

MEMO# 20110

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SEC Seeks Additional Comments on Fund Governance Requirements

©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. [20110] June 15, 2006 TO: BOARD OF GOVERNORS No. 18-06 CLOSED-END INVESTMENT COMPANY MEMBERS No. 23-06 SEC RULES MEMBERS No. 51-06 SMALL FUNDS MEMBERS No. 43-06 RE: SEC SEEKS ADDITIONAL COMMENTS ON FUND GOVERNANCE REQUIREMENTS The Securities and Exchange Commission is requesting additional comment on the costs of certain of its 2004 investment company governance rule amendments.¹ The request for comment was issued in response to an April 7, 2006 opinion of the United States Court of Appeals for the District of Columbia Circuit in a case challenging two provisions in the fund governance rule amendments – specifically, the requirements that a mutual fund relying on certain exemptive rules have (1) a board with no less than 75% independent directors and (2) an independent chair.² The court ruled that the SEC failed to comply with the federal Administrative Procedures Act in estimating the costs of complying with these requirements. On this basis, the court vacated the rules, but delayed issuing its mandate and ordered the SEC to file a status report with the court within ninety days.³ The Release is summarized below. Comments are due to the SEC by August 21, 2006. 1 Investment Company Act Release No. 27395 (June 13, 2006) (“Release”). The Release and a related press release are available on the SEC’s website at <http://sec.gov/rules/proposed/2006/ic-27395.pdf> and <http://sec.gov/news/press/2006/2006-95.htm>, respectively. 2 See *Chamber of Commerce v. Securities and Exchange Commission*, 443 F.3d 890 (D.C. Cir. 2006); see also Memorandum to Board of Governors No. 14-06, Closed-End Investment Company Members No. 13-06, SEC Rules Members No. 33-06, and Small Funds Members No. 28-06 [19942] (Apr. 10, 2006). 3 The SEC’s press release indicates that the SEC filed a status report in which it said it is soliciting comment on costs as well as “any issue related to the underlying purpose of the independence requirements, which is the protection of funds and fund shareholders.” 2 Summary of the Release The Release seeks comment on both monetary and non-monetary costs of the 75 percent and independent chair requirements. It notes that the court found the SEC’s discussion of costs, together with an expressed expectation that these costs would be “minimal,” to be inadequate. To address this, the SEC particularly seeks reliable cost data in support of commenters’ assertions. The Release acknowledges the court’s critique that the SEC had based its cost estimates in part on data from an industry survey that was not a part of the rulemaking record. As a result, the SEC specifically solicits comment on the adequacy of those estimates and on other appropriate measures of costs. The SEC also seeks comment regarding current cost data, including such items as implementation data for funds that have voluntarily complied with either or both of the

requirements. It requests comment on any other costs that funds may incur in coming into compliance with the two requirements that were not identified in an earlier SEC release.⁴ The SEC noted that it is particularly interested in the costs incurred by small fund groups. With respect to the 75 percent requirement, the SEC specifically requests information regarding the costs of hiring and recruiting independent directors and whether the increased percentage resulted in the hiring of additional legal or other resources to support the independent directors. Regarding the independent chair requirement, the SEC requests information about the costs of hiring and compensating independent chairs and whether independent chairs use additional legal services or hire additional staff. The Release notes that comments on costs may be made on an industry-wide basis or on an individual fund basis, and that comments that are accompanied by supporting data and analysis are of greatest assistance. It also requests comment on any issue related to the underlying purpose of the amendments, which is the protection of funds and fund shareholders, and any issue related to the SEC's required determination whether the amendments promote efficiency, competition, and capital formation. General Counsel's Review The SEC also announced in its press release that Chairman Cox has asked the SEC's General Counsel to conduct a top-to-bottom review of the SEC's process for complying with the National Securities Markets Improvement Act of 1996 and other laws that require an economic analysis of rule proposals. According to the press release, the purpose of the review is to ensure that the SEC takes full advantage of the significant expertise of its professional staff – both in the operating divisions and in the 4 Investment Company Act Release No. 26985 (July 1, 2005); see also Memorandum to Board of Governors No. 32-05, Closed-End Investment Company Members No. 39-05, SEC Rules Members No. 84-05, and Small Funds Members No. 63-05 [19004] (July 8, 2005). 3 Office of Economic Analysis – when preparing the legally mandated analysis of economic impact that must accompany proposed regulations. Jane G. Heinrichs Associate Counsel