

Investment Company Corporate Governance

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A. New SEC Rules Regarding Investment Company Governance

1. Certain exemptive rules under the Investment Company Act of 1940, as amended, 15 U.S.C. §80a-1 et seq. (the “1940 Act”), require the oversight and approval of the independent directors if the fund engages in transactions with its adviser and other affiliates that involve inherent conflicts of interest. In June 2004, the SEC adopted amendments to these exemptive rules designed to improve the governance of investment companies and the independence of fund directors. (Throughout this outline use of “director” encompasses “trustee” also.) The Appendix to this outline lists the exemptive rules affected by these amendments. The amendments went into effect on September 7, 2004, and funds relying on these exemptive rules must be in compliance by January 16, 2006. (See SEC Release No. IC-26520.)
2. *Independent Composition Of The Board.* Seventy-Five percent of a fund’s board of directors must consist of independent directors. If a board has only three directors, then two of the three directors must be independent. The SEC intends for this requirement to strengthen the presence of independent direc-

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tors and to improve their ability to negotiate lower advisory fees and other important matters on behalf of a fund.

3. *Independent Chairman Of The Board.* The chairman of a fund's board must be an independent director. The board's chairman generally controls the board's agenda and bears the potential to exert a strong influence on the board's deliberation.
4. *Annual Self-Assessment.* The board must assess its own effectiveness at least once per year. This annual assessment must include consideration of the board's committee structure and the number of funds on whose boards the directors serve.
5. *Separate Sessions Of Independent Directors.* The independent directors must meet in separate sessions at least once every quarter. The SEC intends for this requirement to provide the independent directors with the opportunity for candid discussions about management's performance and to improve collegiality among the independent directors.
6. *Independent Director Staff.* Funds must authorize their independent directors to hire their own staff. The SEC intends for this requirement to help independent directors in dealing with matters for which outside assistance may be necessary.
7. *Recordkeeping For Approval Of Advisory Contracts.* Funds must retain copies of the written materials considered by their boards in approving advisory contracts. Funds must retain such materials for at least six years, the first two years in an easily accessible place. The SEC intends for this requirement to aid its examinations of the effectiveness of a fund's board and to encourage directors to request more information useful for obtaining favorable terms in advisory contracts.

B. Determining Independence Under The 1940 Act

1. The characterization of an investment company's board members as "independent" means that they are not "interested persons" as defined in the 1940 Act. Interested persons include: categories of individuals with potential conflicts of interests; those who own securities in the adviser, underwriter, or their affiliates; a broker for the fund; and individuals with certain business, familial, or financial relationships with management. Under section 2(a)(19), 15

U.S.C. §80a-2(a)(19), “interested person” of another person means, when used with respect to an investment company:

- a. Any affiliated person of such company;
- b. Any member of the immediate family of any natural person who is an affiliated person of such company;
- c. Any interested person of any investment adviser of or principal underwriter for such company;
- d. Any person or partner or employee of any person who at any time since the beginning of the last two completed fiscal years of such company has acted as legal counsel for such company;
- e. Any person or any affiliated person of a person (other than a registered investment company) that, at any time during the six-month period preceding the date of the determination of whether that person or affiliated person is an interested person, has executed any portfolio transactions for, engaged in any principal transactions with, or distributed shares for:
 - i. The investment company;
 - ii. Any other investment company having the same investment adviser as such investment company or holding itself out to investors as a related company for purposes of investment or investor services; or
 - iii. Any account over which the investment company’s investment adviser has brokerage placement discretion;
- f. Any person or any affiliated person of a person (other than a registered investment company) that, at any time during the six-month period preceding the date of the determination of whether that person or affiliated person is an interested person, has loaned money or other property to:
 - i. The investment company;
 - ii. Any other investment company having the same investment adviser as such investment company or holding itself out to in-

vestors as a related company for purposes of investment or investor services; or

iii. Any account for which the investment company's investment adviser has borrowing authority;

- g. Any natural person whom the Commission by order shall have determined to be an interested person by reason of having had, at any time since the beginning of the last two completed fiscal years of such company, a material business or professional relationship with such company or with the principal executive officer of such company or with any other investment company having the same investment adviser or principal underwriter or with the principal executive officer or such other investment company, "*provided*, that no person shall be deemed to be an interested person of an investment company solely by reason of (aa) his being a member of its board of directors or advisory board or an owner of its securities, or (bb) his membership in the immediate family of any person specified in clause (aa)."

2. An "affiliated person" of another person is defined under section 2(a)(3) of the 1940 Act, 15 U. S. C. §80a-2(a)(3), as:

(A) Any person directly or indirectly owning, controlling, or holding with power to vote, five percent or more of the outstanding voting securities of such other person; (B) any person five percent or more of whose outstanding voting securities are directly or indirectly owned, controlled, or held with power to vote, by such other person; (C) any person directly or indirectly controlling, controlled by, or under common control with, such other person; (D) any officer, director, partner, copartner, or employee of such other person; (E) if such other person is an investment company, any investment adviser thereof or any member of an advisory board thereof; and (F) if such other person is an unincorporated investment company not having a board of directors, the depositor thereof.

3. The determination of a director's status as an interested person should occur on at least an annual basis. Each director should provide information concerning business, financial, and family relationships with the investment adviser, principal underwriter, other service providers, and their affiliates.
4. In the SEC Release adopting the amendments to the exemptive rules, the SEC urged independent directors to look beyond the minimum criteria established in the 1940 Act for determination of whether a director would be an "interested person" of a fund. The independent directors should examine