INITIAL BRIEF

NO. 05-1240

IN THE 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.

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

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

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CERTIFICATE AS TO PARTIES, RULINGS, AND RELATED CASES

(A) Parties and Amici:

The parties in this case are the Chamber of Commerce of the United States of America (Petitioner) and the Securities and Exchange Commission (Respondent). The Consumer Federation of America and Fund Democracy, Inc. have moved to participate jointly as amici in support of the Commission.

The Chamber of Commerce is the nation's largest federation of business companies and associations. With substantial membership in each of the fifty states, the Chamber has an underlying membership of more than three million businesses, chambers of commerce, and business and professional organizations of every size and in every industry sector. One of the Chamber's associational purposes is to protect its members from costly and unlawful federal regulation. Chamber members and their subsidiaries include mutual fund advisers that will be injured by the Commission's challenged action. Moreover, the Chamber invests in mutual funds, and thus will itself be injured by the Commission's action.

The Chamber is a non-stock corporation and thus has no parent organization, and no publicly-held corporation holds a 10 percent or greater stake in the Chamber.

(B) Rulings Under Review:

Under review in this case are the independent chair and 75 percent independent director provisions that were re-adopted by the Commission on June 29, 2005. Investment Company Governance; Final Rule, 70 Fed. Reg. 39,390 (July 7, 2005). The provisions were first adopted in 2004, but were declared unlawful by this Court on June 21, 2005. *Chamber of Commerce of the United States v. SEC*, No. 04-1300, 412 F.3d 133 (D.C. Cir. 2005). The Commission re-adopted the provisions unchanged eight days later.

(C) Related Cases:

The regulatory provisions under challenge in this case were previously challenged in No. 04-1300. On June 21, 2005, a panel of this Court unanimously granted in part the Chamber's petition for review, holding: "This matter is remanded to the Commission to address the deficiencies with the 75% independent director condition and the independent chairman condition." *Id.* at 145. On July 28, 2005, the Chamber filed a Petition for Panel Rehearing in that case. The Petition was denied on September 9, but as of the date of this brief a mandate had not yet issued in that case.

Because at the time of the earlier case there was a question whether this Court or a federal district court had jurisdiction of the Chamber's challenge, the Chamber concurrently filed suit in this Court and the U.S. District Court for the District of Columbia (Sept. 2, 2004, No. 1: 04CV01522 (RMC) (D. Ct., D.E. 1)).

In light of this Court's October 18, 2004 Order in No. 04-1300, the District Court stayed the district court action on October 25, 2004. The Chamber of Commerce intends to dismiss its Complaint once a mandate issues in No. 04-1300, the initial proceeding before this Court.

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GLOSSARY

Adopting Release	Investment Company Governance; Final Rule, 70 Fed. Reg. 39,390 (July 7, 2005)
Commission	Securities and Exchange Commission
ICA or the Act	Investment Company Act of 1940, 15 U.S.C. § 80a, *et seq.*
SBREFA	Small Business Regulatory Enforcement Fairness Act, 5 U.S.C. § 601, *et seq.*

JURISDICTIONAL STATEMENT

This case is before the Court on a petition to review two provisions of a final Commission rule under the Investment Company Act of 1940 ("ICA" or "Act"), 15 U.S.C. § 80a, *et seq*. The Court already has determined that direct review of those provisions is available in this Court. *Chamber of Commerce of the United States v. SEC*, 412 F.3d 133, 138 (D.C. Cir. 2005); *see also* 15 U.S.C. § 80a-42(a) (jurisdiction in the United States Court of Appeals for the District of Columbia). The Chamber's petition for review was timely filed within sixty days of the re-adopted provisions' publication, on July 7, 2005.

The Chamber has standing in its capacity as an investor in mutual funds. It also has associational standing.

1. This Court already has held that the Chamber has standing in its capacity as an investor to petition for review of the challenged provisions. *Chamber of Commerce*, 412 F.3d at 138. The Chamber is invested in funds that, as a consequence of the rule, will be compelled to select a new chair and to have 75 percent independent directors. Decl. of Stan M. Harrell, Addendum hereto. The Chamber currently intends to continue to invest in mutual funds, and wishes to have the ability to invest in management-chaired funds and in funds with fewer than 75 percent independent directors. The loss of this ability, this Court has stated, is "injury in fact and, because a favorable ruling would redress that injury,

[the Chamber] has standing to sue the Commission." *Chamber of Commerce*, 412 F.3d at 138 (citing *Consumer Fed'n of Am. v. FCC*, 348 F.3d 1009, 1011-12 (D.C. Cir. 2003); *Competitive Enter. Inst. v. Nat'l Highway Traffic Safety Admin.*, 901 F.2d 107, 112-13 (D.C. Cir. 1990)). The Chamber will be injured for the additional reason that the provisions will increase the costs and diminish the value of the funds in which it is invested.

2. The Chamber also has associational standing. Chamber members and their subsidiaries include fund advisers that will be harmed by the challenged provisions because they manage funds that both have management chairs and fewer than 75 percent independent directors, and rely—and wish to continue to rely—on at least one of the ten rules being amended. Decl. of Aaron Stover, Addendum hereto; *see also Warth v. Seldin*, 422 U.S. 490, 511 (1975) (one affected member is sufficient). Under the provisions, those members must accept a less influential role over the funds they established and manage if they wish to receive the competitive benefits associated with the rules being amended. Further, those Chamber members and their subsidiaries will in the future be prevented from establishing mutual funds over which they may exercise a significantly influential role on the board of directors unless they forgo the competitive benefits associated with the rules being amended. Simply, the rule is intended to reduce advisers' influence over the funds they establish, manage, and on which their income

depends; indeed, the Commission has said it intends to reduce advisers' income. *See* Investment Company Governance; Final Rule, 69 Fed. Reg. 46,378, 46,380-46,381 (Aug. 2, 2004). The other prerequisites to associational standing are also met: the suit is germane to the Chamber's associational purpose of protecting members from costly and unlawful federal regulation, and participation by any individual member is not necessary for this Court to provide meaningful relief. *National Taxpayers Union, Inc. v. United States*, 68 F.3d 1428, 1435 (D.C. Cir. 1995).

STATEMENT OF ISSUES

1. In a unanimous decision, this Court ruled that the independent chair and 75 percent independent director provisions of the Commission's mutual fund "governance" rule had been adopted in violation of the Administrative Procedure Act ("APA") and ICA. Eight days later—before the mandate had issued—the Commission re-adopted the two challenged provisions. Did the Commission have the authority to act prior to the issuance of this Court's mandate?

2. On remand, an agency has the same obligation to comply with the APA and other laws governing rulemaking that it had during the initial rulemaking. In this case, the Commission majority precluded public comment, repeatedly relied on extra-record materials, and gave Commissioners insufficient time to review and

comment on the data and analysis underlying the agency's action. Did this violate the APA, ICA, and this Court's instructions in its earlier decision?

3. The APA, ICA, and this Court's earlier decision required the Commission to consider the costs of the independent chair and 75 percent independent director requirements. Although it previously had said it had "no reliable basis" in the existing record to make these "difficult" cost estimates, in "reconsidering" the provisions the Commission declined to receive additional, current information on the provisions' costs and instead purported to estimate the costs on the basis of extra-record "evidence," dated material from prior rulemakings, and the unspecified experience of unidentified Commission personnel. The Commission also failed to consider whether these costs were warranted with respect to each of the specific rules being amended and each of the ten types of activities being regulated. Did this violate the APA, ICA, and this Court's instructions in its earlier decision?

4. Section 2(c) of the ICA and this Court's earlier decision required the Commission to consider the effects of the independent chair and 75 percent independent director requirements on efficiency, competition, and capital formation. In re-adopting the provisions, the Commission majority did not address the provisions' effects on smaller funds, new entrants to the marketplace, or on competition in the market for mutual funds as a whole, nor did it perform a revised

"final regulatory flexibility analysis." Did this violate the APA, ICA, the Small Business Regulatory Enforcement Fairness Act ("SBREFA"), and this Court's instructions in its prior decision?

5. This Court previously ruled that the Commission had violated the APA by giving inadequate consideration to a "disclosure" alternative to the independent chair provision. In response to the Court's decision, the Commission majority rejected the disclosure alternative again without soliciting the views of two dissenting Commissioners and without assessing the alternative in light of the separate protections already provided by the exemptive rules, the protections attributed to the 75 percent independence requirement, the public's interest in investing in management-chaired funds, and the ten types of activities being regulated. Did this violate the APA, ICA, and this Court's instructions in its prior decision?

6. An agency may use its regulatory powers only to those ends authorized by statute. The Commission used its authority to issue exemptive rules regarding certain transactions as a means of regulating activities outside the exemptive rules. Did this violate the APA, ICA, and this Court's instructions in its prior decision?

STATUTES AND REGULATIONS

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

STATEMENT OF THE CASE

This case concerns the Commission's re-adoption—by a bare 3-2 majority—of two new regulatory requirements that had been invalidated by this Court just one week before. The first provision—the independent chair requirement—provides that the chair of the board of a mutual fund must be independent of the "adviser" that establishes and manages the fund. The second provision—the 75 percent independent director requirement—provides that 75 percent of a fund's board members as a whole must also be independent of the adviser.

The provisions were first adopted in July 2004, and shortly thereafter were challenged in this Court by the Chamber of Commerce on multiple grounds. In a decision dated June 21, 2005, the Court granted the petition for review in part, ruling that the Commission had not fulfilled its statutory duty to consider the provisions' costs and their effects on efficiency, competition, and capital formation. It also ruled that the Commission had failed to consider a "disclosure" alternative to the independent chair provision.

The Commission re-adopted the challenged provisions without change eight days later, before the Court's mandate had issued. During the litigation the Commission had argued to the Court that it had "no reliable basis" to make the "difficult" cost assessments demanded of it, but after the Court's decision the Commission resolved to make the assessments without further notice and

comment. Extensive reliance was placed on materials outside the rulemaking record, however.

Two Commissioners dissented from re-adoption of the provisions, objecting that they had been given insufficient opportunity to review the analysis prepared by the Commission staff and had not been meaningfully consulted on how to respond to the Court's decision.

Mutual funds were to be in compliance with these provisions by January 16, 2006, but—in response to a motion by the Chamber—this Court stayed the requirements pending judicial review. Aug. 10 Order (No. 05-1240). A copy of the Commission's final action, which was published in the Federal Register on July 7, 2005 (70 Fed. Reg. 39,390), is reprinted in the Addendum at the end of this brief.

STATEMENT OF THE FACTS

A. Mutual Funds And The Investment Company Act Of 1940 ("ICA").

Mutual funds are investment vehicles that pool the assets of numerous investors to purchase stocks, bonds, and other financial instruments. Funds currently hold more than $7.5 trillion in assets; mutual fund shares are held by more than one-half of the households in the United States. *See* June 23, 2004 Open Meeting, CRI, Tr. 4, at 53 (No. 04-1300). Generally, funds are established by "advisers" and organized as "investment companies," each with its own board of directors. "Although the board is authorized to operate the fund, it typically delegates that management role" to an adviser. *Chamber of Commerce*, 412 F.3d at 136. A single adviser—the "Acme Advisory Company," for example—might establish a number or "family" of mutual funds to offer an array of investment options, *e.g.*, the Acme Aggressive Growth Fund, or the Acme Large Cap Fund. Each of these funds generally is a separate investment company. *See* Investment Company Institute, *A Guide to Understanding Mutual Funds* 46 (2004), http://www.ici.org/statements/inv/bro_ understanding_mfs_p.pdf (last visited Sept. 7, 2005).

In 1940, Congress enacted the ICA to regulate funds that engage primarily in investing, reinvesting, and trading in securities, and whose own securities are offered to the investing public. The Commission is assigned certain

responsibilities under the ICA, including the authority to allow exemptions from specific provisions of the Act that prohibit funds from engaging in certain transactions. *See, e.g.*, 15 U.S.C. § 80a-6(c). Over the years, the Commission has exercised this authority by issuing "exemptive rules" that permit funds to engage in a number of activities that otherwise would be prohibited, provided the funds meet certain conditions. Since 2001, the rules have required that a majority of a fund's directors be independent of the fund adviser. *Chamber of Commerce*, 412 F.3d at 136-37 (citing 66 Fed. Reg. 3,734 (Jan. 16, 2001)).

B. The Commission's 2004 Mutual Fund Governance Rulemaking.

In 2004, the Commission amended "ten [existing] Exemptive Rules by imposing five new or amended [governance] conditions upon any fund wishing to engage in an otherwise prohibited transaction." *Id.* at 137; *see also* 69 Fed. Reg. at 46,378. Three of the new governance requirements were adopted unanimously, while two were adopted by a 3-2 vote: the independent chair and 75 percent independent director provisions. *Chamber of Commerce*, 412 F.3d at 137. When the Commission first proposed the independent chair condition in 2004, approximately 80 percent of funds did not have an independent chair. CRI, Tr. 4, at 13, 24 (No. 04-1300). At least 40 percent of funds did not meet the 75 percent independent director threshold. *See id.* at 12. "Because almost all funds either rely or anticipate someday relying on at least one of the Exemptive Rules," the

Commission has stated, the new requirements would "apply to most funds." Investment Company Governance; Proposed Rule, 69 Fed. Reg. 3,472, 3,474 n.17 (Jan. 23, 2004). Accordingly, the two provisions will compel thousands of mutual funds to change their current leadership, 69 Fed. Reg. at 46,388 n.89, and will eliminate the predominant corporate governance model in the industry, one that is favored by many investors and that Congress purposely preserved when it enacted the ICA. *See* CRI, Letters 190, 193 (No. 04-1300); 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).

In amending the exemptive rules, the Commission was statutorily required to consider the costs of the independent chair and 75 percent independent director requirements and whether they "will promote efficiency, competition, and capital formation." 69 Fed. Reg. at 46,388-46,389 (citing 15 U.S.C. § 80a-2(c)). Yet in its original adopting release, the Commission provided no cost estimates; instead, it stated that determining important components of the provisions' costs was prohibitively "difficult" and there was "no reliable basis" to do so. *Chamber of Commerce*, 412 F.3d at 143 (citing 69 Fed. Reg. at 46,387). The Commission also said that it had not received "any comments" on efficiency, competition, and capital formation. 69 Fed. Reg. at 46,389. During this original rulemaking, the Commission openly deprecated empirical evidence and economic analysis. The

then-Chairman stated, "there are no empirical studies that are worth much. You can do anything you want with numbers . . . ." CRI, Tr. 4, at 57-58 (No. 04-1300). A second Commissioner voting for the rule stated, "I do not believe that we can wait for economic studies, since as had been amply said today, methodologies will always be flawed or at least subject to question." *Id.* at 55.

Although it was amending ten distinct rules—each which governs a separate activity—the Commission's original adopting release contained no meaningful discussion of those rules, the activities they govern, or the related statutory prohibitions. *See* 69 Fed. Reg. at 46,378-46,390. Rather, the Commission explained that its new "corporate governance conditions" were being adopted for effects they were expected to have on activities outside the exemptive rules, namely "securities law violations such as late trading in mutual funds and market timing violations." *Id.* at 46,388-46,389. (The Commission provided no evidence that firms with management chairs or fewer than 75 percent independent directors permitted these practices at a higher rate than firms with independent chairs or more than 75 percent independent directors. 70 Fed. Reg. at 39,405.)

As noted, two Commissioners dissented from this original adoption of the independent chair and 75 percent independent director provisions.

C. This Court's June 2005 Decision Invalidating The Commission's Adoption Of The Two Provisions.

In September 2004, the Chamber of Commerce petitioned this Court to review the independent chair and 75 percent independence requirements. In a unanimous decision, the Court granted the petition in part. Specifically, the Court held that the Commission had violated the APA and ICA by giving inadequate consideration to the two provisions' costs, and to their effects on efficiency, competition, and capital formation, as required by Section 2(c) of the ICA, 15 U.S.C. § 80a-2(c). *Chamber of Commerce*, 412 F.3d at 143-45. The Court also held that the Commission had given inadequate consideration to at least one significant alternative to the independent chair requirement: a "disclosure" alternative under which funds would have been required to prominently disclose whether they had a management or independent chair. *Id.* at 144-45.[1]

As noted, the Commission had insisted during the rulemaking that determining the provisions' costs and effects on efficiency, competition, and capital formation was "difficult"; indeed, there was no "reliable basis to do so." *Id.*

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[1] The Court rejected the Chamber's argument that the Commission lacked the statutory authority to regulate the composition of mutual fund boards as it had. It also rejected the Chamber's argument that the Commission had not adequately justified the need for amending the exemptive rules, and that the rules had been amended for the improper, collateral purpose of regulating activity outside the exemptive rules. *Id.* at 138-41.

at 143 (citing 69 Fed. Reg. at 46,387); *see also* 69 Fed. Reg. at 46,383 n.52, 46,387 n.81, 46,389; Resp. Br. at 60-61 (No. 04-1300). The Commission made similar representations in a congressionally-mandated report, stating: "[T]he additional costs, if any, [of the independent chair requirement] are speculative at this point, and the Commission has no reliable basis for estimating those costs." Securities and Exchange Commission, *Exemptive Rule Amendments of 2004*, at 60 (April 2004).

In its June 21 decision, the Court rebuked the Commission for failing to ascertain these economic effects. It ordered the Commission to "determine as best it can the economic implications of the rule" and to "do what it can to apprise itself—and hence the public and the Congress—of the economic consequences." The Court also directed the Commission to exercise its "best judgment" on the disclosure alternative to the independent chair requirement. *Chamber of Commerce*, 412 F.3d at 143-45.

On July 28, 2005, the Chamber filed a Petition for Panel Rehearing seeking reconsideration of the Court's ruling that the Commission adequately justified its adoption of the challenged provisions. The Petition was denied on September 9. At the time this brief was filed, the mandate had not yet issued in the case.

D. The Commission's Race To Re-Adopt The Two Provisions.

During the original 2004 rulemaking, the Commission spoke solemnly of how a multi-person decisionmaking body such as a board of directors—or the Commission—should conduct itself. "[H]ealthy . . . governance" requires "meaningful dialogue," it said, as well as the right "tone." 69 Fed. Reg. at 46,383. A "chairman," the Commission said, must "encourage open dialogue and healthy skepticism." *Id.* Now, however, the Commission proceeded with extraordinary haste to "reconsider" its rule in a manner that precluded participation by the public and by the two Commissioners who had dissented from the initial rule.

The very day the Court issued its decision, the chief of staff to the Chairman emailed the Commissioners that "the staff had reviewed the Court's opinion and 'concluded that the Court's concerns can be addressed on the basis of the record already before the Commission.'" 70 Fed. Reg. at 39,403, 39,406. This announcement occurred just hours after the Court's ruling, without time to have reviewed a rulemaking record that—a week later—the Commission majority would characterize as "extensive," indeed "vast." *Id.* at 39,391, 39,402. The two Commissioners who had dissented from the earlier rulemaking were not consulted on the decision to forgo notice and comment. *Id.* at 39,403. Indeed, three of the five Commissioners were traveling abroad.

Also on the day of the Court's decision, a Commissioner who had supported the initial rule told a reporter that "'[t]he procedural deficiencies cited [in the Court's decision] should be easy to remedy. This is better than a total defeat for the Chamber of Commerce, but they should not be feeling good.'" Robert Schmidt, *SEC Must Reconsider Fund Governance Rule, Court Says*, BLOOMBERG NEWS, June 21, 2005 (quoting Commissioner Goldschmid). In other words, "procedures" would change, but the Commissioner intended no substantive change.

The next morning, June 22, the Commission posted a notice that it would consider the Court's decision at an Open Meeting to be held just one week later, on June 29. 70 Fed. Reg. at 39,406. June 22 was the last day a notice could be posted for a meeting on the 29th, since the law requires at least one week's notice for a Commission open meeting. 5 U.S.C. § 552b(e)(1). The 29th, in turn, was the last day the Commission as then composed could "reconsider" the two invalidated provisions, since the following day would be the Chairman's last with the Commission. (A second Commissioner who also had been a vocal proponent of the provisions was serving after the expiration of his term pending confirmation of a successor; his departure also was imminent. *See* John Godfrey, Judith Burns & Deborah Lagomarsino, *Senate Approves Cox As SEC Chairman*, WALL ST. J., July 29, 2005.)

The Commission openly acknowledged that its haste was dictated by the imminent departure of the Chairman. "Because Chairman Donaldson was scheduled to leave the Commission on June 30, 2005," the majority stated, "we considered it important to act on this important matter no later than the time of our open meeting scheduled for June 29, 2005." 70 Fed. Reg. at 39,391. The Chairman had characterized the independent chair requirement as the "keystone" of the mutual fund reforms of his tenure. CRI, Tr. 4, at 61-62 (No. 04-1300). His successor had already been nominated, and it was believed that he might not support re-adoption of the challenged provisions. Kathleen Pender, *SEC's Fund Rule, Revisited*, SAN FRANCISCO CHRONICLE, June 23, 2005, at C1.

Just as they had not been consulted on the decision to forgo notice and comment, the dissenting Commissioners were excluded—indeed, ousted—from the decision to "reconsider" the rule in just a week's time. The day the notice for the June 29 Open Meeting was posted, one of the two dissenters was the designated "duty officer," with responsibility for scheduling and similar administrative matters. The outgoing Chairman—who was out of the country at the time—peremptorily displaced her as duty officer in order to schedule the hastily-called June 29 Open Meeting. This was an "irregular" act that "evidenced the hurried and prejudged nature of the process," the dissenting Commissioner said. 70 Fed. Reg. at 39,403, 39,406 n.9.

The process that ensued was called "The SEC's Race To Beat The Clock" by one dissenting Commissioner. *Id.* at 39,410 (providing chart with chronology). Just three days after the Court's decision, on June 24, the staff gave the Commissioners a 27-page draft "adopting release" that purported to conduct the analysis demanded by the Court. *Id.* at 39,406. The draft release that was to be voted on at the June 29 Open Meeting was not available to Commissioners until the evening of the 28th, despite the fact that normal Commission practice is for drafts to be distributed two weeks to a month before an open meeting. *Id.* at 39,404, 39,406. Any dissents from the decision were due by mid-day on the 28th, even though Commissioners did not receive the draft release that was to be voted on until after that mid-day deadline had passed. *Id.* at 39,403.

As noted, during part of the time the Commission rushed to re-adopt the provisions, the majority of the Commissioners were out of the country. Also during that week, the Commissioners and their personal staff packed and unpacked their offices as they moved from one building to another. *See id.* at 39,410 (chronology). They did not have access to their computers or offices for more than two days. *Id.* at 39,406 n.8.

As a consequence of the Commission's hurried pace, two Commissioners stated, they had insufficient opportunity to perform the responsibilities of their position. "Numerous revisions were made to each draft" of the agency's analysis

"which I have not been afforded the opportunity to review," one Commissioner objected. "I have no way of determining whether there is any validity for the cost analysis and the context for these costs." *Id.* at 39,404. While criticizing numerous aspects of the Commission's "analysis," the other dissenting Commissioner also complained that ultimately he "cannot, without more information and more time, take a position on the quality of the particular estimates in the majority's cost-benefit analysis." *Id.* at 39,406 n.20.

Both dissenters also had insufficient opportunity to share their views with fellow Commissioners. They were given just hours to prepare their written dissents, they complained, so that "as a practical matter, no advance copy of a dissent was possible" prior to the Commission's decision whether to re-adopt the provisions. *Id.* at 39,404. On the day of the vote, one of the dissenters was able to furnish only an initial, draft dissent, and requested "an opportunity to provide a more formal dissent after I have had an opportunity to review the release as adopted." *Id.* The other dissenting Commissioner stated that although "[w]e were instructed by the Chairman's staff to submit any dissenting statements by noon" of the day before the vote, he "was unable to comply" because "I had not yet seen the final pre-meeting version of the release." *Id.* at 39,406 n.11. "Oddly," the Commissioner added, "neither the majority nor the staff solicited our views on the disclosure alternative before (or after) circulating a draft that concluded that the

disclosure alternative was without merit." *Id.* at 39,407-39,408. Indeed, "[n]ot a single member of the SEC staff contacted me or my staff to solicit my view or any input as to how the SEC should respond to the Court's decision." June 29, 2005 Open Meeting, CRI, Tr. 1, at 46 (No. 05-1240).

Public participation was also barred. In light of the Commission's earlier statements that it had "no reliable basis" to make the "difficult" assessments demanded by the Court, the leading industry association of mutual funds submitted a letter to the Commission in which it offered to gather fresh, pertinent data by surveying its members. 70 Fed. Reg. at 39,407. Funds that had begun complying with the new requirements could provide valuable, current information—not just estimates. *Id.* (citing letter from Elizabeth R. Krentzman, Investment Company Institute, to Commission (June 27, 2005)). The Commission rebuffed this offer and sought to exclude from the record evidence that it even had been made. 70 Fed. Reg. at 39,405. The Commission rejected other requests for a period of public comment.

The Commission's race to re-adopt the challenged provisions provoked widespread opposition. *See* Deborah Solomon, *Donaldson's Finale Draws Uproar: Departing SEC Head Sets Vote for Mutual-Fund Rule On the Day Before His Exit*, WALL ST. J., June 28, 2005; Monica Gagnier, *Donaldson's Parting Shot*, BUSINESSWEEK, July 4, 2005; Riva D. Atlas, *Ex-Officials Urge S.E.C. To Postpone*

A Vote, N.Y. TIMES, June 25, 2005. Former Commissioners, including at least one who had publicly supported the provisions, warned that re-adopting them so hastily and without public comment gave the appearance of attempting to entrench a predetermined outcome without due respect for the Court's decision and the requirements of law. The Commission's actions "threaten . . . its long-term credibility with the public, with Congress, and with the courts," one former Commissioner warned.[2]

E. Re-Adoption Of The Two Challenged Provisions.

At the June 29 Open Meeting, the Commission majority proceeded, as expected, to re-adopt the challenged provisions by a 3-2 vote. Although the Commission majority had barred public comment and scheduled the June 29 meeting on the premise that the rule could be reconsidered "on the basis of the record already before the Commission," 70 Fed. Reg. at 39,404, 39,406, the Commission now repeatedly went beyond the rulemaking record to support fundamental aspects of its analysis:

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[2] Letter from former Commissioner Joseph A. Grundfest to Commission (June 23, 2005). *See also* Letter from former Commissioner Bevis Longstreth to Commission (June 24, 2005); Letter from former Chairman Harvey L. Pitt to Commission (June 23, 2005); Letter from former Commission official Walter B. Stahr to Commission (June 24, 2005). (Letters attached at Exh. B1 to Pet. Mot. for Stay.)

The principal costs the Commission attributed to the independent chair requirement were hiring staff; recruiting independent chairs; paying the increased salary these independent chairs would demand; and paying the fees of outside counsel consulted by independent chairs. For none of these cost items did the Commission rely on record material. Rather, for each, it relied exclusively on material outside the record. For instance:

- The Commission's estimate of the cost of recruiting a board chair and other independent directors was based on a single newspaper article that is not in the rulemaking record. *Id.* at 39,393 & n.32.
- The Commission estimated that an independent chair would hire two staff. The sole basis for this estimate was "our judgment." *Id.* at 39,394.
- The Commission's estimates for the increased compensation of independent directors was based solely on a single article that was not in the rulemaking record. *Id.* at 39,395 & nn.64-65.

The Commission's estimates for the same key cost components of the 75 percent independence requirement were also based solely on extra-record materials. *See id.* at 39,392 & n.28; 39,393 nn.32, 33; 39,393 & nn.36, 43.

The Commission majority placed heavy reliance on newsletters prepared by one Meyrick C. Payne of "Management Practices, Inc.," a rulemaking partisan whose income depends in part on seminars he conducts on compliance with the

challenged provisions. *See* Exh. B4 to Pet. Mot. for Stay. During the week the Commission was scurrying to justify re-adoption of the challenged provisions, Payne circulated an email urging others to voice their support for the independent chair provision and suggesting appropriate media contacts. 70 Fed. Reg. at 39,407 n.28. The Commission justified relying on Payne's newsletters on the ground that they were "publicly available." *Id.* at 39,391. As one dissenting Commissioner noted, however, the Commission did not seek to obtain the data underlying the assertions in Payne's newsletters. "[D]oing so," the Commissioner explained, "would contradict the majority's intention to rely only on the purportedly adequate public record." *Id.* at 39,407. For 6 different cost estimates, the Commission relied on Payne's newsletters.

To estimate how many hours of attorney time independent chairs and independent directors would require to obtain counsel while fulfilling their responsibilities, the Commission also relied on the unidentified "experience" of unidentified Commission personnel. "Based upon our experience," the Commission said, "we estimate that, on average, the new independent directors will use an additional 30 hours annually of independent legal counsel services." *Id.* at 39,393. Similarly, "[b]ased upon our experience, we estimate that, on average, the independent chairman will use independent legal counsel a total of 50 hours a year more under the amendments." *Id.* at 39,394-39,395. The

Commission did not identify what this experience was, nor how it resembled—and differed—from the role independent chairs and directors would be fulfilling in the new legal regime the Commission was creating. The Commission also did not explain why it was preferable to rely on the inscrutable "experience" of unidentified people for this quantitative estimate, rather than soliciting comment from funds that already have independent chairs and 75 percent independent directors.

For the first time, the Commission now acknowledged numerous and significant costs that would result from the two provisions. Each fund board forced to replace its current chair with one who is independent, the Commission estimated, could experience new costs of approximately $400,000. *See id.* at 39,394-39,395 (estimating per board: $314,639 for additional staff (each year), $66,900 for increased compensation (each year), and $15,000 for outside legal counsel (each year)). According to the Commission's "back of the envelope" calculations (*id.* at 39,404) (Glassman, dissenting)), complying with the 75 percent independence requirement could cost the same board as much as an additional $650,000, for a total of nearly $1 million in the first year. *See id.* at 39,391-39,394 (estimating per board: $111,500 for recruiting each of the three new independent directors (every 5 years), $111,500 for compensating each of the independent

directors (each year), $9,000 for outside legal counsel (each year)). Over 5 years, a board could spend approximately $4 million to comply with both provisions.[3]

The costs identified by the Commission are likely to be more onerous for smaller fund "families," in part because these complexes have fewer funds over which to spread the costs. (A single board often oversees multiple funds within one family.)[4] However, despite identifying numerous categories of increased costs with a potentially disproportionate impact on smaller funds, the Commission did not conduct a new "final regulatory flexibility analysis" pursuant to SBREFA, 5 U.S.C. § 604. Further, while purporting to analyze the provisions' effects on efficiency, competition, and capital formation, the Commission did not discuss effects on the efficiency and competitiveness of smaller funds and new entrants in the market, or whether stifling smaller funds and new entrants would reduce competition and capital formation in the industry as a whole. The Commission also did not assess the advisability of these costs in light of the specific mutual fund activities being regulated. For example, the Commission amended Exemptive

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[3] Cost of independent chair provision over 5 years: ($314,639 (staff) + $66,900 (increased compensation) + $15,000 (legal counsel)) x 5 = $1,907,770; Cost of 75 percent independent director provision over 5 years: $334,500 (recruiting) + (($334,500 (compensation) + 9,000 (legal counsel)) x 5) = $2,052,000.

[4] The Commission also estimated that the annual compliance cost for the board of a smaller fund family would be less—approximately $415,000—because director compensation putatively would be lower. *See infra* at 53-54.

Rule 17g-1(j), which permits a fund to maintain a joint insured bond with a management investment company and one or more parties. 17 C.F.R. § 270.17g-1(j). This act is often performed just once a year, and under the existing rule already requires approval by a majority of the board's independent directors. The Commission never explained why this often once-a-year activity threatened losses to investors that warranted incurring costs potentially approaching $1 million. As another example, there was no discussion of Exemptive Rule 17d-1(d)(7), which permits a fund and its affiliates to purchase joint liability insurance. 17 C.F.R. § 270.17d-1(d)(7). For this rule—and the nine others it amended—the Commission never discussed whether misconduct in the activities it regulated could cause investor losses that exceeded the $1 million it could take to comply.[5]

Two Commissioners dissented "in the strongest possible terms" from the Commission's "rush" to re-adopt the two requirements. 70 Fed. Reg. at 39,403. One dissenter characterized the agency's final statement of reasons as "flawed,"

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[5] The Adopting Release included an extraordinary clause "instructing" the Commission's Office of General Counsel "to take such action as it considers appropriate to respond to any [additional legal] proceedings relating to this rulemaking." 70 Fed. Reg. at 39,391 n.14. At the June 29 meeting, the General Counsel refused to answer a Commissioner's question about the effect of this clause, which appears to have been intended to insulate the General Counsel from the direction and control of the current Commission. *See* CRI, Tr. 1, at 31-32 (No. 05-1240).

"disingenuous," "unsupported," and "false." *Id.* at 39,404-39,405. The Commission majority had "'pre-judged'" the issues before them, in "violation of our duty as Commissioners." *Id.* at 39,404. "Rather than attempt in good faith to respond appropriately to the Court's direction," the agency had provided "window-dressing" which "makes a mockery of the process." *Id.* at 39,405. Its action was merely "an attempt to obtain the same result without any serious examination of the costs associated with the rule and the alternatives available." The Commissioner apologized "to the Court, for the agency's failure to respond appropriately to the court's directive to undertake a meaningful review, . . . to those staff members who were uncomfortable having to participate in this exercise, [a]nd . . . to the public . . . ." *Id.*

The other dissenting Commissioner called the agency's process "gravely flawed," "far from the informed deliberation that should have preceded any final action." *Id.* The agency had "haphazardly searche[d] for additional information" to "justify" its action, heedless to the "futile pleas" of the dissenters and public for a "more deliberate response to the Court." *Id.* at 39,407-39,408. "[T]he majority's Remand Release only perpetuates the cavalier attitude with which we have approached our obligations in this rulemaking." *Id.* at 39,406. Although "the Court gave the Commission a chance to redeem itself," he said, "the majority has squandered this opportunity." *Id.* at 39,409.

As noted, both dissenters said that they had been given insufficient time to review and comment on the staff's analysis of the rule's costs and effects on efficiency, competition, and capital formation. They also stated that they had been excluded in significant respects from the Commission's consideration of the appropriate steps in light of the Court's June 21 decision, including, one Commissioner noted, from discussion of the "disclosure" alternative that they had proposed. *Id.* at 39,407-39,408.

The majority, for its part, answered that it "prides itself" on meeting "impossible deadlines." *Id.* at 39,402 (statement of Commissioner Campos). This rulemaking, the now-former Chairman pronounced, was "in the best tradition of the institution." *Id.* at 39,400.

F. The Filing Of This Petition And The Court's Stay.

On July 7, 2005, the Chamber petitioned for review of the Commission's re-adoption of the two requirements. On August 10, the Court granted the Chamber's motion to stay the provisions, stating: "Petitioner has satisfied the stringent standards required for a stay pending court review." The Order directed the parties, among other things, "to address in their briefs whether [the Commission] had the authority to act on the Court's remand prior to issuance of the Court's mandate in No. 04-1300."

SUMMARY OF ARGUMENT

The majority of the Securities and Exchange Commission reacted to this Court's June 21 decision with one consuming objective—re-adoption, before the Chairman departed, of the provisions the Court had judged "deficient." The Commission thereby violated numerous requirements of law: First, it acted prior to issuance of this Court's mandate, in violation of Federal Rule of Appellate Procedure 41 and the dictates of orderly legal process. Second, having insisted for a year to the public, the Congress, and this Court that it had "no reliable basis" to make key assessments of the rule's costs, the Commission turned on a dime within hours of the Court's decision and discovered that it could make the assessments on the basis of the existing record. In fact, however, the "analysis" that followed was made with near-total reliance on cherry-picked, extra-record material. Third, the Commission reacted to the Court's decision with an unalterably closed mind—process would change, but substance would not, as one Commissioner effectively proclaimed—and failed to function as a commission at all: a preordained staff analysis was foisted on Commissioners who protested that they had insufficient time to review and comment on the release and who at critical turns were excluded altogether from the decisionmaking of the lame-duck majority.

Unsurprisingly, the "analysis" produced by this flawed and biased process was arbitrary, capricious, and wholly contrary to the APA and the ICA. On

"remand," as before, the Commission majority gave short shrift to the provisions' costs, relying on arbitrary, unreliable estimates to the exclusion of current, empirical data, and failing to assess the costs in light of the specific activities (ostensibly) being regulated. And, this financial regulatory agency that previously could not await economic studies and whose Chairman proclaimed that no empirical studies "are worth much"—"you can do whatever you want with the numbers"—now purported to evaluate the provisions' effects on efficiency, competition, and capital formation without any consideration of adverse effects on new entrants to the marketplace and smaller funds. The Commission's "consideration" of the disclosure alternative to the independent chair requirement was also flawed, failing to take account of existing protections for mutual fund investors and the actual substance of any of the ten rules being amended.

This Court should grant the petition for review and vacate the Commission's independent chair and 75 percent independence requirements.

ARGUMENT

I. The Commission Erred By Acting On The Court's Decision Prior To Issuance Of The Mandate.

Final agency action in response to a court's decision generally may not occur prior to the issuance of a court's mandate. The Commission majority's disregard of this straightforward principle violated Federal Rule of Appellate

Procedure 41. It also risked—and to a degree, caused—undue confusion before this Court and the Commission and a waste of judicial and agency resources.

Federal Rule of Appellate Procedure 41 provides that a court's mandate generally "must" issue seven calendar days after the time to petition for rehearing expires, although the court "may shorten or extend the time." FED. R. APP. P. 41(b). (Issuance of the mandate will be stayed by a timely-filed petition for rehearing.) The mandate, which is "effective when issued" (FRAP 41(c)), accordingly marks the passing of a matter from the court of appeals back to the district court—or, as in this case, to the agency. This Court has stated:

> The filing of a notice of appeal, including an interlocutory appeal, confers jurisdiction on the court of appeals and divests the district court of control over those aspects of the case involved in the appeal. The district court does not regain jurisdiction over those issues until the court of appeals issues its mandate.

United States v. DeFries, 129 F.3d 1293, 1302 (D.C. Cir. 1997) (emphases added). This principle—that only upon issuance of the mandate does a case "return[] to the tribunal to which the mandate is directed" (*Johnson v. Bechtel Associates Professional Corp.*, 801 F.2d 412, 416 (D.C. Cir. 1986))—is "grounded in solid considerations of efficient judicial administration" and "prevents the waste of judicial resources." *DeFries*, 129 F.3d at 1303.

The principle applies to remands to agencies as well as to district courts. The 1998 Advisory Committee Notes refer without distinction to the effect of an appellate court judgment for a lower court and an agency:

> A court of appeals' judgment is not final until issuance of the mandate; at that time the parties obligations become fixed. . . . [T]he mandate is effective upon issuance and . . . its effectiveness is not delayed until receipt of the trial court or agency, or until the trial court or agency acts upon it.

(Emphases added). Treating the mandate similarly for purposes of reviewing both lower courts and agencies is sensible in light of the comparable role lower courts and agencies play in developing a factual record and narrowing the issues for review. *See* Jacob A. Stein, Glenn A. Mitchell, and Basil J. Mezines, 5 *Administrative Law* § 45.04[1] at 45-69 to 45-73 (2005) (noting similarities between district courts and agencies with respect to appellate review). It also is consistent with the rule that a court will not entertain a petition to review while a petition for reconsideration is before the agency, since "'simultaneous jurisdiction raises the possibility that a court of appeals will expend extensive judicial time on a case only to have agency reconsideration nullify its efforts.'" *United Transportation Union v. ICC*, 871 F.2d 1114, 1117 (D.C. Cir. 1989) (citation omitted).

Although a review of the caselaw discloses instances where agencies have been permitted to act prior to this Court's issuance of the mandate, the agency's

action in those cases was at the specific instruction of the Court. In *Hazardous Waste Treatment Council v. EPA*, 886 F.2d 355, 371 (D.C. Cir. 1989), for instance, the court ordered a remand and stated: "In order to avoid disrupting EPA's regulatory program, we will withhold issuance of our mandate for 90 days, during which the agency may either withdraw the Final Rule or publish an adequate statement of basis and purpose." In *National Coalition Against Misuse of Pesticides v. Thomas*, 809 F.2d 875, 884-85 (D.C. Cir. 1987), the Court remanded with special instructions that, due to the "unusual circumstances" of the case, the matter items addressed in its opinion be addressed within 30 days. In this way, the Court has wielded its mandate to determine when its action attains controlling force so as to marshall litigation in an orderly manner through the legal system.[6]

The Commission's premature action in this case invites the very confusion and waste of resources that a Court's careful marshalling of its mandate is meant to avoid. Had the original panel chosen to rehear and modify its opinion in the case, the Commission's hasty "reconsideration" would have been for naught, and this panel would have wasted time and resources by considering this appeal. By acting prior to the mandate, the Commission also risked wasting its time and taxpayer

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[6] *See also Rodway v. USDA*, 514 F.2d 809, 817-18 (D.C. Cir. 1975); *Simmons v. ICC*, 757 F.2d 296, 300 (D.C. Cir. 1985); *Board of Trade of the City of Chicago v. SEC*, 883 F.2d 525, 536-37 (7th Cir. 1989).

resources "responding" to what it treated as a final decision of the Court but which in fact remained subject to change.[7]

In sum, through control of its mandate, this Court determines when its work is complete and when a lower court or agency may resume control of a matter. By purporting to resume the contraverted rulemaking unilaterally, with no notice to the Court, the Commission transgressed this basic principle and violated Rule 41. Its action is null and void.

II. The Commission's Procedures In Re-Adopting The Provisions Violated The APA And This Court's Instructions In Its Earlier Decision.

A. The Commission Improperly Refused Public Notice And Comment And Relied Heavily On Material Outside The Record.

Notice and comment are of course fundamental to agency rulemaking. Public participation "improves the quality of agency rulemaking by exposing

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[7] None of this Court's recognized exceptions to the mandate rule applies here. First, the Commission did not need to act prior to the issuance of the mandate to maintain the status quo or to perform ministerial functions, such as enforcing a preliminary injunction. *See Deering Milliken, Inc. v. Federal Trade Commission*, 647 F.2d 1124, 1129 (D.C. Cir. 1980). Second, there was no indication that the Court's decision had already "hardened into a certitude." *United States v. Salerno*, 868 F.2d 524, 540 (2d Cir. 1989). Third, the Commission can point to no unusual circumstances that justified acting before the mandate and, even if it could, it still failed to seek permission from the Court. *See, e.g., Independent U.S. Tanker Owners Committee v. Dole*, 809 F.2d 847, 854-55 (D.C. Cir. 1987).

regulations to diverse public comment, ensures fairness to affected parties, and provides a well-developed record that enhances the quality of judicial review." *Sprint v. FCC*, 315 F.3d 369, 373 (D.C. Cir. 2003). Public comment "allow[s] the agency to benefit from the expertise and input of [] parties," *National Tour Brokers Ass'n v. United States*, 591 F.2d 896, 902 (D.C. Cir. 1978), and "educates the agency, thereby helping to ensure informed agency decisionmaking." *Chocolate Mfrs. Ass'n of United States v. Block*, 755 F.2d 1098, 1103 (4th Cir. 1985). Notice and comment also help ensure "that the agency maintains a flexible and open-minded attitude towards its own rules." *National Tour Brokers Ass'n*, 591 F.2d at 902 (emphasis added).[8]

When a rule has been remanded to an agency for reconsideration, the requirements of the APA and other statutes governing agency decisionmaking apply no less than in the original rulemaking. *See Checkosky v. SEC*, 139 F.3d 221, 225-26 (D.C. Cir. 1998) (Commission violated the APA on remand). Accordingly, it is standard for an agency to receive and consider additional public comment on remand. That was the procedure in the two cases cited by the Court in

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[8] Vacating the provisions, rather than remand, is appropriate. This is the second time the Commission has unlawfully adopted the provisions. Further, the composition of the Commission has substantially changed, raising a real question—as the lame-duck majority well knew—whether the current Commission would approve the provisions in any circumstance.

remanding the challenged provisions here. *See Chamber of Commerce*, 412 F.3d at 145 (citing *Fox Television Stations, Inc. v. FCC*, 280 F.3d 1027 (D.C. Cir. 2002), and *Allied-Signal, Inc. v. NRC*, 988 F.2d 146 (D.C. Cir. 1993), *and see* 67 Fed. Reg. 65,751 (Oct. 28, 2002), and 58 Fed. Reg. 50,859 (Sept. 29, 1993) (further public comment on both rules)).

The need for additional comment in this case was plain: In the original rulemaking, in briefing and argument before this Court, and in its report to Congress, the Commission insisted that it had "no reliable basis" in the existing rulemaking record to make the "difficult" cost assessments sought by the Commission, other commenters, and ultimately by this Court. *Supra* at 13-14. The Court rejected these protests and instructed the Commission to "determine as best it can the economic implications of the rule" and to "do what it can to apprise itself . . . of the economic consequences" of the provisions. *Chamber of Commerce*, 412 F.3d at 143-45 (emphases added).

The public stood ready to provide information to the Commission. The leading association of mutual funds, for instance, submitted a letter to the Commission offering to gather data by surveying its members, including funds that had begun complying with the new requirements. 70 Fed. Reg. at 39,407 & n.23. The Commission rejected this and numerous other requests for a period of public comment. *Id.* at 39,405.

At the outset of its one-week rulemaking, the Commission's stated reason for precluding public comment was that its "staff had reviewed the Court's opinion and 'concluded that the Court's concerns can be addressed on the basis of the record already before the Commission.'" *Id.* at 39,403, 39,406 (emphasis added). This statement—made before there was time to review the purportedly "extensive," "vast" record in light of the Court's decision—was an extraordinary reversal of the Commission's oft-repeated avowals to this Court, the public, and Congress. And, in fact, the statement was false, because in its release re-adopting the provisions a week later the Commission repeatedly relied on extra-record evidence at key points to appraise the rule's costs and effects on efficiency, competition, and capital formation. Indeed, as discussed immediately below, the Commission's Adopting Release relied exclusively on extra-record materials at key junctures.

In these circumstances, the Commission's failure to allow notice and comment—which was motivated by a resolve to ram these provisions through before key votes were lost, rather than by due regard for the rulemaking process—was a plain violation of the APA. *See AT&T Wireless Servs., Inc. v. FCC*, 365 F.3d 1095, 1103 (D.C. Cir. 2004) (an agency may reject additional notice and comment only where the "existing record was a 'sufficiently adequate base on which to rest the Commission's decision'") (citation omitted).

The Commission's heavy reliance on extra-record materials was a separate and independent violation of the APA. Of the 6 different cost items under the rule "considered" by the Commission, all are estimated exclusively on the basis of extra-record items. (Comment letters are cited in passing, but none is the basis for the actual quantitative estimate.) As one dissenting Commissioner observed, "In several instances . . . the majority appears to rely only on post-adoption sources for cost estimates." 70 Fed. Reg. at 39,407 n.21 (emphasis in original).

1. Among the most important considerations in appraising the costs of the independent chair provision were how many additional staff would be hired, how much it would cost to hire those staff, and the increased compensation that would be paid independent directors. The Commission relied exclusively on extra-record materials to determine these factors. Specifically, it relied on:

- Its "judgment" to conclude that independent chairs would hire no more than two staff employees. *Id.* at 39,394;
- Its "judgment" to assert that the two staff employees would be a senior business analyst and executive assistant. *Id.*; and
- A single 2004 article (which itself merely relied on other extra-record materials) to estimate the increased compensation of an independent chair. *Id.* at 39,395 & nn.64-65.

2. Among the most important considerations in appraising the costs of the 75 percent independence provision were the number of directors who currently serve on a fund board, their typical length of service, their compensation, and how much it would cost to recruit more directors. Once again, the Commission relied exclusively on extra-record materials to estimate these costs. Specifically, it relied on:

- A 2003 bulletin for its assertion that the majority of boards have eight or fewer directors. *Id.* at 39,392 n.24;
- A 2001 bulletin (leavened by some guesswork) to assert that directors would need to be replaced an average of every five years. *Id.* at 39,393 n.33;
- A 2004 bulletin (itself based on an extra-record survey) to estimate director compensation. *Id.* at 39,392 n.28; and
- A 2004 newspaper article to estimate that the cost of recruiting an independent director would equal the director's first-year salary. *Id.* at 39,393 n.32.

3. The Commission majority relied most frequently on newsletters distributed by one Meyrick Payne. *See id.* at 39,392 nn.24, 28; 39,393 n.33; 39,394 n.48; 39,395 nn.64, 73. Mr. Payne is a vocal advocate of the rule whose income depends in part on providing seminars on compliance with the challenged provisions. *Id.* at 39,407 n.28; Exh. B4 to Pet. Mot. for Stay. The Commission has

suggested that reliance on Payne's newsletters and other extra-record materials was appropriate because the materials are "publicly available." 70 Fed. Reg. at 39,391. But "public availability" is no barometer of reliability—the *National Enquirer* is publicly available—nor is the availability of some "evidence" grounds to bar consideration of public comments.

4. Another key consideration in the Commission's analysis was the legal fees that would be incurred by independent directors. For this, as well, there was no record evidence; instead, the Commission relied on the undisclosed "experience" of unidentified Commission personnel. "Based upon our experience," the Commission intoned, "we estimate that, on average, the new independent directors will use an additional 30 hours annually of independent legal counsel services." Similarly: "Based upon our experience, we estimate that, on average, the independent chairman will use independent legal counsel a total of 50 hours a year more under the amendments." *Id.* at 39,393, 39,394-39,395. There is no rational, reliable basis for invoking the "experience" of unidentified people—none of whom has been shown to have served as a mutual fund director, much less as a director under this new regime—to estimate the reliance of independent chairs and directors on outside counsel. The Commission's recourse to unidentified "experience" was especially inappropriate given that mutual funds and directors stood ready to submit reliable estimates—and actual cost experience—through

regular notice-and-comment procedures. *See Horsehead Res. Dev. Co. v. Browner*, 16 F.3d 1246, 1269 (D.C. Cir. 1994) ("speculation is an inadequate replacement for the agency's duty to undertake an examination of the relevant data and reasoned analysis").

In short, the Commission was right the first time: It lacked the record evidence to conduct the analysis directed by the Court and required by law, and further notice and comment were necessary. Once the Commission determined that it did require additional information, moreover, it could not—as it did—base its rule on cherry-picked "evidence" consisting in large measure of its own privately-held (supposed) experience and newsletters by a single rulemaking partisan.

B. The Commission's Race To Re-Adopt The Challenged Provisions Reflected An Impermissible Rubber-Stamping Of Its Earlier Action, And Improperly Precluded The Deliberative, Consultative Process Required Of Commission Decisionmaking.

The Commission's race to conduct the June 29 Open Meeting before Chairman Donaldson departed reflected an impermissible resolve to ram through a pre-ordained, ill-considered conclusion, rather than to soberly and objectively conduct the analyses directed by the Court and to follow them wherever they might lead, as required by the APA. In proceeding in this manner, the Commission also

failed to engage in the consultative, deliberative process required of Commission decisionmaking. In both respects, the Commission violated the APA.

As noted, an agency acting in response to a court decision has no less a duty to comply with rulemaking procedures and obligations than it had during the initial rulemaking. *Checkosky*, 139 F.3d at 225-26. The agency must be open to a different substantive outcome than the one it proposed, and may not "prematurely and arbitrarily rubber stamp[] the previously approved" provisions of a rule. *CPC Int'l, Inc. v. Train*, 540 F.2d 1329, 1332 (8th Cir. 1976) (emphasis added).

But it is precisely such "rubber stamping" that occurred here. The Commission earlier had insisted that the rulemaking record furnished "no reliable basis" to make "difficult" cost assessments. Then, on the very day the Court's decision issued, and without adequate time to have reviewed the record, it was decided that costs "'can be addressed on the basis of the record already before the Commission.'" 70 Fed. Reg. at 39,403. One Commissioner told a reporter that same day, "'The procedural deficiencies cited [in the Court's decision] should be easy to remedy.'" Robert Schmidt, *SEC Must Reconsider Fund Governance Rule, Court Says*, BLOOMBERG NEWS, June 21, 2005. The (now-former) Commissioner's meaning was clear: The Commission majority planned to rubber stamp its prior decision even before reviewing the assessment being prepared at breakneck pace by the staff; "procedures" would be changed, but without the

openness to a different substantive result that is the sole reason courts remand for reconsideration. This violated the APA and this Court's instructions.

Having resolved to re-adopt the provisions before the Chairman departed, the Commission raced through slap-dash, rigged procedures that precluded the consultative, deliberative process required of commission decisionmaking. The Commission's internal Canon of Ethics acknowledges collective decisionmaking to be a "keystone" of the "commission type of administration." Commission Canon of Ethics, 17 C.F.R. § 200.57. "[E]very effort should be made to promote solidarity of conclusion." *Id.* Indeed, in this very rulemaking the Commission declared, "healthy . . . governance" by collective bodies requires "meaningful dialogue" among decisionmakers. 69 Fed. Reg. at 46,383. The chairman of such a group, the Commission continued, must "encourage open dialogue and healthy skepticism," and must not improperly "dominate," or "control the [] agenda." *Id.* at 46,379, 46,383. This Court provided similar guidance when it judged the initial rule "defective" in part because the majority failed to consider their colleagues' suggestion of the "disclosure" alternative.

And yet, in "responding" to the Court's decision, the Commission altogether failed to satisfy these "keystone" principles of decisionmaking, as attested by the two dissenting Commissioners. These Commissioners were excluded from the Commission's decision to "reconsider" the rule in just a week, from the decision to

forgo notice and comment, and from the decision generally how to proceed in light of the Court's decision. Both said they lacked sufficient time to evaluate the staff's economic analysis, and both were unable to provide their dissenting views to their colleagues prior to the vote. *Supra* at 19-20. In the words of one dissenting Commissioner: "Not a single member of the SEC staff contacted me or my staff to solicit my view or any input as to how the SEC should respond to the Court's decision." CRI, Tr. 1, at 46 (No. 05-1240).[9]

Congress did not establish a five-member Commission so that three of them could jam into place pre-ordained decisions without meaningful consultation with, or review by, their other colleagues. But that is precisely how the now-former majority proceeded here. In doing so, it violated the APA. The provisions should be remanded and vacated.

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[9] A former Chairman who had supported the initial rule said of the Commission's conduct on remand:

> If the SEC were evaluating this behavior by the Chairman and two directors of a publicly-held corporation intent on trampling the rule of law and the rights of the minority as lame ducks and expiring terms—its Enforcement Staff would be all over the perpetrators of such conduct, as it should be, and the agency would be expressing appropriate pieties about transparency, governance, and protecting the rights of public investors.

Letter from former Chairman Harvey L. Pitt at 3-4.

III. The Commission's Cost "Analysis" Relied Upon Inadequate And Unreliable Data And Improperly Failed To Consider The Provisions' Costs In Light Of The Specific Rules Being Amended And Conduct Being Regulated.

In purporting to analyze the rule's costs in a week's time on the basis of what it earlier had characterized as an inadequate record, the Commission relied on conclusory findings, stale data, and capricious guesstimates. In this manner too, the agency violated the APA and the ICA.

1. To estimate costs, the Commission relied heavily on "newsletters" that are conclusory in nature and provide no description of the underlying methodology, nor any data that can be subjected to independent testing and verification. *See* 70 Fed. Reg. at 39,392 nn.24, 28; 39,393 n.33; 39,394 n.48; 39,395 n.73. To estimate directors' compensation, for example, the Commission relied on a two-page summary of a 2003-04 survey—but, as a dissenting Commissioner noted, "the Commission staff did not obtain a copy of the underlying nonpublic survey, apparently because doing so would contradict the majority's intention to rely only on the purportedly adequate public record." *Id.* at 39,407. The Commission abdicated its obligations by acting on this data—and the other newsletters—without any examination of the underlying data and methodology. *See Public Citizen Health Research Group v. Tyson,* 796 F.2d 1479, 1487 (D.C. Cir. 1986) (upholding agency reliance on studies where the agency "did not blindly rely on these studies" but "recognized and accounted for the

methodological weaknesses" inherent in them); *St. James Hosp. v. Heckler*, 760 F.2d 1460, 1467 & n.5 (7th Cir. 1985) ("it is an agency's duty to establish the statistical validity of the evidence before it prior to reaching conclusions based on that evidence"); *Texas Office of Public Utility Counsel v. FCC*, 265 F.3d 313, 328 (5th Cir. 2001) ("An agency abdicates its role as a rational decision-maker if it . . . cedes near-total deference to private parties' estimates").

Because it failed to obtain the data underlying the two-page newsletter that was its sole basis for estimating independent director compensation, the Commission was forced to guess as to the data's content and implications: "We have assumed . . . that the compensation reflects annual compensation of independent directors" only, the Commission stated. 70 Fed. Reg. at 39,392. But that is not necessarily true, and if the salaries of management directors were included in the study that would have depressed the overall salary data and potentially seriously underestimated this important cost of the rule.

2. To estimate the tenure of mutual fund directors—and accordingly the frequency with which search costs would be incurred—the Commission relied on data regarding directors that is at least five years old. *Id.* at 39,393 n.33. That data does not account for significant changes in the interim, including the Commission's 2001 mutual fund "governance" rules, enactment of the sweeping requirements of the Sarbanes-Oxley Act, and the Commission's expressed intent to

increase enforcement actions against independent directors. All of these developments make it likely that directors will serve substantially shorter terms than prior to 2000, causing more frequent searching for new directors and, in some cases, special shareholder elections. *See* Amanda Gerut, *Small Fund Boards Struggle to Comply with 75% Provision*, BOARDIQ, July 12, 2005 (noting that directors' willingness to serve has been affected by the developments identified above). *See also Directors' Pay Rising, Survey Says*, CHICAGO TRIBUNE, Aug. 30, 2005, at C3. When the Commission's data was gathered in 2000, moreover, the majority of mutual fund directors could be employed by the adviser; under the new rule, 75 percent of directors will, by design, have no such connection to the fund. It is reasonable to expect that their attachment to the fund, while more tenuous, will also be shorter.

In the Adopting Release, the Commission offered no discussion of the effects of these changes on the length of director service. Rather, with no explanation whatsoever, the majority postulated that directors would be replaced every five years on average, rather than every ten years as indicated in the 2000 survey results. Even supposing this 5-year guesstimate was—as the Commission staff suggested for the first time before this Court (Resp. Opp. Mot. for Stay at 18)—its attempt to account for the significant recent changes in directors' role and duties, the Commission supplied no reasoned explanation for selecting the 5-year

figure. This element of its analysis is, accordingly, ad hoc, arbitrary, and unreliable.[10]

3. The Commission's only support for the proposition that "the costs to recruit an independent director may equal the independent director's first year salary" was a newspaper article. 70 Fed. Reg. 39,393 n.32. Exclusive reliance on a newspaper article would be suspect in any case, and is especially so here: The article appears to discuss recruiting practices in the United Kingdom, not the United States, and it addresses the recruiting of corporate directors generally, not mutual fund directors. Further, the article's estimate is based solely on the recruiter's fee and excludes other associated expenses. *See* Decl. of Geoffrey H. Bobroff at 3, Exh. B3 to Pet. Mot. for Stay (noting costs related to meetings of the nominating committee and travel to interview candidates).

4. The Commission acknowledged that mutual fund boards would make increased use of outside legal counsel, whose fees it estimated to be $300 per hour. That figure—dubious on its face—was taken from a rulemaking almost two years

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[10] The dramatic changes in corporate governance in recent years are an additional reason the Commission's reliance on 2003-04 data to estimate independent director compensation was erroneous. 70 Fed. Reg. at 39,392 n.28; *supra* at 46-47. Because there will be both increased demand for independent directors and a more limited labor pool, higher salaries must be expected. *See* Amanda Gerut, *Small Fund Boards Struggle to Comply with 75% Provision*, BOARDIQ, July 12, 2005.

old, was not based on rates for counsel specializing in mutual funds, and fails to reliably account for rate increases in the interim. 70 Fed. Reg. at 39,393; *see also, e.g.*, Danilo DiPietro, *Picking Up Steam*, AM. LAWYER (Dec. 1, 2004) (noting a 6.2 percent increase in billing rates in the first half of 2004 alone). The Commission has since claimed that it "added to its cost estimates [an across the board] cushion of twenty percent for the very purpose of taking into account factors such as rate increases." Resp. Opp. Mot. for Stay at 18-19. But the only explanation for the "cushion" given in the rulemaking was that directors' compensation increased by 13 percent in 2004 (70 Fed. Reg. at 39,393 & n.43)—in short, it was a fudge factor necessitated by unjustifiably hurried rulemaking, rather than a studied consideration of the rule's effects.

5. To estimate how many hours of lawyers' services would be demanded by independent directors and chairs, the Commission majority cited only the undisclosed "experience" of unidentified Commission personnel. *Id.* at 39,393, 39,397. The Commission neither identified what that experience was, nor explained why it was a better source of information than obtaining comment from funds that already have independent chairs and 75 percent independent directors.[11]

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[11] As noted, the Commission's estimate of the number of staff to be hired by independent chairs was also pulled from thin air. Based on its "judgment," it

[Footnote continued on next page]

6. Finally, the Commission failed to consider the provisions' costs relative to the specific mutual fund activities being regulated.

As shown above, the Commission acknowledged numerous categories of costs for the two new provisions, costs the Commission conceded could approximate $1 million per board. It should go without saying that it was the Commission's responsibility to consider the advisability of such a sizable administrative burden in light of the activities being regulated and the potential misconduct to be averted. It did no such thing.

Many of the activities regulated by the exemptive rules are discrete, non-controversial acts that are performed infrequently and have not been the subject of significant enforcement activity. For instance, Exemptive Rule 17g-1(j) permits a fund to maintain a joint insured bond with a management investment company and one or more parties. 17 C.F.R. § 270.17g-1(j). Exemptive Rule 17d-1(d)(7) permits a fund and its affiliates to purchase joint liability insurance. 17 C.F.R. § 270.17d-1(d)(7). Both activities often occur only once a year; existing regulations, moreover, require that they be approved by a majority of the independent directors. What is the likelihood, under the existing rules, that a

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said, "independent chairmen will be expected to hire no more than two staff employees"—one business analyst and one executive assistant. *Id.* at 39,394.

majority of independent directors will permit an improvident joint insured bond or joint liability insurance? If this occurred, what would the cost be to shareholders? How does that cost—discounted by risk—compare to the $1 million in administrative costs potentially imposed by the two new requirements? Is it in fact possible that, for these and other exemptive rules, the Commission's "solution" will cost more in dollars than the (supposed) exemptive rule problem being addressed? These are obvious, fundamental questions that went wholly unanswered during this arbitrary, capricious, and unlawful agency rulemaking.

IV. The Commission's Superficial "Consideration" Of The Provisions' Effects On Efficiency, Competition, And Capital Formation Violated The ICA, APA, Small Business Regulatory Enforcement Fairness Act, And This Court's Instruction In Its Earlier Decision.

The "exemptive" authority on which the Commission premised its rule required the agency to consider the provisions' effects on "efficiency, competition, and capital formation." 15 U.S.C. § 80a-2(c). As during its initial rulemaking, the Commission inadequately considered these factors. Because the agency "fail[ed] to comply with [a] specific statutory requirement," the rule should be vacated. *Public Citizen v. Federal Motor Carrier Safety Admin.*, 374 F.3d 1209, 1216 (D.C. Cir. 2004).

As noted, the Commission attributed as much as $1 million in new costs to the two new provisions. Yet, with virtually no analysis whatever, the Commission

blithely pronounced that the effects on mutual fund efficiency, competition, and capital formation would be "minimal." 70 Fed. Reg. at 39,395.[12] The agency's failure to consider the provisions' effects on smaller funds—and the ramifications for competition and capital formation in the industry as a whole—was a particular and serious shortcoming.

The Commission acknowledged that the cost burden for smaller funds was potentially greater. *See, e.g., id.* at 39,393, 39,395 (small fund families are able to spread board costs over fewer funds). During the original rulemaking, moreover, it was warned of the severe consequences this could have: "We fear the regulatory burden will be much more intense and time consuming for smaller firms . . . .," one commenter stated. "Industry consolidation and a reduction in investor choice are likely to be fall-outs of this destabilizing cost-structure increase across the industry." CRI, Letter 127 (No. 04-1300) (emphasis added). *See also* Amanda Gerut, *Small Fund Boards Struggle to Comply with 75% Provision*, BOARDIQ, July 12, 2005; *see also* CRI, Letter 168 (warning of these effects).

The Commission ignored this comment, just as it ignored three separate and related respects in which the provisions would adversely affect the efficiency of

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[12] The Commission never even analyzed how the provisions' costs "relate as a percentage of fund's [current] total expenses." *Id.* at 39,404 (Glassman, dissenting).

smaller funds and, accordingly, new entrants, capital formation, and competition among funds as a whole:

1. The competitive consequences of the provisions' disproportionate burden on smaller funds are likely to be substantial. Changes in the financial performance of mutual funds are commonly expressed in terms of "basis points," with each point equaling one hundredth of a percent, or 0.0001. (One hundred basis points thus equal one percent). Generally, a change in yield of less than one percent can be significant for investment decisions. A profile of mutual fund families by the Investment Company Institute shows that as of June 2005, 47 fund complexes (out of a total of 360) had assets under management of less than $50 million. (The list is available to members at http://members.ici.org/.) If each of these 47 funds is assumed to have a single board of directors and the Commission's estimated incremental costs per board are applied, the average fund in this group would experience increased expenses of at least 83 basis points per year—and a corresponding decrease in performance. (This estimate assumes the hiring of three new board members, which the Commission estimates would cost approximately $415,000 annually, or .83% of $50 million.)[13] The effect would be

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[13] According to Commission estimates, the addition of three independent directors would cost smaller fund families approximately $65,000 in additional annual

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even more severe for the 14 fund complexes with assets under management of less than $10 million—for these, the change in costs would be at least 4 percentage points, or 400 basis points per year. To put this in perspective, the average total expense ratio for equity mutual funds is approximately 1.1 percent when weighted by assets. Thus, for the 47 funds with less than $50 million in assets, these expenses would represent a more than 75 percent increase in the total expense ratio (calculated by dividing total expenses by total assets under management). *See* http://www.vanguard.com/bogle_site/sp20050524. htm, at n.2 (last visited Sept. 8, 2005).

Effects of this magnitude would be expected to have potentially devastating consequences for smaller funds. And indeed, a recent study reports that in 2005, more than 250 smaller mutual funds had liquidated by September, compared with 69 smaller fund liquidations for all of 2004. The study attributes these liquidations not to past performance difficulties or enforcement actions, but to the provisions under challenge here. The costs "of maintaining an independent board, including

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expenses (including legal and recruiting costs) per board. Further, an independent chair of a small fund family (7 to 19 funds) would need legal, analyst, and administrative services which cost approximately $350,000 per year according to Commission estimates, for total incremental annual costs of $415,000 per board. Note that this is lower than the $1 million cited above, which would apply to larger fund families.

an independent chair person" have been too much for smaller funds. Herbert Lash, *Over 250 Mutual Funds Liquidate, Cite Rule Costs*, REUTERS, Sept. 14, 2005. (Notably, this was the provisions' effect before the January 2006 compliance deadline had even arrived.)

The Commission's failure to consider these matters violated not only the APA and ICA, but also SBREFA (and the Regulatory Flexibility Act), which required the Commission to publish a "final regulatory flexibility analysis" describing, among other things, the provisions' costs for small funds and steps the Commission took to minimize them. 5 U.S.C. § 604. The Commission purported to provide such an analysis in its original rulemaking (69 Fed. Reg. at 46,387), but obviously that had to be revisited in light of the Court's decision and the Commission's identification of numerous costs that previously were overlooked. The Commission's failure to do so was clear error.

2. The provisions' disproportionate effect on smaller funds will translate to higher costs for new entrants to the mutual fund industry, since new fund complexes typically start out with smaller funds. This, in turn, will serve as a barrier to entry and will reduce capital formation, competition, and innovation.

Analysis of market entry is, of course, fundamental to determining the competitive consequences of changes in market conditions—as reflected, among other things, in the government's guidelines for analyzing mergers. *See* Horizontal

Merger Guidelines, pt. 1.0, U.S. Dep't of Justice and Federal Trade Comm'n, htt://www.usdoj.gov/atr/public/guidelines/horiz_book/10.html (last visited Sept. 12, 2005). Once again, the Commission was warned of these potential adverse consequences: "[I]f this proposal is adopted," a commenter stated, "the mutual fund industry will suffer from a decrease in entrepreneurs willing to put their time, effort and money behind innovation of new worthwhile fund products." CRI, Letter 173 (No. 04-1300). And yet the Commission ignored this comment in its "analysis" of efficiency, competition, and capital formation, and failed to discuss—at all—the effect the rule might have on new entrants to the mutual fund industry. This, also, was clear error.[14]

3. Finally, given the provisions' consequences for small funds and new entrants, it was incumbent on the Commission to assess the implications for competition in the industry as a whole. Once again it failed to do so, ignoring three recent studies that establish grounds for concern. First is a study showing that funds with fees that are significantly below average tend to have larger market shares, whereas funds with higher-than-average fees—which typically are smaller

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[14] The Commission also failed to consider the provisions' effects on investor returns and, in turn, what impact that would have on investment decisions, including the decision to seek alternatives to mutual funds. These factors plainly should have been considered when analyzing effects on capital formation.

funds—tend to have lower market shares.[15] In addition, the study found, when funds with higher-than-average fees increase fees further, their likelihood of asset growth is reduced. This is more evidence—never sought or considered by the Commission—that the rule's incremental board costs are likely to disproportionately affect smaller funds and smaller fund families, causing the funds to stagnate, lose assets, or merge out of existence.

Second, a study comparing the mutual fund industries in the United States and Europe tied the relative efficiency of the U.S. market to its relatively lower level of concentration: In the U.S. market, smaller funds still account for a significant portion of assets under management, whereas the less efficient European markets—despite a large total number of small funds—are dominated by a relative handful of larger funds.[16] As shown above, the new provisions will erode this strength of the U.S. market.

Third, another recent study ignored by the Commission examined relative fund "persistence" in UK markets, that is, the duration of above-average returns for

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[15] Ajay Khorana & Henri Servaes, *Conflicts of Interest and Competition in the Mutual Fund Industry* (July 2004) (unpublished), http://papers.ssrn.com /sol3/papers.cfm?abstract_id=240596 (last visited Sept. 8, 2005).

[16] Rogér Otten & Mark Schweitzer, *A Comparison Between the European and the U.S. Mutual Fund Industry* (Dec. 14, 1998) (unpublished), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=164108 (last visited Sept. 8, 2005).

specific funds, which the study identified as a potential indicator of a less competitive market.[17] This "persistence" is positively correlated with concentration among UK mutual funds, the study found, further suggesting the competitive value of a vibrant market in smaller mutual funds.

Together, these studies suggest that small funds are vital to mutual fund competition, and that the provisions' potentially staggering effects on small funds bear serious implications for the industry—and, more importantly, for the investing public. Effects of this nature are not mere academic minutiae, to be given a back seat to outgoing Commissioners' Solomonic (and Delphic) "judgments" about how many hours directors will consult counsel. Instead, for the nation's principal regulator of financial markets, such factors should be central considerations in discharging a statutory mandate to consider the consequences of the government's action for efficiency, competition, and capital formation. In wholly failing to consider such studies and the factors they address, the Commission violated the ICA and APA.

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[17] Aneel Keswani & David Stolin, *Mutual Fund Performance Persistence and Competition: A Cross-Sector Analysis* (February 2005) (unpublished), http://papers.ssrn.com/sol3/ papers.cfm?abstract_id=666742 (last visited Sept. 8, 2005).

V. The Commission's Failure To Adequately Consider The Disclosure Alternative To The Independent Chair Requirement Violated This Court's Instruction In Its Earlier Decision And The APA.

The Commission's re-adoption of the independent chair provision was arbitrary and capricious for the additional reason that the Commission failed to adequately consider the "disclosure" alternative.

In its June 2005 decision, this Court held that the Commission's initial rulemaking violated the APA by failing to address a significant "proposal[] endorsed by the two dissenting Commissioners, that each fund be required prominently to disclose whether it has an inside or an independent chairman and thereby allow investors to make an informed choice." *Chamber of Commerce*, 412 F.3d at 144. This disclosure alternative was neither "frivolous nor out of bounds," the Court said, in directing the Commission to "bring[] its expertise and its best judgment to bear" in examining the alternative. *Id.* at 145.

As an initial matter, the Commission majority improperly excluded the dissenting Commissioners from its "reconsideration" of the disclosure alternative. These were the members who first suggested a disclosure requirement, yet "[o]ddly[,] neither the majority nor the staff solicited [their] views on the disclosure alternative before (or after) circulating a draft that concluded that the disclosure alternative was without merit." 70 Fed. Reg. at 39,407-39,408 (Atkins, dissenting). For this reason alone, the Commission's rejection of the alternative

"cannot be said to embody the expertise and best judgment of the Commission." *Id.* at 39,407-39,408.

The Commission's explanation of its action is flawed on the merits as well. First, the Commission asserted that disclosure would be insufficient to address the conflicts governed by the exemptive rules, but failed actually to analyze disclosure in light of those rules. For example, the Commission failed to analyze whether the disclosure alternative would provide adequate protection for joint insured bonds, which already require action by an independent director majority and are often voted on only once a year. The Commission placed great weight on the "dialogue" an independent chair would promote, but does the purchase of a joint bond once a year occasion such rich discussion that it warrant establishing a new, perennial bureaucracy for the other 364 days on the calendar?[18] Second, the Commission failed to consider the effectiveness of the alternative in combination with other mutual fund changes, including the 75 percent independence requirement. The Commission had not, it claimed, "adopt[ed] the independent chairman provision in

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[18] In truth, the Commission did not amend this exemptive rule, or any other, out of an intent to reform conduct under the rule itself. The former Chairman would not have proclaimed this rulemaking the "centerpiece" of his mutual fund reform because it ushered new public confidence in funds' purchase of bonds and the like. 70 Fed. Reg. at 39,391. Instead, the provisions were adopted for their supposed effects on activities outside the exemptive rules. *See, e.g.*, 69 Fed. Reg. at 46,388-46,389.

isolation," but rather "as part of a larger package of regulatory reforms." 70 Fed. Reg. at 39,397. Yet it failed to appraise the disclosure requirement as part of that same, larger package. Finally, the Commission gave no consideration at all the public's interest in having management-chaired funds, an interest that the disclosure provision preserved but that the final rule effectively precludes.

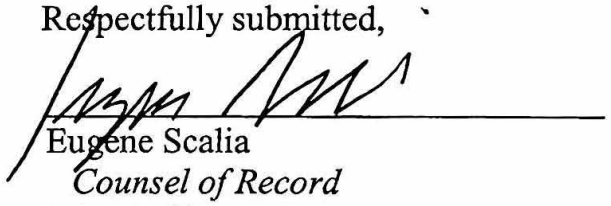
In sum, the Commission failed to assess the disclosure alternative in conjunction with all relevant factors, factors that together weigh strongly in its favor and that surely would have been raised by the dissenters had they been consulted. By failing to address whether the independent chair provision—including its estimated $500,000 cost—was superior to the disclosure alternative against this larger context, the Commission again violated the APA as well as this Court's direction in its earlier decision.

CONCLUSION

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

Dated: September 21, 2005

Respectfully submitted,



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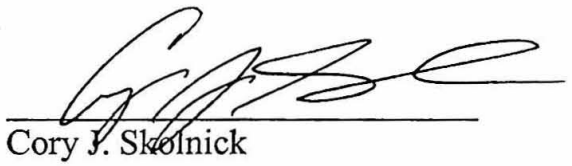

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