

## SECURITIES AND EXCHANGE COMMISSION

### 17 CFR Part 270

[Release No. IC-27395; File No. S7-03-04]

RIN 3235-AJ05

### Investment Company Governance

**AGENCY:** Securities and Exchange Commission.

**ACTION:** Request for additional comment.

**SUMMARY:** On April 7, 2006, a Federal appeals court invalidated certain amendments adopted by the Securities and Exchange Commission ("Commission") to rules under the Investment Company Act of 1940 ("Act"). The Court found that the Commission had failed to seek comment on the data used to estimate the costs of the amendments, but suspended issuing its mandate in order to give the Commission an opportunity to request further comment. Because the Court's decision called into question the regularity of our proceedings, the Commission now invites further comment on the amendments, including particularly their costs. The amendments, first proposed on January 15, 2004, would impose two conditions on investment companies ("funds") relying on certain exemptive rules. First, fund boards would have to be comprised of at least 75 percent independent directors. Second, the boards would have to be chaired by an independent director. In addition to the costs of the two conditions, commenters may address any issue related to the underlying purpose of the two conditions, which is the protection of funds and fund shareholders. As required by section 2(c) of the Investment Company Act, the Commission specifically seeks comment on whether the proposed rule amendments will promote efficiency, competition, and capital formation.

**DATES:** Comments must be received on or before August 21, 2006.

**ADDRESSES:** To help us process and review your comments more efficiently, comments should be sent by one method only.

#### Electronic Comments

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/proposed.shtml>); or
- Send an e-mail to [rule-comments@sec.gov](mailto:rule-comments@sec.gov). Please include File Number S7-03-04 on the subject line; or
- Use the Federal eRulemaking Portal (<http://www.regulations.gov>). Follow the instructions for submitting comments.

#### Paper Comments

- Send paper comments in triplicate to Nancy M. Morris, Secretary, Securities and Exchange Commission, 100 F Street, NE., Washington, DC 20549.

All submissions should refer to File Number S7-03-04. The Commission will post all comments on the Commission's Internet Web site (<http://www.sec.gov/rules/proposed.shtml>). Comments are also available for public inspection and copying in the Commission's Public Reference Room, 100 F Street, NE., Washington, DC 20549. All comments received will be posted without change; we do not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly.

**FOR FURTHER INFORMATION CONTACT:** Vincent Meehan, Staff Attorney, or Penelope Saltzman, Branch Chief, Office of Regulatory Policy, (202) 551-6792, Division of Investment Management, Securities and Exchange Commission, 100 F Street, NE., Washington, DC 20549.

#### SUPPLEMENTARY INFORMATION:

##### I. Background

On July 27, 2004, the Commission adopted amendments to ten exemptive rules under the Investment Company Act<sup>1</sup> ("Exemptive Rules") to require funds that rely on one or more of those rules to adopt certain governance practices.<sup>2</sup> The conditions were part of a package of amendments designed to protect the interests of funds and the fund shareholders they serve. Among other things, the amendments added two conditions for funds relying on the Exemptive Rules. First, such a fund must have a board of directors with no less than 75 percent independent directors.<sup>3</sup> Second, such a fund must be chaired by an independent director. The reasons for the Commission's adoption of these conditions, as well as other amendments to the Exemptive Rules, were set forth at length in the Adopting Release issued July 27, 2004.<sup>4</sup>

The two conditions were challenged in the United States Court of Appeals for the District of Columbia Circuit. On

June 21, 2005, the Court remanded to the Commission for consideration of two deficiencies that it identified in the rulemaking.<sup>5</sup> After considering those two issues at a public meeting on June 29, 2005, the Commission issued a release announcing its decision not to modify the rule amendments ("Remand Release").<sup>6</sup> The June 29 action was then challenged, and the Court on April 7, 2006, issued an opinion holding that the Commission violated the Administrative Procedure Act<sup>7</sup> by failing to seek comment on the data used to estimate the costs of the two conditions.<sup>8</sup> The Court vacated the two conditions, but withheld its mandate for 90 days to afford the Commission an opportunity to reopen the record for comment.<sup>9</sup>

##### II. Discussion

The 75 percent condition and the independent chair condition have been extensively discussed in the prior Commission releases,<sup>10</sup> and commenters are referred to the discussion in those releases for a detailed treatment of them. The Commission requests comment on the costs associated with the two conditions, and suggestions for additional provisions designed to achieve the underlying purpose of the amendments, which is the protection of funds and fund shareholders.

The Court found the Commission's discussion of costs, together with an expressed expectation that these costs would be "minimal," to be inadequate. To address this, the Commission particularly seeks reliable cost data in support of commenters' assertions.

For example, in the Remand Release we attempted to identify all of the potential costs associated with the 75 percent and independent chair conditions when we assigned an estimate of direct and indirect costs to each of them; we seek comment on all of these and any other potential costs. In addition, while the Remand Release acknowledged that these costs would likely vary depending upon which of various methods funds chose to come into compliance with the conditions,

<sup>5</sup> *Chamber of Commerce v. Securities and Exchange Commission*, 412 F.3d 133 (D.C. Cir. 2005).

<sup>6</sup> See *Investment Company Governance*, Investment Company Act Release No. 26985 (June 30, 2005) [70 FR 39390 (July 7, 2005)] ("Remand Release").

<sup>7</sup> 5 U.S.C. 553(c).

<sup>8</sup> *Chamber of Commerce v. Securities and Exchange Commission*, 443 F.3d 890 (D.C. Cir. 2006).

<sup>9</sup> *Id.* at 909.

<sup>10</sup> *Investment Company Governance*, Investment Company Act Release No. 26323 (Jan. 15, 2004) [69 FR 3472 (Jan. 23, 2004)] ("Proposing Release"); *Adopting Release*, *supra* note 2; *Remand Release*, *supra* note 6.

<sup>1</sup> 15 U.S.C. 80a.

<sup>2</sup> *Investment Company Governance*, Investment Company Act Release No. 26520 (July 27, 2004) [69 FR 46378 (Aug. 2, 2004)] ("Adopting Release"). The Exemptive Rules are listed in the Adopting Release at footnote 9.

<sup>3</sup> In this Release, we are using "independent director" to refer to a director who is not an "interested person" of the fund, as defined by the Act. See section 2(a)(19) of the Act [15 U.S.C. 80a-2(a)(19)].

<sup>4</sup> See Adopting Release, *supra* note 2.

such as whether a fund came into compliance with the 75 percent condition as a result of the resignation of one or more interested directors or the selection of one or more new independent directors,<sup>11</sup> the Court was critical of the fact that we based those estimates in part on data from an industry survey that was not a part of the rulemaking record. We specifically solicit comment, therefore, on the adequacy of those estimates and on other appropriate measures of costs.

The Court directed our attention to gaps in the rulemaking record. We now solicit comment regarding current cost data, including such items as implementation data for funds that have voluntarily complied with either or both of the conditions. We also request comment on any other costs that funds may incur, in coming into compliance with the two conditions, that were not identified in the Remand Release. We are particularly interested in the costs incurred by small fund groups.<sup>12</sup>

<sup>11</sup>In the Adopting Release we estimated that approximately 60 percent of funds met the 75 percent condition at the time we adopted the rule. Adopting Release, *supra* note 2, at n.78. Of those that subsequently came into compliance, our staff estimates that, based upon filings made with the Commission during the last year, 49 percent did so solely as a result of one or more interested directors resigning from the board of directors, and 14 percent did so solely as a result of adding one or more independent directors. Thirty-seven percent of funds coming into compliance with the 75 percent condition experienced a change in the composition of their boards as a result of (i) the addition of independent directors and the resignation or retirement of interested directors, (ii) the resignation or retirement of both independent and interested directors, or (iii) the addition of both independent and interested directors.

<sup>12</sup>For purposes of the Small Business Regulatory Enforcement Fairness Act of 1996, we request

With respect to the 75 percent condition, we request comment generally on both the monetary and non-monetary costs that funds experienced specifically relating to compliance. What were the costs of hiring and recruiting independent directors?<sup>13</sup> Has the increased percentage resulted in the hiring of additional legal or other resources to support the independent directors? If so, what are the associated costs?

What were the monetary and non-monetary costs to funds of complying with the independent chair condition?<sup>14</sup> What were the costs of hiring and compensating an independent chair, as we anticipated they might, use additional legal services? If so, how much? Did they hire additional staff? If so, what are the associated costs? The Court, in discussing the two conditions in its April 7 opinion, found that the Commission viewed the costs to an individual fund of the independent chair condition to derive principally from the increased compensation for the independent chair and the costs of

comment on the potential impact of the conditions on the U.S. economy on an annual basis. 5 U.S.C. 804(2). In addition, we incorporate the Regulatory Flexibility Act analyses contained in the prior Commission releases, including the solicitation of comments therein.

<sup>13</sup>Our staff estimates that, based upon filings made with the Commission during the last year, 54 percent of funds that came into compliance with the 75 percent condition solicited a shareholder vote to elect directors.

<sup>14</sup>See Adopting Release, *supra* note 2, at n.81. Our staff estimates, based upon filings made with the Commission during the last year, 97 percent of newly selected independent chairmen were selected from among the incumbent independent directors.

additional staff, without allowing sufficient comment on these matters. Are there other costs that should be taken into account? Are there better sources of information than those upon which the Commission relied?

Comment on costs may be made on an industry-wide basis or on an individual fund basis. Comments that are accompanied by supporting data and analysis are of greatest assistance.<sup>15</sup>

Finally, we note that the underlying purpose of the two conditions was, and remains, the protection of funds and fund shareholders, and that, as we have been reminded by the Court, we are bound in this rulemaking under the Investment Company Act to consider “whether the action will promote efficiency, competition, and capital formation.” For these reasons we solicit comment on any issue related to the underlying purpose of the two conditions, and any issue related to our required determination whether the amendments promote efficiency, competition, and capital formation.

By the Commission.

Dated: June 13, 2006.

**Nancy M. Morris,**  
*Secretary.*

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<sup>15</sup>The Commission considers costs in connection with its obligations under section 2(c) of the Investment Company Act, which requires the Commission, when engaging in rulemaking that requires it to consider or determine whether an action is necessary or appropriate in the public interest, to consider whether the action will promote efficiency, competition, and capital formation. See 15 U.S.C. 80a-2(c). We solicit comment on any other aspect of the conditions that would affect this consideration.