[INITIAL BRIEF]

ORAL ARGUMENT SCHEDULED FOR APRIL 15, 2005

No. 04-1300

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.

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

BRIEF OF THE SECURITIES AND EXCHANGE COMMISSION, RESPONDENT

GIOVANNI P. PREZIOSO
General Counsel

MEYER EISENBERG
Deputy General Counsel

JACOB H. STILLMAN
Solicitor

JOHN W. AVERY
Special Counsel

Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549-0606
(202) 942-0816 (Avery)

CERTIFICATE AS TO PARTIES, RULINGS, AND RELATED CASES

A. PARTIES

All parties, intervenors, and amici appearing before the Commission and in this Court are listed in the brief for the petitioner.

B. RULING UNDER REVIEW

The petitioner seeks review of an order of the Securities and Exchange Commission, Investment Company Act Release No. 26520 (July 27, 2004) [69 FR 46378 (Aug. 2, 2004)]. Petitioner's Addendum, A-1.

C. RELATED CASES

The case on review has not previously been before this Court or any other court. The Chamber of Commerce sued the Commission on September 2, 2004, in United States District Court for the District of Columbia, No. 1:04-cv-01522-RMC, seeking to overturn certain provisions of the rule amendments adopted in the Commission's order for which the petitioner seeks this Court's review. The district court action has been stayed pending action by this Court. Counsel is not aware of any other related cases currently pending in this Court or in any other court.

TABLE OF CONTENTS

Page

TABLE OF AUTHORITIES iv

INTRODUCTION 1

COUNTERSTATEMENT OF JURISDICTION 4

A. Petitioner Has Not Demonstrated Its Standing to Bring This Petition. 4

B. Aside From Standing, This Court Has Jurisdiction to Consider the Petition. 9

COUNTERSTATEMENT OF THE ISSUES 10

COUNTERSTATEMENT OF THE CASE 11

STANDARD OF REVIEW 12

SUMMARY OF ARGUMENT 13

ARGUMENT 17

I. Consistent With Congress' Reliance on Oversight by Independent Directors, the Commission Has Long Relied Upon Independent Directors to Monitor Conflicts of Interest Inherent in Transactions Allowed Under the Exemptive Rules. 17

A. Managing Conflicts of Interest – the Role of Independent Directors. 18

1. The Unique Structure of Mutual Funds 18

TABLE OF CONTENTS (cont'd) **Page**

2. Statutory Curbs on Conflicts of Interest – the Role of Independent Directors. 19

3. The Exemptive Rules Have Long Relied on Independent Director Oversight. 21

B. Rule Amendments to Enhance the Effectiveness of Independent Directors. 24

1. 2001 Amendments 24

2. 2004 Amendments 27

II. The Rule Amendments Are Well Within the Commission's Statutory Authority. 32

A. The Commission Has Express Authority to Adopt Rules Providing Conditional Exemptions That Are Consistent With Statutory Purposes; the Conditions Challenged By Petitioner Are Consistent With the Purposes of the Investment Company Act. 32

B. Contrary to Petitioner's Contentions, Conditioning the Exemptive Rules on Independent Director Oversight Is Consistent With the Structure of the Act. . . . 36

C. Petitioner's Reliance on Case Law Is Misplaced. 41

III. The Commission Articulated a Satisfactory Explanation for the Rule Amendments; The Rational Connection Between the Facts Found and the Choices Made Cannot Be Doubted. . . . 45

A. The Commission Fully Explained Its Rationale for Amending the Exemptive Rules. 46

TABLE OF CONTENTS (cont'd) **Page**

B. The Commission Properly Considered Whether the Rule Amendments Would Promote Efficiency, Competition, and Capital Formation. 51

C. The Commission Properly Considered Both the Costs of the Rule Amendments, and the Alternatives Proposed by the Commenters. 58

CONCLUSION 62

CERTIFICATE OF SERVICE 63

CERTIFICATE OF COMPLIANCE 64

STATUTORY ADDENDUM A1

TABLE OF AUTHORITIES

CASES **Page**

AT&T Corp. v. FCC, 236 F.3d 729 (D.C. Cir. 2001) 12

American Bankers Association v. SEC, 804 F.2d 739 (D.C. Cir. 1986) 44

Bowman Transp., Inc. v. Arkansas-Best Freight System, Inc., 419 U.S. 281(1974) 45

Brown v. Bullock, 194 F. Supp. 207 (S.D.N.Y. 1961), aff'd, 294 F.2d 415 (2d Cir. 1961) 17, 34

Brown v. Bullock, 294 F.2d 415 (2d Cir. 1961) 34

*Burks v. Lasker, 441 U.S. 471 (1979) . . . . 21, 37, 38 passim

Burlington Truck Lines, Inc. v. United States, 371 U.S. 156 (1962) 45

Business Roundtable v. SEC, 905 F.2d 406 (D.C. Cir. 1990) 36, 41, 42

CFTC v. Schor, 478 U.S. 833 (1986) 36

Chamber of Commerce of the United States v. Department of Labor, 174 F.3d 206 (D.C. Cir. 1999) 44

Chevron, U.S.A., Inc. v. Natural Resources Defense Council, Inc., 467 U.S. 837 (1984) 13, 35

Citizens to Preserve Overton Park v. Volpe, 401 U.S. 402 (1971) 45

---

* Asterisks denote authorities chiefly relied upon.

TABLE OF AUTHORITIES (Cont'd)

Cases (Cont'd) **Page**

DEK Energy Co. v. FERC, 248 F.3d 1192 (D.C. Cir. 2001) 7, 8

FCC v. National Citizens Committee for Broadcasting,
436 U.S. 775 (1978) 50, 53

FPC v. Transcontinental Gas Pipe Line Corp.,
365 U.S. 1, 29 (1961) 50, 53

Florida Power & Light Co. v. Lorion, 470 U.S. 729 (1985) 10

Graham v. SEC, 222 F.3d 994 (D.C. Cir. 2000) 13

Investment Co. Institute v. Board of Governors, Federal Reserve Sys.,
551 F.2d 1270 (D.C. Cir. 1977) 10

Levitt v. Johnson, 334 F.2d 815 (1st Cir. 1964) 34

*Lujan v. Defenders of Wildlife, 504 U.S. 555 (1992) 4

Melcher v. FCC, 134 F.3d 1143 (D.C. Cir. 1998) 50, 53, 54

Mississippi Power & Light Co. v. Mississippi ex rel. Moore,
487 U.S. 354 (1988) 36

Mitchell v. Christopher, 996 F.2d 375 (D.C. Cir. 1993) 36

*Motor Vehicle Manufacturers Association v. State Farm
Mutual Automobile Insurance Co., 463 U.S. 29 (1983) 33, 45, 48
passim

*Mourning v. Family Publications Service, Inc., 411 U.S. 356 (1973) 33

NLRB v. City Disposal Systems Inc., 465 U.S. 822 (1984) 36

TABLE OF AUTHORITIES (Cont'd)

Cases (Cont'd) **Page**

Permian Basin Area Rate Cases, 390 U.S. 747 (1968) 48

Schoenbohm v. FCC, 204 F.3d 243 (D.C. Cir. 2000) 13

*Sierra Club v. EPA, 292 F.3d 895 (D.C. Cir. 2002) 5

Tannenbaum v. Zeller, 552 F.2d 402 (2d Cir. 1979) 21

Teicher v. SEC, 177 F.3d 1016 (D.C. Cir. 1999) 43

Telecommunications Research & Action Center v. FCC,
750 F.2d 70 (D.C. Cir. 1984) 10

Thorne v. Housing Auth. of City of Durham, 393 U.S. 268 (1969) 33

Touche Ross & Co. v. SEC, 609 F.2d 570 (2d Cir. 1979) 33

United States v. Mead Corp., 533 U.S. 218 (2001) 13

University Medical Center of Southern Nevada v. Shalala,
173 F.3d 438 (D.C. Cir. 1999) 8

Valley Forge Christian College v. Americans United for
Separation of Church and State, Inc., 454 U.S. 464 (1982) 5

STATUTES AND RULES

Investment Company Act of 1940, 15 U.S.C. 80a-1, et seq.

Section 1, 15 U.S.C. 80a-1 1
Section 1(a), 15 U.S.C. 80a-1(a) 33
Section 1(a)(2), 15 U.S.C. 80a-1(a)(2) 33

Statutes and Rules (Cont'd) **Page**

Section 1(a)(4), 15 U.S.C. 80a-1(a)(4) 33
Section 1(a)(5), 15 U.S.C. 80a-1(a)(5) 33
Section 1(b), 15 U.S.C. 80a-1(b) 35
Section 1(b)(2), 15 U.S.C. 80a-1(b)(2) 34
Section 2(a)(19), 15 U.S.C. 80a-2(a)(19) 11
Section 2(c), 15 U.S.C. 80a-2(c) 51, 53
Section 3(f), 15 U.S.C. 80a-3(f) 43
Section 6(c), 15 U.S.C. 80a-6(c) . . . . 4, 11, 21 passim
Section 10(a), 15 U.S.C. 80a-10(a) 20, 39
Section 10(b), 15 U.S.C. 80a-10(b) 40
Section 10(b)(2), 15 U.S.C. 80a-10(b)(2) 20
Section 10(f), 15 U.S.C. 80a-10(f) 11, 32
Section 12(b), 15 U.S.C. 80a-12(b) 11, 32
Section 15(a), 15 U.S.C. 80a-15(a) 20
Section 15(b), 15 U.S.C. 80a-15(b) 20
Section 15(f)(1), 15 U.S.C. 80a-15(f)(1) 20
Section 15(f)(1)(A), 15 U.S.C. 80a-15(f)(1)(A) 20
Section 16(b), 15 U.S.C. 80a-16(b), ... 20
Section 17(d), 15 U.S.C. 80a-17(d) 11
Section 17(g), 15 U.S.C. 80a-17(g) 11, 32
Section 23(c), 15 U.S.C. 80a-23(c) 11, 32
Section 32(a), 15 U.S.C. 80a-31(a) 20
Section 38(a), 15 U.S.C. 80a-37(a) 33
Section 43(a), 15 U.S.C. 80a-42(a) 9, 12, 50

Section 706 of the Administrative Procedure Act, 5 U.S.C. 706 12

Consolidated Appropriations Act, 2005, Pub. L. No. 108-447,
118 Stat. 2809 (2004) 50

TABLE OF AUTHORITIES (Cont'd)

Statutes and Rules (Cont'd) **Page**

Rules under the Investment Company Act of 1940, 17 C.F.R. 270.01, et seq.

Rule 12b-1, 17 C.F.R. 270.12b-1 23
Rule 15a-4(b)(2), 17 C.F.R. 270.15a-4(b)(2) 47
Rule 17a-7 17 C.F.R. 270.17a-7 23
Rule 17a-8, 17 C.F.R. 270.17a-8 23
Rule 17g-1(j), 17 C.F.R. 270.17g-1(j) 47

Releases under the Investment Company Act of 1940

Investment Company Governance, Investment Company Act Release No. 26520 (July 27, 2004) [69 F.R. 46378 (Aug. 2, 2004)] ("2004 Adopting Release") . . . . 2, 3, 6, passim

Investment Company Governance, Investment Company Act Release No. 26323 (Jan. 15, 2004) [69 F.R. 3472 (Jan. 23, 2004)] ("2004 Proposing Release") . . . . 29, 48, 49 passim

Role of Independent Directors of Investment Companies, Investment Company Act Release No. 24816 (Jan. 2, 2001) [66 F.R. 3734 (Jan. 16, 2001)] ("2001 Adopting Release") 24, 27

Role of Independent Directors of Investment Companies, Investment Company Act Release No. 24082 (Oct. 14, 1999) [64 F.R. 59826 (Nov. 3, 1999)] ("2001 Proposing Release") . . . . 18, 25, 26 passim

Releases under the Investment Company Act of 1940 (Cont'd) **Page**

Interpretive Matters Concerning Independent Directors of Investment Companies, Investment Company Act Release No. 24083 (Oct. 14, 1999) [64 F.R. 59877(Nov. 3, 1999)] ("Interpretive Release") 24

Investment Company Act Release No. 11676, 1981 SEC LEXIS 1873 (Mar. 10, 1981) 23

Investment Company Act Release No. 11414, 1980 SEC LEXIS 444 (Oct. 28, 1980) 23

Investment Company Act Release No. 10886, 1979 SEC LEXIS 599 (Oct. 2, 1979). 23

MISCELLANEOUS

H.R. Rep. No. 2639, 76th Cong., 3d Sess. 10 (1940) 17

Investment Trusts and Investment Companies: Hearings on S. 3580 Before a Subcomm. of the Senate Comm. on Banking and Currency, 76th Cong., 3d Sess. (1940) 22

Investment Trusts and Investment Companies: Hearings on H.R. 10065 Before the House Subcomm. on Interstate and Foreign Commerce, 76th Cong., 3d Sess. (1940) 21, 40

Thomas P. Lemke, Gerald T. Lins, A. Thomas Smith, Regulation of Investment Companies (2004) 42

1 L. Loss & J. Seligman, Securities Regulation (3d ed. rev. 1998) 19

MISCELLANEOUS (Cont'd) **Page**

Report of the Securities and Exchange Commission, Investment Trusts and Investment Companies (1939) 17

Transcripts from the Roundtable on the Role of Independent Investment Company Directors, Feb. 23-24, 1999, http://www.sec.gov/divisions/investment/roundtable.htm. 25

Division of Investment Management, SEC, Protecting Investors: A Half Century of Investment Company Regulation (May 1992) 21, 22

Christine Dugas, Janus, Putnam bear big losses, USA Today, Jan. 6, 2005 28

John Hechinger, Pace of Putnam Redemptions Slows a Bit, Wall St. J., Nov. 18, 2003 27

Ian McDonald, Investors Flee Some Funds Amid Scandal – As Turmoil Grows, So Does Potential Cost of Staying Put; A Look at Some Alternatives, Wall St. J., Nov. 4, 2003 27

GLOSSARY

2001 Adopting Release	Role of Independent Directors of Investment Companies, Investment Company Act Release No. 24816 (Jan. 2, 2001)
2001 Proposing Release	Role of Independent Directors of Investment Companies, Investment Company Act Release No. 24082 (Oct. 14, 1999)
2004 Adopting Release	Investment Company Governance, Investment Company Act Release No. 26520 (July 27, 2004)
2004 Proposing Release	Investment Company Governance, Investment Company Act Release No. 26323 (Jan. 15, 2004)
Act	Investment Company Act of 1940, 15 U.S.C. 80a-1 *et seq*
Bobroff-Mack Report	Geoffrey H. Bobroff and Thomas H. Mack, *Assessing the Significance of Mutual Fund Board Independent Chairs*, A study for Fidelity Investments (March 10, 2004) (attached to Comment Letter 65)
Exemptive Rules	Rule 10f-3, 17 CFR 270.10f-3; Rule 12b-1, 17 CFR 270.12b-1; Rule 15a-4(b)(2), 17 CFR 270.15a-4(b)(2); Rule 17a-7, 17 CFR 270.17a-7; Rule 17a-8, 17 CFR 270.17a-8; Rule 17d-1(d)(7), 17 CFR 270.17d-1(d)(7); Rule 17e-1, 17 CFR 270.17e-1; Rule 17g-1, 17 CFR 270.17g-1; Rule 18f-3, 17 CFR 270.18f-3; and Rule 23c-3, 17 CFR 270.23c-3
Fund	Investment company
Interpretive Release	Interpretive Matters Concerning Independent Directors of Investment Companies, Investment Company Act Release No. 24083 (Oct. 14, 1999)

No. 04-1300

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.

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

BRIEF OF THE SECURITIES AND EXCHANGE COMMISSION,
RESPONDENT

INTRODUCTION

The Investment Company Act of 1940, 15 U.S.C. 80a-1 *et seq*, prohibits various transactions and arrangements involving serious conflicts of interest between investment companies ("funds") and their managers. The Act, however, gives the Securities and Exchange Commission authority to adopt rules granting exemptions, including conditional exemptions, from these prohibitions when such exemptions are consistent with the purposes of the Act. Petitioner Chamber of

Commerce seeks review of an order issued by the Commission adopting amendments to ten such exemptive rules. 1/ Each of the ten rules ("Exemptive Rules") has for some years contained a condition requiring oversight of the exempted transaction or arrangement by fund directors who are independent of the fund's management company. The rule amendments that are the subject of the petition impose two new conditions on funds that seek to rely on any of the Exemptive Rules: (i) at least 75 percent of the directors of the fund must be independent (an increase from the prior condition of a simple majority); and (ii) the chairman of the fund's board must be an independent director. These conditions were adopted to enhance the protection of funds and their shareholders. It is these two conditions that are challenged by petitioner.

The Commission adopted the amendments in the face of mounting evidence that mutual fund managers were misusing their positions of trust to favor themselves at the expense of fund investors, thereby inflicting huge losses on investors and leading them to withdraw large amounts of their fund investments

---

1/ Investment Company Governance, Investment Company Act Release No. 26520 (July 27, 2004) [69 FR 46378 (Aug. 2, 2004)] ("2004 Adopting Release") (R5).

because of their lost trust in the funds. 2/ This misconduct, which involved managers of leading fund groups, cost investors more than half a billion dollars. As a part of its broad response to these well-publicized scandals, the Commission reevaluated the conditions imposed on funds and their affiliates that rely on the Exemptive Rules – conditions designed to safeguard the interests of fund investors from the conflicts of interest inherent in the transactions permitted under the rules. After considering comments received from nearly 200 commenters, and as part of a larger package of reforms designed to restore investor confidence in the nation's mutual funds, the Commission determined it was necessary to strengthen independent director oversight under the Exemptive Rules.

Independent director oversight of conflicts of interest has always been a critical aspect of the extensive corporate governance provisions of the Act, and has long been a cornerstone of the Exemptive Rules. Indeed, the Exemptive Rules have been conditioned upon independent director oversight of the transactions permitted under the rules since the rules were adopted (or amended) at various times over the last 50 years. This independent director oversight was strengthened in 2001, when the Commission amended the Exemptive Rules to include the condition that a majority of the fund's board be independent, and again in 2004

2/ *See* 2004 Adopting Release, 69 FR 46378 n.6 (R5).

when it added the two conditions challenged by petitioner. In so acting, the Commission was doing precisely what Congress intended by expressly authorizing the Commission to grant exemptions to prohibitions under the Act, "conditionally or unconditionally," when the exemptions are consistent with the purposes of the Act. *See* Section 6(c) of the Act, 15 U.S.C. 80a-6(c).

COUNTERSTATEMENT OF JURISDICTION

A. Petitioner Has Not Demonstrated Its Standing to Bring This Petition.

The petition should be dismissed because petitioner has not shown that it has standing to seek review of the rule amendments.

1. Relying upon the declaration of one of its officers (Petitioner's Addendum at A-48), petitioner states (Br. 4) that at least 30 of its members and their subsidiaries (out of its more than 3 million members) are fund advisers, and that these "include firms that have boards with management chairs and fewer than 75 percent independent directors." 3/ But petitioner has not provided evidence that *any* of those members has been injured by the rule amendments, much less any evidence of "concrete and particularized" harm that is "actual or imminent, not conjectural or hypothetical." *Lujan v. Defenders of Wildlife*, 504 U.S. 555, 560

3/ We assume petitioner intended to say that the member firms advise "funds" that have management chairs and fewer than 75 percent independent directors.

(1992). 4/ Petitioner provides no evidence that any of its members would even contend that they have been injured by the rule amendments. Nor has petitioner identified any of its fund adviser members so as to permit inquiry into whether they have been harmed. Petitioner apparently believes that it is sufficient for it simply to *allege* harm to fund advisers generally. It is not. This Court requires a petitioner whose standing is not self-evident to establish its standing, at the latest, in its opening brief. Its burden of production in this Court is the same as that of a plaintiff moving for summary judgment in the district court: it must support each element of its claim to standing by affidavit or other evidence. *Sierra Club v. EPA*, 292 F.3d 895, 899-900 (D.C. Cir. 2002). 5/ But petitioner provided no such evidence of any actual harm to any of petitioner's individual fund adviser members. As far as we know, petitioner's fund adviser members may, unlike petitioner but like many other fund advisers, fully support the rule amendments. Or, the funds advised by petitioner's members may be among those that do not

---

4/ The Supreme Court has said that the "actual injury" requirement "tends to assure that the legal questions presented to the court will be resolved, not in the rarified atmosphere of a debating society, but in a concrete factual context conducive to a realistic appreciation of the consequences of judicial action." *Valley Forge Christian College v. Americans United for Separation of Church and State, Inc.*, 454 U.S. 464, 472 (1982).

5/ Petitioner was reminded of this obligation in the Court's scheduling order issued November 3, 2004.

rely upon any of the Exemptive Rules and are, therefore, unaffected by the amendments. Without the declaration of a single fund adviser member explaining how it has been injured, petitioner has not established its associational standing.

Even petitioner's claims of harm to fund advisers generally is without adequate support. Petitioner claims (Br. 5) that management-chaired funds perform better than independent-chaired funds, and that this will result in reduced fees for fund advisers, thus causing them injury. But petitioner provides no evidence of any such injury. Instead, petitioner points solely to a report prepared by two fund industry consultants, Geoffrey H. Bobroff and Thomas H. Mack (the "Bobroff-Mack Report"), that was commissioned in response to the proposed rule amendments by one of the commenters (R2: Letter 65) opposed to the rule amendments. 6/ That report, however, does not establish that the independence of a fund's chair is the reason for any lesser performance. 7/ Moreover, the report

---

6/ The report addressed only the condition that a fund have an independent chair, not the condition that a fund board be 75 percent independent. As to the latter condition, the Commission noted in the 2004 Adopting Release that nearly 60 percent of all funds already meet this condition. 69 FR at 46387 n.78.

7/ As the Commission pointed out in the 2004 Adopting Release, 69 FR 46383 n.52 (and as more fully discussed *infra* at 54-57), the report is equivocal in its conclusions, and was criticized by other knowledgeable commenters. Even if the report's conclusions are accepted, at best they show that the (continued...)

says nothing about the performance of funds in the future, nothing about adviser fees being reduced as a result of the amendments and, most importantly, nothing about any effect on petitioner's individual members, but only that in the past *some* independently chaired funds as a group may have performed somewhat less well than *some* management chaired funds as a group.

Petitioner has not shown that any of its members will suffer "concrete and particularized" harm that is "actual or imminent, not conjectural or hypothetical" as a result of the rule amendments. There is no evidence that is specific to one or more of petitioner's members that the performance of the funds *they* advise will suffer as a result of the amendments, and that *they* will be harmed thereby. At a minimum, petitioner should have provided declarations from its members themselves demonstrating the probability of "substantial" injury to them. *DEK Energy Co. v. FERC*, 248 F.3d 1192, 1195 (D.C. Cir. 2001). Petitioner has not established its associational standing.

2. Petitioner also argues that it has standing in its own right as an investor in funds. The rule amendments, it argues (Br. 5-6), will "compel" funds to comply

---

7/ (...continued)
small number of existing independent-chaired funds performed somewhat less well during the past ten years than the much more common management-chaired funds. The report offers no explanation for this alleged discrepancy, calling it "an interesting and challenging question."

with the new conditions and thus deprive petitioner of the ability to purchase a desired product, namely a management-chaired fund. Petitioner apparently believes that management-chaired funds will yield higher investment returns than independent-chaired funds. But the amendments do not, as petitioner contends, compel funds to be independently chaired. Only funds that seek to rely upon the exemptions provided in the Exemptive Rules need comply. 8/ Moreover, whether funds that comply with the independent chair condition will, in fact, have lower investment returns than they otherwise would have had is pure conjecture. Petitioner's assertion of injury is not "distinct and palpable," but "merely hypothetical, abstract, or conjectural." *University Medical Center of Southern Nevada v. Shalala*, 173 F.3d 438, 441 (D.C. Cir. 1999). As this Court pointed out in *DEK Energy Co. v. FERC*, 248 F.3d at 1195: "There is quite a gulf between the antipodes of standing doctrine – the 'imminent' injury that suffices and the merely 'conjectural' one that does not. We have insisted that to escape the latter characterization the claimant must show a substantial (if unquantifiable) probability of injury."

Petitioner has not made the required showing. As one commenter, John A.

8/ Funds also can continue to seek individual exemptions without reliance upon the Exemptive Rules.

Hill, the independent chair of the Putnam fund group, pointed out (R2: Letter 171), there is "no dissimilarity of interest * * * between affiliated and independent chairpersons" on the issue of fund performance. He said: "The role of board chairpersons of large complexes is not to manage funds; portfolio managers manage funds. The role of board chairpersons is to insure that his or her board monitors performance and to insist on changes in personnel or strategy when performance lags." Petitioner has offered no credible support for its contention that conditioning reliance on the Exemptive Rules upon an independent chair will adversely affect fund performance. 9/ Indeed, petitioner has presented no evidence that *any* fund in which it wishes to invest has indicated or would contend that the rule amendments will impair its returns or its operations in any way.

B. Aside From Standing, This Court Has Jurisdiction to Consider the Petition.

Where, as here, the governing statute provides for appellate court jurisdiction over appeals of agency "orders," 10/ the courts of appeals possess

---

9/ Petitioner again cites the Bobroff-Mack Report, but the report does not speak to the effect of the independent chair condition on the performance of funds in the future, when all funds that wish to rely upon the Exemptive Rules will have independent chairs. The report provides no basis to believe that funds' future performance will be affected at all.

10/ Section 43(a) of the Act, 15 U.S.C. 80a-42(a).

exclusive jurisdiction under that statute over challenges to "any agency action capable of review on the basis of the administrative record." *Investment Co. Inst. v. Board of Governors, Fed. Reserve Sys.*, 551 F.2d 1270, 1278 (D.C. Cir. 1977). When appellate court review can be conducted on the administrative record, allowing for district court jurisdiction would foster wasteful duplication of effort. *Florida Power & Light Co. v. Lorion*, 470 U.S. 729, 744-45 (1985); *Telecommunications Research & Action Ctr. v. FCC*, 750 F.2d 70, 77-78 (D.C. Cir. 1984). Accordingly, this Court has jurisdiction to consider the petition for review, which was timely filed.

COUNTERSTATEMENT OF THE ISSUES

1. Whether, in exercising its authority under the Investment Company Act to grant conditional exemptions from statutory prohibitions against conflict-of-interest transactions, the Commission exceeded that authority when it amended the conditions to ten Exemptive Rules to strengthen independent director oversight of such transactions, which had long been a condition of the rules and is critical to the Act's corporate governance provisions.

2. Whether the Commission, in light of a series of enforcement actions involving self-dealing by fund managers that cost investors more than half a billion dollars and reflected a serious breakdown in management controls, was

arbitrary and capricious when it determined to strengthen independent director oversight of conflict-of-interest transactions permitted under the Exemptive Rules.

COUNTERSTATEMENT OF THE CASE

On July 27, 2004, the Commission adopted the challenged rule amendments. These amendments add conditions to ten Exemptive Rules that conditionally permit funds and their affiliates to engage in transactions or arrangements that involve potentially serious conflicts of interest between the funds and their managers, and which would otherwise be prohibited under the Act. Congress gave the Commission authority to grant exemptions, "conditionally or unconditionally * * * to the extent that such exemption is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of [the Act]." 11/ The Exemptive Rules have long been conditioned upon the judgment and scrutiny of the funds' independent directors to oversee these conflicts of interest. 12/ The

---

11/ Section 6(c) of the Act, 15 U.S.C. 80a-6(c). *See also* Sections 10(f), 12(b), 17(d), 17(g), and 23(c) of the Act, 15 U.S.C. 80a-10(f), 80a-12(b), 80a-17(d), 80a-17(g), and 80a-23(c).

12/ The term "independent," as used in this brief and in the Commission's release adopting the amendments, describes a director who is not an "interested person" of the fund, as defined by Section 2(a)(19) of the Act, 15 U.S.C. 80a-2(a)(19). Interested persons of a fund include, among others, (continued...)

challenged amendments strengthen this independent oversight by increasing the percentage of independent directors of a fund that seeks to rely on the Exemptive Rules from a simple majority to 75 percent, and by imposing the condition that the board have an independent chair. 13/ The ten Exemptive Rules are summarized in Respondent's Statutory Addendum, attached hereto, at A5. A discussion of the events leading up to the adoption of the amendments is set forth in Argument I, *infra*.

STANDARD OF REVIEW

Under Section 706 of the Administrative Procedure Act, 5 U.S.C. 706, this Court considers whether an order of the Commission is arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law; contrary to constitutional right, power, privilege, or immunity; in excess of statutory jurisdiction, authority, or limitations, or short of statutory right; or without observance of procedure required by law. *See AT&T Corp. v. FCC*, 236 F.3d 729, 734-735 (D.C. Cir. 2001). Under Section 43(a) of the Investment Company Act,

---

12/ (...continued)
the fund's investment adviser and its affiliated persons, such as its officers, directors, and employees, and members of their immediate families.

13/ Until January 16, 2006, funds may continue to rely on the Exemptive Rules without complying with these new conditions.

15 U.S.C. 80a-42(a), no objection to the order of the Commission shall be considered by the Court unless such objection shall have been urged before the Commission or unless there were reasonable grounds for failure to do so. The Commission's findings of fact are conclusive if supported by substantial evidence. *See Graham v. SEC*, 222 F.3d 994, 999-1000 (D.C. Cir. 2000); *Schoenbohm v. FCC*, 204 F.3d 243, 246 (D.C. Cir. 2000) ("possibility of drawing two inconsistent conclusions from the evidence does not prevent an administrative agency's finding from being supported by substantial evidence").

The Commission's conclusions of law with respect to the statutes it administers are "binding in the courts unless procedurally defective, arbitrary or capricious in substance, or manifestly contrary to the statute." *United States v. Mead Corp.*, 533 U.S. 218, 227 (2001), citing *Chevron, U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837, 843-44 (1984). The Commission's interpretation of a statute it administers is entitled to deference under *Chevron*, 467 U.S. at 842-43. As discussed *infra* at 35-36, petitioner's argument (Br. 25 n.9) that *Chevron* does not apply is without merit.

SUMMARY OF ARGUMENT

1. The two conditions challenged by petitioner continue a long history of Commission reliance on independent directors to oversee the conflicts of interest

between funds and fund management inherent in the transactions allowed under the Exemptive Rules. Independent director oversight of conflicts of interest has always been a critical aspect of the extensive corporate governance provisions of the Act, and has long been a cornerstone of the Exemptive Rules. Indeed, the Exemptive Rules have been conditioned upon independent director oversight since the rules were adopted (or amended) at various times over the last 50 years. This independent director oversight was enhanced in 2001, when the Exemptive Rules were amended to include the condition that a majority of the fund's board be independent. In 2004, the majority independent director condition adopted in 2001 was expanded to the current 75 percent condition, and the independent chairman condition was added, because the Commission concluded that, in light of the scandals in the fund industry involving serious wrongdoing by fund managers, the 2001 amendments had not gone far enough in addressing the need for independent oversight of fund managers.

2. Petitioner's argument that the Commission lacked the authority to adopt the challenged conditions because they are related to corporate governance ignores the statute and is without merit. The Commission is expressly authorized to grant exemptions that are *conditional* and are consistent with the purposes of the Act. A central objective of the Act is to impose a scheme of governance and oversight to

regulate conflicts of interest that, in Congress' view, were not addressed adequately by state law. By imposing the challenged conditions to the use of the Exemptive Rules, the rule amendments strengthen independent director oversight of conflict-of-interest transactions covered by the Exemptive Rules – transactions that would otherwise be entirely prohibited by the Act. Conditioning the use of the exemptions on independent director oversight, as enhanced by the rule amendments, is entirely consistent with the purposes and structure of the Act. The requirement of Section 10(a) of the Act that for all funds *at least* 40 percent of the fund's board be composed of independent directors does not prevent the Commission from requiring a greater percentage of independent directors, or from requiring an independent chair, as a condition to exemptive rules allowing funds and their affiliates to engage in transactions that would otherwise be prohibited by the Act.

3. Petitioner's argument that the Commission's adoption of the two conditions was arbitrary, capricious, an abuse of discretion, or not in accordance with law is likewise without merit. In adopting the rule amendments, the Commission examined the relevant facts and articulated a detailed and rational explanation for its action. In light of the scandals in the fund industry, the Commission reasonably concluded that independent director oversight of the

conflict-of-interest transactions permitted under the Exemptive Rules needed to be strengthened. The scandals vividly demonstrated the critical importance of effective independent oversight of fund advisers and affiliates, oversight that had been sorely lacking in the funds involved in the enforcement actions. Contrary to petitioner's argument, the Commission was not required – in considering the effect of the rule amendments on efficiency, competition, and capital formation – to conduct an empirical analysis of whether funds with independent chairs performed better than funds with management chairs. The objective of the rule amendments was to monitor more effectively conflicts of interest and better protect investors. The Commission made a considered and rational policy determination, of a judgmental and predictive nature, after examining widespread evidence of misconduct harmful to investors, reviewing an extensive comment file, and applying its broad regulatory expertise. Contrary to petitioner's argument, the Commission properly considered the costs of the two conditions, responded to commenters who suggested that an independent board should be allowed to pick whomever it wished to be chair, and considered the other major alternatives.

ARGUMENT

I. **Consistent With Congress' Reliance on Oversight by Independent Directors, the Commission Has Long Relied Upon Independent Directors to Monitor Conflicts of Interest Inherent in Transactions Allowed Under the Exemptive Rules**.

The Investment Company Act was enacted in 1940 to meet the crisis of confidence occasioned by scandals in the investment company industry which were disclosed in public hearings leading to, and described in, the Report of the Securities and Exchange Commission, Investment Trusts and Investment Companies (1939). Congress found that the disclosure regimes of the Securities Act of 1933 and the Securities Exchange Act of 1934 were inadequate to cope with the type of conflicts and abuses that then pervaded the investment company industry. *See*, *e.g.*, H.R. Rep. No. 2639, 76th Cong., 3d Sess. 10 (1940). The Act, with its detailed prescriptions for the organization and governance of investment companies – particularly the setting of standards for independent directors, and their role as "watchdogs" for the interests of fund shareholders, subject to Commission oversight – played a crucial role in restoring confidence in investment companies as a regulated medium for investor savings. *See* H.R. Rep. No. 2639, *supra*, and the discussion by Judge Herlands in *Brown v. Bullock*, 194 F. Supp. 207, 244-45 (S.D.N.Y. 1961), *aff'd* 294 F.2d 415 (2d Cir. 1961). The

two conditions challenged by petitioner continue a long history of Commission reliance on independent directors to oversee the conflicts of interest between funds and fund management inherent in the transactions allowed under the Exemptive Rules, consistent with the oversight role that was assigned to the independent directors by Congress under the Act.

A. Managing Conflicts of Interest – the Role of Independent Directors

1. *The Unique Structure of Mutual Funds*

The critical role of independent directors of investment companies is necessitated, in part, by the unique structure of investment companies. As the Commission explained in the release proposing the 2001 amendments, 14/ funds are formed as corporations or business trusts under state law and, like other corporations and trusts, must be operated for the benefit of their shareholders. Funds are unique, however, in that they are organized and operated by people whose primary loyalty and pecuniary interest lie outside the enterprise. This "external management" structure presents inherent conflicts of interest and potential for abuses. An investment adviser typically organizes a fund and is responsible for its day-to-day operations. The adviser generally provides the seed

---

14/ *See* Role of Independent Directors of Investment Companies, Investment Company Act Release No. 24082 (Oct. 14, 1999) [64 FR 59826 (Nov. 3, 1999)] ("2001 Proposing Release"), at 59827.

money, officers, employees, and office space, and usually selects the initial board of directors. As a result of this extensive involvement, investment advisers typically have dominated the funds they advise.

Investment advisers to funds may have an interest that is quite different from the interests of the funds' shareholders. For example, while fund shareholders ordinarily prefer lower advisory fees (to achieve greater fund returns), the fund's investment adviser might want to maximize its own profits through higher fees. And while fund shareholders might prefer that advisers use brokers that charge the lowest possible commissions, advisers might prefer to use brokers that are affiliates of the adviser or that provide services to the adviser. These types of conflicts (and others) resulted in the pervasive abuses that led Congress in 1940 to enact legislation regulating the activities of mutual funds. As noted by Professor Loss, the Investment Company Act "is definitely a regulatory measure for an industry that was thought to require something more than the disclosure treatment of the 1933 and 1934 Acts." 1 L. Loss & J. Seligman, Securities Regulation 242 (3d ed. rev. 1998).

2. *Statutory Curbs on Conflicts of Interest – the Role of Independent Directors*

One of the ways that the Act addresses conflicts between advisers and funds

is by giving fund boards, and in particular the independent directors, an important oversight role. At the outset, in 1940, Congress required that for all funds *at least* 40 percent of the fund's board be composed of independent directors. Section 10(a), 15 U.S.C. 80a-10(a). 15/ The Act further requires that a majority of a fund's independent directors: approve the fund's contracts with its investment adviser and principal underwriter; 16/ select the independent public accountant of the fund; 17/ and select and nominate individuals to fill independent director vacancies resulting from the assignment of an advisory contract. 18/

As the Supreme Court explained, Congress clearly intended independent directors to be "watchdogs" safeguarding the interests of fund investors:

> Congress' purpose in structuring the Act as it did is clear. It "was designed to place the unaffiliated directors in the role of

---

15/ Under certain circumstances, Congress provided for an even greater percentage of independent directors. Section 10(b)(2), 15 U.S.C. 80a-10(b)(2), requires, in effect, that independent directors comprise a majority of a fund's board if the fund's principal underwriter is an affiliate of the fund's investment adviser; Section 15(f)(1), 15 U.S.C. 80a-15(f)(1), which provides a safe harbor for the sale of an advisory business, requires that directors who are independent of the adviser constitute at least 75 percent of a fund board for at least three years following the assignment of the advisory contract.

16/ Sections 15(a) and (b), 15 U.S.C. 80a-15(a) and (b).

17/ Section 32(a), 15 U.S.C. 80a-31(a).

18/ Sections 16(b) and 15(f)(1)(A), 15 U.S.C. 80a-16(b), 15(f)(1)(A).

> ‘independent watchdogs,’” *Tannenbaum v. Zeller*, 552 F.2d [402], at 406 [(2d Cir. 1979)], who would “furnish an independent check upon the management” of investment companies, Hearings on H.R. 10065 before a Subcommittee of the House Committee on Interstate and Foreign Commerce, 76th Cong., 3d Sess., 109 (1940).

Burks v. Lasker, 441 U.S. 471, 484 (1979).

3. *The Exemptive Rules Have Long Relied on Independent Director Oversight.*

Congress did not consider a 40 percent independent director requirement, or even a majority, sufficient to protect investors against conflicts between advisers and funds in all cases. Congress viewed the conflicts of interest inherent in the transactions covered by the Exemptive Rules as being so serious that it imposed a complete prohibition on those transactions. At the same time, however, Congress gave the Commission broad authority in Section 6(c) of the Act to grant exemptions by order or rule, “conditionally or unconditionally,” from these prohibitions. 19/ In his remarks to Congress recommending the bill that later

---

19/ Typically, a fund seeking an exemption must file an application for an exemptive order explaining the purpose of the requested exemption and any conditions to be imposed on the fund in connection with the exemption. When the Commission determines it appropriate, it may adopt an exemptive rule upon which any fund may rely without the need for applying to the Commission. *See generally* Division of Investment Management, SEC, Protecting Investors: A Half Century of Investment Company Regulation 503-22 (May 1992).

became the Act, David Schenker, Chief Counsel of the Commission's Investment Trust Study and a principal author of the Act, explained that "the difficulty of making provision for regulating an industry which has so many variants and so many different types of activities * * * is precisely [the reason that Section 6(c)] is inserted." Investment Trusts and Investment Companies: Hearings on S. 3580 Before a Subcomm. of the Senate Comm. on Banking and Currency, 76th Cong., 3d Sess. 197 (1940). 20/ The Commission has relied extensively on oversight by independent directors in rules that exempt funds from various prohibitions under the Act. Long before the ten Exemptive Rules were amended in 2001 to provide for a majority independent board, reliance by a fund and its affiliates on any of the ten rules was expressly conditioned upon the oversight of the independent directors.

As the Exemptive Rules were adopted or amended at various times over a period of five decades, each rule provided for independent director oversight. The Commission explained that, because the adviser may have a "significant self-

---

20/ Many benefits have flowed to investors and funds as a result of the Commission's exercise of its conditional exemptive authority, including the development of money market funds, exchange offers among funds within the same fund family, and multiple classes of fund shares. Division of Investment Management, SEC, Protecting Investors: A Half Century of Investment Company Regulation 506-07.

interest" in a transaction, an exemption pertaining to the transaction should be conditioned upon approval of the independent directors "to ensure that the interests of the investment companies and their shareholders * * * are not compromised." 21/ The Commission has pointed out that oversight by independent directors is particularly important in the case of an exemptive *rule* because, unlike in the case of an individual application for an exemption, the Commission staff would no longer individually review the transactions exempted under the rule. 22/ When it adopted Rule 12b-1, 17 CFR 270.12b-1, in 1980, the Commission discussed the connection between greater oversight by independent directors and reduced oversight by Commission staff. Citing a study then being conducted, the Commission said: 23/

> Two central goals of the Study are to permit investment companies to exercise wider latitude in making business judgments without Commission approval and to enhance the role of directors, particularly the disinterested directors, in scrutinizing investment company affairs. These goals are interdependent in that the more capable

---

21/ Investment Company Act Release No. 10886, 1979 SEC LEXIS 599, at *8 (Oct. 2, 1979) (proposing Rule 17a-8, 17 CFR 270.17a-8).

22/ Investment Company Act Release No. 11676, 1981 SEC LEXIS 1873, at *8 (Mar. 10, 1981)(adopting an amendment to Rule 17a-7, 17 CFR 270.17a-7).

23/ Investment Company Act Release No. 11414, 1980 SEC LEXIS 444, at *34 (Oct. 28, 1980).

> the disinterested directors are of overseeing the kinds of activities of investment companies which are of regulatory significance, the more the Commission will be willing to reduce regulatory restrictions.

Reliance is placed on the independent directors, rather than the Commission, to oversee any conflicts of interest in the transactions permitted by the Exemptive Rules and to protect the interests of the fund investors.

B. Rule Amendments to Enhance the Effectiveness of Independent Directors

1. *2001 Amendments*

The rule amendments challenged by petitioner were adopted as part of a broad effort by the Commission over a number of years to better address conflicts of interest between funds and their investment advisers or other affiliated persons. 24/ In the late 1990's, questions were being raised about the effectiveness of independent directors. The Commission also had instituted a number of enforcement actions against independent directors for failing to fulfill their legal obligations. 25/ In recognition of the increasingly important role that funds played

---

24/ *See* Role of Independent Directors of Investment Companies, Investment Company Act Release No. 24816 (Jan. 2, 2001) [66 FR 3734 (Jan. 16, 2001)] ("2001 Adopting Release").

25/ *See* Interpretive Matters Concerning Independent Directors of Investment Companies, Investment Company Act Release No. 24083 (Oct. 14, 1999) (continued...)

in Americans' finances and that independent directors played in protecting fund investors, the Commission hosted a two-day public Roundtable in 1999 to discuss the role of independent directors and the steps that could be taken to improve their effectiveness. 26/ Most participants agreed that independent directors could best fulfill their responsibilities when they constitute "a substantial majority" of the board. 27/

The recommendations of the Roundtable participants led the Commission to review its Exemptive Rules – rules "that provide funds and advisers relief from various statutory prohibitions designed to prevent the most egregious conflicts of interest." 2001 Proposing Release, 64 FR at 59829. The Commission stated:

> [I]n light of the recommendations of the Roundtable participants, we believe that our exemptive rules that rely on fund boards to approve and oversee arrangements or transactions that involve conflicts of interest and are otherwise prohibited by the Act also should contain provisions designed to enhance director independence and effectiveness. We

---

25/ (...continued)
[64 FR 59877, 59878 (Nov. 3, 1999)] ("Interpretive Release").

26/ *See* Transcripts from the Roundtable on the Role of Independent Investment Company Directors, Feb. 23-24, 1999, http://www.sec.gov/divisions/investment/roundtable.htm. Participants in the Roundtable included independent directors, investor advocates, executives of fund advisers, academics, corporate governance experts, and experienced legal counsel.

27/ *See* 2001 Proposing Release, 64 FR at 59828, 59830.

> therefore are proposing amendments * * * to enhance the independence of fund directors who are charged with overseeing the fund's activities and transactions covered by those rules.

Id. The Commission said that it selected the ten Exemptive Rules for amendment because those rules "(i) exempt funds or their affiliated persons from provisions of the Act, and (ii) have as a condition the approval or oversight of independent directors." *Id*. Among the amendments proposed was the condition that independent directors constitute a majority of the board of any fund that sought to rely upon the Exemptive Rules. 28/ The Commission requested comment on whether an even higher percentage should be adopted. 2001 Proposing Release, 64 FR at 59831. 29/

In January 2001, the Commission adopted the majority condition, as well as several other conditions. The Commission said that these amendments were

---

28/ The Commission made it clear that this condition was not mandatory, but only applied to funds that wished to rely upon the Exemptive Rules (2001 Proposing Release, 64 FR at 59829):

> Although the Commission urges all funds to adopt these measures to strengthen the independence of their boards, we are *not* proposing to require all funds to adopt these measures.

29/ The Commission pointed out that as a result of the Glass Steagall Act, most bank-sponsored funds had boards comprised entirely of independent directors. 2001 Proposing Release, 64 FR at 59831 n.45.

designed "to increase the ability of independent directors to perform their important responsibilities under each of [the Exemptive Rules]." 2001 Adopting Release, 66 FR at 3736.

2. *2004 Amendments*

In July 2004, the majority independent director condition adopted in 2001 was expanded to the current 75 percent condition, and the independent chairman condition was added. The Commission concluded that, in the wake of a troubling series of ongoing enforcement actions, the 2001 amendments had not gone far enough in addressing the need for independent oversight of fund managers. In these enforcement actions (which involved fraudulent market timing activities, illegal late trading of mutual fund shares, and misuse of nonpublic information about fund portfolios), a significant number of well known fund advisers had engaged in misconduct that cost investors more than $500 million – a figure that has grown in subsequently concluded Commission enforcement actions by at least an additional $750 million. The abuses also caused investors to withdraw assets from funds because of their lost trust in the fund advisers. 30/ With respect to

---

30/ John Hechinger, *Pace of Putnam Redemptions Slows a Bit*, Wall St. J., Nov. 18, 2003 at C1 (reporting announcement by California Public Employees' Retirement System that board decided to fire Putnam as one of its managers "because of a 'severe lack of ethical standards within the firm.'"); Ian

(continued...)

market timing, fund advisers improperly reaped financial benefits (generally in the form of increased fees) at the expense of fund shareholders. The advisers allowed certain select investors to conduct frequent trading in fund shares, even though the fund's prospectus disclosure indicated that such trading would be discouraged or even prohibited. In some cases, fund advisers expected – or even required – these select investors to invest in other funds managed by the adviser, such as other mutual funds or hedge funds. These *quid pro quo* arrangements benefitted the advisers at the expense of ordinary fund investors. In some cases, advisers offered an additional benefit to these select investors – nonpublic information regarding the mutual fund's portfolio holdings. Disclosure of this information, ordinarily considered highly confidential, conferred an advantage on the select investors, allowing them to profit from market timing during falling markets. 31/

30/ (...continued)
McDonald, *Investors Flee Some Funds Amid Scandal -- As Turmoil Grows, So Does Potential Cost of Staying Put; A Look at Some Alternatives*, Wall St. J., Nov. 4, 2003 at D1 (reporting that Bank of American Corp., Bank One Corp., Strong Capital Management Inc., and Janus Capital Group Inc., experienced net redemptions of nearly $8 billion in September of 2003, the month the scandal hit; Putnam's equity funds also suffered significant net redemptions.); Christine Dugas, *Janus, Putnam bear big losses*, USA Today, Jan. 6, 2005 at 3B (reporting that eight of the scandal tainted firms saw a net $78.5 billion in assets withdrawn through Nov. 30, 2003.)

31/ *See* enforcement actions cited in 2004 Adopting Release, 69 FR at 46378
(continued...)

The Commission found that this misconduct reflected a serious breakdown in management controls in a number of large mutual fund complexes. The Commission observed that in each case, the fund was used for the benefit of fund managers rather than fund shareholders. 32/ The Commission further determined that fund advisers were frequently in a position to dominate a fund's board because of the adviser's monopoly over information about the fund and its frequent ability to control the board's agenda. Consequently, the Commission questioned the ability of a management-dominated board to undertake the oversight necessary to address conflicts of interest. 33/

Prior to adopting the 2004 amendments, the Commission received nearly 200 comments from fund investors, management companies, and independent directors to funds, as well as members of Congress. Most commenters supported the 75 percent condition. After considering the comments, the Commission found (2004 Adopting Release, 69 FR at 46382):

31/ (...continued)
n.6.

32/ Investment Company Governance, Investment Company Act Release No. 26323 (Jan. 15, 2004) [69 FR 3472 (Jan. 23, 2004)] ("2004 Proposing Release") (R1).

33/ 2004 Adopting Release, 69 FR at 46379.

> Requiring that each fund that relies upon any Exemptive Rule have a board of directors whose independent directors constitute at least 75 percent of the board, will help ensure that independent directors carry out their fiduciary responsibilities. Management controls the day-to-day activities of the fund and has significantly greater access to information about the fund than do the independent directors. This information gives the management directors a significant advantage over the independent directors in setting the board's agenda and potentially dominating board deliberations. The amendments seek to resolve this imbalance.

Commenters were divided on the independent chair proposal. Among those strongly supporting the proposal were all of the seven living former Chairmen of the Commission (R2: Letter 179). Upon consideration, the Commission determined that a fund board would be in a better position to protect the interests of the fund, and to fulfill the board's obligations under the Act and the Exemptive Rules, if its chairman did not have the conflicts of interest inherent in the role of an executive of the fund adviser. 2004 Adopting Release, 69 FR at 46382. The Commission said (*id.* at 46383):

> The board chairman can play an important role in setting the agenda of the board, and in establishing a boardroom culture that can foster the type of meaningful dialogue between fund management and independent directors that is critical for healthy fund governance. The chairman can play an important role in providing a check on the adviser, in negotiating the best deal for shareholders when considering the advisory contract, and in providing leadership to the board that focuses on the

> long-term interests of investors. We believe that a fund chairman is in the best position to fulfill these responsibilities when his loyalty is not divided between the fund and its investment adviser.

The Commission noted that even with an independent chair, representatives of management would still be responsible for the day-to-day operations of the fund, and would continue to be able to serve as fund directors. "We do not believe that this amendment will deprive the board of management's knowledge and judgment." *Id*. at 46383.

In adopting these amendments, the Commission found that "if funds are to engage in the transactions permitted by the Exemptive Rules, and effectively manage the conflicts of interest inherent in those transactions, greater board independence is needed." *Id*. at 46279-80. The Commission also noted that the rule amendments were part of a larger package of regulatory reforms "designed both to prevent the compliance failures of yesterday and to strengthen a fund board's ability to deal with compliance challenges of the future." *Id*. at 46384. 34/

34/ The Commission has proposed or adopted a range of other regulatory reforms, including rules to require that funds adopt compliance policies and procedures, disclose policies on market timing and selective disclosure of portfolio information, and charge redemption fees for short-term trading in fund shares. *See* 2004 Adopting Release, 69 FR at 46378 n.5.

II. The Rule Amendments Are Well Within the Commission's Statutory Authority.

A. The Commission Has Express Authority to Adopt Rules Providing Conditional Exemptions That Are Consistent With Statutory Purposes; the Conditions Challenged By Petitioner Are Consistent With the Purposes of the Investment Company Act.

The Commission has express authority under the Investment Company Act to amend (as well as to adopt) exemptive rules that are consistent with the purposes of the Act. The conditions imposed by the 2004 amendments, which are challenged by petitioner, are indeed consistent with the Act's purposes and should be upheld.

Section 6(c) of the Act authorizes the Commission, "conditionally or unconditionally," to exempt any person, security, or transaction from any provision of the Act "if and to the extent that such exemption is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of [the Act]." 35/ This provision, by its terms, contemplates an array of conditions designed to ameliorate the fund management's conflicts of interest in dealing with the fund and its shareholders. The Act also gives general authority to the Commission to

---

35/ Other sections of the Investment Company Act provide similar exemptive authority specific to those sections. *See* Sections 10(f), 12(b), 17(d), 17(g), and 23(c).

make such rules as are necessary or appropriate to the exercise of the powers conferred upon the Commission under the Act. Section 38(a), 15 U.S.C. 80a-37(a). It is well settled that "the validity of a regulation promulgated" under an agency's enabling statute "will be sustained so long as it is 'reasonably related to the purposes of the enabling legislation.'" *Mourning v. Family Publications Serv., Inc.*, 411 U.S. 356, 369 (1973) (quoting *Thorpe v. Housing Auth. of City of Durham*, 393 U.S. 268, 280-81 (1969)). *See also Touche Ross & Co. v. SEC*, 609 F.2d 570, 579-80 (2d Cir. 1979).

The purposes of the Act are clear. Section 1(a) of the Act, 15 U.S.C. 80a-1(a), sets out the reasons investment companies "are affected with a national public interest," and notes the necessity for broad *federal* regulation of investment companies. The wide-ranging activities of investment companies "make difficult, if not impossible, effective State regulation of such companies in the interest of investors." Section 1(a)(5). Section 1(a)(2) points to the importance of the activities of investment companies as "constitut[ing] a substantial part of all transactions effected in the securities markets of the Nation," and Section 1(a)(4) points out that investment companies "are media for the investment in the national economy of a substantial part of the national savings and may have a vital effect

upon the flow of such savings into the capital markets." These findings made by Congress in 1940 are more true today than ever, with over $7.65 trillion in fund assets and 53.8 million American households invested in funds.

Section 1(b)(2) of the Act, 15 U.S.C. 80a-1(b)(2), states, among other things, that the national public interest and the interest of investors are adversely affected when investment companies are organized, operated, or managed in the interest of investment advisers or their affiliated persons rather than in the interest of their investors. And Section 1(b) specifically provides that the Act is to be interpreted so as to mitigate or eliminate such abuses. The importance of this language as a guide in the interpretation of the Act was stressed by Judge Friendly in *Brown v. Bullock*, 294 F.2d 415, 421 (2d Cir. 1961). *See also Levitt v. Johnson*, 334 F.2d 815, 819 (1st Cir. 1964).

As discussed above, the two conditions challenged by petitioner were adopted in order to strengthen oversight by independent directors of transactions that would, absent the Exemptive Rules, be prohibited under the Act because of serious conflicts of interest between funds and their management. Independent director oversight of such conflicts of interest, which has long been employed by the Commission under the Exemptive Rules, is entirely consistent with the approach taken by Congress in the Act, as detailed in Argument I. In light of the

recent scandals in the fund industry, the Commission determined that there had been a serious breakdown in the oversight of fund managers – oversight necessitated by the conflicts of interest inherent in the "external management" structure of funds. Because of this breakdown, it was reasonable for the Commission to conclude, as it did, that the current level of independent director oversight under the Exemptive Rules was not sufficient to monitor adequately the conflicts of interest inherent in the transactions covered by those rules, and that it needed to be improved. The adoption of the two new conditions represented a reasonable response to the problem, consistent with the purpose of the Act to rely on effective oversight by independent directors as a means of protecting funds and fund investors from conflicts of interest. The rule amendments were well within the Commission's authority.

Even if the Act had left ambiguous the Commission's authority to impose the two challenged conditions, this Court should adhere to the interpretive direction of Section 1(b) in upholding such authority. In addition, this Court should defer to the Commission's interpretation of the Act under *Chevron*. Petitioner incorrectly argues (Br. 25 n.9) that *Chevron* deference is inappropriate when the scope of the agency's jurisdiction is at issue. The Supreme Court has squarely held that *Chevron* deference applies to agencies' interpretations of the

statutes they administer, including those that implicate the agencies' jurisdiction. *See*, *e.g.*, *CFTC v. Schor*, 478 U.S. 833, 844 (1986); *NLRB v. City Disposal Systems Inc.*, 465 U.S. 822, 829-30 & n.7 (1984). *See also Mississippi Power & Light Co. v. Mississippi ex rel. Moore*, 487 U.S. 354, 381 (1988) (Scalia, J., concurring in the judgment) (giving deference to an agency's interpretation of its statutory authority is necessary because "there is no discernible line between an agency's exceeding its authority and an agency's exceeding authorized application of its authority. To exceed authorized application is to exceed authority."). 36/

B. Contrary to Petitioner's Contentions, Conditioning the Exemptive Rules on Independent Director Oversight Is Consistent With the Structure of the Act.

In spite of the Commission's express authority to grant conditional exemptions, petitioner argues (Br. 26-27) that the Commission lacked the authority to adopt the 75 percent independent board condition and the independent chair condition because they are related to corporate governance, which, petitioner argues, is the domain of state law. Of course, funds, like other corporations, are incorporated pursuant to state, not federal, law. But this does not mean that

---

36/ In *Business Roundtable v. SEC*, 905 F.2d 406, 408 (D.C. Cir. 1990), this Court stated, "we assume that we owe the Commission deference under [*Chevron*], even though the case might be characterized as involving a limit on the SEC's jurisdiction." *See also Mitchell v. Christopher*, 996 F.2d 375, 379 (D.C. Cir. 1993).

federal law imposes no requirements on the corporate governance of funds. While the Act "does not purport to be the source of authority for [a fund's] managerial power," the Act nonetheless "functions primarily to 'impos[e] *controls and restrictions* on the internal management of investment companies.'" *Burks v. Lasker*, 441 U.S. at 478 (citation omitted, emphasis in original). As we have seen, those controls and restrictions include giving to the independent directors "a host of special responsibilities involving supervision of management." *Id*. at 483. This plainly relates to corporate governance, particularly in the case of dealing with conflicts of interest as the Commission has done in the Exemptive Rules. A central objective of the Act is to impose a scheme of governance and oversight to regulate conflicts of interest that, in Congress' view, were not addressed adequately by state law.

Nevertheless, petitioner maintains (Br. 28) that the Act "contains no indication that the Commission was licensed to exceed its customary role and undertake the regulation of mutual fund governance." But this ignores that the Commission was expressly authorized to grant *conditional* exemptions, and that the conditions imposed by the rule amendments are reasonably designed to further the purposes of the Act and to protect investors. Nothing in the language of the statute or the legislative history suggests that Congress intended for the

permissible conditions to *exclude* conditions related to the oversight of the independent directors. To the contrary, as the Supreme Court said in *Burks v. Lasker*, 441 U.S. at 484-85, "the structure and purpose of the [Act] indicate that Congress entrusted to the independent directors of investment companies, exercising the authority granted to them by state law, the primary responsibility for looking after the interests of the funds' shareholders." Because Congress itself relied extensively on independent director oversight under the Act, it is entirely rational to construe the authority delegated by Congress to the Commission under the Act to include the authority to condition exemptions upon independent director oversight – authority the Commission has exercised for decades.

If petitioner's argument to the contrary were correct, the Commission would *never* be able to grant exemptions that relied upon the oversight of independent directors because to do so would infringe on a fund's corporate governance. Not only would the 75 percent independent board and independent chair conditions go out the window, so would the majority independent board condition adopted in 2001, and even the decades-old condition of separate approval by the independent directors. Instead, the Commission would be required either to review individually requests for exemptions for specific transactions, or to impose detailed and strict guidelines applicable to each category of prohibited

transactions. Contrary to petitioner's contention, this is not an approach mandated by Congress, but an approach Congress sought to avoid.

Petitioner next argues that the requirement of Section 10(a) that *at least* 40 percent of a fund's board be composed of independent directors somehow forecloses the possibility of requiring a greater percentage of independent directors, or of requiring an independent chair, as a condition to a fund's relying on an Exemptive Rule (Br. 28). In fact, petitioner claims (Br. 30, emphasis added) that the "Act's provision that 40 percent of a fund's directors be independent of management embodies a *considered congressional decision* to reject" a greater percentage, even in the case of an exemption for transactions the Act would otherwise prohibit. This is wholly unsupported and incorrect. There is nothing in the Act or the legislative history to indicate that the Commission could not require a higher percentage as a condition to an exemption where necessary or appropriate. Petitioner's argument fails to distinguish between the statutory requirements applicable to all funds, and the conditions for reliance upon the Exemptive Rules, which apply only to those funds that choose to rely upon those rules. Regardless of whether the Commission may lack authority to alter the former, nothing in the language of the statute suggests it lacks the authority to impose the latter, so long as they are reasonably related to the Act's purposes.

Petitioner cites (Br. 29) to the testimony of David Schenker, Chief Counsel of the Commission's Investment Trust Study. But while Mr. Schenker explained that a majority independent director provision in the original Senate bill had been reduced to 40 percent because of concerns that an independent majority could repudiate the recommendations of the investment adviser, he went on to say (in discussing the requirement of Section 10(b) of the Act that a *majority* of the directors be independent if the fund's principal underwriter is an affiliate of the fund's adviser):

> You come to a different situation which is dealt with in subsection (b). However, the bill provides that if you have a pecuniary interest more direct than that of merely a manager who gets a fee; if you have a pecuniary interest in the transactions in which the investment company effects and have the power to make these transactions, then you have to give up control of the board.

Investment Trusts and Investment Companies: Hearings on H.R. 10065 Before the House Subcomm. on Interstate and Foreign Commerce, 76th Cong., 3d Sess. 110 (1940). This is precisely what happens in the case of transactions covered by the Exemptive Rules. The conflicts of interest inherent in those transactions indeed involve pecuniary interests beyond the adviser's advisory fee. In fact, the conflicts are so serious the transactions would, absent an exemption, be absolutely prohibited. It is entirely appropriate to condition such transactions on effective

independent oversight.

Petitioner also appears to maintain that the Commission lacked authority to impose the two conditions because the Commission's *motivation* was improper, that the Commission sought not to enhance independent director oversight under the ten Exemptive Rules, but rather to mandate broadly independent control of funds generally. Any such contention is without merit. The Commission made it clear that although it "urge[d] all funds to consider adopting the measures to strengthen the independence of their boards, funds that do not rely on any of the Exemptive Rules will not be subject to these requirements." Adopting Release, 69 FR at 46379 n.12. While the Commission clearly believed (and desired) that the amendments would have salutary effects beyond the oversight of the conflicts involved in the ten Exemptive Rules, the amendments were "designed to enhance the ability of fund boards to perform their important responsibilities under each of the *rules*." *Id*. at 46379 (emphasis added). As long as the amendments were reasonably related to the purposes of the Act, which they unquestionably were, the Commission had authority to act.

C. <u>Petitioner's Reliance on Case Law Is Misplaced</u>.

The situation here is in sharp contrast to the situation presented in *Business Roundtable v. SEC*, 905 F.2d 406, cited by petitioner (Br. 32). There, this Court

determined that a rule adopted by the Commission, which barred securities exchanges from listing stock of a corporation that reduces per share voting rights, was beyond the Commission's authority. This was because the Court determined, 905 F.2d at 408, that the Securities Exchange Act of 1934, 15 U.S.C. 78a *et seq*., could not "be understood to include regulation of an issue that is so far beyond matters of disclosure [by issuers] * * * and of the management and practices of self-regulatory organizations [such as exchanges]." Instead, the effect of the rule was to regulate the management and practices of *issuers*, even though for issuers Congress' central concern in the Exchange Act was disclosure. *Id*. at 410. While the Exchange Act allowed the Commission to regulate the administration and operation of the *self-regulatory organizations*, it could not regulate "the *issuers*' corporate structures." *Id*. at 413. In marked contrast, the Investment Company Act directly regulates the management and practices, including aspects of the corporate governance, of funds, and assigns a specific role to the independent directors. "Unlike other federal securities laws, which are designed to protect investors primarily through disclosure, the Act imposes substantive requirements on the operations of investment companies in addition to disclosure requirements." Thomas P. Lemke, Gerald T. Lins, A. Thomas Smith, Regulation of Investment Companies (2004). Moreover, the Act expressly delegates authority to the

Commission to grant exemptions subject to conditions, provided that the exemptions are conditioned so as to be in the public interest and consistent with the protection of investors and the purposes of the Act. The Commission's imposition of "controls and restrictions" on the operations of a fund's board as a condition to a fund's reliance on the Exemptive Rules is entirely within the regulatory scheme of the Investment Company Act. *See Burks v. Lasker*, 441 U.S. at 478.

The other cases cited by petitioner (Br. 32-33) are equally unavailing. In *Teicher v. SEC*, 177 F.3d 1016 (D.C. Cir. 1999), the Court determined that the Commission could not use its authority under the Exchange Act, which allowed it to "place limitations" upon the activities of a person associated with a broker-dealer, to bar that person from association with an investment adviser. This was because the Exchange Act expressly allowed the Commission to bar a person associated with a broker-dealer from future association with a broker or dealer, while the Investment Advisers Act of 1940, 15 U.S.C. 80b-3(f), expressly allowed the Commission to bar a person associated with an investment adviser from future association with an investment adviser. This suggested that Congress intended there to be a nexus between the securities activity with which the person was associated and the securities activity from which the Commission was authorized

to bar him. Here, there is an obvious nexus between the two conditions challenged by petitioner, which enhance independent oversight of otherwise prohibited conflict-of-interest transactions, and the purpose of the Investment Company Act of protecting funds and fund investors from conflicts of interest.

In *American Bankers Ass'n v. SEC*, 804 F.2d 739 (D.C. Cir. 1986), this Court vacated a Commission rule that required banks engaging in the securities brokerage business to register as broker-dealers under the Exchange Act, even though the Exchange Act "unambiguously" excluded banks from broker-dealer regulation. Although the Commission rule sought to redefine "bank" such that banks engaged in the brokerage business could be regulated, the Court found (804 F.2d at 755) that the statutory definition was "plain as can be" and reflected a basic decision by Congress on how to allocate regulatory responsibility that could not be changed except by Congress. Here, in contrast, there is no claim that the rule amendments conflict with the plain language of the statute. In fact, they are entirely consistent with that language. 37/

37/ In *Chamber of Commerce of the United States v. Dep't of Labor*, 174 F.3d 206 (D.C. Cir. 1999), also cited by petitioner (Br. 33), this Court held that OSHA was required to conduct notice and comment rulemaking before imposing safety and health standards which employers were required to meet in order to avoid costly and inconvenient OSHA inspections. Here, of course, the Commission did conduct notice and comment rulemaking.

III. The Commission Articulated a Satisfactory Explanation for the Rule Amendments; The Rational Connection Between the Facts Found and the Choices Made Cannot Be Doubted.

Petitioner argues (Br. 34-35) that the Commission's adoption of the two conditions was "arbitrary, capricious, an abuse of discretion, or not in accordance with law." As the Supreme Court has explained, the scope of review under the "arbitrary and capricious" standard is narrow and this Court is not to substitute its judgment for that of the Commission. *Motor Vehicle Manufacturers Ass'n v. State Farm Mutual Automobile Insurance Co.*, 463 U.S. 29, 43 (1983). Nevertheless, the Commission was required to examine the relevant data and articulate a satisfactory explanation for its action including a "rational connection between the facts found and the choice made." *Id.* (quoting *Burlington Truck Lines, Inc. v. United States*, 371 U.S. 156, 168 (1962). In reviewing that explanation, the Court must "consider whether the decision was based on a consideration of the relevant factors and whether there has been a clear error of judgment." *Id*. (quoting *Bowman Transp., Inc. v. Arkansas-Best Freight System, Inc.*, 419 U.S. 281, 285 (1974); *Citizens to Preserve Overton Park v. Volpe*, 401 U.S. 402, 416 (1971). Normally, an agency rule would be arbitrary and capricious if the agency has relied on factors which Congress has not intended it to consider, entirely failed to consider an important aspect of the problem, offered an explanation for its

decision that runs counter to the evidence before the agency, or is so implausible that it could not be ascribed to a difference in view or the product of agency expertise. *Id*. As more fully discussed below, in adopting the rule amendments, the Commission indeed examined the relevant facts and properly articulated a detailed and rational explanation for its action.

A. The Commission Fully Explained Its Rationale for Amending the Exemptive Rules.

Petitioner argues (Br. 35-39) that the Commission failed to articulate a cogent explanation for its actions. Apparently, rather than dealing with the Exemptive Rules as a group, petitioner would have the Commission address each rule individually. But the Commission explained in connection with the 2001 amendments and again in connection with the 2004 amendments why it was appropriate to amend these particular rules. The ten rules were selected because each of them (i) exempted funds from provisions of the Act that prohibit certain conflict-of-interest transactions, and (ii) had as a condition the approval or oversight of independent directors. 38/ The Commission explained: "These rules rely on the independent judgment and scrutiny of directors, including independent directors, in overseeing activities that are beneficial to funds and fund

---

38/ 2001 Proposing Release, 64 FR at 59829. In fact, the Commission requested comment on the criteria it used to select the ten rules. *Id*.

shareholders but that involve conflicts of interest between the funds and their managers." 39/ Because the scandals in the fund industry involved serious conflicts of interest in which fund managers benefitted at the expense of the fund investors, the need for greater scrutiny of potential conflicts of interest, including those covered by the Exemptive Rules, was obvious. There was no need for the Commission to discuss, yet again, the reasons why independent director oversight was an essential condition for each individual rule. Rather, the Commission appropriately discussed why independent director oversight needed to be *enhanced* and how the rule amendments would further that objective.

Petitioner focuses (Br. 36-38) on two of the Exemptive Rules, Rules 17g-1(j) and 15a-4(b)(2), and complains that the Commission did not explain why the amendments were necessary "in light of the exemption's longstanding requirement that the [transaction] be approved by a majority of independent directors." 40/ In fact, the Commission explained, both in connection with the 2001 amendments and again in connection with the 2004 amendments, that serious problems had emerged in the mutual fund industry, indicating that the independent oversight

---

39/ 2004 Adopting Release, 69 FR at 46379.

40/ Under petitioner's theory, as discussed above, the Commission lacked the authority to impose even this condition.

conditions provided in the Exemptive Rules needed to be strengthened. In 2001, the Commission had added the condition that a majority of the board be independent, but that change proved to be inadequate. So, in 2004, the Commission further strengthened the conditions for independent oversight by adopting the 75 percent condition and the independent chair condition. "[A]n agency must be given ample latitude to 'adapt their rules and policies to the demands of changing circumstances.'" *Motor Vehicle Manufacturers Ass'n v. State Farm Mutual Automobile Insurance Co.*, 463 U.S. at 42 (quoting *Permian Basin Area Rate Cases*, 390 U.S. 747, 784 (1968)). 41/

Next, petitioner complains (Br. 38) that the Commission "failed to establish a connection between the problems that it claimed justified the rulemaking, and the actual terms of the rule," and that there is no relationship between the scandals

---

41/ Petitioner argues more specifically (Br. 37) that there is no connection between the ability of an independent chair to set the board's agenda, which was cited by the Commission as a benefit of the independent chair condition, and an Exemptive Rule that already requires board consideration of a transaction. As the Commission explained, however, control of the agenda by a management chair, among other things, "may contribute to the adviser's ability to dominate the actions of the board of directors." 2004 Proposing Release, 69 FR at 3474. The objective of having an independent chair is not to assure that transactions covered by the Exemptive Rules get on the board's agenda, but to assure that the independent directors are able to effectively exercise their oversight truly independently of, and not dominated by, management.

involving late trading, market timing, and misuse of nonpublic information, and the transactions for which exemptions are provided under the Exemptive Rules. Of course there is a relationship. Independent directors are supposed to play the role of independent watchdogs who furnish an independent check upon the fund management. *Burks v. Lasker*, 441 U.S. at 484. These scandals, the Commission found, reflected a serious breakdown in controls over the conflicts of interest between funds and their managers that are inherent in the external management structure of funds – the same sort of conflicts that led Congress to prohibit the transactions covered by the Exemptive Rules. The watchdogs (or at least some of them), it appears, were asleep or, worse, were awake but chose not to bark. Since independent director oversight of fund managers in the areas involved in the scandals had proved ineffective, it was reasonable for the Commission to conclude that independent director oversight of fund managers under the Exemptive Rules should be strengthened. The Commission explained both in the 2004 Proposing Release, 69 FR at 3472, and in the 2004 Adopting Release, 69 FR at 46378-79, that, in light of the scandals, the amendments were necessary and appropriate to "provide for greater fund board independence and are designed to enhance the ability of fund boards to perform their important responsibilities under each of the [Exemptive Rules]." The Commission concluded in the 2004 Adopting Release,

69 FR at 46379-80 (footnote omitted): "We recognize that these amendments might not have prevented all of the abuses that were uncovered in the enforcement actions discussed above. Nevertheless, if funds are to engage in the transactions permitted by the Exemptive Rules and effectively manage the conflicts of interest inherent in those transactions, greater board independence is needed." 42/

Finally, petitioner makes the remarkable claim (Br. 34, 39) that the requirement in the Consolidated Appropriations Act, 2005, Pub. L. No. 108-447, 118 Stat. 2809 (2004), that the Commission submit a report to the Senate Appropriations Committee, constitutes a "congressional determination that the Commission failed to satisfy its obligation under the APA" to justify the independent chair condition. Congress made no such determination – it simply

---

42/ Petitioner also claims (Br. 38) that there was insufficient "record evidence" to support the rule amendments. As more fully discussed *infra* at __, the Commission was required, in addressing the effectiveness of independent director oversight, to use its judgment to predict how funds would react to the new conditions imposed by the rule amendments. The Commission relied on an extensive comment file, as well as its own experience and expertise. "[A] forecast of the direction in which future public interest lies necessarily involves deductions based on the expert knowledge of the agency." *FCC v. National Citizens Comm. for Broadcasting*, 436 U.S. 775, 813 (1978) (quoting *FPC v. Transcontinental Gas Pipe Line Corp.*, 365 U.S. 1, 29 (1961); *Melcher v. FCC*, 134 F.3d 1143, 1156 (D.C. Cir. 1998). Petitioner also cites (Br. 38) to a "recent academic study" that was not before the Commission and is not part of the record in this case. It cannot be considered by this Court. *See* Section 43(a).

asked for a report. The appropriation for the Commission included in the bill contains a provision directing the Commission, not later than May 1, 2005, to submit a report to the Committee on Appropriations of the Senate that provides a justification for the independent chair condition. The report is to include an analysis of whether mutual funds chaired by disinterested directors perform better, have lower expenses, or have better compliance records than mutual funds chaired by interested directors. The Commission is directed to act upon the recommendations of the report not later than January 1, 2006. What conclusions, if any, Congress or the Senate committee draws from the report remains to be seen. If Congress had wished to nullify the Commission's action, it easily could have done so.

B. The Commission Properly Considered Whether the Rule Amendments Would Promote Efficiency, Competition, and Capital Formation.

Section 2(c) of the Act, 15 U.S.C. 80a-2(c), requires the Commission, when engaging in rulemaking that requires it to consider or determine whether an action is necessary or appropriate in the public interest, to also consider whether the action will promote efficiency, competition, and capital formation. The Commission specifically considered this in Section VIII of the 2004 Adopting Release, "Consideration of Promotion of Efficiency, Competition and Capital

Formation," 69 FR at 46388-89. The Commission said that it did not expect the amendments to have a significant effect on efficiency, competition and capital formation because the costs associated with the amendments were minimal and many funds had already adopted the required practices. To the extent that these amendments did affect competition or capital formation, the Commission said it believed that the effect would be positive because the amendments were likely to reduce the risk of securities law violations such as late trading in mutual funds and market timing violations, and thus increase investor confidence in mutual funds. In the 2004 Proposing Release, the Commission solicited comments on the impact of the proposed amendments on efficiency, competition and capital formation, but did not receive any from petitioner or any other commenter.

Nevertheless, petitioner now argues (Br. 40-42) that the Commission did not adequately consider the effect of the rule amendments on efficiency, competition, and capital formation, because it did not conduct an empirical analysis of whether funds with independent chairs performed better than funds with management chairs. 43/ But there is nothing in the statute that requires an empirical study to

---

43/ Petitioner contends (Br. 40) that the Commission staff failed to conduct a study although requested to do so by Commissioner Glassman. In fact, at the Commission meeting adopting the amendments, the Commission's Deputy Chief Economist explained that his office had in fact analyzed the (continued...)

demonstrate that a particular action will, in fact, promote efficiency, competition, and capital formation. Section 2(c) required the Commission to consider whether the rule amendments would promote efficiency, competition, and capital formation. The Commission did just that. The primary objectives of the rule amendments were to monitor more effectively conflicts of interest and better protect investors. To the extent that factual determinations were involved in the Commission's decision to adopt the new conditions, "they were primarily of a judgmental or predictive nature." *FCC v. National Citizens Comm. for Broadcasting*, 436 U.S. 775, 813 (1978). "In such circumstances complete factual support in the record for the Commission's judgment or prediction is not possible or required; 'a forecast of the direction in which future public interest lies necessarily involves deductions based on the expert knowledge of the agency.'" *Id*. (quoting *FPC v. Transcontinental Gas Pipe Line Corp.*, 365 U.S. 1, 29 (1961).

In *Melcher v. FCC*, 134 F.3d 1143, this Court considered an FCC decision to bar rural telephone companies from holding licenses for wireless service in the same geographic area in which they provide telephone service if there was more

---

43/ (...continued)
issue, but that it had ceased work when it determined that it was not finding anything new and because the evidence it had found was "mixed" and "inconclusive," and "there is a limited ability to measure" the costs and the benefits. R4:30-36.

than a 10 percent overlap of customers. Among other things, the FCC found that the restriction would not hinder the introduction of the wireless service in rural areas because there was unlikely to be that much overlap between the area served by a rural phone company and the area likely to be served by the wireless service. The rural phone companies argued that the FCC was required to "conduct an analysis of the actual degree of overlap between [wireless service] areas and rural telephone company service areas." *Id*. at 1158. This Court said that the FCC might profitably have undertaken such a factual investigation, but that it was not required to do so. "[W]e do not believe that the comprehensive factual analysis that the rural [phone companies] would have liked was actually required of the FCC in this case. The FCC was entitled to conduct, and did conduct, a general analysis based on informed conjecture. * * * The FCC accordingly drew a reasonable inference from its general knowledge * * *." *Id*.

Petitioner also contends (Br. 41) that the Commission failed to consider the Bobroff-Mack Report, discussed above, even though, according to petitioner, it showed that management-chaired funds outperformed independent-chaired funds. In fact, the Commission did consider the report in the 2004 Adopting Release, 69 FR at 46383 n.52, but did not find it compelling. The report did not purport to discuss the future impact, if any, of the independent chair condition on fund

performance. With respect to past performance, the report was equivocal in its conclusion, stating (p. 4): "Why independent chair funds have performed less well than management chair funds is an interesting and challenging question. Apart from having different types of board chairs, the two groups of funds have other important differences that may have impacted performance results." 44/ As the Commission pointed out in the 2004 Adopting Release, 69 FR 46383 n.52, another commenter, using the same data as the Bobroff-Mack Report, found that the

---

44/ The report explains some of these differences (p. 4-5):

> The independent chair fund groups are mostly bank-based, sales force oriented fund groups, which distribute their funds importantly through the banks' own trust departments and brokerage arms. In contrast, the management chair fund groups are mostly so-called "wholesale" firms: sales force oriented groups that sell mainly through third-party broker-dealers and other distributors. It is possible that differences in the types of clients served (for example, being more or less conservative) or other distribution-related factors could have influenced performance results. * * * [W]e have focused on the larger fund groups, and the independent chair funds and fund groups tend to be smaller than the other firms. * * * Therefore, as it happens the independent chair firms are being compared against mostly larger firms, which by definition have been more successful in asset gathering, which may be because they have produced particularly good investment performance.

The report also pointed out (p. 11) that it had been prepared under "significant time restraints," which "limited the possibilities for further analysis."

independent-chaired funds performed slightly *better* than management-chaired funds (R2: Letter 175). That commenter, John C. Bogle, the founder and former CEO of The Vanguard Group, believed (p. 13) that the Bobroff-Mack Report had mis-categorized some funds as independent chair when they should have been categorized as management chair. 45/ After correcting what he thought were mis-categorizations, and expanding the categories being compared from two to four, Bogle found (p. 14) that "management-chaired funds and bank-managed funds ranked at the bottom * * *. 46/ Independently-chaired funds did only slightly better in terms of returns, but at lower cost." Another commenter, John A. Hill, warned (R2: Letter 171) that "[s]tudies purporting to show that funds with affiliated chairpersons have better investment results are statistically flawed: there are too few funds with independent chairs (less than 1%) and the time frames selected for comparison are too limited to permit any statistically significant

---

45/ One of the poorest performing fund groups, Bogle said (p. 13), had been put in the independent chair group in the Bobroff-Mack Report even though the chairmen during the time period had been the former head of the fund's management company and a former senior executive of the conglomerate that owned the management company.

46/ Bogle compared non-bank funds having independent chairs, bank-managed funds having independent chairs, funds having management chairs, and funds operated under mutualized structures where the fund chair was affiliated with the fund's *administrator* but not with the fund's *investment adviser*.

comparisons on the performance front." 47/

That the Commission would proceed to adopt the independent chair condition in spite of the Bobroff-Mack Report is hardly surprising, especially given the fact that the amendments were not proposed as a means of enhancing fund financial performance, but as a means of enhancing independent oversight of conflict-of-interest transactions. The Commission believed "that having independent chairmen can provide benefits and serve other purposes apart from achieving high performance of the fund. In this regard, corporate governance experts have pointed more generally to the value an independent chairman brings to a corporate board of directors." 48/ That does not mean that the Commission failed to consider whether the rule amendments would promote efficiency, competition, and capital formation, but, as stated by the Supreme Court, "[i]t is not infrequent that the available data do not settle a regulatory issue, and the agency must then exercise its judgment in moving from the facts and probabilities on the

---

47/ We assume Hill's "less than 1%" figure refers to funds that are non-bank funds.

48/ 2004 Adopting Release, 69 FR at 46384.

record to a policy conclusion." *Motor Vehicle Manufacturers Ass'n*, 463 U.S. at 52. 49/

C. The Commission Properly Considered Both the Costs of the Rule Amendments, and the Alternatives Proposed by the Commenters.

Petitioner claims (Br. 43-45) that the Commission failed to consider the costs related to the two conditions, particularly the cost of hiring staff to assist the independent directors and independent chairs. In fact, both the 2004 Proposing Release, 69 FR at 3478-79, and the 2004 Adopting Release, 69 FR at 46386-87, specifically discussed the benefits and the costs of the conditions. In the proposing release the Commission acknowledged that the conditions would impose some additional costs on funds that rely on an Exemptive Rule. 69 FR at 3479. However, the Commission said that it was not aware of any costs associated with the hiring of staff because "boards typically have this authority under state law, and the rule would not require them to hire employees." *Id*. Nevertheless, the Commission requested comment on whether boards would choose to hire employees. *Id*. In the adopting release, the Commission again stated that the

---

49/ Petitioner again makes the claim (Br. 42-43) that Congress has determined that the Commission "violated the [Investment Company Act] and the APA as well," and thus has rendered the independent chair condition "*ipso facto* invalid." Again, Congress did not make any such determinations – it simply asked for a report.

Commission staff was not aware of any costs associated with the hiring of employees or retaining experts. 69 FR at 46387. Although the amendments added a provision to authorize the independent directors to hire employees and to retain advisers and experts necessary to carry out their duties (69 FR at 46385), the amendments did not require that they do so (69 FR at 46387). The cost, if any, would be wholly within their discretion. Presumably any additional cost would be incurred because the independent directors decided that it was in the interest of the fund and its investors for them to retain staff to help them better carry out their duties. 50/

Petitioner asserts (Br. 45) that the independent chair provision "will inevitably impose search costs and in many instances will require funds to pay board members higher salaries." Petitioner does not explain why this is "inevitable." Some commenters believed that the independent chair could be selected from among the fund's existing independent directors. *See* John H. Hill, Chairman of the Board, Putnam Mutual funds (R2: Letter 171), Ashok N. Bakhru, Independent Chairman, Goldman Sachs Trust (R2: Letter 57), Fergus Reid III,

---

50/ The Commission noted (69 FR at 46387 n.81) that an independent chairman might hire staff for assistance in carrying out his or her responsibilities as chairman. However, the Commission said that it had no reliable basis for estimating those costs.

Independent Chairman, JP Morgan Funds (R2: Letter 174). In any event, the additional costs, if any, are speculative at this point, and the Commission had no reliable basis for estimating those costs. 2004 Adopting Release, 69 FR at 46387. Similarly, the Commission explained that it could not estimate the cost of compliance with the 75 percent independent director condition because it had no basis for determining how funds would choose to satisfy the condition. *Id*. One way described by the Commission that a fund could comply – decreasing the size of its board and allowing some interested directors to resign – appears to involve little or no cost. In all events, the Commission *did* find that the costs associated with the amendments were minimal and that many funds had already adopted the required practices. 69 FR at 46388. Because the costs, if any, were minimal and difficult to evaluate, the Commission was not required somehow to come up with a dollar estimate, as petitioner would have it do.

Next, petitioner argues (Br. 46-47) that the Commission did not give adequate consideration to the idea of letting the independent directors choose the board chair, whether the chair be independent or not. Of course, the Commission *did* consider this issue. "To be clear," the Commission said, "the amendments we are adopting today do not prevent the independent directors from choosing the most qualified and capable candidate. That candidate, however, cannot serve two

masters." 69 FR at 46383. Petitioner dismisses the Commission's conclusion that the chair of a fund board "cannot serve two masters" as a "cliché" (Br. 46) and a "quip" (Br. 47). In fact, it goes directly to the heart of the matter: enhancing the board's ability to protect the fund and its shareholders from conflicts of interest with the adviser.

Finally, petitioner argues (Br. 47-48) that the Commission gave inadequate consideration to alternatives to the independent chair condition, including the alternative, mentioned by the dissenting commissioners, of enhanced disclosure of whether or not the chair was independent. But the Commission is not required to discuss every alternative raised. Here, the Commission discussed many of the alternatives suggested by the commenters, including the major alternatives proposed. 2004 Adopting Release, 69 FR at 46384. *See Motor Vehicle Manufacturers Ass'n*, 463 U.S. at 51 ("Nor do we broadly require an agency to consider all policy alternatives in reaching a decision."). No specific discussion of this particular alternative was required, particularly since Congress rejected a purely disclosure-based approach to regulating conflicts of interest under the Act.

CONCLUSION

For the foregoing reasons, the petition should be dismissed for lack of standing or, alternatively, the order of the Commission should be affirmed.

Respectfully submitted,

GIOVANNI P. PREZIOSO
General Counsel

MEYER EISENBERG
Deputy General Counsel

JACOB H. STILLMAN
Solicitor

____
JOHN W. AVERY
Special Counsel

Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549-0606
(202) 942-0816 (Avery)

January 2005

CERTIFICATE OF SERVICE

I hereby certify that on this 12th day of January, 2005, I caused two copies of the initial Brief of the Securities and Exchange Commission, Respondent, to be served on counsel for petitioner, by hand, as follows; and delivered the requisite copies of such brief to the clerk by hand:

Eugene Scalia, Esq.
Gibson, Dunn & Crutcher LLP
1050 Connecticut Avenue, N.W.
Washington, DC 20036-5306
Telephone: (202)955-8500

____
JOHN W. AVERY
Special Counsel

CERTIFICATE OF COMPLIANCE WITH RULE 32(a)

The foregoing brief used 14-point proportionally spaced type and contains 13,905 words according to the word processing program with which it was prepared, WordPerfect 9.

____

JOHN W. AVERY
Special Counsel

January 12, 2005