UNITED STATES COURT OF APPEALS
FOR THE DISTRICT OF COLUMBIA CIRCUIT

CHAMBER OF COMMERCE OF THE UNITED STATES OF AMERICA Petitioner, v. SECURITIES AND EXCHANGE COMMISSION, Respondent.	)	No. 05-1240

RESPONSE OF SECURITIES AND EXCHANGE COMMISSION
IN OPPOSITION TO MOTION FOR STAY OF COMMISSION ORDER
and
IN SUPPORT OF EXPEDITED CONSIDERATION OF PETITION FOR REVIEW

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PRELIMINARY STATEMENT

Petitioner Chamber of Commerce seeks an unwarranted stay of two important investor protections – protections adopted by the Commission in the wake of major scandals that inflicted massive losses on many of the nation's mutual fund investors and left investor confidence severely shaken. The Chamber's motion fails to present any serious legal or factual challenge to these rule amendments, and lacks even a rudimentary evidentiary showing of harm, much less irreparable harm, to the Chamber or anyone else. In contrast, a stay would leave investors without crucial protection from the risk of further devastating losses from misconduct by fund managers, and could result in renewed investor uncertainty at a time when the markets continue to confront new revelations of wrongdoing.

The amendments, which are a central feature of a broad series of reforms, strengthen independent board oversight of transactions involving conflicts of interest between funds and their outside investment managers – conflicts so severe that Congress prohibited the transactions absent a Commission exemption. The amendments, which modify ten exemptive rules, require as a condition to engaging in these transactions that a fund have a board with 75% independent directors (an increase from a simple majority) and an independent chair.

The vital public interest in this enhanced independent oversight is clear. In the three months after the first of the scandals broke, investors withdrew $80 billion from mutual funds. To date, the abuses have cost this nation's 92 million mutual fund investors billions of dollars in losses. Wrongdoing is still coming to light, and losses continue to mount. Even after adoption of the amendments, but before arrival of the compliance date, the Commission has brought enforcement actions involving over $1.3 billion in losses. Indeed, in a single recent case, the lack of effective oversight of a conflict-of-interest transaction cost investors nearly $100 million.

These abuses did not involve a few bad apples at the fringes of the fund industry, but resulted from systemic wrongdoing by major fund groups, including at least nine of the 25 largest fund complexes, and officials at the highest levels of those complexes. Implementation of the enhanced independent oversight of fund managers should not be postponed.

In response to the Chamber's initial petition for review, this Court rejected all of the Chamber's major objections to the new conditions, but remanded the matter for the Commission to consider further the costs associated with the conditions, and to address a disclosure alternative to the independent chair condition. The Court did not vacate the rule amendments, however, leaving in place the January 16, 2006, compliance date. 1/ The Commission responded promptly to the remand. Building on more than a year's work by the Commission and its staff, including an extensive rulemaking record after full notice and comment, the Commission set forth a detailed analysis of the likely costs and a careful consideration of the disclosure alternative. Consistent with its conclusions at the time it adopted the amendments, the Commission found that the costs of the two conditions were minimal, that the benefits far outweighed those costs, and that the proposed disclosure alternative would not afford adequate protection to investors. The Commission also explained the need to act quickly to bolster investor confidence, resolve any uncertainties associated with the remand, and ensure that investors receive the protections afforded by the amendments without delay.

1/ By not vacating the rule amendments, this Court has already weighed the "seriousness of the order's deficiencies (and thus the extent of doubt whether the agency chose correctly) and the disruptive consequences of an interim change that may itself be changed," and implicitly determined that "there is at least a serious possibility that the Commission will be able to substantiate its decision on remand," and that "the consequences of vacating may be quite disruptive." *Allied-Signal, Inc. v. U.S. Nuclear Regulatory Comm'n*, 988 F.2d 146, 150-51 (D.C. Cir. 1993).

The Chamber now seeks a stay pending this Court's consideration of its petition for review of the Commission's response to the remand. Although the potential harm to investors if a stay is granted is clear, the harm to the Chamber if a stay is denied appears wholly illusory. The Chamber has not submitted a single affidavit from any fund industry participant attesting to any harm whatsoever, much less irreparable harm. Nor has the Chamber shown the slightest harm to itself. Moreover, the Chamber fails to present any serious legal challenge to the Commission's action. It does not challenge the Commission's determination that the costs of the two conditions are minimal – a determination amply supported in the record and confirmed by recent letters to the Commission and news reports. Instead, it falsely asserts that the Commission "performed an extraordinary about-face" for which it had "no reliable basis." This totally mischaracterizes the Commission's earlier statements about its difficulties in determining costs to the industry as a whole, and ignores the more focused approach suggested by the Court and followed by the Commission in its response to the remand. The Court itself said the Commission could "readily" estimate some of the costs. Nor does the Chamber seriously challenge the Commission's determination that disclosure cannot adequately substitute for enhanced oversight by independent directors of the transactions that would otherwise be expressly prohibited under the Act. And the Chamber cites no authority that supports its contention that further notice and comment procedures were required. Indeed, it makes little effort to identify *any* legal deficiencies in the Commission's action on remand.

Instead, the Chamber resorts to a series of baseless rhetorical attacks on the Commission's processes. Relying largely on comments made in a campaign by opponents of the amendments to delay action on the remand beyond Chairman Donaldson's tenure at the Commission, the Chamber claims that it was inappropriate for the Commission to act

expeditiously. Yet it does not cite any violation by the Commission of any statute or rule in bringing the matter to a vote. In fact, the Commission faithfully followed *all* of the requirements necessary to respond to the Court's remand. Further, the Commission acted only after thorough deliberation and vigorous debate, as demonstrated by the lengthy concurring and dissenting views of each of the five Commissioners, and the Commission's explicit response in the release to dissenting views. That the Commission was able to act swiftly to reassure investors that their interests would be protected was "in the best tradition" of the agency.

Although there is no justification for a stay, the Commission supports expedited consideration of the petition for review. It is in the interest of investors to settle the Chamber's challenge to the two conditions promptly.

BACKGROUND

The Commission's Exemptive Rules permit investment companies, or funds, to engage in transactions that involve serious conflicts of interest between the funds and their management companies, and that would otherwise be prohibited by the Investment Company Act, 15 U.S.C. 80a-1 *et seq*. Independent director oversight of these conflicts has always been a critical aspect of the Act and has long been a cornerstone of the Exemptive Rules. The two new conditions were adopted to enhance the independence and effectiveness of fund boards so as to improve their ability to oversee these conflicts. These conditions require that: (i) at least 75 percent of the directors of the fund must be independent of the fund's management company; and (ii) the chairman of the fund's board must be an independent director. 2/

Upon considering the Chamber's first petition for review, this Court determined that the

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2/ Investment Company Act Release No. 26520 (July 27, 2004) [69 FR 46378 (Aug. 2, 2004)] ("Adopting Release").

Commission did not exceed its statutory authority and that it had articulated a reasonable rationale for the two conditions. 3/ The Court rejected the Chamber's contention that the Commission was required to conduct an empirical analysis of whether funds with independent chairs performed better than funds with management chairs (Slip Op. 14, citation omitted):

> 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." The Commission's decision not to do an empirical study does not make that an unreasoned decision.

The Court found, 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." *Id.* at 2.

The Commission acted promptly to respond to the Court's remand. 4/ The Commission first determined that the information in the existing record, together with publicly available information, gave it a sufficient basis on which to address the deficiencies identified by the Court. 70 FR at 39391. The Commission found that engaging in further notice and comment procedures was not only unnecessary, it risked "significant harm to investors without significant corresponding benefits, given the adequacy of the information currently available upon which we may rely." *Id.* By acting promptly, the Commission "hope[d] to bolster investor confidence, resolve any uncertainties associated with the remand, and ensure that investors receive the protections afforded by the amendments without delay." *Id.* Moreover, because Chairman

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3/ *Chamber of Commerce of the United States of America v. SEC*, No. 04-1300, slip op. (D.C. Cir. June 21, 2005) ("Slip Op.").

4/ Commission Response to Remand by Court of Appeals, Investment Company Act Release No. 26985 (June 30, 2005) [70 FR 39390 (July 7, 2005)] ("Remand Release").

Donaldson was scheduled to leave the Commission on June 30, 2005, the Commission considered it important to act no later than the time of its previously scheduled open meeting on June 29. "Given our unique familiarity with these matters, we think it is both important and appropriate for the same five of us to consider the issues raised by the Court on remand, especially given the potential harm that may result from delay in resolving this matter." *Id.* 5/

The Commission then reexamined the costs of the two conditions as directed by the Court, and considered whether they would promote efficiency, competition and capital formation as required by Section 2(c) of the Act, 15 U.S.C. 80a-2(c). 70 FR at 39391-95. With respect to the 75 percent condition, the Commission reviewed a widely used 2004 survey of mutual fund directors' compensation, as well as other data, and estimated the range of costs for each of the ways in which a fund might elect to meet the condition. With respect to the independent chair condition, the Commission reviewed the record in this matter, as well as publicly available information, and estimated the possible cost to an individual fund of additional staff, as well as the cost of increased compensation for an independent chair. In each case, the Commission made a detailed analysis of the various costs and set forth with specificity the sources of the data upon which it relied and the methodology it employed. The Commission found that the costs of the two conditions were extremely small relative to the fund assets for which fund boards are responsible, as well to the expected benefits. Consistent with the conclusion it had reached in the Adopting Release, the Commission found that the minimal added expense of compliance with these conditions would have little, if any, adverse effect on efficiency, competition and capital

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5/ The value of continuity in deliberative decision-making is widely recognized. For example, many courts of appeals, including this Court, provide that when a case is remanded by the Supreme Court it is assigned to the same panel that previously considered it.

formation. "Whether the two conditions are viewed separately or together, even at the high end of the ranges, the costs of compliance are minimal." *Id.* at 39395.

The Commission next considered the disclosure alternative to the independent chair condition, which would simply require each fund to disclose whether it has an inside or an independent chairman. The Commission found that the proposal would not adequately protect fund investors from the potential abuses inherent in the conflict-of-interest transactions permitted under the Exemptive Rules, and that the objectives of the Act would best be served by strengthening independent oversight of such transactions. 70 FR at 39396-97.

Accordingly, the Commission determined not to modify the rule amendments. 70 FR at 39398. The Commission did *not*, as the Chamber incorrectly states, "re-adopt" the rule amendments, as they had not been vacated by the Court.

ARGUMENT

This Court considers four factors in determining whether a stay is warranted: (1) the likelihood that the moving party will prevail on the merits; (2) the prospect of irreparable injury to the moving party if relief is withheld; (3) the possibility of harm to other parties if relief is granted; and (4) the public interest. Circuit Rule 18(a)(1). This Court balances the probability of success on the merits with the other three factors. If the other three factors strongly favor interim relief, the Court may exercise its discretion to grant a stay if the movant has only made a substantial case on the merits. *Washington Metropolitan Area Transit Comm'n. v. Holiday Tours, Inc.*, 559 F.2d 841, 843 (D.C. Cir. 1977). All four factors weigh against the imposition of a stay in this case.

A. The Public Interest Will Be Harmed if the Rule Amendments Are Postponed.

A party seeking a stay must show that no substantial harm will come to other interested

parties if the stay is granted, and that the stay will do no harm to the public interest. Here, the grant of a stay *would* significantly harm the public interest by postponing implementation of important investor protections – protections that were intended to prevent further investor losses and restore confidence in the wake of the scandals. The Commission repeatedly emphasized "the importance of avoiding a postponement of the compliance date and the attendant potential harm to investors and the market that would result." 70 FR at 39398. Indeed, in the past year the Commission has continued to uncover new instances of serious wrongdoing involving hundreds of millions of dollars in investor losses. *See* "Exemptive Rule Amendments of 2004: The Independent Chair Condition" (available at www.sec.gov/news/studies/indchair.pdf). As recently as ten weeks ago, the Commission completed enforcement proceedings against a manager of mutual funds who, through various affiliates, concealed and took for itself significant discounts negotiated with the funds' transfer agent, thus reaping nearly $100 million in profits that rightfully belonged to the funds. 6/ If implementation of the two conditions were to be delayed because of a stay, the risk of additional investor losses in the event of further abuses, and the potential adverse effect on investor confidence, would be significant.

B. The Chamber Has Failed to Show Any Irreparable Injury if a Stay Is Not Granted.

At no time during the course of its challenge to the two conditions has the Chamber presented a single declaration from any fund industry participant attesting to any injuries that might be suffered as a result of the conditions. 7/ Rather than providing actual evidence of any

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6/ *In the Matter of Smith Barney Fund Management LLC and Citigroup Global Markets, Inc.*, Investment Advisers Act Release No. 2390 (May 31, 2005).

7/ The Chamber merely resubmits the declarations of a consultant and a professor that accompanied its request for a stay in connection with its first petition for review (which (continued...)

harm, the Chamber simply relies upon arguments of counsel (Mot. 9-10) that out-of-pocket costs of compliance will be unrecoverable in the event this Court ultimately vacates the rule amendments. But courts have held that such costs do not ordinarily constitute irreparable harm. 8/ The Chamber does not explain why this case is any different, particularly where the costs have been found to be *minimal*, a finding the Chamber does not dispute and which has been confirmed in letters to the Commission and news reports following adoption of the conditions. 9/ And while the Chamber cites only to the highest of the cost estimates, the Commission identified options for compliance that had little or no cost at all. In fact, many funds have already complied with the conditions without apparent difficulty.

Next, the Chamber argues (Mot. 11) that the leadership of fund boards "will be altered in a manner that is unlikely to be reversed in the event of a favorable decision for the Chamber." Based solely upon the unsupported speculation of Professor Macey, the Chamber contends that if the rule amendments were vacated, the fund directors would be unwilling to replace the independent chair with a management chair, or to reduce the percentage of independent directors, because they would want to perpetuate themselves in office. In fact, if the amendments were vacated and the directors determined that retaining an independent chair or a 75 percent independent majority was causing actual harm to the fund, they could easily reappoint a

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7/ (...continued)
was denied by this Court). Neither relates any specific evidence from any industry participant about what injuries, if any, might be suffered if a stay is not granted. Each merely speculates as to possible costs and burdens of complying with the new conditions.

8/ *See Freedom Holdings, Inc. v. Spitzer*, 408 F.3d 112 (2d Cir. 2005); *Am. Hosp. Ass'n v. Harris*, 625 F.2d 1328, 1331 (7th Cir. 1980); *A.O. Smith Corp. v. FTC*, 530 F.2d 515, 527-28 (3d Cir. 1976).

9/ *See* letters and articles attached as Exhibit A.

management chair and add one or more new management directors. The Chamber's contention that the independent directors would violate their fiduciary obligation to act in the best interests of the fund simply to perpetuate themselves in office is groundless. Further, it is wholly inconsistent with the Chamber's position in its comment letter following the proposal of the two conditions, in which it said "the question of the desirability of an independent chairman should be judged on the merits by a fund's board of directors." Cert. List, Letter 126.

Moreover, the Chamber has presented no evidence of any injury *to itself* if a stay is not granted. This Court upheld the Chamber's standing on the basis that it was a consumer that had lost the opportunity to purchase a desired product. But the Chamber does not explain how, as a consumer, it will be *irreparably harmed* absent a stay.

C. The Chamber Is Unlikely to Prevail on the Merits.

The Chamber makes six arguments for why, it claims, the Commission failed adequately to respond to the Court's remand. None constitutes even a substantial case on the merits. In fact, the Commission responded to this Court's remand precisely as directed by the Court and as required under the Commission's Rules of Practice, 17 CFR 201.100 *et seq.*, and the Administrative Procedure Act, 5 U.S.C. 551 *et seq.* Adopting the focused approach suggested by the Court, the Commission was able to provide a detailed analysis of the likely costs of the two conditions, and a careful consideration of the proposed alternative. Although it derides the speed with which the Commission acted, the Chamber never demonstrates that the Commission's findings and conclusions were incorrect. Nor does it demonstrate that a second round of notice and comment was required or might have produced a different result. In fact, the Commission's swift response to the Court's remand, which served to reassure investors that their interests would be protected, faithfully followed all legal requirements and was entirely appropriate.

1. The Chamber first argues (Mot. 12) that, by acting quickly, the Commission somehow violated the APA. The Chamber offers no legal support for this contention and it is wholly without merit. The Commission *did* act promptly, and for good reason. Any further delay or ambiguity surrounding implementation of the rules, the Commission found, would disadvantage not only investors but also fund boards and management companies, most of which have already begun the process of coming into compliance with the rules. 70 FR at 39398. By acting swiftly and deliberately, the Commission said it would reduce uncertainty, facilitate better decision-making by funds, and ultimately serve the interests of fund shareholders.

The Commission noted, "the issues remanded to us by the Court are discrete and clearly defined; indeed, the Court observed that part of our task on remand could be accomplished 'readily.'" *Id.* Moreover, the Commission was not starting from scratch. "Because we have previously sought and received comment, the Commission has a significant foundation from which to consider the issues remanded by the Court." 70 FR at 39391. But the Commission's determination to act swiftly did not reflect a failure to make a deliberate and careful consideration of the issues raised by the Court. "We have undertaken to address those issues upon remand promptly because we are convinced that we can do so with the thoroughness and careful consideration required by the Court's direction to us, and without the sacrifice to investor protection that delay would risk." *Id.* "[I]t is in the best tradition of this institution, and not at all unusual, for the Commission to act swiftly on important initiatives in response to market developments and other factors." 70 FR at 39398. 10/

10/ The Commission has often acted expeditiously in issuing final rules, especially in recent years. For example, in the interest of restoring investor confidence, the Commission adopted 15 final rules in a one month period, nine of which were required under the (continued...)

With respect to its consideration of costs, the Commission had said at the time it proposed the rule amendments that it believed the costs were minimal and sought comment on that point. After careful reconsideration of those costs on remand, the Commission confirmed that the costs were indeed minimal, a finding the Chamber has never disputed. Nevertheless, the Chamber castigates the Commission for responding so promptly when it had said in the Adopting Release that it had "no reliable basis" to make the cost estimates. But this misstates what the Commission *actually* said, and ignores the more focused cost determination that this Court directed it to make, a determination for which the Commission indeed *did* have a reliable basis. The Commission had said in the Adopting Release (69 FR at 46387 (emphasis added)) that "our staff has no reliable basis for determining how funds *would choose to satisfy* [the 75 percent condition] and therefore it is difficult to determine the costs associated with electing independent directors." The Court noted, however, that the Commission's difficulty "may mean the Commission can determine *only the range* within which a fund's cost of compliance will fall," depending on how the fund chooses to comply with the condition. Slip Op. 15-16 (emphasis added). As the Court anticipated, by focusing on the range of costs associated with each of the ways funds might comply with the 75 percent condition, the Commission was able reasonably to conclude that it did in fact have a reliable basis upon which to consider the costs associated with the condition. Similarly, the Commission had said that there may be costs associated with the independent chairman condition, such as the costs of hiring staff to assist the chairman in carrying out his or her responsibilities, but that it had no reliable basis for estimating those costs.

10/ (...continued)
Sarbanes-Oxley Act. In one case, the Commission adopted final rules only eight days, and in another only nine days, after the close of the comment period.

The Court noted that "[a]lthough 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 [an] independent chairman would incur that cost, *it readily could have estimated* the cost to an *individual* fund." Slip Op. 16 (emphasis added). By focusing on the range of possible costs to any one fund, the Commission again reasonably concluded that it did in fact have a reliable basis for estimating the costs associated with the independent chairman condition. Far from a rush to judgment, the Commission was perfectly justified in its conclusion that it could promptly respond to the remand and adequately consider the costs of the two conditions.

The Commission also was able expeditiously to consider the disclosure alternative that had been suggested during the comment period and implicitly rejected by the Commission. On remand, the Commission made that rejection and its rationale explicit. There was nothing "premature" or "rubber stamp" about the Commission's thorough and well-considered action.

2. The Chamber next complains (Mot. 13-14) that, in moving quickly, the Commission "precluded any semblance of the deliberative and consultative process required of agencies constituted as a commission." The Chamber does not explain what legal requirements, if any, it thinks were violated. In fact, the process followed by the Commission fully complied with the APA and the Commission's Rules of Practice, and was entirely appropriate.

The June 29 open meeting had been previously scheduled. Consideration of the remand was added to the agenda upon the recommendation of the Commission staff who had concluded that the court's concerns could be addressed on the basis of the record already before the Commission. Thus, the staff was able to put the Commission in a position, if it wished, to respond to the remand promptly and before Chairman Donaldson departed. The timing was not,

as the Chamber asserts, a plot by the Chairman to reach a predetermined result, but an effort by the staff to give the five Commission members optimum flexibility to respond quickly to the Court. Contrary to the Chamber's assertions (Mot. 13), the Commission took action only after thorough deliberation and vigorous debate involving all of its members. Each Commissioner was immediately informed of the staff recommendation and received from the staff several drafts of the proposed Remand Release (the first being delivered on the Friday before the Wednesday meeting). Commissioners were free to comment or respond as they wished. The Commission's release, moreover, included an explicit "Response to Comments of Dissenting Commissioners at Open Meeting." 70 FR at 39397. The deliberative nature of the process here, in which all of the Commissioners were fully engaged, is well illustrated by lengthy concurring and dissenting views of each them appended to the release.

3. The Chamber contends that the Commission improperly failed to hold a second round of public comment. The Chamber does not dispute that an agency on remand may find that the existing record, without further comment, is a sufficient basis for the agency's ultimate rulemaking decision. 11/ Indeed, by not specifying the use of any particular procedures on remand, the Court followed what it has called the "'usual rule that a reviewing court should leave the agency free on remand to determine whether supplemental fact-gathering is necessary'" to correct the deficiencies identified by the court. *Sierra Club v. EPA*, 325 F.3d 374, 382 (D.C. Cir. 2003). Even where some fact gathering might be necessary, "on remand, the court leaves 'to the agency the methods, procedures, and time dimension of the needed inquiry * * *.'" *Natural Resources Defense Council, Inc. v. SEC*, 606 F.2d 1031, 1055 (D.C. Cir. 1979).

11/ *See P.A.M. News Corp. v. Butz*, 514 F.2d 272, 276 n.7 (D.C. Cir 1975); *Mobil Oil Corp. v. EPA*, 35 F.3d 579, 584 (D.C. Cir. 1994).

The Chamber does not dispute that the notice set forth in the proposing release fully complied with the APA by setting forth both the complete terms of the proposed amendments *and* a thorough description of the subjects and issues involved. In fact, the Commission had solicited comment on the issues remanded to it by the Court – the costs of the two conditions and possible alternatives – and the notice actually elicited comment on both issues. The proposing release had said the Commission expected the costs to be "minimal." Thus, all interested parties were on notice, and had a fair and meaningful opportunity, to provide comments if they disagreed. Having given sufficient notice initially, "the focus in [this Court's] rulemaking cases is primarily on whether the final rule changes critically from the proposed rule rather than on whether the agency relies on supporting material not published for comment." *Air Transport Ass'n of Amer. v. FAA*, 169 F.3d 1, 7 (D.C. Cir.1999). Here, far from changing critically, the two conditions were adopted substantially as proposed. The Commission's reliance on information that "only confirmed the findings delineated in the proposal" did not trigger a requirement to engage in a second round of comment. *Building Indus. Ass'n of Superior California v. Norton*, 247 F.3d 1241, 1246 (D.C. Cir. 2001).

The Commission's consideration of the widely used survey of director compensation was entirely appropriate. Although the Chamber seeks to impugn the survey, the Chamber raises no serious challenge to its reliability. Versions of the survey have not only been previously relied upon by the dissenting Commissioners and by opponents of the rule amendments, including the Investment Company Institute, they have also been cited by a broad array of publications as the principal source on fund director compensation over at least the last decade. 12/ Further, the

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12/ *See, e.g.*, ICI, Understanding the Role of Mutual Fund Directors, at 23 (last accessed Aug. (continued...)

Commission's use of the survey did not trigger the need for another round of notice and comment. Contrary to the Chamber's contention, in an informal rulemaking an agency is not limited to the formal "record" evidence. *See Ass'n of Data Processing Serv. Orgs. v. Board of Governors*, 745 F.2d 677, 684 (D.C. Cir. 1984). Because the survey was publicly available, the Chamber and other commenters had access to the same information if they wished to address it prior to the Adopting Release. 13/ This is quite different from information "that, [in] critical degree, is known only to the agency." *Portland Cement Ass'n v. Ruckelshaus*, 486 F.2d 375, 393 (D.C. Cir. 1973). 14/

Finally, the Chamber objects to the Commission's reliance on its experience in estimating that independent directors and independent chairmen will use independent legal counsel an additional thirty and fifty hours per year, respectively. 15/ The Chamber criticizes the

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12/ (...continued)
1, 2005) (www.ici.org/funds/inv/bro_mf_directors.pdf); Mara Der Hovanesian *et al.*, *How to Fix the Mutual Fund Mess*, 3850 Business Week 106 (Sept. 22, 2003); Julie Earle, *Mutual Fund Directors' Pay Beats Market*, Financial Times, April 21, 2003, at 15; Carole Gould, *Fidelity Tinkers With Charity Fund*, N. Y. Times, Sept. 10, 1995, § 3, at 8. An earlier version of the survey was cited in the dissent appended to the Adopting Release. 70 FR at 39392 n.28.

13/ The Commission never suggested, as the Chamber contends, that the public availability of the survey of director compensation was a barometer of its reliability, or a basis not to consider other publicly available information.

14/ The Chamber's reliance on *Connecticut Light & Power Co. v. NRC*, 673 F.2d 525, 530-31(D.C. Cir. 1982), and *Home Box Office Inc. v. FCC*, 567 F.2d 9 (D.C. Cir. 1977), is misplaced. Those cases dealt with the issue of apparent bad-faith where an agency fails to include in a notice the "studies and data that it *has employed* in reaching the decisions to *propose* particular rules." 673 F.2d at 530 (emphasis added).

15/ It is well recognized that the ability to bring agency experience to bear (even in internal deliberations after the close of the comment period) is a primary intended benefit of informal rulemaking's flexible procedures. *See Siegel v. Atomic Energy Commission*, 400 F.2d 778, 786 (D.C. Cir. 1968); Paul R. Verkuil, Judicial Review of Informal
(continued...)

Commission's experience as "unidentified," but the nature of the Commission's experience in this regard should be obvious. The Commission is an agency predominantly made up of lawyers, including former counsel to investment companies, and the Commission frequently solicits comment on similar legal expenses and makes determinations regarding such expenses in its rulemakings. 16/ In any event, the Chamber does not demonstrate that the figures – which represent almost negligible components of the costs – are unreasonable. 17/

4. The Chamber also argues (Mot. 16) that the "extra-record" evidence the Commission used is "dubious on its face." The Chamber has the burden of showing prejudice by indicating with reasonable specificity what information it objects to and demonstrating that had more precise notice been given, it "would have submitted additional, different comments that could have invalidated the rationale for the [rule]." *City of Waukesha v. EPA*, 320 F.3d 228, 246-47 (D.C. Cir. 2003): *see Personal Watercraft Indus. Ass'n v. Department of Commerce*, 48 F.3d 540, 544 (D.C. Cir. 1995). This it has not done.

The Chamber first challenges the Commission's general statement, made in a footnote at the beginning of its cost discussion (70 FR at 39391 n.17), that it relied where appropriate on data that could be obtained or confirmed through publicly available filings made with the Commission. It has long been held that information considered by an agency in its own files is *not* outside the rulemaking record. *See Siegel*, 400 F.2d at 786. Nevertheless, the Chamber

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15/ (...continued)
Rulemaking, 60 Va. L. Rev. 185, 189 & n.14 (1974).

16/ *See, e.g.*, Securities Act Rel. No. 33-8400 (March 16, 2004) (Commission relied on cost estimate of $300 per hour for outside securities counsel, an estimate as to which it had solicited comment).

17/ Contrary to the Chamber's argument (Mot. 16) there was no need to seek additional cost data from funds that have already complied. *See* Remand Release, 70 FR at 39396 n.76.

complains that the Commission failed to identify the particular filings upon which it relied. But this ignores that for each of its cost estimates, the Commission described in detail the source of the various data it relied upon. The Chamber fails to specify a single cost component that it disputes based on this criticism.

The Chamber next objects to the Commission's reliance on the survey of director compensation, discussed above, but does not specify any particular information in the survey to which it objects. Nor does the Chamber specify any studies or other information at odds with the survey. Rather, the Chamber complains that there is "no description of the methodology underlying" the survey. But the information in the survey is not at all of a subjective nature, but is simply a tabulation of compensation data collected periodically from mutual funds and widely relied upon by the industry.

The Chamber further criticizes the Commission's reliance on information from 2000 regarding the frequency with which independent directors will be replaced, contending that the Commission did not "consider" that the frequency will be greater than in the past. Mot. 17. The Chamber, however, ignores that the Commission conservatively estimated the replacement of directors on average every *five* years, based on the information from the year 2000 indicating a typical tenure of *ten* years. 70 FR at 39393 & n.33. The Chamber also criticizes the use of information from 2003 regarding the average hourly rate for legal counsel, contending that this rate has increased over time. But the Chamber ignores that the Commission is required to estimate the potential cost of legal fees in many of its rulemakings 18/ and, in this case, added to

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18/ *See, e.g.*, Securities Act Rel. No. 33-8591 (July 19, 2005) (on the very day it adopted the Remand Release, the Commission, after full notice and comment, adopted an estimate of $300 per hour fee for outside professional services for drafting disclosure).

its cost estimates a cushion of twenty percent for the very purpose of taking into account factors such as rate increases. Again the Chamber offers no contrary studies or other information. Its contention that the data relied upon by the Commission was unreliable is without merit. 19/

5. Contrary to the Chamber's argument (Mot. 18), the Commission carefully analyzed the effects of the costs of the conditions on efficiency, competition, and capital formation. The Commission concluded that the costs were extremely small relative to the fund assets for which fund boards are responsible, and also small relative to the expected benefits of the two conditions. 70 FR at 39395-96. The Commission noted that the costs it had considered represented the high range of potential cost of compliance for any individual fund, and that the average cost per fund to the industry as a whole was likely to be much lower. The Commission pointed out that there were options for compliance (which could be chosen by *any* fund) that had little or no cost. There is no reason to believe that new entrants or smaller funds would fail to choose the low-cost options if they believed that the higher cost options might affect their entry into the industry or jeopardize their ability to survive. 20/

The Commission concluded that the cost of compliance, being minimal, would have little, if any, adverse effect on efficiency, competition and capital formation. Indeed, the Commission said it anticipated that the two conditions should help to increase investor confidence, which

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19/ None of the data challenged by the Chamber is among the "most critical" information underlying the Commission's decision. *Air Transport Ass'n*, 169 F.3d at 7.

20/ The Chamber also argues that the Commission should have analyzed "how the new costs will affect investor returns," but the Commission's finding that the costs are extremely small relative to fund assets addresses precisely that point by making it clear that the effect on investor returns will be minimal. If the Chamber is suggesting that the Commission was obligated to conduct an empirical study, that contention has already been rejected by this Court. Slip Op. 14.

might lead to increased efficiency and competitiveness of the U.S. capital markets, and that this increased market efficiency and investor confidence might encourage more efficient capital formation.

6. Finally, the Chamber argues that the Commission gave short shrift to the disclosure alternative. In fact, the Commission carefully considered the disclosure alternative and explained the reasons why it would not sufficiently serve the interests of investors. "Disclosure concerning conflicts of interest on the part of fund managers and the potential for self-dealing by them does not prevent the managers from putting their interests ahead of investors' interests," the Commission found, and meaningful disclosure would be difficult in any event. 70 FR at 39397. The Commission also pointed out that, absent Commission approval, the Act *prohibits* the transactions permitted under the Exemptive Rules. Further, the Commission noted that it had not adopted the independent chairman provision in isolation, but "as part of a larger package of regulatory reforms that should lead to enhanced compliance by funds that have independent chairs." For all of these reasons, the Commission "continue[d] to find that it is necessary and appropriate in the public interest and consistent with the protection of investors to condition a fund's reliance upon any of the Exemptive Rules upon its having an independent chairman." *Id.*

The Chamber's motion for a stay should be denied, and expedition should be granted.

Respectfully submitted,

August 5, 2005

GIOVANNI P. PREZIOSO, General Counsel

JACOB H. STILLMAN, Solicitor

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JOHN W. AVERY, Special Counsel

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Of Counsel
MEYER EISENBERG
Deputy General Counsel

CERTIFICATE OF SERVICE

I hereby certify that on this 5th day of August, 2005, I caused one copy of the "Response of Securities and Exchange Commission in Opposition to Motion for Stay of Commission Order and in Support of Expedited Consideration of Petition for Review," to be served on counsel for petitioner, by hand, at:

Eugene Scalia, Esq.
Gibson, Dunn & Crutcher LLP
1050 Connecticut Avenue, N.W.
Washington, DC 20036-5306
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and delivered the requisite copies of such Response to the clerk by hand.

John W. Avery

JOHN W. AVERY
Special Counsel

EXHIBIT A

June 28, 2005

BY HAND

The Honorable William H. Donaldson
Chairman
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549

Dear Chairman Donaldson:

We, the independent chairs of the boards of the investment company fund families listed below, understand that the Securities and Exchange Commission will meet on June 29 to reconsider amendments to certain exemptive rules under the Investment Company Act of 1940 which would effectively require the boards of most mutual funds to be comprised of at least 75% independent directors and have an independent chair. The Commission reconsideration is reported to be in response to a June 21 ruling of the U.S. Court of Appeals for the D.C. Circuit, which sent the amendments back to the Commission for review after concluding that the Commission had failed "adequately to consider the costs mutual funds would incur in order to comply" with the amendments and also "a proposed alternative to the independent chairman condition".

In our role as independent chairs, we have had experience with the costs of having a supermajority of independent directors and an independent chair, and the nature and content of disclosure documents filed by our funds. As the Commission prepares for its coming meeting, we thought it might be helpful to share our experience with these two governance changes.

Each of us serves as the independent chair of our respective fund boards and all of our boards have at least 75% independent directors/trustees. Although some of us were serving as independent chairs well before the Commission announced the amendments in question, some of us became board chair in response to the July 2004, "Best Practice" recommendation of the Mutual Fund Directors Forum, and others assumed this role in anticipation of the January 2006, effective date of the Commission's rule.

While our tenures as chair differ, and the asset size of our respective fund groups differs greatly, it is our shared experience that fund costs associated with a 75% independent board and an independent board chair are minimal, if any.

The 75% independence requirement actually represents only a modest change from the Investment Company Institute's 1999 "Best Practice" recommendation that fund boards have at least two-thirds independent directors. No doubt as a result of that recommendation, many fund boards already meet the 75% threshold (as noted all of us serve on boards that do), and in those cases there are no additional costs. Similarly, boards that choose now to comply with the 75% requirement by asking "interested" persons to resign (as opposed to electing new independent directors) will not incur any added expenses. Only fund boards that decide to meet this requirement by electing one or more new independent directors will incur added costs. Even then, the compensation of the new independent directors would undoubtedly take into account the relative asset size of their fund group, and the added cost would be allocated among all funds in the group so that the cost impact on each fund shareholder would be de minimis.

With respect to the independent chair requirement, election of an independent chair by our respective fund families has not led to additional staffing costs beyond adjustments in the compensation of the independent chair. In both asset percentage and absolute dollar terms, when measured against the asset size of our respective funds, this cost is minimal. We believe our experience is typical of the industry in general and we are unaware of any fund or fund complex that has incurred other staffing costs in changing to an independent board chair. Simply stated, empowerment of fund boards in this manner is cheap and efficient.

We note that the Court of Appeals also directed the Commission to consider a disclosure alternative to the independent chair condition of the rule. Although that approach may appear to some to be a viable alternative, it strikes us as unrealistic.

Whether a fund's chair is independent or interested is already required disclosure in the Management Information Table contained in the Statement of Additional Information. Commission spokesmen have acknowledged the lesson of recent focus groups that fund disclosure documents are seldom read. In our view, therefore, requiring more prominent disclosure of whether a fund's chair is independent will not contribute in any meaningful way to a better shareholder understanding of the significance of the existence–or absence–of an independent chair. It would be a serious mistake to assume that investors would be able to make a rational choice between the two alternatives when they are unlikely even to read the suggested disclosure.

We hope our comments are helpful and request that this letter be made a part of the Commission's public files.

Respectfully submitted,

/s/ Arne H. Carlson
Independent Chair, American Express Funds

/s/ David Downes
Quaker Funds

/s/ Leigh Wilson
Independent Chair, The Victory Portfolios

/s/ Albert R. Dowden
Independent Chair, Cortland Trust

/s/ Peter Brown
Independent Chair, Aegon Transamerica Idex Funds

/s/ Bruce Crockett
Independent Chair, AIM Funds

/s/ Lawrence S. Lewin
Independent Chair, H&Q Funds

/s/ Shirley Peterson
Independent Chair, Scudder Funds (Chicago Board)

/s/ Virginia Stringer
Independent Chair, First American Funds

/s/ Michael Scofield
Independent Chair, Evergreen Funds

/s/ Charles Ladner
Independent Chair, John Hancock Funds

/s/ Jock Patton
Independent Chair, ING Funds

/s/ Fergus Reid III
Independent Chair, J.P. Morgan Funds

cc: Paul Atkins, Commissioner
Cynthia A. Glassman, Commissioner
Harvey Goldschmid, Commissioner
Roel Campos, Commissioner
Jonathan G. Katz, Secretary
Meyer Eisenberg, Acting Director, Division of Investment Management

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June 28, 2005

William Donaldson, Chairman
United States Securities and Exchange Commission
100 F Street, N.E.
Washington, DC 20549



Re: Agenda for Open Meeting to be held on June 29, 2005

Dear Chairman Donaldson:

I write in support of the Commission's determination to consider the costs of complying with the 75% independent director condition and independent chairman condition, and the disclosure alternative to the independent chairman condition, currently scheduled as item 3 of the Agenda for the Commission's Open Meeting to be held on June 29, 2005.

I am an independent trustee of a large mutual fund complex and a former lead independent trustee. In my experience as a trustee, I have had personal experience with the costs of having a supermajority of independent directors and an independent chairman, and the nature and content of disclosure documents filed by funds. My experience, however, pales in comparison to the knowledge of the Staff of the SEC's Division of Investment Management on these subjects given their access to broader industry data.

As an independent trustee, I encourage the Commission to complete the fund governance agenda as swiftly as possible in order to move forward on the rules adopted July 27, 2004. I have no doubt that the Commission has in its possession sufficient knowledge and information to satisfy the requirements of the remand order issued by the United States Court of Appeals for the District of Columbia Circuit in *Chamber of Commerce v. SEC*, No. 04-1300 (D.C. Cir. June 21, 2005). I understand that some believe that consideration on remand should await the appointment of a new SEC Chairman. In my view, however, these matters should be resolved promptly, so that fund boards can complete their governance modifications in light of the Commission's fund governance releases and recent best practice recommendations from the Mutual Fund Directors Forum concerning fund governance and board operations. Many funds have already undertaken modifications to comply with the rules and with best practice recommendations designed to improve independent directors' power and authority with respect to managing their oversight functions. Without regard to the emergence of a new SEC Chairman, changes in board constitution are still required to empower independent directors. The change in SEC Chairman should not delay the Commission's making the necessary findings as required by the remand order.

My views with respect to the cost of the 75% independent director and independent chairman conditions, and the disclosure alternative, are as follows:

- Many funds have already added independent directors to compensate for the increased workloads or more rigorous responsibilities resulting from other regulatory changes and increased civil litigation. Having an independent chairman is becoming a "best practice" in the industry. Thus, the cost of additional directors may be imposed whether or not the conditions are mandated.

- The nature of the inherent conflict between the adviser and a fund is tied in no small part to financial gains. Recent experiences make clear that disclosure alone is insufficient to address these types of issues. Thus, for example, disclosure of a fund's anti-market timing policies did not elevate violations of those policies to the adviser's compliance personnel and upward reporting to the funds' boards. Similarly, a management chairman recently failed to bring to the board's attention the details of an affiliated service arrangement that was clearly designed for management to "capture" the profit associated with the service function by subcontracting performance to the prior service provider at a substantially reduced cost.

- Whether a chairman is independent or interested is already disclosed in the required Management Information Table contained in each fund's Statement of Additional Information. Requiring more prominent disclosure of whether a fund's chairman is independent will not lessen the conflict or improve the ability of independent trustees to perform their watchdog function, or contribute in any meaningful way to shareholder understanding of the conflict or how it can be policed.

- Improved or additional disclosure of the chairman's status as independent or interested, either in the Prospectus or Statement of Additional Information, could be required in any case, but I believe these changes should be part of the Commission's consideration of a comprehensive restructuring of the disclosure regime for investment companies, a topic that has been discussed for some time.

Some management-chaired funds provide substantial governance structures designed to avoid or lessen the conflicts of interest that are the focus of the 1940 Act and have strong independent directors who participate in these processes. Conflicts of interest, however, are inherent in fund structures, and can be better addressed by empowering independent directors and independent chairmen to control a fund board's agenda. As many commentators have

previously noted, the independent chairman requirement does not mean that management directors will be unable to participate.

Moving the current disclosure requirement to a more prominent place will not contribute in any meaningful way to enhancing the role of independent directors in fund governance. Empowering independent directors, by requiring a 75% majority and an independent chair, is a more effective. While the costs of compliance may be significant for some smaller funds, the overall cost will be recouped by the improved oversight of the inherent conflicts and benefits to shareholders. I believe that the Commission can and should provide the information to support the conditions, and should do so promptly at Wednesday's meeting.

Respectfully submitted,

Carl Frischling

Carl Frischling

cc: Paul Atkins, Commissioner
Cynthia A. Glassman, Commissioner
Harvey Goldschmid, Commissioner
Roel Campos, Commissioner
Jonathan G. Katz, Secretary

MANAGEMENT PRACTICE®

Assessing the Costs and Alternatives of an Independent Chairman for Mutual Funds

(by C. Meyrick Payne, Senior Partner of Management Practice Inc., a consulting firm specializing in the governance of mutual funds)

By now virtually everyone in the mutual fund world knows that the US Court of Appeals recently remanded the SEC's decision to require 75% independent membership on a fund's board and an independent chair of mutual fund boards back to the Commission so that it could specifically address two issues: (1) the cost of implementation and (2) use of disclosure as an alternative. Since the Chairman and one other Commissioner, who are very familiar with the issue, were about to step down, the SEC decided to hold the required hearing one day before the Chairman's resignation became effective. This MPI Bulletin provided some facts to ease the debate. The independent chairman and the 75% Board composition rule was re-adopted.

Costs

The costs of implementing these rules are minimal. The 75% independence requirement represents no change from the existing "safe harbor" rule which already requires 75% independence for two years after any merger or acquisition by the investment manager. In MPI's latest survey of the fund industry, fund boards were shown to be getting smaller as insiders stepped aside to achieve the 75% requirement.

As to the independent Chair rule, there are about 300 mutual fund families in the US. On average the Chair of each will receive incremental compensation of about $25,000 for a total cost of $7.5 million, which is tiny compared to the $8.3 trillion of mutual fund assets. Furthermore the impact of these incremental costs is proportional to the size of the complex; for example 30 fund families account for about 75% of all fund assets, the Chair of each of these is expected to receive additional compensation of about $75,000, or just $2.25 million, to oversee all $6.2 trillion. The 270 smaller complexes will pay an average Chairman's premium of about $20,000 or $5.25 million.

An independent Chair is needed to strengthen an already cost effective process of fund governance. Consider that there are only 2,800 independent fund trustees in the country (there are over 700,000 lawyers and 600,000 doctors). Of these, 306 are trustees of the 30 largest complexes. From an individual fund investor's viewpoint, each $1 million of fund assets in these large fund families (about the value of a comfortable home in suburban New York) costs $1.93 per year for an independent trustee to personally stand guard. Compare that to a typical home security system!

From a taxpayers' viewpoint, fund governance is also remarkably inexpensive. Compare 2,800 trustees (plus about 400 SEC staff) with the approximately 30,000 bank regulators at the Federal and State levels. The US system of fund governance is generally envied throughout the developed world as effective and cost efficient.

The benefit of an independent Chair is that it clearly separates the investors' interest from that of the manager. Whenever one individual's hard earned money is entrusted to another, potential conflicts of interest arise as they did in the recent late trading, market timing and portfolio disclosure scandals. These conflicts are only magnified when millions of individuals' savings are aggregated together in extremely large investment pools.

The conflicts include the allocation of IPO rights, potentially higher-than-necessary fees and expenses, excess brokerage, sometimes enormous bonus pools, "soft dollar" research credits and unnecessary portfolio churn. The average fund investor can not possibly know enough about these esoteric conflicts to look out for themselves and, as those who oppose this rule argue, vote with their feet. The fund directors are needed to represent the average shareholder – and they need an independent Chairman to guide them, prioritize issues and manage governance resources in an increasingly complicated environment. They also periodically need someone to go toe to toe with the CEO of the management company.

An independent Chairman is also needed to ensure that two other SEC important reforms are truly implemented. First, the requirement that the fund board annually evaluate its own effectiveness becomes toothless unless there is an independent Chair who is empowered to act on the results. Second, the newly appointed Chief Compliance Officer needs a boss of the same stature as the management company CEO. Without one, the role of the CCO is potentially just window-dressing.

Furthermore, the act of rescinding the independent Chairman rule would be worse than never having had it at all. To signal the fund marketplace that a majority of SEC Commissioners (and the SEC staff) thought that the rule was an appropriate response to the late trading, market timing and portfolio disclosure scandals; but then, under new leadership, change its mind, sends an alarming signal at a time when politicians of every stripe are advocating greater personal savings.

Disclosure as an Alternative

Two SEC Commissioners and the US Chamber of Commerce have proposed that disclosure of whether a fund has an independent Chairman would suffice. The trouble with this argument is that SEC knows full well from its recent focus groups that fund prospectuses and annual reports are rarely read. Furthermore the benefits of an independent Chair to actually mediate conflicts of interest are not obtained by disclosure.

About 30 complexes have already appointed an independent Chair (in addition to the 33 or so which already had them) in anticipation of the rule becoming effective. Morningstar reports that 11 of the top 20 complexes already have an independent Chair. In our firm's work with many of these, I know of none which would return to the old days of an inside Chairman, even if the SEC were to reverse its position.

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In summary, the cost of this rule is minimal, the need is conspicuous after the scandals of the past two years, and the alternative proposed is not an appropriate way to achieve any of the benefits.

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