

NOVEMBER 2003

Imposing Corporate Governance Reform: The SEC Takes Action

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November 24, 2003

The partial settlement announced on November 13, 2003, between the Securities and Exchange Commission and Putnam Investment Management LLC highlights a significant trend in recent enforcement actions: the imposition of substantial corporate governance reforms and related independent monitoring of these required changes. While criticized by state officials in New York and Massachusetts as not being tough enough, the Putnam settlement details sweeping, and for the most part, voluntary changes to its boardroom in terms of composition, process and procedure. The SEC emphasized these voluntary remedial efforts and undertakings as part of its decision to accept Putnam's offer of settlement. Understanding these specific reforms provides insight into what non-monetary terms the SEC may expect or require in the current regulatory environment.

The SEC Proceeding

On October 28, 2003, the SEC instituted administrative cease and desist proceedings against Putnam under the Investment Advisers Act of 1940 and the Investment Company Act of 1940. Specifically, the action alleged the following violations:

- *Section 204A of the Investment Advisers Act:* Putnam failed to establish, maintain, and enforce written policies and procedures reasonably designed, taking into consideration the nature of such investment adviser's business, to

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prevent the misuse of material non-public information by such investment adviser or any person associated with such investment adviser. Putnam failed to take adequate steps to detect and deter short-term trading of Putnam funds by its portfolio managers and other investment professionals who had access to non-public information regarding, among other things, current portfolio holdings, valuations, and transactions not readily available to all fund shareholders.

- *Sections 206(1) and 206(2) of the Investment Advisers Act:* Putnam knowingly, recklessly, and/or negligently failed to disclose to the boards of mutual funds it managed that certain investment management professionals were engaging in potentially self-dealing short-term securities trading.
- *Rule 17j-1(c) under the Investment Company Act:* Putnam failed to use reasonable controls to monitor and detect such activity by its employees.
- *Section 203(e) (6) of the Investment Advisers Act:* Putnam failed reasonably to supervise certain employees, who were subject to Putnam's supervision, with a view to preventing their violations of Sections 206(1) and 206(2) of the Advisers Act. Putnam failed to adopt and implement procedures reasonably designed to detect or prevent the violations of certain employees.

In the days immediately following the start of this action, institutional investors withdrew in excess of \$22 billion from Putnam, which moved quickly to reach resolution with the SEC.

The Partial Settlement Agreement

In addition to the payment of restitution and civil money penalties – which will be decided at a later time – Putnam agreed to the following in order to resolve this action:

- Three-quarters of the individuals serving on the Board of Trustees, including the Chairman, must be independent of the company;
- Directors will stand for election by the shareholders at least every five years;
- The independent directors will have an independent staff to assist with monitoring fund activities and compliance;
- No board action can be taken without approval by a majority of the independent trustees;
- Putnam must inform shareholders when measures approved by a majority of the independent directors fail to pass through the full board;
- The Chief Compliance Officer must alert the funds' independent directors to any breach of fiduciary duty or securities law breaches on at least a quarterly basis;

- Putnam is required to maintain a Code of Ethics Oversight Committee which monitors compliance with the Code of Ethics and which meets and reports to the audit committee at least quarterly;
- Putnam must establish an Internal Compliance Controls Committee chaired by the Compliance Officer;
- Putnam is required to retain an Independent Compliance Consultant to undertake a comprehensive review of Putnam's supervisory, compliance, and other policies and procedures designed to prevent or detect breaches of fiduciary duty, breaches of the Code of Ethics, and the federal securities laws; and
- Putnam must undergo an independent third party compliance review every two years.

The Implications

The implications of mandated corporate governance reforms on SEC regulated investment companies may be quite significant. The move to financial transparency embodied in the Sarbanes-Oxley Act reforms reaches new heights with the type of independent director empowerment and control contained in the Putnam settlement. Here, Putnam has agreed to yield significant control to independent trustees, has empowered the trustees to more effectively monitor the activities of the funds with increased resources, has opened itself up for regular independent review and analysis by third parties, and has committed to a regular cycle of independent review to help ensure that problems are raised to the attention of the independent trustees for action. Additionally, actions approved by the independent trustees that do not pass the full board must be communicated to the shareholders.

The takeaway is unmistakable. Non-monetary governance reforms are material terms for resolving issues with the SEC. In order to terminate or avoid regulatory scrutiny, regulated companies may be forced to open up their boardroom doors and internal processes for greater independent participation, control or review.

Practical Considerations

The Putnam settlement should provide a framework for other investment companies to engage in a self-analysis of their governance practices. This form of review will help assure that their governance practices are abreast of industry standards, which, in view of the significant investment withdrawals encountered by Putnam and other mutual funds beset by scandals, are likely to be of increasing concern to investors. As part of this self-analysis, investment companies should consider, among other things:

- How many independent directors serve on your board?
- Do you have an independent nominating committee to select directors?
- Do you have an independent audit committee that is solely responsible for the retention, oversight and termination of all engagements of independent accounting firms?

- Do the independent directors have the opportunity to meet regularly in executive session without the presence of any interested directors or fund managers?
 - Do the independent auditors have the opportunity to meet regularly in executive session with the funds' chief compliance officer, internal auditor and independent auditors?
 - Do you have a regular program for a full independent review and analysis of your compliance procedures?
 - Do you have a code of ethics that binds each of your directors, officers and employees?
 - Do you have independent hotlines for employees and investors to anonymously report suspected ethical, legal or policy transgressions?
 - Are these governance initiatives made public to your investors through your website or other prominent means?
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If you have any questions or require further information regarding these or any other matters, please call your regular Nixon Peabody contact or feel free to contact any of the partners and counsel in our Corporate Governance Law practice group listed on the final page of this *Corporate Responsibility Alert*.

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