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PERSPECTIVE

The Wrong Track To Reforming Corporate Governance

Failed efforts by the government show need for a more discerning approach.

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WHENEVER someone proposes a “reform,” she is staking out the high moral and political ground; this is nowhere more true than in the field of corporate governance, and especially so in the aftermath of the trainwreck of Enron (et al.). After all, who wants to be labeled “anti-reform”/“anti-corporate governance”? And yet there have been numerous such reforms that have been ill-considered or have led to serious unintended consequences.¹

This article will focus on two such reforms, reforms that were ultimately shot down in flames by the courts, as well as a third reform currently being put forward (and which, hopefully, will receive a similar, or worse, fate). Of particular focus will be the questions: (a) Why did they (and why will they) fail?; and, (b) Are we better or worse off as a result of those failures?

The Mutual Fund Industry

On the heels of the well-publicized investigations and prosecutions relating to the “late trading” and market timing of mutual funds,² federal securities regulators decided that fundamental change in the mutual fund industry was needed. One area that drew the Securities and Exchange Commission’s particular attention was the director oversight being exercised (or more specifically in the commission’s view, not being exercised).

In June 2004, a divided commission (3-2) adopted a series of rules governing mutual fund directors; one such rule required that at least 75 percent of a mutual fund’s board, including the chairman, be independent. The rules were then challenged in court by the U.S. Chamber of Commerce; one year later, the U.S. Court of Appeals for the D.C. Circuit remanded the rules back to the commission on the ground that the SEC had not adequately vetted the rules’ costs and possible alternatives. Eight days after that ruling, and one day before SEC Chairman William Donaldson left office, Mr. Donaldson—together with two other commissioners (and over the vociferous dissents of the other two commissioners)—pushed through the exact same rules.³

The Chamber of Commerce again challenged the rulemaking process in court. On April 7, 2006, the D.C. Circuit determined that the SEC’s second rulemaking process was (at least) as flawed as the prior

one. Instead of a blanket vacatur of the rules, however, the court delayed issuing its mandate and ordered the commission “to file a status report with the court within ninety days.”

On June 13, the SEC issued a “status report” to the court. The main thrust of the report was a formal “Request for Additional Comments” (unanimously approved by all five current commissioners); this request sought input not only on costs qua costs, but also on “any issue related to the underlying purpose of the independent requirements, which is the protection of funds and fund shareholders.” Any additional comments were slated to be into the commission by late August; the D.C. Circuit appears to be waiting to see what the SEC does in response thereto before taking action vis-a-vis its April 7 ruling.

That the commission’s rulemaking processes in 2004 and 2005 on mutual fund governance were deeply flawed seems pretty self-evident, and not just from an obvious rush to judgment and failure to vet the economic costs. More important (and as is implicit in the “Additional Comments” request) is that a per se 75 percent independence rule is not only structurally questionable, but is also likely to lead to bad/unintended consequences. Why? Well, first of all, what rules require publicly held companies to have (at least) 75 percent independent directors? And, what rules require publicly held companies to have an independent chairman? [These are not trick questions; there are no such rules.]⁴

Related to these rhetorical questions, are two more: Why are we to believe that, having a huge (and abstract) number of people guide the fortunes of a mutual fund with no prior knowledge about or experience with that fund, is preferable to having a good number of people who do? And why should the leader of each and every mutual fund board’s singular, substantive qualification for the job be that she has no prior connection whatever to the fund?

This all seems like a funny way to run a railroad; does anyone seriously contend that Fidelity’s various funds (and the investors therein), for example, have been poorly served by Fidelity boards’ leadership, much of which has come from Fidelity’s founding family? Another issue raised by the rejected rules is a “bullpen” problem—where are hundreds/thousands of mutual funds going to find enough “independent” people (qualified or not) to fill all the vacant board seats needing warm (“independent”) bodies?⁵

The D.C. Circuit directed the SEC to evaluate its proposed rules’ effects on “efficiency, competition[,] and capital formation.” If the commission does that (with the help of constructive comment letters), it will (hopefully) not just look at pure economic data, but

whether it can ultimately promulgate rules that will lead to the “best and the brightest” being available for mutual fund board service. It does not seem like rocket science to believe that such an outcome would be the best investor protection legacy the commission could bring to that industry.⁶

Regulating Hedge Funds

In December 2004, a divided SEC (by the same 3-2 split on which it divided in the mutual fund rulemaking) reversed long-standing commission rules and determined that hedge funds would henceforth (by Feb. 1, 2006) have to register under the Investment Advisers Act of 1940. Prior to that time, most hedge fund managers had been exempt from registration because they had fewer than 15 clients—each investing fund being counted as one client; by the SEC’s December 2004 re-casting of what/who constituted a “client,” however, each investor in each investing fund was now to be counted as a hedge fund client, thereby easily pushing virtually all hedge funds over the numerosity/registration threshold. And as contemplated by the SEC’s action, registration meant, inter alia: (i) filing disclosures on Form ADV; (ii) adopting a compliance program; (iii) adopting a code of ethics; and (iv) being subject to SEC examinations.

By June 2006, approximately 2,400 hedge fund advisers had registered with the commission, including more than 1,100 who had registered after Feb. 1 (this is out of a total universe of circa 9,000 funds). At the same time the hedge fund “industry” was coming to grips with SEC registration and its implications, one hedge fund manager—Phillip Goldstein of Bulldog Investors—decided to challenge the SEC’s action in court. And on June 23, 2006, the D.C. Circuit once again gave a sharp rebuke to the SEC’s rulemaking process.

In *Goldstein v. SEC*,⁷ the court determined that the three commissioners’ re-interpretation of “client” was “arbitrary,” “counterintuitive,” and wrong as a matter of law because hedge fund do not in fact act as investment advisers to individual investors who commit money to funds that invest with hedge fund managers. Because said managers owe fiduciary duties only to the investing funds and not to those funds’ individual investors, the court ruled that only the investing funds themselves were (and could be) “clients” of the hedge funds.⁸

While pondering an appeal, SEC Chairman Christopher Cox issued a statement that the commission would re-evaluate its approach to these matters, while instructing the staff to pull together “a set of alternatives for...consideration.” And while the

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SEC was pondering, some members of Congress moved to (in effect) reverse the D.C. Circuit's ruling; that initiative, however, does not seem to have gained any traction. Ultimately, on Aug. 7, the SEC announced it would not seek an appeal (which it called "futile"), and instead said it would engage in further rulemaking, using an antifraud hook to require greater hedge fund disclosure.⁹

So, what lessons can be learned from this second significant judicial setback to commission initiatives to seize the corporate governance high ground? First off, it seems clear that when commissioners, deeply divided amongst themselves, proceed into murky waters, things do not turn out so well. The consensus approach favored by Chairman Cox seems to be (by far) the better way for such a powerful government agency to proceed.

Second, was this ever a meaningful attempt to "regulate" hedge funds in the first place? The candid answer to that question is "no." Why? Not only because a great number of hedge fund managers had not registered, but more important, even for those that had, it is unquestionable that the commission (currently) has neither the staff nor the expertise to monitor them effectively. As Commissioner Rod Campos told an industry audience just weeks before the D.C. Circuit's ruling: "It's pretty clear that we will not be knocking on [hedge fund] doors very often...[And even if we did,] the SEC will never have the degree of knowledge or background that you do."¹⁰ Thus, to those who thought that the SEC's registration initiative equaled regulation, or that it would have somehow prevented the next Long Term Capital Management brouhaha, such fictional notions can be put to rest.¹¹

So what happens now while we wait to see what the SEC and Congress do? Some hedge funds are starting to pull their registrations—mostly the smaller ones who have been burdened by the costs and resources imposed by the reform.¹² Other (bigger) funds may just ride it out, having already absorbed the costs, invested the resources, and perhaps not only expected a de-fanged SEC when it comes to any future examinations, but also some competitive advantage in the marketplace for being registered.¹³

It was recently observed that "[a] lot of what is said about hedge funds...is nonsense."¹⁴ With that in mind, about the only thing we can be sure of is that we will hear a fair amount of additional nonsense before there is a resolution of the issue of whether to register/regulate hedge funds.¹⁵

Selective Waiver

On April 26, 2006, the U.S. Judicial Conference's Advisory Committee on Evidence Rules unveiled a new proposed amendment to Rule 502.¹⁶ This "reform" is designed to address the increasingly oppressive cooperation mantra which the government invokes with respect to those in its cross hairs.¹⁷ More specifically, proposed Rule 502(b)(3) would allow for the selective waivers of materials covered by the attorney-client privilege or the work product doctrine; in other words, companies could curry favor by providing the government said materials while refusing to produce the same in civil litigation.

In the Advisory Committee's words, allowing selective waivers "further the important policy of cooperation with government agencies, and maximizes the effectiveness and efficiency of government investigations." Who can argue with those lofty goals? Well, in fact, there are significant problems with this "reform."

The first problem is that it is difficult to envision the amendment ever becoming law. The Rules Enabling Act requires congressional action of any rule "creating, abolishing, or modifying an evidentiary privilege."¹⁸ The plaintiffs' bar—which, at last look, had some political clout—will surely strongly oppose this "reform" since it is directed specifically to making their lives (and livelihoods) more problematic.

More basic issues are whether this "reform" is necessary or is even consistent with basic principles

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undergirding the privilege. As for whether it is necessary, every circuit court that has looked at this question—save one, the U.S. Court of Appeals for the Eighth Circuit almost 30 years ago—has concluded that there is no evidence whatever to support the notion that companies will not cooperate with the government (prosecutors or regulators), but for selective waiver; and this well-reasoned analysis was recently reaffirmed by the U.S. Court of Appeals for the Tenth Circuit on June 19 of this year.¹⁹

And the entire idea of a selective waiver is directly at odds with one of the principal foundations of the privilege—for a confidential communication to be protected it must keep its confidential status.²⁰ Furthermore, and as the Tenth Circuit correctly noted, rather than promoting the purposes served by the privilege and work product doctrine, selective waiver could well have the effect of making corporate personnel reluctant to speak to company attorneys—a result wholly antithetical to why the U.S. Supreme Court extended the corporate attorney-client privilege to all employees in *Upjohn v. U.S.*²¹

Conclusion

Political columnist James J. Kilpatrick once wrote that "reform is like garlic in the dressing: a little bit, as every cook knows, goes a very long way."²² As the foregoing examples well illustrate, we probably need to be a bit more restrained and discerning before we willy-nilly embrace "reforms" put forward in the name of good corporate governance.²³ President Ronald Reagan once said in a very different context: "Trust, but verify." It was good advice then, and it still is today.

1. See C.E. Stewart, WHILE ROME BURNS—FIDDLING WITH REFORMING REFORM IN THE SECURITIES INDUSTRY (NLCP, Washington, D.C., 1998).

2. See C.E. Stewart, "The 'Soft' 4 p.m. 'Brick Wall': A Reality Check on 'Late Trading,'" Money Management Executive (March 22, 2004); C.E. Stewart, "The Criminalization of 'Late Trading': Wrong and Wronger," European Lawyer (July/August 2004).

3. Dissenting Commissioner Paul Atkins was quoted on this process

as follows: "This is one of the saddest days in the 71-year history of SEC."

4. "Best Practices" in the corporate field generally look to a majority (i.e., 51 percent) of directors being independent, with ironclad independence of the audit committee of particular focus. See, e.g., "Report and Recommendation of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees" (Feb. 9, 1998).

5. This, of course, is on top of the broader challenge of finding directors to serve in the first place, given the liability issues that now confront directors. See C.E. Stewart, "The Yin and Yang of Corporate Governance," GC New York (Oct. 11, 2005). The "financial expert" requirement of Sarbanes-Oxley also implicates this "bullpen" problem.

6. And that is not to say that mutual fund boards with numerous independent directors and/or chairmen cannot do (and are not currently doing) effective corporate governance right now. See T. Lauricella, "Independent Directors Strike Back," The Wall Street Journal R1 (July 5, 2006). As the D.C. Circuit noted, moreover, a number of mutual funds had already moved toward having greater numbers of independent directors, irrespective of the outcome of the pending litigation over the commission's rulemaking process.

7. 2006 WL1715766 (D.C. Cir. June 23, 2006).

8. As the D.C. Circuit observed: "If the [individual] investors are owed a fiduciary duty and the entity is also owed a fiduciary duty, then the adviser will inevitably face conflicts of interest...It simply cannot be that investment advisers are the servants of two masters."

9. On Aug. 10, the SEC posted on its Web site a seven-page "no-action" letter for hedge funds seeking guidance on how to proceed during this transition period.

10. See K. Betz, "SEC Has No Secret Plan to Regulate Hedge Funds, Campos Says," BNA Securities Regulation & Law Report 1059 (June 19, 2006). In 2005, the SEC brought 29 fraud cases against hedge funds, up from 19 in 2004. Those cases were brought via the traditional enforcement process, not through staff examinations; in fact, examinations are not the usual means to uncover fraud. Id. See also N. Arnoff & S. Wexler, "Investment Advisory Enforcement Cases," New York Law Journal (July 14, 2006).

11. See J. Anderson, "SEC Lost Its Hedge-Fund Authority and Will Be Glad It Did," The New York Times C9 (June 30, 2006). To the extent the SEC staff had already begun the examination process, it was pretty uniformly described as unsuccessful (at best).

12. See K. Scannell, "Some Hedge Funds Pull SEC Registration Plans," The Wall Street Journal C3 (July 20, 2006).

13. See J. Eisinger, "A David Topples Hedge-Fund Rule, but Was Goliath Really So Bad?," The Wall Street Journal C1 (July 5, 2006).

14. See D. Wessel, "How Would Hedge Funds Behave in a Crisis?," The Wall Street Journal A2 (July 20, 2006). One example of this "nonsense" has been a recently aired debate about the impact of hedge fund registration on the "balance of power between public companies and activist shareholders." A. Davis, "The Buzz," The Wall Street Journal B3 (July 15, 2006).

15. Chairman Cox in testimony before the Senate Banking Committee on July 25 stated that the SEC may take steps to address the current state of affairs, but that legislation may also be needed. Asked whether the SEC currently has statutory authority to regulate hedge funds, Mr. Cox demurred, saying that "I'm not prepared to say yes or no to the question today." See K. Scannell, "Cox to Fill Regulatory 'Hole' on Hedge Funds," The Wall Street Journal C3 (July 26, 2006).

16. This is in addition to a separate amendment to Rule 502 that would address inadvertent waiver of privilege, which has its own shortcomings. See C.E. Stewart, "The Internet, Litigation and the 'Oops' Factor," GC New York (May 15, 2006).

17. See C.E. Stewart, "When the Government Comes Knocking," GC New York (March 15, 2005).

18. 28 U.S.C. §2074(b).

19. See *Diversified Industries Inc. v. Meredith*, 572 F.2d 596 (8th Cir. 1977); *In re Quest Communications International Inc. Securities Litigation*, No. 06-1070 (10th Cir. June 19, 2006); see also C.E. Stewart, "Attorney-Client Privilege: Killing Limited Waiver," New York Law Journal (Jan. 16, 1992).

20. See C.E. Stewart, "The Attorney-Client Privilege—The Best of Times, the Worst of Times," The Professional Lawyer 63 (1999).

21. 449 U.S. 383 (1981). The attorney-client relationship has been under attack especially in light of post-Enron "reforms" (e.g., Sarbanes-Oxley). See C.E. Stewart, "The SEC & The Lawyer-Client Relationship: A Revolution in the Making," Compliance Reporter (Feb. 9, 2004). Rule 502(b)(3), if enacted, would likely accelerate that trend.

22. See W. Safire, Safire's Political Dictionary 605 (Random House 1978).

23. See H. Pitt, "Over-Lawyered at the SEC," The Wall Street Journal A15 (July 26, 2006).

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