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A legal update from Dechert's Financial Services Group

Corporate Governance Rule Comment Period Reopened

At a U.S. Securities and Exchange Commission ("SEC") open meeting held on December 13, 2006, the SEC met to discuss a variety of issues related to the securities markets. The last item on the agenda for the meeting was a consideration of whether the SEC should reopen the June 2006 comment period regarding amendments to its investment company governance provisions ("Fund Governance Rules") that were first adopted in 2004.

At the end of the meeting, Chairman Cox announced that the Commissioners had voted *seriatim* to reopen the comment period earlier in the day. On December 29, 2006, the SEC posted the two papers on its website with comments due by March 2, 2007.

Background[1]

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[2] to adopt practices designed to improve fund governance.[3] By January 16, 2006, among other requirements, each fund seeking to rely on any of the Exemptive Rules was to have a board of directors consisting of at least 75% independent directors and with an independent chairperson.

Soon after their promulgation, the Fund Governance Rules were challenged by both the U.S. Congress and the U.S. Chamber of Commerce. Congress directed the SEC to submit a report justifying the independent chair requirement while the U.S. Chamber of Commerce challenged both the SEC's authority to adopt the two regulations and the method by which the SEC conducted its rulemaking.

On the latter issue, the U.S. Court of Appeals for the District of Columbia Circuit found that the SEC had violated the Administrative Procedure Act ("APA") "by failing adequately to consider the costs mutual funds would incur in order to comply with the conditions and failing

1 For additional details on the amendments and case history of legal challenges to the amendments, see the following *Dechert OnPoint* legal updates: June 2005(Issue 11); July 2005 (Issue 14); September 2005 (Special Alert); January 2006 (Issue 1); and June 2006 (Issue 7).

2 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").

3 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 of whom at least 75% are not "interested persons" of the fund, as the 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.

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adequately to consider a disclosure alternative to the independent chairman condition."[4]

Rather than reopen the issue for further industry comment, the SEC, at an open meeting on June 29, 2005, by a three to two vote, made additional findings of fact and affirmed the adoption of the Fund Governance Rules. The Commission justified its decision not to reopen the comment period by noting that it had solicited comments pertaining to compliance costs during the initial comment period.[5]

The Chamber of Commerce again challenged the actions of the SEC in the U.S. Court of Appeals for the District of Columbia Circuit. On April 7, 2006, the court held in favor of the Chamber of Commerce finding that the SEC had not corrected the violation of section 553(c) of the APA. The court found that, although interested parties had been given the 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.[6]

The court granted the petition of the Chamber of Commerce to vacate the two regulations at issue, but withheld issuing the mandate for 90 days to give the SEC an opportunity to address the APA violation by seeking public comment on the cost estimates used in support of the Fund Governance Rules.[7]

The Comment Periods

On June 13, 2006, the SEC began soliciting comments on costs as well as "any issue related to . . . the protection of funds and fund shareholders."[8] That general comment period closed on August 6, 2006.

On December 13, 2006, prior to its open meeting, the SEC approved the publication of a release announcing that it would reopen the comment period to elicit industry comment on two forthcoming Office of Economic Analysis papers.[9] The first paper, entitled "Literature Review on Independent Mutual Fund Chairs and Directors," addresses conflicts of interest between investment advisers and their investment companies.[10]

The second paper, entitled "Power Study as Related to Independent Mutual Fund Chairs," analyzes the "statistical properties of mutual fund returns and potential limitations inherent in any empirical analysis designed to identify a relationship between those returns and fund governance."[11] The deadline for comments is March 2, 2007.

The SEC stated in its December 13 release that some of the comments provided during the June 2006 comment period addressed the costs of the new provisions, but"[f]ew . . . directly addressed in a meaningful way the economic implications of the provisions."[12] The SEC stated that it is seeking to build the record on the costs of the Fund Governance Rules. In a recent letter to the SEC, the Chamber of Commerce continued to oppose the Fund Governance Rules.[13] How this will ultimately play out remains unclear.

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

5 *Chamber of Commerce v. SEC*, 443 F.3d 890, 902 (D.C.Cir. 2006).

6 *Id* at 901.

7 *Id* at 909.

8 Investment Company Governance, SEC Release No. IC-27395 (June 13, 2006) ("Request for Additional Comment").

9 Investment Company Governance, SEC Release No. IC-27600 (Dec. 15, 2006).

10 OEA Memorandum Investment Company Governance, File No. S7-03-04, Chester S. Spatt, Chief Economist 12/29/06.

11 *Id.*

12. SEC Release No. IC-27600 (Dec. 15, 2006), *supra*, note 9.

13 Rachel McTague, *Hedge Funds: SEC Unanimously Proposes Rules on Hedge Funds, One to Restore Powers*, SEC. REG. & L. REP., Dec. 18, 2006.

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