The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
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Reimagining the 1940 Act: Key Recommendations for Innovation and Investor Protection

Ready for Reform

It's been more than thirty years since policymakers have reviewed the regulatory framework of the Investment Company Act of 1940 (1940 Act)—the law governing mutual funds, exchange-traded funds (ETFs), and other registered investment funds.

Given the extraordinary evolution of investment opportunities in recent decades and the role of investment funds in supporting middle-class wealth creation, **a President Trump SEC should prioritize updating** this framework.

ICI's recommendations follow four themes. These are below "at a glance" and follow in detail:

First Theme: Fostering ETF innovation

1. Enable a new or existing fund to offer both mutual fund and ETF share classes
2. Expand permissible asset classes for semi-transparent ETFs

Second Theme: Expanding retail investors' access to private markets

3. Allow closed-end funds to more flexibly invest in private funds
4. Remove the annual shareholder meeting requirement for listed CEFs
5. Let fund boards rely on state-recognized anti-takeover measures
6. Update the framework for fund co-investments
7. More flexibility for CEFs in providing repurchase opportunities to their investors
8. Let interval funds and tender offer funds operate as series companies

Third Theme: Eliminating unnecessary regulatory costs and burdens

9. Adopt electronic delivery of information as the default delivery option
10. Streamline the shareholder approval process
11. Restore the ability of funds to cross-trade
12. Allow CEFs to use more than one type of debt
13. Permit continuously offered closed-end funds to offer multiple share classes
14. Streamline notification requirements for distributions

Fourth Theme: Better leveraging the expertise and independence of fund directors

15. Update requirements for in-person voting by directors
16. Permit streamlined board approval of new subadvisory contracts and annual renewals
17. Revise the "interested person" standard
18. Permit fund boards to appoint a greater number of new independent directors
19. Update fund board responsibilities with respect to auditor approval

First Theme: Fostering ETF innovation

One of the most important developments in the fund industry has been the rise of ETFs, which was fostered initially by a series of SEC orders providing exemptions from the 1940 Act and then by a dedicated rule, Rule 6c-11 under the 1940 Act. Accordingly, two of the recommendations relate to changes that would broaden how ETFs may be used.

Recommendation 1: Enable a new or existing fund to offer both mutual fund and ETF share classes

Rule 18f-3 under the 1940 Act permits an open-end fund to offer multiple classes of shares to facilitate different shareholder servicing and/or distribution arrangements across classes. This does not allow different share classes to be offered with differences in redeemability. Thus, it does not permit a fund to have a mutual fund share class (which has daily redeemability of individual shares at NAV) and an ETF share class (which has daily redeemability at NAV only for large blocks of shares referred to as "creation units," with individual shares trading on an exchange at market prices).

In the 2000s, the SEC granted one fund sponsor exemptive relief to offer mutual funds with an ETF share class. It has not done so since. Other fund sponsors are required to operate two separate funds—a mutual fund and an ETF—even where the assets are managed in the same strategy.

Since 2023, more than 30 fund sponsors have filed applications seeking relief to offer funds with both mutual fund and ETF share classes. These applications seek to address SEC concerns that shareholders in either class could be disadvantaged (for example, that shareholders of the ETF class could be disadvantaged by cash transactions in the mutual fund class).

Permitting a single fund to offer both mutual fund and ETF share classes would promote efficiency and economies of scale and provide optionality for fund investors. An adviser, which owes a fiduciary duty to the entire fund, would only be expected to offer a fund in this structure where the structure is believed to be in the best interests of the ETF share class, the mutual fund share class, and the fund as a whole. The SEC should act upon the pending applications and develop reasonable conditions that will allow greater use of this fund structure by fund sponsors. The structure would make available to investors a variety of options that will promote competition to their benefit.

Recommendation 2: Expand permissible asset classes for semi-transparent ETFs

Rule 6c-11 under the 1940 Act, which is the rule applicable to the vast majority of ETFs in operation today, requires full daily holdings disclosure to facilitate the arbitrage activity that keeps the market prices of ETF shares at or close to net asset value. Under SEC Chair Jay Clayton, the SEC issued exemptive relief to several fund sponsors to permit the operation of "semi-transparent ETFs" that do not disclose their full holdings daily. Instead, these ETFs rely on alternative mechanisms to facilitate the arbitrage process, generally involving (i) disclosure of information about a "proxy portfolio" or (ii) use of a blind trust mechanism, combined with disclosure of a "verified intraday indicative value." These exemptive orders were limited to ETFs investing in U.S. exchange-traded equities, however.

The requirement to disclose full holdings daily continues to prevent some active managers from entering the ETF market. Expansion of the asset classes in which a semi-transparent ETF may invest could also encourage active managers to enter the market, providing investors with more options and increasing competition in the ETF industry. Trading in semi-transparent active ETFs has functioned well to date, suggesting that expansion of asset classes would be appropriate. This could be done through the exemptive order process, thus allowing the SEC to evaluate asset classes on a case-by-case basis.

Second Theme: Expanding retail investors' access to private markets

Closed-end funds are highly suitable vehicles for providing retail investors with exposure to less liquid classes of assets—including private investments—while maintaining the strong protections of the 1940 Act. At the same time, activist investors in listed closed-end funds have used increasingly aggressive tactics to force through changes in these funds' investment strategies and governance that are damaging to long-term investors in the funds. There are a number of steps that could be taken to expand investment flexibility for closed-end funds without sacrificing investor protection and to create a more level playing field between activist investors and retail shareholders who invest in funds for retirement and other long-term financial goals.

Recommendation 3: Allow closed-end funds to more flexibly invest in private funds

The SEC staff currently prohibits a closed-end fund from investing more than 15 percent of its net assets in privately offered funds, unless the closed-end fund's shares are available only to accredited investors[1] who make minimum initial investments of at least $25,000.[2] Private funds have grown enormously in number and variety in the past two decades, but ordinary investors have been unable to participate in them. The SEC should eliminate limits on a closed-end fund from investing its assets in private funds. The SEC should allow closed-end funds that are offered to retail investors to invest in private funds, subject to board oversight, limitations on leverage and transactions with affiliates, and other provisions of the 1940 Act. As a result, retail investors could gain exposure to the same opportunities for investment returns from alternative asset classes enjoyed by affluent investors.

Recommendation 4: Remove the annual shareholder meeting requirement for listed CEFs

The 1940 Act does not require listed closed-end funds to hold annual shareholder meetings, nor do other federal securities laws or state laws applicable to such funds. Stock exchange rules—which, in the case of the New York Stock Exchange (NYSE), predate the enactment of the 1940 Act—are the only authority that require annual shareholder meetings.

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[1] 17 CFR 230.501(a) (definition of accredited investor).

[2] This prohibition was not established through notice and comment rulemaking; rather, it is a position taken by the Division's disclosure review staff, initially at the direction of a prior SEC Chair.

The annual meeting requirement for listed closed-end funds has created an end-run around the investor protections the 1940 Act is intended to provide and enables harms that Congress and the SEC identified when formulating the 1940 Act. Further, annual meetings frequently lack fulsome retail investor participation and allow for scenarios where a minority investor with an outsized influence over the proxy machinery can engage in conduct that harms other shareholders. After obtaining a controlling interest in a closed-end fund, an activist can force liquidity events or other actions—such as a change in investment strategy or even ouster of the fund adviser—that benefit the activist at the expense of the fund and its shareholders.[3]

Exempting listed closed-end funds from an exchange's annual meeting requirement would not weaken shareholder voting rights. The 1940 Act preserves shareholder rights to elect directors in specified situations and further protects shareholder voting rights by reserving to shareholders certain decisions involving significant fund actions and governance and operational changes.

Both the NYSE and the Chicago Board Options Exchange have proposed listing rule changes to remove the annual meeting requirement for listed closed-end funds. The SEC should approve these rule filings as soon as possible.

Recommendation 5: Let fund boards rely on state-recognized anti-takeover measures

An activist investor often demands actions that can cause a closed-end fund to shrink in size or be liquidated altogether, for the activist's own benefit and to the detriment of the long-term interests of the fund and other investors. If a closed-end fund board concludes that an activist's goals are not in the best interests of the fund and its shareholders, the board should have the discretion, consistent with its fiduciary responsibilities under the 1940 Act and state law, to employ one or more takeover defenses long recognized under state law. These defenses include opting into (or remaining subject to) a "control share statute," which limits a concentrated shareholder's ability to exercise its votes; shareholder rights plans; adopting bylaws with terms designed to protect the fund; requiring a majority of outstanding shares to elect directors; and limiting the authority of non-continuing directors.

Activist investors have argued that control share statutes are inconsistent with Section 18(i) of the 1940 Act, which requires that "except…as otherwise required by law, every share of [fund] stock…be a voting stock and have equal voting rights with every other outstanding voting stock." In 2020, the SEC staff withdrew a prior interpretive position that agreed with that position,[4] and provided no-action assurance for closed-end funds choosing to opt in to such statutes. This assurance was conditioned on the fund board making its decision with reasonable care consistent with other applicable duties and

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[3] For further detail, *see* Letter from ICI to Vanessa Countryman, Secretary, SEC dated July 30, 2024 (supporting New York Stock Exchange proposal to eliminate its annual meeting requirement for listed closed-end funds), available at https://www.sec.gov/comments/sr-nyse-2024-35/srnyse202435-502415-1467842.pdf

[4] *Boulder Total Return Fund, Inc.*, (Nov. 15, 2010), withdrawn in SEC Staff Statement, *Control Share Acquisition Statutes* (May 27, 2020).

laws. Since then, however, courts have held on multiple occasions that control share restrictions violate Section 18(i), with other litigation still pending.[5]

Neither the language of Section 18(i) nor the purposes underlying the 1940 Act justify a limitation on the discretion of independent directors to adopt defensive measures, if doing so is consistent with their fiduciary duty to shareholders. The legislative history of the 1940 Act demonstrates that the Act was intended to eliminate the use of concentrated voting power by arbitrage investors to commandeer control of closed-end funds (at that time, the predominant type of investment fund in the industry) and alter the funds' investment policies to garner a profit at the expense of the long-term interests of funds and shareholders. The SEC should clarify that Section 18(i) does not prevent a closed-end fund from availing itself of these takeover defenses under applicable state law.

Recommendation 6: Update the framework for fund co-investments

The ability of regulated funds to invest in attractive opportunities in private markets is often facilitated when they can invest alongside private funds advised by the same adviser or sub-adviser. However, the framework that the SEC has applied to such co-investments has impeded the ability of retail investors to participate in these opportunities.

The ability of regulated funds to invest alongside affiliates, including affiliated private funds, is governed by Section 17(d) of the 1940 Act and Rule 17d-1 thereunder, which are designed to prevent overreaching in connection with joint transactions involving a fund and its affiliated persons. The SEC has issued numerous exemptive orders permitting a closed-end fund and one or more other funds and their affiliates to enter into co-investment transactions, subject to certain conditions. However, the exemptive orders set forth a complex and rigid set of conditions that are based on unrealistic and outdated assumptions about, for example, the nature of follow-on investments and the appropriate role of independent directors with respect to individual investment decisions. Further, the relief provided extends only to closed-end funds.

This framework should be updated to give funds greater ability to co-invest in private placements and thus provide the benefits of those investment opportunities to retail investors. All co-investments, including follow-on investments, should be governed by more flexible allocation principles, and the fund board's role should be focused on oversight rather than pre-approval of individual transactions. Further, registered open-end funds should be allowed to participate in co-investments just as closed-end funds do, given robust liquidity requirements for open-end funds (including strict limits on illiquid investments). Finally, the orders should take a more flexible approach to co-investment with remote affiliates of a regulated fund. For example, the SEC could impose fewer conditions on co-investment transactions where the sole reason that a private fund is deemed affiliated is that its adviser is also an otherwise unaffiliated sub-adviser of the regulated fund.

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[5] *See, e.g.*, *Saba Capital Master Fund, Ltd. et al. v. BlackRock ESG Capital Allocation Trust* (2d Cir., Jul. 17, 2024 (affirming district court order that decision by certain closed-end funds to opt into Maryland Control Share Acquisition Act violated Section 18(i) of the 1940 Act); *Saba Capital CEF Opportunities 1, Ltd, et al v. Nuveen Floating Rate Income Fund, et al*, (2d Cir., Nov. 30, 2023) (affirming district court order that control share provisions enacted by a closed-end fund board violate Section 18(i) of the 1940 Act); and *Eaton Vance Senior Income Trust v. Saba Capital Master Fund, Ltd.* (Mass. Super. Ct. Mar. 31, 2021) (summary judgment in favor of activist shareholder claiming that closed-end funds' control share bylaw provisions violated Section 18(i) of the 1940 Act and must be rescinded).

One immediate fix would be revision of co-investment exemptive orders to follow a more principles-based structure. Or the SEC should adopt a new rule (or, alternatively, adopt changes to Rule 17d-1) to streamline and enhance the co-investment framework based on its years of experience with co-investing arrangements.

Recommendation 7: More flexibility for CEFs in providing repurchase opportunities to their investors

Traditional listed closed-end funds issue shares in an initial public offering, and those shares then trade on an exchange at market prices. Interval and tender offer funds are specialized types of closed-end funds that generally do not list their shares but instead provide periodic liquidity at net asset value, a feature that makes them attractive to investors seeking exposure to certain alternative investment strategies. For interval funds, periodic redemptions must take place in accordance with Rule 23c-3 under the 1940 Act. Redemptions by tender offer funds occur at the discretion of the fund board, pursuant to requirements under the Securities Exchange Act of 1934.

The SEC should provide interval funds with more flexibility under Rule 23c-3 to adjust the size of repurchase amounts in light of their portfolio holdings and investment strategies. This flexibility may produce superior returns by permitting funds to hold more longer-term illiquid investments. In addition, the SEC should expand the *de minimis* exceptions to the current requirement that all tendering shareholders receive a *pro rata* amount, to enable smaller shareholders and shareholders with unique circumstances to redeem in full. This could be particularly helpful for investors who either receive shares or need liquidity due to events beyond their control (*e.g.*, shares received as part of an estate). Finally, the SEC should codify relief that it has previously granted some interval fund permitting them to conduct monthly repurchases, subject to certain conditions.

Recommendation 8: Let interval funds and tender offer funds operate as series companies

Open-end funds currently have the flexibility to operate as "series investment companies," in which a cluster of individual investment companies is organized or administered under a single set of organizational or governing documents. Each series offers a separate portfolio of securities with its own investment objective, policies, practices, and risks. Investors in a series do not participate in the investment results of any other series. Thus, each series represents a different group of shareholders with an interest in a segregated portfolio of securities. The ability to organize funds as series investment companies provides significant savings in organizational and governance costs.

The SEC should permit interval and tender offer funds to operate as series trusts, similar to open-end funds. Allowing these continuously offered CEFs to operate as series companies would enable fund sponsors to save the time and expense associated with launching separate registrants.

Third Theme: Eliminating unnecessary regulatory costs and burdens

A number of requirements under the 1940 Act and its rules were written in a world where mobile technology did not exist and most communication by funds with their investors was through the postal service, by paper. These and other requirements may be adapted, without any compromise of investor protection.

Recommendation 9: Adopt electronic delivery of information as the default delivery option

Electronic delivery of disclosures provides a variety of benefits, including more dynamic communication through use of images and video; opportunities for layered disclosures; enhanced ability to access, read, and search documents; and expedited communication to fund shareholders. Given changes in technology and investor demographics, electronic delivery should be the default method for communication with fund investors, who would retain the option for a paper copy to be mailed.

The SEC should pass a rule to make electronic delivery of fund disclosure documents the default.

Recommendation 10: Streamline the shareholder approval process

The 1940 Act imposes a heightened threshold for shareholder approval of certain actions, including changes to fundamental investment policies; approval or modification of investment advisory and principal underwriting contracts and certain distribution arrangements; and mergers of affiliated funds.[6] This is often referred to as the "1940 Act Majority" standard.[7] Funds generally face difficulty meeting this standard because of its high quorum requirement. Among other challenges, retail investors are far less likely than institutional investors to vote proxies. SEC proxy regulations further inhibit shareholder engagement in the proxy process and make the proxy process more expensive.[8]

An ICI analysis of fund proxy campaigns from 2012 to 2019 found that the costs of 145 proxy campaigns over this period totaled $373 million, a sizeable share of which was attributable to follow-up solicitations. Further, these figures are understated because they did not account for all campaigns or time spent by management personnel on the proxy campaigns.

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[6] *See* Section 13, Sections 15(a) and (b), Rule 12b-1, and Rule 17a-8, respectively.

[7] Section 2(a)(42) of the 1940 Act states that "[t]he vote of a majority of the outstanding voting securities of a [fund] means the vote… (A) of 67 per centum or more of the voting securities present at [a special or annual shareholder meeting], if the holders of more than 50 per centum of the outstanding voting securities of such company are present or represented by proxy; or (B) of more than 50 per centum of the outstanding voting securities of such company, whichever is less."

[8] *See, e.g.*, Rule 14a-16 under the Securities Exchange Act of 1934 (prohibiting a soliciting party from including a proxy card with the mailing of the initial notice of availability of proxy materials).

The SEC should create additional ways for funds to satisfy the 1940 Act Majority standard. For example, this could involve coupling a lower quorum requirement with a higher affirmative vote requirement. The SEC also should consider allowing certain events, such as changes in fundamental investment policies and permitting a fund to switch from diversified to non-diversified status, to proceed without shareholder approval, subject to appropriate protections (*e.g.*, fund board approval and advance notice to shareholders).

Recommendation 11: Restore the ability of funds to cross-trade

Rule 17a-7 under the 1940 Act permits the purchase and sale of securities between a fund and certain affiliates, subject to detailed conditions to protect against potential abuses (*e.g.*, dumping of unwanted securities; pricing that favors one side of a trade over the other). Cross-trading generates benefits to a fund and its investors that otherwise would not have been realized if the fund had transacted with a third-party dealer on the open market. These benefits include lower transaction costs, reduced settlement risk, and greater efficiencies with respect to portfolio management and compliance with investment policies.

To be eligible for cross-trading, a security must have a "readily available market quotation." In its December 2020 rulemaking on fair valuation, the SEC redefined that term and, in so doing, severely restricted funds' ability to cross-trade fixed-income securities under Rule 17a-7. The SEC at that time indicated that potential revisions to Rule 17a-7 were on its rulemaking agenda.[9] However, under Chair Gary Gensler, the SEC dropped this item from its rulemaking agenda, and following the September 8, 2021, compliance date of the fair valuation rule, regulated funds were no longer able to engage in cross trades.

The SEC should amend Rule 17a-7 to restore funds' ability to cross-trade fixed-income securities subject to appropriate guardrails that recognize the SEC's legitimate policy concerns.[10]

Recommendation 12: Allow CEFs to use more than one type of debt

Closed-end funds depend upon financing to make investments that benefit their shareholders. As market conditions change, a closed-end fund that has entered into one financing arrangement may want to seek financing on different terms than it did in the past. However, its ability to do so is constrained by an unduly narrow view that the SEC has taken of the ability of closed-end funds to issue more than one type of indebtedness under Section 18(c) of the 1940 Act. Section 18(c) generally permits closed-end funds to issue only one class of senior securities representing indebtedness and one class of senior securities representing stock.

Closed-end funds thus may be unable to engage in financing arrangements that would be favorable to their shareholders. For example, a closed-end fund that obtains leverage through an unsecured lending facility may be able to obtain leverage on better terms by refinancing a portion of its existing

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[9] *See* Good Faith Determinations of Fair Value, Investment Company Act Release No. 34128 (Dec. 3, 2020), 86 Fed. Reg. 748, 773 [Jan. 6, 2021].

[10] *See* Letter from Susan Olson, General Counsel, ICI, to Sarah ten Siethoff, Acting Director, Division of Investment Management, SEC, dated April 9, 2021; Preliminary Recommendation Regarding Modernizing Rule 17a-7 under the 1940 Act (June 1, 2020) ("FIMSAC recommendation").

indebtedness with a secured facility. The SEC's current interpretation of Section 18(c) does not permit this arrangement. Further, the lack of clarity in the SEC's existing guidance regarding what a "class" of indebtedness is hinders the ability of closed-end fund sponsors to determine the regulatory status of more complex financial instruments such as tender option bonds, which are widely used by municipal bond closed-end funds.

The SEC should adopt a rule or issue Commission-level guidance to align its interpretation of Section 18(c) with the plain language of the statute and provide clear guidance on the distinction between "classes" and "series" of indebtedness for purposes of Section 18(c) to provide closed-end funds with greater flexibility to take advantage of attractive financing opportunities without exposing investors to materially higher risks. Existing requirements relating to asset coverage and reporting already afford shareholders robust protection against the risks arising from senior securities.

Recommendation 13: Permit continuously offered closed-end funds to offer multiple share classes

Section 18 of the 1940 Act limits the capital structure of funds by limiting funds' ability to issue or sell "senior securities." Rule 18f-3, adopted by the SEC in 1995, permits open-end funds to maintain or create classes without seeking individual exemptive orders, as long as certain conditions are met.

Shortly after the adoption of Rule 18f-3, continuously offered closed-end funds began to apply for and receive exemptive relief to offer multiple classes of shares. Applicants successfully argued that the same operational and distribution features on which the Commission relied in adopting Rule 18f-3 applied equally to such closed-end funds. The SEC now routinely grants exemptive orders to continuously offered closed-end funds requiring compliance with the provisions of Rule 18f-3 as if the funds were open-end funds. Codifying this relief would eliminate the need for the SEC to grant individual exemptive orders.

Recommendation 14: Streamline notification requirements for distributions

Section 19(a) and Rule 19a-1 of the 1940 Act prohibit a fund from making a distribution from any source other than the fund's net income unless the distribution is accompanied by a notice to shareholders that adequately discloses the sources of the payment. The notice requirement is intended to preclude funds from creating a misleading impression of investment income.

These requirements are outdated in light of technology changes and the fact that the record owners of fund shares are now often broker-dealers and other intermediaries. Further, investors generally receive a Form 1099-DIV, which reports the tax character of a fund's distribution, after the close of the calendar year. Thus, separate Rule 19a-1 notices often are not relevant to investors. The SEC should adopt a rule that allows a fund to provide this disclosure on its website, rather than a specific notice mailed to shareholders.[11]

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[11] *See* Letter from Susan Olson, General Counsel, ICI, et al., to Vanessa Countryman, Secretary, SEC, dated Dec. 20, 2020 (recommending that funds disclose in shareholder reports that the distribution information required by Rule 19a-1 is available at a specified website address).

Fourth Theme: Better leveraging the expertise and independence of fund directors

The 1940 Act places significant responsibility on a fund's board of directors, typically comprising at least a majority of members who are independent of the adviser, for oversight of actions by the fund's investment adviser and other service providers that impact the fund. There are a number of steps that could be taken to enhance the ability of fund boards to provide strong independent oversight, including by allowing them to use their fiduciary judgment to determine how best to comply with certain procedural requirements under the 1940 Act.

Recommendation 15: Update requirements for in-person voting by directors

The 1940 Act was amended in 1970 to require that a fund board approve certain matters at an in-person meeting.[12] Since the adoption of these requirements, however, technology and videoconferencing capabilities have vastly improved.

Over the years, the SEC has permitted temporary exceptions to the in-person requirements for unforeseen circumstances such as illness, weather events, natural disasters, and travel disruptions. More recently, in response to the COVID-19 pandemic, the SEC provided temporary relief allowing fund boards to approve all required matters virtually, subject to certain conditions.

The SEC should grant permanent relief that provides fund boards with discretion to hold required approval meetings either in person or through videoconferencing. Fund boards are well suited to determine whether their meetings can and should be held virtually based on their fiduciary duty to each fund they serve. Through written policies and procedures, fund boards could specify the intended frequency of in-person meetings, identify whether particular matters must be discussed in person, and establish parameters for meetings with remote participation (*e.g.*, technology and security protocols).

Recommendation 16: Permit streamlined board approval of new subadvisory contracts and annual renewals

Under Sections 15(a) and (c) of the 1940 Act, the decision to enter into an agreement with a new subadviser requires approval from both the fund board and fund shareholders. The SEC has granted relief to many fund complexes from the shareholder approval requirement, subject to detailed conditions. This relief does not extend to the fund board's initial approval of a new subadviser or to the requirement that, after an initial two-year period, the subadvisory contract must be approved by the fund board on an annual basis. Absent an exemption, these approvals by the fund board must occur at an in-person meeting.

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[12] These in-person requirements include: (1) Section 15(c), which requires that a fund's contracts with its adviser and underwriters be approved initially and annually thereafter by a majority of the board's independent directors at an in-person meeting; (2) Rule 12b-1, which requires any plan adopted by the fund pursuant to that Rule to be approved initially and annually thereafter by a majority of the board's independent directors at an in-person meeting; (3) Section 32(a), which requires that the board's selection of the independent auditor also be completed at an in-person meeting; and (4) Rule 15a-4, which requires that certain interim contracts be approved by a majority of a board's independent directors at an in-person meeting.

Since these board approval requirements were added, the use of unaffiliated subadvisers by funds has grown dramatically. An adviser, acting pursuant to its fiduciary duty to the fund, may recommend the hiring (or replacement) of unaffiliated subadvisers to manage distinct portions of the fund's portfolio to align with the fund's overall investment strategy. In this respect, such unaffiliated subadvisers are similar to other third-party service providers that act pursuant to a delegation of authority and subject to oversight from the adviser. From the perspective of fund shareholders, the role of subadvisers is substantially equivalent to the role of individual portfolio managers employed directly by an investment adviser.

Given these changes in the fund industry, the SEC should reconsider the role of fund boards in approving new subadvisory contracts and annual renewals, such that fund boards would not necessarily have to review every advisory and sub-advisory agreement at an in-person meeting every year.[13] Alleviating the burden of routine approvals would not lessen directors' obligations to oversee the nature and quality of advisory services being provided to a fund. Fund boards will review subadvisers' services on an ongoing basis, as part of the annual approval of the primary adviser, and always have the discretion to review a subadviser's services and performance more frequently or to "take a deeper dive." The adviser, which also owes a fiduciary duty to the fund, likewise engages in an ongoing analysis of the continued advisability of retaining a sub-adviser, including the fees paid.

Recommendation 17: Revise the "interested person" standard

Under Section 2(a)(19) of the 1940 Act, an individual is considered an "interested person" of the fund (*i.e.*, not independent) if they have *any* direct or indirect interest in a subadviser. This means that independent directors must manage their personal investments to ensure that they do not hold any securities issued by any principal underwriter or subadviser engaged by a fund within the complex or any parent company of such principal underwriter or subadviser. In the modern financial services industry, principal underwriters and subadvisers are often part of large, publicly traded global organizations. As a result, independent directors must monitor for changes in control of the companies in which they are invested and could be required to sell their holdings at inopportune times or forgo investment opportunities. In addition, independent directors may have other business relationships with remote affiliates of an adviser or principal underwriter that must be monitored. These burdens can disincentivize high-quality candidates from serving on certain fund boards and potentially lead to delays in replacing underperforming subadvisers.

Section 2(a)(19) was not intended to disqualify persons with remote interests from serving as an independent director. The SEC should revise this overly rigid standard, including to address inadvertent interests and *de minimis* situations that do not impact independence. This could include rulemaking or approval of exemptive applications.

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[13] Among potential ideas for consideration are (i) changing the required frequency of renewal approval to every two or three years and (ii) requiring a fund board to approve new subadvisory agreements and material changes to existing agreements but no longer requiring approval of annual renewals of such agreements.

Recommendation 18: Permit fund boards to appoint a greater number of new independent directors

The 1940 Act generally requires that at least two-thirds of a fund's board of directors be elected by the fund's shareholders.[14] It therefore strictly limits the ability of fund boards to add directors or fill vacancies without obtaining shareholder approval through proxy campaigns.

The costs of proxy campaigns can be significant,[15] and fund shareholders typically bear the costs associated with relatively routine events such as director elections. Even a relatively straightforward director election campaign can be very expensive: one fund complex's 2018 proxy campaign to elect directors cost nearly $50 million, due to the number of fund shareholders and the attendant costs of preparing, printing, and mailing even one set of proxy materials to each shareholder.[16] These disincentives can lead to extended periods between the identification of potential board members and the opportunity for those potential members to be elected, which can deprive shareholders of the expertise and perspective of those potential board members for months if not years. These negative impacts may have a chilling effect on a fund board's ability to refresh its membership.

Given these challenges, fund boards should be permitted to appoint a greater number of new independent directors without having to seek shareholder approval. It is appropriate to rely on the business judgment of the then-serving independent directors to evaluate potential candidates and assess any potential conflicts of interest.

Recommendation 19: Update fund board responsibilities with respect to auditor approval

Section 32(a)(1) under the 1940 Act requires a fund board, including a majority of the independent directors, to select an independent auditor for the fund at least annually at an in-person meeting. Audit committees of fund boards, however, have oversight responsibilities with respect to a fund's financial reporting processes. Section 2-01 of Regulation S-X, adopted following the Sarbanes-Oxley Act of 2002, requires the audit committee to approve in advance the engagement with the auditor to provide audit services. Further, the audit committee for any listed fund must be "directly responsible" for the appointment, compensation, retention and oversight of the independent auditor.[17] For these reasons, annual in-person approval by the full board is not necessary to protect the interests of fund shareholders.

The SEC should eliminate the Section 32(a)(1) requirement or permit a fund board to ratify the audit committee's selection of the independent auditor other than at an in-person meeting.

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[14] Section 16(a) of 1940 Act.

[15] *See* ICI Letter to Vanessa Countryman, Secretary, SEC regarding SEC Roundtable on the Proxy Process (File No. 4-725) (June 11, 2019) at 4–5.

[16] ICI, *Analysis of Fund Proxy Campaigns: 2012–2019* (Dec. 2019) (ICI Study) at 20.

[17] Rule 10A-3 under the Securities Exchange Act of 1934.