INITIAL BRIEF

ORAL ARGUMENT SCHEDULED FOR FRIDAY, APRIL 15, 2005

NO. 04-1300

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.

Petition for Review of Final Rule of the
United States Securities and Exchange Commission

OPENING BRIEF OF PETITIONER CHAMBER OF COMMERCE OF THE UNITED STATES OF AMERICA

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CERTIFICATE AS TO PARTIES, RULINGS, AND RELATED CASES

(A) Parties and Amici:

The parties in this case are the Chamber of Commerce of the United States of America (Petitioner) and the United States Securities and Exchange Commission (Respondent). There are no intervenors or amici.

The Chamber of Commerce is the nation's largest federation of business companies and associations, with an underlying membership of more than three million businesses and professional organizations of every size, in every industry sector, and in each of the fifty states. Among its members, and their subsidiaries, are firms that serve as mutual fund advisers. The Chamber itself is an investor in mutual funds. The Chamber is a non-stock corporation. It has no parent organization and no publicly-held corporation holds a stake in it.

(B) Rulings Under Review:

Under review in this case are the independent chair and 75 percent independent director provisions of the Commission's final mutual fund "governance" rule (Investment Company Governance; Final Rule; 69 Fed. Reg. 46,378 (Aug. 2, 2004)).

(C) Related Cases:

This case was not previously before this Court or any other court. However, because there was some question whether jurisdiction lies in this Court or in federal district court, the Chamber of Commerce concurrently filed suit in the U.S. District Court for the District of Columbia (Sept. 2, 2004, No. 1: 04CV01522 (RMC)) (D. Ct., D.E. 1). *See Investment Co. Inst. v. Board of Governors of Fed. Reserve*, 551 F.2d 1270, 1280 (D.C. Cir. 1977) (stating that when there is uncertainty whether the district court or court of appeals has jurisdiction to review agency action, filing in both courts is appropriate). On October 21, 2004, the Chamber moved the District Court to stay the proceedings before it in light of this Court's October 18 Order granting expedited review of the Chamber's Petition for Review (D. Ct., D.E. 11). The District Court granted the stay on October 25 (D. Ct., D.E. 12).

TABLE OF CONTENTS

Page

TABLE OF AUTHORITIES v

GLOSSARY x

STATEMENT REGARDING JURISDICTION AND STANDING 2

STATEMENT OF ISSUES 6

STATUTES AND REGULATIONS 7

STATEMENT OF THE CASE 8

STATEMENT OF THE FACTS 9

I. Mutual Funds And The Investment Company Act Of 1940. 9

II. Proposed Mutual Fund "Governance" Rule. 11

III. Final Mutual Fund "Governance" Rule. 16

IV. Congressional Action. 23

SUMMARY OF ARGUMENT 24

ARGUMENT 25

I. In Adopting The Independent Chair And 75 Percent Independent Director Requirements, The Commission Exceeded Its Statutory Authority. 25

A. Both Provisions Are An Exercise Of Authority Over Mutual Fund Boards That The Commission Does Not Possess, And That Conflicts With The Investment Company Act. 26

B. The Commission May Not Leverage The Authority It Does Have To Exercise Authority That It Was Denied By Congress. 31

II. The Commission's Adoption Of The Independent Chair And 75 Percent Independent Director Requirements Was Arbitrary, Capricious, And Otherwise Not In Accordance With Law................ 34

A. The Commission Did Not Adequately Justify Its Exercise Of Rulemaking Authority. 35

B. The Commission Failed To Satisfy Its Statutory Obligation To Consider The Provisions' Effect On "Efficiency, Competition, And Capital Formation." 40

C. The Final Rule Was Arbitrary And Capricious In Other Fundamental Respects, Including The Commission's Failure To Adequately Consider Costs, Disregard For Public Comments, And Failure To Consider Alternatives. 43

CONCLUSION 49

TABLE OF AUTHORITIES

Page(s)

Cases

ACLU v. FCC, 823 F.2d 1554 (D.C. Cir. 1987).. 25

Allied-Signal, Inc. v. United States Nuclear Regulatory Comm'n, 988 F.2d 146 (D.C. Cir. 1993).. 33

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Chamber of Commerce v. United States Dep't of Labor, 174 F.3d 206 (D.C. Cir. 1999).. 33

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Chevron U.S.A. Inc. v. NRDC, 467 U.S. 837 (1984).. 25

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FDA v. Brown & Williamson Tobacco Corp.,
529 U.S. 120 (2000) 28

Fox Television Stations, Inc. v. FCC, 280 F.3d 1027
(D.C. Cir. 2002) 33

General Electric Co. v. United States Dep't of Commerce,
128 F.3d 767 (D.C. Cir. 1997) 37

International Ladies Garment Workers Union v. Donovan,
722 F.2d 795 (D.C. Cir. 1983) 47

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551 F.2d 1270 (D.C. Cir. 1977) .... ii, 2, 3, 4

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41 F.3d 721 (D.C. Cir. 1994) 25

National Taxpayers Union v. United States, 68 F.3d 1428
(D.C. Cir. 1995) 5

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374 F.3d 1209 (D.C. Cir. 2004) 40, 46

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Warth v. Seldin, 422 U.S. 490 (1975) 5

Statutes

5 U.S.C. § 706(2)(A) 25, 35

5 U.S.C. § 706(2)(C) 25

* 15 U.S.C. § 80a-2(c) 20, 40, 43

15 U.S.C. § 80a-6(c) 10

15 U.S.C. § 80a-8 9

* 15 U.S.C. § 80a-10(a) 10, 28

15 U.S.C. § 80a-10(b) 11

15 U.S.C. § 80a-15 10

15 U.S.C. § 80a-15(a) 37

15 U.S.C. § 80a-15(c) 11

15 U.S.C. § 80a-15(f) 11

15 U.S.C. § 80a-17 10

15 U.S.C. § 80a-17(d) 17, 36

15 U.S.C. § 80a-35 47

15 U.S.C. § 80a-35(b) 10

15 U.S.C. § 80a-38 2

* 15 U.S.C. § 80a-42(a) 2

* Omnibus Consolidated Appropriations Act, 2005, H.R. 4818 .... 23, 39, 42

Securities Acts Amendments of 1975, Pub. L. No. 94-29, 89 Stat. 97 (June 4, 1975) 4

Rules, Regulations and Federal Register Publications

17 C.F.R. § 270.15a-4 37

17 C.F.R. § 270.17g-1(j) 17, 20, 36

66 Fed. Reg. 3,734 (Jan. 16, 2001) 12

69 Fed. Reg. 3,472 (Jan. 23, 2004) (proposed rule) 11, 12

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Legislative Materials

H.R. Rep. No. 76-2639 (June 18, 1940) 3

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Adopting Release	Investment Company Governance; Final Rule; 69 Fed. Reg. 46,378 (Aug. 2, 2004)
Bobroff Study	Geoffrey H. Bobroff & Thomas H. Mack, *Assessing the Significance of Mutual Fund Board Independent Chairs*, submitted as an attachment to Comment Letter of Eric D. Roiter, Fidelity Management & Research Co. (Mar. 10, 2004) (Letter 65)
Commission	Securities and Exchange Commission
ICA or the Act	Investment Company Act of 1940, 15 U.S.C. § 80a, *et seq.*

The Securities and Exchange Commission has adopted a "governance" rule that compels mutual funds to have a chair of the board of directors who is independent of the "adviser" that manages the fund. Seventy-five percent of the board's directors must also be independent.

The Commission has no general authority to regulate corporate governance. Further, Congress purposely provided that generally no more than 40 percent of a mutual fund's board must be independent. Nonetheless, the Commission imposed these requirements by exercising an authority it does have to exempt mutual funds from certain prohibitions of the Investment Company Act—ten pre-existing "exemptive" rules were amended to provide that in the future, funds wishing to rely on those exemptions would have to satisfy the new "governance" requirements.

While deploying this artifice to regulate fund governance, the Commission neglected to meaningfully discuss the ten rules it was amending. It also failed to evaluate evidence that management-chaired funds outperform independent-chaired funds, even though the statute expressly required considering the rule's effect on efficiency, competition, and capital formation. "[T]here are no empirical studies that are worth much," the Chairman of the Commission explained; "You can do anything you want with numbers . . . ." Congress recently ordered the Commission

to "justif[y]" the new rule and to review the empirical data that it had failed to consider.

This Court should grant the Chamber's petition for review and vacate these two fundamentally flawed provisions.

STATEMENT REGARDING JURISDICTION AND STANDING

1. This case is before the Court on a petition to review a final rule under the Investment Company Act of 1940 ("ICA" or "Act"), 15 U.S.C. § 80a, *et seq.* The petition for review was filed within sixty days of the rule's publication, on September 2, 2004.

Section 43(a) of the Act is titled "Court Review of Orders" and provides:

> Any person or party aggrieved by an order issued by the Commission under this title may obtain a review of such order in the United States court of appeals.

15 U.S.C. § 80a-42(a). The Act refers to "rules and regulations," *see id.* at § 80a-38, but makes no explicit provision for judicial review of them.

Decisions of this Court indicate that where an agency's organic statute provides for direct appellate court review of agency "orders," but is unclear whether agency "rules" are similarly reviewable in the courts of appeals, uncertainties regarding jurisdiction are resolved in favor of appellate court review. *See Investment Co. Inst.*, 551 F.2d at 1280; *see also* III RICHARD J. PIERCE, JR., ADMINISTRATIVE LAW TREATISE § 18.2, at 1329-33 (4th ed. 2002) ("[m]odern case

law adopts the position" that the term "order," as used in judicial review provisions of statutes administered by agencies, encompasses any agency action reviewed on a full administrative record, including rulemaking, that is not otherwise precluded from review). "[I]f the administrative record forms the basis for review," the leading case explains, "requiring petitioners challenging regulations to go first to district court results in unnecessary delay and expense." *Investment Co. Inst.*, 551 F.2d at 1276; *see also NRDC v. EPA*, 673 F.2d 400, 405 n.15 (D.C. Cir. 1982).

The Chamber is aware of only one other case involving a pre-enforcement challenge to a rule under the ICA. There, the district court rendered an oral decision that jurisdiction lay in the court of appeals, and transferred the case to the Seventh Circuit. *DH2, Inc. v. SEC*, Docket No. 04C789 (N.D. Ill.) (Shadur, J.). At the time of this filing, the Seventh Circuit had not rendered a decision; the question of jurisdiction was not addressed in the parties' briefs or at oral argument. *DH2, Inc. v. SEC*, Nos. 04-2242, 04-2487 (7th Cir.).

In *PBW Stock Exchange v. SEC*, 485 F.2d 718 (3d Cir. 1973), the Third Circuit held that the judicial review provision of Section 25 of the Securities Exchange Act of 1934 did not provide for direct appellate court review of rules. That provision—which has since been amended—was similar to Section 43(a) of the ICA. *See* H.R. Rep. No. 76-2639, at 26 (June 18, 1940) (stating that Section 43(a) of the ICA contained the "usual" review provision existing in other major

securities laws, including Section 25). In *Investment Co. Inst.*, 551 F.2d 1270, this Court explicitly rejected the Third Circuit's holding, stating that the approach that "persist[s] in reading special review statutes covering 'orders' as not encompassing regulations," "is no longer good law in this circuit." *Id.* at 1276 (rejecting *PBW*).[1]

In light of the ICA's ambiguity regarding the review of rules and this Court's precedents indicating that appellate court jurisdiction is appropriate in cases of such ambiguity, this Court should determine that it has jurisdiction of this matter under Section 43(a) of the ICA.[2]

2. The Chamber has associational standing, and has standing in its own capacity as an investor in mutual funds.

At least 30 Chamber members and their subsidiaries are fund advisers. These include firms that have boards with management chairs and fewer than 75

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[1] In 1975, the Exchange Act was amended to explicitly provide for direct appellate court review of some but not all Exchange Act rules. Securities Acts Amendments of 1975, Pub. L. No. 94-29, 89 Stat. 97 (June 4, 1975); Senate Committee on Banking, Housing and Urban Affairs, S. Rep. No. 94-75, at 36 (Apr. 14, 1975) ("At the present time there is no Exchange Act provision for review of Commission rules."). Although Congress amended provisions of the ICA in the same law, *see* Pub. L. No. 94-29, § 28 (1975), it did not amend the ICA's judicial review provision.

[2] The Chamber initially presented this jurisdictional issue in its September 20, 2004 motion to this Court for a stay or, alternatively, for expedited review. The Court denied the request for stay, granted expedited briefing, and directed the parties to address the Court's jurisdiction in their briefs. *See* Oct. 18 Order.

percent independent directors. Decl. of Jennifer Reutershan, Addendum hereto; *see also Warth v. Seldin*, 422 U.S. 490, 511 (1975) (one affected member is sufficient for associational standing). The rule is intended to reduce these advisers' influence over the funds they establish, manage, and on which their income depends. Further, there is record evidence that management-chaired funds are less profitable than independent-chaired funds (Certified Record Index ("CRI"), Letter 65); because advisers' income depends in part on funds' performance, the independent chair requirement therefore would reduce advisers' income (as well as investors'). Indeed, the Commission intends the rule to reduce advisers' income. *See* 69 Fed. Reg. at 46,380-46,381. The other prerequisites to associational standing are also met: 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 Chamber filed comments during the rulemaking (CRI, Letter 126).

The Chamber has standing in its own capacity to challenge the Commission's 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 have more than 75 percent independent directors. Decl. of Stan M. Harrell, Addendum hereto. The

Commission's 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 (CRI, Letter 65, at 4-5, 8-27). Elimination of the ability to purchase a desired product is legally-cognizable injury. *Consumer Fed'n of Am. v. FCC*, 348 F.3d 1009, 1012 (D.C. Cir. 2003); *Competitive Enter. Inst. v. Nat'l Highway Traffic Safety Admin.*, 901 F.2d 107, 112-13 (D.C. Cir. 1990).

STATEMENT OF ISSUES

1. Whether the Commission, which has no general authority to regulate mutual fund governance, exceeded its statutory authority in promulgating provisions of a mutual fund "governance rule" to require (i) that the chair of fund boards be independent of the adviser, and (ii) that 75 percent of funds' directors be independent of the fund adviser.

2. Whether the Commission's adoption of the independent chair and 75 percent independent director requirements exceeded the Commission's authority under the ICA, in light of Congress's provisions in the Act that no more than 40 percent of directors must be independent of the fund adviser, except in certain statutorily-identified circumstances.

3. Whether the Commission engaged in agency action that was arbitrary and capricious, an abuse of discretion, and otherwise unlawful within the meaning of the Administrative Procedure Act ("APA"), when it adopted the independent

chair and 75 percent independent director requirements by amending ten separate and distinct rules without discussing the rules' existing terms; mutual funds' activities in connection with each rule; and the need for amending each rule in light of its current terms, fund activities in connection with the rule, and the statutory provision the rule addresses.

4. Whether the Commission, by repeatedly failing to address empirical data and other record evidence of the costs for funds and fund shareholders of the independent chair and 75 percent independence requirements, violated the Act and the APA by failing to discharge its statutory obligation to consider whether the new requirements would "promote efficiency, competition, and capital formation."

5. Whether the Commission's adoption of the independent chair and 75 percent independent director requirements was arbitrary and capricious, an abuse of discretion, and otherwise unlawful within the meaning of the APA, given the Commission's failure to adequately consider and address rulemaking comments, empirical evidence in the record, and alternatives to each requirement.

STATUTES AND REGULATIONS

The text of relevant statutes and regulations is set forth in the Addendum to this brief.

STATEMENT OF THE CASE

This case concerns the Commission's mutual fund "governance" rule, which was published in the Federal Register on August 2, 2004. 69 Fed. Reg. 46,378. The rule amends ten pre-existing rules in order to impose five new "governance" requirements on mutual funds. *Id.* at 46,378-46,379, 46,381-46,385. The rule became effective on September 7, 2004, and funds must comply with the rule's new requirements by January 16, 2006. *Id.* at 46,378. Steps to comply already are underway.

Two of the rule's requirements are challenged here. The first would compel mutual funds to have a chair of the board of directors who is independent of the fund adviser. *Id.* at 46,382-46,384. Currently, approximately 80 percent of funds do not have an independent chair. *See* June 23, 2004 Open Meeting Tr., CRI, Tr. 4, at 13, 24. The second would require that at least 75 percent of the directors of funds be independent of the adviser. 69 Fed. Reg. at 46,381-46,382. Currently, at least 40 percent of funds do not meet this threshold. *See* CRI, Tr. 4, at 12. Together, these two provisions will require thousands of mutual funds to change their current leadership. *See, e.g.*, 69 Fed. Reg. at 46,388 n.89 (noting that 4,619 funds rely on at least one of the amended "exemptive" rules).

A copy of the final rule is reprinted in the Addendum at the end of this brief.

STATEMENT OF THE FACTS

I. Mutual Funds And The Investment Company Act Of 1940.

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 more than one-half of households in the United States (CRI, Tr. 4, at 53). Generally, funds are organized as "investment companies," each with its own board of directors. Funds are established by "advisers" that typically also assume responsibility for fund management. 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 Large Cap Fund, etc. Each of these generally is a separate investment company. *See* Investment Company Institute, *A Guide to Understanding Mutual Funds* 46 (2004), *available at* http://www.ici.org/statements/inv/bro_ understanding_mfs_p.pdf (last visited Dec. 12, 2004).

In 1940, Congress enacted the ICA 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) regulates and proscribes certain transactions between a fund and its investment adviser, *id.*

§§ 80a-15, 80a-17; (c) 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.* § 80a-15; and (d) specifies that an investment adviser has a fiduciary duty with respect to the receipt of compensation for services paid by the fund, *id.* § 80a-35(b).

The Commission is assigned certain responsibilities under the Act, including the authority to allow exemptions from certain provisions of the Act. *See, e.g.*, *id.* § 80a-6(c). Over the years, the Commission has exercised this authority by issuing "exemptive rules" that permit certain activities otherwise prohibited by statute, provided that certain conditions are met.

The ICA contains no provision that authorizes the Commission to regulate mutual fund governance or the composition of fund boards. Further, the Act unambiguously requires that only 40 percent of a fund's directors must be independent from management. *Id.* § 80a-10(a). When the Act was passed, Congress considered and rejected a general requirement that a majority of a fund's directors be independent:

> The 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 inserted.[3]

Hearings on H.R. 10065 Before the House Subcomm. on Interstate and Foreign Commerce, 76th. Cong. 3d Sess. 109-10 (June 14, 1940) (testimony of David Schenker). A 1992 internal Commission report recognized that a statutory amendment would be needed to require that funds have more than 40 percent independent directors. Division of Investment Management, United States Securities and Exchange Commission, *Protecting Investors: A Half Century of Investment Company Regulation* xxix, 260-61 (May 1992).

II. Proposed Mutual Fund "Governance" Rule.

The Commission published its proposed governance rule in the Federal Register in January 2004. *See* Investment Company Governance; Proposed Rule, 69 Fed. Reg. 3,472 (Jan. 23, 2004). It described the proposal as a response to recent concerns regarding mutual funds and "late trading," "market timing," and "misuse of nonpublic information about fund portfolios." *Id.* The Commission claimed that the rule would curb conflicts of interest between funds and fund

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[3] Congress required a larger complement of independent directors only in specific circumstances. *See* 15 U.S.C. §§ 80a-10(b), 80a-15(f). It also assigned certain responsibilities to independent directors—what it calls "disinterested" directors—to avoid conflicts that arise between the fund and the adviser in certain circumstances. *See, e.g.*, *id.* § 80a-15(c) (requiring independent directors to approve adviser's contract).

advisers that purportedly had contributed to mutual fund misconduct. *Id.* at 3,472-3,473.

The Commission did not claim to base its adoption of the rule on any statutory provision authorizing it to regulate mutual fund governance or the composition of fund boards; the ICA contains no such general grant of authority. Instead, the Commission framed the requirements as amendments to ten pre-existing rules that allow funds to engage in certain activities otherwise prohibited by the Act; in the future, exemption under the rules would be conditioned on funds' satisfying the new "governance" requirements. *See id.* at 3,472. "Because almost all funds either rely or anticipate someday relying on at least one of the Exemptive Rules," the Commission stated, the new requirements would "apply to most funds." *Id.* at 3,474 n.17; *see also* 69 Fed. Reg. at 46,388 n.89 (4,619 funds—or approximately 90 percent of funds—rely on at least one of the exemptive rules).[4]

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[4] In 2001, the Commission amended these same rules to provide that a majority of directors be independent. Role of Independent Directors of Investment Companies; Final Rule; 66 Fed. Reg. 3,734 (Jan. 16, 2001). The instant rulemaking increased that requirement to 75 percent.

1. The Commission has identified the independent chair requirement as the "most controversial" aspect of its proposed rule. 69 Fed. Reg. at 46,382. Commenters objected to the requirement on several grounds, including that:

- It intrudes on the internal processes of boards, and upsets the careful balance between state and corporate law established in the Act (*see, e.g.*, CRI, Letter 59).
- It conflicts with the confidence the Act reposes in independent directors, by denying them the ability to appoint a management chair when they find that in the best interests of the fund and its investors (*see, e.g.*, CRI, Letter 65, at 1, 4; CRI, Letter 186).
- It denies investors the ability—which many currently exercise—to invest in a fund based on the identity, reputation, and ability of a fund chair who is affiliated with the fund adviser (*see, e.g.*, CRI, Letters 190, 193).

Commenters also objected that the independent chair requirement would impose unnecessary costs by forcing funds to recruit new directors, pay independent chairs higher fees, and compensate the staff retained by independent chairs (*see, e.g.*, CRI, Letter 118).

Commenters suggested numerous less costly and intrusive 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 to investors whether they have an independent chair or management chair (*see, e.g.*, CRI, Letter 65, at 2-3; 69 Fed. Reg. at 46,392-46,393).

At the Open Meeting where the rule was 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; she urged the Commission's Office of Economic Analysis to gather the data and conduct research. *See* Jan. 14, 2004 Open Meeting Tr., CRI, Tr. 3, at 17-19, 22. The Commission's Chairman stated that he was committed to such an economic analysis and "look[ed] forward" to it (CRI, Tr. 3, at 34).

A 20-page empirical study of the issue was submitted during the comment period. The study found that management-chaired funds have outperformed funds with independent 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 & Thomas H. Mack, *Assessing the Significance of Mutual Fund Board Independent Chairs*, attached to CRI, Letter 65, at 8 ("Bobroff Study") (emphases added).

2. The 75 percent independent director requirement was the second most controversial aspect of the proposed rule. Public commenters objected to the provision on several grounds, including that:

- The requirement conflicted with Congress's considered determination to require that only 40 percent of directors be independent (*see, e.g.*, CRI, Letter 154).
- No rational basis existed for selecting 75 percent as the requisite percentage of independent directors (*see, e.g.*, CRI, Letter 173).
- The requirement would effectively exclude many of the most knowledgeable candidates from active roles in the governance of mutual funds, particularly since bona fide conflicts of interest would make it difficult to obtain independent directors from within the financial services industry. As a consequence, mutual fund boards would have

less pertinent knowledge and experience and would be less effective in delivering satisfactory returns to investors (*see*, *e.g.*, CRI, Letter 127).

III. Final Mutual Fund "Governance" Rule.

At an Open Meeting on June 23, 2004, the Commission—by a 3-2 vote—adopted the independent chair and 75 percent independent director requirements, together with other "governance" amendments to the ten exemptive rules. (Under the final rule, funds with a three-person board must have at least two independent directors.) (CRI, Tr. 4, at 67-68). The final rule, which was published in the Federal Register on August 2, 2004, became effective on September 7, 2004. 69 Fed. Reg. at 46,378. Funds seeking to rely on the exemptive rules must be in compliance with the new requirements by January 16, 2006. *Id.* Of necessity, funds already are taking steps to implement the mandated changes. *See* Chamber's Mot. Stay, or, Alternatively, Expedited Briefing at 18-19 (Sept. 20, 2004); Arden Dale, *Funds Prep for New Chairman Rule*, WALL ST. J., Dec. 7, 2004, at C17.[5]

Although the final rule amended ten distinct regulations, the Commission's 13-page final statement of reasons—or "Adopting Release"—contained no

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[5] Other provisions of the rule—which are not challenged here—require that fund directors perform an annual self-assessment; that independent directors meet in periodic sessions, separate from management and non-independent directors; and that funds explicitly authorize independent directors to hire their own staffs. *See* 69 Fed. Reg. at 46,384-46,385.

meaningful discussion of those pre-existing rules or the related statutory prohibitions. *See* 69 Fed. Reg. at 46,378-46,390.

Thus, for example, there was no discussion of Exemptive Rule 17g-1(j), 17 C.F.R. § 270.17g-1(j). That rule provides an exemption from Section 17(d) of the ICA, which makes it unlawful for persons affiliated with a fund or fund underwriter to jointly participate with the fund in a transaction. 15 U.S.C. § 80a-17(d). Under Rule 17g-1(j), joint insured bonds provided by a registered management investment company and at least one other party are exempt from Section 17(d) of the Act if, among other things, a majority of independent directors approves the bond at least annually. In amending Rule 17g-1(j) to require that funds relying on this exemption have an independent chair and 75 percent independent board, among other requirements, the Commission did not explain why the independent chair and 75 percent independent director amendments were necessary in light of the exemption's longstanding requirement that the bond be approved by a majority of independent directors. Similarly, although the Commission relied heavily on the asserted importance of a chair "setting the agenda" for the board of directors, *see* 69 Fed. Reg. at 46,383, it 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.[6]

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[6] In addition to Rule 17g-1(j), the exemptive rules amended were: Rule 10f (permitting a fund to purchase securities in a primary offering when an affiliated broker-dealer is a member of the underwriting syndicate, if the fund directors, including a majority of the independent directors, approve procedures governing the purchases and review quarterly reports on purchases); Rule 12b-1 (permitting use of fund assets to pay distribution expenses pursuant to a plan approved by the fund directors, including a majority of the independent directors); Rule 15a-4(b)(2) (permitting a fund board to approve an interim advisory contract without shareholder approval when the adviser or a controlling person receives a benefit in connection with the assignment of the contract, if the fund directors, including a majority of the independent directors, review and approve the contract); Rule 17a-7 (permitting securities transactions between a fund and another client of the fund investment adviser, if the fund directors, including a majority of the independent directors, approve procedures governing the transactions and review quarterly reports on transactions); Rule 17a-8 (permitting mergers between certain affiliated funds if the fund directors, including a majority of the independent directors, request and evaluate information about the merger and determine that the merger is in the best interests of the fund and its shareholders); Rule 17d-1(d)(7) (permitting a fund and its affiliates to purchase joint liability insurance policies if the fund directors, including a majority of the independent directors, annually determine that the policies are in the best interests of the fund and its shareholders); Rule 17e-1 (specifying conditions under which a fund may pay commissions to affiliated brokers in connection with the sale of securities on an exchange, including a requirement that the fund directors, including a majority of the independent directors, adopt procedures for the payment of the commissions and review quarterly reports of any commissions paid); Rule 18f-3 (permitting a fund to issue multiple classes of voting stock, if the fund board of directors, including a majority of the independent directors, approves a plan for allocating expenses to each class); and Rule 23c-3 (permitting the operation of an interval fund by enabling a closed-end fund to repurchase shares from investors, if the directors adopt a repurchase policy for the fund and review fund operations and

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Altogether, in explaining the independent chair requirement, the Commission did not cite or discuss 7 of the 10 exemptive rules it was amending. 69 Fed. Reg. at 46,382-46,384. In explaining the 75 percent independent director requirement, the Commission did not cite or discuss a single one of the rules it was amending. *Id.* at 46,382-46,383. A section of the statement of reasons titled "Reasons for and Objectives of the Amendments" contained no reference to the specific rules being amended or their related statutory provisions. *Id.* at 46,382-46,384, 46,387. And at the Open Meeting where Commissioners explained their decision to adopt the new rule, none of those voting for the rule referred to any of the ten rules they were voting to amend. *See generally* CRI, Tr. 4.[7]

Rather than discuss the rules it was amending and the mutual fund activities they concern, the Commission justified its new rule on general theories of corporate governance. The Commission's "primary concern, and the one that has led [it] to adopt" the independent chair requirement, was that "too often the

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portfolio management in order to assure adequate liquidity of investments to satisfy repurchase payments). 69 Fed. Reg. at 46,379 n.9.

[7] In total, the Adopting Release contained a handful of references to the exemptive rules being amended; nearly all the references were made in passing or in footnotes. *See, e.g.*, 69 Fed. Reg. at 46,379 n.9 (listing the exemptive rules amended); 46,382 n.46 (citing three exemptive rules after noting that "a number of our Exemptive Rules require the board to address the fund's activities in circumstances involving . . . conflicts of interest").

proper balance" between a "board['s] cooperation with and oversight of management . . . has not been achieved." 69 Fed. Reg. at 46,383. 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.

Although it predicated the asserted need for the amendments on "late trading," "inappropriate market timing," and "misuse of nonpublic information about fund portfolios," *id.* at 46,378, the Commission identified no data indicating that firms with management chairs or with fewer than 75 percent independent directors permitted these practices at a higher rate than firms with independent chairs or more than 75 percent independent directors. *See id.* at 46,391. The Commission also did not suggest that late trading, market timing, or other fund abuses resulted from activities pursuant to the exemptive rules being amended. To use the example above, Exemptive Rule 17g-1(j) authorizes certain joint insured bonds, but neither the Commission nor any commenter suggested that these bonds led to market timing abuses.

In amending the exemptive rules, the Commission was statutorily required to consider "whether the action will promote efficiency, competition, and capital formation." 69 Fed. Reg. at 46,388-46,389 (citing 15 U.S.C. § 80a-2(c)). As noted, a 20-page study had been submitted which concluded that management-

chaired funds outperformed independent-chaired funds by "several historical performance measures"; this Bobroff Study was the only empirical data on the subject in the rulemaking record (CRI, Letter 65, at 8). This data was of no interest, the Commission stated, because there are other, "more general[]" benefits associated with independent chairs. 69 Fed. Reg. at 46,384. As to the findings of the 20-page study, they were dismissed in a brief footnote in which the Commission noted that other commenters viewed the study's data differently than the study's authors—the Commission did not undertake to determine which commenters had the better view of the data. *Id.* at 46,383 n.52. The Commission also discounted the Bobroff Study because at one point the study's authors noted that the strong performance of management-chaired funds could be due to other "important differences" besides the identity of the chair. *Id.* The Commission neglected to mention that the authors then proceeded to consider what other explanatory factors might exist, and identified none (CRI, Letter 65, at 11).

During the Open Meeting where the rule was initially proposed, the Chairman had indicated that he supported an empirical examination by Commission staff of the issues addressed in the Bobroff Study (CRI, Tr. 3, at 34). No such study was performed, however, and in voting to adopt the rule, the Commissioners openly deprecated the value of empirical evidence. The Chairman stated:

> [I]t seems to me that the lack of economic studies has been a constant refrain up here, the lack of empirical evidence, and I think that the general counsel made a very articulate argument about why the lack of empirical evidence is not the only justification when it comes to a matter of judgment. I believe, and I base this on too many years, more years than I'm willing to admit in and around the investment business, tempered by years in and around the academic community, that there are no empirical studies that are worth much. You can do anything you want with numbers and we've seen evidence of that in a number of our submissions, and we've seen evidence of that in a number of academic tracts.

CRI, Tr. 4, at 57-58 (emphasis added). A second Commissioner voting for the rule stated: "I do not believe that we can wait for economic studies, since as had been amply said today, methodologies will always be flawed or at least subject to question" (CRI, Tr. 4, at 55). *See also* CRI, Tr. 4, at 16 (the third Commissioner voting for the rule, stating: "We've got to look beyond whether empirical evidence is definitive to insight in an imperfect world brought about by experience— experience in boardrooms, experience with independent directors, by looking at anecdotal experience").

Commissioners Paul Atkins and Cynthia Glassman dissented from the adoption of the final rule, including the independent chair and 75 percent independent director requirements, and took the unusual step of filing a joint written dissent from the Commission's action. 69 Fed. Reg. at 46,390-46,393. The Commission had acted by "regulatory fiat," "simply to appear proactive," the dissent stated. *Id.* at 46,392-46,393. "There were alternatives we [as a

Commission] could have considered," the dissenting Commissioners said, "but we didn't" (CRI, Tr. 4, at 8). *See* 69 Fed. Reg. at 46,392-46,393. The dissenters described the rule as resting on "tortured logic and circular reasoning," and "question[ed] whether the Commission . . . act[ed] outside its authority." *Id.* at 46,390 n.7, 46,392.

IV. Congressional Action.

On December 8, 2004, the President signed the Omnibus Consolidated Appropriations Act, 2005, H.R. 4818, a provision of which requires the Commission to revisit key aspects of the independent chair requirement. First, by May 1, 2005, the Commission must submit a report to the Senate Appropriations Committee that "provides a justification" for the independent chair requirement. Second, the Commission's report must analyze the issue raised by Commissioner Glassman and addressed in the Bobroff Study, namely, "whether mutual funds chaired by disinterested directors perform better, have lower expenses, or have better compliance records than mutual funds chaired by interested directors." Third, the Commission must "act upon the recommendations of such report" no later than January 1, 2006. *Id.*[8]

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[8] Two days after the legislation was signed and three days before filing this brief, the Chamber sent a letter to the Commission asking that it stay the challenged

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SUMMARY OF ARGUMENT

In adopting "governance" requirements intended to give a dominant role to independent directors of mutual funds, the Commission exercised an authority over corporate governance that it does not possess, and overrode Congress's own determination that management directors should be permitted to play a dominant role in mutual fund boards. The Commission's ability to <u>exempt</u> funds from certain statutory prohibitions is not authority to impose sweeping new requirements that defy the statute's text and purpose.

Even if the Commission did have authority to adopt these two requirements, neither the ICA nor the APA would have permitted it to proceed in the manner that it did here. The Commission ignored the terms, function, and purpose of the ten rules it amended; refused to consider mutual fund performance, although required to do so by statute; and gave short shrift to the provisions' costs, the public's comments, and alternatives to the provisions adopted. Indeed, Congress's action in the recent Budget Act shows the independent chair requirement to be fundamentally flawed and invalid as a matter of law.

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provisions of the rule in light of this legislation. The Commission had not responded at the time the brief was filed.

This Court should grant the petition for review and vacate the two challenged provisions of the Commission's "governance" rule.

ARGUMENT

I. In Adopting The Independent Chair And 75 Percent Independent Director Requirements, The Commission Exceeded Its Statutory Authority.

It is axiomatic that Commission rules "cannot exceed the power granted the Commission by Congress." *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 473 (1977) (internal quotations omitted). Under the APA, this Court "shall hold unlawful and set aside" a final agency rule that is "in excess of statutory jurisdiction [or] authority." 5 U.S.C. § 706(2)(C). The Court shall also "hold unlawful and set aside" a final agency rule that is "arbitrary and capricious, an abuse of discretion, or otherwise not in accordance with law." *Id.* § 706(2)(A).[9]

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[9] The Commission's rule does not rest on an agency interpretation of a particular statutory command, and therefore no deference is due under *Chevron U.S.A. Inc. v. NRDC*, 467 U.S. 837 (1984). *See National Ass'n of Regulatory Util. Comm'rs v. ICC*, 41 F.3d 721, 727 (D.C. Cir. 1994). In any event, *Chevron* deference is inapplicable where, as here, the statute is clear and the agency seeks "to alter the clearly expressed intent of Congress." *Business Roundtable v. SEC*, 905 F.2d 406, 408 (D.C. Cir. 1990) (vacating a Commission rule for exceeding statutory authority). Further, this Court has suggested that *Chevron* deference does not apply when an agency seeks to define the scope of its own power. *See, e.g., ACLU v. FCC*, 823 F.2d 1554, 1567 n.32 (D.C. Cir. 1987) ("it seems highly unlikely that a responsible Congress would implicitly delegate to an agency the power to define the scope of its own power"); *United Transp. Union-Illinois Legislative Bd. v. Surface Transp. Bd.*, 169 F.3d 474, 477 (7th

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In this case, the Commission has exceeded its statutory mandate by exercising an authority over corporate governance that it does not have, and by altering a "balance" between independent and management directors of mutual funds that was deliberately set by Congress.

A. Both Provisions Are An Exercise Of Authority Over Mutual Fund Boards That The Commission Does Not Possess, And That Conflicts With The Investment Company Act.

The final rule adopted by the Commission is avowedly a corporate "governance" rule. It is entitled "Investment Company Governance," and the Commission referred to "governance" dozens of times in its Adopting Release explaining the purpose and function of the amendments. *See, e.g.*, 69 Fed. Reg. at 46,379 (characterizing the rule as requiring new "fund governance standards"). "Our primary concern, and the one that has led us to adopt" the requirement, the Commission explained, is that "too often the proper balance" between independent and management directors has not been achieved. *Id.* at 46,383-46,384.[10]

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Cir. 1999) ("an administrative agency's determination about the scope of its own jurisdiction, a matter within the peculiar expertise of the courts, does not receive *Chevron* deference but is reviewed de novo") (internal quotation omitted).

[10] The Commission's adoption of a rule that places more authority with independent directors reflects a number of "[r]ecent reform efforts that place a relentless emphasis" on director independence. *See* John F. Olson & Michael T. Adams, *Composing A Balanced And Effective Board To Meet New*

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And yet, matters of corporate governance are "traditionally relegated to state law." *Santa Fe Indus.*, 430 U.S. at 479 (internal quotations omitted). This is because, as the Supreme Court has observed, "corporations are creatures of state law, and investors commit their funds to . . . directors on the understanding that, except where federal law *expressly* requires certain responsibilities of directors . . . state law will govern the internal affairs of the corporation." *Id.* As a consequence, the Commission has no general authority to regulate corporate governance. This Court relied on this principle to vacate a rule of the Commission in *Business Roundtable v. SEC*, 905 F.2d 406 (D.C. Cir. 1990), explaining: "[S]tate corporate law . . . regulates the distribution of powers among the various players in the process of corporate governance," including as a general matter, "requirements for independent directors." *Id.* at 411-12. This is so with respect to mutual funds as well. The Supreme Court has held that state law remains dominant for mutual funds except where Congress has enacted requirements in the ICA that directly contradict or preempt state law. *Burks v. Lasker*, 441 U.S. 471,

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Governance Mandates, 59 BUS. LAW. 421, 422, 431 (Feb. 2004). That emphasis is often misplaced, however, as management directors have a more extensive understanding of a company and its business and, some believe, are better suited to engage in honest dialogue and provide constructive criticism. *See id.* at 422, 430-31, 445-47.

479-80 (1979) ("Congress has never indicated that the entire corpus of state corporation law is to be replaced").

The ICA contains no indication that the Commission was licensed to exceed its customary role and undertake the regulation of mutual fund governance. The Act does provide that 40 percent of a fund's directors must generally be independent. 15 U.S.C. § 80a-10(a). But that is hardly a delegation to the Commission of authority to regulate fund boards—and the Commission has not claimed that it is. *Cf. FDA v. Brown & Williamson Tobacco Corp.*, 529 U.S. 120, 160 (2000) ("[W]e are confident that Congress could not have intended to delegate a decision of such economic and political significance to an agency in so cryptic a fashion"). Rather, as recently as 1992 the Commission recognized that requiring all funds to have more than 40 percent independent directors would require statutory change. Division of Investment Management, United States Securities and Exchange Commission, *Protecting Investors: A Half Century of Investment Company Regulation* xxix, 260-61 (May 1992).

The Act's provision for 40 percent independent directors is in fact an additional reason that both the independent chair requirement and the 75 percent independent director requirement are statutorily invalid:

Independent Chair Requirement. In requiring that 40 percent of fund directors be independent, the Act ensured that independent directors would have a

significant voice in fund management but that directors affiliated with the adviser could have a dominant role. This "balance"—as the Commission calls it, *see* 69 Fed. Reg. at 46,383—was purposeful: Congress explicitly considered and rejected a requirement that would have assigned dominant control to independent directors. Initially the legislation had required that a majority of fund directors be independent, but during deliberations on the bill

> [i]t 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 inserted.

Hearings on H.R. 10065, at 109-10; *see also* 69 Fed. Reg. at 46,390 n.7.[11]

If allowed to stand, the independent chair requirement would—by the Commission's own admission—upset this primacy of management directors that Congress purposely allowed. "Our primary concern, and the one that has led us to adopt" the requirement, was to alter the "balance" between independent and management directors, the Commission explained. 69 Fed. Reg. at 46,383-46,384. The Commission discussed at length the influence that the board chair can have over the direction of the fund. *See id.* at 46,383 (stating, among other things, that a

[11] The Commission failed to address this legislative history in the Adopting Release.

chairman "can play an important role in providing a check on the adviser," "plays an important role in setting the agenda of the board and determining what information is provided to the board," and "is in a unique position to set the tone of meetings, and to encourage open dialogue and healthy skepticism"). The independent chair requirement was for these reasons the centerpiece of the Commission's effort to vest control of mutual fund boards in independent directors. In so imposing the independent chair requirement to "correct" Congress's decision to permit a dominant role by management directors, the Commission exceeded its statutory authority. *See American Bankers Ass'n v. SEC*, 804 F.2d 739, 755 (D.C. Cir. 1986) (vacating a Commission rule because statutory language "reflects a basic decision by Congress" that the Commission rule sought to override).

75 Percent Independent Director Requirement. The Commission similarly lacked authority to adopt the 75 percent independent director requirement. The Act's provision that 40 percent of a fund's directors be independent of management embodies a considered congressional decision to reject a blanket requirement that even a majority of directors be independent. *See* Hearings on H.R. 1006, at 109-10. By requiring 75 percent independent directors so that funds would be "firmly under the control" of independent directors, the Commission transgressed the text and purpose of this statutory provision. 69 Fed. Reg. at

46,382. The Commission may believe it has a better idea than Congress, but it "has no power to correct flaws that it perceives in the statute it is empowered to administer. Its rulemaking power is limited to adopting regulations to carry into effect the will of Congress." *Board of Governors v. Dimension Fin. Corp.*, 474 U.S. 361, 373-74 (1986) ("Invocation of the 'plain purpose' of legislation at the expense of the terms of the statute itself takes no account of the processes of compromise and, in the end, prevents the effectuation of Congressional intent").[12]

B. The Commission May Not Leverage The Authority It Does Have To Exercise Authority That It Was Denied By Congress.

In adopting the challenged provisions of its rule, the Commission tacitly conceded that it lacked general authority to regulate mutual fund governance, but claimed that this authority could in effect be derived from its authority to exempt funds from certain prohibitions in the Act. *See* 69 Fed. Reg. at 46,378-46,379. That is mistaken—an authority to relax certain statutory requirements is not a

[12] 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. 69 Fed. Reg. at 46,382. The Commission did not explain how a single 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.

mandate to impose requirements that conflict with the Act and that arrogate to the agency a broad authority over boards of directors that was never conferred by Congress.

This Court consistently has barred agencies from deploying the regulatory powers they do possess to regulate matters outside their mandate. In the *Business Roundtable* case, for example, the Commission adopted a rule that prohibited stock exchanges from listing the stock of corporations that reduced the per-share voting rights of common stockholders. 905 F.2d at 407. The Commission defended the rule as an exercise of its authority "to regulate the proxy process." *Id.* at 410. This Court rejected that argument, ruling that the Commission could not wield its authority to regulate proxy "disclosure" as a means to govern a matter outside its mandate, *viz.*, the "substantive allocation of powers among classes of shareholders." *Id.* at 407-08. "[T]he Exchange Act cannot be understood to include regulation of an issue that is so far beyond matters of disclosure," the Court explained, "and that is concededly part of corporate governance traditionally left to the states." *Id.* at 408.

In *Teicher v. SEC*, 177 F.3d 1016 (D.C. Cir. 1999), the Commission had used its statutory authority to bar an individual from being associated with broker-dealers as a basis for excluding the individual from association with investment advisers also. *Id.* at 1019-22. This Court held that although Section 15(B)(6) of

the Exchange Act authorized the Commission to "place limitations" on the activities of persons convicted of securities fraud in the broker-dealer industry, the Commission could not invoke that statutory authority to exclude persons from other branches of the securities industry that it regulates under other statutes. *Id.* at 1019 (noting that the Commission could not interpret the "place limitations" language to bar someone from "being a retail shoe salesman, or to exclude him from the Borough of Manhattan"). *See also American Bankers Ass'n*, 804 F.2d at 754-55 ("The [Commission] cannot use its definitional authority to expand its own jurisdiction and to invade the jurisdiction" of others through rulemaking, particularly where the agency action is in direct conflict with the language of the statute); *Chamber of Commerce v. United States Dep't of Labor*, 174 F.3d 206 (D.C. Cir. 1999) (Ginsburg, J.) (OSHA had authority to conduct inspections, but could not use that as "leverage" to impose obligations that are not required by law).[13]

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[13] Vacating the rule, rather than remand, is appropriate in this case. *See Allied-Signal, Inc. v. United States Nuclear Regulatory Comm'n*, 988 F.2d 146, 150-51 (D.C. Cir. 1993) (decision whether to vacate depends in part on the "seriousness of the [action's] deficiencies"). The Commission had no authority to adopt the challenged provisions, the most serious of deficiencies. *See, e.g., Fox Television Stations, Inc. v. FCC*, 280 F.3d 1027, 1052 (D.C. Cir. 2002) (vacating rule where agency's failure stemmed from "an error of law"); *Chemical Mfrs. Ass'n v. EPA*, 28 F.3d 1259, 1268 (D.C. Cir. 1994) (vacating

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II. The Commission's Adoption Of The Independent Chair And 75 Percent Independent Director Requirements Was Arbitrary, Capricious, And Otherwise Not In Accordance With Law.

Even if the Commission did have statutory authority to adopt the independent chair and 75 percent independent director requirements, these provisions of the rule would still be invalid because the Commission failed to satisfy the most basic rulemaking requirements of the APA. Indeed, in the recent Budget Act, Congress legislatively determined that the Commission failed to provide adequate "justification" for imposing the independent chair requirement—as was required by the APA—and that it erroneously omitted consideration of the relative performance of independent- and management-chaired funds, as required by both the APA and the ICA.

Under the APA, this Court will invalidate a rule that is "arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law." 5 U.S.C.

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agency decision where there was no alternative basis in the record to support it). Further, as discussed in the section that follows, the agency's consideration of the record evidence and the rules being amended was so deficient that there can be no confidence the agency would adopt the same provisions on remand, even if it did have the authority. Finally, vacating the provisions is necessary to prevent the "egg [from being] scrambled"—if the provisions remain in effect, thousands of companies in a crucial sector of the economy will be forced to replace their current leadership, with irreversible effects. *Sugar Cane Growers Coop. of Fla. v. Veneman*, 289 F.3d 89, 97 (D.C. Cir. 2002); *see also* Chamber's Mot. Stay, or, Alternatively, Expedited Briefing at 17-18.

§ 706(2)(A); *Motor Vehicle Mfrs. Ass'n v. State Farm Mut. Auto Ins. Co.*, 463 U.S. 29, 43 (1983). This requires, among other things, that the agency (1) articulate a satisfactory explanation for its action, including "a rational connection between the facts found and the choice made"; (2) consider all important aspects of the problem; and (3) examine relevant data. *Motor Vehicle Mfrs. Ass'n*, 463 U.S. at 43 (internal quotation omitted). The Commission failed in each of these respects.

A. The Commission Did Not Adequately Justify Its Exercise Of Rulemaking Authority.

This rulemaking is flawed for the elementary reason that the Commission amended ten separate and distinct pre-existing rules without any meaningful consideration of them. In proffering its justification for the independent chair requirement, the Commission did not cite or discuss 7 of the 10 rules it was amending. *See* 69 Fed. Reg. at 46,382-46,384. In explaining the 75 percent independent director requirement, the Commission did not cite or discuss a single one of the rules. *Id.* at 46,381-46,382. In a section of the statement of reasons titled "Reasons for and Objectives of the Amendments," the Commission included no reference to the specific rules being amended or the related statutory provisions. *Id.* at 46,387-46,388. And, at the Open Meeting where the challenged requirements were adopted, none of the Commissioners voting in favor of the rule mentioned any of the specific exemptive rules they voted to amend. *See generally* CRI, Tr. 4.

For this reason alone, the independent chair and 75 percent independent director requirements are invalid. An agency's statement of reasons must articulate a "satisfactory explanation for its action" and "consider a[ll] important aspect[s] of the problem." *Motor Vehicle Mfrs. Ass'n*, 463 U.S. at 43. The "agency must cogently explain why it has exercised its discretion in a given manner." *Id.* at 48. This manifestly has not occurred when an agency amends a whole series of rules without discussing them.

The provisions are invalid for the additional reason that there is not a "rational connection between the facts found and the choice[s] made" by the Commission in amending the ten rules. Simply, the Commission did not <u>attempt</u> to articulate a "fit" between its amendments and the rules' existing terms and, indeed, no such fit exists. *Cf. Radio-Television News Dirs. Ass'n v. FCC*, 184 F.3d 872, 888 (D.C. Cir. 1999) (Rogers, J.) (rejecting a rule where the agency failed to "show[ ] a fit between its policy preferences and the actual . . . market in which the rules operate"). Two examples are illustrative:

1. As discussed above, Exemptive Rule 17g-1(j), 17 C.F.R. § 270.17g-1(j), provides an exemption from Section 17(d) of the Act, 15 U.S.C. § 80a-17(d), for joint insured bonds provided and maintained by a registered management investment company and one or more parties; the exemption depends, among other things, on a majority of independent directors approving the bond at least annually.

In amending Rule 17g-1(j) to require that funds relying on this exemption also have an independent chair and 75 percent independent board, the Commission did not explain why these requirements were necessary to the exemption in light of the exemption's longstanding provision that the bond be approved by a majority of independent directors. Similarly, although the Adopting Release relied heavily on the asserted importance of a chair "setting the agenda" for the board of directors, *see* 69 Fed. Reg. at 46,383, it 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. As this Court has made clear, an agency "fail[s] to exercise reasoned decisionmaking" when it does not explain how a rule interacts with existing provisions of law. *General Electric Co. v. United States Dep't of Commerce*, 128 F.3d 767, 775 (D.C. Cir. 1997) (Tatel, J.) (vacating agency rule).

2. Exemptive Rule 15a-4(b)(2), 17 C.F.R. § 270.15a-4, provides exemption 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. 15 U.S.C. § 80a-15(a). Under the Exemptive Rule, an advisory contract not approved by a majority of outstanding voting securities is permitted on an interim basis when, among other things, a majority of independent directors reviews and approves the interim

contract. Yet, in adopting the final rule, the Commission did not explain why the independent chair and 75 percent independent director requirements were necessary in light of the longstanding requirement that any interim advisory contract be approved by a majority of independent directors. Nor did it explain why a short-term interim contract warranted a prohibition on a fund having a management chair for all purposes, and on a long-term or permanent basis.

Finally, the Commission failed to establish a connection between the problems that it claimed justified the rulemaking, and the actual terms of the rule. The Commission premised its rule on concerns regarding late trading, market timing, and misuse of nonpublic information. 69 Fed. Reg. at 46,378. Yet there is no evidence that these purported fund abuses resulted from activities under the exemptive rules being amended. There also is no record evidence that firms with management chairs or fewer than 75 percent independent directors permitted these practices at a higher rate than firms with independent chairs or a supermajority of independent directors. Indeed, a recent academic study found no correlation between the practices and a fund's having an independent chair or independent directors. *See* Stephen P. Ferris & Xuemin Yan, *Do Independent Directors and Chairmen Really Matter? The Role of Boards of Directors in Mutual Fund Governance* (working paper at the University of Missouri-Columbia) (Nov. 2004),

announced at http://www.newswise.com/articles/view/508620/ (last visited Dec. 12, 2004).[14]

The Commission's imposition of the independent chair requirement was indeed so deficient that it has been determined unacceptable by Congress. In the 2005 Budget Act, the Commission is ordered to "provide[ ] a justification" for the independent chair requirement. Omnibus Consolidated Appropriations Act, H.R. 4818. That constitutes a congressional determination that the Commission failed to satisfy its obligation under the APA to "articulate a satisfactory explanation for its [rulemaking] action." *Motor Vehicle Mfrs. Ass'n*, 463 U.S. at 43 (emphasis added). Congress's action in the Budget Act is a separate and independent reason that the independent chair requirement must be vacated.

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[14] The Commission's suggestion that "a large majority" of mutual funds—approximately 80 percent—implicated in recent "scandals" have had management chairs is specious. 69 Fed. Reg. at 46,384 n.54. As the dissenters to the rule noted, "because approximately [80] percent of all fund firms have interested chairpersons, this number suggests only that funds with inside chairpersons are proportionally implicated in the abusive activity." *Id.* at 46,391. In any event, the Commission cannot rely on its own (self-selected) enforcement data to establish relative rates of misconduct without establishing that the two types of funds were sampled at the same rate.

B. The Commission Failed To Satisfy Its Statutory Obligation To Consider The Provisions' Effect On "Efficiency, Competition, And Capital Formation."

The Commission also committed clear error by failing to consider factors expressly mandated by the Investment Company Act—factors that Congress has now ordered the Commission to go back and examine. When an agency "fail[s] to comply with [a] specific statutory requirement," that is sufficient to vacate the rule. *Public Citizen v. Federal Motor Carrier Safety Admin.*, 374 F.3d 1209, 1216 (D.C. Cir. 2004).

The "exemptive" authority on which the Commission premised its rule required the agency to consider the effect the provisions of the rule would have on "efficiency, competition, and capital formation." 15 U.S.C. § 80a-2(c); *see also* 69 Fed. Reg. at 46,388-46,389. At the outset of the rulemaking, Commissioner Glassman identified an issue that bore directly on these factors when she urged Commission staff to conduct an empirical analysis of whether mutual funds with management chairs perform better than funds with independent chairs (CRI, Tr. 3, at. 17-22). If management-chaired funds performed better, the Commission would be imposing a governance model that was less efficient, less competitive with other investment options, and that diminished the formation of capital.

No such study was performed (CRI, Tr. 4, at 12). *See also* 69 Fed. Reg. at 46,391-46,392. And, when the 20-page Bobroff Study was submitted and

demonstrated that management-chaired funds outperform independent-chaired funds, the Commission simply dismissed it. "Some have argued that the Commission needs to demonstrate conclusively that there is a link between having an independent chairman and increased performance or decreased expenses," the Commission said of these factors that bear directly on funds' efficiency, competitiveness, and capital formation. *Id.* at 46,383. But, the Commission explained, it would not examine the issue carefully because it "believe[d] that having independent chairmen can provide benefits and serve other purposes apart from achieving high performance of the fund." *Id.* at 46,384. The merits of the Bobroff Study were dismissed in a superficial footnote where the Commission noted that other commenters viewed the data differently. *Id.* at 46,383 n.52. That, of course, is no substitute for the Commission's obligation to exercise its judgment to reach a considered determination of the merits of the study. *Motor Vehicle Mfrs. Ass'n*, 463 U.S. at 52.

The rejection of the Bobroff Study and the failure to consider relative fund performance were part of a larger, wholesale rejection of empirical data that would be astonishing in any rulemaking, let alone one by an agency with such important responsibilities for financial markets. Commissioners voting for the rule deprecated empirical studies—none of them "are worth much," in part because "methodologies will always be flawed or at least subject to question"—and

preferred to rely on unexplained (and hence unreviewable) invocations of their own "experience." CRI, Tr. 4, at 15, 55, 57-58. In the words of dissenting Commissioner Atkins:

> Instead of addressing this glaring deficiency [in the rulemaking] through considered empirical inquiry, we march forward boldly armed with anecdotal evidence and gut instincts. . . . Gut feelings . . . are not a sufficient basis to reorganize the boardrooms of most of the mutual funds in this country.

CRI, Tr. 4, at 23-24.[15]

The plain terms of the ICA required the Commission to determine whether it was imposing a less efficient, less productive management model on mutual funds. In flatly declining to do so, the Commission violated the ICA and the APA as well. Congress has confirmed this, ordering the Commission in the 2005 Budget Act to analyze "whether mutual funds chaired by disinterested directors perform better, have lower expenses, or have better compliance records than mutual funds chaired by interested directors." Omnibus Consolidated Appropriations Act, H.R. 4818. Because Congress has ratified this principal criticism of the rule made by the

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[15] The Commission's rejection of empirical evidence in this rulemaking is part of a troubling recent trend. *See* Peter J. Wallison, Financial Services Outlook: *Shooting from the Hip: The SEC Has Stopped Doing Its Homework* (AEI, Oct. 2004).

dissenting Commissioners and others, the independent chair requirement is *ipso facto* invalid and—for this and the other reasons given above—must be vacated.

C. The Final Rule Was Arbitrary And Capricious In Other Fundamental Respects, Including The Commission's Failure To Adequately Consider Costs, Disregard For Public Comments, And Failure To Consider Alternatives.

The Commission's adoption of the independent chair and 75 percent independent director requirements was arbitrary and capricious for additional reasons: the Commission failed to consider adequately the costs of the requirements; failed to respond to important issues raised by commenters; and failed to give adequate consideration to alternatives to the independent chair requirement.

1. The Commission gave inadequate consideration to record evidence of the costs of the challenged provisions. Because all costs unnecessarily imposed on funds reduce their efficiency, competitiveness, and capital formation, each failure by the Commission to consider costs identified by commenters was a violation not only of the APA, but also of the ICA requirement to consider those specific factors. 15 U.S.C. § 80a-2(c).

Numerous commenters stated that independent chairs and directors would be less familiar with the fund than management chairs and directors—as a consequence they would need to hire and pay additional staff, imposing additional costs and diminishing investor returns (CRI, Letters 118, 168). The Adopting

Release acknowledged that management directors often have a "significant advantage" over independent directors in their knowledge of fund activities, 69 Fed. Reg. at 46,382, and the final rule specifically granted independent directors the authority to hire staff. *Id.* at 46,385. The rule is "designed to enable independent directors to hire employees and others," the Adopting Release stated. *Id.*

The Commission nonetheless refused to assign any cost to the hiring of additional staff, and failed to take account of the effect that additional staff would have on fund efficiency, competitiveness, and capital formation. *See id.* at 46,387, 46,388-46,389, 46,392. That alone would be grounds under the ICA and APA to vacate the challenged provisions of the rule. Even more troubling is the Commission's "explanation" for refusing to assign a cost: state law already permitted hiring staff, it said. *Id.* at 46,387. But commenters had offered evidence that the rule's effect would be a need for more staff; the Commission confirmed this, both by acknowledging the information "advantage" that management directors often have, *id.* at 46,382-46,383, and by including as one of the rule's five provisions a requirement to "enable" the hiring of staff. *Id.* at 46,385. The Commission accordingly was required to address the cost effect its action would have. Its refusal to do so is the very quintessence of arbitrary and capricious

agency action—yet it is characteristic of this rulemaking where the Commission repeatedly ignored unwelcome comments and evidence.

The agency's consideration of the provisions' costs was deficient in additional respects. For the independent chair provision, the Commission "did not identify 'any out-of-pocket costs,'" the dissent observed. *Id.* at 46,392. Yet, requiring 80 percent of mutual funds to appoint a new chair will inevitably impose search costs and in many instances will require funds to pay board members higher salaries. (Management directors ordinarily serve without additional compensation.) *Id.*; Chamber's Reply Br. Mot. Stay, or, Alternatively, Expedited Briefing at 8-9 (Oct. 7, 2004). The Commission was required to consider these costs.

With respect to the 75 percent independent director requirement, the Commission refused to assign a cost because there was "no reliable basis for determining how funds would choose to satisfy this requirement." 69 Fed. Reg. at 46,387. That is insufficient; agencies are required to make the best estimates possible given available information. As this Court stated recently in vacating another agency rule:

> The agency said that the costs and benefits . . . are unknown, because cost estimates "vary enormously." But nothing prevented the agency from itself estimating the costs. The agency's job is to . . . make tough choices. . . . Regulators by nature work under conditions of serious uncertainty, and regulation would be at an end if uncertainty

> alone were an excuse to ignore a congressional command to "deal[ ] with" a particular regulatory issue.

Public Citizen, 374 F.3d at 1221.

2. The Commission gave short shrift to other comments on the independent chair requirement. A central premise of the rule was that "when Congress passed the Investment Company Act, it relied on independent directors to protect the interests of fund investors." 69 Fed. Reg. at 46,381. In light of this, numerous commenters questioned why—if independent directors were reliable guardians of investor interests—the decision whether to have a management chair should not be left to a majority of the independent directors, rather than being pre-determined by the Commission (CRI, Letter 65, at 1, 4; CRI, Letter 186). 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." 69 Fed. Reg. at 46,383. That cliché is an inadequate response to an important rulemaking question. *See Chemical Mfrs. Ass'n*, 28 F.3d at 1265-66 (agency arbitrary and capricious when handling comments in a "high-handed and conclusory manner"). The statement is also flatly inconsistent with the statute and with the Commission's own action in the rulemaking: Congress consciously permitted management directors for mutual funds; under federal and state law <u>all</u> mutual fund directors have fiduciary duties, including the duty to act in the best interests of the fund and its investors. *See* 15

U.S.C. § 80a-35; 69 Fed. Reg. at 46,392 n.31 and accompanying text. For the Commission to hold that management chairs invariably "serve two masters" is to take the position that the fiduciary constraints imposed by Congress are meaningless. The Commission did not even pause to explain why the judgment of independent directors—combined with constraints and liability associated with fiduciary duties—would not yield management chairs who could be trusted to obey the law. The Commission cannot nullify the statute that it purports to implement in this manner. The "two masters" quip also cannot be squared with the Commission's acknowledgment in this very rulemaking that management directors can—and "should"—*see* 69 Fed. Reg. at 46,383—continue to serve on fund boards, just not as the board chair.

3. Finally, the Commission gave inadequate consideration to alternatives to the independent chair requirement. *Motor Vehicle Mfrs. Ass'n*, 463 U.S. at 43; *International Ladies Garment Workers Union v. Donovan*, 722 F.2d 795, 815 (D.C. Cir. 1983).

Altogether, the Commission devoted a total of one paragraph—6 sentences—to alternatives to the independent chair requirement. 69 Fed. Reg. at 46,384. There, it cursorily discussed only 2 of the approximately 20 alternatives suggested. *Id.* Among the alternatives it ignored was a requirement that funds prominently disclose whether they had a management or independent chair—in

this way investors could choose for themselves which investment model they preferred, rather than the Commission eliminating the current predominant investment model in the industry that is favored by many investors (*see*, *e.g.*, CIR, Letters 190, 193). *See also* 69 Fed. Reg. at 46,393.

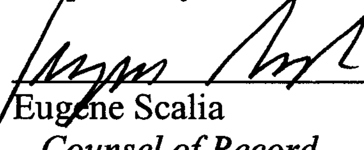
The Commission nonetheless has claimed that it discussed all "major" alternatives. Commission Opp'n Br. Mot. Stay at 15 (Sept. 30, 2004). But the "disclosure" alternative was suggested by the two dissenting Commissioners, among others—that is a "major" alternative by any measure. *See* 69 Fed. Reg. at 46,393. Small wonder the dissenting Commissioners—who personally participated in these agency deliberations where rulemaking norms were flouted so frequently—titled a section of their dissent, "The Commission Failed To Consider Alternatives." *Id.* at 46,392.

CONCLUSION

For the foregoing reasons, the Chamber of Commerce requests that the petition for review be granted and the rule's independent chair and 75 percent independent director requirements be vacated.

Dated: December 13, 2004

Respectfully submitted,



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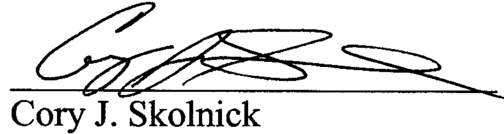

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I hereby certify that on this 13th day of December, 2004, I have caused to be served two true and correct copies of Opening Brief of Petitioner by hand, upon the following:

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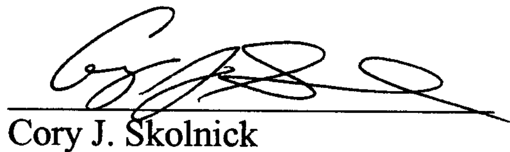

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