

FS Regulatory Briefs*

Fund Directors and the New Proxy Disclosure Rules

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On December 16, 2009, the U.S. Securities and Exchange Commission ("SEC") adopted amendments to the proxy disclosure and other reporting requirements aimed at improving the information disclosed by public companies and U.S. registered investment companies ("funds").¹ The amendments require funds to disclose more detail about their governance activities in registration statements and proxy statements to shareholders. Since the proxy enhancements apply to public companies generally, they may also affect how funds develop proxy voting guidelines and vote ballots.

While fund directors already had oversight responsibilities with respect to overall fund governance and proxy voting, the proxy disclosure enhancements add to and reinforce these responsibilities.

Given this recent rulemaking, directors should have a thorough understanding concerning:

- What information is disclosed to fund shareholders about directors in fund proxy materials and other filings?
- How are boards organized to oversee risks to funds and to protect the interests of fund shareholders?
- How funds develop and update proxy voting guidelines?

Boards should incorporate regular reviews of these topics into their oversight programs.

Disclosures Concerning Director Qualifications and Outside Relationships

Previously, information about fund directors was required to be disclosed in easy-to-read, tabular format in three places: the fund's annual report to shareholders, statement of additional information and proxy statements for the election of directors. The required disclosure for each director included his/her 1) name, address and age; 2) current positions held with the fund; 3) term of office and length of time served; 4) principal occupations during the last five years; 5) number of portfolios overseen within the fund complex; and 6) other directorships held outside the fund complex. In addition, directors are required to disclose their personal ownership interests in fund shares, whether they are an "interested person" of the fund, and any circumstances that would cause one to question a director's allegiance to fund shareholders.²

The new guidance significantly enhances this disclosure regime. Funds are now required to disclose the qualifications of directors or any nominee for director, including narrative on the experience, skills or attributes that qualify that person to serve as a director of the company and any fund committee on which the person sits. Disclosures must include all directorships held by directors or nominees at any time during the last five years at public companies and/or registered investment companies as well as any legal proceedings involving the directors or nominees for the last ten years

¹ U.S. Securities and Exchange Commission Release Nos. 33-9089, 34-61175; Proxy Disclosure Enhancements (December 16, 2009)

² U.S. Securities and Exchange Commission Release Nos. 33-7932; 34-43786; IC-24816; File No. S7-23-99 Final Rule: Role of Independent Directors of Investment Companies (January 2, 2001)

(expanded from the previous five-year disclosure period).³

Whereas the previous disclosure requirements were focused on each director's association with the fund industry primarily, the new disclosures take a more holistic view of directors' experiences and potential conflicts outside of the fund industry.

Notably, the final rules do not specify minimum criteria that would qualify someone to serve as a fund director. Ultimately, it will be up to fund shareholders to review the disclosures and determine whether a director or fund board is qualified and organized to represent their interests.

Disclosures Concerning Board Leadership Structure and its Role in Risk Oversight

Funds are now required to disclose their leadership structure and why they believe it is appropriate for the fund. In addition, disclosures must include a discussion of whether the fund has chosen to combine the principal executive officer and chairman of the board positions and their rationale for making that decision. If one person serves in both positions, funds must disclose whether they have a lead independent director and what role the lead independent director plays in the board's leadership structure.

Public companies and funds are also required to disclose whether, and if so how, a nominating committee considers diversity when identifying nominees for director. If the nominating committee has a policy regarding the consideration of diversity in director nominations, disclosures should discuss how the policy is implemented and how the effectiveness of the policy is measured. Public companies and funds are given latitude for determining the characteristics that they choose to define diversity such as professional

experience, education, skills, viewpoints, national origin, sex and/or race.

Additionally, disclosures must now discuss the board's role in risk oversight. Although SEC rules do not formally require the board to be involved in risk management oversight, the new rules may imply that funds should have formal risk management programs that include some form of board oversight or if not that funds should disclose a lack of oversight in this area.

The SEC does not state what would constitute an effective risk management program for funds and implies that different oversight structures could be effective. For example, the risk oversight framework could involve the whole board, a special risk committee, the audit committee, or another oversight mechanism.

Consequently, fund directors and their advisers must ask themselves:

- How will fund boards administer their risk oversight responsibilities?
- Will fund boards oversee risk through a separate committee or the whole board?
- What role will the fund's investment adviser play in overseeing risk?
- To whom will individuals responsible for risk oversight report? Directly to the board or to a board committee? To the investment adviser?
- How frequently will boards receive information about risk oversight? Should risk oversight be a regular agenda item at board meetings?
- What are the key indicators of risk, both numeric and qualitative, and how will these be measured and reported (e.g. static measures vs. trend analysis)? What are the quality controls around measurement and reporting of key risk information?

³ This disclosure would include legal proceedings involving mail or wire fraud; violations of securities, commodities, banking or insurance laws; and any disciplinary actions imposed by a stock, commodities or derivatives exchange.

Location of Disclosure Amendments

The proxy disclosure enhancements apply to fund proxy materials relating to the election of directors. Amendments to registration statements on Forms N-1A, N-2, and N-3 require these enhanced disclosures about directors and board governance in fund statements of additional information.⁴

Proxy Guidelines

The SEC's 2003 proxy voting rules clearly stated that fund boards of directors have the right and obligation to vote proxies relating to a fund's portfolio securities. The fact that boards typically delegate this function to the fund's investment adviser does not relieve them of their continuing oversight responsibilities.⁵ Consequently, directors should regularly inquire about how proxy voting guidelines are updated in response to industry and regulatory developments.

The new disclosure rules, by requiring issuers to disclose more information about their compensation practices, director qualifications and risk management oversight, present similar opportunities for fund proxy voting guideline development. Fund boards should inquire how these new disclosure requirements might be incorporated into their existing voting guidelines.

Unlike other stakeholders of companies, shareholders primarily rely on a corporation's board of directors to protect their interests. The enhanced disclosures by issuers related to compensation practices, board composition and leadership structure should give shareholders a more thorough view of the board's ability to look after shareholder interests. Fund board's may:

- Consider how the new narrative disclosure of compensation policies and practices as they relate to risk management might be used to evaluate proposals approving equity based compensation plans;
- Consider how the enhanced summary compensation table and new narrative disclosure on compensation could be utilized to assess and evaluate the decisions of the compensation committee. Might compensation decisions be used as a "window" into the activities of the full board?
- Consider how enhanced director and nominee disclosures might be incorporated into proxy voting decisions while electing directors. Additionally, would the nominating committee's consideration of diversity when identifying and evaluating potential nominees be a factor in evaluating the board's ability to represent shareholders;
- Consider how new disclosures on the board leadership structure might allow shareholders to further evaluate the board's ability to advance shareholder interests. How might this affect the evaluation of proposals related to the election of directors, board and committee independence or other issues?

What Should Directors Do Now?

Fund directors should use the recent regulatory interest as an opportunity to assess how well their funds comply with the enhanced proxy and fund governance disclosure requirements.

Directors should consider querying fund management and taking the following actions.

⁴ Form N-1A is used by open-end management investment companies. Form N-2 is used by closed-end management investment companies. Form N-3 is used by separate accounts, organized as management investment companies, which offer variable annuity contracts.

⁵ U.S. Securities and Exchange Commission Release Nos. 33-8188, 34-47304, IC-25922; File No. S7-36-02 Final Rule: Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management Investment Companies (January 31, 2003)

With regard to the proxy disclosure enhancements outlined in the SEC's recent guidance, directors should:

- Discuss with fund management and advisers how the additional background about directors required by the SEC's disclosure enhancements will be collected;
- Consider the board's role in overseeing risk for the fund;
- Consider the role of diversity in nominating and selecting directors;
- Consider what qualifications and experience the board considers important for its members; and,
- Review fund disclosures concerning the board's leadership structure, qualifications and role in risk oversight in proxy statements for the election of directors and fund registration statements.

With respect to the voting of proxies for portfolio companies, directors should:

- Review and approve proxy policies and procedures for the fund;
- Ensure that the fund discloses in its registration statement (or, on Form N-CSR⁶) its proxy policies and procedures;

- Understand how funds or those that vote on their behalf develop proxy voting guidelines.
- Ask whether funds amended their proxy guidelines given the enhanced disclosure requirements implemented by the SEC in December 2009?
- Inquire whether any guideline gaps were identified during the recent proxy season?
- Understand how funds disclose in shareholder reports and registration statements how shareholders may obtain information about fund proxy voting?
- Ensure funds file with the SEC on Form N-PX⁷ and make available to shareholders actual voting records with respect to portfolio securities.
- Inquire whether the fund's proxy voting process is functioning properly? Are all ballots voted in a timely manner? If not, why?
- Determine whether any proxy conflicts have been identified as part of the voting process? If so, how were the conflicts resolved and was the resolution documented?
- Ask whether any votes were cast contrary to stated guidelines? If so, why?

⁶ Form N-CSR is filed by registered investment companies within 10 days after the transmission of any annual or semi-annual financial reports to shareholders. Since closed-end funds are not required to file annual updates to their registration statements, certain policies - including those for proxy voting - are communicated to shareholders through Form N-CSR filings.

⁷ Form N-PX must be filed no later than August 31 each year detailing the fund's proxy voting records for the most recent 12 month period ended June 30.

Additional Information

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