

SEC STAFF EASES CERTAIN "IN-PERSON" BOARD APPROVAL REQUIREMENTS

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Investment Management Alert

By: Lori L. Schneider, Marguerite W. Laurent, Jin H. Ahn

On February 28, 2019, the staff of the Division of Investment Management of the U.S. Securities and Exchange Commission ("SEC") issued a no-action letter to the Independent Directors Council ("IDC") that provides boards of directors of registered investment companies and business development companies greater flexibility in complying with the "in-person" voting requirements under the Investment Company Act of 1940 ("1940 Act") for the approvals and renewals of investment advisory contracts, and distribution contracts, and Rule 12b-1 plans, and the approvals of the fund's independent public accountants.^[1] The IDC requested no-action relief to allow boards to make these required approvals at meetings held by telephone, video conference, or other similar methods instead of in person under two specific sets of circumstances (the "IDC Relief Request"): (1) when directors are unable to meet in- person due to unforeseen or emergency circumstances ("Relief #1"); or (2) the directors had previously met in person and discussed all material aspects of a proposal, but did not vote on the proposal at the in-person meeting ("Relief #2"). The no-action letter appears to be part of an ongoing initiative by the SEC and its staff that aims to review and reevaluate the responsibilities of fund directors.

In granting the relief, the SEC staff states that it will not recommend enforcement action to the SEC if a fund board does not adhere to the in-person voting requirements in certain circumstances, as described in the IDC Relief Request. We describe these circumstances below. Given the importance of ensuring thoroughly considered and timely approvals in these areas and the potential ramifications of not properly approving or renewing an advisory contract, funds and their managers and boards should carefully consider whether they fit within the situations described in the IDC Relief Request before making a determination to rely on the SEC's no-action relief. They should also be sure to record the basis for reliance on the no-action letter and may choose to do so in the board meeting minutes at which the action is taken.

In the case of Relief #1, the no-action relief applies where the directors needed for the required approvals cannot meet in person due to "unforeseen or emergency circumstances," provided that (i) no material changes to the relevant contract, plan, or arrangement are proposed to be approved, or are approved, at the meeting, and (ii) such directors ratify the applicable approval at the next in-person board meeting. The IDC Relief Request defines "unforeseen or emergency circumstances" to include "any circumstances that, as determined by the board, could not have been reasonably foreseen or prevented and that make it impossible or impracticable for directors to attend a meeting in-person," such as the following: "illness or death, including of family members, weather events or natural disasters, acts of terrorism and disruptions in travel that prevent some or all directors from attending the meeting in person." Such circumstances could include natural disasters or extreme weather events, such as a blizzard, that prevent all the directors on a fund board from being able to attend a meeting in person. The relief is less likely to be relied upon in unforeseen or emergency circumstances for an individual director, such as an

illness or death in the family, because the rest of the directors would likely be able to convene in person and constitute a quorum to make the required approvals.

The IDC Relief Request clarified that Relief #1 is limited to situations where a fund's board is renewing an existing contract, plan, or arrangement, and does not apply to the board's approval of a new contract, plan, or arrangement, or the approval of interim advisory contracts pursuant to Rule 15a-4(b)(2) under the 1940 Act.[2] Thus, an adviser trying to expedite the introduction of a new product to market between board meetings would not be able to rely on the no-action relief. The IDC Relief Request notes that Relief #1 would not apply in the case of a "change in control," of an investment adviser to a fund that results in the termination of the prior contract. Funds and their boards could seek individualized relief under those circumstances, as has been done in the past. The IDC Relief Request further clarified that if the required approval related to the selection of the fund's independent public accountant, such accountant must be the same accountant as selected in the immediately preceding fiscal year.

In the case of Relief #2, the no-action relief applies where the directors needed for the required approvals had fully discussed and considered all material aspects of the proposed matter previously at an in-person meeting, but did not vote on the matter at that time, provided that no director requested another in-person meeting. The IDC Relief Request clarified that this relief would be permitted both when a fund's board is approving a new contract, plan, or arrangement, including an interim advisory contract, and when renewing an existing contract, plan, or arrangement. It stated that these circumstances may arise, for example:

- if directors prefer to wait to vote until after a contingent event takes place (such as the vote of shareholders of the investment adviser or a parent company of the investment adviser with respect to a proposed change of control of the investment adviser or parent company);
- if a majority of the independent directors have selected the independent public accountant for certain funds in a fund complex and subsequently select the same independent public accountant at a later date for other funds in the same fund complex that have different fiscal years and a majority of the directors have concluded that no additional information is needed from the independent public accountant; or
- if directors wish to wait to vote on a matter until further requested information is provided or previously-provided information is confirmed, and they determine at the in-person meeting that the nature of the information to be provided or confirmed would not be likely to change the vote of any director needed for the required approval.

Although Relief #2 could apply to interim advisory contracts, it appears to fall short of covering them where there is an 'unexpected' "change in control" of an investment adviser to a fund that results in the termination of the prior contract before the board has met in person to consider it. The relief could apply to changes of control only if the board previously met in person and discussed all material aspects of the proposed interim advisory contract.

In granting the requested relief, the SEC staff emphasized that the 1940 Act requires each fund to be governed by a board with general oversight and specific responsibilities, and adds that the requested relief would not diminish a board's ability to carry out these responsibilities. The IDC Relief Request acknowledged the important purpose of the in-person voting requirements - helping to ensure fund directors are informed on voting matters - but states that emergency circumstances can "make it impossible or impracticable" for in-person attendance. The IDC Relief Request emphasizes that the no-action position would not undermine the intent behind the in-person voting

requirements, and states that the SEC staff has previously recognized the need for flexibility in past cases of emergency.^[3] The letter also explains that without the requested relief, if an investment advisory contract, engagement with an independent public accountant, or 12b-1 Plan were allowed to lapse because directors were unable to meet in person to approve its continuance, a fund would be required to obtain shareholder approval to reinstate the arrangement. The letter notes that “the costs, including the cost of a proxy solicitation, would greatly outweigh any benefits to shareholders, given that there would have been no substantive changes to the terms of the contract, plan, or arrangement on which shareholders would be asked to vote.”

As noted above, the no-action letter appears to be part of an ongoing initiative by the SEC and its staff that aims to review and reevaluate the responsibilities of fund directors. The SEC staff notes in its letter that, given “market, regulatory and technological developments,” it continues to review director responsibilities and consider whether they are appropriate and serve shareholders’ best interests. In the IDC Relief Request, the IDC reiterates that the current regulatory framework can be improved to help directors focus on areas where their oversight is most valuable, and that the no-action position would decrease the need for individual relief in future unforeseen or emergency circumstances. In granting the relief, the SEC staff acknowledged that the relief requested by the IDC would remove “significant or unnecessary burdens for funds and their boards.”

This no-action letter is the second recent no-action letter from the SEC staff providing greater flexibility in how fund directors fulfill certain responsibilities. The SEC staff also issued a no-action letter ^[4] to the IDC on October 12, 2018 making it easier for fund boards to oversee affiliated transactions executed in reliance on SEC exemptive rules, such as cross-trades between funds managed by the same investment adviser, by relying on quarterly written representation from the fund’s chief compliance officer that any transactions effected in reliance on the exemptive rule complied with board-approved procedures adopted pursuant to the rule.^[5] Both of these no-action letters follow letters from the IDC and from the Mutual Fund Directors Forum (“MFDF”) (together, the “2017 Letters”) sent in 2017 to SEC leadership highlighting the need to review fund directors’ responsibilities.^[6] Starting in 2017, Dalia Blass, Director of the Division of Investment Management, and the SEC staff have engaged in a “Board Outreach Initiative” to meet with fund boards and discuss possible regulatory changes that could improve the ability of fund boards to serve shareholders.^[7]

There is still progress to be made as some larger topics discussed in the 2017 Letters, and topics discussed in depth with boards during the Board Outreach Initiative, have yet to be formally addressed by the SEC or its staff, including, in particular, director responsibilities relating to fair valuation, distribution, and derivatives. In its 2017 letter, the IDC also addressed the need to eliminate those director responsibilities and approvals that have become “routine and ritualistic,” such as board responsibility to oversee foreign custody arrangements, to approve the form and amount of fidelity bonds, and to approve multiple-class plans.

Notes:

[1] *Independent Directors Council* (pub. avail. Feb. 28, 2019),

<https://www.sec.gov/divisions/investment/noaction/2019/independent-directors-council-022819>. Section 15(c) of the 1940 Act requires that the terms of an investment advisory contract or principal underwriting agreement, and any renewal thereof, be approved by the vote of a majority of the fund’s directors who are not parties to the contract or agreement, or “interested persons” (as defined in Section 2(a)(19) of the 1940 Act) of any such party. Section 12(b) of the 1940 Act prohibits an investment company from acting as a distributor of its own securities in contravention of any rule promulgated by the SEC. Rule 12b-1 under the 1940 Act requires that a plan regarding

distribution -related payments pursuant to that Rule (“12b-1 Plan”) be approved by a vote of the fund's board of directors, and of the directors who are not interested persons of the fund (“independent directors”) and have no direct or indirect financial interest in the operation of the 12b-1 Plan or in any agreements related to the 12b-1 Plan. Section 32(a) of the 1940 Act requires that independent public accountants be selected by a vote of a majority of the fund's independent directors. Rule 15a-4(b)(2) under the 1940 Act requires that certain interim contracts be approved by the vote of the fund's board of directors, including a majority of independent directors.

[2] Rule 15a-4(b)(2) applies to situations in which an advisory contract was terminated by assignment, which is defined to include a change in control of the adviser, and the adviser receives money or other benefit. Under this rule, an adviser may operate under an interim contract after the termination of the previous contract if, among other requirements, the board of directors, including a majority of the directors who are not interested persons of the fund, voted in person to approve the interim contract before the previous contract terminated.

[3] The IDC Relief Request gives examples of previous SEC exemptive and no-action relief from the in-person voting requirements following the September 11, 2001 terrorist attacks and the 2008 financial crisis. See Commission Notice: Order Under Sections 6(c), 17(d) and 38(a) of the Investment Company Act of 1940 Granting Exemptions from Certain Provisions of the Act and Certain Rules Thereunder, SEC Release No. IC-25156 (Sept. 14, 2001); Fortis Investment Management SA, SEC No-Action Letter (Jan. 27, 2009); JPMorgan Chase/Bear Stearns Asset Management I, SEC No-Action Letter (July 14, 2008).

[4] *Independent Directors Council* (pub. avail. Oct. 12, 2018),

<https://www.sec.gov/divisions/investment/noaction/2018/independent-directors-council-101218.htm>.

[5] For more information, see *Investment Management Alert: SEC Staff No-Action Letter Eases Board's Burden in Reviewing Affiliated Transactions*, by Lori L. Schneider, Fatima S. Sulaiman, Christopher R. Bellacicco (Nov. 1, 2018), <http://www.klgates.com/sec-staff-no-action-letter-eases-boards-burden-in-reviewing-affiliated-transactions-11-01-2018/>.

[6] Letter from Amy B.R. Lancellotta, Managing Director, IDC, to Dalia Blass, Director, Division of Investment Management, SEC, Modernizing Fund Directors' Responsibilities (Oct. 16, 2017),

<https://www.idc.org/pdf/30912a.pdf>. See also Letter from Susan Wyderko, President, MFDF, to Jay Clayton, Chairman, SEC (June 20, 2017),

<https://mfdf.org/images/uploads/newsroom/Clayton2017.pdf>.

[7] See Dalia Blass, Director, SEC Division of Investment Management, Keynote Address at the Investment Company Institute 2018 Mutual Funds and Investment Management Conference (Mar. 19, 2018),

<https://www.sec.gov/news/speech/speech-blass-2018-03-19>.

KEY CONTACTS



LORI L. SCHNEIDER
PARTNER

WASHINGTON DC
+1.202.778.9305
LORI.SCHNEIDER@KLGATES.COM



MARGUERITE W. LAURENT
PARTNER

WASHINGTON DC
+1.202.778.9403
MARGUERITE.LAURENT@KLGATES.COM

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