considered in approving the advisory contract, if the materials were available. Our examiners have found that the nature and quality of these materials vary widely among funds. Some fund boards have failed to request the materials they need to make an informed assessment of the advisory contract. In one case, we brought an enforcement action against directors who neglected to request and evaluate sufficient information under section 15(c).[56]

Our compliance examiners also have reported that often they are unable to determine whether the requirements of section 15 of the Act were met, in part because the funds did not retain the materials that the board considered in approving the advisory contract. We propose to address this problem by amending our recordkeeping rules.[57] Funds would retain the materials on which the board relied in approving the advisory contract, for at least six years, the first two years in an easily accessible place.[58]

We request comment on the proposed amendment to our fund recordkeeping rule. Are there any reasons why a fund would not be able to keep some or all of the required documents? Are there additional documents that funds should maintain that are relevant to the directors' consideration of the advisory contract? Should we require that funds maintain the records for a period shorter or longer than six years? We also specifically request comment, as required by section 31(a)(2) of the Investment Company Act [15 U.S.C. 80a–30(a)(2)], that commenters address whether there are feasible alternatives to the proposed amendment that would minimize the recordkeeping burdens, the necessity of these records in facilitating the examinations carried out by our staff, the costs of maintaining the required records, and any effects that the proposed recordkeeping requirements would have on the nature of firms' internal compliance policies and procedures.

III. General Request for Comments

The Commission requests comment on the rule amendments proposed in this Release, suggestions for additional provisions or changes to existing rules, and comments on other matters that might have an effect on the proposals in this Release. We note that comments that are of greatest assistance are those that are accompanied by supporting data and analysis of the issues addressed in those comments.

IV. Paperwork Reduction Act

Certain provisions of the proposals contain ''collection of information'' requirements within the meaning of the

[49] *See* 2001 Adopting Release, *supra* note 4, at nn. 34–56 and accompanying text.

[50] American Bar Association, *Report of the Task Force on Independent Director Counsel, Subcommittee of Investment Companies and Investment Advisers, Committee on Federal Regulation of Securities, Section of Business Law: Counsel to the Independent Directors of Registered Investment Companies* at 3 (Sept. 8, 2000). *See also* 2001 Adopting Release, *supra* note 4, at n. 35.

[51] The directors must approve the advisory contract initially, and annually thereafter if it continues in effect for more than two years. 15 U.S.C. 80a–15(a) and (c). The Act also requires that shareholders approve the contract, and prohibits the assignment of the contract to other advisers. 15 U.S.C. 80a–15(a) and (b). The advisory contract must be very specific about the amount of the adviser's fee, and the adviser has a fiduciary duty with respect to that fee. 15 U.S.C. 80a–15(a)(1), 80a–35(b).

[52] 15 U.S.C. 80a–15(c). This requirement was added to the Investment Company Act in 1970, to ensure that directors would have adequate information upon which to base their decision about the advisory contract generally and the advisory fee in particular. *See* Securities and Exchange Commission, Analysis of S. 1659 (*in* Staff of Senate Comm. on Banking and Currency, 90th Cong., 1st Sess., Investment Company Act Amendments of 1969 9 (Comm. Print 1967)). *See also* S. Rep. No. 90–1351, at 6 (1968).

[53] This provision was intended to ''facilitate well-informed directorial consideration of the matters relating to advisory fees'' and ensure that ''the attention of the directors will be fixed on their responsibilities.'' *See* Securities and Exchange Commission, Analysis of S. 1659 (*in* Staff of Senate Comm. on Banking and Currency, 90th Cong., 1st Sess., Comparative Print Showing Changes in Existing Law 9 (Comm. Print 1967)); S. Rep. No. 91–184, at 7 (1969).

[54] *See* S. Rep. No. 90–1351, at 14 (1968) (''[T]he directors would be handicapped in determining the reasonableness of compensation for advisory services if they [for example] could not determine what portion of the total compensation was paid for that service and if they did not have relevant information.''). *See also Gartenberg* v. *Merrill Lynch Asset Management, Inc.,* 694 F.2d. 923, 930 (2d Cir. 1982) (''[T]he expertise of the independent trustees of a fund, whether they are fully informed about all facts bearing on the adviser-manager's service and fee, and the extent of care and conscientiousness with which they perform their duties are important factors to be considered in deciding whether they and the adviser-manager are guilty of a breach of fiduciary duty in violation of § 36(b)'').

[55] Chairman Donaldson recently requested that the Mutual Fund Directors Forum develop best practices recommendations to guide directors in areas where director oversight and decision making is critical for investors, including information requested to approve the advisory contract. *See* Letter from William H. Donaldson, Chairman, Securities and Exchange Commission, to David S. Ruder, Chairman, Mutual Fund Directors Forum (Nov. 17, 2003). The Mutual Fund Directors Forum is a non-profit organization for independent directors ''dedicated to improving mutual fund governance by promoting the development of concerned and well-informed independent directors.'' Mutual Fund Directors Forum Web Site, *www.mfdf.com.*

[56] *See* Heart of America Investment Services, Investment Company Act Release No. 11975 (Oct. 6, 1981) (settling an administrative proceeding that arose in part because of the failure of the fund's independent directors to ''request and evaluate'' the proper information in connection with their approval of advisory contracts).

[57] *See* proposed rule 31a–2(a)(6).

[58] *Id.*

Paperwork Reduction Act. We are submitting these proposals to the Office of Management and Budget (''OMB'') for review in accordance with 44 U.S.C. 3507(d) and 5 CFR 1320.11. ''Collection of information'' requirements would apply to funds because the proposed amendments would require them to maintain records. The proposed amendments to rule 31a–2 would require funds to retain copies of the written materials that boards consider in approving advisory contracts under section 15(c) of the Investment Company Act. Funds would have to retain these materials for at least six years, the first two years in an easily accessible place for our examiners. The information would not be kept confidential. The title for the collection of information associated with the proposed amendments is ''Rule 31a–2, 'Records to be preserved by registered investment companies, certain majority-owned subsidiaries thereof, and other persons having transactions with registered investment companies.' '' An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid control number. The approved collection of information associated with rule 31a–2, which would be revised by the proposed amendments, displays control number 3235–0179.

Our staff estimates that each fund would spend a total of 0.5 hours annually and a total of $9.46 for clerical time to comply with this proposal, and that all funds would spend a total of 2,562 hours annually and a total of $48,473.04 annually to comply with this proposal.[59] Pursuant to 44 U.S.C. 3506(c)(2)(B), we solicit comments in order to: (i) Evaluate whether the proposed collections of information are necessary for the proper performance of the functions of the Commission, including whether the information will have practical utility; (ii) evaluate the accuracy of the Commission's estimate of the burden of the proposed collections of information; (iii) determine whether there are ways to enhance the quality, utility, and clarity of the information to be collected; and (iv) minimize the burden of the collections of information on those who are to respond, including through the use of automated collection techniques or other forms of information technology.

Persons wishing to submit comments on the collection of information requirements of the proposed amendments should direct them to the Office of Management and Budget, Attention Desk Officer of the Securities and Exchange Commission, Office of Information and Regulatory Affairs, Room 10102, New Executive Office Building, Washington, DC 20503, and should send a copy to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549–0609, with reference to File No. S7–03–04. OMB is required to make a decision concerning the collection of information between 30 and 60 days after publication of this Release; therefore a comment to OMB is best assured of having its full effect if OMB receives it within 30 days after publication of this Release. Requests for materials submitted to OMB by the Commission with regard to this collection of information should be in writing, refer to File No. S7–03–04, and be submitted to the Securities and Exchange Commission, Records Management, Office of Filings and Information Services.

V. Cost-Benefit Analysis

We are sensitive to the costs and benefits imposed by our rules. As discussed in section II above, we are proposing to require that funds relying on any of the Exemptive Rules adopt certain governance practices that are designed to enhance the independence and effectiveness of fund boards. We also are proposing to require that funds maintain materials considered by a fund board when approving an advisory contract.

A. Benefits

We believe that funds and fund shareholders are likely to benefit from the proposals, which are designed to strengthen the role of independent directors so that fund boards can more effectively manage conflicts of interest, monitor service providers, and protect the interests of fund shareholders. The proposed amendments are designed to enhance the independence and effectiveness of independent directors, who are charged with overseeing the fund's activities and transactions under the Exemptive Rules. Boards that meet these conditions should be more effective at exerting an independent influence over fund management. Their independent directors should be more likely to have their primary loyalty to the fund's shareholders rather than the adviser.

A board of directors whose independent directors constitute at least seventy-five percent of the board may help strengthen the hand of the independent directors when dealing with fund management, and may help assure that independent directors maintain control of the board in the event of the illness or absence of other independent directors. Requiring fund boards to be chaired by an independent director should provide similar benefits. The chairman of a fund board can have a substantial influence on the fund boardroom's culture, which can foster (or suppress) meaningful dialogue between fund management and independent directors and can support (or diminish) the role of the independent directors in fund management. We expect that the opportunity for frank and candid discussions among independent directors will increase their effectiveness.

Requiring funds to explicitly authorize the independent directors to hire employees should help independent directors fulfill their fiduciary duties. Use of staff and experts may be particularly important to help independent directors address complex matters or provide an understanding of the practices of other mutual funds. This requirement should provide substantial benefits to shareholders by helping to ensure that independent directors are better able to fulfill their role of representing shareholder interests.

Finally, the proposed annual self-assessment of the effectiveness of the board and its committees is intended to improve fund performance by strengthening directors' understanding of their role and fostering better communications and greater cohesiveness. Moreover, the self-assessment could help identify potential weaknesses and deficiencies.

The proposed recordkeeping amendment is designed to improve the documentation of a fund board's basis for approving an advisory contract, which would assist our examination staff in determining whether fund directors are fulfilling their fiduciary duties when approving advisory contracts. The proposed amendment to rule 31a–2 would underscore the importance of the information requests that precede the directors' consideration of the advisory contract. Further, it may encourage independent directors to request more information, and this information may enable them to obtain more favorable terms in advisory contracts. These amendments would benefit both shareholders and the Commission by enabling the Commission's staff to monitor the

[59] We estimate that 5,124 funds would incur costs under this proposal. To calculate these costs, our staff used $18.92 per hour as the average cost of clerical time.

independent directors' determination of whether their counsel is independent.

The proposed amendments seek to promote strong fund boards that effectively perform their oversight role. By increasing the independence of fund boards, the amendments are designed to improve the quality of the oversight of the process for the benefit of fund investors. Vigilant and informed oversight by a strong, effective and independent fund board may help to prevent problems such as late trading and market timing. These benefits may increase investor confidence in fund management. While these benefits are not easily quantifiable in terms of dollars, we believe they are real, and that the proposed amendments will strengthen the hand of independent directors to the advantage of shareholders.

B. Costs

The proposals would impose additional costs on funds that rely on an Exemptive Rule by requiring them to satisfy the fund governance standards in proposed rule 0–1(a)(7).[60] The proposals would require that independent directors constitute at least seventy-five percent of the fund board. Our staff estimates that nearly sixty percent of all funds currently meet this requirement.[61] Therefore, this proposal would impose costs on funds that do not already meet this standard. A fund could comply with this requirement in one of three ways: (i) Decrease the size of its board and allow some inside directors to resign; (ii) maintain the current size of its board and replace some inside directors with independent directors; or (iii) increase the size of its board and elect new independent directors. If a fund were to hold a shareholder election, it would incur costs to prepare proxy statements and hold the shareholder meeting. A fund also would incur costs of finding qualified candidates and compensating those new independent directors.[62] We have no reliable basis for determining the costs associated with electing independent directors, however, because we have no reliable basis for determining how funds would choose to satisfy this requirement.[63] We request comment on the manner in which funds would likely choose to satisfy a seventy-five percent independence requirement.

The proposals also would require: (i) An independent director to be chairman of the board; (ii) directors to perform an evaluation of the board and its committees, at least once annually; (iii) independent directors to meet in an executive session at which no interested person of the fund is present, at least once quarterly; and (iv) independent directors to be given specific authority to hire employees. We are not aware of any out-of-pocket costs that would result from the first three items because these requirements could be performed at a regularly scheduled board meeting. We are not aware of any costs associated with the fourth item because boards typically have this authority under state law, and the rule would not require them to hire employees. We request comment on the costs of the first three items above, and on whether boards would choose to hire employees.

The proposal that funds retain copies of materials considered by the board in approving advisory contracts would result in increased recordkeeping costs. Our staff anticipates that the cost increases will be limited, however, because many if not most funds already maintain the documents that the proposed amendment would require them to keep.[64] Even for firms that do not already maintain such records, our staff anticipates that the costs of the proposed amendment will be limited.[65] This recordkeeping proposal merely requires the retention of documents already prepared. Further, as with other records, funds would be able to maintain the required records electronically.[66] For purposes of the Paperwork Reduction Act, our staff estimates that each fund would spend a total of 0.5 hours annually and a total of $9.46 for clerical time to comply with this proposal, and that all fund would spend a total of 2,562 hours annually and a total of $48,473.04 annually to comply with this proposal.[67] We request comment on the number of funds that already retain these materials, and on the costs of retaining such materials. We also request comment on whether directors, as a result of the proposed amendment, are likely to request more written materials from investment advisers.

C. Request for Comments

We request comment on the potential costs and benefits of the proposals. We encourage commenters to identify, discuss, analyze, and supply relevant data regarding any additional costs and benefits. For purposes of the Small Business Regulatory Enforcement Act of 1996,[68] we also request information regarding the potential impact of the proposals on the U.S. economy on an annual basis. Commenters are requested to provide data to support their views.

VI. Initial Regulatory Flexibility Analysis

This Initial Regulatory Flexibility Analysis (''IRFA'') has been prepared in accordance with 5 U.S.C. 603. It relates to the proposed amendments to the Commission's rules relating to independent directors of investment companies.

A. Reasons for the Proposed Action

As described more fully in Section I of this Release, the reasons for the proposed amendments are that the Investment Company Act relies heavily on fund boards of directors to manage conflicts of interest that the fund adviser inevitably has with the fund, and the breakdown in fund management and compliance controls evidenced by our enforcement cases raises troubling questions about the ability of many fund boards, as presently constituted, to effectively oversee the management of funds.

B. Objectives of the Proposed Action

As described more fully in Section II of this Release, the objectives of the proposed amendments, which would apply to funds relying on any of the

[60] Funds that do not rely on any Exemptive Rules, however, will not be subject to enhanced fund governance standards in rule 0–1(a)(7) and would not incur costs associated with the proposed amendments. Our staff estimates for purposes of this cost-benefit analysis that approximately 4,610 funds (90 percent of all 5,124 registered investment companies) rely on at least one Exemptive Rule.

[61] *See also Hearing on H.R. 2420, the Mutual Fund Integrity and Fee Transparency Act of 2003, Before the Subcomm. on Capital Markets, Insurance and Government-Sponsored Enterprises of the Committee on Financial Services,* 108th Congress (2003) (prepared testimony of Paul G. Haaga, Executive Vice President, Capital Research and Management Company, and Chairman, Investment Company Institute (*http://financialservices.house.gov/media/pdf/061803ph.pdf*) (''It is the Institute's understanding that most fund boards * * * currently have a super-majority of independent directors.'').

[62] Under some circumstances a vacancy on the board may be filled by the board of directors. *See* section 16(a) of the Investment Company Act [15 U.S.C. 80a–16(a)].

[63] With respect to the requirements related to independent selection and nomination of other independent directors and independent legal counsel, this proposal incorporates the current requirements of the Exemptive Rules, and therefore funds would not bear new costs related to those provisions.

[64] Of course, if this proposal causes independent directors to request more information from the adviser, the fund's cost of recordkeeping may also increase.

[65] For purposes of the Paperwork Reduction Act, our staff estimates that each fund would spend approximately 0.5 hours annually maintaining records of documents reviewed by fund boards when approving advisory contracts. *See supra* Section IV.

[66] See rule 31a–2(f) under the Act [17 CFR 270.31a–2(f)].

[67] *See infra* Section IV of this Release.

[68] Pub. L. No. 104–121, Title III, 110 Stat. 857 (1996).

Exemptive Rules, are to enhance the independence and effectiveness of fund boards and to improve their ability to protect the interests of the funds and fund shareholders they serve.

C. Legal Basis

The proposed amendment to rule 0–1 and proposed amendments to the Exemptive Rules are proposed pursuant to the authority set forth in sections 6(c), 10(f), 12(b), 17(d), 17(g), 23(c), and 38(a) of the Investment Company Act. The proposed amendment to rule 31a–2 is proposed pursuant to the authority set forth in sections 12(b) and 31(a).[69]

D. Small Entities Subject to the Proposed Rule and Amendments

A small business or small organization (collectively, ''small entity'') for purposes of the Regulatory Flexibility Act is a fund that, together with other funds in the same group of related investment companies, has net assets of $50 million or less as of the end of its most recent fiscal year.[70] Of approximately 5,124 registered investment companies, approximately 204 are small entities.[71] As discussed above, the proposed amendments would require funds relying on an Exemptive Rule to comply with proposed rule 0–1(a)(7) and all funds to retain records under proposed rule 31a–2. Whether these proposed amendments to the Exemptive Rules would affect small entities would depend on whether the small entities rely on an Exemptive Rule.[72] Under proposed rule 31a–2, all small entities would be required to maintain records of materials consulted by a fund board when approving an advisory contract. We request comment on the effects and costs of these proposed amendments on small entities.

E. Reporting, Recordkeeping, and Other Compliance Requirements

The proposals do not introduce any new mandatory reporting requirements. The proposals contain mandatory recordkeeping requirements. Any fund, regardless of size, would be required to maintain records of written materials that directors consider to approve an advisory contract. The proposed amendments also would introduce new compliance requirements for any fund that relies on an Exemptive Rule. Any fund that relies on an Exemptive Rule would be required to satisfy the fund governance standards in proposed rule 0–1(a)(7), including having: (i) A board of directors whose independent directors constitute seventy-five percent of the board; (ii) an independent director be chairman of the board; (iii) directors perform an evaluation of the board and its committees, at least once annually; (iv) independent directors meet in an executive session at which no interested person of the fund is present, at least once quarterly; and (v) independent directors be given specific authority to hire employees and others for the independent directors.

F. Duplicative, Overlapping, or Conflicting Federal Rules

We have not identified any federal rules that duplicate, overlap, or conflict with the proposed amendments.

G. Significant Alternatives

The Regulatory Flexibility Act directs us to consider significant alternatives that would accomplish the stated objective, while minimizing any significant adverse impact on small entities. Alternatives in this category would include: (i) Establishing different compliance or reporting standards that take into account the resources available to small entities; (ii) clarifying, consolidating, or simplifying the compliance requirements under the rule for small entities; (iii) using performance rather than design standards; and (iv) exempting small entities from coverage of the rule, or any part of the rule.

With respect to the establishment of special compliance requirements or timetables under the proposals for small entities, we do not presently think this is feasible or necessary. The proposals arise from enforcement actions and settlements that underscore the need to strengthen the role of independent directors so that fund boards can more effectively manage conflicts of interest, monitor service providers, and protect the interests of fund shareholders. Excepting small entities from the proposed amendments could disadvantage fund shareholders of small entities and compromise the effectiveness of the proposed amendments. Nevertheless, we request comment whether it is feasible or necessary for small entities to have special requirements or timetables for compliance with the proposed amendments. Should any of the proposed amendments be altered or reduced in order to ease the regulatory burden on small entities, without sacrificing the effectiveness of the proposed amendments?

With respect to (i) further clarifying, consolidating or simplifying the compliance requirements of the proposed amendments, (ii) using performance rather than design standards, and (iii) exempting small entities from coverage of the rule or any part of the rule, we believe such changes are impracticable. Small entities are as vulnerable to the problems uncovered in recent enforcement actions and settlements as large entities; shareholders of small entities are equally in need of more independent fund boards. We believe that specific measures must be undertaken by all funds, regardless of size, to increase the independence of boards to provide better oversight of service providers and compliance matters, to better manage conflicts of interest and to better protect fund shareholders. Exempting small entities from coverage of the rule or any part of the rule could compromise the effectiveness of the proposed amendments.

H. Solicitation of Comments

We encourage the submission of comments with respect to any aspect of this IRFA. Comment is specifically requested on the number of small entities that would be affected by the proposed amendments, and the likely impact of the proposals on small entities. Commenters are asked to describe the nature of any impact and provide empirical data supporting the extent of the impact. These comments will be considered in connection with the adoption of the proposed rule and amendments, and reflected in the Final Regulatory Flexibility Analysis.

Comments should be submitted in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street NW., Washington, DC 20549–0609. Comments also may be submitted electronically to the following E-mail address: *rule-comment@sec.gov.* All comment letters should refer to File No. S7–03–04; this file number should be included on the subject line if E-mail is used.[73]

VII. Efficiency, Competition and Capital Formation

Section 2(c) of the Investment Company Act requires the Commission,

[69] *See infra* Statutory Authority Section of this Release.

[70] 17 CFR 270.0–10.

[71] Some or all of these entities may contain multiple series or portfolios. If a registered investment company is a small entity, the portfolios or series it contains are also small entities.

[72] As discussed above, our staff estimates that approximately 4,610 funds (90 percent of all 5,124 registered investment companies) rely on at least one Exemptive Rule. If 90 percent of all small entities rely on at least one Exemptive Rule, then approximately 184 funds that are small entities would rely on at least one Exemptive Rule and would therefore be affected by the proposed amendments to the Exemptive Rules.

[73] Comments on the IRFA will be placed in the same public file that contains comments on the proposed amendments themselves.

when engaging in rulemaking that requires it to consider or determine whether an action is necessary or appropriate in the public interest, to consider whether the action will promote efficiency, competition, and capital formation. The proposal to require that funds adopt certain governance practices if they rely on any of the Exemptive Rules is designed to enhance the independence and effectiveness of fund boards. The proposal to require that funds maintain materials considered by a fund board when approving an advisory contract is designed to improve the documentation of a fund board's basis for approving an advisory contract, which would assist our examinations staff in determining whether fund directors are fulfilling their fiduciary duties when approving advisory contracts. We do not anticipate that these proposals will have a significant effect on efficiency, competition and capital formation with regard to funds because the costs associated with the proposals are minimal and many funds have already adopted some of the proposed practices. To the extent that these proposals do affect competition and capital formation, we believe that the effect will be positive because the proposals would likely reduce the risk of securities law violations such as late trading in mutual funds and market timing violations, and thus increase investor confidence in mutual funds.

We request comments on whether the proposed rule amendments, if adopted, would promote efficiency, competition, and capital formation. Will the proposed amendments or their resulting costs materially affect the efficiency, competition, and capital formation of funds? Comments will be considered by the Commission in satisfying its responsibilities under section 2(c) of the Investment Company Act. Commenters are requested to provide empirical data and other factual support for their views to the extent possible.

Statutory Authority

We are proposing amendments to rule 0–1(a) and the Exemptive Rules pursuant to the authority set forth in sections 6(c), 10(f), 12(b), 17(d), 17(g), 23(c), and 38(a) of the Investment Company Act [15 U.S.C. 80a–6(c), 80a–10(f), 80a–12(b), 80a–17(d), 80a–17(g), 80a–23(c), and 80a–37(a)]. We are proposing amendments to rule 31a–2 under the Investment Company Act pursuant to the authority set forth in sections 12(b) and 31(a) [80a–12(b) and 80a–31(a)].

Text of Proposed Rules

List of Subjects in 17 CFR 270

Investment companies, Reporting and recordkeeping requirements, Securities.

For the reasons set out in the preamble, the Commission proposes to amend Title 17, Chapter II of the Code of Federal Regulations as follows.

PART 270—RULES AND REGULATIONS, INVESTMENT COMPANY ACT OF 1940

1. The general authority citation for Part 270 is amended by adding the following citation to read as follows:

Authority: 15 U.S.C. 80a–1 *et seq.,* 80a–34(d), 80a–37, 80a–39, unless otherwise noted.

* * * * *

Section 270.0–1(a)(7) is also issued under 15 U.S.C. 80a–10(e);

* * * * *

2. Section 270.0–1 is amended by adding paragraph (a)(7) to read as follows:

§ 270.0–1 Definition of terms used in this part.

(a) * * *

(7) *Fund governance standards.* The board of directors of an investment company (''fund'') satisfies the *fund governance standards* if:

(i) At least seventy-five percent of the directors of the fund are not interested persons of the fund (''disinterested directors''), and those directors select and nominate any other disinterested director of the fund;

(ii) Any person who acts as legal counsel for the disinterested directors of the fund is an independent legal counsel as defined in paragraph (a)(6) of this section;

(iii) A disinterested director serves as chairman of the board of directors of the fund, or otherwise presides over meetings of the board of directors and has substantially the same responsibilities as would a chairman of a board of directors;

(iv) The board of directors evaluates at least once annually the performance of the board of directors and the committees of the board of directors, which evaluation must include a consideration of the effectiveness of the committee structure of the fund board and the number of funds on whose boards each director serves;

(v) The disinterested directors meet at least once quarterly in a session at which no directors who are interested persons of the fund are present; and

(vi) The disinterested directors have been authorized to hire employees and to retain advisers and experts necessary to carry out their duties.

* * * * *

3. Section 270.10f–3 is amended by revising paragraph (c)(11) to read as follows:

§ 270.10f–3 Exemption for the acquisition of securities during the existence of an underwriting or selling syndicate.

* * * * *

(c) * * *

(11) *Board composition.* The board of directors of the investment company satisfies the fund governance standards defined in § 270.0–1(a)(7).

* * * * *

4. Section 270.12b–1 is amended by revising paragraph (c) to read as follows:

§ 270.12b–1 Distribution of shares by registered open-end management investment company.

* * * * *

(c) A registered open-end management investment company may rely on the provisions of paragraph (b) of this section only if its board of directors satisfies the fund governance standards as defined in § 270.0–1(a)(7);

* * * * *

5. Section 270.15a–4 is amended by revising paragraph (b)(2)(vii) to read as follows:

§ 270.15a–4 Temporary exemption for certain investment advisers.

* * * * *

(b) * * *

(2) * * *

(vii) The board of directors of the investment company satisfies the fund governance standards defined in § 270.0–1(a)(7).

6. Section 270.17a–7 is amended by revising paragraph (f) to read as follows:

§ 270.17a–7 Exemption of certain purchase or sale transactions between an investment company and certain affiliated persons thereof.

* * * * *

(f) The board of directors of the investment company satisfies the fund governance standards defined in § 270.0–1(a)(7).

* * * * *

7. Section 270.17a–8 is amended by revising paragraph (a)(4) to read as follows:

§ 270.17a–8 Mergers of affiliated companies.

* * * * *

(a) * * *

(4) *Board composition.* The board of directors of the Merging Company satisfies the fund governance standards defined in § 270.0–1(a)(7).

* * * * *

8. Section 270.17d–1 is amended by revising paragraph (d)(7)(v) to read as follows:

§ 270.17d–1 Applications regarding joint enterprises or arrangements and certain profit-sharing plans.

* * * * *

(d) * * *

(7) * * *

(v) The board of directors of the investment company satisfies the fund governance standards defined in § 270.0–1(a)(7).

* * * * *

9. Section 270.17e–1 is amended by revising paragraph (c) to read as follows:

§ 270.17e–1 Brokerage transactions on a securities exchange.

* * * * *

(c) The board of directors of the investment company satisfies the fund governance standards defined in § 270.0–1(a)(7); and

* * * * *

10. Section 270.17g–1 is amended by revising paragraph (j)(3) to read as follows:

§ 270.17g–1 Bonding of officers and employees of registered management investment companies.

* * * * *

(j) * * *

(3) The board of directors of the investment company satisfies the fund governance standards defined in § 270.0–1(a)(7).

* * * * *

11. Section 270.18f–3 is amended by revising paragraph (e) to read as follows:

§ 270.18f–3 Multiple class companies.

* * * * *

(e) The board of directors of the investment company satisfies the fund governance standards defined in § 270.0–1(a)(7).

* * * * *

12. Section 270.23c–3 is amended by revising paragraph (b)(8) to read as follows:

§ 270.23c–3 Repurchase offers by closed-end companies.

* * * * *

(b) * * *

(8) The board of directors of the investment company satisfies the fund governance standards defined in § 270.0–1(a)(7).

* * * * *

13. Section 270.31a–2 is amended by:

a. Removing the word ''and'' at the end of paragraph (a)(4);

b. Removing the period at the end of paragraph (a)(5) and adding ''; and''; and

c. Adding paragraph (a)(6) to read as follows:

§ 270.31a–2 Records to be preserved by registered investment companies, certain majority-owned subsidiaries thereof, and other persons having transactions with registered investment companies.

(a) * * *

(6) Preserve for a period not less than six years, the first two years in an easily accessible place, any documents or other written information considered by the directors of the investment company pursuant to section 15(c) of the Act (15 U.S.C. § 80a–15(c)) in approving the terms or renewal of a contract or agreement between the company and an investment adviser.

* * * * *

By the Commission.

Dated: January 15, 2004.

J. Lynn Taylor,

Assistant Secretary.

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