Proskauer

SEC Issues No-Action Relief Increasing Flexibility for Certain In-Person Director Voting Requirements

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On February 28, 2019, the staff of the Division of Investment Management (the "Staff") of the Securities and Exchange Commission (the "SEC") issued a no-action letter[1] permitting the board of directors of a registered fund or business development company [2] to meet and take certain actions by telephone, videoconference or other similar means in circumstances where directors (i) are unable to meet in-person due to unforeseen or emergency situations or (ii) previously met in-person and discussed all material aspects of the matter, but did not vote on the matter during the in-person meeting.

In the No-Action Letter, the Staff emphasized its ongoing efforts to assess whether existing director responsibilities continue to be appropriate and are carried out in a manner that serves investors' best interests in light of market, regulatory and technological developments. The No-Action Letter is the second recent no-action position issued as part of ongoing discussions among the Staff and the fund industry to modernize board oversight and reduce certain burdens imposed on funds and their boards due to the rigid application of the technical requirements of the Investment Company Act of 1940, as amended (the "1940 Act"), in cases where the burdens outweigh any benefits to fund investors.[3] The Staff stated it did not believe this new relief "would diminish [a] board's ability to carry out its oversight role or other specific duties."

Legal Framework Requiring In-Person Board Votes

Sections 15(c) and 32(a) of the 1940 Act require the vote of a majority of a fund's independent directors "cast in person at a meeting called for the purpose of voting" for the annual renewal of an advisory or principal underwriting contract and approval of the selection of an independent public accountant, respectively. The legislative purpose for this in-person voting requirement was to assure informed voting by fund boards.[4] Rules 12b-1 and 15a-4 under the 1940 Act each contains a substantially identical requirement for the purposes of approving 12b-1 plans and interim advisory agreements, respectively.

No-Action Relief Provided; Staff Conditions

As outlined in the Incoming Letter, "in-person voting requirements may create a significant or unnecessary burden for funds and their boards that outweigh any benefits to fund shareholders" in certain situations when the directors that are necessary for the required approval:

1. cannot meet in person due to unforeseen or emergency circumstances, provided that (i) no material changes to the relevant contract, plan and/or arrangement are proposed to be approved, or approved, at the meeting, and (ii) such directors ratify the applicable approval at the next in-person board meeting ("Scenario 1"); or
2. previously fully discussed and considered all material aspects of the proposed matter at an in-person meeting, but did not vote on the matter at that time, provided that no director requests another in-person meeting ("Scenario 2").

In the No-Action Letter, the Staff stated, provided the required conditions are satisfied, it would not recommend enforcement action to the SEC with respect to the following board actions if not conducted in-person:

a. renewal (or approval or renewal in the case of Scenario 2) of an investment advisory contract or principal underwriting contract pursuant to Section 15(c) of the 1940 Act;
b. approval of an interim advisory contract pursuant to Rule 15a-4(b)(2) under the 1940 Act (with respect to Scenario 2 only);
c. selection of the fund's independent public accountant pursuant to Section 32(a) of the 1940 Act (with respect to Scenario 1, there can be no change in the accountant as that selected in the immediately preceding fiscal year); and

4. renewal (or approval or renewal in the case of Scenario 2) of the fund's 12b-1 Plan;

Analysis and Further Considerations

Unforeseen or Emergency Circumstances

Absent available Staff relief and a resulting lapse of board approval of an investment advisory contract, engagement with an independent public accountant or 12b-1 plan due to directors being unable to attend an in-person meeting, a fund would need to secure shareholder approval for continuance of such arrangements.[5] The proxy solicitation costs for a continuation of such a contract, engagement or plan could be a "significant or unnecessary burden" outweighing the benefits to shareholders when such arrangement did not contain material amendment from what had been reviewed by the board. The SEC and its Staff have previously granted relief through exemptive orders and no-action letters in previous emergency situations, such as the terrorist attacks on September 11, 2001 and the 2008 financial crisis.[6]

The Incoming Letter provides a non-exhaustive list of examples of unforeseen or emergency circumstances including, but not limited to, illness or death (including of family members), weather events or natural disasters, acts of terrorism and disruptions in travel that prevent some or all members from attending the meeting in person. Unforeseen or emergency circumstances include any circumstances, as determined by the fund's board, that (i) could not have been reasonably foreseen or prevented and (ii) make it impossible or impracticable for directors to attend a meeting in-person. Prudence suggests that the minutes of the board meeting carefully document the basis for this determination.

Furthermore, the Incoming Letter explicitly excludes change of control events from Scenario 1 but provides that Scenario 2 could cover a change of control depending on the facts and information previously provided to, and considered by, a fund's board and the timing of their presentation. Specifically, the No-Action Letter may provide additional flexibility to address change of control events for manager-of-manager funds with respect to the fund's sub-investment advisers, which are likely to be more frequent and outside of the control of the fund's primary investment adviser and management.

Additional Considerations

While the No-Action Letter provides assurances that the Staff will not recommend enforcement action to the SEC if a fund's board does not meet "in-person" under Scenario 1 or 2, it does not address the validity of contracts entered into in reliance on the No-Action Letter. Section 47(b) of the 1940 Act provides that contracts that are made in violation of provisions of the 1940 Act are unenforceable by either party, subject to certain defenses, a provision that provides for a private right of action. Funds, their boards and investment advisers, therefore, may wish to consider the benefits of taking advantage of the relief with the risks of potential private rights of action.

In light of the risks, alternative approaches may be available. Many boards, for example, have more than the minimum number of required independent directors to accommodate the absence of one director due to a family or weather-related emergency, and it may be desirable to convene as many independent directors in-person as possible in any circumstance, rather than excusing all directors from in-person attendance. Boards anticipating receipt of additional information also could consider approving an arrangement at an in-person meeting, subject to reconsideration of the matter when additional information is forthcoming. Fund complexes also may consider revisiting their annual approval calendars to determine if certain items, such as the approval of auditors, could be further consolidated across the complex.

Finally, the No-Action Letter does not require a fund board to take current action to adopt emergency-related policies in order to take advantage of the relief provided. Boards and fund managers may therefore decide to wait and evaluate the need for reliance on the relief should future circumstances so warrant.

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[1] Independent Directors Council, SEC Staff No-Action Letter (pub. avail. Feb. 28, 2019) (the "No-Action Letter"). *See also*, Incoming Letter from the Independent Directors Council ("IDC") to Paul G. Cellupica (pub. avail. Feb. 28, 2019) (the "Incoming Letter").

[2] The Incoming Letter defines "fund" as a registered management investment company or a separate series thereof. In issuing the No-Action Letter, the Staff extended the relief to business development companies or "BDCs".

[3] *See*, Independent Directors Council, SEC Staff No-Action Letter (pub. avail. Oct. 12, 2018) (permitting fund boards to rely on written representations from a fund's chief compliance officer regarding affiliated transactions effected in reliance on Rules 10f-3, 17a-7 or 17e-1 under the 1940 Act).

[4] H.R. Rep. No. 91-1382 at 77 (1970).

[5] A principal underwriting contract could be continued by board approval at the next in-person meeting.

[6] *See*, *e.g.*, 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); and JPMorgan Chase/Bear Stearns Asset Management I, SEC No-Action Letter (July 14, 2008).