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

CHAMBER OF COMMERCE
OF THE UNITED STATES OF AMERICA,

Petitioner,

v.

UNITED STATES
SECURITIES AND EXCHANGE
COMMISSION,

Respondent.

ON PETITION FOR REVIEW

No. 04-1300

PETITION FOR PANEL REHEARING OF PETITIONER CHAMBER OF COMMERCE OF THE UNITED STATES OF AMERICA

Dated: July 28, 2005

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Pursuant to Circuit Rule 35, petitioner Chamber of Commerce of the United States of America respectfully requests panel rehearing of one of the rulings in the June 21 decision that granted in part, and denied in part, the petition for review. *Chamber of Commerce of the United States v. Securities and Exchange Commission*, No. 04-1300, Slip Op. (D.C. Cir. June 21, 2005) (attached in the "Addendum" hereto). Specifically, the Chamber seeks reconsideration of the Court's ruling that the Commission adequately justified adoption of the regulatory provisions at issue as "prophylactic" measures under the Commission's exemptive rules.

INTRODUCTION

In this case, the Chamber of Commerce challenged provisions of a 2004 Securities and Exchange Commission rule that amended ten pre-existing "exemptive" rules. Investment Company Governance; Final Rule; 69 Fed. Reg. 46,378 (Aug. 2, 2004). These exemptive rules permit mutual funds to engage in certain activities that otherwise would be prohibited by the Investment Company Act, provided that the funds satisfy conditions enumerated in the rules. In the rulemaking at issue, the Commission adopted several new conditions. The Chamber petitioned for review of two of these. The first is a provision requiring that the chair of the board of mutual funds be independent of the "adviser" that

establishes and manages the fund. The second is a requirement that 75 percent of the board members as a whole also be independent of the adviser.

In its decision, the Court granted the petition for review in part, on the grounds that (i) the Commission had not adequately considered certain costs the provisions would impose; (ii) had not adequately considered the provisions' effect on efficiency, competition, and capital formation; and (iii) had not adequately considered a significant alternative to the independent chair requirement. Slip Op. at 15-19. However, the Court rejected the Chamber's argument that the Commission lacked the statutory authority to regulate the composition of mutual funds boards as it did. *Id.* at 6-9. The Court also rejected the Chamber's argument that the Commission had not adequately justified the need for amending the exemptive rules to impose the independent chair and 75 percent independence requirements. *Id.* at 10-12. It is this latter determination that the Chamber respectfully requests be reconsidered.[1]

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[1] After the Court's decision issued, the Commission purported to address the issues remanded in just a week before the departure of the Commission Chairman, who had been a forceful proponent of the provisions and whose vote was needed to ensure readoption. The Chamber of Commerce has filed a petition for review of the Commission's hasty "reconsideration," and on July 26 moved the Court to stay the provisions' January 16, 2006 compliance date. *Chamber of Commerce of the United States v. Securities and Exchange Commission*, No. 05-1240 (D.C. Cir. 2005).

DISCUSSION

In its decision, the Court upheld the challenged amendments to the exemptive rules as a reasonable "prophylactic response[ ] to perceived risks." Slip Op. at 12 (internal quotations omitted). The Commission had found "new evidence that some boards were failing to prevent egregious conflicts of interest involving late trading and market timing," the Court observed.

> Although it is true, as the Chamber repeatedly notes, that none of the documented abuses involved a transaction covered by the Exemptive Rules, the Commission, as we have said, thought it prudent to amend those rules because the particular abuses . . . revealed a more general problem with conflicts of interest than it had previously suspected and portended further abuses if that perceived problem was not addressed. The Commission thus viewed strengthening the role of independent directors ***in relation to exemptive transactions*** as a prophylactic measure, not a response to a present problem involving abuse of the Exemptive Rules.

Id. at 11 (emphases added). In light of the late-trading and market-timing abuses, the Court continued, the Commission sensibly had queried:

> Might not [mutual fund boards] also fail to police sufficiently the conflicts of interest inherent in the exemptive transactions? That those transactions already were subject to some regulation does not render unreasonable the Commission's judgment that additional regulation was called for as a prophylactic.

Id.

The Chamber respectfully submits that the Court's decision that the provisions were reasonably-adopted prophylactic measures was mistaken.

1. In the rulemaking, the Commission itself did not base the adoption of the new provisions on their perceived "prophylactic" effect "in relation to exemptive transactions." *Id.* Rather, the amendments were adopted for the effect they were expected to have on activities outside the exemptive rules. This is reflected in the Commission's Proposing Release, its Adopting Release, and in both Open Meetings where the Commission considered the disputed provisions.

In proposing the rule in 2004, the Commission stated:

> To the extent that these proposals do affect competition and capital formation, we believe that the effect will be positive because the proposals would likely reduce the risk of securities law violations such as late trading in mutual funds and market timing violations, and thus increase investor confidence in mutual funds.

J.A. at 46 (emphasis added). Thus, the rules were proposed to address activity outside the scope of the exemptive rules. A virtually identical statement was made in the final statement of reasons when the rules were adopted:

> To the extent that these amendments do affect competition or capital formation, we believe that the effect will be positive because the amendments are likely to reduce the risk of securities law violations such as late trading in mutual funds and market timing violations, and thus increase investor confidence in mutual funds.

J.A. at 127-28 (emphasis added).

Similarly, in the Open Meeting adopting the rules, the Chairman of the Commission stated that the independent chair requirement was the "keystone" to the Commission's recent changes to the mutual fund industry. He elaborated:

> This requirement provides independent directors the leadership that they need to be truly effective day in, day out in the future. The leadership of an independent chairman will be the critical pivot point for avoiding potential conflicts of interest that can in the future lead to new forms of mismanagement, non-compliance, and even fraud. Consider just a few of the duties of a mutual fund director, including the chairman of the board of the mutual fund. Fund directors determine how much money the investment adviser will be allowed to charge for fees. Fund directors negotiate the terms of the management contract with the investment adviser. Fund directors determine whether and to what extent the investment advisor and its affiliates will be able to purchase or redeem fund shares of securities in a fund portfolio. Fund directors negotiate the cost and terms of joint liability insurance contracts, and custody contracts with the investment advisers. And, fund advisers monitor the investment adviser's compliance with the terms of all its agreements with the investment adviser and all applicable laws and regulations.

J.A. at 108-09. These activities by fund boards are wholly unrelated to the vast majority of the exemptive rules amended by the Commission.

Just as notable as the frequency with which the Commission expressed its intent to influence activity outside the exemptive rules, is its near total failure to mention an intent to address even potential problems under the exemptive rules. For instance, in a section of the final statement of reasons titled "Reasons for and Objectives of the Amendments," the Commission made no reference to any of the specific rules being amended or the transactions they regulate. J.A. at 126; *see also* Chamber Br. at 35; Chamber Reply at 9. And while the sections of the Proposing and Adopting Releases enumerating the rule's "benefits" mentioned "reduc[ing] risk of securities law violations such as late trading in mutual funds

and market timing violations," they failed to identify benefits associated with activities under the exemptive rules themselves.[2]

In sum, the Commission did not discuss misconduct in non-exemptive activities merely as a barometer, or harbinger, of problems that could emerge with exemptive transactions also, as this Court's June 21 decision supposed. Rather, the agency's intention toward non-exemptive conduct was prospective, reflecting the unmistakable aim to regulate those non-exemptive activities. The Chamber believes that the *sine qua non* of the amendments was to use the exemptive rules collaterally to regulate matters that the rules themselves—and the statutory authority on which they rest—do not reach. At minimum, the Commission based its action to such an extent on an intent to regulate activity beyond the ambit of the statutory authority it invoked, that a remand is warranted for the agency to clarify whether these far-reaching amendments are justified by activities the exemptive

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2 In the Open Meeting where the amendments were proposed, the exemptive rules were not mentioned until near the end of the meeting, when a Commissioner who eventually dissented from adopting the two provisions questioned the Commission's authority. The General Counsel responded, "[T]his approach builds on what the staff has done in the past in this area, which is to look at a number of exemptions that exist under the statute and to tie certain independence standards to those exemptions. That use of the exemptive authority is something the Commission has done in the past." J.A. at 28. In other words, the Commission first resolved to impose "independence standards," and then "used" the exemptive authority to impose them. It was not addressing problems it foresaw with exemptive transactions themselves.

rules do regulate, without regard to effects on activities outside the statutory provisions involved.

2. A principal means by which courts police the bounds of agencies' statutory authority is by ensuring that agencies' stated reasons for their actions hold water. If an agency's final statement of reasons cogently links its action with the rulemaking record and the regulatory authority it deployed, then the action will be permitted even if others may postulate that the agency had some other, collateral objective.

The Chamber respectfully submits that it is for this reason that the Commission's failure to meaningfully discuss the rules it was amending is so notable in this case, and commands a remand. Many of the activities regulated by the exemptive rules are finite, narrow acts that funds perform infrequently. For instance, Exemptive Rule 17g-1(j) permits a fund to maintain a joint insured bond with a management investment company and one or more parties. 17 C.F.R. § 270.17g-1(j). Exemptive Rule 17d-1(d)(7) permits a fund and its affiliates to purchase joint liability insurance. 17 C.F.R. § 270.17d-1(d)(7). Both are matters acted on just once a year.

In this rulemaking—that would change virtually all fund boards—the Commission adopted unusually broad-gauged requirements ostensibly to address these and other narrow mutual fund activities, without ever discussing the rules'

existing protections and explaining why those protections fell short.[3] Further, as noted above, the explanations the Commission did offer for its action were often irrelevant to the exemptive transactions at issue. For instance, the Commission said that a <u>prospective reason for and benefit of</u> the amendments was that they would ensure that directors "negotiat[e] the best deal for shareholders when considering the advisory contract." J.A. 122. That is irrelevant to the two rules just cited, however, and to all or virtually all the rules amended. Similarly, during the rulemaking the Commission emphasized repeatedly that the amendments would play "an important role in setting the agenda of the board." J.A. 122. But in the litigation the Commission conceded, "The objective of having an independent chair is <u>not to assure that transactions covered by the Exemptive Rules</u> get on the board's agenda . . . ." Commission Br. at 48 n.41 (emphasis added). As also

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[3] The Court described the Chamber as arguing that "the Commission's decision was unreasonable because the conditions for engaging in exemptive transactions had already been tightened in 2001." Slip Op. at 11. The Chamber's argument was more than that, however: Exempted transactions already are subject to protections that do not exist in the areas where the Commission found mutual fund misconduct. Late-trading, for instance, did not require specific approval by a majority of independent directors, as required for activities under the exemptive rules. Therefore, abuses in areas uncontrolled by the exemptive rules' are poor predictors of whether abuses will occur in areas governed by the rules' more thorough protections. Chamber Reply at 12-14. Given this, the Commission's obligation was, at minimum, to consider and discuss whether the exemptive rules' existing protections were sufficient. It failed to do so.

noted, the Commission said that a principal benefit of the amendments was "reduc[ing] the risk of securities law violations such as late trading in mutual funds and market timing violations." J.A. at 46, 128. That is not an acceptable rationale for increasing restrictions on exemptive rule activities.

The Court's decision in this case placed considerable emphasis on the appropriateness of deferring to agency expertise. Slip Op. at 13-15; *see also Ruling Backing 'Informed Conjecture' Raises Fear Over EPA Powers*, 16 CLEAN AIR REP. 14 (July 14, 2005). The Chamber does not request rehearing of that aspect of the Court's decision. We respectfully submit, however, that to the extent a rulemaking involves "technical" and predictive matters that limit a court's capacity to review the agency's judgments, it is all the more important for the court to assure that the agency is exercising its judgment as to the right things, and within the sphere of the authority it claims to be invoking. In this case, the agency predicated its action on objectives outside the statutory authority it was exercising.

3. The Chamber believes that rehearing is appropriate for the additional reason that the implications of the Court's decision extend well beyond the case at hand. The rulemaking record in this case bears two unusually strong indications that the agency endeavored to use its powers collaterally, to achieve objectives beyond the statutory authority it cited: First, the agency repeatedly based its action on benefits associated with activities that are not regulated by the statutory

authority it invoked. Second, the agency consistently failed to explain its action "in relation to" (Slip op. at 11) the activity it ostensibly was regulating and the existing regulatory framework that it was amending.

In light of these two patent defects in the agency's final statement of reasons, a remand to the agency for a more satisfactory explanation of the necessity for its action would have been an unremarkable legal precedent. However, because the Court accepted the agency's rationale for the amendments despite these conspicuous flaws—and because this enabled the agency to leverage a narrow statutory grant of deregulatory authority to implement sweeping regulatory changes in a widely-noticed case—the Chamber is concerned that this decision will either become an important precedent for agencies' expansive use of their statutory authority, or will instead have to be distinguished in the future in a way that produces confusion rather than clarity in the law.

CONCLUSION

For the foregoing reasons, petitioner Chamber of Commerce respectfully requests that the panel reconsider its ruling that the Commission adequately justified the need for amending the exemptive rules, and that it vacate the independent chair and 75 percent independence requirements and remand for further proceedings before the Commission.

Dated: July 28, 2005

Respectfully submitted,

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ADDENDUM

United States Court of Appeals
FOR THE DISTRICT OF COLUMBIA CIRCUIT

Argued April 15, 2005 Decided June 21, 2005

No. 04-1300

CHAMBER OF COMMERCE OF THE UNITED STATES OF AMERICA,
PETITIONER

v.

SECURITIES AND EXCHANGE COMMISSION,
RESPONDENT

On Petition for Review of an Order of the
Securities and Exchange Commission

Eugene Scalia argued the cause for petitioner. With him on the briefs were *John F. Olson*, *Douglas R. Cox*, *Cory J. Skolnick*, *Stephen A. Bokat*, and *Robin S. Conrad*.

Giovanni P. Prezioso, General Counsel, Securities & Exchange Commission, argued the cause for respondent. With him on the brief were *Meyer Eisenberg*, Deputy General Counsel, *Jacob H. Stillman*, Solicitor, and *John W. Avery*, Special Counsel.

Before: GINSBURG, *Chief Judge*, and ROGERS and TATEL, *Circuit Judges*.

Opinion for the Court filed by *Chief Judge* GINSBURG.

GINSBURG, *Chief Judge*: The Chamber of Commerce of the United States petitions for review of a rule promulgated by the Securities and Exchange Commission under the Investment Company Act of 1940 (ICA), 15 U.S.C. § 80a-1 *et seq.* The challenged provisions of the rule require that, in order to engage in certain transactions otherwise prohibited by the ICA, an investment company – commonly referred to as a mutual fund – must have a board (1) with no less than 75% independent directors and (2) an independent chairman. The Chamber argues the ICA does not give the Commission authority to regulate "corporate governance" and, in any event, the Commission promulgated the rule without adhering to the requirements of the Administrative Procedure Act, 5 U.S.C. § 551 *et seq.*

We hold the Commission did not exceed its statutory authority in adopting the two conditions, and the Commission's rationales for the two conditions satisfy the APA. We agree with the Chamber, however, that the Commission did violate the APA by failing adequately to consider the costs mutual funds would incur in order to comply with the conditions and by failing adequately to consider a proposed alternative to the independent chairman condition. We therefore grant in part the Chamber's petition for review.

I. Background

A mutual fund, which is "a pool of assets ... belonging to the individual investors holding shares in the fund," *Burks v. Lasker*, 441 U.S. 471, 480 (1979), is operated by an "investment company" the board of directors of which is elected by the shareholders. Although the board is authorized to operate the fund, it typically delegates that management role to an "adviser," which is a separate company that may have interests

other than maximizing the returns to shareholders in the fund. In enacting the ICA, the Congress sought to control "the potential for abuse inherent in the structure of [funds]" arising from the conflict of interests between advisers and shareholders, *id.*; to that end, the ICA prohibits a fund from engaging in certain transactions by which the adviser might gain at the expense of the shareholders. *See generally* 15 U.S.C. § 80a-12(a)-(g). Pursuant to the Commission's long-standing Exemptive Rules, however, a fund that satisfies certain conditions may engage in an otherwise prohibited transaction. *See, e.g.*, Rule 10f-3, 17 C.F.R. § 270.10f-3 (2004) (when conditions are satisfied, fund may purchase securities in primary offering although adviser-affiliated broker-dealer is member of underwriting syndicate).

Early in 2004 the Commission proposed to amend ten Exemptive Rules by imposing five new or amended conditions upon any fund wishing to engage in an otherwise prohibited transaction. *See* Investment Company Governance, Proposed Rule, 69 Fed. Reg. 3472 (Jan. 23, 2004). Although the Commission had amended the same ten rules in 2001 to condition exemption upon the fund having a board with a majority of independent directors (that is, directors who are not "interested persons" as defined in § 2(a)(19) of the ICA), *see* Role of Independent Directors of Investment Companies, Final Rule, 66 Fed. Reg. 3734 (Jan. 16, 2001), by 2004 the Commission had come to believe that more was required. "[E]nforcement actions involving late trading, inappropriate market timing activities and misuse of nonpublic information about fund portfolios" had brought to light, in the Commission's view, "a serious breakdown in management controls," signaling the need to "revisit the governance of funds." 69 Fed. Reg. at 3472. Accordingly, the Commission proposed to condition the ten exemptions upon, among other things, the fund having a board of directors (1) with at least 75% independent directors

and (2) an independent chairman. *Id.* at 3474.

After a period for comment and a public meeting, the Commission unanimously adopted three of the proposed new conditions and, by a vote of three to two, adopted the two corporate governance conditions challenged here. *See* Investment Company Governance, Final Rule, 69 Fed. Reg. 46,378 (Aug. 2, 2004). The Commission majority adopted those two conditions in light of recently revealed abuses in the mutual fund industry, reasoning that the Exemptive Rules

> rely on the independent judgment and scrutiny of directors, including independent directors, in overseeing activities that are beneficial to funds and fund shareholders but that involve inherent conflicts of interest between the funds and their managers. ... These further amendments provide for greater fund board independence and are designed to enhance the ability of fund boards to perform their important responsibilities under each of the rules.

Id. at 46,379. Raising the percentage of independent directors from 50% to 75%, the Commission anticipated, would "strengthen the independent directors' control of the fund board and its agenda," *id.* at 46,381, and "help ensure that independent directors carry out their fiduciary responsibilities," *id.* at 46,382. The Commission justified the independent chairman condition on the ground that "a fund board is in a better position to protect the interests of the fund, and to fulfill the board's obligations under the Act and the Exemptive Rules, when its chairman does not have the conflicts of interest inherent in the role of an executive of the fund adviser." *Id.*

The dissenting Commissioners were concerned the two disputed conditions would come at "a substantial cost to fund shareholders," and they believed the existing statutory and

regulatory controls ensured adequate oversight by independent directors. 69 Fed. Reg. at 46,390. Specifically, they faulted the Commission for not giving "any real consideration to the costs" of the 75% condition, *id.* at 46,390-46,391; for failing adequately to justify the independent chairman condition, *id.* at 46,391-46,392; and for not considering alternatives to that condition, *id.* at 46,392-46,393. The Chamber timely petitioned for review, asserting an interest in the new conditions both as an investor and as an association with mutual fund advisers among its members.

II. Analysis

The Chamber makes two arguments on the merits: The Commission had no authority under the ICA to adopt the two conditions; and the Commission violated the APA in the rulemaking by which it promulgated the conditions. Before addressing those arguments, we must assure ourselves of the Chamber's standing, and thus of our jurisdiction.

A. Jurisdiction of the Court

Under Article III of the Constitution the "judicial Power of the United States" is limited to the resolution of "Cases" or "Controversies," a corollary of which is that a party invoking our jurisdiction "must show that the conduct of which he complains has caused him to suffer an 'injury in fact' that a favorable judgment will redress." *Elk Grove Unified School Dist. v. Newdow*, 124 S.Ct. 2301, 2308 (2004). In this case the Chamber claims it is injured by the two challenged conditions because it would like to invest in shares of funds that may engage in transactions regulated by the Exemptive Rules but do not meet those conditions. *See* Dec'l of Stan M. Harrell ¶ 2 (Chamber currently invests in funds, intends to continue doing so, and would like to invest in funds unconstrained by the

conditions).

The Chamber cites two cases for the proposition that loss of the opportunity to purchase a desired product is a legally cognizable injury. *Consumer Fed'n of Am.* v. *FCC*, 348 F.3d 1009, 1011-12 (D.C. Cir. 2003) (injury-in-fact where merger would deprive plaintiff of opportunity to purchase desired service); *Competitive Enter. Inst. v. Nat'l Highway Traffic Safety Admin.*, 901 F.2d 107, 112-13 (D.C. Cir. 1990) (injury-in-fact where fuel economy regulations foreclosed "opportunity to buy larger passenger vehicles"). The Commission argues in response that there is no evidence a fund of the type in which the Chamber wants to invest would perform better than a fund that conforms to the two corporate governance conditions. In *Consumer Federation*, however, we held "the inability of consumers to buy a desired product ... constitute[d] injury-in-fact even if they could ameliorate the injury by purchasing some alternative product." 348 F.3d at 1012. Under our precedent, therefore, the Chamber has suffered an injury-in-fact and, because a favorable ruling would redress that injury, it has standing to sue the Commission. And so to the merits.

B. The Commission's Authority under the ICA

The Chamber maintains the Commission did not have authority under the ICA to condition the exemptive transactions as it did. First the Chamber observes rather generally that "matters of corporate governance are traditionally relegated to state law"; and second, it maintains these particular conditions are inconsistent with the statutory requirement that 40% of the directors on the board of an investment company be independent, *see* 15 U.S.C. § 80a-10(a). The Commission points to § 6(c) of the ICA, 15 U.S.C. § 80a-6(c), as the source

of its authority.* That provision conspicuously confers upon the Commission broad authority to exempt transactions from rules promulgated under the ICA, subject only to the public interest and the purposes of the ICA.

The thrust of the Chamber's first contention is that § 6(c) should not be read to enable the Commission to leverage the exemptive authority it clearly does have so as to regulate a matter, namely, corporate governance, over which the states, not the Commission, have authority. For support the Chamber relies principally upon two cases from this circuit concerning the Commission's authority under the Securities and Exchange Act of 1934. Neither of those cases, however, arose from an exercise of authority analogous to the rulemaking here under review.

In *Business Roundtable v. SEC*, 905 F.2d 406, 416-17 (1990), we held the Commission did not have authority under the 1934 Act to bar a stock exchange from listing common stock with restricted voting rights. The Commission had invoked the provision of that Act authorizing it to make rules "otherwise in furtherance of the purposes" of the Act. *Id.* at 410. Reasoning that "unless the legislative purpose is defined by reference to the

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* That section provides:

> The Commission, by rules and regulations upon its own motion, or by order upon application, may conditionally or unconditionally exempt any person, security, or transaction, or any class or classes of persons, securities, or transactions, from any provision or provisions of this [Act] or of any rule or regulation thereunder, if and to the extent that such exemption is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of this [Act].

means Congress selected, it can be framed at *any* level of generality," and the means the Congress selected in the 1934 Act was disclosure, *id.*, we vacated the rule because it went beyond disclosure to regulate "the substance of what the shareholders may enact," *id.* at 411.

Business Roundtable is of little help to the Chamber because, as the Commission documents, the purposes of the ICA include tempering the conflicts of interest "inherent in the structure of investment companies," *Burks*, 441 U.S. at 480; *see also* 15 U.S.C. § 80a-1(b) ("policy and purposes of [ICA] ... shall be interpreted ... to eliminate" conflicts of interest); and regulation of the governance structure of investment companies is among the means the Congress used to effect that purpose. *See Burks*, 441 U.S. at 479 (ICA "functions primarily to impose controls and restrictions on the internal management of investment companies") (emphases removed); *id.* at 484 (in enacting ICA Congress "place[d] the unaffiliated directors in the role of independent watchdogs ... who would furnish an independent check upon the management of investment companies"). Moreover, the Commission's effort to enlarge the role of independent directors on the boards of investment companies accords with "the structure and purpose of the ICA [both of which] indicate that Congress entrusted to the independent directors ... the primary responsibility for looking after the interests of the funds' shareholders." *Id.* at 484-85.

In *Teicher v. SEC*, 177 F.3d 1016, 1019-20 (1999), we held a provision of the 1934 Act authorizing the Commission to "place limitations on the activities or functions" of a person convicted of securities fraud in the broker-dealer industry did not authorize it to place limitations upon the activities or functions of that person in an industry regulated under a different "occupational licensing regime" administered by the Commission. The Commission's authority, we reasoned, must

be read with "some concept of the relevant domain" in mind; even the Commission did not "suggest that [provision] allows it to bar one of the offending parties from being a retail shoe salesman, or to exclude him from the Borough of Manhattan." *Id.* at 1019. The present case is different from *Teicher* because here the Commission did not exercise its regulatory authority to effect a purpose beyond that of the statute from which its authority derives.

The Chamber's second contention is that the conditions conflict with the intent of the Congress, expressed in § 10(a) of the ICA, that 40% of the directors of an investment company be independent. *See Chevron, U.S.A., Inc. v. NRDC*, 467 U.S. 837, 842-43 (1984) ("If the intent of Congress is clear, that is the end of the matter; for the court, as well as the agency, must give effect to the unambiguously expressed intent of Congress"). Section 10(a), however, states only that a fund may have "no more than" 60% inside directors, 15 U.S.C. § 80a-10(a), which necessarily means at least 40% must be independent and strongly implies a greater percentage may be; it speaks not at all to authority of the Commission to provide an incentive for investment companies to enhance the role of independent directors and, as the Commission is keen to point out, the challenged conditions apply only to funds that engage in exemptive transactions.

C. The Requirements of the APA

The condemnation of the APA extends to any rule that is "arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law." 5 U.S.C. § 706(2)(A). Although the "scope of review under the 'arbitrary and capricious' standard is narrow and a court is not to substitute its judgment for that of the agency," we must nonetheless be sure the Commission has "examine[d] the relevant data and articulate[d] a satisfactory

explanation for its action including a rational connection between the facts found and the choice made." *Motor Vehicle Mfrs. Ass'n v. State Farm Mutual Auto. Ins. Co.*, 463 U.S. 27, 43 (1983); *see also Pub. Citizen v. Fed. Motor Carrier Safety Admin.*, 374 F.3d 1209, 1216 (D.C. Cir. 2004).

The Chamber argues the Commission violated the APA because it (1) failed to show the connection between the abuses that prompted the rulemaking and the conditions newly included in the Exemptive Rules; (2) did not comply with its obligation under the ICA to consider whether those conditions "will promote efficiency, competition, and capital formation," 15 U.S.C. § 80a-2(c); *see Pub. Citizen*, 374 F.3d at 1216 (rule is "arbitrary and capricious" if agency fails to consider factors "it must consider under its organic statute"); and (3) did not consider reasonable alternatives to the independent chairman condition.

1. Justification for the Rulemaking

The Chamber maintains the "rulemaking is flawed for the elementary reason that the Commission amended ten separate and distinct pre-existing rules [by imposing the two challenged conditions] without any meaningful consideration of them." Similarly, the Chamber argues the Commission did not adequately explain why the conditions it added were necessary in light of the conditions previously contained in the Exemptive Rules. The Commission answers that its stated justification for amending the Exemptive Rules satisfies the standards of the APA. We agree.

In the wake of recent revelations of certain abuses in the mutual fund industry, the Commission was concerned about what it diagnosed as "a serious breakdown in management controls." *See* 69 Fed. Reg. at 46,378-46,379; 69 Fed. Reg. at

3472. Although it is true, as the Chamber repeatedly notes, that none of the documented abuses involved a transaction covered by the Exemptive Rules, the Commission, as we have said, thought it prudent to amend those rules because the particular abuses that had come to light revealed a more general problem with conflicts of interest than it had previously suspected and portended further abuses if that perceived problem was not addressed. The Commission thus viewed strengthening the role of independent directors in relation to exemptive transactions as a prophylactic measure, not a response to a present problem involving abuse of the Exemptive Rules. *See* 69 Fed. Reg. at 46,379.

The Chamber claims the Commission's decision was unreasonable because the conditions for engaging in exemptive transactions had already been tightened in 2001. But that begs the question whether the conditions of 2001 were adequate in view of the new evidence that some boards were failing to prevent egregious conflicts of interest involving late trading and market timing. Might not they also fail to police sufficiently the conflicts of interest inherent in the exemptive transactions? That those transactions were already subject to some regulation does not render unreasonable the Commission's judgment that additional regulation was called for as a prophylactic.

Finally, the Chamber argues the "actual terms" of the conditions were not reasonable in light of "the problems [the Commission] claimed justified the rulemaking." Those problems all trace to the failure of investment company boards, for whatever reason, to guard against advisers' conflicts of interest. *See* 69 Fed. Reg. at 3473 ("boards may have simply abdicated their responsibilities, or failed to ask the tough questions of advisers; in other cases, boards may have lacked the information or organizational structure necessary to play their proper role"). So that boards are apprised of the activities of

their fund's adviser, the Commission, in a separate proceeding first required funds to designate a chief compliance officer charged with bringing relevant information to the board. *See* Compliance Programs of Investment Companies and Investment Advisers, 68 Fed. Reg. 74,714 (Dec. 24, 2003). The Commission then undertook in the present rulemaking to ensure that independent directors would be in a position to put such information to good use.

To that end, the Commission reasonably concluded that raising the minimum percentage of independent directors from 50% to 75% would "strengthen the hand of the independent directors when dealing with fund management, and may assure that independent directors maintain control of the board and its agenda." 69 Fed. Reg. at 46,382. Similarly, the Commission concluded that having an independent chairman would be beneficial because the chairman plays "an important role in setting the agenda of the board[,] ... 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 interests of investors." 69 Fed. Reg. at 46,383. We have no basis upon which to second-guess that judgment.

In sum, the Chamber points to nothing in the ICA to suggest the Congress restricted the authority of the Commission to make "precautionary or prophylactic responses to perceived risks," *Certified Color Mfrs. Ass'n v. Mathews*, 543 F.2d 284, 296 (D.C. Cir. 1976); and the Commission's effort to prevent future abuses of exemptive transactions was not arbitrary, capricious, or in any way an abuse of its discretion, in violation of the APA.

2. Consideration of Costs

The ICA mandates that when the Commission "engage[s]

in rulemaking and is required to consider or determine whether an action is consistent with the public interest [it] shall ... consider ... whether the action will promote efficiency, competition, and capital formation." 15 U.S.C. § 80a-2(c). The Chamber argues the Commission violated this mandate, and hence the APA, by failing (1) to develop new, and to consider extant, empirical data comparing the performance of funds respectively led by inside and by independent chairmen; and (2) to consider the costs of the conditions it was imposing, which costs in turn impede efficiency, competition, and capital formation. The Commission denies the charges.

The particulars of the Chamber's first contention are that the Commission should have directed its staff to do a study of the effect of an independent chairman upon fund performance and that when such a study, commissioned by Fidelity Investments, was presented during the comment period, the Commission gave it short shrift. 69 Fed. Reg. at 46,383 n.52; *see* Geoffrey H. Bobroff and Thomas H. Mack, Assessing the Significance of Mutual Fund Board Independent Chairs (Mar. 10, 2004). As to the former point, although we recognize that an agency acting upon the basis of empirical data may more readily be able to show it has satisfied its obligations under the APA, *see Nat'l Ass'n of Regulatory Util. Comm'rs v. FCC*, 737 F.2d 1096, 1124 (D.C. Cir. 1984) (in informal rulemaking it is "desirable" that agency "independently amass [and] verify the accuracy of" data), we are acutely aware that an agency need not – indeed cannot – base its every action upon empirical data; depending upon the nature of the problem, an agency may be "entitled to conduct ... a general analysis based on informed conjecture." *Melcher v. FCC*, 134 F.3d 1143, 1158 (D.C. Cir. 1998); *Nat'l Ass'n of Regulatory Util. Comm'rs*, 737 F.2d at 1124 (failure to conduct independent study not violative of APA because notice and comment procedures "permit parties to bring relevant information quickly to the agency's attention"); *see also*

FCC v. Nat'l Citizens Comm. for Broad., 436 U.S. 775, 813-14 (1978) (FCC, in making "judgmental or predictive" factual determinations, did not need "complete factual support" because "a forecast of the direction in which future public interest lies necessarily involves deductions based on the expert knowledge of the agency").

Here the Commission, based upon "its own and its staff's experience, the many comments received, and other evidence, in addition to the limited and conflicting empirical evidence," concluded an independent chairman "can provide benefits and serve other purposes apart from achieving high performance of the fund." 69 Fed. Reg. at 46,383-46,384. The Commission's decision not to do an empirical study does not make that an unreasoned decision. *See BellSouth Corp. v. FCC*, 162 F.3d 1215, 1221 (D.C. Cir. 1999) ("When ... an agency is obliged to make policy judgments where no factual certainties exist or where facts alone do not provide the answer, our role is more limited; we require only that the agency so state and go on to identify the considerations it found persuasive").

Nor did the Commission violate the APA in its consideration of the Fidelity study. Although Chairman Donaldson did, as the Chamber points out, betray a dismissive attitude toward the value of empirical data, SEC Open Meeting, 57-58 (June 23, 2004) ("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"), the Commission did not reject the Fidelity study or decline to do its own study upon that basis. Rather, the Commission concluded the Fidelity study was "unpersuasive" because, as the authors acknowledged, it did not rule out "other important differences [than independence of the chairman] that may have impacted performance results," 69 Fed. Reg. at 46,383 n.52 (quoting study), and because it did not use a reliable method of calculating fund expenses, *id.* The Commission also noted that

other commenters reviewing the Fidelity study had concluded funds with an independent chairman did "slightly better in terms of returns, but at lower cost." *Id.* Although a more detailed discussion of the study might have been useful, the Commission made clear enough the limitations of the study, and we have no cause to disturb its ultimate judgment that the study was "unpersuasive evidence." *Cf. Hüls Am. Inc. v. Browner*, 83 F.3d 445, 452 (D.C. Cir. 1996) (court owes "extreme degree of deference to the agency when it is evaluating scientific data within its technical expertise").*

We reach a different conclusion with regard to the Commission's consideration of the costs of the conditions. With respect to the 75% independent director condition, the Commission, although describing three methods by which a fund might comply with the condition, claimed it was without a "reliable basis for determining how funds would choose to satisfy the [condition] and therefore it [was] difficult to determine the costs associated with electing independent directors." 69 Fed. Reg. at 46,387. That particular difficulty may mean the Commission can determine only the range within which a fund's cost of compliance will fall, depending upon how it responds to the condition but, as the Chamber contends, it does not excuse the Commission from its statutory obligation to determine as best it can the economic implications of the rule

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* The Chamber also argues the Congress's subsequent direction to the Commission to "provide[] a justification" for the independent chairman condition, *see* Consolidated Appropriations Act, 2005, Pub. L. No. 108-447, 118 Stat. 2809 (2004), establishes that the Commission failed to provide an adequate justification in the rulemaking proceeding. That does not follow, however; the Congress may require a more detailed explanation for a rule than is required by the APA. *See Motor Vehicle Mfrs. Ass'n*, 463 U.S. at 44-45 (rejecting view "congressional reaction" to rule necessitated stricter judicial review).

it has proposed. *See Pub. Citizen*, 374 F.3d at 1221 (in face of uncertainty, agency must "exercise its expertise to make tough choices about which of the competing estimates is most plausible, and to hazard a guess as to which is correct, even if ... the estimate will be imprecise").

With respect to the costs of the independent chairman condition, counsel maintains the Commission "was not aware of any costs associated with the hiring of staff because boards typically have this authority under state law, and the rule would not require them to hire employees." The Commission made that observation, however, in regard not to the independent chairman condition but to a condition not challenged here, and we cannot therefore consider counsel's rationalization for the regulation under review. *See Motor Vehicle Mfrs. Ass'n*, 463 U.S. at 50 ("courts may not accept appellate counsel's *post hoc* rationalizations for agency action"). In any event, the argument is a *non sequitur*; whether a board is authorized by law to hire additional staff in no way bears upon the contention that, because of his comparative lack of knowledge about the fund, an independent chairman would in fact cause the fund to incur additional staffing costs.

What the Commission itself did was acknowledge in a footnote that an independent chairman "may choose to hire [more] staff" but it stopped there because, it said, it had no "reliable basis for estimating those costs." 69 Fed. Reg. at 46,387 n.81. Although the Commission may not have been able to estimate the aggregate cost to the mutual fund industry of additional staff because it did not know what percentage of funds with independent chairman would incur that cost, it readily could have estimated the cost to an individual fund, which estimate would be pertinent to its assessment of the effect the condition would have upon efficiency and competition, if not upon capital formation. And, as we have just seen, uncertainty may limit what the Commission can do, but it does not excuse

the Commission from its statutory obligation to do what it can to apprise itself – and hence the public and the Congress – of the economic consequences of a proposed regulation before it decides whether to adopt the measure.

In sum, the Commission violated its obligation under 15 U.S.C. § 80a-2(c), and therefore the APA, in failing adequately to consider the costs imposed upon funds by the two challenged conditions.

3. Consideration of Alternatives

Finally, the Chamber argues the Commission gave "inadequate consideration" to suggested alternatives to the independent chairman condition, citing as an example – the only significant one, it seems to us – the proposal, endorsed by the two dissenting Commissioners, that each fund be required prominently to disclose whether it has an inside or an independent chairman and thereby allow investors to make an informed choice. Commission counsel responds by noting generally that the agency is "not required to discuss every alternative raised" and that it did consider the "major alternatives" proposed by commenters, adding more specifically that it had no obligation to consider the dissenters' disclosure alternative because the "Congress rejected a purely disclosure-based approach to regulating conflicts of interest under the [ICA]."

We conclude the Commission's failure to consider the disclosure alternative violated the APA. To be sure, the Commission is not required to consider "every alternative ... conceivable by the mind of man ... regardless of how uncommon or unknown that alternative" may be. *Motor Vehicle Mfrs. Ass'n*, 463 U.S. at 51. Here, however, two dissenting Commissioners raised, as an alternative to prescription, reliance upon disclosure, *see* 69 Fed. Reg. at 46,393 – a familiar tool in

the Commission's toolkit – and several commenters suggested that the Commission should leave the choice of chairman to market forces, making it hard to see how that particular policy alternative was either "uncommon or unknown."

The Commission would nevertheless be excused for failing to consider this alternative if it were, for whatever reason, unworthy of consideration. Commission counsel accordingly suggests one such reason, namely, that in the ICA the Congress rejected a "purely disclosure-based approach." *See also SEC v. Variable Annuity Life Ins. Co.*, 359 U.S. 65, 78 (1959) (ICA "passes beyond a simple 'disclosure' philosophy"). Counsel's statement is true but irrelevant; that the Congress required more than disclosure with respect to some matters governed by the ICA does not mean it deemed disclosure insufficient with respect to all such matters. On the contrary, the ICA requires funds to make extensive disclosures. *See, e.g.*, 15 U.S.C. § 80a-8(b) (fund must file registration statement with Commission); *id.* § 80a-29(e) (fund must send semiannual report to shareholders); *id.* § 80a-44(a) (fund must make available to public all documents filed with Commission); *see also* Mary M. Frank et al., *Copycat Funds: Information Disclosure Regulation and the Returns to Active Fund Management in the Mutual Fund Industry*, 47 J.L. & ECON. 515 (2004) ("[ICA] regulates information disclosure by mutual funds"). Indeed, the Commission augmented the disclosure requirements of the ICA even as it was considering the independent chairman condition. *See* Final Rule, Shareholder Reports and Quarterly Portfolio Disclosure of Registered Management Investment Companies, 69 Fed. Reg. 11,244, 11,245 (Mar. 9, 2004).

In sum, the disclosure alternative was neither frivolous nor out of bounds and the Commission therefore had an obligation to consider it. *Cf. Laclede Gas Co. v. FERC*, 873 F.2d 1494, 1498 (D.C. Cir. 1989) ("where a party raises facially reasonable alternatives ... the agency must either consider those alternatives

or give some reason ... for declining to do so") (emphases removed). The Commission may ultimately decide the disclosure alternative will not sufficiently serve the interests of shareholders, but the Commission – not its counsel and not this court – is charged by the Congress with bringing its expertise and its best judgment to bear upon that issue. *See SEC v. Chenery Corp.*, 332 U.S. 194, 196-97 (1947); *see also Motor Vehicle Mfrs. Ass'n*, 463 U.S. at 54.

III. Conclusion

For the foregoing reasons, we grant in part the Chamber's petition for review. This matter is remanded to the Commission to address the deficiencies with the 75% independent director condition and the independent chairman condition identified herein. *See Fox Television Stations, Inc. v. FCC*, 280 F.3d 1027, 1048-49 (D.C. Cir. 2002); *Allied Signal, Inc. v. U.S. Nuclear Regulatory Comm'n*, 988 F.2d 146, 150-51 (D.C. Cir. 1993).

So ordered.

CHAMBER OF COMMERCE OF THE UNITED STATES OF AMERICA, Petitioner, v. UNITED STATES SECURITIES AND EXCHANGE COMMISSION, Respondent.	**ON PETITION FOR REVIEW** NO. 04-1300

CERTIFICATE AS TO PARTIES

Pursuant to Circuit Rules 35 and 28(A)(1)(A), Petitioner Chamber of Commerce of the United States of America states as follows:

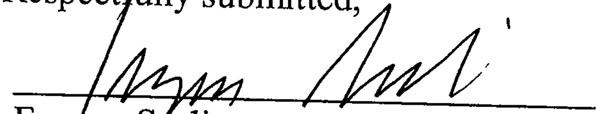
The parties in this case are the Chamber of Commerce of the United States of America (Petitioner) and the United States Securities and Exchange Commission (Respondent). There are no intervenors or amici.

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.

Dated: July 28, 2005

Respectfully submitted,



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

CHAMBER OF COMMERCE OF THE UNITED STATES OF AMERICA, Petitioner, v. UNITED STATES SECURITIES AND EXCHANGE COMMISSION, Respondent.	**ON PETITION FOR REVIEW** NO. 04-1300

CORPORATE DISCLOSURE STATEMENT

Pursuant to Circuit Rules 35 and 26.1, Petitioner Chamber of Commerce of the United States of America states as follows:

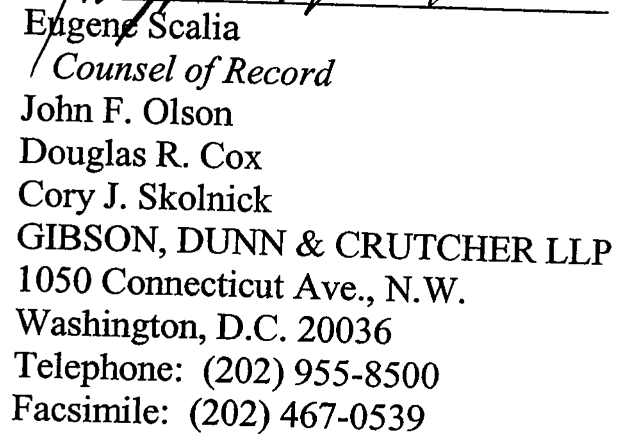
1. The Chamber of Commerce of the United States is a non-profit, tax-exempt organization incorporated in the District of Columbia. It is a non-stock corporation and thus has no parent organization.

2. Because the Chamber is a non-stock corporation, no publicly-held corporation holds 10% or more of Chamber stock.

3. The Chamber is unaware of any publicly-held corporation that is not a party to the proceeding before this Court which has any direct financial interest in the outcome of this proceeding.

Dated: July 28, 2005

Respectfully submitted,



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CERTIFICATE OF SERVICE

I hereby certify that I have caused to be served a true and correct copy of the Petition for Panel Rehearing of Petitioner Chamber of Commerce of the United States of America, Petitioner's Certificate as to Parties, and Corporate Disclosure Statement via hand delivery this 28th day of July, 2005, upon the following:

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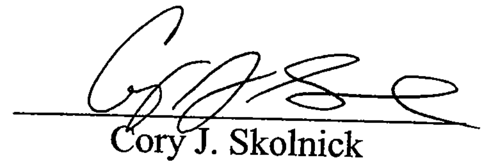

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