

**MEMO# 19004**

July 8, 2005

## **SEC RESPONSE TO COURT DECISION ON FUND GOVERNANCE RULES; CHAMBER OF COMMERCE PETITION FOR REVIEW**

©2005 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. [19004] July 8, 2005 TO: BOARD OF GOVERNORS No. 32-05 CLOSED-END INVESTMENT COMPANY MEMBERS No. 39-05 SEC RULES MEMBERS No. 84-05 SMALL FUNDS MEMBERS No. 63-05 RE: SEC RESPONSE TO COURT DECISION ON FUND GOVERNANCE RULES; CHAMBER OF COMMERCE PETITION FOR REVIEW The Securities and Exchange Commission last week approved by a 3 to 2 vote a proposed response to a decision by the U.S. Court of Appeals for the District of Columbia Circuit. The decision remanded for further consideration two issues related to the Commission's 2004 adoption of governance reforms requiring 75 percent of a fund's directors, and the board's chairman, to be independent.<sup>1</sup> Specifically, the court unanimously ruled that the Commission failed to adequately consider the costs of complying with the requirements, as well as to adequately consider a proposed disclosure alternative to the independent chair requirement. The Commission's release responding to the court's decision<sup>2</sup> and the dissenting statements of Commissioners Glassman and Atkins<sup>3</sup> are summarized below. Yesterday, the Chamber of Commerce filed a petition for review with the Court of Appeals. The petition also is summarized below and a 1 Chamber of Commerce of the United States v. SEC, No. 04-1300, slip op. (D.C. Cir. June 21, 2005) (<http://pacer.cadc.uscourts.gov/docs/common/opinions/200506/04-1300a.pdf>). See also Memorandum to Board of Governors No. 30-05, Closed-End Investment Company Members No. 35-05, SEC Rules Members No. 80-05 and Small Funds Members No. 58-05 [18962], dated June 22, 2005 (regarding court of appeals ruling in Chamber of Commerce lawsuit challenging fund governance rules). 2 Investment Company Act Release No. 26985 (July 1, 2005) (the "Release") (<http://www.sec.gov/rules/final/ic-26985.pdf>). See also Concurring Views of Chairman Donaldson at Open Commission Meeting (<http://www.sec.gov/rules/final/donaldson062905.pdf>); Concurring Views of Commissioner Harvey J. Goldschmid at Open Commission Meeting (<http://www.sec.gov/rules/final/goldschmid062905.pdf>); and Concurring Views of Commissioner Roel C. Campos at Open Commission Meeting (<http://www.sec.gov/rules/final/campos062905.pdf>). 3 Dissent of Commissioner Cynthia A. Glassman (<http://www.sec.gov/rules/final/glassman062905.pdf>); Dissent of Commissioner Paul S. Atkins (<http://www.sec.gov/rules/final/atkins062905.pdf>). 2 The Release briefly discusses the court's remand order, noting that the court "did not vacate the rule amendments" and that "they remain in effect." As a threshold matter, the Release addresses whether it was necessary for the Commission to engage in additional fact-

gathering to implement the court's remand order, or otherwise to engage in further notice and comment procedures. The Release states that the Commission majority found that the existing record and other publicly available information are "a sufficient base on which to rest the Commission's consideration of the deficiencies identified by the court." The Release also cites several reasons why the Commission majority believed prompt action was necessary. For example, the Release states that a failure to act prior to the departure of Chairman Donaldson on June 30, 2005 would risk a delay in resolving the matter, which would create "significant uncertainties and potential harm to investors." The Release then addresses the costs of complying with the two new conditions. First, with regard to the condition that at least 75 percent of a fund's board be independent, the Release provides an estimate of certain costs associated with adding independent directors, including costs for recruiting new directors, additional annual compensation costs and the cost of increased reliance by new independent directors on the services of independent legal counsel. According to the Release, funds that choose to comply by decreasing the number of interested directors likely would incur only minimal direct costs, and it would be impracticable to quantify the indirect costs of this approach. With respect to the costs of complying with the condition that the chairman be independent, the Release first provides an estimate of the costs that funds may incur if the independent chair decides to hire additional staff to help fulfill his or her responsibilities. It also provides an estimate of the cost of possible increased compensation for independent chairs to reflect their additional responsibilities. The Release next discusses the impact of the costs of compliance on funds' efficiency, competition and capital formation. It states that the Commission majority found that the costs associated with complying with the new governance rules are "extremely small relative to the fund assets for which fund boards are responsible, and also are small relative to the expected benefits of the two conditions." It reiterates the Commission majority's view that any potential impact of the amendments would be positive, due to several benefits that the Commission majority believes the amendments will have. For example, the Release cites the Commission majority's belief that the new rules would enhance the quality and accountability of the fund governance process and promote investor confidence. Turning to the disclosure alternative to the independent chair requirement, the Release discusses distinctions between the Investment Company Act and other federal securities laws as well as between investment companies and ordinary business corporations. It states that the Commission majority does not believe that disclosure alone is sufficient to adequately protect against the risk that a fund's manager will engage in self-dealing. The Release also notes that there are obstacles to providing investors with meaningful disclosure and that the independent chair requirement was adopted as part of a larger series of reforms to promote fund compliance. 3 The Release includes a brief response to the comments of the two dissenting Commissioners at the Commission's open meeting on June 29, 2005. The Release summarizes their objections as: (i) the quick action by the Commission majority prevents further notice and comment and sufficient consideration by the staff and Commission; (ii) the action taken is inconsistent with the court's opinion; (iii) the comments sought at the time of the initial rulemaking did not include the costs associated with the independent chair condition; and (iv) the Commission majority's quick action is unprecedented and unjustified. In addition to noting that these concerns largely are addressed elsewhere in the Release, the Release states that "it is in the best tradition" of the Commission, "and not at all unusual, for the Commission to act swiftly on important initiatives in response to market developments and other factors." Finally, the Release states that upon further consideration, the Commission majority has concluded that the benefits of the two conditions "far outweigh their costs, and that the disclosure alternative does not afford adequate protection to fund investors." Therefore, according to the Release, the Commission majority has determined not to

modify the amendments. Dissenting Statement of Commissioner Glassman In her dissent, Commissioner Glassman objected to the Commission majority's action "in the strongest possible terms." She expressed the view that the prudent response to the court's mandate would be to seek public comment on the issues identified by the court. She then described several "procedural deficiencies." Commissioner Glassman referred to the Release as "an assembly of false statements, unsupported assumptions, flawed analyses and misinterpretations." She took issue with the statements in the Release that the Commission could address the court's concerns on the basis of the record already before it because, she noted, the proposing release did not solicit comment on the particular matters at issue. In addition, Commissioner Glassman objected to the failure to include in the public record letters from the public submitted relating to this reconsideration. Dissenting Statement of Commissioner Atkins Commissioner Atkins echoed many of the same points as Commissioner Glassman relating to the procedural and substantive deficiencies of the action, which was conducted in a very short time frame and without a "serious attempt made to solicit my views or incorporate them into the Commission's release."

Commissioner Atkins also criticized the majority's reliance on estimates of costs and newly discovered information in the public realm when some funds had already begun to comply with the new requirements and the Commission could have obtained actual costs. He expressed the view that the Commission majority failed to consider the disclosure alternative prior to the adoption of the rule and efforts to remedy this defect were inadequate. Finally, Commissioner Atkins challenged the reasons cited by the Commission majority for not taking a more deliberate approach. He noted, for example, that "if the Commission adopts a meritorious rule under lawful procedures, then the composition of the Commission that adopted it is irrelevant." 4 Chamber of Commerce Petition for Review The Chamber of Commerce filed a petition for review of the Commission's final rule re-adopting requirements that mutual funds have an independent chair of the board and 75 percent independent directors. The petition notes that the Commission re-adopted these requirements at an open meeting "held only 6 business days after" the court ordered the SEC to address certain deficiencies in its original adoption of the requirements. It asks the court: (1) to hold the two requirements unlawful under the Investment Company Act, Administrative Procedure Act, and the terms of the court's remand in its June 21, 2005 decision; (2) to vacate the requirements; (3) to issue a permanent injunction prohibiting the Commission from implementing and enforcing the requirements; and (4) for such other relief as the court deems appropriate. Frances M. Stadler Deputy Senior Counsel Attachment (in .pdf format) Note: Not all recipients receive the attachment. To obtain a copy of the attachment, please visit our members website (<http://members.ici.org>) and search for memo 19004, or call the ICI Library at (202) 326-8304 and request the attachment for memo 19004.