IN THE
UNITED STATES COURT OF APPEALS
FOR THE DISTRICT OF COLUMBIA CIRCUIT

CHAMBER OF COMMERCE
OF THE UNITED STATES OF AMERICA,

Petitioner,

v.

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION,

Respondent.

ON PETITION FOR REVIEW

No. 04-1300

REPLY IN SUPPORT OF EMERGENCY MOTION FOR STAY, OR, ALTERNATIVELY, FOR EXPEDITED BRIEFING BY PETITIONER CHAMBER OF COMMERCE OF THE UNITED STATES OF AMERICA

Dated: October 7, 2004

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INTRODUCTION

The Chamber's Motion showed this to be a case of rulemaking conducted as if the agency were unaccountable—unaccountable to statutory limits on its authority, unaccountable to procedural requirements for rulemaking, unaccountable to the public's comments and empirical data in the record.

In the Commission's Opposition, this fundamental error persists. The Commission declares, with pride, that this is a "corporate governance" rule, although it quietly concedes that it has no general authority to regulate corporate governance. The Commission admits—indeed, proclaims—that the purpose of this rulemaking was to address conduct other than the conduct that is the subject of the rules being amended. It tacitly concedes that its "Adopting Release" provided no meaningful discussion of any of the ten distinct rules being amended.

And, consistent with its nonresponsiveness to opposing views and empirical data in the rulemaking, the Commission almost wholly fails to respond to the Chamber's evidence of irreparable harm. The Chamber submitted two declarations showing that this rule is imposing immediate and irretrievable costs: The very identity of thousands of mutual fund boards will be changed, with new leaders installed who—even if the rule is invalidated—cannot be expected to return the reins to their improperly ousted predecessors, nor to reverse the countless decisions they made after taking office by dint of the Commission's unlawful rule. Right now, search costs are being incurred—and in some instances, proxy solicitations prepared—for new independent directors and chairs who will command higher fees and hire staff that impose still more costs on investors. Many of these and the other immediate costs of the rule the Commission does not even deign to address; some it denies with no basis at all; and as to none does it offer opposing evidence to the Court.

This is a serious case of government disregard for constraints on its authority. A stay is appropriate.[1]

JURISDICTIONAL STATEMENT

The Commission questions whether the Chamber has standing because—while its members and their subsidiaries include advisers to mutual funds—the "number" of those advisers and their "percentage" of Chamber membership are not identified. That is immaterial; one affected member is sufficient for associational standing. *Warth v. Seldin*, 422 U.S. 490, 511 (1975). Here, at least 30 Chamber members and their subsidiaries are fund advisers. Decl. of Jennifer Reutershan, Exh. 1 hereto. The Commission also professes uncertainty as to the harm advisers would suffer from the rule. That harm is self-evident: the rule is intended to reduce advisers' influence over the funds they establish, manage, and on which their income depends; the Commission hopes the rule will reduce advisers' income. *See* Final Rule, 69 Fed. Reg. 46,378, 46,380-46,381 (Aug. 2, 2004) (App., Exh. 3). These harms were identified repeatedly in the Chamber's moving papers. *See generally* Bobroff and Macey Decls. (App., Exhs. 1-2). Further, the suit is germane to the Chamber's associational purpose of protecting members from costly and unlawful federal regulation, and participation by any individual member is not necessary for this Court to provide meaningful relief. *National Taxpayers Union v. United States*, 68 F.3d 1428, 1435 (D.C. Cir. 1995).

The Commission questions the Chamber's separate ground for standing—that it is an investor in mutual funds—by musing that perhaps only a "fund itself" would have standing. Opp. at 2. That is a remarkable suggestion for an agency that champions the rule principally for

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[1] For discussion of the growing concern with the Commission's practices in recent rulemakings, *see* Peter J. Wallison, Financial Services Outlook: *Shooting from the Hip: The SEC Has Stopped Doing Its Homework* (AEI, Oct. 2004).

its predicted effects on investors. *Id.* at 19. Further, this rule effectively eliminates the dominant investment option in the mutual fund industry, the management-chaired fund, which the record shows to yield higher investment returns. Macey Decl. ¶¶ 19-21. Elimination of the ability to purchase a desired product is legally-cognizable injury. *Consumer Fed'n of Am. v. Federal Communications Comm'n*, 348 F.3d 1009, 1013 (D.C. Cir. 2003); *Competitive Enter. Inst. v. Nat'l Highway Traffic Safety Admin.*, 901 F.2d 107, 112-13 (D.C. Cir. 1990).[2]

DISCUSSION

I. PETITIONER IS SUBSTANTIALLY LIKELY TO PREVAIL ON THE MERITS

The Commission's Opposition shows that the parties agree on three central predicates:

First, the Commission has no general authority to regulate mutual fund governance. *See* Motion at 9-10 and the cases cited therein. The Commission tacitly concedes this.

Second, this rulemaking is intended to implement broad changes in corporate governance. *Id.* at 9-11, 16-19. The Commission promulgated the rule to address what it deemed "mounting evidence that mutual fund managers were misusing their positions of trust." Opp. at 1; *see also id.* at 19-20. Specifically, the Commission was concerned with market-timing, late trading, and misuse of nonpublic information. *See id.* at 8 n.18, 9. As one of a "number of initiatives" undertaken in response, the Commission adopted this self-styled "governance rule" to "impose[ ] corporate governance standards." *Id.* at 17; *accord* 69 Fed. Reg. at 46,378-46,379.

Third, the rule was <u>not</u> animated by conduct taken pursuant to the preexisting "exemptive" rules being amended. Petitioner's Motion identified by way of example two amended rules that were not meaningfully discussed in the rulemaking—one concerned "interim

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[2] The Commission does not provide the Court a direct response to the discussion of jurisdiction in the Chamber's Motion. Instead, it refers the Court to an earlier and somewhat nonresponsive filing the Commission made in the District Court. Opp. at 2.

contracts" for fund advisers; the other concerned "joint insured bonds." Motion at 12-13. There is no evidence that late trading resulted from improvident "interim contracts"; nor is there evidence that ill-considered "joint insured bonds" underlay market-timing abuses. Indeed, there is no discernable connection between activities under <u>any</u> exemptive rules and the misconduct the Commission seeks to address here—and the Commission has asserted no such connection.

1. Against this undisputed background, the Commission's concept of its regulatory authority is, frankly, not entirely clear. At times the Commission appears to argue that its authority to address conflicts of interest in activities under the exemptive rules is an authority to address conflicts of interest generally—as reflected in the following (flawed) syllogism:

- Recent fund misconduct involved conflicts of interest.
- The exemptive rules involve conflicts of interest.
- The exemptive rules may address recent fund misconduct.

That is faulty logic and worse administrative law. The Commission cannot use the regulatory powers it does have to regulate matters outside its mandate, as this Court made clear in *Business Roundtable v. SEC*, 905 F.2d 406 (D.C. Cir. 1990). *See also Chamber of Commerce v. United States Department of Labor*, 174 F.3d 206 (D.C. Cir. 1999) (agency had authority to conduct inspections, but could not use that authority as "leverage" to impose obligations that are not currently required by law). Likewise, it is a fallacy that the Commission's authority to permit certain activities "conditionally" is an authority to regulate other activities as well. That is a prescription for unfettered regulatory power, and is particularly inapt here, where the Commission attempts to convert a <u>narrow</u> authority to <u>ease</u> regulation into a <u>broad</u> authority to <u>impose</u> regulation. The lesser includes the greater, it would seem.

2. At other times the Commission may be arguing that this rule targets activities under the exemptive rules exclusively, and the unrelated fund misconduct is merely a sign—a barometer—that the exemptive rules do not adequately address conflicts in activities under those

rules themselves. There are multiple problems with this argument. First, it is disingenuous: The overwhelming evidence in the record and in the Opposition is that this rule was adopted to regulate fund governance generally, not to address specific, narrow exempted activities which were not even discussed in the Adopting Release or in the Commission's public hearings. Second, this argument remains premised on the erroneous conception of the Commission's authority discussed above: Since the exemptive rules cannot be used to regulate non-exempted conduct, any problems that emerge in non-exempted conduct can hardly be attributed to exemptive rules that do not address that conduct![3]

Finally, the Commission cannot escape the fact that its "discussion" of the terms of the rules it was amending was wholly inadequate under the APA. The Chamber's Motion took pains to discuss—merely by way of example—two exemptive rules that the Commission never meaningfully discussed in the rulemaking. The Motion described those rules' current requirements and the activities they authorize, and then showed how the Commission's governance amendments appeared unnecessary for those rules in view of their terms and the conduct they address. Motion at 12-13. The Commission does not respond with its own discussion of those rules' terms and why the amendments were in fact a good fit. (It is indeed a marvel that the Motion's brief discussion of Rules 17g-1 and 15a-4(b)(2) is a more sustained examination of specific rules at issue than the Commission has offered at any point in the rulemaking or litigation.) Instead, the Commission says in response that it:

> [E]xplained, both in connection with the 2001 amendments and again in connection with the 2004 amendments, that serious problems had emerged in the mutual fund

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[3] The record does not demonstrate that funds with management chairs were implicated in market timing or other improper practices at a higher rate than independent-chaired funds. Nor has the Commission provided any empirical evidence that its governance changes would have the beneficial effects the Commission claims.

> industry that indicated that the independent oversight conditions provided in the Exemptive Rules needed to be enhanced. In 2001, the Commission added the condition that a majority of the board be independent. That change proved to be inadequate. So, in 2004, the Commission [adopted the provisions at issue here].

Opp. at 13 (emphasis added). That is nonresponsive—the 2001 amendments did not "prove[ ] to be inadequate" to the rules the Commission was amending. There is no evidence that the 2001 amendments failed to assure proper practices when it comes to "joint insured bonds" or "interim contracts," or any of the other exempted activities. Rather, the amendments proved "inadequate," in the view of a bare majority of the Commission, to the agency's efforts to address collateral concerns through corporate governance requirements that it has no independent authority to impose.[4]

3. The Commission also fundamentally misapprehends its procedural obligations:

- The Commission gave short-shrift to empirical data.

The Commission was statutorily required to consider the rule's effect on "efficiency, competition, and capital formation." Motion at 13-14. A 20-page study was submitted in the comment period which showed that management-chaired funds outperform independent-chaired funds. *Id.* at 14. The Commission says it discussed this study "at length" in the Adopting Release—actually, all reference was consigned to a footnote—and asserts that it properly discharged its responsibility under *State Farm* to "'exercise its judgment'" with regard to the study. "The Commission pointed out that other commenters viewed the data differently" than the study's authors, it explains. Opp. at 14. How "other commenters viewed" the data is

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[4] The Commission's discussion of the exemptive rules in 2001 was similarly superficial, cursory, and pretextual, and in any event does not excuse the agency from fully complying with the APA in this rulemaking. *See Action on Smoking & Health v. CAB*, 713 F.2d 795, 800 (D.C. Cir. 1983) ("If one rulemaking proceeding has culminated and another has begun, then new notice and comment procedures are required.").

irrelevant—what matters is the Commission's obligation to exercise its judgment to reach a considered determination of the merits of the study. That was not done. The Opposition adds that "the study itself noted that the correlation it found may have been due to other factors," but omits that the study then proceeded to consider what other factors might explain the correlation between management-chaired funds and strong fund performance, and identified none. *Id.*

This failure to grapple with the serious questions posed by this rule is characteristic of a rulemaking where the Chairman of the agency confided that "there are no empirical studies that are worth much." The Opposition claims this statement was made in the context of "conflicting empirical data." Opp. at 14 n.20. In fact, the Chairman attributed his judgment to "many years . . . in and around the investment business, tempered by years in and around the academic community." June 23 Open Meeting Transcript (App., Exh. 9 at 33; Supp. App., Tab 4 at 58).

- The Commission gave insufficient consideration to other important issues.

The Motion noted commenters' concern that the rule would increase costs and decrease investment returns by causing the hiring of staff. The Opposition merely reiterates the response in the Adopting Release: "[T]he rule amendments did not require fund boards to hire employees or retain experts." Opp. at 15. In fact, however, the Adopting Release said the rule is "designed to enable independent directors to hire employees and others"; giving independent directors the authority to do so is one of the rule's six provisions. 69 Fed. Reg. at 46,385 (emphasis added). It is disingenuous wordplay to say that something a rule is "designed" to cause is not a cost of the rule because it is not expressly required.

- The Commission failed to give adequate consideration to alternatives.

The Commission addressed all "major alternatives" to the rule's disputed provisions, it claims. Opp. at 15. But one alternative it failed to address—enhanced disclosure of whether a chair is independent—was advocated by two of the Commission's five members; that qualifies

as a "major" alternative under any test. Altogether the Commission devoted a total of one paragraph—6 sentences—to a discussion of alternatives to the independent chair requirement; it addressed only 2 of the approximately 20 alternatives suggested. *See* 69 Fed. Reg. at 46,384. Small wonder the dissenting Commissioners—who personally participated in the agency's deliberations—titled a section of their dissent, "The Commission Failed To Consider Alternatives." *Id.* at 46,392.

II. A STAY IS NECESSARY TO PREVENT IRREPARABLE HARM AND WILL SERVE THE PUBLIC INTEREST WITHOUT HARMING OTHER PARTIES

The Commission tacitly concedes most of the description of irreparable harm in the Chamber's Motion and declarations, and makes fleeting and inadequate response to the rest:[5]

- Identifying new board members already is imposing immediate and irretrievable costs, including meetings of nominating committees, travel to interview candidates, and retaining search firms. Motion at 16; Bobroff Decl. ¶¶ 5-6; Macey Decl. ¶ 28. The Commission disputes none of this. And, contrary to its suggestion, these and the costs discussed below do warrant a stay because they are not merely speculative—they are required by the rule or are practical necessities of it, as attested by two distinguished experts—and the losses they will cause are irretrievable. *Wisconsin Gas Co. v. FERC*, 758 F.2d 669, 674 (D.C. Cir. 1985) (per curiam).

- "There [a]re no out-of-pocket costs associated with appointing an independent chair," the Commission asserts without supporting evidence. Opp. at 17. In fact, the undisputed

[5] The Commission—which submitted no evidence of its own—objects that the Chamber did not submit a declaration by a mutual fund. That is immaterial; the question is whether there is competent evidence of irreparable harm, not who provided it. Mr. Bobroff previously has served as an expert witness on the Investment Company Act for the Commission; Professor Macey is a nationally-respected scholar who has participated at the Commission's invitation in a public "roundtable" hearing in a separate rulemaking. Bobroff Decl. ¶ 1; http://www.sec.gov/spotlight/roundtables/accountround030602. htm (Professor Macey serving as Roundtable panelist).

evidence is that the rule will increase total compensation paid to independent directors, and empirical work by one of the Chamber's declarants indicates that independent chairs will command premiums of at least 20 to 40 percent. Bobroff Decl. ¶¶ 5-6.

- The Commission suggests there is no cost to meeting the 75 percent independence requirement by removing management members from the board. In fact, funds compelled to take this route will be forced to have a smaller board than they deemed optimal, and will lose the expertise of management-affiliated directors. Bobroff Decl. ¶ 5; Macey Decl. ¶ 25. The Commission does not dispute this. *See* Opp. at 9 (describing the "greater access to information" of management directors and the "significant advantage" this carries).

- The record indicates that management-chaired funds—which are being eliminated—are more profitable than funds with independent chairs. That lost income to investors cannot be recouped. Bobroff Decl. ¶ 4; Macey Decl. ¶ 21. The Commission does not address this.

- The Commission tacitly concedes that new boards constituted under this rule will make "countless significant decisions," many of which will be irreversible. Opp. at 18; Macey Decl. ¶¶ 24-27. "There is no reason to believe" the decisions would not be good ones, the Commission claims. Opp. at 18. In fact, to the extent boards are unlawfully altered and make irreversible decisions that the original board would not have made, that is irreparable harm.

- The Commission tacitly acknowledges that the rule's January 2006 compliance date reflects the time that many funds will need to come into compliance with the rule. Accordingly—as attested by both the Chamber's declarants—costs to comply already are being incurred. Motion at 16; Bobroff Decl. ¶ 5. Simply, this is a rule with immediate consequences for funds as confirmed by the Commission's vigorous insistence that a stay—or even expedited briefing—would impede implementation. Opp. at 2.

- Finally, the Commission does not dispute the Chamber's illustration that by changing who a corporation's decisionmakers are, the rule makes it highly unlikely that the matters changed by this regulation will revert to their prior state once the rule is invalidated. Rather, for multiple reasons, many board chairs and directors who acquire office through the Commission's unlawful rule will retain control of the funds even after the rule is invalidated. Because it changes not merely available decisions but decisionmakers, this rule has consequences that are uniquely powerful and irreversible.

CONCLUSION

The Commission opposes even expedited briefing in this case because the case has "serious implications" for the Commission's current exercise of regulatory authority. Opp. at 2. The case does indeed go to the heart of the Commission's role and responsibilities. And that the Commission so seriously misapprehends the limits on its authority is yet another reason a stay is not merely appropriate, but is necessary to assuring that this important agency wields its considerable power within lawfully-prescribed limits.

Dated: October 7, 2004

Respectfully submitted,

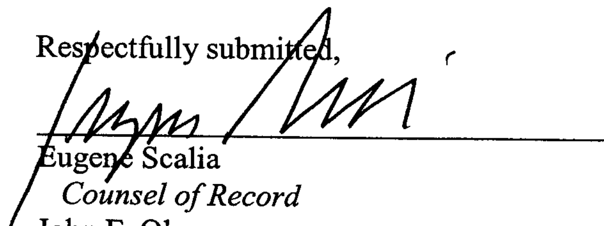

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EXHIBIT 1

Declaration of Jennifer Reutershan

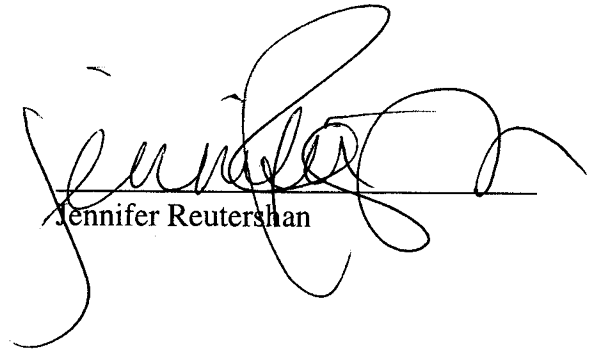
I, Jennifer Reutershan, hereby state and declare as follows:

1. I currently serve as the Director of Strategic Marketing for the Chamber of Commerce of the United States of America. In that capacity, I am familiar with the Chamber's membership.

2. As of September 2, 2004—the date that the Chamber filed a lawsuit against the United States Securities and Exchange Commission in the United States Court of Appeals for the District of Columbia Circuit (Case No. 04-1300)—at least 30 Chamber members, or their subsidiaries, served as advisers to mutual funds. These entities include firms that have non-independent chairs, and that have fewer than 75 percent independent directors.

3. I hereby declare under penalty of perjury that the forgoing is true and correct.

Dated: October 7, 2004



Jennifer Reutershan

CERTIFICATE OF SERVICE

I hereby certify that I have caused to be served a true and correct copy of the Reply in Support of Emergency Motion for Stay, or, Alternatively, for Expedited Briefing via hand delivery this 7th day of October, 2004, upon the following:

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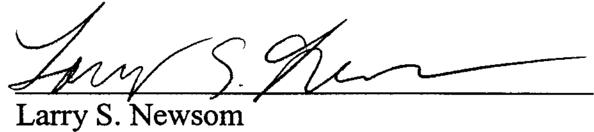

Larry S. Newsom