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A legal update from Dechert's Financial Services Group

SEC's Response to Appeals Court Ruling in Chamber of Commerce Case Leads to Further Appeal

On June 21, 2005, the United States Court of Appeals for the District of Columbia Circuit (the "Court"), in response to a petition by the Chamber of Commerce of the United States (the "Chamber"), remanded to the Securities and Exchange Commission ("SEC" or "Commission"), in part, for additional consideration, amendments to certain exemptive rules.[1] The SEC held a meeting on June 29, 2005, the day before Chairman Donaldson's last day on the Commission, and over the dissent of two Commissioners, re-adopted these amendments (the "Exemptive Rule Amendments"). Subsequently, the SEC issued a 32-page release justifying its actions.[2]

On July 7, 2005, the Chamber appealed the adoption of the Exemptive Rule Amendments, asking the Court for a permanent injunction to block them. The Chamber then submitted to the SEC a motion for a stay of the effectiveness of the Exemptive Rule Amendments. On July 15, that motion was rejected.[3] On July 26, the Chamber filed a 26-page Motion for Stay ("Motion") with the Court, requesting that the Court stay the requirements of the Exemptive Rule Amendments, or alternatively, expedited review. Among other things, the Motion generally repeats the arguments of the two dissenting Commissioners, and argues that a stay is necessary to prevent irreparable harm and to enable the Court to provide meaningful relief.

Background

The SEC originally adopted the Exemptive Rule Amendments in July 2004, with two Commissioners dissenting.[4] The Chamber challenged the Commission's action in the Court on the grounds that the SEC lacked the legal authority to impose the 75% independent board and the independent chair requirements. The Chamber based its challenge on three grounds:

- In adopting the requirements, the SEC exceeded its authority under the Investment Company Act of 1940, ("1940 Act").
- The SEC offered inadequate justification for the two requirements.

1 *Chamber of Commerce of the United State of America v. SEC*, No. 05-1240, (D.C. Cir. Jun. 21, 2005); Rel. No. IC-26520 (Jul. 27, 2004) (the "*Adopting Release*"). By January 16, 2006, each fund seeking to take advantage of any of the ten commonly-used exemptive rules to engage in certain transactions otherwise prohibited by the Act, must have a board of directors with (1) no less than 75% independent directors, and (2) a chairman who is independent of the fund's investment adviser. 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 Rel. No. IC-26985 (Jun. 30, 2005) (the "Response").

3 The Commission met on July 15, deadlocked 2-2 (Commissioners Glassman and Atkins for the stay and Commissioners Goldschmid and Campos against), and issued an Order, signed by Commissioner Glassman as acting Chairman, denying the motion (IC. Rel. No 26989, Jul. 15, 2005). The filing of the motion was required as a prerequisite to filing a motion for a stay with the Court.

4 *See* Adopting Release, *supra* note 1.

- The SEC violated basic requirements of the Administrative Procedure Act ("APA"), in that the SEC was required by law to consider the effect of the new rules on competition, efficiency, and capital formation.

On June 21, 2005, the Court held that the SEC has the legal authority to adopt the two requirements, but that it failed to adequately consider the costs that funds would incur in order to comply with the rules, and did not fully consider disclosure as an alternative. Accordingly, the Court remanded the matter to the SEC to address these deficiencies.

Regarding the 75% independence requirement, the SEC stated in the Adopting Release that "our staff has no reliable basis for determining how funds would choose to satisfy this requirement, and therefore it is difficult to determine the costs associated with electing independent directors." However, the Court had noted "[t]hat [this] particular difficulty [of determining aggregate costs] may mean that the Commission can determine only the range within a fund's cost of compliance will fall," and directed the SEC "to determine as best it can the economic implications of the rule."

The SEC's Response

The 75% Condition

In the Response, the SEC concluded that, relying on comment letters and publicly available information, it did have a reliable basis to consider the range of costs associated with the different ways in which funds can comply with the 75% condition. Funds can comply with the requirement by (a) adding independent directors, or (b) decreasing interested directors. The costs per fund vary based on whether a board oversees a large number of funds or only one fund.

Adding Independent Directors

The SEC estimated that the annual compensation cost per fund for appointing one independent director could range from $1,593 to $12,500 per fund.[5] Further, the SEC estimated that the total costs in the first year for funds that appoint three new independent directors could range from $9,687 per fund (for boards that oversee a large number of funds) to $84,000 per fund (for boards that oversee one fund). Annual costs in subsequent years would decrease to a range of $5,864 per fund (for boards that oversee a large number of funds) to $54,000 per fund (for boards that oversee only one fund). The SEC estimated that the costs will be higher if a board elects, rather than appoints, new directors.[6] Funds that must obtain shareholder approval for new independent directors will incur additional costs of soliciting proxies from shareholders. It estimated the average costs of soliciting proxies as $75,000 per fund.[7]

Decreasing Interested Directors

The SEC stated that funds that simply decrease the size of their boards and allow some interested directors to resign are likely to incur only minimal direct costs. Because this option is the simplest of the three options and imposes the lowest direct costs, it is likely that most funds will use this option. The SEC acknowledged that the loss of experience on the board can have a possible non-monetary cost, and stated that nothing in the Exemptive Rule Amendments would prohibit interested persons from participating in board meetings.

The Independent Chair Condition

The Court noted that "the Commission may not have been able to estimate the aggregate cost to the mutual fund industry of additional staff because it did not know what percentage of funds with [an] independent chairman would incur that cost, [but] it readily could have estimated the cost to an individual fund." In the Response, the SEC stated that, based on the record and publicly available information, "[it had] concluded that [it] in fact [has] a reliable basis for estimating the costs to an individual fund" associated with the independent chairman condition. The SEC noted that some commenters have raised the issue of loss of experience and the associated non-monetary cost if the interested

5 For boards that oversee a large number of funds as defined in the Response and boards that oversee only one fund, respectively.

6 The SEC estimated that current first year costs for funds in which the board appoints three new independent directors could range from $11,624 per fund (for boards that oversee a large number of funds) to $100,800 per fund (for boards that oversee only one fund). It further estimated that the current first year costs for funds that elect three new independent directors could range from $101,624 per fund (for boards that oversee a large number of funds) to $190,800 per fund (for boards that oversee only one fund).

7 If a fund must obtain shareholder approval for three new independent directors, the costs to add the directors could range from $84,687 per fund (for bards that oversee a large number of funds) to $159,000 per fund (for boards that oversee one fund).

chairperson were to resign from the board. But the SEC pointed out that, since the interested chairperson typically is one of the most senior officers of the fund's investment adviser, and thus has a direct interest in the operations of the fund, it is unlikely that such a director will resign even though he or she no longer functions as the chairperson.

In the Response, the SEC estimated that the compensation for an independent chairperson may be 25% to 50% higher than the compensation of other directors. Therefore, the SEC estimates that the total cost increases could range from $1,147 to $9,000 each year, per fund.

The SEC acknowledged that it could not determine how many independent chairmen would require the hiring of additional staff to support them, but stated that, in its judgment, in most cases independent chairpersons will be expected to hire no more than two staff employees, consisting of one full-time senior business analyst and one full-time executive assistant. The SEC believes that these costs will be borne primarily by larger fund complexes, and that independent chairmen at smaller complexes will rarely choose to hire additional staff.

Promotion of Efficiency, Competition, and Capital Formation

As required by the Court , the SEC considered the quantitative and qualitative impact of the costs of compliance with the two requirements on a fund's efficiency, competition, and capital formation. In the Response, the SEC found that the costs are extremely small relative to the assets for which fund boards are responsible, and are also small relative to the expected benefits. The SEC expects that the minimal added expense of compliance with these conditions will have little, if any, adverse effect on efficiency, competition, or capital formation. Indeed, it anticipates that compliance with the Exemptive Rule Amendments will help increase investor confidence, which may lead to increased efficiency and competitiveness of the U.S. capital markets. It also anticipates that this increased market efficiency and investor confidence may encourage more efficient capital formation.

With respect to the 75% condition, the SEC argued that costs are minor compared to the amount of assets under management.[8] For funds that decrease the size of the board, the costs are insignificant. For funds that appoint three new independent directors, using the data from a 2004 survey and adding a 20% cushion, the ongoing annual costs range from $64,800 per fund for boards that oversee only one fund, down to $7,037 per fund for boards that oversee a large number of funds. Startup costs in the first year are somewhat more per fund: from $100,800 per fund for boards that oversee only one fund, to $11,624 per fund for boards that oversee a large number of funds. For funds that cannot appoint the new directors and must solicit proxies, the first year costs per fund increase to $190,800 for boards that oversee only one fund, and to $101,624 for boards that oversee a large number of funds.

The SEC stated that the costs of the independent chairperson condition are likewise small. If the independent chairperson hires two full-time staff and additional independent legal counsel, the total is only $329,639, which would be divided among the number of funds overseen by the independent chairman. The additional per fund compensation received by the independent chairman could range from $9,000 for a single fund, down to $1,147 for an independent chairman who oversees a large number of funds. The average fund will incur only $47,220 in additional compensation costs.

The SEC noted that its estimates represent the high range of potential cost of compliance, and the average cost per fund to the industry as a whole will likely be much lower. At the time the SEC adopted the rule amendments, 60% of funds already complied with the 75% condition and will incur no additional cost as a result of the implementation. The SEC expects that few boards will hire additional staff and add three new independent directors; and that most are likely to decrease the size of their board or add one or two new directors. Its highest cost estimates are for boards that oversee only a single fund, which is an atypical situation.

Furthermore, the SEC argued the requirements provide very important benefits. The 75% condition will:

- Promote strong fund boards that effectively perform their oversight role;
- Enhance oversight by a strong, effective, and independent fund board that will protect funds and their shareholders from abuses that can

8 The SEC pointed out that, using any of the options, the costs per fund will be no more than a very small fraction of the fund assets for which the fund boards are responsible. The SEC estimates that average fund assets in 2003 were $912 million based on a total of assets in 2003 of $7.414 trillion and a total of 8,126 mutual funds (excluding funds that invest in other mutual funds).

occur when funds engage in the conflict-of-interest transactions permitted under the Exemptive Rule Amendments;

- Increase investor confidence and promote investment in funds.

The SEC asserted that the independent chairperson condition will provide similar benefits:

- The chair can have a substantial influence on the fund's board agenda and boardroom culture.
- An independent chair will advance meaningful dialogue between the fund adviser and independent directors, and will support independent directors in overseeing the fund adviser.
- An independent board led by an independent chair is more likely to vigorously represent investor interests when negotiating with the fund adviser on matters such as fees and expenses.

The SEC found that that these cumulative benefits fully justify the costs associated with the rule amendments; and that each of the proposed amendments is likely, when taken together with other Commission reforms, to have a significant potential prophylactic benefit in preventing harm from conflict-of-interest transactions. It stated that it does do not expect the Exemptive Rule Amendments to have a significant adverse effect on efficiency, competition, or capital formation, because the costs associated with the amendments are minimal and many funds have already adopted the required practices.

To the extent that these amendments do affect competition or capital formation, the SEC continues to believe that the effect will be positive and will enhance the fund governance process. The SEC believes that promoting investor confidence in the fairness and integrity of the individuals that monitor investment companies promotes investment in mutual funds, and this will lead to increased efficiency and competitiveness of the U.S. capital markets.

Consideration of the Disclosure Alternative

The Court also stated that the Commission did not adequately consider an alternative to the independent chair condition, discussed by the two dissenting Commissioners, that "each fund be required prominently to disclose whether it has an inside or an independent chairman and thereby allow investors to make an informed choice."

In the Response, the SEC stated that it does not believe that this proposal would adequately protect fund investors from the potential abuses inherent in the conflict-of-interest transactions permitted under the Exemptive Rule Amendments given the nature of investment companies and the purposes of the statutory prohibitions. The SEC argued that:

- Funds are unique in that they are organized and operated by people whose primary loyalty and pecuniary interest lie outside the enterprise, thereby presenting an inherent conflicts of interest and potential for abuses.
- Congress enacted the 1940 Act, including the statutory prohibitions to which the Exemptive Rule Amendments apply, to address these conflicts of interest. In particular, the 1940 Act, by setting standards for independent directors, and their role as "watchdogs" for the interests of fund shareholders, played a crucial role in restoring confidence in investment companies.
- Federal securities laws protect investors by providing disclosure to enable them to make an informed investment decision. The utility of such disclosure is limited and it does not prevent self-dealing. The 1940 Act prohibits certain transactions that involve conflicts of interest and the resulting potential for self-dealing. The objectives of these prohibitions will best be served by enhanced independent oversight and strengthening investor confidence that those in charge of managing the fund will act in the investors' interests.
- Even assuming that meaningful disclosure is an adequate alternative, the SEC doubts the sufficiency of disclosure. Prospectus disclosure needs to inform investors of the conflicts of interest that fund advisers face, the complex role of the fund board in managing those conflicts, and the potential consequences to investors of the failure of fund boards to protect against conflicts. Meaningful disclosure of these matters is difficult.
- The SEC did not adopt the independent chairperson requirement in isolation, as it is part of a larger package of regulatory reforms that should lead to enhanced compliance by funds that have independent chairs. Under rules the

SEC adopted in December 2003, each fund is required to have a chief compliance officer who is responsible for, among other things, keeping the fund's board of directors apprised of significant compliance events at the fund or its service providers and for advising the board of needed changes in the fund's compliance program.

- The chairperson can play an important role "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." An independent chairperson is better equipped to serve in this role.

The SEC continues to find that it is necessary and appropriate in the public interest and consistent with the protection of investors to condition a fund's reliance upon any of the Exemptive Rule Amendments upon it having an independent chairperson.

Response to Dissenting Commissioners at the Open Meeting

At the Commission's open meeting, the dissenting Commissioners raised various objections to the SEC's Response. The dissenters asserted that the Commission is acting too quickly, which prevents further notice and comment procedures that are either required or desirable, and which prevents sufficient consideration by the staff and Commission. They argued that:

- The Commission's action is inconsistent with certain aspects of the Court's opinion.
- The Commission did not seek comments on the costs associated with the independent chair condition at the time of the initial rulemaking.
- Acting so quickly is unprecedented and unjustified.[9]

The Commission disagrees and asserts that the Response has largely addressed these concerns.

The SEC finds that any further delay or ambiguity surrounding the implementation of the rules would disadvantage not only investors, but also fund boards and management companies, most of which have already begun the process of coming into compliance. It also notes that the issues remanded to the Commission by the Court are discrete and clearly defined; indeed, the Court observed that part of its task on remand could be accomplished "readily."

Finally, the Commission notes that it is in the best tradition of the institution, and not unusual, for the Commission to act swiftly on important initiatives in response to market developments and other factors. The Commissions states that the staff and the Commission have a strong foundation of experience with the fund governance rules, which has enabled it to address the issues raised by the Court within a relatively short period of time.

Conclusion

The SEC concluded that the benefits of the 75% independent director condition and the independent chairman condition far outweigh their costs, and that the disclosure alternative does not afford adequate protection to fund investors. Accordingly, it determined not to modify the amendments.

Additional Appeal

On July 7, 2005 the Chamber petitioned the Court to review the SEC's final rule re-adopting the New Fund Governance Rules. In this petition, the Chamber claimed that the SEC "had not adequately addressed the deficiencies previously identified by the Court in its June 21 decision," and asked the Court "to hold the independent chair and the 75% independent director requirements unlawful under the Investment Company Act, the Administrative Procedure Act and the terms of this Court's remand . . ., to vacate the requirements and to issue a permanent injunction prohibiting the implementing and enforcing the requirements. . . ." Further substantive bases of the Chamber's arguments are not included in the petition, but Eugene Scalia, who represents the Chamber in the case, has stated that the SEC "has engaged in an unprecedented, headlong rush to rubber-stamp its earlier decisions, without the thorough, deliberate, and open-minded consideration demanded by the unanimous court of appeals, and by the law."

As noted earlier, pending the Court's response to the Chamber's petition, the Chamber filed a motion with the SEC for a stay of the independent chair and 75% independent director requirements. On July 15, 2005,

[9] Commissioners Glassman and Atkins put these comments in writing and they were appended to the Response, together with the separate concurring opinions of Chairman Donaldson and Commissioners Goldschmid and Campos.

the Commission denied this motion.[10] On July 26, the Chamber filed a Motion, requesting that the Court stay the requirements of the Exemptive Rule Amendments, or alternatively, expedited review.

At the time of the drafting of this Alert, it is uncertain how the Court will respond to the Chamber's petition or Motion. On June 2, 2005, President Bush nominated Representative Christopher Cox as Chairman of the SEC. It is unclear what immediate effect his appointment will have on the Exemptive Rule Amendments.

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10 *See supra* note 3

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