SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 271

[Release No. IC–24083]

Interpretive Matters Concerning Independent Directors of Investment Companies

AGENCY: Securities and Exchange Commission.

ACTION: Statement of Staff Position.

SUMMARY: The Securities and Exchange Commission is publishing the views of the Commission and its staff concerning certain issues under the Investment Company Act of 1940 that are related to the independent directors of registered investment companies.

EFFECTIVE DATE: October 14, 1999.

FOR FURTHER INFORMATION CONTACT: Mercer E. Bullard, Assistant Chief Counsel, or Alison M. Fuller, Assistant Chief Counsel, at 202–942–0659, in the Office of Chief Counsel, Division of Investment Management, or by writing to the Office of Chief Counsel, Division of Investment Management, Securities and Exchange Commission, 450 5th St., NW., Washington, DC 20549–0506.

SUPPLEMENTARY INFORMATION:

Executive Summary

Management investment companies are governed by a board of directors, at least 40% of whom must not be ''interested persons'' of the company under section 2(a)(19) of the Investment Company Act of 1940 (the ''Act'') (*i.e.*, ''independent directors'').[1] Independent directors of registered investment companies (''investment companies'' or ''funds'') play a critical role in overseeing the funds operations and protecting the interests of their shareholders. Today, in a companion release,[2] the Commission is proposing to amend a number of rules and forms as part of a broad initiative to enhance the effectiveness of independent directors. Simultaneously, the Commission is publishing this release, which contains the views of its staff concerning a number of interpretive issues under the Act that relate to independent directors, and briefly describes the role of the Commission in connection with certain disputes between independent fund directors and fund management.

Following some general background on the role and duties of fund directors, this release addresses the following interpretive topics:

- Section 2(a)(19) of the Act authorizes the Commission to issue an order finding that a person is an ''interested person'' due to a material business or professional relationship with a fund or certain persons or entities. This release provides guidance from the staff about the types of business and professional relationships that may be material for purposes of section 2(a)(19).
- Some have argued that, if fund directors take an action on behalf of the fund that benefits themselves, the action may constitute a ''joint transaction'' under section 17(d) of the Act and rule 17d–1 thereunder, thereby requiring prior Commission approval. This release explains the view of the staff that actions taken by fund directors within the scope of their duties generally would not be ''joint transactions.''
- Some have questioned when a fund may pay an advance of legal fees to its directors consistent with section 17(h) of the Act, which limits a fund's ability to indemnify its directors. This release provides guidance from the staff regarding when funds may pay such advances.
- Section 22(g) of the Act prohibits open-end funds from compensating their directors with shares of the fund. This release provides guidance from the staff concerning the circumstances under which open-end funds may compensate fund directors with fund shares consistent with section 22(g).

The Commission believes that publishing the staff's views on these issues will enhance the effectiveness of independent directors by: encouraging funds to nominate directors who will effectively protect the interests of shareholders; relieving independent directors of concerns regarding their ability to act in shareholders' best interests without undue fear of personal liability; helping funds attract the most qualified persons to serve on their boards; and facilitating the implementation of fund policies that encourage or require that fund directors be compensated with fund shares, thereby aligning more closely the interests of independent directors and fund shareholders.

We also discuss the Commission's views regarding its role and response in disputes between independent directors and investment advisers when there are allegations of violations of the federal securities laws. The Commission and the staff hope thereby to dispel any confusion that may exist regarding the Commission's role in connection with disputes between independent fund directors and fund management.

I. Background

A. The Role and Independence of Independent Directors

The critical role of independent directors of investment companies is necessitated, in part, by the unique structure of investment companies. Unlike a typical corporation, a fund generally has no employees of its own. Its officers are usually employed and compensated by the fund's investment adviser, which is a separately owned and operated entity. The fund relies on its investment adviser and other affiliates—who are usually the very companies that sponsored the fund's organization—for basic services, including investment advice, administration, and distribution.

Due to this unique structure, conflicts of interest can arise between a fund and the fund's investment adviser because the interests of the fund do not always parallel the interests of the adviser. An investment adviser's interest in maximizing its own profits for the benefit of its owners may conflict with its paramount duty to act solely in the best interests of the fund and its shareholders.

In an effort to control conflicts of interest between funds and their investment advisers, Congress required that at least 40% of a fund's board be composed of independent directors.[3] Congress intended to place independent directors in the role of ''independent watchdogs,'' who would furnish an independent check upon the management of funds and provide a means for the representation of shareholder interests in fund affairs.[4]

Independent directors play a critical role in policing the potential conflicts of interest between a fund and its investment adviser. The Act requires that a majority of a fund's independent directors: approve the fund's contracts with its investment adviser and

[1] 15 U.S.C. § 80a–10(a).

[2] Role of Independent Directors of Investment Companies, Investment Company Act Release No. 24082 (Oct. 14, 1999) (''Companion Release'').

[3] Section 2(a)(19) [15 U.S.C. § 80a–2(a)(19)] (defining the term ''interested person'') and Section 19(a) [15 U.S.C. § 80a–10(a)]. In addition, Congress required that at least a majority of the directors not be: (1) ''interested persons'' of the fund's principal underwriter, Section 10(v) [15 U.S.C. § 80a–10(b)]; (2) investment bankers, or affiliated persons of investment bankers, Section 10(b)(3) [15 U.S.C. § 80a–10(b)(3)]; or (3) officers, directors or employees of any one bank. Section 10(c) [15 U.S.C. § 80a–10(c)].

[4] *See Burks* v. *Lasker*, 44 U.S. 471, 484 (1979) (quoting *Tannenbaum* v. *Zeller*, 552 F. 2d 402, 406 (2d Cir. 1979) and *Investment Trusts and Investment Companies: Hearings on H.R. 10065 Before the House Subcomm. on Interstate and Foreign Commerce*, 76th Cong., 3d Sess. 109 (1940) (statement of David Schenker, Chief Counsel, Investment Trust Study, SEC) (''House Hearings'')).

principal underwriter;[5] select the independent public accountant of the fund;[6] and select and nominate individuals to fill independent director vacancies resulting from the assignment of an advisory contract.[7] In addition, rules promulgated under the Act require independent directors to: approve distribution fees paid under rule 12b–1 under the Act;[8] approve and oversee affiliated securities transactions;[9] set the amount of the fund's fidelity bond;[10] and determine if participation in joint insurance contracts is in the best interest of the fund.[11] Each of these duties and responsibilities is vital to the proper functioning of fund operations and, ultimately, the protection of fund shareholders.[12]

In addition to the requirements of federal law, directors must abide by standards of care prescribed by state statutory and common law. Specifically, directors are subject to state law duties of care and loyalty.[13] The duty of care generally requires that directors act in good faith and with that degree of diligence, care and skill that a person of ordinary prudence would exercise under similar circumstances in a like position.[14] The duty of loyalty generally requires that directors exercise their powers in the interests of the fund and not in the directors' own interests or in the interests of another person or organization.[15]

B. Improving Fund Governance

The role of independent fund directors, and proposals to enhance their independence and effectiveness, have been the subject of a number of initiatives since the Act was enacted in 1940. For example, the Wharton School, at the request of the Commission, began a detailed study of the fund industry in the late 1950s. At that time, any person who was not an officer, employee or investment adviser of a fund, or an affiliated person of the investment adviser, could serve as an independent director of the fund. Under this standard, the Wharton study questioned the ''extent to which reliance can be placed on the independent directors to safeguard adequately the rights of shareholders in negotiations between the [fund] and the investment adviser.'' [16] The Commission followed the Wharton study with its own study, which agreed that the then-current standard for director independence was inadequate.[17] Subsequently, Congress enacted an amendment to the Act in 1970 which required that independent directors not be ''interested persons'' of a fund under new section 2(a)(19) of the Act.[18] The amendment substantially limited the categories of persons who could serve as independent directors for funds.[19]

The Commission staff revisited the issue of the effectiveness of fund directors in the early 1990s, which culminated in a published report in 1992.[20] The staff concluded that the governance model embodied in the Act was sound, but suggested a number of changes designed to improve the effectiveness of fund directors. One of these recommendations was to increase the minimum percentage of independent directors on fund boards from 40% to greater than 50%. In addition, the staff suggested that a fund's independent directors be allowed to choose the persons who would fill independent director vacancies and that the independent directors be given the express authority to terminate advisory contracts.

Fund governance has recently returned to the forefront. The press has questioned the effectiveness of independent directors [21] and, in a number of instances, independent directors have come under fire by fund management and been replaced with directors who were nominated by management.[22] Private litigants have challenged independent directors' independence,[23] and the Commission has instituted enforcement actions against independent directors for failing to fulfill their legal obligations.[24] The prominence of these developments has been magnified by the extraordinary growth of the fund industry.[25]

In recognition of the increasingly important role that funds play in Americans' finances, and that independent directors play in protecting fund investors, the Commission launched an initiative to explore the state of fund governance and to determine what improvements could be made. Last February, the Commission hosted a Roundtable on the Role of Independent Investment Company Directors to discuss the role of

[5] Sections 15(a) and (b) [15 U.S.C. §§ 80a–15(a), (b)].

[6] Section 32(a) [15 U.S.C. § 80a–31(a)].

[7] Sections 16(b) and 15(f)(1)(A) [15 U.S.C. §§ 80a–16(b), 15(f)(1)(A)].

[8] Rule 12b–1 [17 CFR 270.12b–1]

[9] Rules 10f–3, 17a–7, 17a–8, and 17e–1 [17 CFR 270.10f–3, 270.17a–7, 270.17a–8, and 270.17e–1]

[10] Rule 17g–1 [17 CFR 270.17g–1]

[11] Rule 17d–1(d)(7) [17 CFR 270.17d–1(d)(7)].

[12] The full board of directors also has certain other responsibilities, including, but not limited to: (1) Approving the fund's valuation procedures, custody agreements, and brokerage allocation policies; (2) monitoring the fund's investments and investment performance and any allocation of expenses between the company and its affiliates; (3) authorizing the mergers of two or more affiliated funds and the issuance and sale of shares of the fund; and (3) declaring dividends in accordance with the fund's investment policies and objectives.

[13] The business judgment rule generally protects fund directors from liability for their decisions so long as the directors acted in good faith, were reasonably informed, and rationally believed that the action taken was in the best interests of the fund. *See Solomon* v. *Armstrong,* 1999 Del. Ch. LEXIS 62, 23 (Del. Ch. Mar. 25, 1999). *See generally* James Solheim, J.D. and Kenneth Elkins, J.D., 3A Flechter Cyc Corp § 1036 (perm. ed.).

[14] *See Hanson Trust PLC* v. *ML SCM Acquisition Inc.,* 781 F.2d 264, 273 (2d Cir. 1986) and *Norlin Corp.* v. *Rooney, Pace Inc.,* 744 F.2d 255, 264 (2d Cir. 1984). *See generally* Solheim and Elkins, *supra* note 13 at § 1029.

[15] *See Norlin Corp.* 744 F.2d at 264 (*citing Pepper* v. *Litton,* 308 U.S. 295, 306–07 (1939)). *See generally* Beth A. Buday and Gail A. O'Gradney, 3 Fletcher Cyc Corp § 913 (Perm Ed).

[16] Wharton School of Finance and Commerce, A Study of Mutual Funds, H.R. Rep. No. 2274, 87th Cong., 2d Sess. 8 (1962).

[17] SEC, Public Policy Implications of Investment Company Growth, H.R. Rep. No. 2337, 89th Cong., 2d Sess. 333 (1966).

[18] *See* S. Rep. No. 184, 91st Cong., 1st Sess. 32–33 (1969).

[19] The Commission, however, has provided some flexibility by promulgating rules that broaden the categories of persons who can serve as independent directors of a fund. For example, registered broker-dealers and their affiliated persons are considered ''interested persons'' of a fund, and its investment adviser or principal underwriter. *See* Sections 2(a)(19)(A) and (B)(v) [15 U.S.C. §§ 80a–2(a)(19)(A)(v), (B)(v)]. Under rule 2a19–1, however, a fund director who is an affiliated person of a registered broker or dealer will not be deemed to be an ''interested person'' of the fund, or its investment adviser or principal underwriter, provided that, among other things, the broker or dealer does not sell fund shares or effect portfolio transactions for the fund. Rule 2a19–1 [17 CFR 270.2a19–1].

[20] Division of Investment Management, SEC, Protecting Investors: A Half Century of Investment Company Regulation, Ch. 7 (1992).

[21] *See, e.g.,* Russ Wiles, *Third Quarter Review: Your Money, Investments and Personal Finance; Study Raises Questions About the Vigilance of the Family Watchdog,* L.A. Times, Oct. 6, 1996, at D5; Charles Jaffe, *Don't Count on Directors to Guard Your Interests,* Kansas City Star, Mar. 9, 1999, at D19; and Edward Wyatt, *Empty Suits in the Board Room; Under Fire, Mutual Fund Directors Seem Increasingly Hamstrung,* N.Y. Times, June 7, 1998, at C1.

[22] *See, e.g., Defeating Dissidents,* Institutional Investor, Feb. z1999, at 112; and Edward Wyatt, *Investing: Funds Watch; SEC Explores Directors' Roles,* N.Y. Times, Jan. 31, 1999, at C9.

[23] *See, e.g., Strougo* v. *Scudder, Stevens & Clark, Inc.,* 964 F.Supp. 783 (S.D.N.Y. 1997); *Strougo* v. *Bassini, et al.,* 97 Civ. 3579 (S.D.N.Y. 1998); *Strougo* v. *BEA Associates.,* 98 Civ. 3725 (S.D.N.Y. 1999); and *Verkouteren* v. *Blackrock Financial Management, Inc.,* 98 Civ. 4673 (S.D.N.Y. 1999).

[24] *See, e.g., In the Matter of Parnassus Investments, et al.,* Initial Decision Release No. 131 (Sept. 3, 1998); *In the Matter of the Rockies Fund, Inc., et al.,* Investment Company Act Release No. 23229 (June 1, 1998) (pending); and *In the Matter of Monetta Financial Services, Inc., et al.,* Investment Company Act Release No. 23048 (May 8, 1998) (pending).

[25] *See* Investment Company Institute, Mutual Fund Fact Book 3 (1999). Total assets of open-end funds were $5.525 trillion at the end of 1998, compared with $809.4 billion in 1988. In 1998, an estimated 44 percent of U.S. households owned open-end funds, up from 5.7 percent in 1980 and 24.4 percent in 1988. *Id.* at 45.

independent directors and the steps that could be taken to improve their effectiveness. There was broad agreement among Roundtable participants that fund governance could be improved to enable independent directors to better serve fund shareholders.[26]

Following the Roundtable, the Commission undertook a rulemaking initiative to implement some of the suggestions made at the Roundtable on how to improve fund governance.[27] In the Companion Release, the Commission is proposing amendments to a number of exemptive rules under the Act, and is proposing to amend a number of forms to provide fund shareholders with improved information with which to judge the independence of their funds' directors. This release provides staff interpretive guidance regarding certain issues relating to the independence and role of independent fund directors, and briefly describes the role of the Commission in connection with disputes between independent fund directors and fund management.

II. Interpretive Guidance

A. Commission Orders Under Section 2(a)(19) of the Act

Sections 2(a)(19)(A)(vi) and (B)(vi) of the Act authorize the Commission to issue an order finding that a person is ''interested'' by reason of a material business or professional relationship with certain persons and entities.[28] The Commission and the staff have not publicly provided guidance concerning these sections for a significant period of time.[29] The staff believes that it would be useful to provide additional guidance about the types of professional and business relationships that may be considered to be material for purposes of sections 2(a)(19)(A)(vi) and (B)(vi).[30] This guidance should be particularly useful because the staff understands that many fund groups will not nominate an individual as an independent director if they identify a material business or professional relationship that the individual has with a Specified Entity (as defined below) due to concerns that the Commission may commence proceedings under section 2(a)(19).[31]

The Commission has the authority to issue an order under section 2(a)(19) of the Act when it finds that a person has or had a ''material business or professional relationship'' with certain specified persons and entities, including some fund affiliates (''Specified Entities'').[32] Section 2(a)(19) does not define a ''material business or professional relationship.'' The legislative history, however, indicates that a business or professional relationship would be material if it ''might tend to impair the independence of [a] director.'' [33] The legislative history also states that ''[o]rdinarily, a business or professional relationship would not be deemed to impair independence where the benefits flow from the director of an investment company to the other party to the relationship. In such instances the relationship is not likely to make the director beholden to that party.'' [34]

The staff believes that issues arising under sections 2(a)(19)(A)(vi) and (B)(vi) must be analyzed based on the particular facts of each case to determine whether a director's interests and relationships might tend to impair his or her independence.[35] The staff also believes, however, that it would be useful to provide guidance about the types of professional and business relationships between a director and a Specified Entity that may be considered to be material. In particular, this section of the release describes how the staff will analyze whether a person should be treated as ''interested'' by virtue of (1) holding or having held certain positions with a Specified Entity, and (2) engaging or having engaged in certain material transactions with a Specified Entity.[36]

Positions as Material Business or Professional Relationships

The staff believes that a fund director may be treated as ''interested'' if he or she currently holds or held, at any time since the beginning of the last two completed fiscal years of the fund (the ''two-year period''), certain positions with a Specified Entity. The staff would consider a position that a director holds with a Specified Entity as a ''material business or professional relationship'' if it would tend to impair a director's independence by providing incentives for the director to place his or her own interests over the interests of fund shareholders. The key factors in evaluating whether a director's position with a Specified Entity would tend to impair his or her independence include the level of the director's responsibility in the position and the level of compensation or other benefits that the director receives or received from the position.

For instance, the staff would consider an individual who served as the fund's portfolio manager during the two-year

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[26] *See* SEC, Roundtable on the Role of Independent Investment Company Directors, Feb. 23–24, 1999 (''Roundtable Transcript''). The Roundtable Transcripts are available to the public in the Commission's public reference room, the Commission's Louis Loss Library, and on the Commission's Web site at www.sec.gov/offices/invmgmt/roundtab.htm. *See also* Companion Release, *supra* note 2, nn. 41, 63 and 76 (citing statements of Roundtable participants).

[27] At the Roundtable, Commission Chairman Arthur Levitt also asked the fund industry to assume an active role in establishing and promoting best fund governance practices. In June 1999, the Investment Company Institute issued a Report of the Advisory Group on Best Practices for Fund Directors (''ICI Advisory Group Report'').

[28] Section 2(a)(19)(A)(vi) of the Act defines ''interested person,'' when used with respect to an investment company, in part, as: ''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 of such other investment company.'' 15 U.S.C. § 80a–2(a)(19)(A)(vi).

Section 2(a)(19)(B)(vi) of the Act defines ''interested person,'' when used with respect to an investment adviser of or principal underwriter for, any investment company, in part, as: ''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 investment company a material business or professional relationship with such investment adviser or principal underwriter or with the principal executive officer or any controlling person of such investment adviser or principal underwriter.''

15 U.S.C. § 80a–2(a)(19)(B)(vi).

[29] For a number of years, the staff provided some informal guidance by issuing no-action letters, but has not done so since 1984 as a matter of policy. *See* Daniel Calabria, SEC No-Action Letter (Sept. 12, 1984); Capital Supervisors Helios Fund, Inc., SEC No-Action Letter (June 13, 1984).

[30] In the Companion Release, the Commission has proposed rules that would require additional disclosure about fund directors to, among other things, assist the Commission and its staff in evaluating directors' independence. Companion Release, *supra* note 2.

[31] *See* ICI Advisory Group Report, *supra* note 27, at 6; Roundtable Transcript of Feb. 24, 1999, at 253 (statement by Thomas R. Smith, Jr.). The staff believes that the guidance provided in this portion of the release may assist funds in the independent director nominating process.

[32] Those entities include the fund, its principal executive officer, the investment adviser and principal underwriter of the fund, the principal executive officer of the investment adviser or principal underwriter, or any controlling person of the investment adviser or principal underwriter, any other fund with the same investment adviser or principal underwriter, and the principal executive officer of such other fund. *See* Sections 2(a)(19)(A)(iv) and (B)(vi) [15 U.S.C. §§ 80a–2(a)(19)(A)(vi), (B)(vi)].

[33] H.R. Rep. No. 1382, 91st Cong., 2d Sess. 14 (1970); S. Rep. No. 184, 91st Cong., 1st Sess. 33 (1969).

[34] *Id.*

[35] The legislative history indicates that Congress intended for the Commission to determine whether a material business and professional relationship exists on a case-by-case basis. H.R. Rep. No. 1382, 91st Cong. 2d Sess. 15 (1970); S. Rep. No. 184, 91st Cong., 1st Sess. 33 (1969).

[36] The examples discussed in this release are not exhaustive and are provided for illustrative purposes only. There may be other relationships that would be viewed by the staff as material under section 2(a)(19).

period to have had a material business or professional relationship with the fund and its investment adviser. The staff previously has informally advised certain funds of this position on several occasions. The staff believes that a fund's former portfolio manager must be viewed as having had a material business or professional relationship with the fund and its adviser because he or she would have had significant responsibilities with the fund and the adviser, and likely would have received substantial compensation and other benefits from the adviser and/or the fund.[37] Indeed, the staff would view the former portfolio manager's position as material due to the manager's responsibility in the position even if the manager had not received substantial compensation from adviser or the fund. Similarly, the staff believes that former directors, officers, and employees of the fund's investment adviser or principal underwriter could be viewed as having had a material business or professional relationship with a Specified Entity, depending on the facts and circumstances.[38]

In addition, a fund director who at any time during the two-year period also was a director, officer or employee of a current or former holding company of the fund's investment adviser may be treated as interested by reason of a material business or professional relationship with the controlling person of the fund's adviser (a Specified Entity).[39] As described above, the staff's analysis of the materiality of the relationship would focus on, among other things, the level of the director's responsibility with the holding company and the level of compensation or other benefits that the director received from the position.

The staff believes that not every position that a director holds or held with a Specified Entity would be deemed to impair his or her independence. For example, a director of a fund who also is a director of another fund managed by the same adviser generally would not be viewed as an interested person of the fund under section 2(a)(19) solely as a result of this relationship.[40]

Material Transactions as Material Business or Professional Relationships

The staff believes that a fund director may be treated as ''interested'' if he or she has, at any time during the two-year period, directly or indirectly engaged (or proposed to engage) in any material transactions (or proposed material transactions) with a Specified Entity. Such a relationship could result from a single transaction or from multiple transactions. These transactions may be structured as service arrangements, including legal, investment banking, and consulting services, or other business transactions, such as business and personal loans, and real estate purchases.[41] In addition, a material business or professional relationship with a Specified Entity may result from a fund director's position with, or ownership interest in, an entity that engages in material transactions with a Specified Entity.

For example, the staff believes that a fund director may be treated as ''interested'' if the fund's investment adviser manages or managed for the director, at any time during the two-year period, an advisory or brokerage account, and the adviser favors, or creates the expectation that it will favor, the account over the other accounts that it manages.[42] In the staff's view, a director would receive favored treatment, for instance, if the adviser charged the director no fees or fees that were lower than the fees that it charged for similar types of accounts, or accorded the director's account special treatment regarding portfolio management decisions or securities allocations. By favoring the director's account over other accounts that it manages, the adviser may create an incentive for the director to act in a manner that will preserve or increase the favorable treatment.[43] In this instance, significant economic benefits from the relationship between the director and the adviser would flow to the director, or the director may have the expectation that significant economic benefits would flow in the future to the director.[44]

The staff believes that a fund director who serves as a chief executive officer of any company for which the chief executive officer of the fund's adviser serves as a director also may be treated as ''interested.'' The relationship between the fund director and the adviser's chief executive officer may tend to impair the director's independence because the adviser's chief executive officer has the power to vote on matters that affect the director's compensation and status as chief executive officer of the company. In this instance, the fund director may act with respect to fund matters in a manner to preserve his or her relationship with the company and with the adviser's chief executive officer, rather than in the interest of the fund's shareholders.[45]

A fund director may be deemed to have indirectly engaged in a material transaction with a Specified Entity through his or her interest in a company that conducted business with the Specified Entity.[46] In determining

[37] Similarly, the ICI Advisory Group recommends that former employees of a fund's investment adviser who had significant responsibilities in their positions with the adviser not serve as independent directors of the fund. *See* ICI Advisory Group Report, *supra* note 27, at 13.

[38] In addition, the staff notes that many former officers and employees of a fund's investment adviser or principal underwriter may own securities issued by the adviser or underwriter. Such persons are interested persons of the fund by virtue of sections 2(a)(19)(A)(iii) and (B)(iii) [15 U.S.C. §§ 80a–2(a)(19)(A)(iii), (B)(iii)].

[39] *See also* Western Separate Account A, SEC No-Action Letter (Mar. 8, 1976) (directors who are employees or executives of a fund adviser, principal underwriter or controlling person may not be disinterested); NEA Mutual Fund, SEC No-Action Letter (June 3, 1971) (directors who are employees or executives of an entity that controls the fund's adviser or principal underwriter may not be disinterested).

[40] *See* H.R. Rep. No. 1382, 91st Cong., 2d Sess. 15 (1970); S. Rep. No. 184, 91st Cong., 1st Sess. 34 (1969) (stating that ''a director of one investment company would not ordinarily be deemed an interested person of that company by reason of being a director of another investment company with the same adviser'').

[41] *See, e.g.,* Alpha Investors Fund, SEC No-Action Letter (Jan. 9, 1972) (director who is a partner at a law firm that provides legal services to an entity that controls the fund's adviser may be interested under section 2(a)(19)(B)(vi) because the director has a material business or professional relationship with that entity).

[42] *Cf.* H.R. Rep. No. 1382, 91st Cong., 2d Sess. 15 (1970); S. Rep. No. 184, 91st Cong., 1st Sess. 34 (1969) (stating that ''a director ordinarily would not be considered to have a material business relationship with the investment adviser simply because he is a brokerage customer who is not accorded special treatment'').

[43] Such favoritism would raise additional issues under the federal securities laws. See, *e.g.,* In the Matter of Monetta Financial Services, Inc., *supra* note 24.

[44] For an example of a relationship in which the staff believed that significant economic benefits did not flow to the director, *see* Securities Groups, SEC No-Action Letter (Apr. 20, 1981) (staff stated that a nominated director's participation in a symposium sponsored by the parent of the fund's adviser did not constitute a material relationship because ''the $2,000 paid to him for taking part in that seminar is not so significant as to tend to impair his independence were he to serve as a disinterested director of the fund'').

[45] *See* Southwestern Investors, Inc., SEC No-Action Letter (June 13, 1971) (fund director who is an officer and director of company A may not be disinterested if the president of a company that indirectly controls the fund's investment adviser and principal underwriter also serves as a director of company A). *Cf.* H.R. Rep. No. 1382, 91st Cong., 2d Sess. 15 (1970); S. Rep. No. 184, 91st Cong., 1st Sess. 34 (1969) (fund director that serves with the chief executive officer of the fund's adviser on the board of another company generally would not be deemed to have a material business or professional relationship with the chief executive officer). Unlike the facts in Southwestern Investors, Inc., the fund director described in the House and Senate Reports was not an officer or employee of the other company, such that the chief executive officer of the fund's adviser did not appear to have the power to vote on matters affecting the fund director's status with the other company.

[46] *See also* The MONY Fund, Inc., SEC No-Action Letter (Jan. 29, 1972) (director who is a senior

whether the director would have a material business or professional relationship with a Specified Entity due to his or her interest in the company and the company's transaction with the Specified Entity, the staff would look to the nature and significance of the director's interest in the company and the company's interest in the transaction. In particular, the staff would focus on the significance of any economic or other benefit that would flow to the director. For example, a fund director who had a controlling interest in a company that conducted material business with a fund would likely receive significant economic benefits, either directly or indirectly, as a result.[47] Such a director may be treated as interested because the director may have a material business or professional relationship with the fund as a result of having indirectly engaged in a material transaction with the fund.

A material relationship resulting from a *proposed* material transaction with a Specified Entity might include the negotiation of a service contract between a company controlled by the director and the Specified Entity. During the negotiation of such a contract (and even if such contract is never finalized), the director may be concerned about interests other than those of the fund and its shareholders. As a result, the process of negotiating a material transaction may tend to impair the director's independence, and thus may itself create a material business or professional relationship with a Specified Entity for purposes of section 2(a)(19).

Other Related Matters

In the Companion Release, the Commission is proposing amendments to various disclosure requirements. The purpose of the proposed disclosure amendments is, in part, to assist the Commission and the staff in determining whether it would be appropriate to make further inquiry into a particular director's independence. If the proposed rules are adopted, the staff will review and monitor the new disclosure. Based on its review of the disclosure, the staff will consider whether to issue additional guidance regarding other types of relationships that may be considered to be material under section 2(a)(19).

B. Independent Directors and Section 17(d) and Rule 17d–1

In the course of their duties, fund directors often take actions on behalf of a fund that may also benefit themselves in some way. Some have questioned whether these actions may run afoul of certain provisions of the Act that prohibit affiliated transactions. As discussed in greater detail below, the staff generally believes that they do not, and believes that it would be beneficial to fund directors for the staff to clarify its views on these matters.

As discussed previously, a fund's board of directors is charged with the responsibility of protecting the interests of fund shareholders by overseeing the operations of the fund and policing conflicts of interests. Fund directors must fulfill this responsibility, regardless of whether they may personally benefit from their actions, or whether their actions are contrary to the wishes of fund management. Some have argued that actions taken by directors on behalf of a fund that also provide some benefit to the directors could constitute a joint transaction for purposes of section 17(d) [48] of the Act and rule 17d–1 [49] thereunder.[50]

Section 17(d) and rule 17d–1 generally prohibit an affiliated person of an investment company (which includes a fund director) or an affiliated person of such person (''affiliate''), acting as principal, from participating in or effecting any transaction in connection with any joint enterprise or other joint arrangement or profit-sharing plan in which the investment company is also a participant, unless an application regarding the joint arrangement has been filed with and an order authorizing the transaction has been granted by the Commission. A joint enterprise or other joint arrangement or profit-sharing plan (''joint arrangement'') is broadly defined in rule 17d–1(c) to include any written or oral plan, contract, authorization or arrangement, or any practice or understanding concerning an enterprise or undertaking whereby the investment company and the affiliate have a joint or a joint and several participation, or share in the profits of such enterprise or undertaking.

Fund directors commonly authorize the use of fund assets to make payments from which the directors may personally benefit, such as director salaries, board meeting expenses, proxy expenses, and legal fees of counsel to the independent directors. As a practical matter, the staff believes that interpreting rule 17d–1 as encompassing such actions could impede, or in some cases prevent, fund directors from taking actions that would be in the best interests of shareholders. Such a broad reading also could be used to prevent fund directors from fulfilling their responsibilities, such as opposing a proxy solicitation that they believe is not in the best interests of fund shareholders, or otherwise acting to protect shareholder interests.[51] Furthermore, the staff believes that requiring a fund to obtain a Commission order for every action that results in some benefit to directors would be unduly burdensome and could impede the efficient operation of funds.

The staff believes that it would be helpful to fund directors to clarify the meaning of ''joint arrangement'' in the context of actions taken in their capacities as directors. As a general matter, the staff believes that the actions of fund directors taken in their capacities as directors would not constitute joint arrangements for purposes of rule 17d–1. Joint arrangements require ''some element of combination'' between the fund and its affiliate.[52] The staff believes that, when a fund's directors are acting on behalf of the fund in their capacities as fund directors, the requisite element of ''combination'' is not present. Indeed, in order for the requisite element of ''combination'' to be present, the staff generally believes that the joint arrangement must involve activities that

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officer of a company that contracted with company A, which wholly owns the fund's investment adviser, to find a vice president for company A, may have a material relationship with a controlling person of the fund's adviser).

[47] *Cf.* Travelers Equities Fund, Inc., SEC No-Action Letter (Jan. 11, 1982) (director who is a limited partner of a partnership that obtained a loan from the principal underwriter of the fund is not an interested person of the underwriter).

[48] Section 17(d) [15 U.S.C. § 80a–17(d)].

[49] Rule 17d–1 [17 CFR 270.17d–1].

[50] *See* Verified Complaint, *In the Matter of Yacktman* v. *Carlson,* No. 98278117 (Cir. Ct. Md. 1998).

[51] This prospect was raised in connection with recent litigation arising out of a dispute between the independent directors of a fund and its investment adviser. In the course of the dispute, the president of the fund, who also was the president of the investment adviser, called a special shareholders meeting and initiated a proxy contest to replace the independent directors. In addition, the investment adviser filed a lawsuit seeking to enjoin the fund's independent directors from using the fund's assets to pay for the fund's proxy expenses on the theory that such payment would be a joint arrangement among the fund and the independent directors in violation of section 17(d) and rule 17d–1. In response, the staff issued a letter to the parties indicating that it seriously questioned whether payment of the proxy expenses out of fund assets required a prior order under section 17(d) and rule 17d–1. *See* Letter from Jacob H. Stillman and Douglas Scheidt to Richard Teigen, Esq., *et. al,* October 16, 1998. This letter is included in the public comment file for the Companion Release. *See supra* note 2, at S7–23–99.

[52] *SEC* v. *Tally Industries, Inc.,* 399 F.2d 396, 403 (2d Cir. 1968), *cert. denied,* 393 U.S. 1015 (1969); and Deferred Compensation Plans for Investment Company Directors, SEC No-Action Letter (May 14, 1998).

are beyond the scope of the directors' duties to the fund.[53]

In the staff's view, the fact that fund expenditures may benefit the directors in some way is not sufficient to render them ''joint arrangements'' among the fund and the directors for purposes of rule 17d–1. Whether there is ''some element of combination'' does not depend on whether the directors' actions were motivated by self-interest. If, in fact, the directors were motivated solely by self-interest, they may have breached their duties of care or loyalty under state law or breached their fiduciary duties under section 36(a) of the Act.[54] But whether rule 17d–1 applies turns on the nature of the transaction, not on its propriety or the affiliate's motives, provided that the directors are acting within the scope of their duties. The staff believes that fund directors must be able to fulfill their duties without fear that their actions, even those from which they may personally benefit, may result in a joint transaction for purposes of rule 17d–1.

C. Advances of Legal Expenses to Independent Directors

As a consequence of their ''watchdog'' role in policing potential conflicts of interests, fund directors have heightened exposure to personal liability for actions that they take which they believe to be in the best interests of the fund and its shareholders.[55] The risk of personal liability could, however, deter some independent directors from making controversial decisions that may benefit the fund and discourage qualified individuals from serving as independent directors. The staff has sought to address these concerns by interpreting the Act to permit funds to advance legal fees to their directors under certain circumstances. Nonetheless, participants at the Commission's Roundtable on the Role of Independent Investment Company Directors (and others) have advised the staff that additional guidance may be necessary to clarify some uncertainties that may exist about certain aspects of the staff's positions. These uncertainties could make it unnecessarily difficult for some independent directors to receive advances of legal fees, particularly during disputes with the fund's investment adviser. The staff therefore is providing the following guidance regarding when funds may advance legal fees to their independent directors.

The defense of a lawsuit against a fund director can severely deplete the director's personal assets. If a director is found liable, even for mere negligence, the potential financial burdens may far exceed the director's ability to pay, and be greatly disproportionate to the financial and other benefits of serving as a director. Even if the lawsuit is without legal merit, the costs of defending it can be high. Without some protection against the risks of incurring these costs, directors may avoid making controversial decisions, even if those decisions would have been in the best interests of the fund and its shareholders. Indeed, the potential liability attendant upon service as a director of a fund can have the effect of discouraging qualified individuals from serving in that capacity.

One commonly used approach to address this problem is for funds to agree to indemnify directors for personal financial liability arising out of actions taken in their capacities as directors.[56] Any indemnification provisions, however, are subject to section 17(h) of the Act. Section 17(h) generally prohibits a fund from including in its organizational documents any provision that protects a director or officer of a fund against any liability to the fund or its shareholders by reason of willful misfeasance, bad faith, gross negligence or reckless disregard of his or her duties as director or officer (collectively, ''disabling conduct'').[57] Section 17(h) is intended to balance the need to ensure that funds have the ability to indemnify directors for liability arising out of actions that they took in good faith with the need for funds and their shareholders to be able to hold fund directors personally accountable for their actions as directors.[58]

The staff has taken the position that the prohibitions of section 17(h) apply to advances for legal fees, as well as to payments for settlements and judgments.[59] The staff believes that

[53] For example, the staff believes that a joint transaction would not exist if fund directors authorized the use of fund assets to pay for proxy expenses incurred in connection with the directors' uncontested re-election, notwithstanding that they could benefit personally from such expenditures. Similarly, the staff believes that, if a third party such as the fund's investment adviser initiated a proxy contest to unseat the fund's independent directors, the directors' use of fund assets to solicit proxies in favor of their re-election would not constitute a joint transaction. *Accord* Order Granting Defendants' Emergency Motion to Modify Temporary Restraining Order, *Yacktman* v. *Carlson,* Case No. AMD 98–3496 (D. Md. 1998) (vacating temporary restraining order enjoining directors from using fund assets to pay proxy expenses).

[54] Section 36(a) [15 U.S.C. 80a–35(a)]. Section 36(a) authorizes the Commission to institute a lawsuit alleging, among other things, that an officer or director of a fund, including an independent director, has engaged in an ''act or practice constituting a breach of fiduciary duty involving personal misconduct in respect of any [fund] for which such person so serves or acts.'' The Commission has used its authority under section 36(a) in a number of cases, including cases in which the Commission called into question the conduct of a fund's independent directors. *See, e.g., SEC* v. *Treasury First, Inc.,* Litigation Release No. 13094 (Nov. 19, 1991); *SEC* v. *Forty Four Management, Ltd.,* Litigation Release No. 11717 (Apr. 28, 1988); and *SEC* v. *American Birthright Trust Management Company, Inc.,* Litigation Release No. 9266 (Dec. 30, 1980).

In addition, section 37 of the Act prohibits persons from unlawfully and willfully converting to their own use or the use of another person any funds or assets of a registered investment company. *See, e.g., SEC* v. *Donna Tumminia,* Litigation Release No. 14217 (Sept. 1, 1994); and SEC v. Lazzell, Litigation Release No. 12585 (Aug. 17, 1990).

[55] The Act places substantial responsibilities on the independent directors of investment companies to protect the interests of fund shareholders by policing potential conflicts of interest. These responsibilities are in addition to the general duties of loyalty and care imposed on directors under state law. The Act and state law also provide fund shareholders with private rights of action against directors who fail to exercise reasonable care in the fulfillment of their duties. *See, e.g., Strougo* v. *Scudder, Stevens & Clark, Inc., supra* note 23, at 796–798 (holding that fund shareholder has a private right of action under section 36(a) against, among others, the independent directors of the fund). *See also* Pui-Wing Tam, ''Jury Gives Boost to Independent Directors,'' Wall St. J. at C19 (July 26, 1999) (trial of action by certain shareholders of a fund and the fund's investment adviser against former independent fund directors for breach of fiduciary duty resulted in jury verdict for defendants); Richard A. Oppel Jr., *A Potentially Costly Lawsuit,* N.Y. Times at sec. 3, at 7 (Aug. 1, 1999) (former independent fund directors sued by investment adviser and fund shareholders, *see supra,* may seek recovery of millions of dollars in legal fees from fund that has assets of only $37.5 million).

[56] American Bar Association, Section of Business Law, Fund Director's Guidebook 70 (1996). Funds also commonly obtain ''errors and omissions'' insurance policies to cover expenses incurred by directors and officers in the event of litigation. These policies often are joint policies that cover numerous funds within a fund family as well as the funds' investment adviser and principal underwriter, and have generally excluded claims in which one party covered by the policy sues another. Although section 17(d) of the Act and rule 17d–1 thereunder generally prohibit such jointly arrangements, *see supra* text accompanying notes 48–51, rule 17d–1(d)(7) permits the purchase of joint errors and omission policies. The Commission is proposing to amend rule 17d–1(d)(7) [17 CFR 270.17d–1(d)(7)] to make the rule available only for joint insurance policies that do not exclude coverage for litigation between a fund's independent directors and investment adviser. *See* Companion Release, *supra* note 2, at Section II.B.

[57] *See* Section 17(h) [15 U.S.C. § 80a–17(h)]. State laws similarly limit the ability of investment companies to indemnify their directors and officers. At least one commenter has suggested that such state law provisions that are more restrictive than section 17(h) probably are not susceptible to challenge on the grounds of federal preemption. *See* Newman, O'Dell and Kenyon, *Indemnification and Insurance,* ALI–ABA Course of Study: Investment Company Regulation and Compliance 217,220 (June 11, 1998).

[58] *See Chabot* v. *Empire Trust Co.,* 301 F.2d 458,460 (2d Cir. 1962) (''The purpose of [section] 17(h) is to ensure that liability for violation of the duties and standards provided by the Act will not be defeated by the inclusion of protective contractual clauses'').

[59] ''Indemnification by Investment Companies,'' Investment Company Act Release No. 11330 (Sept.

section 17(h) is intended to ensure that directors can be held personally accountable for any costs that may result from their disabling conduct, including those costs, such as legal fees, that are indirect results of litigation or the threat thereof.

The staff also has taken the position that, before advancing legal fees to a director, a fund's board must either (1) obtain assurances, such as by obtaining insurance or receiving collateral provided by the director, that the advance will be repaid if the director is found to have engaged in disabling conduct, or (2) have a reasonable belief that the director has not engaged in disabling conduct and ultimately will be entitled to indemnification.[60] The staff has stated that a reasonable belief may be formed either by a majority of a quorum of the independent, non-party directors of the investment company, or based on a written opinion [61] provided by independent legal counsel that in turn is based on counsel's review of the readily available facts (as opposed to a full trial-type inquiry).[62] These positions are intended to permit a fund to protect its directors against the legal costs attendant upon defending and resolving lawsuits, while preventing or minimizing the risk that a fund's assets will be used to indemnify directors for legal fees that are incurred as a result of the directors' disabling conduct.

The staff has been advised that these positions may make it unnecessarily difficult for funds to advance legal fees to their directors. This could inhibit the willingness of independent directors to take appropriate but controversial actions and discourage qualified individuals from serving as independent directors. This problem may be particularly acute when there is a dispute between the fund's investment adviser and the fund's independent directors, as the investment adviser in some circumstances would be able to influence any determination about the whether the directors had engaged in disabling conduct. For example, persons who had been ousted as independent directors in a proxy battle with management might question the ability or willingness of the fund's new independent directors to objectively determine whether there was reason to believe that the ousted directors had engaged in disabling conduct because the directors may have been nominated by the fund's investment adviser.

The staff has recently addressed the issue of whether independent directors should be afforded a presumption that they have not engaged in disabling conduct within the meaning of section 17(h). Independent directors are presumed by the nature of their qualifications to be free of many of the kinds of conflicts that may color their judgment and affect their actions as directors.[63] On this basis, the staff reasoned that it would be consistent with section 17(h) and prior staff positions if legal counsel—in providing an opinion as to whether a fund should advance legal fees either to its independent directors or to any directors who are interested persons solely by reason of serving as officers of the fund—afforded the directors a rebuttable presumption that they had not engaged in disabling conduct.[64] The staff stated that this position was limited to actions taken by directors while acting in their capacities as directors. The staff believes that the rebuttable presumption also should apply in situations when the independent, non-party directors of the investment company, rather than independent legal counsel, make the reasonable belief determination.

Another related issue is the degree of due diligence that would be necessary for independent, non-party directors or independent legal counsel to make a reasonable belief determination. As noted above, the staff has stated that the directors or counsel could rely on a review of the readily available facts, and that a full trial-type inquiry was unnecessary. Thus, we would not expect the directors or counsel to engage in fact-finding to the same degree as one might undertake to prepare for a trial, which might include taking depositions, issuing interrogatories, or interviewing every witness involved in the dispute. Furthermore, while the level of review that would be required to be undertaken by the directors or counsel would depend on the particular facts and circumstances of each situation, the review need only be sufficient to form the basis of a reasonable, but not necessarily conclusive, belief.

The staff believes, however, that the directors and counsel should give certain information significant weight when making a reasonable belief determination. For example, the staff believes that the directors and counsel would be precluded, in most cases, from making a reasonable belief determination once a court or other body before which the relevant proceeding was brought found that a director had engaged in disabling conduct, notwithstanding the possibility that the director might prevail on appeal.[65] When directors and counsel cannot make a reasonable belief determination, the staff believes that section 17(h) would prohibit the fund from advancing legal fees to the director unless the fund obtained assurances that the advance will be repaid if the director ultimately is found to have engaged in disabling conduct. Conversely, the dismissal of a court action or an administrative proceeding against a director for insufficiency of evidence of any disabling conduct would likely provide the basis for a reasonable belief that the director had not engaged in such conduct.[66]

4, 1980) (''Release 11330'') [20 SEC Docket 1342]. As noted in Release 11330, improper advances or payments for settlements or judgments could form the basis of an action under sections 36(a) and 37 of the Act. *See supra* note 54.

[60] Before Release 11330 was issued, the staff has taken the position that a fund could not advance legal fees unless it had obtained insurance or received sufficient collateral. It response to complaints that this requirement was unduly burdensome and expensive, the staff revised its position to permit a fund also to advance legal fees on the basis of a reasonable belief that the director had not engaged in disabling conduct and ultimately would be entitled to indemnification. *See id.*

[61] The opinion must set forth the facts and legal analysis that formed the basis for counsel's conclusion. *See* Steadman Security Corp., SEC No-Action Letter (Apr. 18, 1983) (concluding, among other things, that neither the board's resolutions, nor the legal opinion submitted to the board, contained any facts or legal analysis supporting indemnification). Similarly, any finding made by the disinterested, non-party directors should be memorialized in a written document that also contains the information upon which the directors relied to reach their decision. *Id.*

[62] The staff also believes that non-party independent directors or independent legal counsel must make a reasonable belief determination prior to each advance of legal fees to fund directors. *See infra* note 65. Such a determination should include the consideration of any new information that is readily available.

[63] For example, affiliated persons of the fund's investment adviser cannot serve as a independent directors. *See* Section 2(a)(19) [15 U.S.C. 080a–2(a)(19)].

[64] The Yacktman Funds, Inc., SEC No-Action Letter (Dec. 18, 1998).

[65] The staff also has previously stated that directors should consider whether advances of legal expenses may involve a breach of fiduciary duty involving personal misconduct under section 36(a) of the Act or misuse of fund assets in violation of section 37 of the Act. Sections 36(a) and 37 [15 U.S.C. §§ 80a–35(a), 80a–36]. *Id.* and *supra* note 54. When authorizing the fund to make an advance of legal expenses, fund directors should consider whether the amount of the advance is reasonable at that point in the litigation. For example, it generally may be inappropriate for the fund directors to authorize the fund to advance—at the earliest stages of litigation when little information regarding the dispute may be readily available—an amount that would cover the expenses of an entire trial. If a director-defendant requests additional advances from the fund, and a reasonable belief determination no longer can be made, the fund's board should decline to authorize the advance, unless the fund obtained assurances that the advance will be repaid if the director ultimately is found to have engaged in disabling conduct.

[66] *See* Release 11330, *supra* note 59.

D. Compensating Fund Directors With Fund Shares

The Commission staff believes that effective fund governance can be enhanced when funds align the interests of their directors with the interests of their shareholders. Fund directors who own shares in the funds that they oversee have a clear economic incentive to protect the interests of fund shareholders. In addition, as fund shareholders, these directors are in a better position to evaluate the services that the funds provide to their shareholders.

Certain funds have instituted policies that encourage or require their independent directors to invest the compensation that they receive from the funds in shares of the funds.[67] The Commission staff believes that the implementation of such policies gives the independent directors a direct and tangible stake in the financial performance of the funds that they oversee, and can help more closely align the interests of independent directors and fund shareholders. Recently, an advisory group organized by the Investment Company Institute recommended this practice.[68]

The staff believes that some fund groups have not instituted these policies because of concerns that they may be prohibited by section 22(g) of the Investment Company Act.[69] The staff believes that such concerns may be misplaced, and would like to clarify the circumstances in which open-end funds may (1) encourage or require fund directors to purchase fund shares with the compensation that they receive from a fund and (2) compensate directors directly with fund shares, consistent with section 22(g).

Prior to the enactment of section 22(g) in 1940, some open-end funds issued their shares to fund insiders for providing management, promotion, distribution and other services to the funds.[70] In some instances, this practice apparently resulted in the dilution of shareholder interests. For example, some funds agreed to pay insiders a definite number of shares of the fund at a future date for their services (rather than assign a fixed dollar value to the services). If the value of the fund's shares appreciated by the time that the shares were payable by the fund, the compensation paid to the insiders exceeded the value of the services provided. As a result, the fund treated the insiders on a basis more favorable than other shareholders by allowing them to acquire fund shares at less than the net asset value of the shares. The insiders received a ''windfall'' that diluted the value of the shares of other shareholders.

Consequently, Congress enacted section 22(g) to prohibit open-end funds from issuing shares to any person or entity that performs services for the fund. Section 22(g) generally provides that no open-end fund shall issue any of its securities (1) for services or (2) for property other than cash or securities.[71] Both the Commission and the representatives of investment companies agreed in 1940 that ''[n]o security issued by an investment company shall be sold to insiders or to anyone other than an underwriter or dealer, except on the same terms as are offered to other investors.'' [72]

As previously mentioned, some open-end funds have instituted policies that encourage or require their independent directors to invest their compensation in the shares of the funds that they oversee. Under these policies, a fixed dollar value is assigned to the services provided by the directors prior to the time that the directors perform any services or purchase the funds' shares. The directors' fees, therefore, cannot be inflated by allowing directors to receive fund shares with an aggregate net asset value that exceeds the dollar value that was previously assigned to the directors' services. The staff believes that, under these circumstances, funds may institute policies that encourage or require their directors to purchase fund shares with the compensation that the directors receive from the funds, consistent with section 22(g).[73]

In addition, the staff would not recommend enforcement action to the Commission under section 22(g) if funds directly compensate their directors with fund shares, rather than compensating the directors in cash and requiring them subsequently to purchase fund shares, provided that a fixed dollar value is assigned to the directors' services prior to the time that the compensation is payable.[74] The staff similarly believes that this method of compensation, which is functionally equivalent to paying the directors in cash, does not present the dangers of dilution and the overvaluation of services that section 22(g) was designed to prevent.

In implementing these policies, funds should ensure that their directors purchase their shares from the funds on the same basis as other shareholders, and not on preferential terms.[75] Funds also should disclose the directors' compensation structure and the dollar amount or value of their compensation to current and prospective fund shareholders in registration statements, shareholder reports and proxy statements, as required by the federal securities laws.

III. The Role of the Commission in Disputes Between Independent Fund Directors and Fund Management

Over the past few years, the Commission has been criticized for not taking certain actions in connection with disputes between independent fund directors and fund management.[76] Specifically, some persons have suggested that the Commission should have taken action against certain investment advisers based on allegations made by funds' independent directors that the advisers had violated the federal securities laws. We believe that these suggestions may reflect confusion regarding the significance that should be attached to the Commission's public silence, or

[67] Some funds have implemented deferred compensation plans for directors allowing directors to defer receipt of director fees to obtain tax and other benefits. Under these plans, directors can be credited with amounts tied to the performance of the funds. *See* Deferred Compensation Plans for Investment Company Directors, *supra* note 52.

[68] *See* ICI Advisory Group Report, *supra* note 27, at 17.

[69] *Id.* at n.31.

[70] *See House Hearings, supra* note 4, at 124.

[71] Section 22(g) [15 U.S.C. §§ 80a–22(g)].

[72] *See House Hearings, supra* note 4, at 99 (memorandum of agreement in principle between the Commission and representatives of open-end and closed-end investment companies dated May 13, 1940).

[73] Closed-end funds also may wish to institute policies that encourage or require their directors to use the compensation that they receive from the funds to purchase fund shares in the secondary market on the same basis as other fund shareholders. The staff believes that these policies would be consistent with section 23(a) of the Investment Company Act. Section 23(a) [15 U.S.C. § 80a–23(a)]. Like section 22(g), section 23(a) prohibits a closed-end fund from issuing any of its securities (1) for services or (2) for property other than cash or securities.

[74] Similarly, the staff would not recommend enforcement action to the Commission under section 23(a) if closed-end funds directly compensate their directors with fund shares, provided that the directors' services are assigned a fixed dollar value prior to the time that the compensation is payable. Closed-end funds, however, are generally prohibited by section 23(b) of the Investment Company Act from selling their shares at a price below their current net asset value. Section 23(b) [15 U.S.C. § 80a–23(b)]. As a result, any closed-end fund that compensates its directors by issuing fund shares would generally be required to issue those shares at net asset value, even if the shares are trading at a discount to their net asset value.

[75] A fund may sell its shares to its directors at prices that reflect scheduled variations in, or the elimination of, any sales load pursuant to rule 22d–1 under the Act [17 CFR 270.22d–1].

[76] *See, e.g.,* Charles Jaffe, An oversight on oversight; SEC wants directors to stand by shareholders, but won't help them, Boston Globe, Feb. 28, 1999, at D6; and Edward Wyatt, SEC Explores Directors' Roles, N.Y. Times, Jan. 31, 1999, at S3.

determination not to institute an enforcement action, in the face of allegations of violations of the federal securities laws. Indeed, as discussed below, no one should presume that the Commission has not carefully considered such allegations or that the Commission has failed to take appropriate action merely because the Commission has not instituted an enforcement action or taken other public actions.

Two principles are important to understanding the Commission's response to disputes between independent fund directors and fund management. First, the Commission's staff may conduct an examination or investigation, but the public generally will be unaware of such action. As a matter of policy, the Commission and its staff generally will not comment on the existence or non-existence of a particular examination or investigation, or disclose publicly any actions taken in connection with an examination or investigation, unless the Commission institutes an enforcement action.[77] This policy is necessary to protect both the integrity of an examination or investigation against premature disclosure, and the personal privacy of individuals against whom others may make unfounded charges. Second, the Commission and its staff may decide that enforcement action is not warranted based on all available information, including information to which commentators and others are not privy, even though publicly available information may suggest that a federal securities law violation has occurred. Thus, a decision by the Commission not to institute an enforcement action may be based on nonpublic, exculpatory information, and the Commission's policies preclude it from disclosing this information or explaining its decision to the public. It therefore is wrong to presume, merely because the Commission has not made any public statement or taken any public action in connection with an internal fund dispute, that the Commission has not investigated any allegations made by the parties or failed to take appropriate action in view of all available facts.[78]

We also believe that it would be helpful to clarify the Commission's role and procedures in connection with disputes between independent fund directors and fund management. The Commission's role, as a general matter, is to interpret, administer and enforce the federal securities laws for the protection of investors. Accordingly, the Commission's role in connection with internal fund disputes generally is to provide guidance regarding the requirements of the federal securities laws, investigate possible violations of these laws, and institute enforcement actions in appropriate circumstances when the Commission believes that these laws have been violated. While there may be instances in which the Commission, in fulfilling this role, may indirectly assist one party in a dispute, the Commission generally will not mediate private disputes, side with one party over another, or seek to effect a particular outcome. Rather, the Commission will assist the parties to understand the requirements of the federal securities laws, evaluate all allegations of violations of those laws, and take appropriate action for the protection of investors.

As a general matter, the procedures followed by the Commission and the staff in connection with internal fund disputes are similar to the procedures that it follows in connection with any private dispute that involves the application of, and compliance with, the federal securities laws. As a matter of practice, the Commission affords substantial consideration to all such allegations of violations and promptly assigns staff to carefully evaluate them. During this initial, informal evaluation, the staff typically will review public documents, such as registration statements and other Commission filings, and may invoke the Commission's examination authority to review fund records, including board minutes, or the records of the fund's investment adviser.[79] The staff also may ask interested parties, including independent and interested directors, fund officers, and investment advisory personnel, to cooperate voluntarily by agreeing to provide additional information and documents to the staff. If more information is needed, the staff may conduct an investigation and, if necessary, the Commission may issue a formal order of investigation. Under a formal order, the Commission authorizes the staff to conduct an investigation, pursuant to which the staff may subpoena witnesses and compel the production of documents.[80] This information gathering is critical to the Commission's determination of the appropriate course of action, for it often uncovers exculpatory or inculpatory nonpublic information that bears upon the validity of the allegations.

The Commission may take more serious steps if the public interest so requires. For example, if the Commission finds evidence of serious violations of the federal securities laws, it may institute administrative proceedings or initiate an action in federal district court.[81] In some circumstances, the staff may refer the matter to the Department of Justice to consider whether criminal charges are warranted.

The Commission's role in disputes between independent fund directors and fund management will not necessarily involve an examination or investigation. If, for example, the parties disagree as to the correct interpretation of some provision of the federal securities laws and regulations, or the parties need further clarification of particular legal issues, the staff may provide its interpretation of the provision or its views regarding the issue in question, either in writing or orally. The Commission also may file a friend-of-the-court brief in ongoing litigation, or otherwise seek to intervene in private litigation when it believes that its views on certain matters may be

[77] The Commission's rules require that both informal and formal investigations be non-public. 17 CFR 202.5 and 203.5. Section 210(b) of the Investment Advisers Act of 1940 (''Advisers Act'') [15 U.S.C. § 80b–10(b)] generally prohibits the Commission and its staff from disclosing the existence of, and information obtained as a result of, an examination of an investment adviser under the Act. Further, records or information that are obtained in the course of an investigation or examination generally are exempt from disclosure under the Freedom of Information Act. Exemptions 7 and 8 of the Freedom of Information Act [5 U.S.C. §§ 552(b)(7), (8)].

[78] *See* Roundtable Transcript of Feb. 23, 1999, at 25 (statement of Arthur Levitt, Chairman, SEC) (the Commission ''will aggressively and vigorously pursue reports by directors of violations of federal law and not sit idly by''); Roundtable Transcript of Feb. 24, 1999, at 207–208 (statement of Paul Roye, Director, Division of Investment Management, SEC) (allegations of violations of federal securities laws will be resolutely pursued).

[79] *See* Section 31(b) of the Act [15 U.S.C. § 80a–30(b); Section of the Advisers Act [15 U.S.C. § 80b04].

[80] *See* Section 42(b) of the Act [15 U.S.C. § 80a–41(b)]; Section 209(b) of the Advisers Act [15 U.S.C. § 80b–9(b)].

[81] Section 36(a) of the Act [15 U.S.C. (80a–35(a)] authorizes the Commission to institute an action in federal district court against certain individuals for breaches of fiduciary duties involving personal misconduct regarding a registered investment company. Section 36(b) [15 U.S.C. (80a–35(b)] authorizes the Commission to institute an action in federal district court against an investment adviser for breach of fiduciary duty in connection with its receipt of compensation from a registered investment company. The Commission also may institute other actions in federal district court pursuant to Section 42(d) of the Act [15 U.S.C. (80a–41(d)] and Section 209(d) of the Advisers Act [15 U.S.C. (80b–9(d)]. Administrative proceedings may be instituted under Section 9 of the Act [15 U.S.C. (80a–9] and Section 203 of the Advisers Act [15 U.S.C. (80b–3].

helpful to the court or necessary for the protection of investors.[82]

As described above, the Commission and the staff are committed to carefully reviewing all allegations of violations of the federal securities laws, and taking appropriate action when a violation has occurred. The Commission's and the staff's actions, and any decisions not to act, will be based on all facts that are available to us, and will not necessarily be explained to the public. These positions are necessary to ensure the fairness and integrity of the examination and investigative process. The Commission and the staff also are dedicated to enhancing the fairness and integrity of the fund governance process, and will consider instituting enforcement proceedings or taking other public positions if they will further this goal.

[82] *See, e.g.,* discussion of Letter from Jacob H. Stillman and Douglas Scheidt to Richard Teigen, Esq., *et. al,* October 16, 1998, supra note 51 and accompanying text; and discussion of The Yacktman Funds, Inc., SEC No-Action Letter (Dec. 18, 1998), *supra* note 64 and accompanying text. *See also* Section 44 of the Act [15 U.S.C. § 80a–43] (authorizing the Commission to intervene in private litigation brought under Section 36(b) of the Act) [15 U.S.C. § 80a–35(b)]). *See also* statements of Commission Chairman Arthur Levitt: regarding the need for the fund industry to assume an active role in establishing and promoting best fund governance practices, *supra* note 27, and expressing concerns about standard ''insured versus insured'' exclusions in joint insurance policies. *See* Companion Release, *supra* note 2, n.111; and *supra* note 56.

List of Subjects in 17 CFR Part 271

Investment companies.

Amendment of the Code of Federal Regulations

For the reasons set out in the preamble, title 17 chapter II of the Code of Federal Regulations is amended as set forth below:

PART 271—INTERPRETATIVE RELEASES RELATING TO THE INVESTMENT COMPANY ACT OF 1940 AND GENERAL RULES AND REGULATIONS THEREUNDER

1. Part 271 is amended by adding Release No. IC–24083 and the release date of October 14, 1999, to the list of interpretive releases.

Dated: October 14, 1999.

By the Commission.

Jonathan G. Katz,

Secretary.

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