SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 270

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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

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[1] *Chamber of Commerce of the United States of America v. SEC*, No. 04-1300, slip op. (D.C. Cir.

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

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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.

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]

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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)).

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 whether there were alternatives that would serve the same or similar purposes, and elicited comment on the disclosure alternative.[11] We find

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[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' …. ").

[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

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

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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.

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

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[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).

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

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[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.

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 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.

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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.

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

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

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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

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

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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).

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 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

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[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.

$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

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

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

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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

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

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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 x 1.2 = $11,624); ($84,000 x 1.2 = $100,800).

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 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

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

46 These estimates are based on the following calculations: ($5864 x 1.2 = $7037); ($54,000 x 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.

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.").

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

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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.

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]

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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.

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]

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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,

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 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

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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 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.

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

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[67] These estimates are based on the following calculations: (($4779 + $956) x 1.2 ÷ 3 x .5 = $1147); (($37,500 + $7500) x 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

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]

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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

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

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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) x 1.2 20% cost increase x .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.

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

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

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procedures to obtain additional information would create a risk of significant harm to investors.

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

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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.").

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]

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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):

Congress found that the disclosure regimes of the Securities Act of 1933 and the Securities Exchange Act of 1934 were inadequate 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

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> 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.

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).

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

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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.

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

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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.

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 unprecedented and unjustified. We disagree.

We have largely addressed these concerns, which are inter-related in many respects,

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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

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

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provide us with copies of their written dissents prior to the completion of this Release.

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.

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

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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).

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.

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By the Commission.

Margaret H. McFarland

Deputy Secretary

June 30, 2005