

## Independent Director Requirements for Registered Investment Companies

Independent director requirements are necessitated, in part, by the unique structure of investment companies (funds). Unlike a typical corporation, an investment company usually has no employees of its own. Its officers are typically employed and compensated by its investment adviser, which provides most of the services. Due to this unique structure, conflicts of interest can arise because the interests of the investment company do not always parallel the interests of the investment 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 investment company and its shareholders. Independent directors play a critical role in policing the potential conflicts of interest between the investment company and its investment adviser and affiliates.<sup>1</sup>

A registered investment company ("RIC") is required under Section 10 of the Investment Company Act of 1940 (the "Company Act") to have a board of directors with at least 40 percent of its members being independent, i.e., not "interested persons" as defined in Section 2(a)(19). A business development company ("BDC") is required under Section 56 to have a majority of its board made up of independent directors.<sup>2</sup> In addition, since July 2002, the SEC has required independent directors to make up a majority or super-majority (i.e., 75 percent or two-thirds if there are only three members)<sup>3</sup> of the boards of RICs that utilize any of the following ten exemptions:

- Rule 10f-3, under which an RIC can acquire securities in a primary offering when the underwriting syndicate includes a broker-dealer affiliated with the RIC;
- Rule 12b-1, under which a registered open-end management investment company can use its assets to pay the expenses of distributing the shares it issues;
- Rule 15a-4(b)(2), under which the board of an RIC can, without the approval of its shareholders, approve an interim contract with an investment adviser when a previous contract was terminated by an assignment by an investment adviser or a controlling person of the investment adviser who directly or indirectly receives money or other benefit;
- Rule 17a-7, under which securities transactions are allowed between an RIC and another client of the RIC's investment adviser;

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<sup>1</sup> Interpretive Matters Concerning Independent Directors of Investment Companies, Investment Company Act Release No. 24083, 64 Fed. Reg. 59877 (Nov. 3, 1999)

<sup>2</sup> A BDC is a special RIC designed to facilitate capital formation for small companies. BDCs are exempt from many of the regulatory constraints imposed by the Company Act and the rules promulgated thereunder. Section 2(a)(48) of the Company Act defines "business development company" to mean a domestic closed-end company (i.e., issues non-redeemable securities) that (i) operates for the purpose of making investments in certain securities specified in Section 55(a) of the Company Act, and with limited exceptions, makes available "significant managerial assistance" with respect to the issuers of such securities; and (ii) has elected BDC status.

<sup>3</sup> 17 C.F.R. §270.0-1(a)(7).

- Rule 17a-8, under which mergers are permitted between certain affiliated RICs;
- Rule 17d-1(d)(7), under which an RIC and its affiliates can purchase joint liability insurance policies;
- Rule 17e-1, under which an RIC may pay commissions to affiliated brokers in connection with the sale of securities on an exchange;
- Rule 17g-1(j), under which RICs can maintain joint-insured fidelity bonds;
- Rule 18f-3, under which an investment company can issue multiple classes of voting stock; and
- Rule 23c-3, under which a registered closed-end investment company (i.e., an RIC that does not issue redeemable securities) can offer to repurchase, at periodic intervals, shares it has issued to investors.

Additional safeguards against potential conflicts of interest are also provided for. Various activities require not only the approval of a majority of the entire board of directors of an RIC, but also require the approval of a majority of the independent directors (i.e., approval by the “majority of the majority”).<sup>4</sup> In addition to approving the ten exemptions mentioned above, a majority of independent directors must:

- approve contracts with the investment adviser and principal underwriter;<sup>5</sup>
- approve the compliance policies and procedures (for securities laws) of the company and its investment adviser, principal underwriter, administrator and transfer agent;<sup>6</sup>
- approve the codes of ethics of the company, the investment adviser and the principal underwriter;<sup>7</sup>
- approve the designation, compensation and removal of the chief compliance officer;<sup>8</sup>
- select the public accountant;<sup>9</sup>
- select and nominate individuals to fill independent director vacancies resulting from the assignment of an advisory contract;<sup>10</sup>
- approve and oversee transactions with affiliates;<sup>11</sup> and

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<sup>4</sup> The following scenario illustrates how such a “majority of the majority” requirement could provide an additional safeguard. Suppose a company has a five-member board of directors (three of which are independent directors and two of which are interested directors). Without a “majority of the majority” requirement, the two interested directors would need the approval of only one independent director to cause the company to act in matters requiring board approval. For activities requiring the approval of a “majority of the majority,” however, the interested directors would need the approval of at least two independent directors.

<sup>5</sup> Section 15(c)

<sup>6</sup> Rule 38a-1(a)(2)

<sup>7</sup> Rule 17j-1(c)(1)(ii)

<sup>8</sup> Rule 38a-1(a)(4)

<sup>9</sup> Section 32(a)

<sup>10</sup> Section 16(b)

<sup>11</sup> Section 57(f) and (o)

- set the form and amount of the fidelity bond and determine if participation in joint insurance contracts is in the best interest of the company.<sup>12</sup>

Rule 31a-2(a)(4) requires every RIC, including BDCs, to preserve for at least six years any record of the initial determination that a director is not an interested person of the investment company and each subsequent determination that the director is not an interested person of the investment company. These records must include any questionnaire and any other document used to make the determination. Similarly, Rule 31a-2(a)(5) requires the preservation for at least six years of any materials used by the disinterested directors to determine that a person who is acting as legal counsel to those directors is an “independent legal counsel” (as defined by Company Act rules and regulations).

Who is considered independent under the Company Act?

Section 2(a)(19) defines “interested person” and covers an extensive array of relationships:

“Interested person” of another person means -

(A) when used **with respect to an investment company** –

- (i) any **affiliated person**<sup>13</sup> of such company,
- (ii) any member of the **immediate family** of any natural person who is an affiliated person of such company,
- (iii) any interested person **of any investment adviser** or **principal underwriter** for such company,
- (iv) any person or partner or employee of any person who at any time since the beginning of the last two completed fiscal years of such company has acted as **legal counsel** for such company,
- (v) any person or any affiliated person of a person (other than a registered investment company) that, at any time during the 6-month period preceding the date of the determination

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<sup>12</sup> Rule 17g-1(d)-(e)

<sup>13</sup> Under Section 2(a)(3) "Affiliated person" of another person means (A) any person directly or indirectly owning, controlling, or holding with power to vote, 5 per centum or more of the outstanding voting securities of such other person; (B) any person 5 per centum or more of whose outstanding voting securities are directly or indirectly owned, controlled, or held with power to vote, by such other person; (C) any person directly or indirectly controlling, controlled by, or under common control with, such other person; (D) any officer, director, partner, copartner, or employee of such other person; (E) if such other person is an investment company, any investment adviser thereof or any member of an advisory board thereof; and (F) if such other person is an unincorporated investment company not having a board of directors, the depositor thereof.

of whether that person or affiliated person is an interested person, has **executed any portfolio transactions for**, engaged in any principal transactions with, or distributed shares for –

- (I) the investment company;
- (II) any other investment company having the same investment adviser as such investment company or holding itself out to investors as a related company for purposes of investment or investor services; or
- (III) any account over which the investment company's investment adviser has brokerage placement discretion,

(vi) any person or any affiliated person of a person (other than a registered investment company) that, at any time during the 6-month period preceding the date of the determination of whether that person or affiliated person is an interested person, **has loaned** money or other property to –

- (I) the investment company;
- (II) any other investment company having the same investment adviser as such investment company or holding itself out to investors as a related company for purposes of investment or investor services; or
- (III) any account for which the investment company's investment adviser has borrowing authority,

(vii) 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:

Provided, That no person shall be deemed to be an interested person of an investment company solely by reason of (aa) his being a member of its board of directors or advisory board or an owner of its securities, or (bb) his membership in the immediate family of any person specified in clause (aa) of this proviso; and

(B) when used **with respect to an investment adviser of or principal underwriter** for any investment company –

- (i) any **affiliated person** of such investment adviser or principal underwriter,

(ii) any member of the **immediate family** of any natural person who is an **affiliated**<sup>14</sup> person of such investment adviser or principal underwriter,

(iii) any person who **knowingly** has any direct or indirect **beneficial interest** in, or who is designated as trustee, executor, or guardian of any legal interest in, any security issued either by such investment adviser or principal underwriter or by a controlling person or such investment adviser or principal underwriter,

(iv) any person or partner or employee of any person who at any time since the beginning of the last two completed fiscal years of such investment company has acted as **legal counsel** for such investment adviser or principal underwriter,

(v) any person or any affiliated person of a person (other than a registered investment company) that, at any time during the 6-month period preceding the date of the determination of whether that person or affiliated person is an interested person, has **executed any portfolio transactions for**, engaged in any principal transactions with, or distributed shares for –

(I) any investment company for which the investment adviser or principal underwriter serves as such;

(II) any investment company holding itself out to investors, for purposes of investment or investor services, as a company related to any investment company for which the investment adviser or principal underwriter serves as such; or (III) any account over which the investment adviser has brokerage placement discretion,

(vi) any person or any affiliated person of a person (other than a registered investment company) that, at any time during the 6-month period preceding the date of the determination of whether that person or affiliated person is an interested person, has **loaned** money or other property to –

(I) any investment company for which the investment adviser or principal underwriter serves as such;

(II) any investment company holding itself out to investors, for purposes of investment or investor services, as a company related to any investment company for which the investment adviser or principal underwriter serves as such; or (III) any account for which the investment adviser has borrowing authority,(!1)

(vii) 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**

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<sup>14</sup> Note that the language says affiliated not “interested.” See Twentieth Century Investors, Inc., No-Action Letter, (Feb. 19, 1972) at 1972 SEC NOACT LEXIS 805).

**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.