SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 270

[Release No. IC–26985; File No. S7–03–04]

RIN 3235–AJ05

Investment Company Governance

AGENCY: Securities and Exchange Commission.

ACTION: Commission response to remand by court of appeals.

SUMMARY: The Commission has considered further its adoption of amendments to rules under the Investment Company Act of 1940 to require investment companies (''funds'') that rely on certain exemptive rules to adopt certain governance practices. The reconsideration responds to a decision by the United States Court of Appeals for the District of Columbia Circuit remanding to us for further consideration two issues raised by the rulemaking.

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SUPPLEMENTARY INFORMATION: In *Chamber of Commerce of the United States of America* v. *Securities and Exchange Commission,* the United States Court of Appeals for the District of Columbia Circuit remanded to us, in part, for additional consideration certain amendments we adopted last year to ten rules under the Investment Company Act of 1940 (''Investment Company Act'' or ''Act'').[1] The amendments are applicable to funds that rely on any of ten exemptive rules the Commission has adopted under the Investment Company Act (''Exemptive Rules'').[2] The amendments were designed to enhance the independence and effectiveness of fund boards and to improve their ability to protect the interests of the funds and fund shareholders they serve. As the Court directed, the Commission has carefully considered the issues identified by the Court in remanding this matter to us. We have determined, in light of that consideration, that the amendments to the Exemptive Rules require no modification.

I. Background

On July 27, 2004, the Commission adopted amendments to the Exemptive Rules under the Investment Company Act to require funds that rely on one or more of those rules to adopt certain governance practices.[3] Among other things, the amendments added two conditions for relying on the Exemptive Rules. The amendments require that, if a fund relies on at least one of the Exemptive Rules to engage in certain transactions otherwise prohibited by the Act, the fund must have a board of directors with (i) no less than 75 percent independent directors,[4] and (ii) a chairman who is an independent director. We adopted the amendments in the wake of a troubling series of enforcement actions involving late trading, inappropriate market timing activities, and misuse of nonpublic information about fund portfolios.[5]

The two new conditions were challenged by the Chamber of Commerce, which submitted a petition for review to the United States Court of Appeals for the District of Columbia Circuit. In that case, the Chamber of Commerce asserted that the Commission (i) lacked authority to adopt the amendments, and (ii) violated the Administrative Procedure Act (''APA'').[6]

On June 21, 2005, the Court of Appeals issued its decision that ''the Commission did not exceed its statutory authority in adopting the two conditions, and the Commission's rationales for the two conditions satisfy the APA.'' [7] The Court noted the broad authority granted to the Commission to exempt transactions ''subject only to the public interest and the purposes of the [Act].'' [8] In addition, the Court found that our actions were reasonable in light of the significant problems we identified with mutual funds that have arisen as a result of serious conflicts of interest.

The Court, however, remanded to the Commission for our consideration two deficiencies that it identified in the rulemaking. First, the Court held that, in connection with our statutory obligation to consider whether the conditions will promote efficiency, competition and capital formation, we did not adequately consider costs associated with the 75 percent independent board and the independent chairman conditions. Second, the Court stated that we did not give adequate consideration to an alternative discussed by the two Commissioners who dissented from the adoption of the rules (''disclosure alternative''). The Court did not vacate the rule amendments, however, and they remain in effect.[9]

II. Introduction

In this Release, we further consider and address the two issues raised by the Court's remand order. As a threshold matter, we consider whether it is necessary to engage in additional fact-gathering to implement the Court's remand order, or otherwise engage in further notice and comment procedures.[10] The existing record, which was before the Commission at the time the amendments were adopted, was developed through full notice and comment procedures. The notice initiating those procedures and soliciting public comment proposed two conditions for exemption that were substantially identical to the conditions that we adopted and that are supported by our additional discussion in this Release. Although the Court held that we ultimately failed in our Adopting Release adequately to address the issues identified by the Court in its opinion, we had specifically sought and received comment on the costs associated with the two conditions and had considered those costs at the time of the initial rulemaking. We further note that the original notice solicited comment on

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[1] *Chamber of Commerce of the United States of America* v. *SEC,* No. 04–1300, slip op. (D.C. Cir. June 21, 2005) (''Slip Opinion'').

[2] 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.

[3] Adopting Release, *supra* note 2.

[4] 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)].

[5] *See* Adopting Release, *supra* note 2, at nn.5–6 and accompanying text.

[6] 5 U.S.C. 551 *et seq.*

[7] Slip Opinion, *supra* note 1, at 2.

[8] *Id.* at 7.

[9] *See id.* at 19 (ordering the matter ''remanded'' and citing *Fox Television Stations, Inc.* v. *FCC,* 280 F.3d 1027, 1048–49 (D.C. Cir. 2002) (explaining reasons for remanding a rulemaking without vacating) and *Allied Signal, Inc.* v. *U.S. Nuclear Regulatory Comm'n,* 988 F.2d 146, 150–51 (D.C. Cir. 1993) (same)).

[10] Where, as here, a court does not specify a required procedure, the agency is free on remand to determine whether supplemental fact-gathering is necessary. Furthermore, if the existing record is a sufficient base on which to address on remand the court-identified deficiencies, additional notice and comment procedures are not required. *See Sierra Club* v. *EPA,* 325 F.3d 374, 382 (D.C. Cir. 2003) (following the ''usual rule'' by remanding ''for further explanation, though not necessarily for further notice-and-comment rulemaking''); *National Grain and Feed Ass'n, Inc.* v. *OSHA,* 903 F.2d 308, 310–11 (5th Cir. 1990) (leaving ''the agency free on remand to determine whether supplemental fact-gathering is necessary for correction of the perceived error or deficiency.''). *See also AT&T Wireless Servs., Inc.* v. *FCC,* 365 F.3d 1095, 1103 (D.C. Cir. 2004) (upholding after remand additional explanation of prior FCC decision where FCC found on remand that ''the existing record was 'a sufficiently adequate base on which to rest the Commission's decision * * *'').

whether there were alternatives that would serve the same or similar purposes, and elicited comment on the disclosure alternative.[11] We find that the 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. Thus, our consideration and discussion in this Release of the two issues relies upon that record and previously available public information, and we have determined that it is not necessary to engage in further notice and comment procedures in order to follow the Court's direction on remand.

Moreover, engaging in further notice and comment procedures is not only unnecessary, it risks significant harm to investors without significant corresponding benefits, given the adequacy of the information currently available upon which we may rely. The amendments to the Exemptive Rules are the centerpiece of a broader regulatory effort to restore investor confidence in the mutual fund industry in the wake of the discovery of serious wrongdoing at many of the nation's largest fund complexes and by officials at the highest levels of those complexes. Fund managers acted in their own interests rather than in the interests of fund investors (which they are required to do), resulting in substantial investor losses that were well documented at the time we adopted the amendments. Further, subsequent events, although they do not form the basis of our action, have shown that the level of wrongdoing, and the corresponding investor losses, were in fact significantly greater than was known at that time. By acting promptly, we hope to bolster investor confidence, resolve any uncertainties associated with the remand, and ensure that investors receive the protections afforded by the amendments without delay.[12] It is important that we avoid postponement of the compliance date and the attendant potential harm to investors and the market that would result.[13]

Because Chairman Donaldson was scheduled to leave the Commission on June 30, 2005, and his replacement, although announced by the President, had not been formally nominated by him or confirmed by the Senate, we considered it important to act on this important matter no later than the time of our open meeting scheduled for June 29, 2005. In adopting the amendments to the Exemptive Rules, we carefully considered the issues presented by the rulemaking and reviewed the extensive record before the Commission. This is the last opportunity to bring the collective judgment and learning of all of us, who have spent the last year and a half thinking about the issues raised in this rulemaking, to bear on the important questions presented to us by the Court. Given our unique familiarity with these matters, we think it is both important and appropriate for the same five of us to consider the issues raised by the Court on remand, especially given the potential harm that may result from delay in resolving this matter.

We take very seriously and act with the utmost respect for the Court of Appeals' admonition that we failed adequately to consider the costs imposed upon funds by the two challenged conditions, and failed to consider the disclosure alternative. Our determination to act promptly in no way diminishes our obligation to make a deliberate and careful consideration of the issues raised by the Court. We have undertaken to address those issues upon remand promptly because we are convinced that we can do so with the thoroughness and careful consideration required by the Court's direction to us, and without the sacrifice to investor protection that delay would risk. Because we have previously sought and received comment, the Commission has a significant foundation from which to consider the issues remanded by the Court. In light of that experience, and because the existing record and other publicly available information allow us to undertake the additional consideration required, we have determined that we can fully discharge our responsibilities within the time necessary to allow participation by the same group of Commissioners that adopted the amendments to the Exemptive Rules. Our failure to act at this time, moreover, risks the creation of significant uncertainties and potential harm to investors that would not, in our judgment, be in the public interest.[14]

III. Discussion

A. Costs Resulting From Exemptive Rule Amendments

In the release proposing the amendments to the Exemptive Rules, we discussed and solicited comment on the costs and benefits of those rule amendments, and whether they would promote efficiency, competition and capital formation.[15] In the Adopting Release, we again discussed the costs and benefits of the amendments, and whether they would promote efficiency, competition and capital formation.[16]

In this Release, we reexamine the costs of the Exemptive Rule amendments in the two areas identified by the Court: (i) The costs to funds of complying with the condition that at least 75 percent of a fund's directors be independent; and (ii) the costs to funds of complying with the condition that the chairman be an independent director, particularly the costs of possible additional staff that the independent chairman might hire.[17]

1. Board Composition

The amendments will impose additional costs on funds that rely on any of the Exemptive Rules by requiring that independent directors constitute at least 75 percent of the fund board or, if the fund board has only three directors, that all but one director be independent. As discussed in the Adopting Release, we have estimated that nearly 60 percent of all funds currently meet the 75 percent condition.[18] A fund that does not already meet this condition may come into compliance with the 75 percent condition by: (i) Decreasing the size of its board and allowing some

[11] *See* Investment Company Governance, Investment Company Act Release No. 26323 (Jan. 15, 2004) [69 FR 3472 (Jan. 23, 2004)] (''Proposing Release''), at text preceding n.32; *see also* Comment Letter of the Financial Services Roundtable, File No. S7–03–04 (Mar. 10, 2004) (''[I]nvestors will be able to express their views on this [independent chairman] issue, given clear and appropriate disclosure. * * * Investors for whom this issue is a priority can direct their investments to those funds.''); Comment Letter of Greenspring Fund, Incorporated, File No. S7–03–04 (June 17, 2004) (''Greater disclosure of relevant information would allow shareholders to make better informed decisions. If an independent Chairman is desirable in the eyes of some investors, then make that information readily accessible.'').

[12] As noted above, the Court, while remanding a portion of the rulemaking for our consideration, did not vacate the rule amendments. *See* Slip Opinion, *supra* note 1, at 19.

[13] *See* Adopting Release, *supra* note 2, at Section IV (funds relying on Exemptive Rules must begin complying with the Exemptive Rule amendments after January 15, 2006).

[14] Even prior to our having issued this Release, there have been reports that additional legal proceedings may result from our action today. Accordingly, we are instructing our Office of the General Counsel to take such action as it considers appropriate to respond to any proceedings relating to this rulemaking.

[15] Proposing Release, *supra* note 11, at Sections V and VII.

[16] Adopting Release, *supra* note 2, at Sections VI and VIII. As the Court noted, section 2(c) of the Investment Company Act [15 U.S.C. 80a–2(c)] 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. Slip Opinion, *supra* note 1, at 12–13.

[17] In preparing estimates in this Release, we rely where appropriate on data that can be obtained or confirmed through publicly available filings under the Federal securities laws.

[18] *See* Adopting Release, *supra* note 2, at n.78.

interested directors to resign; (ii) appointing new independent directors either to replace interested directors (maintaining the current size of its board) or to increase the current size of its board; [19] or (iii) electing new independent directors either to replace interested directors (maintaining the current size of its board) or to increase the current size of its board.[20] In order to provide funds with maximum flexibility, we did not specify which option they must select.

In the Adopting Release, we stated 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.'' [21] The Court of Appeals noted, however, that ''[t]hat particular difficulty may mean the Commission can determine only the range within which a fund's cost of compliance will fall,'' [22] and directed that the Commission determine as best it can the economic implications of the rule. Based on the record in this matter, as well as our review of publicly available information, we have concluded that we do in fact have a reliable basis upon which to consider the range of costs associated with each of the different ways in which funds may choose to comply with the 75 percent condition, as the Court directed.

a. Adding Independent Directors

Funds that elect to add independent directors in order to meet the 75 percent condition have two options. They may replace some interested directors with independent directors, or they may increase the size of the board. Funds that choose simply to replace interested directors with independent directors or that add additional independent directors and are able to *appoint* the new independent directors may incur three kinds of costs. First, funds may incur initial and periodic costs of finding qualified candidates. Second, funds will incur annual compensation costs for the new independent directors. Third, funds could incur additional annual costs if new independent directors use additional services of independent legal counsel.[23] Because smaller fund groups typically provide less compensation (for overseeing fewer funds) than larger fund groups (for overseeing more funds), our compensation estimates are based on a range of potential costs.

We understand that a majority of funds have eight or fewer directors.[24] Accordingly, we conclude that most funds could appoint one or two independent directors in order to comply with the 75 percent condition.[25] For example, a board with eight directors could comply with the condition by replacing one interested director with an independent director.[26] However, we received one comment from a fund with five directors that stated it would not want to reduce the number of interested directors, and therefore would have to add three new independent directors in order to meet the 75 percent condition.[27] In light of this comment, and acting conservatively so as not to underestimate costs, we have estimated for purposes of this discussion that a fund would appoint three new independent directors.

Based on data from a 2004 survey of mutual fund directors' compensation,[28] we estimate that the median annual salary for directors ranges from $111,500 (for boards that oversee a large number of funds [29]) down to $12,500 (for boards that oversee from 1 to 6 funds). Consistent with the approach suggested by the Court with respect to the hiring of additional staff in connection with the independent chairman condition, we make the estimates based upon the potential costs to an individual fund. Thus, we estimate the annual compensation cost *per fund* for appointing one independent director could range from $1593 (for boards that oversee a large number of funds) to $12,500 (for boards that oversee only one fund).[30] Accordingly, if a fund were to appoint three independent directors, we

[19] Under some circumstances a vacancy on the board may be filled by the board of directors. *See* section 16(a) of the Investment Company Act [15 U.S.C. 80a–16(a)] (board vacancy may be filled by any legal manner if immediately after filling the vacancy at least two-thirds of directors have been elected by fund shareholders).

[20] Our description of the three options available to funds differs slightly from the description in the Adopting Release. As discussed in greater detail below, funds will incur costs to add new independent directors regardless of whether those new independent directors replace interested directors or increase the size of the board. Funds' costs will differ, however, depending on whether the board can appoint the new independent directors under section 16(a) of the Act or whether the fund's shareholders must approve the new independent directors. Unlike funds whose boards can appoint new independent directors, funds that must obtain shareholder approval for new independent directors will incur proxy solicitation expenses.

[21] *See* Adopting Release, *supra* note 2, at text accompanying n.80.

[22] Slip Opinion, *supra* note 1, at 15–16 (''That particular difficulty [of determining aggregate costs] may mean the Commission can determine only the range within which a fund's cost of compliance will fall, depending upon how it responds to the condition * * * .'').

[23] We also considered whether funds might incur additional costs as a result of additional premiums for directors' liability insurance. Most policies covering mutual fund directors' liability are priced based principally on the level of risk estimated by the insurer, on the amount of assets under management, and on the maximum aggregate limit of liability covered, rather than on the number of directors. Given our expectation that implementation of the rule amendments, with their effect of strengthening independent oversight of conflicts of interest, will reduce the risk of misconduct and ensuing investor losses, the cost of insuring against such risk should, if anything, be reduced. In any event, we have concluded that an increased cost of coverage associated with the two conditions, if any, will be minimal and will be adequately covered by the allowances for overhead and the cushions we have used in considering costs.

[24] *See* Management Practice Inc. Bulletin: *Fund Directors' Pay Increases 17% in Smaller Complexes, 8% in Larger* (June 2003) (''Boards are getting smaller with 60% having 8 directors or less.'') (available at: *http://www.mfgovern.com/*); Management Practice Inc. Bulletin: *More Meetings Means More Pay for Fund Directors* (Apr. 2004) (''April 2004 MPI Bulletin'') (''Boards are staying about the same overall size, with a slight decrease in the number of interested directors, which facilitates a new 75% independent requirement.'').

[25] A fund that currently relies on any of the Exemptive Rules would already have a majority of independent directors on the board. *See* Role of Independent Directors of Investment Companies, Investment Company Act Release No. 24816 (Jan. 2, 2001) [66 FR 3734 (Jan. 16, 2001)].

[26] An 8 member board of a fund that relies on at least one Exemptive Rule currently must have at least 5 independent directors. By replacing an interested director with an independent director, 6 out of 8 (75%) would be independent. By replacing two interested directors with two independent directors on a 7 member board (which must have at least 4 independent directors), 6 out of 7 (86%) would be independent.

[27] *See* Comment Letter of the Disinterested Directors of ICAP Funds, Inc., File No. S7–03–04 (Mar. 4, 2004).

[28] *See* April 2004 MPI Bulletin, *supra* note 24. The information provided in the Bulletin ''summarizes 2003/4 findings of the Mutual Fund Directors'' Compensation and Governance Practices survey with data drawn from public documents of 290 complexes, representing 1,620 directors/trustees and the confidential responses of participating complexes.'' Thus, the survey may include compensation information concerning both independent and interested directors. Because interested directors generally are compensated by the adviser, not the fund, we have assumed for purposes of the estimates that the compensation reflects annual compensation of independent directors. This survey is a widely used industry survey, an earlier version of which was cited by the dissenting Commissioners in their statement attached to the Adopting Release. *See* Adopting Release, *supra* note 2, Dissent of Commissioners Cynthia A. Glassman and Paul S. Atkins, at n.24.

[29] For purposes of these estimates, we define boards that oversee a ''large number'' of funds as boards that oversee 70 or more funds. The *per fund* estimates we discuss related to these boards are calculated by basing per fund costs on a board that oversees 70 funds, which yields greater per fund costs than using a higher number would.

[30] These annual estimates of the cost of one independent director are based on the following calculations: ($111,500 ÷ 70 funds = $1593); ($12,500 ÷ 1 fund = $12,500). In considering the range of costs per fund, we divided the median salary for a director overseeing a large number of funds (70 or more) by 70 funds, and the median salary for a director overseeing a small number of funds (1 to 6) by 1 fund. The range of funds was based on data provided in the April 2004 MPI Bulletin, *supra* note 24.

estimate that these annual compensation costs could range, *on a per fund basis,* from $4779 (for boards that oversee a large number of funds) to $37,500 (for boards that oversee one fund).[31]

We further estimate that the costs to recruit an independent director may equal the independent director's first year salary.[32] This cost may be incurred initially when the independent directors are first appointed, and periodically thereafter when, from time to time, an independent director is replaced. In our judgment, we conservatively estimate that the need to replace a director will, on average, occur no more often than once every five years.[33] Thus, the initial *per fund* cost for recruiting services for three independent directors could range from $4779 (for boards that oversee a large number of funds) to $37,500 (for boards that oversee one fund).[34] Based on turnover every five years, the annual cost per fund thereafter to replace independent directors could range from $956 to $7500.[35]

We expect that funds will incur additional costs because of increased reliance by new independent directors on the services of independent legal counsel. Based upon our experience, we estimate that, on average, the new independent directors will use an additional 30 hours annually of independent legal counsel services. We have estimated that the average hourly rate for an independent counsel is $300,[36] which yields a total cost of $9000 annually, per board. Thus, the range of costs for additional independent counsel services could range from $9000 per fund (for a board that oversees one fund) to $129 per fund (for a board that oversees a large number of funds).[37]

Estimated total costs per fund. Based on this data, we estimate that the total costs in the first year, for funds that appoint three new independent directors, could range from $9687 per fund (for boards that oversee a large number of funds) to $84,000 per fund (for boards that oversee one fund).[38] Annual costs in subsequent years would decrease to a range of $5864 per fund (for boards that oversee a large number of funds) to $54,000 per fund (for boards that oversee only one fund).[39]

Funds that must obtain shareholder approval for new independent directors (whether to replace interested directors or to increase the size of the board) will incur additional costs of soliciting proxies from shareholders. We estimate the average costs of soliciting proxies as $75,000 per fund.[40] If a fund must obtain shareholder approval for three new independent directors, the initial costs to add the directors could range from $84,687 per fund (for boards that oversee a large number of funds) to $159,000 per fund (for boards that oversee one fund).[41] And as discussed above, costs would decrease in subsequent years to a range of $5864 per fund (for boards that oversee a large number of funds) to $54,000 per fund (for boards that oversee only one fund).[42]

We have also estimated increased costs to funds to reflect the increased responsibilities that independent directors may take on as a result of the 75 percent condition. To reflect this and other possible cost increases (including proxy cost increases), we have estimated that costs of complying with the condition may today have increased by as much as 20 percent.[43] Accordingly, we have estimated current first year costs of the condition for funds in which the board *appoints* three new independent directors. These costs 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 one fund).[44] We have further estimated that the current first year cost 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 one fund).[45] Whether the new independent directors are appointed or elected, ongoing costs could range from $7037 per fund (for boards that oversee a large number of funds) to $64,800 per fund (for boards that oversee one fund).[46]

b. Decreasing Interested Directors

Finally, funds that simply decrease the size of their boards and allow some interested directors to resign are likely to incur, at most, only minimal direct costs. The decision to reduce the size of the board and eliminate one or more interested directors from the board would likely be made at a previously scheduled board meeting.[47] Because this option is the simplest of the three options and imposes the lowest direct costs, it is likely that many, if not most, funds will choose to comply with the 75 percent condition by using this

[31] These annual estimates of the cost per fund are based on the following calculations: ($1593 × 3 directors = $4779); ($12,500 × 3 directors = $37,500).

We note that commenters' estimated costs of paying new independent directors ranged from $4000 to $20,000, which are roughly comparable with and do not exceed our estimated range. See Comment Letter of New Alternatives Fund, Inc., File No. S7–03–04 (Feb. 9, 2004); Comment Letter of Independent Directors of Flaherty & Crumrine Preferred Income Opportunity Fund Inc., File No. S7–03–04 (Feb. 23, 2004).

[32] *See, e.g.*, Andrea Felsted, *Headhunters Feel the Heat in Quality Quest: Shareholder Reaction to Sainsbury's Choice of a Chairman-Designate has Shed a Harsh Light on a Secretive World*, FINANCIAL TIMES, Feb. 21, 2004, at 5. This one-time cost would be shared among the funds that the director oversees.

[33] *See, e.g.*, Management Practice Inc. Bulletin: *Mutual Fund Directors' Compensation Increases 9% in a Turbulent Year* (last modified Oct. 30, 2001) (available at *http://www.mfgovern.com/*) (noting that, based on a 2000 survey, ''[s]erving trustees have a median age of 62 with a median of 10 years of service.'').

[34] *See supra* note 31.

[35] These estimates are based on the following calculations: ($4779 ÷ 5 = $956); ($37,500 ÷ 5 = $7500).

[36] The $300 per hour estimated billing rate is one we have used in recent rulemakings. *See, e.g.*, Disclosure Regarding Nominating Committee Functions and Communications Between Security Holders and Boards of Directors, Securities Act Release No. 8340 (Nov. 24, 2003) [68 FR 69204 (Dec. 11, 2003)] at n.149.

[37] These estimates are based on the following calculations: ($9000 ÷ 1 = $9000); ($9000 ÷ 70 = $129).

[38] These estimates are based on the following calculations: ($4779 (first year compensation) + $4779 (recruiting costs) + $129 (independent counsel costs) = $9687); ($37,500 (first year compensation) + $37,500 (recruiting costs) + $9000 (independent counsel costs) = $84,000).

[39] These estimates are based on the following calculations: ($4779 (annual compensation) + $956 (recruiting costs) + $129 (independent counsel costs) = $5864); ($37,500 (annual compensation) + $7500 (recruiting costs) + $9000 (independent counsel costs) = $54,000).

[40] *See* Investment Company Mergers, Investment Company Act Release No. 25666 (July 18, 2002) [67 FR 48512 (July 24, 2002)], at Section V. That cost could be substantially diminished if a proxy vote were scheduled to be held during the period on other matters.

[41] These estimates are based on the following calculations: ($9687 (first year compensation, recruiting and independent legal counsel costs) + $75,000 (proxy costs) = $84,687); ($84,000 (first year compensation, recruiting and independent legal counsel costs) + $75,000 (proxy costs) = $159,000).

[42] *See supra* note 39.

[43] As to director compensation, the conservative nature of this estimate is confirmed by publicly available information indicating that in 2004, directors' compensation increased by 13 percent. See Management Practice Inc. Bulletin: *More Meetings, More Pay: Fund Directors' Compensation Increases 13% as Workload Grows* (Apr. 2005) (available at *http://www.mfgovern.com*).

[44] These estimates are based on the following calculations: ($9687 × 1.2 = $11,624); ($84,000 × 1.2 = $100,800).

[45] These estimates are based on the following calculations: ($84,687 × 1.2 = $101,624); ($159,000 × 1.2 = $190,800).

[46] These estimates are based on the following calculations: ($5864 × 1.2 = $7037); ($54,000 × 1.2 = $64,800).

[47] In the unusual circumstances in which the interested directors are compensated by the fund rather than by the fund's adviser, the termination of the interested directors could result in a cost savings for the fund. We understand, however, that in most cases the fund's adviser compensates the interested directors directly.

option.[48] There is the possible non-monetary cost of the loss of experience on the board. In other words, having fewer interested directors on the board might decrease the expertise of the board. As we discussed in the Adopting Release, however, nothing in the Exemptive Rule amendments would prohibit interested persons from participating in board meetings, if the directors decide to include them in those meetings.[49] Thus we believe that the reduction in the number of interested directors will likely result, at most, in only minimal direct costs.[50]

2. Independent Chairman

The Exemptive Rule amendments also require that a fund relying on an Exemptive Rule have an independent director serve as chairman of the board. As we noted in the Adopting Release, there may be costs associated with the independent chairman condition, such as the costs of hiring staff to assist the chairman in carrying out his or her responsibilities.[51] However, we said that we had no reliable basis for estimating those costs. The Court of Appeals noted that ''[a]lthough 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, it readily could have estimated the cost to an individual fund.'' [52] Based on the record in this matter, as well as a review of publicly available information, we have concluded that we do in fact have a reliable basis for estimating the costs to an individual fund associated with the independent chairman condition, as the Court directed. This estimate also includes possible increased compensation to independent chairs to reflect their additional responsibilities.

In addition to the monetary costs we discuss below, some have raised, as a possible non-monetary cost, the loss of experience on the board if the interested chairman were to resign from the board. The interested chairman, however, typically is one of the most senior officers of the fund's investment adviser, which has a direct interest in the operations of the fund. Therefore, we anticipate that the interested chairman is unlikely to resign from the fund's board, and will likely continue to participate actively in board meetings even though he no longer functions as the chairman.[53]

A. Additional Staff

Several commenters suggested that an independent chairman might decide to hire staff to help fulfill his or her responsibilities.[54] Although we cannot determine how many independent chairmen would require the hiring of additional staff to support them,[55] we have estimated the costs that fund boards may incur as a result of hiring additional staff.[56]

In our judgment, in most cases, independent chairmen 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. We believe 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. We have estimated the costs of retaining these personnel based on salary surveys conducted by the Securities Industry Association (''SIA''), a source on which we commonly rely in our rulemakings.[57] The SIA found the average salary (including bonus) of a senior business analyst to be $136,671.[58] Adjusting this salary upwards by 50 percent to reflect possible overhead costs and employee benefits, this salary amounts to $205,007. The SIA found the average salary of an executive assistant (including bonus) to be $73,088.[59] Adjusting this salary upwards by 50 percent to reflect possible overhead costs and employee benefits, this salary amounts to $109,632. Thus, the hiring of both a full-time senior business analyst and a full-time executive assistant for an independent chairman would total approximately $314,639 for each board. This cost can be expressed on a per fund basis, which we calculate to be $42,519.[60]

Some commenters suggested that another cost of the amendments could result from increased reliance by the independent chairman on the services of independent legal counsel.[61] Based

[48] *See, e.g.*, April 2004 MPI Bulletin, *supra* note 24 (''Boards stayed about the same size, but the number of affilaited directors declined as the preferred method of achieving the required 75% independent.''); Comment Letter of the Directors' Committee of the Investment Company Institute, File No. S7–03–04 (Mar. 10, 2004) (''While it is our expectation that most funds would reach this percentage by asking an interested director to step down from the board, there are some boards that will do so by adding an independent director.''); Comment Letter of New Alternatives Fund, Inc., File No. S7–03–04 (Feb. 9, 2004) (''[I]t is difficult to find competent directors. An alternative is for the undersigned founder to resign as a director while remaining a manager. We could then reach the 75% requirement.'').

[49] *See* Adopting Release, *supra* note 2, at text following n.50 and at text preceding and following n.60.

[50] It would be impracticable to quantify the indirect costs of choosing this option. Of course, if those indirect costs (plus the insignificant direct costs) of this option were to exceed the total direct and indirect costs associated with either of the other two options, then the fund could choose to use one of those other, lower-cost options.

[51] *See* Adopting Release, *supra* note 2, at n.81.

[52] Slip Opinion, *supra* note 1, at 16–17.

[53] Even in the unlikely case that the chairman resigns from the board, we believe that the resignation would have minimal costs because, as discussed above and in the Adopting Release, nothing in the Exemptive Rule amendments would prohibit the former chairman from participating in board meetings if the directors decide to include him or her in those meetings. *See supra* note 49 and accompanying text.

[54] *See, e.g.*, Comment Letter of Disinterested Trustees of EQ Advisors Trust, File No. S7–03–04 (Mar. 4, 2004) (''[A] fund group would need to compensate the [independent] chair commensurate with his or her additional responsibility and time commitment and would need to hire additional support for that individual.''); Comment Letter of New Alternatives Fund, Inc., File No. S7–03–04 (Feb. 9, 2004) (estimating a $25,000 cost of ''aids to directors''); Comment Letter of Sullivan & Cromwell LLP, File No. S7–03–04 (Mar. 9, 2004) (''[W]e believe that mandating an independent chairman will effectively mandate the retention of an independent staff and/or enhanced participation by independent counsel in fund complexes both large and small.''). The [chief compliance officer] and independent counsel were viewed as the logical persons to interface regularly with the Chair and their involvement may alleviate the need for permanent staff to the board or Chair. The management company typically provides the bulk of the secretarial and clerical support for most boards.''). Despite the lack of consensus on whether an independent chairman is likely to hire any additional staff, the estimate discussed in this section—to avoid any underestimate of costs—assumes the hiring of two additional staff members.

[55] Adopting Release, *supra* note 2, at n.81.

[56] These costs are for *additional* staff. An independent chair, like a management affiliated chair, will continue to have available the services of the existing staff of the fund management company.

[57] *See, e.g.*, Disclosure Regarding Approval of Investment Advisory Contracts by Directors of Investment Companies, Investment Company Act Release No. 26486 (June 23, 2004) [69 FR 39798 (June 30, 2004)] at n.55.

[58] *See* Securities Industry Association, REPORT ON MANAGEMENT & PROFESSIONAL EARNINGS IN THE SECURITIES INDUSTRY (2004). This estimate is for a New York salary. The SIA also estimates non-New York salaries, which are lower. The estimates in this section use the higher figure.

[59] *See* Securities Industry Association, REPORT ON OFFICE SALARIES IN THE SECURITIES INDUSTRY (2004).

[60] This estimate is based on the following calculation: ($314,639 ÷ 7.4 funds per board = $42,519 per fund). We estimate that there are, on average, 7.4 funds per board. There were 8126 funds in 2003. *See* Investment Company Institute, 2004 MUTUAL FUND FACT BOOK (May 2004). We estimate that there are approximately two boards of directors per fund complex. We also estimate that in 2003 there were 550 fund complexes, yielding a total of 1100 fund boards. Therefore, there are approximately 7.4 funds per board (8126 funds ÷ 1100 boards).

This estimate exceeds an estimate provided by a commenter. *See* Comment Letter of New Alternatives Fund, Inc., File No. S7–03–04 (Feb. 9, 2004) (estimating a $25,000 cost of ''aids to directors'').

[61] *See, e.g.*, Comment Letter of Sullivan & Cromwell, LLP, File No. S7–03–04 (Mar. 9, 2004) (''[W]e believe that mandating an independent chairman will effectively mandate the retention of

upon our experience, we estimate that, on average, the independent chairman will use independent legal counsel a total of 50 hours a year more under the amendments. We have estimated that the average hourly rate for an independent counsel is $300,[62] which yields a total cost of $15,000 annually, per board. This amounts to $2027 per fund.[63]

B. Increased Compensation for an Independent Chairman

We estimate that compensation for an independent chairman may be from 25 to 50 percent higher than the compensation of other directors.[64] In order to calculate maximum likely costs and avoid understating those costs, the estimate in this section will use the assumption of the higher end of the range, *i.e.*, a 50 percent premium, and takes into account the 20 percent increase reflecting possible increased compensation costs.[65] Therefore, based on the estimates discussed above regarding compensation for fund independent directors,[66] we estimate that the additional ongoing compensation cost, and other cost increases, of appointing an independent director as chairman could range from $1147 to $9000 each year, per fund.[67]

3. Promotion of Efficiency, Competition and Capital Formation

As noted by the Court, we must consider the impact of the costs of compliance with the two conditions, both quantitative and qualitative, on funds' efficiency, competition and capital formation. We find that the costs of the 75 percent condition and of the independent chairman condition are extremely small relative to the fund assets for which fund boards are responsible, and are also small relative to the expected benefits of the two conditions. We expect that the minimal added expense of compliance with these conditions will have little, if any, adverse effect on efficiency, competition and capital formation. Indeed, we anticipate that compliance with the two conditions by funds that rely upon the Exemptive Rules will help increase investor confidence, which may lead to increased efficiency and competitiveness of the U.S. capital markets. We also anticipate that this increased market efficiency and investor confidence may encourage more efficient capital formation.

With respect to the 75 percent condition, even for funds that elect to add independent directors and are required to solicit proxies, the costs are minor compared to the amount of assets under management. For funds that choose to comply with the 75 percent condition simply by decreasing the size of the board, the costs are insignificant. For funds that appoint three new independent directors, using the data from the 2004 survey and adding a 20 percent cushion as discussed above, the ongoing annual costs range from $64,800 per fund, for boards that oversee only one fund, down to $7037 per fund, for boards that oversee a large number of funds.[68] Start-up 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.[69] 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.[70] 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.[71]

The costs of the independent chairman condition are likewise small. Even if the independent chairman hires two full-time staff (at New York salaries), and uses 50 hours of additional independent legal counsel, the total is only $329,639,[72] which would be divided among the number of funds overseen by the independent chairman. And the additional per fund compensation received by the independent chairman could range from $9000 for an independent chairman who oversees a single fund, down to $1147 for an independent chairman who oversees a large number of funds. Even using the highest additional compensation figure, the average fund will incur a total cost for staff, legal counsel and additional compensation of only $47,220.[73]

Whether the two conditions are viewed separately or together, even at the high end of the ranges, the costs of compliance are minimal.[74] We also note that the ranges of costs considered above represent the high range of potential cost of compliance for any individual fund. The average cost per fund to the industry as a whole will likely be much lower.[75] At the time we adopted the rule amendments, 60 percent of funds already complied with the 75 percent condition and will incur no additional cost as a result of the implementation of that condition. Moreover, we expect few boards to appoint or elect as many as three new independent directors. Most are likely to decrease the size of their board or add one or two new directors. Our highest cost estimates are for boards that oversee only a single fund, which is an atypical situation. We think it unlikely that such a board would choose the

an independent staff and/or enhanced participation by independent counsel in fund complexes both large and small.'').

[62] *See supra* note 36.

[63] This estimate is based on the following calculation: ($15,000 ÷ 7.4 funds per board = $2027 per fund).

[64] *See* Beagan Wilcox, ''Wanted: Independent Chairmen,'' Board IQ, July 6, 2004 (citing estimate of Meyrick Payne, senior partner, Management Practice Inc.).

[65] *See supra* text accompanying note 44.

[66] *See supra* Section III.A.1.

[67] These estimates are based on the following calculations: (($4779 + $956) × 1.2 ÷ 3 × .5 = $1147); (($37,500 + $7500) × 1.2 ÷ 3 x .5 = $9000). Funds that already have 75% independent directors would only incur costs for the additional pay when one of these directors is appointed chairman. The costs for funds that must appoint or elect new independent directors is discussed in the previous section. We expect that almost all funds that do not have an independent chairman would select one of the current independent directors to be the chairman. If a fund chooses to recruit an independent chairman, however, the fund would incur recruiting costs in the first year equal to the independent chairman's first year salary.

[68] *See supra* note 46.

[69] *See supra* note 44.

[70] *See supra* note 45.

[71] We estimate 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). *See* Investment Company Institute, 2004 MUTUAL FUND FACT BOOK, at 113. Fund expenses are typically measured as a percentage of assets under management and are required to be disclosed to investors in this manner. *See* Item 3 of Form N–1A. We believe that comparison to net assets is the most helpful for investors.

[72] Two full-time staff ($314,639) plus 50 hours of independent counsel ($15,000) equals $329,639.

[73] Two full-time staff per fund ($42,519, *see supra* text accompanying note 60) plus 50 hours of legal counsel per fund ($2027, *see supra* text accompanying note 63) plus $2674 (increased compensation and recruiting costs for an independent chairman) equals $47,220. The increased compensation and recruiting costs for the independent chairman was calculated based on a board that oversees 7.4 funds. *See supra* 60. The estimate of $2674 is based on the following calculation: ((($27,480 median compensation for a director that oversees 7 to 19 funds ÷ 7.4 funds) + $743 recruiting costs) × 1.2 20% cost increase × .5 = $2674). The median salary for a board overseeing 7 to 19 funds was based on data provided in the April 2004 MPI Bulletin, *supra* note 24.

[74] These costs represent our best estimates of the ranges. We recognize that there may be ancillary costs, but we expect them to be minor and such costs should be covered by the generous cushion we have built into our estimates and by our use of the high end of the cost ranges. Moreover, in light of the benefits, we believe that even if the costs were several times higher, they would continue to be minimal and the rule amendments would still be justified.

[75] While the high-end costs may be applicable to a given fund, the high-end costs clearly will not be applicable to all funds or even most funds. It would be incorrect, and indeed misleading, to take the highest possible cost for a single fund and extrapolate for the entire industry.

more costly options of adding as many as three new directors and hiring two full-time staff to assist the independent chairman.[76]

Moreover, these costs are slight in relation to the very important benefits of the two conditions, as more fully discussed in the Adopting Release. The 75 percent condition is intended to promote strong fund boards that effectively perform their oversight role. Enhanced oversight by a strong, effective and independent fund board will serve to protect funds and their shareholders from abuses that can occur when funds engage in the conflict-of-interest transactions permitted under the Exemptive Rules. This will increase investor confidence in fund management and promote investment in funds. While these benefits are not easily quantifiable in terms of dollars, we believe they are substantial, particularly in comparison to the estimated cost of compliance. The independent chairman condition will provide similar benefits. The chairman of a fund board can have a substantial influence on the fund board agenda and on the fund boardroom's culture. An independent chairman will advance meaningful dialogue between the fund adviser and independent directors and will support the role of the independent directors in overseeing the fund adviser. Moreover, an independent board led by an independent chairman is more likely to vigorously represent investor interests when negotiating with the fund adviser on matters such as fees and expenses. We find that these cumulative benefits fully justify the costs associated with the rule amendments. Further, it is our judgment that, in the future, 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—itself a benefit sufficient to justify these costs.

Consistent with our view expressed in the Adopting Release, we do not expect the amendments to the Exemptive Rules 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.[77] To the extent that these amendments do affect competition or capital formation, we said we believed, and we continue to believe, that the effect would be positive. Among other things, we believe the 75 percent and independent chairman conditions would enhance the quality and accountability of the fund governance process. The estimates discussed in this release of the costs associated with compliance with the 75 percent condition and the independent chairman condition, and our further consideration of the effect of those costs on efficiency, competition and capital formation, do not alter this conclusion. We believe that a more robust system of checks and balances on fund boards should raise investors' expectations regarding the governance of these funds.[78] By promoting investor confidence in the fairness and integrity of the individuals that monitor investment companies, we promote investor confidence in the fairness and integrity of our markets. Investors will likely be more willing to effect transactions in those markets, which in turn will help to increase liquidity and to foster the capital formation process. Increased investor confidence in the integrity of mutual funds also will lead to increased efficiency and competitiveness of the U.S. capital markets.

B. Consideration of the Disclosure Alternative

The Court of Appeals also stated that the Commission did not give adequate consideration to an alternative to the independent chairman 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."[79] As discussed below, we do not believe this proposal—to provide information to enable an informed investment decision—would adequately protect fund investors from the potential abuses inherent in the conflict-of-interest transactions permitted under the Exemptive Rules. We reach this conclusion in light of the nature of investment companies and the purposes of the statutory prohibitions to which the Exemptive Rules apply.

As we explained in the release proposing the 2001 amendments to the Exemptive Rules, funds are unique in that they are organized and operated by people whose primary loyalty and pecuniary interest lie outside the enterprise.[80] This "external management" structure presents inherent conflicts of interest and potential for abuses. The investment adviser firms that manage the funds have interests in their own profits that may conflict with the interests of the funds they manage. And in many cases, as we noted in the Adopting Release, fund boards continue to be dominated by their management companies.[81]

It was to address these conflicts of interest that Congress in 1940 enacted the Investment Company Act, including the statutory prohibitions to which the Exemptive Rules apply.[82] Congress found that the disclosure regimes of the Securities Act of 1933 and the Securities Exchange Act of 1934 were inadequate

[76] Because we find the adoption of the two conditions to be appropriate even looking at the high end of the range of costs, we would reach the decision not to modify the rule amendments even apart from our discussion of the rest of the range of costs. However, we consider that range pertinent and helpful in reinforcing our determination. Our use of the high end of the range also offsets any potential benefit from seeking information as to costs incurred by funds that have come into early compliance with the two conditions since the date of our original adopting release (which funds are likely to constitute an evolving subset that may, in any event, not be representative of funds more generally). As we have previously noted, engaging in further notice and comment procedures to obtain additional information would create a risk of significant harm to investors.

[77] *See* Adopting Release, *supra* note 2, at Section VIII. The costs for any fund are sufficiently small that we think any adverse effect on competition will continue to be minimal and will be justified by the benefits of the rule, especially given our judgment that small funds will choose options for compliance with the conditions at cost levels that do not approach the upper end of the range.

[78] *See, e.g.*, Comment Letter of Morningstar, Inc., File No. S7–03–04 (Mar. 10, 2004) ("Overall, we support the proposal, which should be beneficial in restoring the system of checks and balances that is essential to ensuring that the interests of fund shareholders are represented."); Comment Letter of Joseph J. Kearns, File No. S7–03–04 (June 3, 2004) ("Having an independent chairman is in my opinion the most important governance regulation needed. * * * The shareholders need to see that boards are truly independent including their leadership.").

[79] Slip Opinion, *supra* note 1, at 17. In their dissent to the adoption of the rule amendments, Commissioners Glassman and Atkins said: "We were hopeful when these board governance amendments were proposed that alternative measures would be considered. Requiring a fund to disclose prominently whether or not it had an independent chairperson, for example, would allow shareholders to decide whether that matters to them or not." Adopting Release, *supra* note 2, Dissent of Commissioners Cynthia A. Glassman and Paul S. Atkins, at text following n.46.

[80] *See* Role of Independent Directors of Investment Companies, Investment Company Act Release No. 24082 (Oct. 14, 1999) [64 FR 59826 (Nov. 3, 1999)], at n.9 and accompanying text.

[81] Adopting Release, *supra* note 2, at text preceding n.8.

[82] *See, e.g.*, S. Rep. No. 1775, 76th Cong., 3d Sess. 7 (1940):

The representatives of the investment trust industry were of the unanimous opinion that "self-dealing"—that is, transactions between officers, directors, and similar persons and the investment companies with which they are associated—presented opportunities for gross abuse by unscrupulous persons, through unloading of securities upon the companies, unfair purchases from the companies, the obtaining of unsecured or inadequately secured loans from the companies, etc. The industry recognized that, even for the most conscientious managements, transactions between these affiliated persons and the investment companies present many difficulties.

to cope with the type of conflicts and abuses that pervaded the investment company industry.[83] The Investment Company Act, with its prohibitions against transactions involving conflicts of interest and its detailed prescriptions for the organization and governance of investment companies—particularly the setting of 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 as a regulated medium for investor savings.

In the case of ordinary business corporations, the Federal securities laws protect investors by providing disclosure to enable them to make an informed investment decision.[84] Even with respect to conflicts of interest on the part of managers of investment companies, disclosure in some cases can provide important protections. In the context of the subject of this rulemaking, for example, disclosure may enable fund investors to decide whether to invest in a fund that does not have an independent chair. But the utility of such disclosure is limited. Disclosure concerning conflicts of interest on the part of fund managers and the potential for self-dealing by them does not prevent the managers from putting their interests ahead of investors' interests. Disclosure does not prevent them from engaging in self-dealing. While this is also true in the case of managers of ordinary companies, investment companies are different in this regard because of the structure and purposes of the Investment Company Act. That Act *prohibits* certain transactions that involve conflicts of interest and the resulting potential for self-dealing. Indeed, protection against harm from self-dealing is one of the express purposes of the Investment Company Act.[85] We believe the objectives of these conflict-of-interest prohibitions of the Act will best be served by strengthening—through enhanced independent oversight—investor confidence that those charged with managing their fund will act in the investors' interests. Under these circumstances, we do not believe that disclosure alone is sufficient to adequately protect a fund investor against the serious risk that the managers of his or her investment will engage in self-dealing.[86]

Moreover, even if we assume that meaningful disclosure would be an adequate alternative to a requirement of an independent chair, there are obstacles to making disclosure that would be meaningful. We doubt the sufficiency of merely disclosing that a fund does not have such a chair.[87] For prospectus disclosure to be meaningful, investors considering a fund would have to be informed of the conflicts of interest faced by fund advisers, 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. It would be difficult to provide meaningful disclosure of these matters.

In addition, we did not adopt the independent chairman provision in isolation. We adopted it as part of a larger package of regulatory reforms that should lead to enhanced compliance by funds that have independent chairs.[88] The independent chairman will be in a position to receive reports from the fund's compliance personnel. Under rules we 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.[89]

We also observed that the chairman 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.'' [90] Meaningful dialogue is particularly important where the board is evaluating the types of transactions permitted by the Exemptive Rules. A board can most effectively manage the conflicts of interest inherent in these transactions where the board culture encourages rather than stifles open and frank discussion of what is in the best interest of the fund. This is especially true in connection with the conflicts of interest presented by these transactions because the best interest of the fund frequently is different from the best interest of the fund's management company. Similarly, we stated that the chairman of a fund board ''is in a unique position to set the tone of meetings and to encourage open dialogue and healthy skepticism.'' [91] An independent chairman is better equipped to serve in this role. An independent chairman also can play an important role in serving as a counterbalance to the fund's management company by providing board leadership that focuses on the long-term interests of investors.

None of these benefits can be achieved merely by disclosure. We continue 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 Rules upon its having an independent chairman.

IV. Response to Comments of Dissenting Commissioners at Open Meeting

At the Commission's open meeting in this matter, the dissenting Commissioners [92] raised various objections to our response to the Court of Appeals. The dissenters, echoing requests made by others, claim (i) that we are 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, (ii) that our action is inconsistent with certain aspects of the Court's opinion, (iii) that we did not seek comments on the costs associated with the independent chair condition at the time of the initial rulemaking, and (iv) that acting so quickly is

[83] *See, e.g.*, H.R. Rep. No. 2639, 76th Cong., 3d Sess. 10 (1940):

The Securities Act of 1933 and the Securities Exchange Act of 1934 have not acted as deterrents to the continuous occurrence of abuses in the organization and operation of investment companies. Generally these acts provide only for publicity. The record is clear that publicity alone is insufficient to eliminate malpractices in investment companies.

[84] Even in the context of ordinary business corporations, the federal securities laws do not rely exclusively on disclosure. *See, e.g.*, section 13(k) of the Securities Exchange Act of 1934, 15 U.S.C. 78m(k) (prohibition on personal loans to executives).

[85] *See* Section 1 of the Act, 15 U.S.C. 80a-1.

[86] The disclosure alternative would benefit prospective or future investors to a greater degree than existing investors in a fund. Existing investors, once they receive disclosure of the independence of the board's chairman, may not be able to redeem without incurring costs, due to deferred sales loads, redemption fees, taxes, or other transaction costs. *See* Payment of Asset-Based Sales Loads by Registered Open-End Management Investment Companies, Investment Company Act Release No. 16431 (June 13, 1988) [53 FR 23258 (June 21, 1988)] at text following n.188 (noting the restrictions on the ability of existing investors to ''vote with their feet'').

[87] Indeed, most funds already disclose in their public filings whether the chairman of the board is independent.

[88] *See* Adopting Release, *supra* note 2, at text accompanying nn. 5–6.

[89] Compliance Programs of Investment Companies and Investment Advisers, Investment Company Act Release No. 26299 (Dec. 17, 2003) [68 FR 74714 (Dec. 24, 2003)].

[90] *See* Adopting Release, *supra* note note 2, at text preceding n.47.

[91] *Id.* at text following n. 50.

[92] Commissioners Cynthia A. Glassman and Paul S. Atkins (''dissenters'') voted against this Response to Remand by Court of Appeals. Although Commissioner Glassman provided a written copy of her oral remarks made at the meeting, the dissenting Commissioners did not otherwise provide us with copies of their written dissents prior to the completion of this Release.

unprecedented and unjustified. We disagree.

We have largely addressed these concerns, which are inter-related in many respects, previously in this Release. We have discussed the reasons that further notice and comment procedures are not required, finding that the existing record, together with other information on which the Commission may rely, is a sufficient basis for our decision on remand.[93] We also have explained why, although they are not required, we should not under the circumstances engage in further notice and comment procedures.[94]

We have furthermore explained the need to act promptly in this matter, noting, among other things, the importance of avoiding a postponement of the compliance date and the attendant potential harm to investors and the market that would result.[95] We find that any further delay or ambiguity surrounding 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 with the rules. By acting swiftly and deliberately to respond to the Court's remand order, the Commission will reduce uncertainty, facilitate better decision-making by funds, and ultimately serve the interests of fund shareholders. We also note that the issues remanded to us by the Court are discrete and clearly defined;[96] indeed, the Court observed that part of our task on remand could be accomplished ''readily.''[97]

With respect to suggestions by the dissenters that our response to the disclosure alternative is inconsistent with the Court's opinion, we note that our discussion sets out the reasons why the Commission does not believe that the disclosure alternative is superior for achieving the objectives of the Act, including those of the specific conflict-of-interest provisions that are addressed by the Exemptive Rules.[98]

Finally, we note that it is in the best tradition of this institution, and not at all unusual, for the Commission to act swiftly on important initiatives in response to market developments and other factors. The Commission has done so on many occasions previously. In this matter, the staff and the Commission have a strong foundation of experience with the fund governance rules, and that experience has enabled us to address the issues raised by the Court within a relatively short period of time, with the assistance and extraordinary efforts of our staff.

V. Conclusion

We believe that this release fully addresses the two issues remanded to us for our further consideration and explication. The Commission commends the efforts of the Commission staff in this matter. The staff worked with great diligence, care and tirelessness, as well as with its usual even-handedness in the treatment of all Commissioners. We further commend the staff for maintaining this high degree of professionalism in the face of a sharply divided Commission, and against the backdrop of a campaign of unwarranted public attacks on the Commission and its processes apparently orchestrated by some outside the Commission.

Upon our further consideration of the costs and of the disclosure alternative, we have concluded that the benefits of the 75 percent 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, we have determined not to modify the amendments.

* * * * *

By the Commission.

Dated: June 30, 2005.

Margaret H. McFarland,

Deputy Secretary.

Concurring Views of Chairman Donaldson at Open Commission Meeting Commission Response To Remand by Court of Appeals

The last item on our agenda is a recommendation from the Division of Investment Management relating to rules we adopted last year to enhance the governance practices of mutual funds. As a condition to a mutual fund engaging in certain transactions involving conflicts of interest with the fund's management company, the rules require that the fund have a board with at least 75 percent independent directors and an independent chairman.

The Commission voted to approve these fund governance rules in June 2004, and we are acting today as a result of a recent decision by the District of Columbia Circuit Court of Appeals in a case brought by the Chamber of Commerce. In that case, the Court agreed with the Commission on two central points: first, that the Commission had the statutory authority under the Investment Company Act to adopt the fund governance rules; and second, that the Commission's underlying policy rationale for adopting the rules was reasonable.

However, the Court remanded two issues for our consideration. The Court instructed the Commission to further consider certain potential costs of the new rules, and to consider a potential alternative to the independent chair rule. Today's recommendation addresses the Court's concerns, which we take quite seriously.

Before turning to the specific issues raised by the Court, I would like to briefly put this rulemaking in perspective and highlight some of the very important benefits that I believe it will bring to investors and to the mutual fund industry.

When Congress enacted the Investment Company Act in 1940, it recognized that conflicts of interest in the mutual fund industry pose serious risks to fund shareholders. Funds are organized and operated by people whose primary economic interests lie outside the enterprise, and, without appropriate checks and balances, this structure can readily lead to abuse. To address the conflicts, Congress established minimum governance requirements under the Act, based on its determination that a fund's board of directors, particularly its independent directors, should serve as watchdogs to protect the interests of investors.

[93] *See supra* Section II. As noted in our Adopting Release, we received nearly 200 comments from fund investors, management companies, independent directors to mutual funds, as well as members of Congress; and we also received several comments from organizations that had a more general interest in corporate governance issues. *See* Adopting Release, *supra* note 2, at Section I.

Commissioner Glassman disputed that we sought comments in the Proposing Release on the costs associated with the independent chairman's hiring of additional staff. In support of this, she cited language in the Proposing Release which, she argues, requested comments on certain other costs but ''expressly declined'' to request comments on the cost of the independent chairman's hiring of additional staff. This is incorrect. In fact, the Proposing Release expressly sought comments on ''the costs'' of the condition requiring ''[a]n independent director to be chairman of the board.'' *See* Proposing Release, *supra* note 11, at Section V.B. In addition, the Proposing Release included a general request for comments on the potential costs and benefits of the rule. *See id.*, at Section V.C.

[94] *See supra* Section II & note 76. Commissioner Glassman argues that we are using estimates rather than ''actual data'' when ''actual costs'' are available, now that funds have started to come into compliance with the rule amendments. As discussed above, however, the estimates are based on actual data previously available to us; and, for reasons stated above, we have determined that it is unnecessary to supplement that data with information about funds that have come into early compliance. *See supra* note 76.

[95] *See supra* Section II.

[96] *See* Slip Opinion, *supra* note 1, at 2, 15–17.

[97] *Id.* at 16.

[98] *See supra* Section III.B. (Consideration of the Disclosure Alternative).

Congress also prohibited funds from engaging in certain types of affiliate transactions and other transactions that are most susceptible to abuse, while at the same time granting the Commission broad authority to provide exemptions when in the public interest. Since 1940, the Commission has adopted a variety of exemptive rules that permit otherwise prohibited transactions, but only under certain carefully tailored conditions, which include active oversight by independent directors.

Beginning in 2003, a series of scandals were uncovered in the mutual fund industry involving truly egregious, illegal and unethical behavior on the part of fund advisers. Advisers in a host of different fund complexes knowingly endorsed, among other abuses, late trading, market timing (including some advisers timing their own funds), directed brokerage, and selective disclosure to favored investors. The scandals resulted in enormous losses for investors, and revealed systemic breakdowns in compliance systems, weaknesses in fund governance structures and a significant betrayal of investors' trust.

The Commission responded to the scandals in a swift and comprehensive manner. We have brought numerous enforcement cases and obtained over $2.2 billion in disgorgement and penalties, which can be used to compensate harmed investors. In addition, in the last year and a half, the Commission has adopted a number of rules designed to ensure better compliance by funds and advisers with the Federal securities laws, promote the accountability of fund officers and directors, and enhance disclosure to investors.

The fund governance rules are a critical component of the Commission's reform efforts. By strengthening the role of the independent directors, the rules enhance the ability of fund boards to provide badly needed oversight of the activities of their advisers and monitor conflicts of interest. The independent chair condition allows individuals who are truly free from conflict to exercise leadership in the boardroom. This point was underscored in a comment letter submitted by all seven of the living former Chairmen of the Commission, who wrote: ''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.''

The Commission recognizes that there are fund chairmen who strive to represent the interests of fund investors in the boardroom while also serving as executives of the fund's adviser. But they undeniably face a central conflict of interest. When the CEO of a mutual fund's adviser is simultaneously serving as the chairman of the mutual fund itself, this person is in the untenable position of having to serve two masters. On the one hand, he or she owes a duty of loyalty and care to the mutual fund; on the other hand, the person owes a separate duty to the shareholders of the fund's investment adviser. It is easy to see that these two duties are often in conflict, particularly when it comes to setting the level of fees the fund will pay the adviser.

The independent chair condition is the capstone of our series of mutual fund governance reforms that will help foster a culture in fund boardrooms based on transparency, arm's length dealing, and, above all, protection of the interests of fund shareholders. The rules will also, I believe, help to strengthen the compliance function at mutual funds by providing a truly independent body to which the chief compliance officer can report.

Before turning to today's proposals, I would like to underscore an important point. The recent opinion of the Court of Appeals upheld the validity of the fundamental rationale underlying the Commission's fund governance rules. The Court agreed with the Commission that strengthening the role of independent fund directors was a reasonable response to the risks of further abuse in the mutual fund industry. Moreover, as I noted a moment ago, the Court found that the governance rules fall within the Commission's statutory authority under the Investment Company Act and, specifically, that the emphasis on independent directors is consistent with the structure and purpose of the Act.

The Court identified two specific issues that required further consideration by the Commission. First, with respect to costs, the Court stated that the Commission should give further consideration to the potential costs of the 75 percent independent director condition and the independent chair condition. Prior to adopting the fund governance rules, the Commission sought and received comment on the costs associated with these conditions, and we concluded that the costs were minimal in relation to the benefits. As instructed by the Court, today's proposal provides a detailed estimate of these potential costs, based on a variety of different possible approaches of complying with the new rules, and the Commission has carefully considered the potential impact of these costs. I will leave it to the staff to explain the numbers in greater detail, but suffice it to say that our analysis strongly confirms the conclusion that the potential costs to mutual funds of appointing independent chairmen, and ensuring that 75 percent of their directors are independent, are minimal when compared to the substantial benefits that these governance rules can bring in terms of reducing conflicts of interest and protecting investors.

Second, with respect to alternatives, the Court asked the Commission to give further consideration to an alternative to the independent chair condition that would require funds simply to disclose whether or not they have independent chairmen. This is an issue on which we received comment prior to adopting the independent chair rule last year, and today's proposal explains our reasons for rejecting the disclosure alterative. While many of our other rules are based on disclosure requirements, there are important reasons for taking a stronger, more substantive approach in the context of mutual fund governance. As I noted a few moments ago, the very structure of the typical mutual fund gives rise to serious conflicts of interest between the adviser and the shareholders, and this is the reason that Congress established flat prohibitions on certain types of fund transactions. For the Commission to grant exemptions from these prohibitions, we must see to it that investors are given assurances that their interests will be protected. As adopted, the independent chair condition will go a long way toward providing those assurances. Relying solely on disclosure, on the other hand, would allow a flawed governance structure to continue in many funds to the detriment of fund shareholders.

Concern has been raised about the timing of the Commission's actions today. The Commission's actions today are fully consistent with the opinion of the Court of Appeals and with the other legal requirements applicable to Commission rulemaking. The issues raised by the Court are clearly defined, and the existing rulemaking record and other publicly available materials have permitted the Commission to address them in the manner contemplated by the Court without further notice and comment. Indeed, by not vacating the governance rules, but instead remanding them to the Commission without ordering any particular procedures, the Court contemplated that any deficiencies in the initial rulemaking could be cured without unnecessarily reversing course or restarting the rulemaking process.

Moreover, there are compelling policy reasons for the Commission to act expeditiously on these matters. As I have stated, the governance rules are a critical component of our reform efforts, and any further delay or ambiguity surrounding their implementation would disadvantage not only investors but fund boards and management companies, most of which have already begun the process of coming into compliance with the rules. By acting swiftly and deliberately to respond to the Court's concerns, the Commission will facilitate better decision-making and ultimately serve the interests of fund shareholders.

I would also point out that it is in the best tradition of this institution, and not at all unusual, for the Commission to act swiftly on important initiatives in response to market developments and other factors. In this case, the staff and this Commission have a strong foundation of experience with the fund governance rules, and that experience has enabled us to address the issues raised by the Court within a relatively short period of time, albeit with the assistance of truly Herculean efforts on the part of our staff.

There is another important reason for us to act today. Our failure to act would, I fear, throw the future of this rulemaking into an uncertain limbo until a new Chairman is confirmed and the new Chairman is able to familiarize himself with the rulemaking record and the policy considerations weighing for and against the decision that we made last year. Today, however, we have intact the full complement of Commissioners who have spent the last year-and-a-half thinking about the issues raised in this rulemaking, and with my imminent departure from the Commission, today is the last opportunity to bring the collective judgment and learning of we five Commissioners to bear on the important questions presented to us by the Court.

Concurring Views of Commissioner Harvey J. Goldschmid at Open Commission Meeting Commission Response To Remand by Court of Appeals

As has just been demonstrated by Commissioner Glassman, emotions have run extremely high in this area. There has been too much confusion and hyperbole—''hyperbole'' is the most gentle word that I can use. Among others, I found her statement about the staff's cost analysis being ''back of the envelope'' quite extraordinary. I reviewed the cost analysis with great care, and everyone knows how hard the staff has worked on it. It is a very serious cost analysis.

Let me begin a more serious discussion by making clear what the D.C. Circuit Court did—and did not do—on June 21st.

First, the Court expressly upheld our statutory authority to require mutual funds to have a board consisting of no less that 75% independent directors and an independent chair. In the face of claims of ''regulatory overreach,'' the Court held that the ''Commission did not exceed its statutory authority'' in adopting the two governance conditions.

Second, there were challenges to the wisdom and effectiveness of our mutual fund governance provisions. I have stated often that given the fundamental need for directors to deal with the inherent conflicts of investment managers, a critical mix of at least 75% of independent directors makes compelling policy sense. The Supreme Court has described mutual fund independent directors as necessary ''watchdogs'' to police mutual fund conflicts of interest. Similarly, an independent chair helps to ensure proper information flows, establish sensible board priorities and agendas, and encourage candid and thorough discussions in the boardroom.

The D.C. Circuit Court recognized our prudence in ''strengthening the role of independent directors in relation to exemptive transactions as a prophylactic measure * * * .'' The Court held that our policy rationales for the two new governance provisions were justified.

Third, the Court then remanded in the two deficiency areas that have been identified , and asked us to address them.

An initial issue for us was whether it was necessary to engage in additional fact-gathering or further notice and comment procedures. We concluded that the information in the existing record (which had involved an extensive notice and comment process) provided a more than sufficient basis to address the deficiencies. The Circuit Court could, of course, have required us to do new fact-gathering, but did not do so.

Given what we believe is the adequacy of the information available in the record, there would be large costs to new fact-gathering. By acting promptly we avoid the cost of new fact gathering, avoid what could be a substantial period of uncertainty for mutual fund governance, and ensure that fund shareholders will receive the critical protections afforded by the new governance rules without further delay. The mutual fund business is based on investor trust, and, after the grievous breaches of trust disclosed by the mutual fund scandals, it is of great importance to continue to bolster investor confidence in the governance of funds.

This Commission has spent nearly two years considering mutual fund disclosure, governance, and other rules. As was true of our action today on ''securities offering reform,'' we have labored too hard—and the governance provisions are too important—for us not to act in the public interest. As Chairman Donaldson put it, ''failure to act would have a severe detrimental effect'' on investors. Of course, as we have just done with respect to securities offering reform, a future Commission would be able to modify or reverse anything we do today that the new Commission concludes is counterproductive.

Let me now address briefly the crocodile tears being shed about the need to not move forward out of respect for the Court of Appeals. I believe that the release we will approve today fully responds to the Court's concerns. I have great respect for our panel of three strong, highly intelligent and talented judges. This matter will quickly be back before those judges. If we are wrong about being fully responsive, the Court will certainly tell us so. But, if we are right about being fully responsive, we will have ensured an enormously better day for investors in mutual funds. As the Circuit Court recognized, our two governance rules are designed to strengthen the independence and effectiveness of fund boards, and thereby, protect shareholders from serious conflicts of interest.

Obviously, for me, in an $8 trillion industry, the benefits of the two new governance provisions plainly and overwhelmingly outweigh their costs.

A full discussion of the ''disclosure alternative'' to the independent chair provision is contained in our release. For now, let me just emphasize again that the interrelation between investment advisers and mutual funds presents complex and pervasive conflict-of-interest issues.

The dynamics of a mutual fund boardroom—including what may be the dominance of the chair (who often controls information flows, board agendas, etc.)—is extremely difficult to disclose in a meaningful way. It is similarly difficult for the 90-plus million shareholders of mutual funds to digest and evaluate. But those of us who have spent most of our professional lives working on issues of corporate governance—and have witnessed the failings of mutual fund governance demonstrated by nearly two years of enforcement actions—fear that permitting investment managers to continue to chair mutual fund boards would significantly increase the danger of future abuse.

I think the same reasoning convinced Congress in 1940, in enacting the Investment Company Act, to go well beyond disclosure and provide both Exemptive Rules (prohibitions against transactions involving conflicts of interest) and detailed prescriptions for the organization and governance of mutual funds. As we said in our July 2004 Adopting Release: ''[the chair of a fund board] is in a unique position to set the tone of meetings and to encourage open dialogue and healthy skepticism.'' An independent chair can both help to counterbalance the fund's investment adviser and provide leadership that makes paramount the interests of fund investors. Put bluntly, the disclosure alternative does not afford adequate protection to fund shareholders. In this area, it is simply an unrealistic idea.

Finally, this is Chairman Donaldson's final public meeting. I must express my deep sadness—both on a personal level and for all decent participants in our financial markets—at his leaving. Bill, you have played a major role in restoring investor faith in the integrity and fairness of the nation's financial markets. You have also restored the public's faith in the SEC. Your leadership, honesty, and courage will long be celebrated, and you will be greatly missed.

The Commission staff has done a splendid job on this release. Mike Eisenberg, Bob Plaze, Giovanni Prezioso, Jonathan Sokobin, and all the rest of you, thanks for your terrific effort.

I have no questions.

Concurring Views of Commissioner Roel C. Campos at Open Commission Meeting Commission Response To Remand by Court of Appeals

Thank you Chairman Donaldson. I have a short statement to make about this action regarding our Agency's mutual fund governance rulemaking and the Response to the Remand by the Court.

I. American Mutual Fund Investors Have Been Under Attack

Beginning about two years ago the American public and this Agency became suddenly aware that American mutual fund investors were under attack. In quick order, investigations by this Agency and other State Attorney Generals revealed that dozens of well known mutual fund families had turned large profits at the expense of mutual fund investors. Looking only at the top nine fund families, billions of dollars were literally stolen from mutual fund investors by executives who placed their personal gain above the interests of their investors whom they were sworn to protect. It became clear that many fund executives participated in sweetheart schemes in which privileged third parties such as hedge funds were allowed to market time mutual funds and to engage in late trading, siphoning off billions of dollars of fund value at the expense of unknowing and unsuspecting mutual fund investors.

Indeed the scandal and harm was so egregious that Republican Congressman Mike Oxley, who of course authored with Senator Paul Sarbanes the famed Sarbanes-Oxley Act, decided to study the situation. Long a champion of protecting investors, Congressman Oxley did his homework and wrote several strong letters of support for the SEC's subsequent independent Chairman rulemaking that is the subject of the Court's Remand. In his letter to the Commission dated May 20, 2004, Congressman Oxley noted that he had been closely following the debate regarding the SEC's proposal to require independent fund Board Chairman. After reviewing publicly available information, the Congressman stated in his letter that ''The statistics I uncovered are startling. Eighty-four percent of the mutual fund families implicated in the market timing and late trading scandals (sixteen of the nineteen mutual funds) have had management-affiliated chairmen [non-independent] at some point during the alleged or admitted violations.'' He noted the SEC's actions against Invesco Funds, Franklin Templeton Funds, Janus, Putnam, Strong Funds, and MFS Funds in particular, which collectively settled for a total of over $700 million in disgorgement and penalties. Urging the Commission to adopt the proposed rule without amendment, Congressman Oxley went on to say, ''I believe the Commission's independent chairman proposal would eradicate the self-dealing by interested, management-affiliated chairmen and its harmful effect on mutual fund shareholders.''

Unfortunately, threats to mutual fund investors continue to be uncovered by our Agency. On May 31, 2005, for example, the Commission announced a settlement with Citigroup Global Markets, Inc and Smith Barney Fund Management. The Commission's Order noted that the investment adviser placed its interest in making a profit ahead of the interests of the mutual funds it had a duty to serve. In this case the adviser recommended that the mutual funds contract with an affiliate of the adviser to serve as transfer agent without fully disclosing to the mutual funds' boards that most of the actual work was to be done under a subcontract arrangement that had been negotiated with the mutual funds' existing third-party transfer agent at steeply discounted rates. Rather than passing the substantial fee discount on to the mutual funds, the adviser, through the newly created affiliated transfer agent took most of the benefit of the discount for themselves, reaping nearly $100 million in profit at the funds' expense over a five year period. The funds did not have an independent Chairman. Citigroup and Smith Barney paid over $200 million in disgorgement and penalties.

II. The Agency's Objective Has Been Investor Protection and To Restore Confidence

In response to this explosion of mutual fund fraud and theft by adviser executives, the Agency moved promptly to protect investors. It designed a combination of new governance and compliance rules. One of these rules mandates that advisers establish chief compliance officers who report directly to the mutual fund board. The capstone however of the SEC's effort to protect investors and deal with a serious breakdown in management controls were the two conditions adopted on July 27, 2004 that are the subject of this Remand, that fund boards have at least 75% independent directors and an independent chairman.

The Agency's purpose in proposing the conditions was to protect investors from serious harm and from a breakdown in funds' existing controls and structure. In addition to investor protection, I and the other majority Commissioners were also very concerned that the mutual fund industry as a whole was under siege by the acts of a greedy few. Investor confidence in the integrity of mutual funds was damaged and needed to be restored. Our mission also to protect the integrity of the financial sector was being challenged. It is worth noting that the industry association the Mutual Fund Directors Forum also supports the rules because of their concern for the overall health of the industry, even though a significant fund family was against the rule.

III. The Court of Appeals Upheld the SEC's Authority To Enact the Rules and Approved of the Rationale

The two new conditions adopted by the SEC were challenged by the Chamber of Commerce, which submitted a petition for review to the U.S. court of Appeals of the District of Columbia Circuit. On June 25, 2005, the Court of Appeals issued its decision. The decision has been regularly been mischaracterized in the press.

The DC Circuit Court stated on page 2 of its opinion, ''We hold that the Commission did not exceed its authority in adopting the two conditions, and the Commission's rationales for the two conditions satisfy the Administrative Procedures Act.'' The decision is meaningful because it clarifies the Commission's authority to regulate the corporate governance of mutual funds under section 6(c) of the Investment Company Act and dispels the notion that such issues are left entirely to state law.

As the Court holds on page 12 of its opinion, ''The Commission reasonably concluded that raising the minimum percentage of independent directors from 50% to 75% would strengthen the hand of the independent directors when dealing with fund management, and may assure that independent directors maintain control of the board and its agenda.'' The Court also upheld the Commission's conclusion that an independent chairman provides ''a check on the adviser, in negotiating the best deal for shareholders * * * and in providing leadership to the board that focuses on long-term interests of investors.''

In considering both the 75% rule and the independent chairman requirement, the Court held, on page 12 of the opinion, ''In sum, the Chamber points to nothing in the Investment Company Act that suggest the Congress restricted the authority of the Commission to make 'precautionary or prophylactic responses to perceived risks' and the Commission's effort to prevent future abuses * * * was NOT arbitrary, capricious, or in any way an abuse of its discretion. * * *''

IV. The Commission Has Carefully Followed the Directions of the Remand With Respect to the Finding That the Commission Did Not Adequately Consider the Costs Imposed Upon the Funds by the Two Challenged Conditions

The Court remanded to the Commission two deficiencies that it identified in the rule making. First, the Court held that, in connection with the statutory obligation to consider whether the conditions will promote efficiency, competition and capital formation, the Commission did not adequately consider costs associated with both the 75 percent independent board and the independent chairman conditions. Secondly, the Court stated that the Commission did not give adequate consideration to an alternative called the ''disclosure alternative.''

The Commission in its Response to the Court's Remand has carefully considered the adequacy of the existing record and the need for further fact finding to properly consider and to follow the Court's direction on remand. Given that the Commission labored for over one year in studying the matter, it is not surprising that the existing record, developed through full notice and comment procedures, is vast and ample. Specifically the Commission had also previously sought and received comment on the costs of the two conditions and had further elicited comment on the disclosure alternative. It is clear under Circuit cases that the agency is free on remand to determine whether supplemental fact-gathering is necessary and sufficient to address on remand the court-identified deficiencies. Accordingly, after careful review, the Commission has determined that the existing record and information publicly available at the time of the original adoption is a sufficient base on which to consider and follow the Court's directions on remand.

The proof of the sufficiency of the existing record is in the careful estimates of costs and calculations performed in the Commission's Response. The estimates and ranges track exactly the directions in the Court's Opinion for formulating the estimates for the costs of the two conditions. Conservative estimates have been made and cushions to cover all possible costs have been added to calculations.

The key conclusion is that under the most conservative estimates of costs for implementing the conditions, the total costs are minimal under any measure. As such, there is no reasonable basis for believing that any additional fact finding would alter in any way this conclusion. Indeed, as allowed for consideration under Circuit cases, the Commission's Response cites recent studies subsequent to the original adoption that confirm the original information. (See Response, FN 69)

The Commission also reanalyzes and discusses why the notice alternative is deficient. As explained, this alternative was previously considered and implicitly rejected. The Court's directions to expressly consider the alternative is accomplished in a full and adequate manner in the Commission's response.

V. Dispatch, Focus, and Diligence Does Not Equate to Inattentiveness or Failure to Analyze Carefully

There has been a consistent reporting in the press that advocates for the Chamber's position claim that any action in response to the Court's remand that does not include a new notice and comment period is somehow improper and disrespectful to the Court of Appeals. Quite simply, that contention is absurd on its face. Immediate attention and diligence and a focusing of staff resources to respond to the Court's Remand shows the utmost in respect and in placing the matter at the highest level of priority.

Quite frankly, this Agency prides itself in meeting impossible deadlines and turning around prodigious amounts of work in short time frames. Examples are innumerable. However, one clear example occurred during the last days of former Chairman Pitt's tenure from January 22, 2003 to January 31, 2003. In a ten day period, the Commission (with the same four Commissioners that enacted the rule in question, except for Chairman Donaldson), enacted no less than ten rulemakings, several on a twice a day schedule, and several being final rules or comments. The day after WorldCom filed a surprise restatement, this Agency had filed a lengthy complaint to move swiftly to protect assets for victims of fraud. This Agency never missed a deadline in fulfilling Congress' mandates to implement the requirements of Sarbanes Oxley, resulting in more rulemakings in one year alone, during 2003, than in any other decade in its history.

The ultimate refutation of the accusation to a rush to judgment is the ostensible high quality of the Commission's Response and the analysis therein.

VI. There Is an Absolute Urgency in Moving Forward To Implement the Protections Judged Necessary by This Agency

This Commission has concluded that serious threats exist to mutual fund investors. The Commission's judgment is that extra prophylactic measures in the two conditions involving the 75% independent board and the independent Chair will add significant benefits to investor protection to combat the types of fraud that have been uncovered. The Court in its Opinion stated that such conclusions were reasonable and that there exists ''no basis upon which to second guess that judgment.''

The Commission therefore has a binding obligation to implement as expeditiously as possible the subject rule to protect investors and also to aid sustaining investor confidence resulting in protecting the integrity of the markets. Quite simply, a variation of an old adage applies in this context: ''Investor protection delayed is investor protection denied.'' To not move quickly would be a violation of the duty of the Agency to protect investors and the markets.

There have been accusations that the Commission is doing something for that, for lack of a better term, is ''sneaky'' or devious in responding to the Court within the last days of this particularly constituted Commission. Again, this accusation is patently absurd. The Commission is not doing anything ''under the cover of darkness.'' The Commission acknowledges the fact that Chairman Donaldson is at the end of his service. This fact only adds to the urgency in that the full Commission that has thoroughly studied the issue should be the one to deal if possible with proper care with the Court's instructions on Remand.

There is also another clear set of facts that the Commission must deal with. If it did not act expeditiously in responding carefully and fully to the Court's Remand, a state of limbo will occur as to this rulemaking. There can be no prediction when the new Chairman and possibly other Commissioners will be nominated by the President and confirmed by the Senate. What is certain is that many mutual funds that are in the midst of implementing the new rules will be ''left hanging'' and may have to incur unnecessary or additional costs as they await finality on these rules.

Ultimately, if the Commission were not to have acted with speed and dispatch in responding to the Court's Remand, investor protection and integrity of the markets will not be served.

I for one must support the protection of investors and our markets.

Therefore, I conclude that the Commission had no choice but to act expeditiously and quickly in responding to the Court's Remand. The Commission was also in a position to prepare a thoughtful and quality response in short order.

Indeed, anyone who supports another course of action by the Commission risks hampering investor protection and places other interests above investors and the overall health of the markets.

I vote in favor of the proposed response to the Court's Remand and I support all of the substantive contents in the proposed response.

Dissent of Commissioner Cyntha A. Glassman to the Commission Response To Remand by Court of Appeals Investment Company Governance

I disagree with this rush to respond to the Court's remand of the ''independent chair'' rulemaking in the strongest possible terms. Last fall, the Chamber of Commerce of the United States of America challenged two provisions in the Commission's mutual fund governance rule, adopted over my and Commissioner Atkins' dissent, in July 2004, namely, the requirements that investment companies relying on our exemptive rules have an independent chair of the board of directors and a board composed of at least 75 percent independent directors. Last Tuesday, June 21st, the United States Court of Appeals for the District of Columbia Circuit granted the Chamber's petition requesting the Court to set these requirements aside and prohibit the Commission from implementing and enforcing them. In its unanimous decision, the Court held that the Commission violated the Administrative Procedures Act, or the APA, by failing adequately to consider the costs mutual funds would incur in order to comply with the conditions and failing adequately to consider at least one reasonable proposed alternative to the independent chair condition. The Court therefore remanded the proceeding to the Commission to address the deficiencies identified by the Court.

In my view, a prudent response to the Court's mandate would be for the Commission to seek public comment on the issues identified by the Court as violating the APA. Instead, if this action is approved, the agency, through a chairman who is resigning effective tomorrow, will have elevated form over substance once again.

On the same day that the Court issued its decision, I received an e-mail message from the Chairman's chief of staff informing me, without prior consultation, that the staff had reviewed the Court's opinion and ''concluded that the court's concerns can be addressed on the basis of the record already before the Commission.'' As such, the Chairman determined that this matter would be on today's open meeting agenda—a mere week following the Court's remand. While the Commission has an excellent and hardworking staff, it is simply not possible to conduct a thorough review ''of the record'' in this time frame. The fact that the decision to hold today's meeting was made just hours after the issuance of the Court's decision further demonstrates the cursory nature of the ''review.'' It does not require a clairvoyant to discern the real reason for the rush to judgment—indeed, much to my surprise, the proposed release openly states it—the Chairman has announced his resignation effective tomorrow and therefore this meeting must be held today. What is not expressly stated in the release, but is equally clear, is the majority's fear that in the absence of the Chairman's participation, the rule will not be implemented. This concern, whether real or imagined, does not justify ignoring the Commission's obligation to address properly the APA deficiencies found by the Court.

Before addressing some of the substantive problems with the proposed release, it is important for the public to understand the procedural deficiencies surrounding this proceeding. To begin, the procedure employed by the Chairman in placing this matter on the agenda today was unusual. The Code of Federal Regulations requires that we provide a ''sunshine notice'' of an open meeting. An individual Commissioner known at the ''duty officer'' typically signs this notice. The designation of duty officer rotates weekly among the Commissioners, but not the Chairman. Last week, I was the designated ''duty officer.'' Nonetheless, I did not learn until the next day that the Chairman had instead opted to serve as the duty officer for this matter and ''sign off'' on the notice. To the best of my knowledge, the Chairman has never previously served as duty officer during his tenure and his decision to do so—in this matter only—is without precedent.

A claimed rationale for proceeding on the matter today is that it is ''important and appropriate for the same five of us to address the issued raised by the Court on remand'' because of our ''unique familiarity with these matters.'' This is ludicrous—I do not believe and I challenge the majority to find any support for the notion that only those involved in a particular rulemaking have enough knowledge to effect any changes to it. Indeed, if this observation were true, the agency's regulations would be set in stone and could never be modified once there was a change in the Commission's constitution.

More disturbing is the statement in the action memorandum circulated with the proposed release ''request[ing] that any concurring or dissenting statements be circulated prior to the meeting'' today. This is yet another new procedure unique to this proposal. The stated basis for this request is to allow any such statement to be published contemporaneously with the release, because it is contemplated that the release will be adopted today and published before the Chairman's departure. What this really shows is that the issues have been ''pre-judged,'' which is a violation of our duty as Commissioners and yet another reason to believe that this matter will not survive a legal challenge. In any event, as a practical matter, no ''advance copy'' of a dissent was possible given the compressed time frame for this meeting and the fact that the staff continued to revise the proposed release up until and including yesterday evening. I request that this statement accompany the release and serve as my dissent pending an opportunity to provide a more formal dissent after I have had an opportunity to review the release as adopted.

Turning to the proposed release, on Friday evening, June 24, the staff circulated a 27-page draft of it. This draft, produced a mere three days after the Court's opinion, contains what can only be described as a back of the envelope calculation of costs that rest largely on the staff's ''estimates'' and ''judgment''—two buzzwords used repeatedly in the release. Subsequent drafts were circulated late Monday and Tuesday evening. Numerous revisions were made to each draft to which I have not been afforded adequate opportunity to review. I have no way of determining whether there is any validity for the cost analysis and the context for these costs. For example, how do these costs relate as a percentage of a fund's total expenses?

I need not dwell on the failings of the proposed release. It is sufficient to state that the release is an assembly of false statements, unsupported assumptions, flawed analysis, and misinterpretations. However, one often-repeated statement in the release—that the Commission can address the Court's concerns on the basis of the record already before the Commission—must be corrected. To be clear, the Commission cannot address the Court's concerns on the basis of the record already before the Commission. It cannot address the costs because, contrary to whatever representations the staff makes today, the Commission has repeatedly and consistently represented to the Court, to Congress and to the public that it has ''no reliable basis for estimating'' the costs. This statement, both in connection with the costs associated with electing independent directors, and with the costs incurred by an independent chair hiring staff, appears repeatedly in the proposing and adopting release, in the Commission's brief to the Court, and most recently, in the April 2005 staff report submitted to the Congress which submission was mandated by the Consolidated Appropriations Act of 2005. It strains all credibility to believe that the Commission, professing for the past year and a half its lack of a reliable basis, has mystically within the past week been able conclusively to estimate costs associated with the rule.

More fundamentally, the Commission cannot address the costs associated with the independent chair's hiring of staff and experts because it expressly declined to ask for comment on this issue. Specifically, in part V.B. of the proposing release, published in January 2004, the Commission recited that the proposed release would require: (1) An independent director to be chair; (2) directors to perform an annual evaluation of the board; (3) independent directors to meet in executive session at least quarterly; and (4) independent directors be given specific authority to hire employees. Immediately thereafter, the release states: ''We request comment on the costs of the first three items above, and on whether boards would choose to hire employees.'' Although the last version of the proposed release I received last night continues to state that we ''specifically sought and received comment'' on this cost, it is indisputable that we have never solicited comment on the costs associated with the hiring of staff—one of the very issues that the Court has now directed the Commission to address on remand.

In an apparent effort to bolster the argument that the Commission had, in fact, considered costs based on the record before it, the proposed release indicates that information ''publicly available at the time we originally adopted the amendments'' is sufficient to base the Commission's current discussion of costs. The latest version of the release now also includes a passing reference to ''supplementary public information'' without elaboration. It is curious indeed that in proposing this release the Commission has forgone examining subsequent data of real costs that mutual funds have incurred since the adoption of this rule last year as these funds prepare for the rule's implementation date. It is even more curious that the purported basis to exclude actual data rests on the theory that our estimate of costs is on the ''high end of the range'' rendering an examination of actual data unnecessary. This logic is backwards—it is the actual data which makes estimates unnecessary. As an economist, I cannot accept estimates and ''best judgments'' to support a cost/benefit analysis when actual costs are readily available and can easily be obtained through a request for public comment.

Likewise, the Commission cannot on the basis of the record before it address the alternative proposal identified by the Court that each fund be required prominently to disclose whether it has an inside or an independent chair and thereby allow investors to make an informed choice. When the Commission initially sought comment at the proposal stage, it did not seek specific comment on whether disclosure was a viable alternative. Rather, the Commission only asked generally for comment on alternatives, followed by a series of specific alternatives that did not include disclosure. Nonetheless, today's proposed release attempts to suggest that robust comment on a disclosure alternative was solicited, citing two comment letters that briefly mention—and I might add support—disclosure as an alternative. It is noteworthy that the staff, in compiling for us a summary of the 200 plus comment letters to this rulemaking, did not include any reference to disclosure as alternative. This is because this issue simply was not addressed in more than a handful of these letters.

As the Commission conceded in its brief to the Court, the truth of the matter is that the Commission did not consider ''all'' alternatives in adopting the rule because, in the majority's view, the Commission was not required to do so. Implicit in the single paragraph in the Commission's brief devoted to this significant issue is the acknowledgement that no consideration was given to a disclosure alternative, even though this alternative provides the Commission with a rule-making option that, as the Court observed, is ''neither frivolous nor out of bounds.''

The proposing release rejects disclosure as an inadequate alternative on the basis that it would not protect investors from the ''potential abuses inherent in the conflict-of-interest transactions permitted under the exemptive rules.'' In its remand opinion however, the Court dismisses this argument as irrelevant, finding instead that the fact the Congress in the Investment Company Act required more than disclosure with respect to some matters governed by that statute does not mean that Congress deemed disclosure insufficient with respect to all matters. Without soliciting comment on this issue, we have no basis to discern whether the public would or would not find disclosure meaningful. Nonetheless, the release concludes that disclosure would not be meaningful, citing a recent speech in which I questioned the length of fund prospectuses. Not only does this argument misinterpret what I said, but it leads to the illogical conclusion that once a prospectus reaches a certain length, it is full and therefore no additional information can be added.

The proposed release indicates that a reason for proceeding today is because expedited consideration is necessary in order to protect investors. For the reasons stated above, this statement is completely disingenuous. The case has never been made to my satisfaction that the benefits of this rule are more than cosmetic. In this regard, the Chairman's reference to market timing scandals at mutual funds with an interested chair as warranting the rule is misplaced. The share of these scandals at funds with interested chairs versus independent chairs was proportionate to their share of funds. In any event, in my view, protection of investors compels that we carefully consider the costs and alternatives before rushing to judgment. To allow this open meeting to proceed as if the Commission can simply fill in the blanks for APA deficiencies, without requesting public comment on these significant issues, makes a mockery of the process. Today's action is nothing more than window-dressing. It violates the spirit, if not the letter of the Court's opinion, which in directing the Commission to address the deficiencies, clearly contemplated that the Commission would do so by applying ''its expertise and its best judgment'' to bear. Rather than attempt in good faith to respond appropriately to the Court's direction, the Chairman has hastily scheduled this meeting designed to give the appearance that the Commission has judiciously considered its prior APA deficiencies, but in reality, is simply an attempt to obtain the same result without any serious examination of the costs associated with the rule and the alternatives available.

One additional point is worth mentioning. While the Chairman has refused to allow a public comment period for this proceeding, the public has not been silent in the past week. The Commission has received letters and statements from former Commissioners (including at least one Chairman), former staff, and trade associations, and there has also been much media coverage. Many of these public comments voice their opposition to the manner in which this proceeding has been conducted. They question the timing of this proceeding, the lack of public input into the process, and the likely long-term damage that will result to the agency as a result of operating in this fashion. While we are responding to these letters in our release, it is my understanding that the letters will not be posted to our Web site for public review.

Accordingly, for all the foregoing reasons, I am compelled to vote against the proposal. In closing, I would like to take this opportunity to apologize. First, to the Court, for the agency's failure to respond appropriately to the Court's directive to undertake a meaningful review. Second, to those staff members who were uncomfortable having to participate in this exercise. And third, to the public, which must continue to live with the uncertainty surrounding the legality of a rule that was adopted in violation of the APA and, after having already been stricken by a Court, will most certainly be challenged again as a result of our action today.

I have one question. The most recent version of the release has added a new footnote 15 which states that: ''Even prior to our having issued this Release, there have been reports that additional legal proceedings may result from our action today. Accordingly, we are instructing our Office of the General Counsel to take such action as it considers appropriate to respond to any proceedings relating to this rulemaking.'' I have never seen this before.

- Have we ever done this before?
- What does it mean?
- What is the effect?

Addedum June 30, 2005

These dissenting remarks are based on the draft release circulated Tuesday evening, June 28, 2005 for the open meeting held at 10 a.m. on June 29, 2005. The final post-meeting release has been changed by the majority apparently in reaction to some of the procedural deficiencies noted in my dissent. These changes do not cure those deficiencies, however they may make some of my references at the meeting to statements in the release appear inapposite. As an aside, footnote 15, which the general counsel refused to explain in response to my questioning at the open meeting, has now been renumbered footnote 14.

Dissent of Commissioner Paul S. Atkins to the Commission Response To Remand by Court of Appeals Investment Company Governance

On June 29, 2005, three of the five commissioners (the ''majority'') of the U.S. Securities and Exchange Commission (''SEC'' or ''Commission'') voted to reaffirm a rulemaking [1] eight days after the United States Court of Appeals for the District of Columbia Circuit (the ''Court'') remanded the rulemaking to the Commission.[2] I dissented from the majority's action. Although I have substantive objections to the rule amendments that the majority reaffirmed,[3] my concerns about today's actions of the majority run much deeper. The majority's action is the product of a gravely flawed process, which is far from the informed deliberation that should have preceded any final action in response to the Court's remand. My concerns are set forth below.

Background

Last year, the Commission, in a split vote, adopted amendments to ten widely relied-upon exemptive rules in order to mandate a uniform corporate governance structure for all investment companies.[4] The three commissioners who voted in favor of the amendments last year are now reaffirming the adoption of these amendments. In the interim, the Chamber of Commerce of the United States of America (the ''Chamber'') petitioned the Court for a review of two of the amendments.[5] On the morning of Tuesday, June 21, 2005 the Court granted, in part, the Chamber's petition and remanded the matter to the Commission to address two violations of the Administrative Procedure Act (''APA'')[6] that the Court identified in the process by which the Commission had approved the rules. Specifically, the court held that the Commission had (i) ''violated its obligation under 15 U.S.C. 80a–2(c), and therefore the APA, in failing adequately to consider the costs imposed upon funds by the two challenged conditions,'' and (ii) violated the APA by failing to consider a disclosure based

[1] Investment Company Governance, Investment Company Act Release No. 26985 (June 30, 2005) (''Remand Release''). Because at the time of this writing (2:30 p.m. on June 30, 2005) I do not yet have a final version of the release, this dissent refers to the draft release circulated on June 27, 2005.

[2] *Chamber of Commerce of the United States of America* v. *Securities and Exchange Commission*, No. 04–1300, slip op. (D.C. Cir. June 21, 2005) (''Slip Opinion'').

[3] These concerns are set forth in the dissent that Commissioner Glassman and I filed when the rules were adopted. *See* Dissent of Commissioners Cynthia A. Glassman and Paul S. Atkins to Investment Company Governance (July 27, 2004) [69 FR 46390 (Aug. 2, 2004)] (available at: *http://www.sec.gov/rules/final/ic-26520.htm#dissent*) (''Adoption Dissent'').

[4] Investment Company Governance, Investment Company Act Release No. 26520 (July 28, 2004) [69 FR 46378 (Aug. 2, 2004)] (''Adopting Release'').

[5] The amendments require that, if a fund relies on one of the exemptive rules, the fund must have a board of directors with (i) no less than 75 percent independent directors, and (ii) a chairman who is an independent director.

[6] 5 U.S.C. 551 *et seq.*

alternative to the independent chairman condition.[7]

A summary of the events that followed the issuance of the Court's opinion provides a window into the nature of the deliberation that preceded the majority's reaffirmation of the rule amendments.[8] On Tuesday evening, less than twelve hours after the Court had issued its opinion, the Chairman of the Commission scheduled the matter for a vote on June 29, 2005. The Chairman's chief of staff explained in an e-mail that the staff had ''concluded that the court's concerns can be addressed on the basis of the record already before the Commission.'' That same evening, the Chairman displaced the designated duty officer for the week to authorize unilaterally the issuance of a public notice of the meeting.[9] This ''sunshine act notice'' was issued the next morning.[10]

On Friday evening, less than eighty hours after the Court's decision, the staff, recommending against additional fact-gathering, provided the Commissioners with a 27-page draft release that purported to analyze the issues remanded by the court. The staff typically provides their recommendations to the Commission at least two weeks (and often thirty days) before the meeting at which they are scheduled for consideration. On Monday evening, shortly after asking the Chairman to remove the item from the Commission's calendar in order to seek additional comment, a substantially revised draft of the release was distributed. We were instructed by the Chairman's staff to submit any dissenting statements by noon the following day.[11] On Tuesday, after the close of business, we received the draft of the release that would be considered at the Commission meeting the next morning.

Thus, before the ink on the Court's opinion was even dry, the die was cast for the predetermined result of the Commission's deliberations. There was never a serious attempt made to solicit my views or incorporate them into the Commission's release. The procedural flaws that characterized this process did not mitigate, but rather compounded, the flaws in the adoption process that were identified by the Court. This peculiar sequence of events is a very fitting capstone on this rulemaking process in which the majority's self-described ''logic and experience and anecdotal evidence'' [12] has counted more than anything else.

Analysis of Costs

After protesting repeatedly over the past year and a half about the Commission's inability to conduct an analysis of costs, the majority claims to have done just that in about a week. When the majority adopted the rule, it described the costs as minimal, explained that our staff had no ''reliable basis'' for estimating costs, and complained that doing so would be ''difficult.'' [13] After the rule's adoption, Congress directed the Commission to submit a report justifying the rule.[14] The staff report,[15] which the majority submitted in April 2005 over Commissioner Glassman's and my objections,[16] continued to insist that costs were ''minimal,'' ''speculative,'' or could not be estimated.[17]

The order of an unanimous court should have chastened the Commission, but the majority's Remand Release only perpetuates the cavalier attitude with which we have approached our obligations in this rulemaking.[18] While the Court, appreciating the difficulty of estimating costs in this area, did not demand perfection, it did direct us to do the *best we can*.[19] I respectfully submit that our eight-day reconsideration of the rule does not meet this standard.[20]

[7] Slip Opinion, *supra* note 2, at 17.

[8] A timeline laying out the events of the past week is attached to this dissent. *See* Exhibit A. Even under normal circumstances, the Commission could not conduct a meaningful analysis within eight days, as the majority claims it has done. During the eight day period at issue, the commissioners and their staffs moved to a new headquarters building, which meant that they had no access to office space or computers for more than two of the eight days. In addition, the Chairman and two commissioners were out of the country for much of this period.

[9] The Commission's Rules of Practice provide for the delegation of certain matters to a ''duty officer.'' *See* 17 CFR 200.43. ''To the extent feasible, the designation of a duty officer shall rotate, under the administration of the [Commission's] Secretary, on a regular weekly basis among the members of the Commission *other than the Chairman*.'' 17 CFR 200.43 (a)(2) (emphasis added). I can recall only one other instance from my years as a Commissioner and, before that, on the Commission staff, when a Commission chairman has taken the place of the designated duty officer to authorize Commission action. I am not contending that the Chairman's acting as duty officer was illegal, simply that it was irregular and evidenced the hurried and prejudged nature of the process.

[10] Available at: *http://www.sec.gov/news/openmeetings/ssacmtg062905.htm*.

[11] Because I had not yet seen the final pre-meeting version of the release, I was unable to comply.

[12] Open Meeting to Consider Investment Company Governance Amendments (Jan. 14, 2004) (Webcast available at: *http://www.sec.gov/news/openmeetings.shtml*) (statement of Commissioner Harvey Goldschmid) (''there are moments where logic and experience and anecdotal evidence compels your conclusions and this for me is one of those areas . . .'').

[13] *See* Adopting Release, *supra* note 4, at VI.B (''Costs''). In addition, the ''Consideration of Promotion of Efficiency, Competition and Capital Formation'' section of the adopting release, which the Court found to be deficient (Slip Opinion, supra note 2, at 17), contained only two sentences of analysis. *See* Adopting Release, *supra* note 4, at Section VIII. This is peculiar given the majority's belief that these amendments will have a profound effect on the market. *See, e.g.*, Remand Release, *supra* note 1, at text accompanying note 13 (''It is important that we avoid postponement of the compliance date [of the investment company governance amendments] and the attendant potential harm to investors and the market that would result.'').

[14] *See* Consolidated Appropriations Act, 2005, Pub. L. No. 108–447, 118 Stat. 2809, 2910 (2004).

[15] Staff Report, EXEMPTIVE RULE AMENDMENTS OF 2004: THE INDEPENDENT CHAIR CONDITION: A REPORT IN ACCORDANCE WITH THE CONSOLIDATED APPROPRIATIONS ACT, 2005 (April 2005) (available at: *http://www.sec.gov/news/studies/indchair.pdf*) (''Staff Report'').

[16] *See* Letter from Commissioners Cynthia A. Glassman and Paul S. Atkins to the Honorable Thad Cochran, Chairman, Senate Committee on Appropriations (Apr. 29, 2005) (available at: *http://www.sec.gov/news/speech/spch050205cagpsa.htm*.

[17] Staff Report, *supra* note 15, at 60–61.

[18] Arguably, the Commission should already have been chastened by embarrassing miscalculations of cost in connection with earlier rulemakings. In connection with the adoption of regulations to implement Section 404 of the Sarbanes-Oxley Act, for example, ''we estimated the aggregate annual costs of implementing Section 404(a) of the Sarbanes-Oxley Act to be around $1.24 billion (or $91,000 per company).'' Management's Reports on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports, Securities Act Release No. 8238 (June 5, 2003) [68 FR 36636 (June 18, 2003)] at Section V.A. A subsequent industry report found the implementation costs to be ''more than 20 times greater than our 2003 estimates.'' Alex Davern, *et al.*, SARBANES–OXLEY SECTION 404: THE ''SECTION'' OF UNINTENDED CONSEQUENCES AND ITS IMPACT ON SMALL BUSINESS (Feb. 2005), at 2 (available at: *http://www.aeanet.org/governmentaffairs/AeASOXPaperFinal021005.asp*). *See also* Financial Executives International, Press Release: Sarbanes-Oxley Costs Exceed Estimates (Mar. 21, 2005), at 1 (available at: *http://www.fei.org/files/spacer.cfm?file_id=1498*) (based on a survey of 217 public companies with average revenues of $5 billion, FEI found that ''[t]heir total cost of compliance averaged $1.34 million for internal costs, $1.72 million for external costs and $1.30 million for auditor fees''). Additionally, Congress has reprimanded the Commission in the past for its failure to conduct the type of analysis that the Court found flawed. *See* Gramm-Leach-Bliley Conference Report (Nov. 1, 1999) (available at: *http://banking.senate.gov/conf/somfinal.htm*), at Title II.A) (''In addition, during the rulemaking process, the SEC must also make a number of findings. When considering whether such an action is in the public interest, the SEC must also consider whether the action will promote efficiency, competition and capital formation * * * The Conferees note that the SEC's record in implementing section 3(f) has failed to meet Congressional intent. The Conferees expect that the SEC will improve in this area.'').

[19] The Court stated specifically that the difficulty of the task ''does not excuse the Commission from its statutory obligation to determine as best it can the economic implications of the rule.'' Slip Opinion, *supra* note 2, at 15.

[20] I cannot, without more information and more time, take a position on the quality of particular estimates in the majority's cost-benefit analysis, but the majority's estimates may not be conservative. For example, how would the majority's estimates change if it used *average* instead of *median* salary information to calculate the cost of new independent directors? *See* Remand Release, *supra*

The Remand Release purports to undertake a consideration of the deficiencies identified by the Court on the basis of information in the existing record and information that was publicly available at the time of adoption.[21] This approach is problematic on several fronts. First, and most importantly, some funds have already begun to comply with the fund governance rules. Instead of relying on estimates, the Commission could easily conduct a survey asking questions about *actual costs* to comply with the rules. Why would we not seize on this fortuitous opportunity to utilize current, relevant data? [22] In this regard, just two days ago, the ICI volunteered to assist the Commission with obtaining this information from its widespread and representative membership.[23]

Second, the Remand Release implicitly acknowledges that the rulemaking record contained critical gaps regarding costs. Recognizing this flaw, the majority haphazardly searches for additional information that happened to be publicly available at the time of the rule's adoption to attempt to justify its actions.[24] The majority takes a sort of ''judicial notice'' of the newly-discovered information by treating it as irrefutable fact and uses it to ratify its prior decision.[25]

The majority's primary discovery to supplement the flawed rulemaking record was a two-page newsletter, which summarizes the results of a nonpublic survey about director compensation conducted by a private consulting firm.[26] Incidentally, the Commission staff did not obtain a copy of the underlying nonpublic survey, apparently because doing so would contradict the majority's intention to rely only on the purportedly adequate public record. In any case, before relying so heavily on this summary, the majority should have included this summary in the comment file to alert the public of its intention to rely upon it. The public then could have reacted to it. The Commission's economists should have evaluated the underlying data. The information presented in the summary may inform any decision that we make,[27] but it should not do so in isolation. Others who are not consultants to independent directors, as the author of this summary is, might have supplemented or contradicted the data.[28] Of course, this process could not possibly have occurred within the eight-day period the majority allowed itself. Therefore, after having forced the Commission to act within an impossibly short timeframe, the majority cannot claim to have not done the ''best it can,'' as the Court directed the Commission to do.[29]

Disclosure Alternative

In addition to finding fault with the Commission's analysis of costs, the Court took issue with our consideration of alternatives. Specifically, the Court stated that the Commission should have considered the disclosure alternative that Commissioner Glassman and I suggested as an alternative to the independent chairman requirement.[30] The Commission's failure to do so violated the APA [31] because, as the Court said, ''the disclosure alternative was neither frivolous nor out of bounds.'' [32] Accordingly, the Court directed the Commission to ''bring[] its expertise and its best judgment to bear'' to consider the disclosure alternative.[33] Oddly, neither the majority nor the staff solicited our views on the disclosure

note 1, at text following note 28. Do the salary figures cited include additional costs of expenses related to traveling to board meetings?

[21] *See* Remand Release, *supra* note 1, at text preceding note 11. The majority purports to look at ''supplementary public information available subsequent to our original adoption of the amendments'' only to ''confirm[] the information available at the time of our original adoption.'' *See* Remand Release, *supra* note 1, at note 11. In several instances, however, the majority appears to rely *only* on post-adoption sources for cost estimates. *See* Remand Release, *supra* note 1, at note 32 (for cost of recruiting an independent director, citing J. Bel Bruno, ''Recruiter Picked for HP Search,'' THE PHILADELPHIA INQUIRER, Feb. 18, 2005, at C03); Remand Release, *supra* note 1, at note 43 (for percentage increase in director compensation during 2004, citing MPI Bulletin, ''More Meetings, More Pay: Fund Directors'' Compensation Increases 13% as Workload Grows'' (Apr. 2005) (available at *http://www.mfgovern.com*)).

[22] The majority cited post-adoption materials when doing so served its purposes. *See, e.g.*, Remand Release, *supra* note 1, at note 69 (citing, for proposition that ''[r]ecently industry experts have similarly noted that the quantitative effect of the independent chairman condition will be modest,'' Kathleen Pender, ''SEC's Fund Rule, Revisited,'' San Francisco Chron., June 23, 2005, at C1 (quoting fund governance analyst Meyrick Payne as estimating ''that the industry-wide cost of having independent chairs, 'at an absolute maximum, is $18 million' a year, which is 'a drop in the bucket' for an industry with $8 trillion in assets.'').

[23] *See* Letter from Elizabeth R. Krentzman, General Counsel, Investment Company Institute, to Jonathan G. Katz, Secretary, SEC (June 27, 2005) (''ICI Letter''), at 2.

[24] Given that the majority supplements the record, it is not clear why they cite cases that stand for the proposition that ''if the existing record is a sufficient base on which to address on remand the court-identified deficiencies, additional notice and comment procedures are not required.'' *See* Remand Release, *supra* note 1, at note 9 (citing *Sierra Club* v. *EPA*, 325 F.3d 374, 382 (D.C. Cir. 2003); *National Grain and Feed Ass'n* v. *OSHA*, 903 F.2d 308, 310–11 (5th Cir. 1990); *AT&T Wireless Servs., Inc.* v. *FCC*, 365 F.3d 1095, 1103 (D.C. Cir. 2004). Each of these cases is also distinguishable on the grounds that there was no dissent *within* the decisionmaker. Both the Environmental Protection Agency and the Occupational Safety and Health Administration are led by a single administrator and the action at issue in the third case was reached by the decision of an unanimous Federal Communications Commission. The instant matter is distinguishable; the Commission's action is the product of a divided Commission, two members of which have continually expressed concerns about the process by which the determination on how to proceed was reached.

[25] The majority also relies heavily on its own experience for specific estimates that are central to its cost-benefit analysis. See, *e.g.*, Remand Release, *supra* note 1, at text preceding note 36 (''Based upon our experience, we estimate that, on average, the new independent directors will use additional independent legal counsel services a total of 30 hours a year.''); Remand Release, *supra* note 1, at text following note 56 (''In our judgment, independent chairmen will hire no more than, on average, two staff employees, consisting of one full time senior business analyst and one full time executive assistant.''); Remand Release, *supra* note 1, at text following note 61 (''Based upon our experience, we estimate that, on average, the independent chairman will use independent legal counsel a total of 50 hours a year more under the amendments.''). The use of the Commission's judgment and experience is appropriate, but where, as here, the Commission's judgment and experience are the source of the basic elements of its cost analysis, members of the public should have the opportunity to counter with estimates from their own judgment and experience and with empirical data.

[26] Management Practice Inc., ''More Meetings Means More Pay for Fund Directors'' (Apr. 2004) (''April 2004 MPI Bulletin''). The Remand Release cites to this or one of three other MPI Bulletins approximately seven times. The Remand Release also cites two newspaper articles that quote from Meyrick Payne, a senior partner of MPI. *See* Remand Release, *supra* note 1, at note 64 (citing Beagan Wilcox, ''Wanted: Independent Chairmen,'' Board IQ, July 6, 2004 (citing estimate of Meyrick Payne, senior partner, Management Practice, Inc.)); Remand Release, *supra* note 1, at note 69 (citing Kathleen Pender, ''SEC's Fund Rule, Revisited,'' San Francisco Chron., June 23, 2005, at C1 (quoting fund governance analyst Meyrick Payne as estimating ''that the industry-wide cost of having independent chairs, 'at an absolute maximum, is $18 million' a year, which is 'a drop in the bucket' for an industry with $8 trillion in assets.'')). Before relying so heavily on the data from Management Practice Inc., the majority should have analyzed whether the data are robust and representative.

[27] As the Draft Release notes, Commissioner Glassman and I cited an earlier version of the data in our dissent. Remand Release, *supra* note 1, at note 28 and Adoption Dissent, *supra* note 3, at note 24.

[28] A recent e-mail from C. Meyrick Payne, a senior partner at Management Practice Inc. (''MPI''), the author of the summary, suggests that MPI might have an interest in perpetuating this rulemaking. *See* E-mail from C. Meyrick Payne to Various Recipients (June 26, 2005) (attachment to Letter from Cory J. Skolnick of Gibson, Dunn & Crutcher LLP to Jonathan G. Katz, Secretary of the SEC (June 28, 2005) (in the email, Mr. Payne stated that, in advance of the Commission's open meeting, people might want to express their support for the independent chairman provision: ''If you, or your board, feel that an independent chair is an appropriate response to the recent mutual fund scandals you might like to write to SEC or your favorite newspaper on Monday or Tuesday so that your opinion can be influential.'').

[29] Slip Opinion, *supra* note 2, at 15.

[30] Slip Opinion, *supra* note 2, at 17.

[31] Slip Opinion, *supra* note 2, at 17.

[32] Slip Opinion, *supra* note 2, at 18 (citation omitted).

[33] Slip Opinion, *supra* note 2, at 19.

alternative before (or after) circulating a draft that concluded that the disclosure alternative was without merit. Thus, the majority's action cannot be said to embody the expertise and best judgment of the Commission.

The Remand Release largely reiterates an argument, already dismissed by the Court as unconvincing,[34] namely that the Investment Company Act always favors a prescriptive approach over a disclosure approach.[35] As the court explained, ''that the Congress required more than disclosure with respect to some matters governed by the ICA does not mean it deemed disclosure insufficient with respect to all such matters.'' [36] The release ignores that we have found disclosure rather than presciptive, one-size-fits-all solutions to be sufficient in other contexts.[37]

The majority claims that the proposing release elicited comment on the disclosure alternative. Although the proposing release *did* ask whether the Commission should consider any alternatives to the proposal, disclosure was not specifically mentioned.[38] As the majority notes, a few commenters [39]*sua sponte* raised the possibility of allowing investors to choose among funds based on clear disclosure about the independence of their chairman.[40] These comments were ignored and the staff's summary of comments, which was provided to the Commission prior to adoption, did not discuss them. Commissioner Glassman's and my attempts to find a disclosure-based compromise were also ignored. In light of the failure of the majority to consider the disclosure alternative prior to adoption, it is hard to understand how the pre-adoption rulemaking record can now be relied upon to form the basis for a full and fair discussion of this alternative.

Plea for a Deliberative Approach

Commissioner Glassman and I have both called for a more deliberate response to the Court. We could, for example, conduct a formal, unbiased survey, host a roundtable, or solicit additional public comment on the issues raised by the Court. Many others have made similar pleas for a more deliberate approach than that pursued by the majority.[41] Because the failures identified by the Court relate to issues that were not fully aired during the notice-and-comment process, one logical approach would seem to be to do so now. As the Court explained, ''uncertainty may limit what the Commission can do, but it does not excuse the Commission from its statutory obligation to do what it can to apprise itself—and hence the public and the Congress—of the economic consequences of a proposed regulation *before* it decides whether to adopt the measure.'' [42]

In the Remand Release, the majority boldly states that taking more than eight days to reflect on this issue ''risks significant harm to investors.'' [43] The majority does not elaborate on how delaying action on the remand for the short time that it would take to do a thorough study would endanger investors.[44] When circumstances have required it, the Commission has delayed other actions that it has deemed to be of great importance to investors.[45] The urgency of forcing funds to change their governance structures seems to be more closely tied to the imminent departures of Chairman William Donaldson [46] and Commissioner Harvey Goldschmid [47] than to legitimate concerns about the well-being of the shareholders in the many fund groups that do not have independent chairmen.

The Remand Release admits that the timing of this action is personnel-driven. It explains that the Commission needs to act expeditiously to marshal ''the collective judgment and learning'' of the five commissioners that originally considered the rule.[48] It does not note the significant procedural and substantive objections that Commissioner Glassman and I raised before the rule was originally adopted. It does not note our futile pleas that the Commission obtain more empirical

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[34] Slip Opinion, *supra* note 2, at 18.

[35] Remand Release, *supra* note 1, at text accompanying notes 76–82.

[36] Slip Opinion, *supra* note 2, at 18.

[37] *See, e.g.*, Disclosure Regarding Approval of Investment Advisory Contracts by Directors of Investment Companies, Investment Company Act Release No. 26486 (June 23, 2004) [69 FR 39798 (June 30, 2004)] (requiring investment companies to provide disclosure to shareholders regarding determinations that formed the basis for the board's approval of advisory contracts).

[38] *See also* Staff Report, *supra* note 15, at 59–60 (a section entitled ''Alternatives Were Considered'' makes no mention of disclosure as an alternative).

[39] *See* Comment Letter of the Financial Services Roundtable, File No. S7–03–04 (Mar. 10, 2004) (''[I]nvestors will be able to express their views on this [independent chairman] issue, given clear and appropriate disclosure. * * * Investors for whom this issue is a priority can direct their investments to those funds.''); Comment Letter of Charles K. Carlson, President, Greenspring Fund Incorporated, File No. S7–03–04 (June 17, 2004) (''Greater disclosure of relevant information would allow shareholders to make better informed decisions. If an independent Chairman is desirable in the eyes of some investors, then make that information readily accessible.'').

[40] Remand Release, *supra* note 1, at note 10 and accompanying text.

[41] *See, e.g.*, ICI Letter, *supra* note 23, at 1 (''In light of the court's decision, we recommend that the Commission invite additional public comment and collect additional data to assure a thoughtful and deliberative process.''); Letter from Eight Senators to Commission (June 22, 2005), at 1 (''[W]e are asking that the Commission defer final action on this controversial and complex matter until the Commission's new chairman is in office and the full Commission can make a deliberate decision.''); Letter from Joseph A. Grundfest, W.A. Franke Professor of Law and Business, Stanford Law School, to Commission (June 23, 2005), at 3 (''The inescapable concern is that this sequence of events supports the inference that the matter has been prejudged and that any additional consideration of the record is being conducted more as a procedural fig leaf than as a professional and good faith inquiry.''); Letter from Bevis Longstreth to the Commission (June 24, 2005) (''Input on these issues from both the industry and its client base must be obtained, and this evidence-gathering cannot be done in a week's time.''); Letter from Harvey L. Pitt, Kalorama Partners LLC, to Commission (June 23, 2005) (writing, as one of the seven ''living former SEC Chairmen'' who supported the rulemaking prior to adoption, to recommend a more deliberative approach); Letter from Eugene Scalia, Gibson, Dunn & Crutcher LLP, to Giovanni P. Prezioso, General Counsel, SEC (June 23, 2005) (writing on behalf of the Chamber of Commerce to urge the Commission to ''engage in a thorough, rigorous, and deliberate process''); Letter from Walter B. Stahr to Commission (June 24, 2005), at 1 (urging the Commission to reconsider its plan ''to re-issue the same rules, presumably on the basis of a quick analysis of the costs and alternatives''); Letter from Richard M. Whiting, Executive Director and General Counsel, The Financial Services Roundtable, to Jonathan Katz, Secretary, SEC (June 27, 2005), at 1 (requesting that ''no final action on the Rule be taken prior to the conclusion of [a] new public comment and fact-finding process'').

[42] Slip Opinion, *supra* note 2, at 17 (emphasis added).

[43] Remand Release, *supra* note 1, at text following note 11.

[44] The majority's claimed interest in certainty for funds rings hollow because, by taking this hasty action, they have virtually ensured further litigation over this matter. *See* Remand Release, *supra* note 1, at note 15 (''Even prior to our having issued this Release, there have been reports that additional legal proceedings may result from our action today. Accordingly, we are instructing our Office of the General Counsel to take such action as it considers appropriate to respond to any proceedings relating to this rulemaking'').

[45] *See, e.g.*, Amendment to Rule 4–01(a) of Regulation S–X Regarding the Compliance Date for Statement of Financial Accounting Standards No. 123 (Revised 2004), Share-Based Payment, Securities Act Release No. 8568 (Apr. 15, 2005) [70 FR 20717 (Apr. 21, 2005)] (allowing companies to delay implementation of accounting standard governing employee stock options); Management's Report on Internal Control over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports of Non-Accelerated Filers and Foreign Private Issuers; Extension of Compliance Dates, Securities Act Release 8545 (Mar. 11, 2005) [70 FR 13328 (Mar. 18, 2005)] (extending a rule implementing Section 404 of the Sarbanes-Oxley Act, which was a direct statutory mandate).

[46] SEC Chairman William H. Donaldson to Step Down on June 30, SEC Press Release 2005–82 (June 1, 2005) (*http://www.sec.gov/news/press/2005–82.htm*).

[47] Robert Schmidt and Otis Bilodeau, *SEC's Nazareth is Democrats' Choice for Commissioner,* BLOOMBERG (May 18, 2005) (reporting ''Goldschmid's plan to retire from the SEC by August and return to teach at Columbia's law school'').

[48] Remand Release, *supra* note 1, at text preceding note 14.

evidence. More importantly, though, if the Commission adopts a meritorious rule under lawful procedures, then the composition of the Commission that adopted it is irrelevant. The rule should be able to weather the inevitable personnel changes at the Commission and stand on its own without the support of the three commissioners that originally voted for it.

Lastly, I question the majority's conclusion that ''[t]he Court did not vacate the rule amendments * * * and they remain in effect.'' [49] The Court specifically identified two statutory violations in the process by which the majority adopted these rules. Until these statutory violations are remedied, the rule is *not* in effect, because the Commission has not satisfied the statutory predicate for legitimacy and enforceability of our rules. The only way for us to cure these fatal flaws is to comply with the Administrative Procedure Act and the Investment Company Act as the Court has directed us to do and which today's action does not do.

The Court gave the Commission a chance to redeem itself. It told us what we needed to do to fulfill our legal obligation. Unfortunately, the majority has squandered this opportunity. For the reasons stated above, I dissent.

[49] Remand Release, *supra* note 1, at text preceding Section II (''Introduction'').

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THE SEC'S RACE TO BEAT THE CLOCK

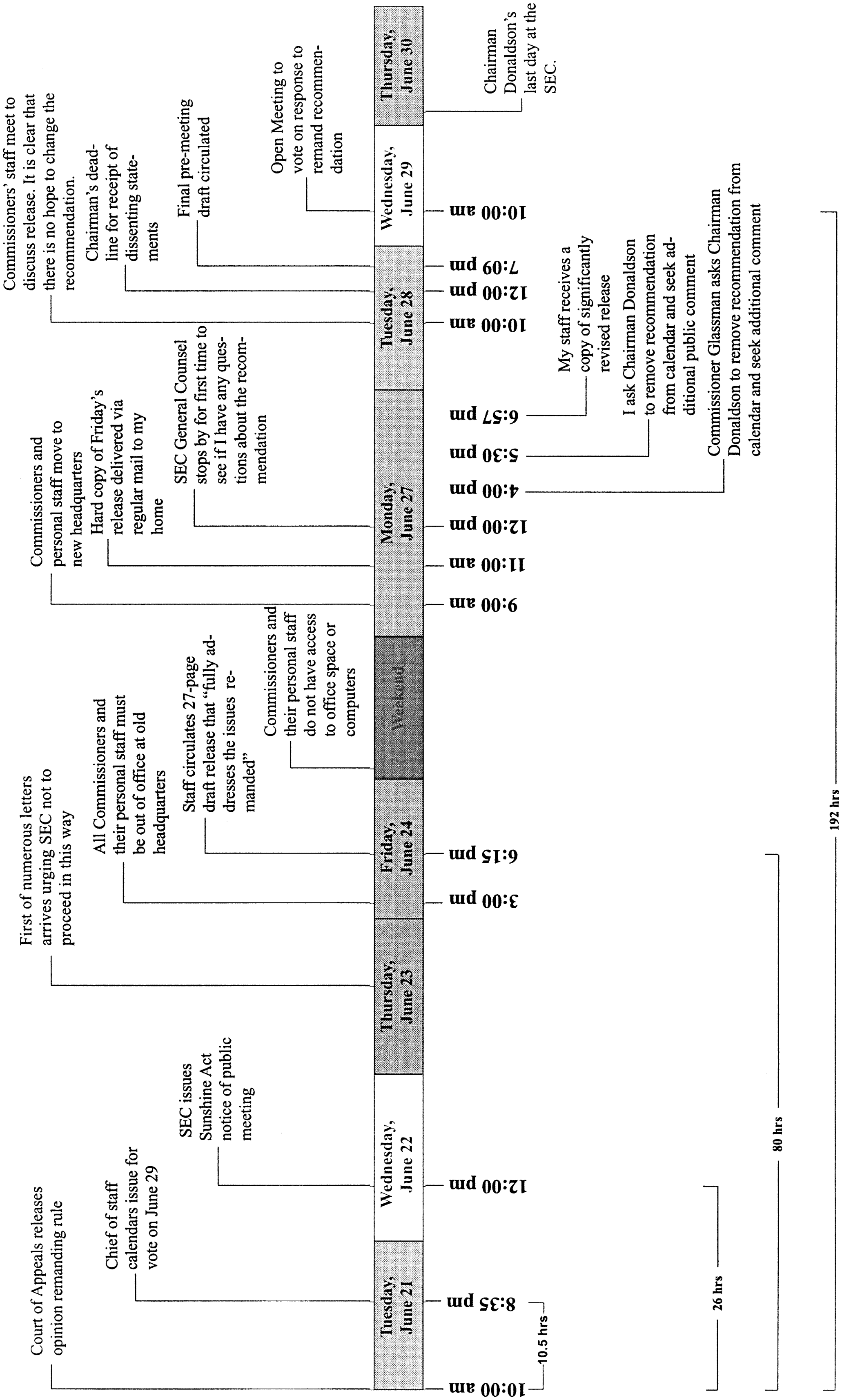

EXHIBIT A to Commissioner Atkins' Dissent

[FR Doc. 05–13314 Filed 7–6–05; 8:45 am]

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