

**MEMO# 19942**

April 10, 2006

## **Court of Appeals Vacates Fund Governance Standards But Gives SEC 90 Days to Seek Public Comment on Implementation Costs**

©2006 Investment Company Institute. All rights reserved. Information may be abridged and therefore incomplete. Communications from the Institute do not constitute, and should not be considered a substitute for, legal advice. [19942] April 10, 2006 TO: BOARD OF GOVERNORS No. 14-06 CLOSED-END INVESTMENT COMPANY MEMBERS No. 13-06 SEC RULES MEMBERS No. 33-06 SMALL FUNDS MEMBERS No. 28-06 RE: COURT OF APPEALS VACATES FUND GOVERNANCE STANDARDS BUT GIVES SEC 90 DAYS TO SEEK PUBLIC COMMENT ON IMPLEMENTATION COSTS The United States Court of Appeals for the District of Columbia Circuit has issued an opinion concluding that the Securities and Exchange Commission failed to comply with the federal Administrative Procedure Act (APA) in estimating the costs of complying with two provisions in its fund governance rule amendments – specifically, the requirements that a mutual fund must have (1) a board with no less than 75% independent directors and (2) an independent chair.\* The court has vacated those standards but, in essence, will delay the effectiveness of this ruling for 90 days. The opinion explains that this 90-day period will give the SEC time to seek public comment on the costs of implementing the two standards and to file a status report with the court. The court ruled that the SEC relied extensively on material outside of the public record in developing certain of its cost estimates and failed to afford an opportunity for public comment on the material, as required by the APA. In particular, the opinion states that the SEC relied on privately produced “Management Practice Inc. Bulletins” and a nonpublic survey of compensation and governance practices in the fund industry. The bulletins, which summarized the survey, were the only source of data on which the SEC based its assumptions regarding the average number of directors serving on a fund board, the average director salary, and the average number of funds overseen by an individual director, and the SEC used these assumptions to estimate the annual compensation cost per fund of the 75% requirement. \* See *Chamber of Commerce v. SEC*, No. 05-1240 (D.C. Cir. Apr. 7, 2006). A copy of the opinion is available on the Institute’s website at <http://members.ici.org/getPublicPDF.do?file=secvcommerce2006>. 2 The court found that interested parties were not placed on notice that the SEC “would base its cost estimates on an extra-record summary of extra-record survey data that, although characterized as ‘a widely used survey,’ was not the sort, apparently, relied upon by [the SEC] during the normal course of its official business.” According to the court, the Chamber of Commerce was prejudiced by the SEC’s reliance on the extra-record material, based on the Chamber’s showing that “it had something useful to say about this critical data.” In determining the

appropriate remedy for the SEC's procedural violation, the court observed that a significant portion of the fund industry appears to be in "substantial compliance" with the fund governance rule amendments, so that immediately vacating the two standards could cause substantial disruption for the industry and investors. The opinion further notes that the SEC's noncompliance with the APA does not necessarily mean that the agency's cost estimates, nor its weighing of the costs and benefits of the two requirements, were incorrect. The opinion states that "[the SEC] is in a better position than the court to assess the disruptive effect of vacating" the two standards. Rachel H. Graham Associate Counsel

---

Copyright © by the Investment Company Institute. All rights reserved. Information may be abridged and therefore incomplete. Communications from the Institute do not constitute, and should not be considered a substitute for, legal advice.