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

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

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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) (CRI, Letter 65)
Commission	Securities and Exchange Commission
Investment Company Act or the Act	Investment Company Act of 1940, 15 U.S.C. § 80a, *et seq.*

STATUTES AND REGULATIONS

The text of relevant statutes and regulations are set forth in the Chamber's Opening Brief.

SUMMARY OF ARGUMENT

The government's brief rests on a fiction: That the provisions under challenge do not regulate "mutual fund governance" (the rule's title), but instead are "entirely consistent" with a "long history" of provisions that for "50 years" the Commission has "always" used to provide "oversight of conflict-of-interest transactions" permitted by the exemptive rules that the Commission amended. Opp. at 13-15, 34.

In fact, the provisions are a sharp break from the Commission's "long history" of regulating transactions under the exemptive rules. Historically, the Commission has regulated the transactions, requiring that they be approved by a majority of independent directors, for instance. Now, the Commission regulates the board itself, requiring that to engage in exempted activities the board must—for all purposes—have an independent chair and 75 percent independent directors.

The Commission is correct that Congress intended independent directors to serve as "watchdogs" for investor interests when it required that 40 percent (but no more) of directors be independent of the "adviser" that sets up and manages the fund. But when independent directors are given the chairmanship of the board and control of 75 percent of board seats, they are no longer just the watchdog; they are masters of the house. And it is folly to claim this is "precisely what Congress intended" (Opp. at 4) when undisputed legislative history shows it is precisely

what Congress <u>rejected</u>, believing as it did that a mutual fund investor "is buying management of a particular [adviser] and if the majority of the board [is independent and can] repudiate his advice, then . . . you are depriving the stockholders of that [adviser's] advice." 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); Chamber Br. at 11, 29.

This brief first addresses the government's baseless standing argument, under which neither of the two principal groups affected by the rule—fund advisors and investors—would have standing to challenge it. The brief then analyzes the rule's challenged provisions on the terms the government would have this Court accept them—as an attempt to regulate funds in their transactions under the ten exemptive rules. The Commission did not justify the provisions this way during the rulemaking, and its litigation-driven attempt to advance that explanation now is wholly unconvincing, arbitrary, and capricious. Instead, the amendments to the exemptive rules can only be understood as a regulation of "mutual fund governance," which is how the provisions were presented from their inception until their publication in the *Federal Register* under that name—and which exceeds the Commission's statutory authority. Unsurprisingly, as the last section of this brief shows, a rulemaking so indifferent to substantive constraints on agency rulemaking also trampled important procedural requirements along the way.

ARGUMENT

I. Because The Challenged Rule Will Affect Advisers And Investors, The Chamber Has Standing In Both Capacities.

The rule at issue is intended to reduce the influence of mutual fund advisers, for the supposed benefit of mutual fund investors. As this Court has stated, where a party "is 'an object of the action (or foregone action) at issue'—as is the case usually in review of a rulemaking . . . —there should be 'little question that the action or inaction has caused him injury . . . .'" *Sierra Club v. EPA*, 292 F.3d 895, 900 (D.C. Cir. 2002) (emphasis added) (quoting *Lujan v. Defenders of Wildlife*, 504 U.S. 555, 561-62 (1992)). Because members of the Chamber of Commerce are mutual fund advisers targeted by the rule, and because the Chamber itself is among the investors the Commission intends to affect, it plainly has standing.

1. The Commission argues there is no evidence that any mutual fund adviser is sufficiently affected by the rule to have standing. Opp. at 6. Yet advisers are "'an object of the action'"; for that reason alone, "there should be 'little question that the action . . . has caused [them] injury.'" *Sierra Club*, 292 F.3d at 900 (citation omitted). Specifically, advisers "organize[] . . . operate," and "provide seed money for" mutual funds, the Commission asserts, and "typically . . . dominate" them; this rule is meant to sharply diminish advisers' ability to direct these entities they establish at their expense. Opp. at 18-19. The rule also is intended to reduce advisers' fees, and will reduce funds' returns while increasing

costs. 69 Fed. Reg. 46,378, 46,381 (Aug. 2, 2004); Chamber Br. at 40-46. The Commission may dispute the weight of the record evidence on these effects, but that is an argument to be addressed in connection with the merits, not on a standing inquiry. *Sierra Club*, 292 F.3d at 899; *Competitive Enter. Inst. v. Nat'l Highway Traffic Safety Admin.*, 901 F.2d 107, 113 (D.C. Cir. 1990).

The Commission also complains that the Chamber has not shown that any of its adviser members will be affected by the rule. But the Chamber specifically attested that its members include advisers to mutual funds that currently have management chairs and fewer than 75 percent independent directors, two conditions incompatible with the new rule. Those funds "may be among those that do not rely upon any of the Exemptive Rules," the Commission hypothesizes, and therefore purportedly would be "unaffected by the amendments." Opp. at 5-6. This suggestion—that a significant number of funds do not rely on the exemptive rules—is the second sustained fiction of the government's brief. In fact, as the Commission stated at the outset of the rulemaking, "[b]ecause almost all funds either rely or anticipate someday relying on at least one the Exemptive Rules," the new requirements "apply to most funds." 69 Fed. Reg. 3,472, 3,474 (Jan. 23, 2004). That is why the rules were selected for the collateral purpose of regulating fund governance, and it is why the Commission Chairman could herald the amendments as "requiring" broad changes in "fund governance" without any

suggestion that the rule's sweep would be circumscribed by funds' limited reliance on the exemptive rules (indeed he summarized the rules without mentioning the exemptive rules or exempted transactions at all). *See* CRI, Tr. 3, at 2-4. In any event, an adviser to a fund that has not yet relied on the exemptive rules is harmed by loss of the ability, in the future, to engage in exemptive rule transactions available to competitor funds—a fact the Commission recognized when it said the rules "apply" to "almost all" funds because almost all "rely or anticipate someday relying" on the rules. 69 Fed. Reg. at 3,474 (emphases added). A supplemental declaration appended hereto makes explicit what was implicit in the Chamber's earlier declaration, *viz.*, funds advised by Chamber members rely on the exemptive rules.

Finally, the Commission complains that specific Chamber members have not been identified to it. But the agency does not explain what "inquiry" it has been unable to perform for lack of that confidential information, and an association is under no obligation to "name the members on whose behalf suit is brought." *Doe v. Stincer*, 175 F.3d 879, 882 (11th Cir. 1999). The Commission muses that perhaps some Chamber members "fully support" the rule, but even if true, that is irrelevant: "Organizations, like people, may face the problem of 'two souls in one breast,' but—as long as they do not violate internal procedures—[organizations] are free to choose for themselves which purpose to pursue on any specific

occasion." *Louisiana Envtl. Action Network v. EPA*, 172 F.3d 65, 69 (D.C. Cir. 1999). The Commission's bid to require "outing" Chamber members to secure standing is baseless, and would chill associational standing in cases across the board.

2. With regard to the Chamber's standing as an investor, the Commission again suggests that an appreciable market will remain in management-chaired funds because the rule "only" applies to funds relying on the exemptive rules. Opp. at 8. That is disingenuous, as explained above, and it is irrelevant: the Chamber indisputably will become unable to invest in funds that (i) have management chairs or fewer than 75 percent independent directors and (ii) can engage in the full range of exemptive rule transactions available to other, competitor funds. That particular, desired product is being eliminated, and the "inability of consumers to buy a desired product may constitute injury-in-fact even if they could ameliorate the injury by purchasing some alternative product." *Consumer Fed'n of Am. v. FCC*, 348 F.3d 1009, 1012 (D.C. Cir. 2003) (internal quotations omitted). Notably, numerous commenters emphasized the value they placed on management-chaired funds (*see, e.g.*, CRI, Letter 190), and the statute itself was written to provide for 40 percent independent directors rather than a majority because "if a person is buying management of a particular person and if the majority of the board can repudiate his advice, then . . . <u>you are depriving the</u>

stockholders of that person's advice." Hearings on H.R. 10065, at 109-10 (emphasis added). The Commission ignores ample record evidence that the challenged provisions will increase costs and thereby decrease returns for funds in which the Chamber currently is invested, and is simply mistaken when it says there is no evidence that any fund held by the Chamber indicated the rule would "impair its returns or its operations in any way." Opp. at 9. *See* CRI, Letter 129 (comment by Vanguard directors).

II. The Commission Did Not Adequately Justify The Challenged Provisions As A Means Of Regulating Transactions Under The Exemptive Rules That Were Amended; The Provisions Accordingly Should Be Vacated Under The APA.

The Commission rests this rulemaking on its authority to exempt mutual funds from certain provisions of the Investment Company Act of 1940 ("Investment Company Act" or "Act"), 15 U.S.C. § 80a, *et seq.* This rulemaking was necessary, it contends, to address conflicts of interest in the activities authorized by the ten amended exemptive rules.

As this section will show, the Commission's brief only confirms that the rule lacks a rational connection to the ten rules amended. From this, two things follow: First, the rule is arbitrary and capricious and invalid under the Administrative Procedure Act. Second, as demonstrated in Section III, the absence of a rational basis for the rule's ostensible objective confirms that its true aim was to regulate mutual fund governance in a manner that exceeds the Commission's authority.

1. The Commission maintains that it adopted the rule "to safeguard the interests of fund investors from the conflicts of interest inherent in the transactions permitted under the [exemptive] rules." Opp. at 3. The Chamber's Opening Brief showed, however, that while discussing theories of governance at virtually every page of the rulemaking, the Commission scarcely discussed the exemptive rules or the transactions they regulate at all. In explaining the independent chair requirement, the Commission failed to cite or discuss 7 of the 10 rules. In justifying the 75 percent independent director requirement, and in the section of the Adopting Release titled "Reasons for and Objectives of the Amendments," the Commission made no reference to any of the specific rules being amended, their related statutory provisions, or the fund transactions at issue. Chamber Br. at 35.[1]

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[1] It is instructive to compare the agency's past descriptions of what must be considered when granting exemptions under the Act:

> [T]he propriety of granting the relief which is sought largely depends upon the purposes of the section from which an exemption is requested, the evils against which it is directed, and the end which it seeks to accomplish. To determine whether the exemption . . . requested would be consistent with the policy and purposes of the Act, we think it appropriate generally to consider the purposes and provisions of Section 17, which establish the policy of the Act with respect to affiliate transactions of the type involved in this case.

In re Transit Inv. Corp., 28 SEC 10, 15-16 (May 5, 1948); *See also In re Harbine Fin. Serv.*, 46 SEC 1328, 1330 (Aug. 14, 1978) (articulating same principles); Division of Investment Management Commission, Proposed Rules

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The Commission responds that it did not discuss the rules or transactions because it had done so three years before in an earlier rulemaking. "There was no need," the Commission declaims in scarcely disguised exasperation at the administrative process, "to discuss, yet again, the reasons why independent director oversight was an essential condition for each individual rule." Opp. at 46-47 (emphases added).

There was a need, of course. "If one rulemaking proceeding has culminated and another has begun, then new notice and comment procedures are required." *Action on Smoking & Health v. CAB*, 713 F.2d 795, 800 (D.C. Cir. 1983). More to the point, the Commission misunderstands its obligation, which was not merely to discuss "why independent director oversight" generally was an "essential condition for each individual rule," but to explain why there was insufficient oversight for each rule currently, and why the particular changes the Commission proposed were appropriate. *See General Electric Co. v. United States Dep't of Commerce*, 128 F.3d 767, 775 (D.C. Cir. 1997) (an agency "fail[s] to exercise reasoned

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Re: Exemptive Relief, 47 Fed. Reg. 47,860, 47,861 n.4 (Oct. 28, 1982) (same); Division of Investment Management, Securities and Exchange Commission, *Protecting Investors: A Half Century of Investment Company Regulation* 520 (May 1992) ("any consideration of an application under section 6(c) necessarily must be informed by a careful examination of the purpose(s) of the particular provision").

decisionmaking" when it does not explain a proposal's intended interaction with existing provisions of law).[2]

In its Opening Brief, the Chamber singled out two exemptive rules as examples of how there is no evident rational connection between the rules' pre-existing terms and the Commission's amendments. *See* Chamber Br. at 36-38 (discussing Exemptive Rules 17g-1(j) and 15a-4(b)(2)). Given that transactions under each rule already had to be approved by a majority of independent directors, the Chamber asked, why was it necessary to require that the board as a whole have a super-majority of independent directors, or that the board chair be independent? And why was it necessary that those conditions obtain at all times and for all purposes, rather than solely when the particular transactions at issue were under consideration? To be sure, one thing the Commission emphasized in the rulemaking was the power of the chair to set the agenda; yet why did this matter for Rule 17g-1(j), which already required consideration of the exempted transaction annually so that, in effect, the agenda already was set?

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[2] The discussion of the exemptive rules in the 2001 rulemaking was in any event similarly superficial, cursory, and pretextual. *See generally* 66 Fed. Reg. 3,734 (Jan. 16, 2001).

The Commission gives no answer in its brief, and—more to the point—it cites no record evidence indicating that these real and substantial questions received any consideration in the rulemaking.[3]

2. The agency's reasoning is deficient for the separate and independent reason that the justifications it did offer bear no rational relationship to the action it took.

This rule was a response to revelations of late trading, market timing, and misuse of nonpublic information by mutual funds. Chamber Br. at 11; Opp. at 27. As the Chamber's brief noted and the Commission tacitly concedes, however, there is no record evidence that this conduct arose from the transactions permitted by the exemptive rules. Chamber Br. at 38-39.

The Commission appears to argue that although there was no misconduct under the exemptive rules themselves, the fact that boards' current structure failed to stop late trading, etc., indicated that boards were not constituted to prevent misconduct in transactions under the exemptive rules either. That is, late trading

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[3] Indeed, with respect to the "agenda-setting" rationale for the rule, the Commission concedes that "[t]he objective of having an independent chair is not to assure that transactions covered by the Exemptive Rules get on the board's agenda . . . ." Opp. at 48 n.41 (emphasis added). That is an admission that this prominent rationale for the amendments bore no relation to the rules amended.

was a "signal" that the rules were not adequately drawn to safeguard the exempted transactions.

That logic is profoundly flawed, for multiple reasons:

a) As an initial matter, the perverse nature of the Commission's argument should not be mistaken. The Commission is positing that the exemptive rules failed to address something they don't regulate (late trading, etc.), and that this signals their inability to address activities they do regulate (the exempted transactions). Ordinarily, one would think it a good thing that a rule adopted to regulate one realm of activity—the exempted transactions—did not have spill-over effects and regulate other activities as well. In this case, the Commission's dismay that its 2001 amendments did not effectively address late trading is all the more peculiar because the central conceit of its brief is that the exemptive rules are not intended to regulate activities other than transactions under the exemptive rules. That is, the Commission's sole basis for claiming that the 2001 amendments were insufficient is that those earlier amendments failed to remedy conduct that, the Commission claims, it did not then and does not now intend to directly regulate.

b) The exemptive rules' failure to prevent late trading, etc., can only signal their inability to prevent abuses in transactions under the rules themselves if, among other things, the two sets of activities are subject to the same constraints. If the rules apply additional protections to "exempted" transactions, then their

ineffectiveness as to other activities is a meaningless barometer. And that in fact is the case: For transactions under the exemptive rules, specific approval by a majority of independent directors is required. No such requirement exists for activities related to late-trading, etc. It therefore is utterly illogical to infer that the exemptive rules' failure to prevent late trading signals their inability to prevent something they regulate by *different* and *heightened* means.

3. Finally, the Commission's explanation is wholly unreasonable because the solution it adopted conflicts with the facts found. There is no record evidence that funds with management chairs, or with fewer than 75 percent independent directors, permitted late-trading or other improper practices at a higher rate than firms with a smaller management role on the board. *See* Chamber Br. at 38-39; Opp. at 48-50. Accordingly, there was no basis to assume an independent chair, or more independent directors, was the solution.

In its brief, the Commission actually goes farther and posits that independent directors are part of the reason improper fund practices occurred. "In the late 1990's . . . [t]he Commission . . . [had] instituted a number of enforcement actions against independent directors for failing to fulfill their legal obligations." Opp. at 24. Concerned by independent directors' lapses, the Commission decided in 2001 to enhance their role by requiring that a majority of directors be independent. This, however, was promptly followed by the late-trading abuses in which—again—the

independent director "watchdogs (or at least some of them), it appears, were asleep or, worse, were awake but chose not to bark." Opp. at 49; *see also id.* at 24. The irrationality of concluding that yet more independent director control was the solution is unwittingly captured by the Commission itself:

> Since independent director oversight of fund managers in the areas involved in the scandals had proved ineffective, it was reasonable for the Commission to conclude that independent director oversight of [mutual] fund managers under the Exemptive Rules should be strengthened.

Opp. at 49 (emphasis added). It does not ordinarily follow that when personnel are "asleep" or indifferent, the solution is having more of them.[4]

4. After this suit was filed, legislation was enacted ordering the Commission to "justif[y]" the independent chair requirement; to prepare a report

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[4] The Commission's unshakeable faith that independent directors are the answer to nearly all problems has other peculiar manifestations: In the Adopting Release, the Commission noted that management directors have "significantly greater access to information" because of their "day-to-day" involvement with the fund; this gives them "a significant advantage over the independent directors." By decreasing management's role on the board, "[t]he amendments seek to resolve this imbalance." Opp. at 30 (quoting 69 Fed. Reg. at 46,382). That is to say, the rule purposely stocks the board with less knowledgeable directors in the belief that knowledge itself is problematic.

With regard to the belief that directors with no attachment to a corporation serve it better, *cf.* R. Franklin Balotti, Charles M. Elson & J. Travis Laster, *Equity Ownership And The Duty Of Care: Convergence, Revolution, Or Evolution?*, 55 BUS. LAW. 661, 665-66 (Feb. 2000) (citing evidence that a corporate director who holds a stake in the company on whose board she serves is more vigilant than a director who owns no stake in the company).

that evaluates the relative performance of management- and independent-chaired funds; and to "'act upon the recommendations of such report.'" Chamber Br. at 23 (quoting Omnibus Consolidated Appropriations Act, 2005, Pub. L. No. 108-447, 118 Stat. 2809 (2004)). The Commission is mistaken in stating that when Congress mandated these things, it "simply asked for a report." Opp. at 50-51. Rather, Congress (and the President) indisputably determined that no satisfactory "justification" had been provided to date, as required by the APA. This was in part because the Commission refused to conduct the empirical evaluation of fund performance that two Commissioners and numerous commenters sought. That Congress's judgments are of so little moment to the Commission is all the more reason for close scrutiny of the rule by this Court.

III. In Adopting Two Regulatory Requirements That Have The Purpose And Effect Of Fundamentally Altering The Governance Structure Of Mutual Funds, The Commission Exceeded Its Statutory Authority.

Because of the many and obvious flaws in the Commission's ostensible reason for the independent chair and 75 percent independence requirements, the provisions must be vacated as arbitrary and capricious under the APA. The gaping holes in the Commission's stated rationale also show the rationale to be a pretext, and that the true purpose and effect is—as the Chamber has maintained and as the rule's very title proclaims—to regulate "mutual fund governance" in a manner that exceeds the Commission's statutory authority. "Our primary concern," the

Commission avowed in the rulemaking, "and the one that has led us to adopt" the independent chair requirement, is to achieve "the proper balance" between independent and management directors. 69 Fed. Reg. at 46,383. Likewise, the 75 percent independence requirement was to correct the "imbalance" allowed by the statute in order that fund boards would be "firmly under the control" of independent directors. *Id.* at 46,382. For this reason, the rule should be vacated under the Investment Company Act as well as under the APA.

The Commission tacitly concedes that it has no general authority to regulate mutual fund governance. Its principal argument to support the authority it exercised here has been addressed above, namely, the pretextual claim that the rule's purpose was merely to regulate transactions taken pursuant to the exemptive rules. The Commission makes a handful of other defenses of its improper exercise of statutory authority that merit only brief mention:[5]

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[5] The Commission contends that its interpretation of the Act is entitled to *Chevron* deference. Opp. at 35-36. Yet, as stated in the Chamber's brief, *Chevron* deference is inapplicable where, as here, the statute is clear and the agency seeks "'to alter the clearly expressed intent of Congress.'" Chamber Br. at 25 (quoting *Business Roundtable v. SEC*, 905 F.2d 406, 408 (D.C. Cir. 1990)). Furthermore, this Court repeatedly has suggested that *Chevron* deference does not apply when an agency seeks to define the scope of its own power. *See ACLU v. FCC*, 823 F.2d 1554, 1567 n.32 (D.C. Cir. 1987); *New York Shipping Ass'n, Inc. v. Federal Mar. Comm'n*, 854 F.2d 1338, 1363 n. 9

[Footnote continued on next page]

1. The Commission claims that the new provisions are merely the latest in a "long line" of exemptive rule requirements that provide for "independent director oversight of the conflict-of-interest transactions permitted under the Exemptive Rules." Opp. at 15-16; *id.* at 23 (many other provisions recognize that "transactions should be conditioned upon approval of the independent directors"). The Commission notes ominously, "[i]f petitioner's argument . . . were correct, the Commission *never* would be able to grant exemptions that relied upon the oversight of independent directors." Opp. at 38.

In truth, of course, the other provisions the Commission describes merely highlight the dramatic departure the Commission has taken here. In the past, the Commission regulated the transaction, by requiring that it have the "oversight" and "approval" of independent directors. Now, however, the Commission regulates the board, by requiring that if it ever intends to engage in an exempted transaction it be dominated by independent directors at all times. The Commission has converted independent directors from what it claims they should be—"watchdogs"—to full-blown masters of the house, supervising all fund affairs. To be sure, only funds that engage in exempted transactions need meet this requirement—but virtually all

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(D.C. Cir. 1988); *National Wildlife Fed'n v. ICC*, 850 F.2d 694, 699 n.6 (D.C. Cir. 1988).

funds do, which is precisely why the exemptive rules were such an attractive vehicle for the Commission's gross expansion of its regulatory reach. *See* p. 5 above.[6]

2. To the Chamber's objection that it may not regulate fund governance, the Commission also answers that it may impose whatever conditions its chooses when adopting exemptive rules so long as they are "reasonably designed to further the purposes of the Act and to protect investors." Opp. at 37. The conditions here are not reasonably designed, as shown above. More importantly, this Court already has rejected the Commission's claim to have a regulatory power to do whatever it chooses so long as it can be linked to some broadly-defined "purpose" of the Act. The Commission cannot deploy "open-ended" invocations of the purpose of the Act to regulate in a manner that conflicts with what "Congress had in mind when it enacted the legislation." *Business Roundtable v. SEC*, 905 F.2d

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[6] Even if the Commission had been wielding its authority this way "for decades," persistent violation of the law is no defense. *Accord SEC v. Sloan*, 436 U.S. 103, 117-18 (1978) (rejecting Commission argument that its interpretation was valid because it had "been both consistent and longstanding, dating from 1944").

The Commission notes that the Investment Company Act gives independent directors "'a host of special responsibilities involving supervision of management.'" Opp. at 37 (quoting *Burks v. Lasker*, 441 U.S. 471, 483 (1979)) (emphasis added). That is no basis for giving independent directors a dominant general role, however. And it most certainly is not a license for an assumption of authority by the Commission itself over fund governance.

406, 413 (D.C. Cir. 1990) (internal quotations omitted). *See also 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."). In this instance, the "purposes of the Act" do not include licensing the Commission to alter the "balance" between independent and management directors—and between the states and federal government—through a pretextual exercise of its exemptive authority.[7]

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[7] The Commission is unpersuasive in attempting to distinguish *Business Roundtable* and other cases regarding the limits on its authority. *See* Chamber Br. at 32-33 (citing *Teicher v. SEC*, 177 F.3d 1016 (D.C. Cir. 1999); *American Bankers Ass'n v. SEC*, 804 F.2d 739 (D.C. Cir. 1986); and *Chamber of Commerce v. United States Dep't of Labor*, 174 F.3d 206 (D.C. Cir. 1999)). All of these cases involved an agency improperly attempting to wield its authority over one matter as "leverage" to regulate another. As the Commission's brief concedes, *Business Roundtable* involved an attempt to use authority over self-regulatory organizations as a means to regulate issuers' corporate structure. Opp. at 42. The court rejected this, despite the Commission's appeal to broad statutory "purposes." In *Teicher*, the Commission concedes, it failed to establish sufficient "nexus" between the authority it had and the limitation it sought to impose. Opp. at 43. In this case, too, the Commission has failed to establish a genuine nexus between transactions under the exemptive rules and its sweeping "governance" mandates. Finally, the Commission distinguishes *American Bankers Ass'n* as a case where it attempted to augment its authority in a manner inconsistent with "'plain'" statutory language that "reflected a basic decision." Opp. at 44. Here, too, Congress enacted a clear and "basic decision" to generally require that mutual fund boards have only 40 percent independent

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3. It is notable, finally, that by statute the Commission's exercise of its exemptive authority must be consistent not only with the Act's "purposes," but also with its "provisions." 15 U.S.C. § 80a-6(c). As discussed in the Chamber's brief at 28-31, the Act provides that 40 percent—but no more—of a fund's directors must generally be independent from management. This provision reflected a calculated congressional decision to stop short of requiring a majority of independent directors, so that investors would not be deprived of the advice of the adviser they sought in acquiring the fund. The Commission tacitly concedes this was Congress's aim, but says the Chamber's reliance on this provision and the related legislative history is "wholly unsupported and incorrect" because the Chamber "fails to distinguish between the statutory requirements applicable to all funds, and the conditions for reliance upon the Exemptive Rules, which apply only to those funds that choose to rely upon those rules." Opp. at 39 (emphases added). That is a distinction without a difference, because—as the Commission well knows—nearly all funds rely on the exemptive rules. *See* p. 5 above. The Commission purposely has done the very thing Congress sought to avoid.

[Footnote continued from previous page]
directors; the Commission has taken it upon itself to "correct" that congressional action.

By no stretch of the imagination is this deeply flawed rule "precisely what Congress" intended the Commission to be doing under the Investment Company Act. Opp. at 4. Rather, the challenged provisions violate the Act as well as the APA and must be vacated.

IV. The Commission Failed To Satisfy Its Statutory Obligation To Consider "Efficiency, Competition, And Capital Formation," And Gave Short Shrift To Public Comments And Alternatives To The Challenged Provisions In Violation Of The APA

The Commission concedes that it was statutorily-required to consider whether the challenged provisions would promote "efficiency, competition, and capital formation." *See* 15 U.S.C. 80a-2(c). The Commission gave these factors all of a paragraph's discussion at the tail end of its final statement of reasons, stating—as it reiterates in its brief—that none of the 200-some rulemaking comments bore on those issues. 69 Fed. Reg. at 46,389; Opp. at 52.

That is incorrect. The Commission received a lengthy comment comparing the performance of funds under the prevailing management model in the industry—the management-chaired fund—with the performance of funds managed on the independent-chair model that the Commission proposed to make the industry standard. It also received numerous comments on the costs that would result from the challenged provisions. Those comments bore importantly on efficiency, competition, and capital formation, but were given short shrift by the Commission.

1. The Commission claims that it considered the Bobroff Study on the relative performance of independent- and management-chaired funds, but "did not find it compelling." Opp. at 54. It then devotes two pages of its brief to attempting to discredit the Study. Opp. at 54-57. What matters is not the points the Commission makes in its brief, however, but its treatment of the Study in the rulemaking. *See Motor Vehicle Mfrs. Ass'n v. State Farm Mut. Auto Ins. Co.*, 463 U.S. 29, 50 (1983); *ALLTELL Corp. v. FCC*, 838 F.2d 551, 562 (D.C. Cir. 1988). That treatment was fleeting and superficial, with the Commission discussing the Study's findings and then explaining how, "on the other hand, some commenters viewed the data differently . . . ." A rulemaking agency is not to function as a spectator to commenters' disputes; it is to resolve them. That must be particularly the case when the comments address the market effects of a contemplated agency action and the agency is under a statutory duty to consider efficiency, competition, and capital formation.[8]

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[8] The Commission's criticism of the Bobroff Study is unavailing in any event. The Commission discounts the Study because at one point its authors noted that the strong performance of management-chaired funds could be due to other "important differences" besides the identity of the chair. Opp. at 55. The Commission neglects to mention, however, that the authors then proceeded to consider other explanatory factors that might exist, and identified none. Chamber Br. at 21. Further, one of the two comments cited by the Commission reached different results partly by declining to classify the Vanguard funds as

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Even more damning than how little attention the Commission gave the Bobroff Study is the reason that was so, as emerges from the context in which the Study was mentioned. "Some have argued that the Commission needs to demonstrate conclusively that there is a link between having an independent chair and increased performance or decreased expenses," the Adopting Release began. The Release then dropped a footnote addressing the Bobroff Study in the margin, while in the main text it continued with its principal point: "The Commission considered its own and its staff's experience, the many comments received, and other evidence, in addition to the limited and conflicting empirical evidence. From this, we believe that having independent chairmen can provide benefits and serve other purposes apart from achieving high performance of the fund." 69 Fed. Reg. at 46,383-46,384 (emphasis added). In other words, while "some" may believe the

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management-chaired funds, even though Vanguard's management model indisputably includes an interested chairman. CRI, Letter 175; cited in Opp. at 55-56. This comment also created a separate category for "bank-managed funds with an independent chairman," even though the Bobroff Study's analysis had accounted for differences between these funds and other independent-chaired funds. The other comment cited by the Commission suggested that the Bobroff Study's results were statistically flawed because "less than 1 %" of funds have independent chairs. CRI, Letter 171; cited in Opp. at 56-57. But the Commission's own data state that approximately 20 percent of funds have independent chairs, Chamber Br. at 8, and 14 of the 57 mutual fund families reviewed in the Bobroff Study are chaired by independent directors. CRI, Letter 65. Both comment letters were received long after the filing deadline.

Commission needed to "conclusively" study the implications for fund performance, the Commission would not be detained because it had "other purposes." That is why the Bobroff Study was not taken seriously, and the Commission's *ex post facto* rationalizations are unavailing.[9]

Of course, the still broader context in which these decisions were made was one of a general disdain for empirical evidence and economic analysis, in spite of the Commission's statutory duty to consider effects on efficiency, competition, and capital formation. "There are no empirical studies that are worth much," the Chairman stated, as a fellow Commissioner said there was no point "wait[ing] for economic studies, since . . . methodologies will always be flawed or at least subject to question." Chamber Br. at 22. Congress itself has now ordered the Commission to perform the empirical analysis that it disparaged, and to examine the effects on

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[9] Attempting to have it both ways, the Commission says in a footnote that its staff did engage in "preliminary analysis" of the relative performance of management- and independent-chaired funds. Opp. at 52-53 n.43. Results were "mixed," however, and the staff stopped. We can only wonder what the staff's data actually showed, since the Commission omitted it from the Adopting Release and the rulemaking record and therefore may not rely upon it now. The use of the word "mixed" suggests that at least some of the staff's results were contrary to the rule. *See AT&T Corp. v. FCC*, 86 F.3d 242, 247 (D.C. Cir. 1996) ("evidence must take into account whatever in the record fairly detracts from its weight").

performance that during the rulemaking it regarded as immaterial to its loftier goals.[10]

For this reason too, the Court should vacate the rule's ill-considered independent-chair requirement.

2. The Commission also failed to adequately consider the costs of the challenged provisions, indeed it neglected to provide any dollar estimate at all.

The Commission refused to assign any cost to the hiring of staff on the ground that boards already had this authority under state law. The Chamber's brief explained that this was arbitrary and capricious because the Commission was so confident independent directors would need more staff as a result of the rule that one of the rule's five requirements was "'designed to enable independent directors to hire employees and others.'" Chamber Br. at 44 (quoting 69 Fed. Reg. at

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[10] The Commission's brief fails to address this Court's decision in *Public Citizen v. Federal Motor Carrier Safety Admin.*, 374 F.3d 1209 (D.C. Cir. 2004), which required the Commission to study empirical evidence to satisfy a statutory obligation such as the one at issue here. *Id.* at 1218, 1222. The Commission's reliance on *FCC v. National Citizens Comm. for Broadcasting*, 436 U.S. 775, 813 (1978), and *Melcher v. FCC*, 134 F.3d 1143 (D.C. Cir. 1998) (Opp. at 53-54), for the proposition that it need not have considered empirical evidence is misplaced. Neither case concerned a statutory obligation to consider economic effects that by their nature are informed by consideration of empirical evidence; in neither case did the agency cavalierly dismiss empirical and economic data as innately unreliable; and in neither case did Congress itself then order the analysis that the agency had disparaged.

46,385). The Commission's brief simply ignores this troubling inconsistency in its positions, while speculating that "[p]resumably any additional cost [for staff] would be incurred because the independent directors decided that it was in the interest of the fund and its investors for them to retain staff to help them better carry out their duties." Opp. at 59. It is extraordinary that a sophisticated federal agency would make this statement and overlook the possibility that independent directors will err on the side of over-hiring staff to protect themselves from liability. Indeed, elsewhere in its own brief the Commission speaks of independent directors being "asleep" at the switch so as to warrant Commission enforcement action. Opp. at 24, 49. In any event, this rationale was not put forward in the rulemaking and would not excuse the Commission from its obligation to faithfully examine the rule's costs and their effects on efficiency, competition, and capital formation.

With respect to the costs of identifying and retaining independent chairs and additional independent directors, the Commission objects that it should not have to "speculat[e]" about such things particularly since, in the case of the 75 percent independent director provision, "it had no basis for determining how" funds would go about complying with the requirement it was imposing. Opp. at 60. The Commission simply ignores the decision of this Court cited in the Chamber's brief which makes clear that the Commission must make the best estimates possible

under the circumstances. Chamber Br. at 43-46 (citing *Public Citizen*, 374 F.3d at 1221). That obligation is all the greater in light of the statutory obligation to consider effects on efficiency, competition, and capital formation.

3. In the last page-and-a-half of its brief, the Commission "responds" to the Chamber's argument that it gave inadequate consideration to important rulemaking comments and to alternatives to the independent chair requirement. Little more need be said on those issues because the Commission wholly fails to address the Chamber's arguments, as a comparison of the briefs will reveal. One statement the Commission makes warrants mention, however: An alternative suggested in the rulemaking was that funds prominently disclose whether the fund manager was also the board chair—investors could then decide for themselves whether that made the fund more or less attractive. In addition to asserting without explanation that this suggestion (endorsed by two Commissioners) was not "major" and therefore warranted no discussion, the Commission states that such a disclosure requirement was off-limits because "Congress rejected a purely disclosure-based approach to regulating conflicts of interest under the Act." Opp. at 61 (emphasis added). But of course, this alternative was not a "purely" disclosure-based approach; it would stand beside the prophylaxes that already existed in the exemptive rules and the new ones the Commission was adding. And it is emblematic of the unreasonableness of this rulemaking as a whole that the

Commission would claim to be bound by Congress's wishes on this point, but would have no reservations about purposely placing independent directors "firmly in control" of mutual funds to correct a supposed "imbalance" that was consciously designed by Congress with investor interests in mind.

CONCLUSION

For the foregoing reasons, the Court should grant the petition for review and vacate the rule's independent chair and 75 percent independent director requirements.

Dated: January 26, 2005

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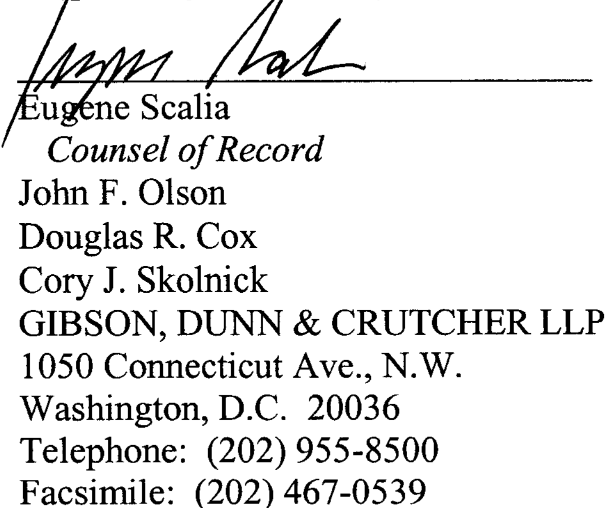

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CERTIFICATE OF COMPLIANCE

I hereby certify that this brief was printed in Times New Roman 14-point typeface and that it contains 6,925 words, as calculated under FED. R. APP. P. 32(a)(7)(B) and Circuit Rule 32(a)(2).

Cory J. Skolnick

CERTIFICATE OF SERVICE

I hereby certify that on this 26th day of January, 2005, I have caused to be served two true and correct copies of Reply Brief of Petitioner by hand, upon the following:

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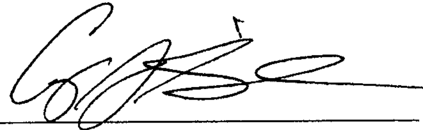


Cory J. Skolnick

ADDENDUM

Supplemental Declaration of Jennifer Reutershan

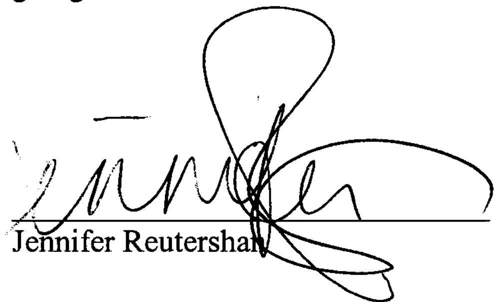
I, Jennifer Reutershan, hereby state and declare as follows:

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

2. As stated in my October 7, 2004 Declaration, at least 30 Chamber members, or their subsidiaries, served as advisers to mutual funds on the date that the Chamber of Commerce filed its lawsuit against the Securities and Exchange Commission (D.C. Cir., Case No. 04-1300). As also stated in that Declaration, these entities include funds that have non-independent chairs, and that have fewer than 75 percent independent directors. Funds managed by these advisers engage in transactions covered by one or more of the ten exemptive rules the Commission has amended.

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

Dated: January 26, 2005



Jennifer Reutershan