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SEC Adopts New Disclosure Requirements on Board Leadership, Board Oversight of Risk Management and Qualification for Board Membership

On December 16, 2009, the SEC adopted amendments to the proxy rules for both registered investment companies and operating companies, and amendments to the registration forms for open- and closed-end investment companies, including separate accounts offering variable annuity contracts. (See SEC Release 33-9089, Dec. 16, 2009 (“Adopting Release”).) The new provisions require investment companies to provide new or expanded disclosure on the leadership structure of the board, the board’s oversight of risk management efforts, and qualifications for board membership. All amendments are effective February 28, 2010.

Proxy Statement Disclosure Changes

Item 22 of Schedule 14-A, the SEC’s proxy rules, contains special requirements for investment company proxy statements. Item 22(b), which governs information to be provided in connection with the election of directors, has been amended in several important respects.

Board Leadership Structure

Item 22(b)(11) has been amended to require disclosure of the information called for by new Item 407(h) of Regulation S-K. This item requires disclosure of the board’s leadership structure, including:

- whether the same person serves as both principal executive officer and board chair;
- whether the board chair is an “interested person” of the fund as defined in Section 2(a)(19) of the Investment Company Act of 1940;
- if one person serves in both roles, or if the board chair is an interested person, whether the registrant has a lead independent director and what specific role the lead independent director plays in the leadership of the board; and
- why the registrant has determined that its leadership structure is appropriate, given the specific characteristics or circumstances of the registrant.

The Adopting Release states that the amendments regarding disclosure of the board’s leadership structure “are intended to provide investors with more transparency about the company’s corporate governance, but are not intended to influence a company’s decision regarding its board leadership structure.” Participants in the fund industry will no doubt remember that the SEC in 2001 attempted to require all registered investment companies to have independent board chairs. A federal appeals court

suspended the effectiveness of that rule and sent it back to the SEC for further consideration of the potential benefits of such a requirement. Although the SEC did conduct some additional studies, the rule never reemerged.

The new governance disclosure requirements have now seemingly replaced efforts to adopt such a rule. Indeed, the Adopting Release, in discussing companies in general, notes that “different leadership structures may be suitable for different companies depending on factors such as the size of a company, the nature of a company’s business, or internal control considerations, among other things” – a statement seemingly inconsistent with any attempt to impose a single governance structure on all companies, even those within a single industry, such as investment companies.

Board Role in Risk Oversight

Amended Item 22(b)(11) also requires disclosure of the extent of the board’s role in overseeing risk management, such as how the board administers its oversight function, and the effect that this has on the board’s choice of leadership structure. The Adopting Release notes that the SEC changed its description of this requirement from the proposing release, which called for a discussion of the board’s role in the company’s “risk management.” The Commission cited comments on the proposal urging that the board’s role is not risk management, but “to oversee management, which is responsible for the day-to-day issues of risk management” and that risk oversight is a “key competence” of the board.

The Adopting Release notes that funds face a number of risks, including “investment risk, compliance and valuation.” The release states that the Commission’s new disclosure requirement should 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 material risks facing the fund. In discussing this requirement as it applies to registrants generally, the Adopting Release states that the requirement gives companies the flexibility to describe how the board administers its risk oversight function, such as through the whole board, or through a separate risk committee or the audit committee, for example. The release notes that companies may want to discuss how the board

interfaces with individuals who supervise the day-to-day risk management responsibilities.

Although the new provisions are flexible in their application, the SEC is clearly using disclosure requirements to assure that boards are giving appropriate attention to risk oversight. In responding to this item, it is important that registrants not over- or understate the board’s responsibilities with respect to oversight of risk management. Overstating the board’s role may subject directors to a standard of conduct higher than what the law would otherwise impose on them, while understating the board’s role could subject the board to criticism for not having taken a sufficiently strong stance on the matter.

Qualifications and Experience of Directors and Nominees

Item 22(b)(3) has been amended to require disclosure of the specific experience, qualifications, attributes, or skills that led to the conclusion that each director or nominee should serve as a director of the fund. This information is required for all directors, whether or not they are up for reelection (although, in accordance with the general instructions, information need not be provided with respect to directors who will not continue to serve after the election to which the proxy statement relates). Although certain disclosure requirements relate only to the last five years, disclosure under this item should cover more than the past five years, including “information about the person’s particular areas of expertise or other relevant qualifications, if material.” Proponents other than the registrant that put forward candidates for director must include this information in their proxy materials.

The Commission noted in the Adopting Release that it had determined not to eliminate the existing requirement in Item 407(c)(2)(v) to disclose the minimum qualifications and the specific qualities or skills used by the nominating committee in evaluating potential candidates. The Commission stated that it was retaining this provision “because it will allow investors to compare and evaluate the skills and qualifications of each director and nominee against the standards established by the board.”

The final amendments do not specify the particular information that should be disclosed in response to this item. However, the release notes that if particular skills were part of the specific qualifications that led the board or proponent to put forward the person as a director, this should be disclosed.

In responding to this requirement, registrants should bear in mind that individuals with expertise in relevant areas may be subject to heightened standards of liability under federal and state securities laws. When the Commission in 2003 adopted the requirement that registrants disclose whether their audit committees include at least one “audit committee financial expert,” it also provided relief from some forms of potential liability to which such “experts” might otherwise be subject. The new disclosure requirements provide no such relief, despite comments from several organizations having raised concerns about such liability. Accordingly, registrants may wish to be circumspect in their descriptions of director qualifications, while honoring the requirement that disclosure be complete in all material respects.

Prior Directorships

Item 22(b)(4) has been amended to require disclosure of any directorships held during the past five years by each director or nominee for election as director in any company with a class of securities registered under Section 12 of the Exchange Act or subject to the requirements of Section 15(d) of the Exchange Act, or any registered investment company (collectively, “Reporting Companies”). The Adopting Release states that this information will allow investors to better evaluate the relevance of a person’s past board experience, “as well as professional or financial relationships that might pose potential conflicts of interest”

Prior Legal and Disciplinary Actions

Item 22(b)(11) has also been amended to require disclosure of information called for by new items 401(f)(7) and (8) of Regulation S-K. These items require disclosure of whether any director, nominee or executive officer was the subject of, or a party to:

- any federal or state judicial or administrative order, judgment, decree or finding, not

subsequently reversed, suspended or vacated, relating to alleged violation of:

- any federal or state securities or commodities law or regulation,
- any law or regulation respecting financial institutions or insurance companies, or
- any law or regulation prohibiting mail or wire fraud or fraud in connection with any business entity; or
- any sanction or order, not subsequently reversed, suspended or vacated, of any self-regulatory organization or equivalent organization.

The language of this provision, which requires disclosure where a person is “the subject of or a party to” a proceeding “relating to” alleged violations of the named statutory or regulatory provisions, is potentially very broad. It seems intended to sweep in a wide array of judicial and administrative actions that might be missed by the existing provisions of Item 401(f), which are quite specific. The new requirement to disclose involvement in court or administrative proceedings does not include any settlement of a civil proceeding among private litigants. While this exclusion is helpful, it also may be taken as an indication of how broadly the SEC intends the provision to be read otherwise. As with the existing provisions of Item 401(f), registrants responding to the new requirements may omit disclosure of proceedings that are not “material to an evaluation of the ability or integrity” of any director, nominee or executive officer.

The requirement to disclose a director’s or nominee’s involvement in various legal proceedings covers proceedings occurring in the past ten years. This expanded time period applies to the entire list of proceedings included in Item 401(f) of Regulation S-K, and not just the newly listed types of proceedings described above. (The disclosure period for the existing items had previously been five years.) For purposes of computing the ten-year period, the date of a reportable event is the date on which the final order, judgment or decree was entered, or the date on which any rights of appeal have lapsed.

Role of Diversity in Considering Board Candidates

Item 22(b)(15) currently requires a description of the board's process for identifying and evaluating nominees for director. This provision has been amended to require disclosure of whether and, if so, in what way, the nominating committee or the board considers diversity in identifying nominees. If the committee or the board has a policy with regard to consideration of diversity, the registrant must describe how the policy is implemented, as well as how the committee or the board assesses the effectiveness of its policy.

In its Adopting Release, the Commission stated that some commenters responding to its proposal believed that requiring such disclosure would provide information on corporate culture and governance practices that would enable investors to make more informed voting and investment decisions. The release also noted comments to the effect that "there appears to be a meaningful relationship between diverse boards and improved corporate financial performance, and that diverse boards can help companies more effectively recruit talent and retain staff."

The SEC made a point in the new disclosure requirements of not defining the term "diversity." The Adopting Release notes that companies may define diversity in various ways, with some looking to differences of viewpoint, professional experience, education, skill and other individual qualities and attributes that contribute to board heterogeneity, while others may focus on diversity of race, gender and national origin. The Commission noted that, for purposes of this disclosure requirement, "companies should be allowed to define diversity in ways that they consider appropriate." Thus, although the Commission is not defining "diversity" in the new disclosure rules, it will apparently be looking for registrants' definitions of the term.

Registration Statement Disclosure Changes

Item 17 of Form N-1A requires open-end funds to disclose in the statement of additional information certain information concerning management of the fund. This item has been amended to require disclosure similar to that described above regarding:

- the leadership structure of the board;
- the extent of the board's role in risk oversight;
- directorships held by fund directors during the past five years in any Reporting Companies; and
- the specific experience, qualifications, attributes or skills that led to the conclusion that each board member should serve as a director of the fund.

Similar changes have been made to Item 18 of Form N-2 (the registration statement for closed-end funds) and Item 20 of Form N-3 (the registration statement for separate accounts offering variable annuity contracts).

Effective Date

According to the Adopting Release, all amendments are effective February 28, 2010, as the Commission wanted the changes in place for the 2010 proxy season. There is no indication of a later phase-in or compliance date for the registration form amendments. The Adopting Release also gave no indication of whether this effective date refers to the filing date or the effective date of the various documents. Because of the relatively short time before the effective date, registrants may wish to act promptly to supplement their D&O questionnaires to gather the necessary information.

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