

SEC Seeks Public Comment on Mutual Fund Governance Amendments

On April 7, 2006, the U.S. Court of Appeals for the District of Columbia Circuit found that the SEC had violated the Administrative Procedure Act (the "APA")¹ by failing to seek public comment on certain data used to estimate the compliance costs of the amendments to ten exemptive rules ("Exemptive Rules") under the Investment Company Act of 1940 that require that mutual funds wishing to rely on the Exemptive Rules be comprised of at least 75% independent directors and chaired by an independent director.² (the "Governance Rules") The court's opinion addressed a challenge brought by the United States Chamber of Commerce to these two provisions of the Exemptive Rules. The court found that the SEC had the authority to adopt these rules but that the APA violation warranted vacating them.

However, in the interest of preventing disruption to the mutual fund industry, and in light of widespread fund compliance with the rules, the court delayed issuing a mandate vacating these amendments for 90 days to give the SEC an opportunity to address this violation by seeking public comment on the cost estimates used in support of the amendments.³

On June 13, 2006, within the required 90-day period, the SEC issued a Release announcing that the SEC is seeking comments on costs as well as "any issue related to . . . the protection of funds and fund shareholders."⁴ Separately,

SEC Chairman Christopher Cox has asked the SEC's general counsel to review 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.

Background ⁵

The SEC adopted the Governance Rules in July 2004, and as noted above, the Chamber of Commerce challenged the enactment of these amendments in court on the grounds that the SEC lacked authority to adopt the amendments, and that the enactment of these amendments violated the APA.

On June 21, 2005, the court found that the SEC "did not exceed its statutory authority in adopting the two conditions."⁶ However, the court found that "the Commission did violate the APA by failing adequately to consider the costs mutual funds would incur in order to comply with the conditions and by failing adequately to consider a disclosure alternative to the independent chairman condition."⁷ As a result, the court remanded to the SEC to address these deficiencies in the rulemaking process.

On June 29, 2005, one day preceding the departure of then SEC Chairman Donaldson, the

¹ 5 U.S.C. § 551 *et seq.* (2000).

² *Chamber of Commerce v. SEC*, 443 F.3d 890 (D.C. Cir. 2006).

³ *Id.* at 909.

⁴ Rel. No. IC- 27395 (June 13, 2006). The SEC also filed the release with the court.

⁵ For additional details on the amendments and history of this case, see the following "Dechert: On Point" legal updates: June 2005 (Issue 11), July 2005 (Issue 14), September 2005 (Special Alert), and January 2006 (Issue 1).

⁶ *Chamber of Commerce v. SEC*, 412 F.3d 133, 136 (D.C. Cir. 2005).

⁷ *Id.* at 136.

SEC addressed these issues in a public meeting, making additional findings of fact and affirming the adoption of the amendments, and the following day issued a release to that effect.⁸ The SEC found that “information in the existing record, together with publicly available information upon which we may rely, is a sufficient base on which to rest the Commission’s consideration of the deficiencies identified by the Court.”⁹ The “publicly available” reports on which the Commission relied were two privately produced bulletins released by Management Practice Inc. in June 2003 and April 2004, which summarized a non-public survey of compensation and governance practices in the mutual fund industry. These sources provided three key assumptions on which the SEC relied, including the number of directors serving on the boards of most mutual funds, the median annual salaries for directors, and the rough breakdown between boards overseeing a large number of funds versus a small number of funds.¹⁰

Due to the solicitation of comments pertaining to compliance costs from the initial comment period, the SEC found no reason to reopen the record for additional comment in response to the court’s holding, instead making findings of fact related to the independent director condition based on the comments and other data that had been gathered during the initial notice and comment period, as well as the extra-record materials described above. Ultimately, the SEC concluded that costs would be “minimal” relative to the benefits conferred by the amendments, even at the high end of the possible range of compliance costs identified.¹¹

The SEC’s response to the remand was challenged by the Chamber of Commerce, and on April 7, 2006, the court held that the SEC’s response had failed to remedy the APA violation identified in the court’s June 21, 2005, opinion. The court held that by failing to reopen the notice and comment period to get public comment on the data used to estimate the costs of the amendments to the governance rules, the SEC had not corrected the violation of section 553(c) of the APA. The court found that, although interested parties had been

given an opportunity to comment on the conditions of the proposed amendments, interested parties were denied the opportunity to comment on extra-record materials that were extensively relied upon during the rulemaking process.¹²

The court granted the petition of the Chamber of Commerce to vacate the two conditions at issue, but withheld issuing the mandate for ninety days to give the SEC the opportunity to address the violation. As the court noted, the rulemaking record, though incomplete, “does not, of itself, indicate that the Commission’s cost estimates are incorrect, much less that . . . the costs of implementing the two conditions do not outweigh the benefits of adopting the two conditions.”¹³

The court did not reach the Chamber of Commerce’s other challenges to the SEC’s Remand Release.

The SEC’s Request for Comments

Comments Solicited on Costs

As indicated above, the SEC is soliciting comments on the costs associated with these amendments to address procedural shortcomings identified by the court, specifically regarding the gaps in the rulemaking record. The court found the SEC’s reliance on data from an industry survey that was not part of the rulemaking record, and the absence of data on costs from the notice and comment process, left a hole in the record, which was not remedied by the SEC’s discussion of costs and assertion that costs would be “minimal.”¹⁴

The SEC has requested comments on the following issues related to costs:

- Potential direct and indirect costs associated with the 75% and independent chair conditions
- Adequacy of the estimates used in the rulemaking process, and the adequacy of the underlying industry survey on which those estimates were partially based

⁸ Rel. No. IC-26985 (June 30, 2005).

⁹ *Id.*

¹⁰ 443 F.3d at 902.

¹¹ *Id.*

¹² 443 F.3d at 901.

¹³ *Id.* at 909.

¹⁴ *Id.* at 903 citing Rel. No. IC-26985, *supra*.

- Current cost data for funds that have voluntarily complied with either or both conditions
- Any other compliance costs incurred, particularly those incurred by small fund groups
- Better sources of cost information than those on which the SEC relied

In addition to these general categories of comments, the SEC also requested comment on specific issues related to the implementation costs for funds that have already complied with the new amendments. For the 75% independent director condition, the issues to be addressed include the costs of hiring and recruiting independent directors, as well as costs associated with additional legal or other support staff for these independent directors. For the independent chair condition, the issues to be addressed include the costs of hiring and compensating an independent chair, whether additional legal services and staff costs have been associated with the new independent chair, and whether there are any other costs associated with this condition that were not addressed by the SEC during the initial notice and comment period.

The SEC has specified that these comments can be made on an industry-wide or individual fund basis, but that comments accompanied by supporting data and analysis will be of greatest assistance.

Comments Solicited on Protection of Funds and Fund Shareholders

The SEC Release also requests comments on whether these two mutual fund conditions will provide improved governance for funds and improved protection

for fund shareholders. In addition to comments on the current mutual fund governance conditions, the SEC has also requested suggestions for additional amendments to the governance rules that would achieve these goals.

As noted by the court, the SEC's "reliance on extra-record materials . . . effectively acknowledges gaps in the rulemaking record that could not be properly supplemented without further opportunity for comment..."¹⁵ Therefore, the SEC has also solicited comments about whether these conditions will promote efficiency, competition, and capital formation, as required when the SEC is engaged in rulemaking under Section 2(c) of the Investment Company Act.¹⁶

The deadline for comments is August 21, 2006.



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¹⁵ *Id.* at 909.

¹⁶ 15 U.S.C. § 80a-2(c) (2000).

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