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Enhanced Governance and Risk Oversight Disclosure for Investment Companies

by Michael V. Wible

On December 16, 2009, the Securities and Exchange Commission (SEC) adopted final rule and form amendments requiring new or expanded disclosure in proxy and registration statements.[1] By enhancing corporate governance information in proxy statements, registration statements and other reports filed with the SEC, the amendments are designed to help investors evaluate the leadership of public companies and make informed voting and investment decisions. The disclosure enhancements, which were effective February 28, 2010, are part of the SEC's effort to respond to increased investor focus on corporate governance and accountability.[2] The SEC received over 130 letters from commenters, which generally were supportive of the proposed disclosure requirements.

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The amendments apply to operating companies, as well as investment companies (funds) registered under the Investment Company Act of 1940 (the 1940 Act).[3] The amendments require funds to expand

disclosure regarding director and nominee qualifications; past directorships held by directors and nominees; and legal proceedings involving fund directors, nominees and executive officers; and for the first time to provide new disclosure regarding a fund's leadership structure, the consideration of diversity in the process for nominating individuals to serve on the board of directors and the board's role in risk oversight. The amendments also require operating companies to provide disclosure regarding a company's compensation policies, stock and option awards and the use of compensation consultants. These additional disclosure requirements are not applicable to funds, but are applicable to publicly traded investment advisers that manage funds.

The amendments affect disclosure in a fund's proxy statements and registration statements, including the Statement of Additional Information (SAI). To comply with the new disclosure requirements, fund boards will need to ensure that the qualifications and skills of each nominee to the board are fully vetted and memorialized during the nomination process. Fund boards also will need to revamp their data collection and disclosure processes to ensure that adequate information is received from nominees and incumbent directors to satisfy the disclosure requirements.

Experience, Qualifications, Attributes or Skills of Directors and Nominees

Under the amended proxy rules, funds are required to disclose the particular experiences, qualifications, attributes and skills of each director and any nominee for director considered by the board in concluding that the individual should serve as a director.[4] Similar disclosure is required in the SAIs of funds filing registration statements on Forms N-1A, N-2 and N-3.[5] If an individual is nominated for election as a director by a proponent other than the board of directors, the proxy solicitation materials prepared by that proponent also must include the required disclosure. If material, this disclosure should cover more than the past five years. Disclosure is required for all incumbent directors, including those not up for reelection, because the SEC felt that the composition of the entire board, including the experiences, qualifications, attributes and skills of each incumbent director, is important information that investors should have when voting for fund directors. In addition, the discussion must be current as of the time the disclosure is made. This means that the disclosure must discuss the *current* qualifications, skills and attributes of incumbent directors, not the qualifications, skills and attributes considered when they were initially elected to the Board.

The amendments give funds the flexibility to determine what experiences, qualifications, attributes and skills are most beneficial to the fund and its shareholders and do not specify the information that must be disclosed.[6] However, in adopting the amended rule and form amendments, the SEC stated that if an individual's particular skill or expertise led the board or proponent to conclude that the individual should serve as a director, that fact should be disclosed. It is unclear, however, whether disclosure of particular attributes or qualifications could imply that a director is assuming additional responsibilities or duties, thus exposing him or her to heightened liability for a compliance failure in the area of his or her expertise. For instance, if an individual is nominated based on his or her prior trading desk experience, would the SEC or shareholders hold that director to a higher standard if the fund experiences compliance failures related to fair valuation or use of fund brokerage commissions? Because of these concerns, funds should carefully consider the basis for their nominating decisions and scrutinize the meeting minutes and disclosure in proxy statements and other filings reflecting those deliberations.

The proposed rule had required that funds disclose the particular experience, qualifications, attributes and skills that "qualified" the individual to serve as a director. In response to comments, the final rules do not require a discussion of why a director "qualifies" to serve on the board. However, the SEC did note that it was retaining the requirements in Item 407(c)(2)(v) of Regulation S-K requiring disclosure of the specific minimum qualifications and specific qualities or skills used by a nominating committee.[7]

Prior Directorships

Under the amended proxy rules, each director and nominee must disclose any directorships at public companies and funds held by the director or nominee at any time during the past five years, even if the director or nominee is no longer serving on that board.[8] Similar disclosure is required in the SAIs of funds filing registration statements on Forms N-1A, N-2 and N-3.[9] Prior to the amendments, the proxy rules and the registration forms required the disclosure only of current director positions held by each director and nominee. The SEC believes that this expanded disclosure will allow investors to better evaluate the relevance of a director's or nominee's board experience, as well as past professional or financial relationships that might pose potential conflicts of interest. In the adopting release, the SEC cites past memberships on boards of major suppliers, customers or competitors as potential conflicts.

Legal Proceedings

The amended proxy rules expand the list of legal proceedings involving directors, executive officers and nominees that are covered by Item 401(f) of Regulation S-K.[10] The additional legal proceedings include any sanction or order, not subsequently reversed, suspended or vacated, of any self-regulatory organization or any equivalent exchange, association, entity or organization that has disciplinary authority over its members or persons associated with a member. In addition, a fund is required to disclose any federal or state judicial or administrative order, judgment, decree or finding, not subsequently reversed, suspended or vacated, relating to an alleged violation of:

- Any law or regulation prohibiting mail or wire fraud or fraud in connection with any business entity;
- Any federal or state securities or commodities law and regulation, or any settlement of such actions; or
- Any law or regulation respecting financial institutions or insurance companies including, but not limited to, a temporary or permanent injunction, order of disgorgement or restitution, civil money penalty or temporary or permanent cease-and-desist order, or removal or prohibition order.

Proceedings that are not material to "an evaluation of the ability or integrity" of a nominee, director or executive officer can continue to be omitted.[11]

In adopting the amendments, the SEC agreed with those commenters that asserted that certain legal proceedings can reflect on an individual's competence and integrity to serve as a director and provides investors with valuable information for assessing the competence, character and overall suitability of a director, nominee or executive officer. The settlement of a civil proceeding among private parties, however, does not need to be disclosed.[12]

The amended proxy rules also lengthen from five years to 10 years the time period for which disclosure of legal proceedings involving directors, director nominees and executive officers is required.[13] The SEC believes that the expanded time period gives more extensive information regarding an individual's competence and character. The 10-year period is calculated from the date on which the final order, judgment or decree was entered, or the date on which any rights of appeal from preliminary orders, judgments or decrees have lapsed.[14]

Corresponding changes have not been made to the disclosure requirements in Forms N-1A, N-2 and N-3.

Consideration of Diversity by the Nominating Committee

When proposing the amended rules, the SEC requested comment on whether it should revise the proxy rules to require disclosure of additional factors considered by a nominating committee when selecting an individual for a board position, such as diversity among board members. A significant number of commenters responded affirmatively, with many stating that disclosure about board diversity is important information that would enable investors to make informed voting and investment decisions. The SEC also reported that commenters felt that there was "a meaningful relationship between

diverse boards and improved corporate financial performance, and diverse boards can help companies more effectively recruit talent and retain staff." Consequently, amended Item 407(c) of Regulation S-K requires disclosure of whether, and if so how, a nominating committee considers diversity in identifying director nominees.[15] If a fund's nominating committee or the board has adopted a policy with regard to the consideration of diversity in identifying director nominees, the fund must disclose how this policy is implemented, as well as how the nominating committee or the board assesses the effectiveness of the diversity policy.

The amendments do not define diversity. Rather, funds are allowed to define diversity in any way that they consider appropriate. This flexibility is recognition that funds may view diversity in a variety of ways. Some funds may define diversity based on race, gender and national origin, while others may take a more expansive view and include differences in social or cultural background, education, and personal or professional experience. If a fund discloses that diversity is a consideration in the nomination process, it should adopt a written policy defining diversity and develop procedures for implementing and testing the effectiveness of that policy.

Disclosure regarding a fund's board diversity policy, if any, is not required by Forms N-1A, N-2 and N-3.

Board Leadership Structure

The amended proxy rules require that a fund describe its leadership structure and discuss why it believes its structure is the most appropriate for the fund.[16] The disclosure should address whether the chairman of the board is an "interested person" of the fund as defined in Section 2(a)(19) of the 1940 Act. If the chairman is an interested person, the fund must disclose whether it has a lead independent director and what specific role the lead independent director plays in the leadership of the fund. The disclosure should give the reasons why the fund has determined that its leadership structure is appropriate given its specific characteristics or circumstances. Similar disclosure is required in the SAIs of funds filing registration statements on Forms N-1A, N-2 and N-3, with the additional requirement that a fund describe the responsibilities of the board of directors with respect to the fund's management.[17]

The amendments are intended to provide investors with more transparency about the fund's corporate governance, but are not intended to influence a company's decision regarding its board leadership structure. Interestingly, in adopting the amendments, the SEC appears to be abandoning its effort to require that open-end funds relying on certain exemptions under the 1940 Act have an independent chairman. In fact, the SEC seems to concede that funds can be well served by an interested chairman, stating in the adopting release that "different leadership structures may be suitable for different companies depending on factors such as size of the company, the nature of the company's business, or internal control considerations, among other things."

Role of the Board in Risk Oversight

Under the amended proxy rules, a fund is required to disclose the extent of the board's role in the oversight of fund risk, such as how the board administers its oversight function and the effect that this has on the board's leadership structure.[18] Similar disclosure is required in the SAIs of funds filing registration statements on Forms N-1A, N-2 and N-3.[19] The SEC was convinced by commenters that risk oversight is a key competence of the board, and that additional disclosure would improve investor and shareholder understanding of the role of the board in the organization's risk management practices. As with disclosure about the leadership structure of the board, the SEC believes that disclosure of the board's involvement in the oversight of the risk management process will provide important information to investors about how a fund perceives the role of its board and the relationship between the board and the fund's adviser in managing the material risks facing the fund.

The rule amendments give funds the flexibility to describe how the board administers its risk oversight function. For example, the entire board may participate in overseeing risk management or the responsibility may be delegated to a separate risk committee or the audit

committee. Funds may, if relevant, address whether individuals who supervise the day-to-day risk management responsibilities, such as the fund's chief compliance officer, report directly to the board as a whole or to a board committee and in what form and how often the board or committee receives information from the chief compliance officer or other person with risk management responsibilities.

The amendments are a continuation of the SEC's focus on fostering the appropriate "tone at the top," much as it has done with fund compliance programs. However, while appropriate for the board to assume an oversight role, it is important that the disclosure clearly emphasize the primary risk management role of the fund's adviser and, if appropriate, the chief compliance officer. The fund's disclosure should highlight that the board's role is one of oversight and not day-to-day risk management. To do otherwise could expose the board to additional liability.

Compliance Dates

The amendments to Schedule 14A and Forms N-1A, N-2 and N-3 were effective February 28, 2010, with no stated transition or implementation period. To address questions about the transition under the rule and form amendments, especially with respect to post-effective amendment and preliminary proxy statements, the Division of Investment Management issued the following guidance:[20]

- If an existing fund's fiscal year ends on or after December 20, 2009, any proxy statement must comply with the amendments if filed on or after February 28, 2010. If a fund is required to file a preliminary proxy statement and expects to file a definitive proxy statement on or after February 28, 2010, then the preliminary proxy statement must comply with the new proxy disclosure requirements, even if filed before February 28, 2010.
- If an existing fund's fiscal year ends on or after December 20, 2009, any registration statement or post-effective amendment to an existing registration statement must comply with the amendments if filed on or after February 28, 2010.
- An existing fund may file a post-effective amendment, complying with the new disclosure requirements, pursuant to rule 485(b), provided that any other changes to the post-effective amendment meet the conditions for immediate effectiveness under the rule.
- If a fund's fiscal year ends before December 20, 2009, the fund's registration statements and post-effective amendments will not be required to comply with the new disclosure requirements unless they are filed after the end of the fund's 2010 fiscal year, even if filed on or after February 28, 2010.
- If an existing fund has multiple series, and the fiscal year of any series ends on or after December 20, 2009, any post-effective amendment to the fund's existing registration statement must comply with the form amendments if the amendment is filed on or after February 28, 2010, and the amendment is filed to make changes that affect a series with a fiscal year that ends on or after December 20, 2009.
- If a new fund files a registration statement on or after December 20, 2009, compliance with the amendments is required for the registration statement to be declared effective on or after February 28, 2010.
- If an existing fund adds a new series by filing a post-effective amendment on or after December 20, 2009, compliance with the amendments would be required for the registration statement to be declared effective or become effective automatically on or after February 28, 2010.
- A fund may voluntarily provide some or all of the new disclosures prior to the time it is required to comply.

Conclusion

Fund boards will need to ensure that the qualifications and skills of each nominee to the board are fully vetted and memorialized during the nomination process, to comply with the amended proxy statement rules and registration statement form requirements. Director and

officer questionnaires also should be revised to ensure that information satisfying the disclosure requirements is collected from nominees and incumbent directors. Finally, a board's re-examination of its fund governance policies and nomination procedures may be warranted to determine whether diversity should be a criteria for board service, and if so, how to develop and implement a meaningful diversity policy. A board's annual self-assessment is a good time to examine policies and procedures with an eye toward compliance with the amended rules and form requirements.[21]

Notes

1. *Proxy Disclosure Enhancements*, SEC Rel. Nos. 33-9089; 34-61175; and IC-29092 (Dec. 16, 2009).

2. *Id.*

3. Registered investment companies include open-end management investment companies registered on Form N-1A, closed-end management investment companies registered on Form N-2 and separate accounts offering variable annuity contracts, which are registered on Form N-3.

4. Item 401(e)(1) of Regulation S-K and Item 22(b)(3)(i) of Schedule 14A.

5. Item 17(b)(10) of Form N-1A, Section 17 of Item 18 of Form N-2 and Item 20(o) of Form N-3.

6. The amended rules delete references to "risk assessment skills" that were included in the proposed amendments.

7. Item 22(b)(15)(2)(a) of Schedule 14A requires disclosure regarding a fund's nominating process in proxy statements relating to the election of directors.

8. Item 22(b)(4(ii) of Schedule 14A.

9. Item 17(b)(3)(ii) of Form N-1A, Section 6(b) of Item 18 of Form N-2 and Item 20(e)(ii) of Form N-3.

10. Item 401(f)(7) and (8) of Regulation S-K and Item 22(b)(11) of Schedule 14A.

11. Item 401(f) of Regulation S-K.

12. Instruction 5 to Item 401(f) of Regulation S-K.

13. Item 401(f) of Regulation S-K and Item 22(b)(11) of Schedule 14A.

14. *See* Instruction 1 to Rule 401(f).

15. Investment companies are subject to the diversity disclosure requirement in Item 407(c)(2)(vi) of Regulation S-K under Item 22(b)(15)(ii)(A) of Schedule 14A.

16. Item 407(h) of Regulation S-K and Item 22(b)(11) of Schedule 14A.

17. Item 17(b)(1) of Form N-1A, Section 5(b) of Item 18 of Form N-2 and Item 20(d)(i) of Form N-3.

18. As originally proposed, funds would have been required to disclose the board's role in the fund's "risk management" process. The final amendments were revised to require disclosure of the board's role in "risk oversight" in recognition of the board's responsibility to oversee management, which in turn is responsible for the day-to-day issues of risk management.

19. Item 17(b)(1) of Form N-1A, Section 5(b) of Item 18 of Form N-2 and Item 20(d)(i) of Form N-3.

20. *Frequently Asked Questions About Proxy Disclosure Enhancements Transition for Registered Investment Companies*, Division of Investment Management, US Securities and Exchange Commission (Dec. 23, 2009).

21. The board of directors of an open-end fund relying on certain exemptive rules is required to annually evaluate the performance of the board of directors and the committees of the board of directors. The evaluation must include a consideration of the effectiveness of the committee structure of the fund board.

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