IN THE UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF COLUMBIA

CHAMBER OF COMMERCE OF THE UNITED STATES OF AMERICA, 1615 H Street, NW Washington, D.C. 20062 Plaintiff, v. UNITED STATES SECURITIES AND EXCHANGE COMMISSION 450 Fifth Street, NW Washington, D.C. 20549 Defendant.	Case No. __________

COMPLAINT

Plaintiff Chamber of Commerce of the United States of America, by way of complaint, alleges as follows:

INTRODUCTION

1. This is a lawsuit under the Administrative Procedure Act challenging two provisions of the Securities and Exchange Commission's new mutual fund "governance" rule. The first provision, which the Commission concedes to be the most controversial aspect of its new rule, effectively requires the vast majority of mutual funds to change their governance structure so that the chair of their board of directors is not affiliated with the firm that provides advisory services to the fund. The second provision effectively requires that at least 75 percent of a fund's directors be "independent" of the fund adviser (or, in the case of funds with three-member boards, that two of the three directors be independent).

2. Each of these new requirements upsets the balance Congress established in the Investment Company Act of 1940 for the governance of mutual funds, and improperly usurps States' role as the primary authority on matters of corporate governance. In exceeding its statutory mandate in this manner, the Commission also flouted basic requirements of notice and comment rulemaking by amending in a single rulemaking ten quite different and long-standing Commission rules without any meaningful discussion of those rules' current requirements, their original purpose, the manner in which the rules will operate as a result of these wholesale amendments, and why each such change was necessary in light of each rule's purpose and the Commission's legitimate objectives.

3. The new Commission requirements are arbitrary, capricious, and contrary to law in other respects as well. The independent chair requirement will prevent independent directors of mutual funds from deciding for themselves whether an independent or management chair is best for the fund; will strip investors of the option they currently have to invest in a fund chaired by a management director if they so choose; and will force the vast majority of mutual funds to change their governance structure in a manner the record shows will adversely affect the funds, the investing public, and the economy. Yet, as noted by two members of the Commission in a strong dissent from the agency's action, the Commission failed to give adequate consideration to alternatives to its independent chair requirement, paid insufficient attention to the scores of comments opposing the requirement, and gave short shrift to empirical evidence of the mandate's dubious value. The Commission similarly identified no rational basis for selecting 75 percent as the requisite percentage of independent directors, and conceded that it had "no reliable basis" for determining how funds would satisfy that requirement, nor for estimating the costs it would impose.

4. Plaintiff accordingly requests that this Court enter a declaratory order that the independent chair requirement and 75 percent independent director requirement are unlawful; enjoin the Commission from implementing and enforcing the requirements or giving them effect in any manner; and order such other relief as may be appropriate.

JURISDICTION AND VENUE

5. This action arises under the Administrative Procedure Act, 5 U.S.C. §§ 701-706 ("APA"), and the Investment Company Act of 1940, 15 U.S.C. §§ 80a *et seq.* ("ICA" or "Act").

6. Judicial review is sought pursuant to the APA, which authorizes review of agency action, including rulemaking. 5 U.S.C. §§ 701-706.

7. This Court has federal question jurisdiction over this action under 28 U.S.C. § 1331, and may grant declaratory judgment and further relief pursuant to 28 U.S.C. §§ 2201 and 2202.

8. Venue in this Court is proper under 28 U.S.C. § 1391(e).

PARTIES

9. Plaintiff Chamber of Commerce of the United States of America, which is incorporated under the laws of the District of Columbia and has its principal place of business in the District, is the nation's largest federation of business companies and associations. It has an underlying membership of more than three million businesses and professional organizations of every size and in every industry sector and from every region of the country. Chamber of Commerce members and their subsidiaries include mutual fund advisers that will be affected by the rule. The Chamber of Commerce also will be directly affected by this rule because it is invested in mutual funds that as a consequence of the rule will be compelled to select a new chair

and to satisfy the 75 percent independent director requirement. The Chamber of Commerce filed comments with the agency during the course of the rulemaking.

10. Defendant United States Securities and Exchange Commission, which has its principal office in the District of Columbia, is an agency of the United States government created by the Securities Exchange Act of 1934, 15 U.S.C. § 78d.

FACTUAL BACKGROUND

Mutual Funds, Mutual Fund Advisers, And Investment Companies

11. Mutual funds are investment vehicles that pool assets of numerous investors to purchase stocks, bonds, and other financial instruments. Funds currently hold more than $7.5 trillion in assets; mutual fund shares are held by nearly 50 percent of all families in the United States. Funds are popular and effective investment vehicles because they enable individual investors to obtain the benefits of diversification, economies of scale, and the expertise of financial managers who invest the funds' assets. Under the law, mutual funds are organized as "investment companies"; individuals invest in mutual funds by purchasing shares in the company.

12. Investors typically associate mutual funds with the "adviser" that created the fund and that in most instances is responsible for fund management. The adviser is a separate entity from the fund. A single adviser—the "Acme Advisory Company," for example—might establish a number of mutual funds to offer an array of investment options: *e.g.*, the Acme Aggressive Growth Fund, the Acme International Fund, the Acme Large Cap Fund, etc., each of which would be a separate investment company.

13. Investors commonly invest in a particular fund based on the adviser's reputation for expertise in the market sector covered by the fund as reflected in the fund's performance. If

investors are dissatisfied with a fund's performance, they can sell their shares and invest elsewhere.

14. Each fund has its own board of directors. The investment adviser appoints the initial board, with state law determining the process for selecting the board chair. Directors of fund boards have a fiduciary duty to the fund and are subject to state-law duties of loyalty and care, as well as to federal-law duties expressly set forth in the Investment Company Act.

15. Currently, approximately 80 percent of mutual funds have a chair of the board who is affiliated with the adviser that established the fund. The Commission's rule effectively would require all of these funds to replace their chair. The rule also would compel approximately half of mutual funds to change the balance between independent and management directors in order to satisfy the 75 percent independent director requirement.

Investment Company Act Of 1940

16. In 1940, Congress enacted the Investment Company Act to regulate funds that engage primarily in investing, reinvesting, and trading in securities, and whose own securities are offered to the investing public. Among other things, the Act:

a. governs the registration of funds with the Commission, 15 U.S.C. § 80a-8;

b. requires funds to have boards of directors that are at least 40 percent independent of the adviser that established the fund (a majority of directors must be independent when the principal underwriter is an affiliate of the fund, and 75 percent of directors must be independent for funds using the limited safe harbor discussed in paragraph 41 below), *id.* at §§ 80a-10, 80a-15(f);

c. regulates and proscribes certain transactions between a fund and its investment adviser, *id.* at §§ 80a-15, 80a-17;

d. requires that a majority of both the independent directors and the fund's outstanding voting securities approve a fund's contract with its adviser, *id.* at § 80a-15; and

e. specifies that an investment adviser has a fiduciary duty with respect to the receipt of compensation for services paid by the fund, *id.* at § 80a-35b.

17. The Securities and Exchange Commission is assigned certain responsibilities under the Act, including the authority to allow exemptions from certain prohibitions in the Act. *See, e.g.*, *id.* at § 80a-6(c). Over the years, the Commission has issued a number of "exemptive rules" pursuant to this authority. The Commission's new "governance" rule amends ten of these exemptive rules to impose additional conditions on funds' reliance on those exemptions. Among these new conditions are the independent chair requirement and 75 percent independent director requirement. The vast majority of mutual funds currently rely on one or more of the amended exemptive rules.

18. In enacting the Investment Company Act, Congress specifically considered and rejected a blanket requirement that a majority of a fund's directors be independent. As recounted in Congressional testimony at the time, "[t]he bill as originally introduced . . . required that a majority of the board be independent of the management. However, the argument was made that it is difficult for a person or firm to undertake the management of an investment company, [and] give advice, when the majority of the board may repudiate that advice. It was urged that if a person is buying management of a particular person and if the majority of the board can repudiate his advice, then in effect, you are depriving the stockholders of that person's advice. . . . [T]hat is why the provision for 40 percent of independents was included." Hearings on H.R. 10065 Before the House Subcomm. on Interstate and Foreign Commerce, 76th. Cong. 3d Sess. 109-10 (1940) (testimony of David Schenker); *see also* 15 U.S.C. § 80a-10. As noted,

the Act requires a larger complement of independent directors only in specific, statutorily-identified circumstances, and nowhere mandates that the chair of the board be independent.

19. While the Act regulates mutual funds in certain important, discrete respects, funds remain primarily creatures of state law; the powers and responsibilities of directors accordingly are determined according to state law where the Act does not specify otherwise. *Burks v. Lasker*, 441 U.S. 471 (1979).

Proposed Rule

20. On January 23, 2004, the Commission published in the Federal Register a proposed rule that would amend ten commonly-used exemptive rules. The proposed amendments provided that, in the future, exemption under the rules would be conditioned on certain "corporate governance" requirements to be added to 17 C.F.R. § 270.0-1(a)(7). *See* Investment Company Governance; Proposed Rule, 69 Fed. Reg. 3,472 (Jan. 23, 2004).

21. The new conditions proposed by the Commission included:

- Independent chair. The directors, who under current law appoint the fund's chair, would have to appoint a chair who is an independent director, that is, unaffiliated with the fund adviser.

- Independent board composition. Independent directors would have to constitute at least a 75 percent supermajority of the fund's board.

- Annual self-assessment. The fund's board would have to assess its own effectiveness at least once a year. This assessment would include consideration of the board's committee structure and the number of funds on whose boards the directors serve.

- Separate meetings of independent directors. Independent directors would have to meet in separate sessions at least once a quarter.

- Independent director staff. Funds would have to authorize independent directors to hire their own staff.

See generally 69 Fed. Reg. 3,472.

Public Comment On The Commission Proposal

22. The Commission received nearly 200 comments on its proposed rule. Commenters objected to the independent chair requirement on a number of grounds, including:

a. According to the Committee on Investment Management Regulation of the Association of the Bar of the City of New York, the proposed independent chair requirement "disregards the careful balance between state and federal law reflected in the [Act]" and "conflicts with the basic approach of the Commission to entrust certain important matters to an investment company's disinterested directors." Further, "the selection of a chairman of a board of directors clearly is one of the core issues affecting the internal affairs of a corporation" that is reserved to the States. Comment Letter of Stuart H. Coleman, Chair, Committee on Investment Management Regulation, The Association of the Bar of the City of New York.

b. Investors frequently choose to invest in a fund based on the identity, reputation, and ability of a chair of the fund who is affiliated with the fund adviser; they should not be precluded from making that investment choice in the future. *See, e.g.*, Comment Letter of Bill Majure, an individual investor.

c. The independent directors of a fund—who under a 2001 Commission rule must already constitute a majority of the board (and under the proposed rule would constitute at least 75 percent)—reasonably could decide to select as chair a management director who brings extensive expertise to the position as well as a strong commitment to the fund's shareholders and to fiduciary duties. *See* Comment Letter of Sen. Judd Gregg, Chairman, Subcommittee on Commerce, Justice, State, the Judiciary, and Related Agencies, Senate Appropriations Committee.

d. Indeed, a centerpiece of the Investment Company Act is the role of independent directors, yet the independent chair requirement "would reduce the very discretion and authority of independent directors that the Investment Company Act is founded upon" by denying them the ability to appoint a management chair when they find that in the best interests of the fund and its investors. Comment Letter of Eric D. Roiter, Senior Vice President and General Counsel, Fidelity Management & Research Company.

e. The proposed rule constituted an improper "one-size-fits-all" regulatory approach that "compel[s] a single result for all mutual funds, without regard to their origins, history, performance, or the adviser's record." *Id.*

23. Commenters also objected that the independent chair requirement would impose additional and unnecessary costs:

a. By causing funds to recruit new directors, pay independent chairs higher fees, and compensate staff retained by an independent chair, the independent chair requirement would divert resources from other, more profitable uses. Comment Letter of Daniel F. Clifton, Executive Director, American Shareholder Association. As a consequence, "[t]he introduction of new funds by entrepreneurs and the jobs they create would be curtailed; [and] higher barriers to entry and operational costs would likely force unwanted consolidation and leave the mutual fund industry in the hands of a few." Comment Letter of Elizabeth Bramwell, President, Bramwell Funds, Inc.

b. The independent chair requirement would have a disproportionate impact on smaller funds: "The expense associated with retaining additional, qualified, independent directors to serve as chairman will disproportionately impact the expense ratios of

small mutual funds, placing them at a competitive disadvantage to larger mutual funds." Comment Letter of Rep. Gil Gutknecht, Member of Congress.

24. Commenters suggested numerous alternatives to the independent chair requirement, including that independent directors vote separately to approve the agenda for each board meeting; that boards designate a lead independent director; that board chairs be elected by both a majority of the board, and a majority of the independent directors as well; that independent directors have the authority to require the adviser to provide any information they believe relevant to their decisionmaking; and that funds prominently disclose whether they have an independent chair or management chair. Numerous commenters also contended that the separate proposal to require 75 percent independent directors would accomplish the Commission's avowed aims with less cost.

25. During the rulemaking, the Commission purported to premise its amendments on sections of the Act that permit exemptions from statutory requirements when "in the public interest." *See, e.g.*, 69 Fed. Reg. 46,389 (citing, *inter alia*, 15 U.S.C. § 80a-6(c)). Those statutory provisions require that in determining the public interest, the Commission "consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation." 15 U.S.C. § 80a-2(c). Accordingly, at the Open Meeting where the amendments were proposed, Commissioner Cynthia Glassman expressed concern at the lack of empirical data comparing the performance of mutual funds that have independent chairs to the performance of funds with management chairs. Commissioner Glassman urged that the Commission's Office of Economic Analysis gather empirical data and conduct more research. The Commission's Chairman stated that he was committed to such an economic analysis and looked forward to it. *See* Transcript of Open Meeting (Jan. 14, 2004).

26. To aid the Commission's examination of the issue, a 20-page empirical study of independent and management chaired funds was submitted to the rulemaking record during the comment period. The study found that funds with independent chairs have on average lesser economic performance than funds with management chairs:

> On each of several historical performance measures, independent chair funds have not performed as well as those having management chairs. For example, using Morningstar's fund rankings within style-based peer groups, independent chair funds on average rank in the 53rd percentile (100=best) over the past three years, while management chair funds on average rank in the 58th percentile. Over ten years the ranking difference is more pronounced, with the independent chair funds averaging in the 48th percentile versus the 59th percentile for the management chair funds. For these and other performance comparisons included in this study, the differences were statistically significant.

Geoffrey H. Bobroff and Thomas H. Mack, Assessing the Significance of Mutual Fund Board Independent Chairs (Mar. 10, 2004).

27. Commenters objected to the 75 percent independent director requirement on several grounds also, including:

a. Requiring that 75 percent of directors be independent conflicted with Congress's considered determination to require that only 40 percent of directors be independent. Comment Letter of W. Hardy Callcott.

b. No rational basis existed for selecting 75 percent as the requisite percentage of independent directors. *See, e.g.,* Comment Letter of Lacy B. Hermann, Chairman and Chief Executive Officer, Aquila Management Corp.

c. The 75 percent independent director requirement would effectively exclude many of the most knowledgeable candidates from active roles in the governance of mutual funds, particularly since conflicts of interest would make it difficult to obtain independent directors from within the financial services industry. As a consequence,

board members collectively would have less pertinent knowledge and experience and would be less effective in delivering satisfactory returns to investors. *See, e.g.,* Comment Letter of Scott L. Barbee, Managing Director, Berno, Gambal & Barbee, Inc.

d. The 75 percent independent director requirement would effectively require approximately half of mutual funds to change their boards' composition, diverting time, effort, and resources from other activities more likely to enhance the value of investors' holdings. *See, e.g.,* Comment Letter of Craig S. Tyle, General Counsel, Investment Company Institute; Comment Letter of Graham T. Allison, Jr., *et al.,* Independent Directors of CDC Nvest Funds and Loomis Sayles Funds.

e. Smaller fund complexes would be hit particularly hard by compliance costs. For example, the independent directors of one small fund ($218 million in total assets) estimated that compliance with the proposed requirement would cost its shareholders $20,000 per year. Comment Letter of Martin Brody, *et al.,* Independent Directors of Flaherty & Crumrine Preferred Income Opportunity Fund, Inc. *See also* Comment Letter of Dr. James A. Gentry, *et al.,* Independent Directors of ICAP Funds, Inc.

Final Rule

28. At an Open Meeting on June 23, 2004, the Commission—by a 3-2 vote—adopted the independent chair requirement and the 75 percent independent director requirement, together with other "governance" amendments to the ten exemptive rules. (The final rule provided that two independent directors would be sufficient for funds with a total of three directors.) The final rule was published in the Federal Register on August 2, 2004. Investment Company Governance; Final Rule; 69 Fed. Reg. 46,378 (Aug. 2, 2004) (amending "exemptive rules" 10f-3; 12b-1; 15a-4(b)(2); 17a-7; 17a-8; 17d-1(d)(7); 17e-1; 17g-1; 18f-3; and 23c-3).

29. The Commission cast its justification of the amendments in broad and general terms, with no meaningful reference to the specific statutory and regulatory provisions implicated. Thus, the final statement of reasons, or "Adopting Release," accompanying the rule stated that:

a. Adoption of the rule was a response to recent enforcement actions involving "late trading" of mutual fund shares, inappropriate "market timing," and misuse of nonpublic information about fund portfolios. 69 Fed. Reg. at 46,378.

b. The Commission's "primary concern, and the one that led [it] to adopt" the independent chair requirement, is that "too often the proper balance" between a "board's cooperation with and oversight of management . . . has not been achieved." *Id.* at 46,383.

c. The independent chair requirement was part of a "larger package" of regulatory reforms predicated on the belief that "a fund board is in a better position to protect the interests of the fund, and to fulfill the board's obligations" when it has an independent rather than a management chair. *Id.* at 46,383-46,384. This is because a board chair

plays an important role in "setting the [final] agenda of the board and determining what information is provided to the board"; in "establishing a boardroom culture [and tone] that can foster . . . meaningful dialogue"; in "providing a check on the adviser, in negotiating the best deal for shareholders when considering the advisory contract"; and in "providing leadership to the board that focuses on the long term." *Id.* at 46,383.

d. The 75 percent independent director requirement would alter a perceived "imbalance" between management and independent directors, so that henceforth the fund's board would be "firmly under the control" of independent directors. *Id.* at 46,382.

30. Although the Commission premised its action in substantial part on concerns regarding late trading, market timing, and misuse of nonpublic information, the final statement of reasons identified no statistical data indicating that firms with management chairs permitted these practices at a higher rate than firms with independent chairs. Similarly, the Commission identified no data indicating that firms with a higher percentage of independent directors were less likely to permit these practices.

31. The final rule remained premised in part on provisions of the Act that require the Commission to "consider . . . whether [its] action will promote efficiency, competition, and capital formation." 15 U.S.C. §§ 80a-2(c), 80a-6(c). And yet, although at the time the rule was proposed Commissioners had expressed concern with the lack of data on the comparative performance of independent and management-chaired funds and the Chairman had indicated an intent to have Commission staff examine the issue, no such Commission study was performed. Rather, the only empirical evidence on the issue in the rulemaking record was the Bobroff & Mack study which concluded "that independent chair funds have not performed as well as those

having management chairs." The Commission failed to address this study in the body of its Adopting Release, choosing instead to give it cursory reference in a footnote to the Release. 69 Fed. Reg. at 46,383 n.52. "There are no empirical studies that are worth much," the Chairman of the Commission stated in the Open Meeting where the Commission voted to adopt the new rule. Economic studies should not be awaited, another Commissioner stated, because "methodologies will always be flawed, or at least subject to question." Transcript of Open Meeting (June 23, 2004).

32. Other evidence of the rule's costs was also quickly dismissed by the Commission. For instance, commenters had stated that independent chairs would hire their own staff, thereby imposing additional costs on the fund and diminishing investors' returns. The proposed and final rule both specifically granted independent directors the authority to hire staff. Yet, in its analysis of the rule's costs, the Commission assigned no cost to the hiring of new staff. State law already permits the hiring of staff, the Commission explained, a fact wholly immaterial to the additional hiring of staff which the rule plainly, and purposefully, is likely to cause to occur. Indeed, elsewhere in the Release the Commission stated that its rule was "designed to enable independent directors to hire employees and others . . . ." 69 Fed. Reg. at 46,385. Similarly, with regard to the cost of the new 75 percent independent director requirement, the Commission confessed that "our staff has no reliable basis for determining how funds would choose to satisfy the . . . requirement" and therefore no meaningful cost analysis was conducted. *Id.* at 46,391.

33. The public comments submitted for the Commission's consideration were given fleeting consideration in other respects. For example, numerous commenters had expressed concern that the Commission was undermining the statutory role accorded independent directors by denying them the power to appoint a management chair when they determine that to be in the

best interest of the fund and its shareholders. The Commission responded: "[T]he amendments we are adopting today do not prevent the independent directors from choosing the most qualified and capable candidate. That candidate, however, cannot serve two masters." *Id.* at 46,383. In so responding, the Commission failed to address commenters' point that at times independent directors will find a chair affiliated with the adviser to be in the best interest of the fund and its investors. The Commission also did not square its decision to bar independent directors from selecting a management chair with its statement elsewhere in the Release that "when Congress passed the Investment Company Act, it relied on independent directors to protect the interests of investors. A principal purpose of the amendments is to strengthen the independent directors' control of the fund board . . . ." *Id.* at 46,381. Finally, the Commission did not square its boilerplate explanation that directors affiliated with fund advisers will impermissibly "serve two masters," with the judgment of Congress and the Commission itself that directors affiliated with the adviser can and indeed should serve on fund boards.

34. While basing its action largely on observations about boardroom "culture" and related concepts that the Act gives it no authority to regulate, the Commission provided no meaningful discussion in its Adopting Release of the ten separate and individual exemptive rules it was amending, nor of the impact on mutual funds and their shareholders of narrowing the availability of those exemptions. Rather, the only discussion of the specific provisions of these rules—which served as a mere pretext for the Commission's collateral regulatory objectives—was consigned to a handful of footnotes. The Adopting Release thus did not explain why the independent chair and 75 percent independent director requirements were necessary in light of each rule's specific provisions, nor did it discuss how the requirements would operate in

conjunction with the existing provisions of each rule being amended, or even how the new conditions relate in any rational way to the reasons for each exemption.

35. For example, among the exemptive rules amended was Rule 17g-1(j), 17 C.F.R. § 270.17g-1(j). That rule provides an exemption from Section 17(d) of the Act, which makes it unlawful for persons affiliated with a fund or fund underwriter to jointly participate with the fund in a transaction. Under Exemptive Rule 17g-1(j), joint insured bonds provided and maintained by a registered management investment company and one or more other parties are exempt from Section 17(d) of the Act if, among other things, a majority of independent directors approves the bond at least annually.

36. In its final rule, the Commission amended Exemptive Rule 17g-1(j) to require that funds relying on that exemption have an independent chair and 75 percent independent board, among other requirements. In so doing, the Commission wholly failed to discuss why an independent chair is necessary to a board's decision to approve a bond pursuant to 17g-1(j), or what advantages would accrue to the fund from such a requirement. Indeed, the Commission did not cite or discuss Rule 17g-1(j) at all in discussing its independent chair requirement. The Commission thus did not explain why the independent chair amendment was necessary to the exemption in light of the exemption's longstanding requirement that the bond be approved by a majority of independent directors. Similarly, although the final statement of reasons repeatedly referred to the importance of a chair's ability to "set the agenda" for the board of directors, the statement of reasons offered no explanation why control of the agenda is necessary to approving a bond when, under the terms of the existing exemptive rule, covered bonds already are required to be considered by the board annually.

37. By way of a second example, the final rule also amended Commission Rule 15a-4(2), 17 C.F.R. § 270.15a-4. That rule exempts certain investment advisers from Section 15(a) of the Act, which generally makes it unlawful for a person to serve as an investment adviser without a written contract that is approved by a majority of the fund's outstanding voting securities. Under Exemptive Rule 15a-4(2), an advisory contract not approved by a majority of outstanding voting securities is permitted on an interim basis where, among other things, a majority of independent directors reviews and approves the interim contract and finds the scope of services under the contract to be equivalent to the scope and quality under the previous contract. 17 C.F.R. § 270.15a-4(b)(2).

38. The final statement of reasons accompanying the rule contained no substantive discussion of Exemptive Rule 15a-4(b)(2). Thus, the Commission did not explain why the independent chair requirement was necessary for the exemption in light of the exemption's longstanding requirement that any interim advisory contract be approved by a majority of independent directors. Nor did the Commission explain why a short-term interim contract warranted a prohibition on the fund having a management chair for all purposes, on a long-term or permanent basis.

39. In explaining the independent chair requirement in the final statement of reasons, the Commission did not discuss or even cite 7 of the 10 different exemptive rules it was amending to impose that requirement. *See* 69 Fed. Reg. at 46,382-46,384. In explaining the 75 percent independent director requirement, it did not cite or discuss a single one of the exemptive rules. *See id.* at 46,382-46,383. Similarly, in a section of the statement of reasons titled "Reasons for and Objectives of the Amendments," the Commission made no reference to the specific rules being amended and the related statutory provisions. *See id.* at 46,387. Instead, the

rationale given for the rulemaking was such general concerns as the purported "breakdown in fund management and compliance controls" and an intent to "enhance the independence and effectiveness of fund boards." *Id.*

40. In the Public Meeting in which the Commissioners discussed and explained their decision to adopt the new rule, none of the Commissioners voting in favor of the rule mentioned any of the specific rules they were voting to amend.

41. Although it was cited by two dissenting Commissioners, the Commission did not address the legislative history indicating that Congress adopted the statutory 40 percent independent director requirement to preserve investors' ability to select funds led principally by management directors. The Commission's sole explanation for selecting 75 percent as the requisite percentage of independent directors was that Section 15(f) of the Act establishes a safe harbor when the fund's advisory business is sold if, among other things, 75 percent of directors remain independent for three years following the sale. The Commission did not explain how a single, narrow statutory provision for 75 percent independent directors—which is an optional safe harbor applicable in narrow circumstances for a limited time period—militates for, rather than against, the Commission's effectively requiring that 75 percent of directors be independent at all times for all purposes.

42. Two Commissioners objected to the final rule and took the unusual step of filing a joint written dissent from the Commission's action, including the independent chair and 75 percent independent director requirements. In so doing, Commissioners Paul Atkins and Cynthia Glassman stated that the Commission had failed to consider alternatives to the independent chair requirement, including requiring funds to appoint a lead independent director or to disclose whether they had a management chair. Both Commissioners expressed concern with the costs

the rule would impose on funds and, ultimately, on fund investors. In their strongly-worded dissent, Commissioners Atkins and Glassman stated that the Commission had acted by "regulatory fiat" "simply to appear proactive." The Commission had adopted "measures the benefits of which are illusory, but the costs of which are real," the Commissioners stated. The final rule rested on "tortured logic and circular reasoning." The dissenters also "question[ed] whether the Commission . . . act[ed] outside its authority" in adopting the rule. 69 Fed. Reg. at 46,390-46,393.

CAUSES OF ACTION

COUNT I

The Commission Exceeded Its Statutory Authority (ICA; APA)

43. Plaintiff repeats and incorporates by reference the allegations contained in paragraphs 1-42 above.

44. The Investment Company Act establishes certain requirements for the operation and governance of mutual funds, confers certain authorities on the Commission, and otherwise leaves the regulation of the governance structure of funds for determination by the laws of the States.

45. Except in certain limited and statutorily-identified circumstances, the Act requires that only 40 percent of a fund's directors be independent of the fund's adviser. Setting the independence requirement at 40 percent was a conscious and deliberate Congressional decision to preserve—except in limited, statutorily-identified circumstances—shareholders' ability to invest in mutual funds that they knew would be guided principally by the adviser associated with the fund.

46. In adopting the independent chair requirement and the 75 percent independent director requirement, the Commission purposely altered the balance established by Congress between management and independent directors. The Commission employed a statutory authority it does have—to grant exemption from certain statutory prohibitions—as a mere artifice and pretext for exerting far-reaching, non-statutory authority over the governance of virtually all mutual funds. This arrogation of power by the Commission improperly upsets the considered statutory determinations of Congress; impermissibly intrudes on the province of the States; and exceeds the Commission's statutory role. The Commission's authority to provide exemption from certain statutory requirements is not a license to impose a raft of new and unrelated obligations on mutual funds.

47. Plaintiff accordingly is entitled to a declaration that the Commission lacks the legal authority under the Act to adopt the 75 percent independent director requirement and independent chair requirement. The requirements should be declared unlawful, set aside, and enjoined from enforcement, implementation, and being given effect in any manner. 5 U.S.C. § 706.

COUNT II

<u>The Commission Failed To Justify Its Exercise Of Rulemaking Authority (ICA; APA)</u>

48. Plaintiff repeats and incorporates by reference the allegations contained in paragraphs 1-42 above.

49. The Administrative Procedure Act requires federal agencies to provide a thorough explanation of the significant regulatory decisions and choices embodied in all final rules. This requires, among other things, that agencies consider all important aspects of a problem, and that their final statement of reasons establish a rational connection between the facts found and

regulatory choices made. *Motor Vehicle Mfrs. Ass'n v. State Farm Mut. Auto Ins. Co.*, 463 U.S. 29 (1983).

50. In deploying its narrow and specific exemptive authority as a pretext for effectuating sweeping alterations in the governance structure of nearly all mutual funds, the Commission wholly failed its obligation under the APA to provide a thorough and reasoned explanation for its action. The Commission amended ten separate and distinct pre-existing rules without any meaningful discussion of each rule's current requirements; of the statutory prohibition from which each rule provided exemption; of the reasons that amendment of each rule was necessary in light of the statutory prohibition it addressed; and of possible alternative amendments and why those alternatives were inadequate to effectuate each rule's purpose without compromising the statutory provision from which it provided exemption.

51. Plaintiff accordingly is entitled to a declaration that the Commission failed adequately to justify or explain its adoption of the independent chair and 75 percent independent director requirements, and that the requirements are arbitrary, capricious, and otherwise unlawful. The requirements should be declared unlawful, set aside, and enjoined from enforcement, implementation, and being given effect in any manner. 5 U.S.C. § 706.

COUNT III

The Commission's Adoption Of The New Requirements Is Otherwise Arbitrary, Capricious, And Not In Accordance With The Law (ICA; APA)

52. Plaintiff repeats and incorporates by reference the allegations contained in paragraphs 1-42 above.

53. Under the Administrative Procedure Act, the Commission was required to give full and adequate consideration to all comments and other evidence submitted in the rulemaking

record, and to weigh all significant alternatives to adopting the regulation as originally proposed. In adopting the independent chair and 75 percent independent director requirements, the Commission violated these basic rulemaking requirements in numerous and fundamental respects.

54. The Commission failed to respond adequately to numerous commenters' objections to the independent chair requirement. These shortfalls include, but are not limited to, (a) failing to respond adequately to the contention that investors should be permitted to make their own investment decisions regarding the value of an independent chair, and (b) failing to address the contention that independent directors—whose power and autonomy the final rule expanded—should be permitted to determine on a case-by-case basis whether the best chair is a person who also is affiliated with the adviser to the fund.

55. The Commission purported to base its rulemaking on sections of the Act requiring that it consider whether the rule would promote "efficiency, competition, and capital formation." At the time the rule was proposed, a member of the Commission explicitly called for a Commission study of the relative performance of funds with independent and management chairs, and of the costs that would result from independent chairs hiring staff. The Chairman of the Commission endorsed such a study. The Commission performed no such study, however, and gave insufficient attention and weight to the empirical data on these matters submitted for the rulemaking record, with the Chairman of the Commission stating that "[t]here are no empirical studies that are worth much." Further, the Commission admitted that it had "no reliable basis" for estimating the costs of the 75 percent independent director requirement, yet imposed the requirement nonetheless.

56. The Commission failed to consider adequately the many suggested alternatives to the independent chair requirement, including but not limited to: (a) authorizing independent directors to vote separately to approve the agenda for each board meeting; (b) empowering each board to designate a lead independent director; (c) requiring the chair be elected by majorities of both the full board and the independent directors; (d) requiring mutual funds to disclose whether they have an independent chair; and (e) empowering independent directors to require advisers to provide any information that they believe to be relevant to their decisionmaking.

57. Plaintiff accordingly is entitled to a declaration that the Commission's adoption of the independent chair and 75 percent independent director requirements are arbitrary and capricious and otherwise unlawful. The requirements should be declared unlawful, set aside, and enjoined from enforcement, implementation, and being given effect in any manner.
5 U.S.C. § 706.

PRAYER FOR RELIEF

Wherefore, Plaintiff respectfully requests that this Court:

A. Enter judgment in Plaintiff's favor;

B. Declare that the Commission lacks legal authority to adopt the independent chair requirement and the 75 percent independent director requirement under the Act and APA;

C. Declare that the Commission's failure to adequately justify the exercise of its rulemaking authority to adopt the independent chair and 75 percent independent director requirements violates the Act and the APA;

D. Declare that the Commission's adoption of the independent chair and 75 percent independent director requirements are otherwise arbitrary and capricious and unlawful under the Act and the APA;

E. Declare the independent chair and 75 percent independent director requirements unlawful;

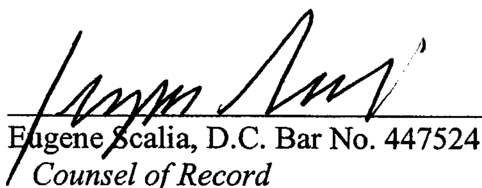
F. Set aside the requirements;

G. Issue a permanent injunction prohibiting the Commission from giving effect to the requirements in any manner, including implementing and enforcing the requirements;

H. Grant such additional relief as the Court may deem appropriate.

Dated: September 2, 2004

Respectfully submitted,



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