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A legal update from Dechert's Financial Services Group

Challenges to Mutual Fund Governance Rule Continue

Last summer, the Securities and Exchange Commission ("SEC") adopted amendments to the corporate governance rules applicable to registered funds. The amended rules require that in order for a fund to take advantage of several commonly-used exemptive rules, among other requirements, at least 75% of the members of its board of directors and the board chair must be independent of the fund's investment adviser.

The mutual fund governance rule has been the subject of two recent challenges: first, Congress directed the SEC to submit a report justifying the independent chair requirement; and second, the Chamber of Commerce of the United States filed a lawsuit seeking to overturn the two requirements.

On June 21, 2005, a federal court of appeals ruled that although the SEC has the authority to adopt the two requirements, it failed to adequately consider the costs funds would incur in order to comply, and did not fully consider alternatives. The battle may not yet be won, however. In response to the ruling, the SEC quickly scheduled an open meeting on June 29, 2005, one day before the scheduled resignation of SEC Chairman William H. Donaldson, to consider the matters remanded to the SEC by the court.

Background

In July 2004, the SEC adopted rule amendments under the Investment Company Act of 1940, as amended ("1940 Act"), requiring every registered investment company ("fund") that seeks to rely on ten commonly used SEC exemptive rules[1] to adopt new practices designed to improve fund governance.[2] By January 16, 2006, among other requirements, each fund seeking to rely on any of the Exemptive Rules must have a board of directors (1) consisting of at least 75% independent directors and (2) with an independent chairperson.

75% Independent Directors

The SEC believes that the 75% requirement will help (1) ensure that independent directors carry out their fiduciary responsibilities and (2) counter fund management's control over day-to-day activities and greater access to fund

[1] The exemptive rules are Rules 10f-3, 12b-1, 15a-4(b)(2), 17a-7, 17a-8, 17d-1(d)(7), 17e-1, 17g-1, 18f-3 and 23c-3 (collectively, the "Exemptive Rules").

[2] Investment Company Governance, SEC Release No. IC-26520 (July 27, 2004), 69 FR 46378 (Aug. 2, 2004) ("Adopting Release"). By January 16, 2006, each fund seeking to rely on any of the Exemptive Rules must adopt the following fund governance practices:

- The board of directors must consist of directors, at least 75% of whom are not "interested persons" of the fund, as such term is defined in the 1940 Act.
- The chairperson of the board must be an independent director.
- The board must conduct an annual self-assessment of its performance.
- Independent directors must meet quarterly outside the presence of non-independent directors.
- Independent directors must be authorized to hire employees and retain experts.

information than that afforded to independent directors. The goal of the 75% requirement is to "strengthen the hand of the independent directors when dealing with fund management, and ... assure that independent directors maintain control of the board and its agenda."[3]

Independent Director as Chairperson

The SEC believes that requiring an independent director to serve as chairperson of a fund's board of directors will enhance a board's ability to act independently from the fund's investment adviser. In the Adopting Release, the SEC stated that "a fund board is in a better position to protect the interests of the fund, and to fulfill the board's obligations under the [1940] Act and the Exemptive Rules, when its chairman does not have the conflicts of interest inherent in the role of an executive of the fund adviser."[4] The SEC also stated that:

> [T]he board chairman can play an important role in setting the agenda of the board, and in establishing a boardroom culture that can foster the type of meaningful dialogue between fund management and independent directors that is critical for healthy fund governance. The chairman can play an important role in providing a check on the adviser, in negotiating the best deal for shareholders when considering the advisory contract, and in providing leadership to the board that focuses on the long-term interests of investors. We believe that a fund chairman is in the best position to fulfill these responsibilities when his loyalty is not divided between the fund and its investment adviser.[5]

Stressing that the independent chairperson requirement should not be viewed as diminishing the value that executives, including the CEO, of the adviser bring to a fund's boardroom, the SEC indicated that it "fully expect[s] that these executives will continue to serve on fund boards, although not in the capacity of chairman, and thus will have every opportunity to engage the board on issues important to the fund investors as well as the management company."[6]

[3] Adopting Release at Sec. III.A.

[4] Adopting Release at Sec. III.B.

[5] *Id.*

[6] *Id.*

Recent Challenges

The new fund governance requirements have been controversial since they were first proposed by the SEC. The SEC adopted the rule by a three-to-two vote, with the two dissenting commissioners, Paul Atkins and Cynthia Glassman, taking the unusual step of questioning in writing the factual basis upon which the rule was adopted.[7] On September 2, 2004, the U.S. Chamber of Commerce filed suit against the SEC, claiming that the agency lacked the legal authority to impose the new governance standard on funds. More recently, in its current fiscal-year appropriation for the SEC, Congress directed the agency to justify the reason for requiring funds to have independent chairpersons and to report back to Congress by May 1, 2005.

U.S. Chamber of Commerce Litigation

The U.S. Chamber of Commerce ("Chamber") challenged the independent chair and the 75% independence requirements on three grounds:

- In adopting the two requirements, the SEC exceeded its authority under the 1940 Act.
- The SEC offered inadequate justification for the two requirements.
- The SEC violated basic requirements of the Administrative Procedure Act ("APA")[8], in that the SEC was required by law to consider the effect of the new rule on competition, efficiency, and capital formation.

The United States Court of Appeals for the District of Columbia Circuit ruled on June 21, 2005, that the SEC acted within its authority to adopt the two conditions and that the SEC's rationale for the conditions satisfies the APA.[9] However, the three-judge panel agreed with the Chamber that the SEC failed to consider the costs funds would incur in complying with the new governance rule, and stated that the SEC has an "obligation to determine as best it can the economic implications of the rule it has proposed."[10] Therefore, the court sent the governance

[7] Adopting Release at page 36.

[8] 5 U.S.C. §551 et seq.

[9] *Chamber of Commerce of the United States of America v. SEC*, 04-1300, U.S. Court of Appeals for the District of Columbia Circuit.

[10] *Id.* at page 15-16.

rule back to the SEC to address the deficiencies with the two conditions.

Staff Report

In response to Congress' request, the SEC submitted a report on the independent chair requirement to the SEC dated April 2005 ("Report")[11]. In the 78-page Report, the SEC staff acknowledges that "the empirical data regarding the relationship between an independent chairman and fund performance and fees are inconclusive."[12] Nevertheless, it defends the new fund governance standards as a necessary response to the recent mutual fund scandals.

According to the Report, the SEC found it necessary to strengthen independent oversight of fund operations with new rules that preclude fund management executives from serving as chairperson of the fund board: "[T]he Commission adopted the independent chair condition as a means of enhancing independent oversight of the conflicts of interest inherent in the transactions permitted by the Exemptive Rules."[13] A majority of the Report consists of a comprehensive review of fund governance, conflicts of interest and recent mutual fund scandals.

The staff approaches the independent chair requirement with the premise that "[i]ndependently chaired boards are better able to oversee fund operations and monitor conflicts of interest."[14] In support of this premise, the Report cites numerous comment letters from investors, directors, associations, institutions, and members of Congress. The staff included as an appendix a comment letter from all seven living former chairmen of the Commission, stating, "An independent mutual fund board chairman would provide necessary support and direction for independent fund directors in fulfilling their duties by setting the board's agenda, controlling the conduct of meetings, and enhancing meaningful dialogue with the adviser."[15]

In contrast with the extended discussion of conflicts, the analysis of the relationship between an independent chair and fund performance, expenses and compliance, as requested by Congress, is relatively brief. The staff begins by noting that "[t]he Commission did not adopt the independent chair provision as a means of enhancing fund financial performance or reducing fund expenses."[16] The report calls into question a study which concluded that funds with a management chairperson have better performance and lower fees than those with an independent chairperson.[17]

With respect to compliance, the Report notes the difficulties of determining in hindsight whether unethical and unlawful conduct would have been prevented with an independent chair in place. The staff emphasizes that the independent chair rule is "part of a larger package of regulatory reforms in the wake of the Commission's enforcement actions involving mutual fund trading that demonstrated a serious compliance breakdown."[18] The staff believes that an independent chair can improve fund compliance because "[i]n several of the Commission's enforcement actions, senior personnel of advisers to funds overruled their compliance personnel in favor of business considerations that benefited the fund's managers rather than the fund's investors."[19]

At the conclusion of the Report, the staff asserts that the reaction to the independent chair rule has been largely positive; that it is not aware of any funds having problems finding qualified candidates to serve as independent chair; and that many funds have already begun implementing the independent chair requirement.[20] The Report ends with the recommendation that the Commission and staff continue to monitor how the presence of an independent chair on the board changes the independence and effectiveness of the board.[21]

In an unusual step, Commissioners Atkins and Glassman dissented in a letter which accompanies the Report. The letter states that the Report failed to respond adequately

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11 *See* Staff Report to the U.S. Securities and Exchange Commission, *Exemptive Rule Amendments of 2004: The Independent Chair Condition* (April 2005).

12 *Id.* at page 2.

13 *Id.*

14 *Id.* at pages 50-60.

15 Comment Letter of Richard C. Breeden, G. Bradford Cook, Roderick M. Hills, Arthur Levitt, Harvey L. Pitt, David S. Ruder, and Harold M. Williams (June 15, 2004), File No. S7-03-04.

16 Report at page 54.

17 *Id.* at p. 64.

18 Id. at page 74, citing Compliance Programs of Investment Companies and Investment Advisers, Investment Company Act Release No. 26299 (Dec. 17, 2003).

19 *Id.*

20 *Id.* at p. 77.

21 *Id.* at pages 77-78.

to the questions posed by Congress, and that it offers no evidence to support its premises.[22] The Commissioners wrote that the Report does not justify the independent chair rule, and that the SEC staff did not provide the analysis Congress requested on whether funds with independent chairmen have lower fees, better performance or better compliance records than those chaired by management executives. Instead, "[t]he bulk of the report is merely a lengthy history of the SEC's exemptive rules and a description of the recent market timing and late trading enforcement cases."

They disagreed with the Report's claim that the independent chair rule improves management of funds' conflicts of interest and that such management aims to "deter overreaching by fund managers and protect the interests of fund investors."[23] The Commissioners urged that managing conflicts is a "means to an end, not an end in itself," and called for a focus on investor protection—"protecting investors from fraud, maintaining good performance, and keeping costs down."[24]

Conclusion

In a swift response to the ruling in the Chamber lawsuit, the SEC scheduled a meeting on June 29, 2005, to consider the matters remanded to the SEC by the court. It remains to be seen whether the SEC will consider new cost data at that meeting.

Congress has not yet acted in response to the Report filed in April by the SEC.

A key factor in the future of the mutual fund governance rule is the scheduled resignation of the SEC Chairman William H. Donaldson at the end of this month. If the SEC does not act on the rule at the June 29 meeting, the decision on whether to proceed with the rule would be left to Chairman Donaldson's successor.

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22 *Letter from Commissioners Glassman and Atkins re: Staff report on the Exemptive Rule Amendments of 2004: The Independent Chair Condition* (April 29, 2005).

23 *Id.* citing the Report.

24 *Id.*

Additional practice group contacts

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