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A legal update from Dechert's Financial Services Group

SEC and Chamber of Commerce Oral Arguments and Briefs Filed with Court of Appeals

Introduction

Oral arguments in the case in which the Chamber of Commerce of the United States (the "Chamber") is suing the Securities and Exchange Commission (the "SEC" or "Commission") were held on January 6, 2006.[1] This update sets forth the history of the case, summarizes the briefs filed by the parties, and reports on the oral argument. The presiding judges in the case were Karen LeCraft Henderson, Judith W. Rodgers, and Janice Rodgers Brown. Eugene Scalia of Gibson, Dunn & Crutcher, LLP, represented the Chamber, and Giovanni P. Prezioso, General Counsel of the SEC, represented the Commission.

The parties generally adhered to the positions set forth in their respective briefs, with some additions mentioned in the Appendix at the end of this update. In this regard, a large proportion of the time spent in the oral argument concerned the issue of the SEC's authority to take the actions it did prior to the issuance of the Court's mandate, rather than on more substantive matters. Judge Rodgers questioned the parties closely on their positions, with the other judges asking questions infrequently.

Background

On September 21, October 21, November 7, November 10, and November 14, 2005, the Chamber and the SEC filed briefs with the U.S. Court of Appeals for the District of Columbia Circuit (the "Court") in connection with the Chamber's challenge of certain exemptive rule amendments promulgated by the SEC.

Under these amendments, as of January 16, 2006, each fund seeking to take advantage of any of the ten commonly-used exemptive rules to engage in certain transactions otherwise prohibited by the Investment Company Act of 1940 (the "1940 Act") must have a board of directors consisting of no less than 75% independent directors, and a chairman who is independent of the fund's investment adviser (the "Amendments").[2]

The SEC's briefs and the Chamber's briefs respond to the Court's ruling on June 21, 2005. The Court found that the SEC acted within its authority in adopting the Amendments, but failed adequately to consider the costs imposed upon funds by those Amendments, and failed adequately to consider a proposed disclosure alternative to the independent chair amendment. The Court remanded the matter to the SEC to address these issues, but did not vacate the Amendments. On June 29, 2005, the SEC affirmed the adoption of the Amendments.[3] The Chamber appealed, eventually filing a motion to stay the Amendments with the Court. On August 10, 2005, the Court granted the Chamber's

[1] *Chamber of Commerce of the United States of America v. SEC*, No. 04-1300 (D.C. Cir. June 21, 2005).

[2] Dechert issued legal updates providing an in-depth look at the Amendments, as well as the procedural history of this case, in June 2005 (Issue 11), July 2005 (Issue 14), and September 2005 (Special Alert).

[3] Rel. No. IC-26985 (June 30, 2005). The SEC's actions occurred prior to the Court issuing its mandate. While the Court made its ruling on June 21, 2005, its mandate in No. 04-1300 was not issued until over a week later (the "Mandate"). *See supra* note 1.

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motion to stay the Amendments' effectiveness pending judicial review.[4]

Issues

In their briefs, the Chamber and the SEC addressed the following seven major points:

- Did the SEC have authority to take the actions it did prior to the issuance of the Court's Mandate?
- Was additional public notice and comment required for the SEC's actions on June 29, 2005?
- Did the SEC respond appropriately to the Court's remand?
- Did the SEC give proper consideration to the cost of the Amendments?
- Did the SEC properly consider the Amendments' effects on efficiency, competition and capital formation?
- Did the SEC adequately consider the disclosure alternative?
- Did the Chamber have standing to challenge the Amendments?

The Chamber argued that: (i) the SEC violated the Federal Rules of Appellate Procedure[5] by acting on the Court's decision at its June 25, 2005 meeting prior to the issuance of the Court's Mandate; (ii) the SEC procedures in "re-adopting" the Amendments violated the Administrative Procedure Act (the "APA") which required further notice and comment; (iii) in resolving at the outset to "re-adopt" the Amendments, the SEC failed to conduct the analysis directed by the Court's remand; (iv) the SEC did not give proper consideration to the cost of the Amendments because its cost analysis was dependent on inadequate and unreliable evidence; (v) the SEC did not properly consider the Amendments' effect on efficiency, competition, and capital formation, particularly with respect to smaller funds; (vi) the SEC failed to adequately consider the disclosure alternative and improperly excluded the Commissioners who first suggested the disclosure option; and (vii) the Chamber had a legally cognizable injury which provided standing.

The SEC responded that: (i) it never lost jurisdiction to take the actions it took in response to the Court's ruling and before the issuance of its Mandate; (ii) it was not required by the APA to engage in a comprehensive re-evaluation of the Amendments through full-blown notice and comment rulemaking; (iii) the issues remanded by the Court were "'discrete and clearly defined'" and the SEC response was "entirely appropriate in the public interest;" (iv) it considered the range of costs associated with each of the ways funds might comply with the 75% independent director amendment and the range of possible costs to an *individual* fund associated with the independent chair amendment and concluded the costs were indeed minimal; (v) it considered the effects of the costs of the Amendments on efficiency, competition, and capital formation and determined that they would have little if any adverse effect; (vi) it had carefully considered the disclosure alternative and the reasons why it would not sufficiently serve the interests of investors; and (vii) standing should not be based on a claim of lost opportunity to purchase a desired product.

In the oral argument, the parties covered the foregoing issues, except for the last one, concerning the Chamber's standing to challenge the Amendments. A more detailed summary of the parties' arguments is set out in the Appendix at the end of this update.

Possible Results

Once the Court reaches a decision, it could issue its mandate within two months. If the SEC loses, the Court could declare the Amendments invalid or remand the matter to the SEC for additional action—for example, re-publishing the Amendments as proposals for additional comments.

If the SEC were to prevail, it is unlikely that it will impose the original January 16, 2006 compliance date retroactively. The Chamber could seek *en banc* review by the Court if the Chamber successfully argues that the proceedings involved questions of exceptional impor-

[4] *Chamber of Commerce of the United States of America v. SEC*, No. 05-1240 (D.C. Cir. August 10, 2005). While not otherwise limited, the parties were directed to address in their briefs whether the SEC had the authority to act on the Court's remand prior to the issuance of the Court's Mandate.

[5] Federal Rules of Appellate Procedure 41.

tance.[6] If that review was denied, the Chamber could also appeal the decision to the U.S. Supreme Court if certiorari was granted.

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[6] *See* Fed. R. App. P. 35(a).

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Appendix

In their briefs, the Chamber and the SEC addressed the seven major issues set out below. Certain points from the parties' oral argument are also included.

Acting Prior to Issuance of Mandate

Chamber's primary arguments include:

- SEC violated the Federal Rules of Appellate Procedure[7] by acting on the Court's decision at its June 25, 2005 meeting prior to the issuance of the Court's Mandate.
- SEC was not authorized to act until the Court had issued its Mandate.
- In prior cases where agencies were permitted to act prior to the issuance of a mandate, agency action was at the specific instruction of the court.
- SEC's actions were *not* the same as a district court denying a motion for reconsideration while an appeal is pending because the SEC was obligated by the Court to analyze numerous additional matters.
- SEC's "premature action" invited "the very confusion and waste of resources that a Court's careful marshalling of its mandate is meant to avoid."

SEC's responses include:

- SEC never lost jurisdiction to take the actions it took in response to the Court's ruling and before the issuance of its Mandate. At the oral argument, Mr. Prezioso asserted that the SEC retained its statutory rule-making authority.
- SEC acted consistently with precedent authority holding that a lower tribunal, either a court or an agency, retained jurisdiction to consider modifying or to deny modification of an order that was the subject of a pending appeal.
- At its June 29, 2005 meeting, the SEC considered the Amendments and declined to modify them.
- SEC's actions in advance of the Court's Mandate did not present the risk of confusion and conflict that mandate principles were intended to avoid.
- In reviewing the Amendments, the SEC "was taking the very action that the Chamber had argued for and this Court had ordered."
- SEC could not have violated Federal Rule of Appellate Procedure 41 because Rule 41 addresses certain technical aspects of a mandate and not whether an agency was divested of jurisdiction to act in advance of the issuance of a mandate.
- At the oral argument, Judge Rodgers acknowledged that the Court had not established rules concerning the significance of an agency taking action prior to the issuance of its mandate

Additional Public Notice and Comment for SEC's Actions

Chamber's primary arguments include:

- SEC procedures in "re-adopting" the Amendments violated the APA.
- "When a rule has been remanded to an agency for reconsideration, the requirements of the APA and other statutes governing agency decision making apply no less than in the original rulemaking."
- It is standard practice for an agency to receive and consider additional public comment on remand.
- The need for additional public comment was clear: "In the original rulemaking, in briefing and argument before this Court, and in its report to Congress, the Commission insisted that it had 'no reliable basis' in the existing rulemaking record to make the 'difficult' cost assessment sought by the Commission, other commenters, and ultimately by this Court."
- Although the public "stood ready to provide information" to the SEC, the SEC rejected public comment because it was "motivated by a resolve to ram [the Amendments] through before key votes were lost, rather than by due regard for the rulemaking process."

[7] Federal Rules of Appellate Procedure 41.

- Further notice and comment was required by the APA because the SEC relied heavily on "extra-record" materials for its actions on June 29, 2005.

SEC's responses include:

- SEC was not required by the APA to engage in a comprehensive reevaluation of the Amendments through full-blown notice and comment rulemaking.

- Court would only find a notice and comment defect in the context where "new underlying data not previously published for comment was the 'most critical' information underlying the agency's decision," and none of its cost estimates rose to that threshold.

- In order to obtain relief for an absence of notice and comment, the Chamber had "the burden of showing prejudice by indicating with reasonable specificity what information it objects to and demonstrating that had more precise notice been given, it 'would have submitted additional, different comments that could have invalidated the rationale for the [rule],'" and "[n]ot having shown any material inaccuracy in the Commission's cost estimates," the Chamber had not carried its burden.

- Focus in rulemaking cases "'is primarily on whether the final rule changes critically from the proposed rule rather than on whether the agency relies on supporting material not published for comment.'"

- SEC's notice in the proposing release fully complied with the APA by setting out the terms and substance of the proposed rule and a description of the subjects and issues involved.

- SEC's notice in the proposing release had solicited comment on the two issues later remanded by the Court—the costs of the Amendments and possible alternatives.

- "[A]ll interested parties were on notice, and had a fair and meaningful opportunity, to provide comments if they disagreed."

- Further notice and comment was not required because the SEC relied to some extent on what the Chamber called "extra-record" evidence.

- There is a distinction between the record requirements for informal rulemakings as compared with formal agency actions.

- While formal agency actions require a hearing "on the record," the SEC's informal rulemaking on June 29, 2005 did not.

- An "administrative record in an informal rulemaking 'might well include crucial material that was neither shown to nor known by the private parties in the proceedings.'"

Responding Appropriately to the Court's Remand

Chamber's primary arguments include:

- SEC's procedures in "re-adopting" the Amendments violated the Court's remand.

- By not receiving and considering additional public comment, the SEC violated the Court's instructions to "'determine as best it can the economic implications'" of the Amendments and to "'do what it can to apprise itself . . . of the economic consequences'" of the Amendments (emphases omitted).

- SEC "lacked the record evidence to conduct the analysis directed by the Court" and as a result further notice and comment was necessary.

- In remanding the Amendments, the Court had cited two cases in which an agency had sought additional public comment on remand.

- SEC's rush to judgment to re-adopt the Amendments reflected an impermissible rubber-stamping of its earlier action and improperly precluded the deliberative, consultative process required of SEC decision making.

- In resolving at the outset to "re-adopt" the Amendments, the SEC violated the Court's remand.

SEC's responses include:

- SEC's response to the Court' remand was "entirely appropriate in the public interest."
- SEC's "swift response to the Court's remand, which served to reassure investors that their interests would be protected, was the most responsible course of action for the Commission to take under the circumstances."
- Issues remanded by the Court were "'discrete and clearly defined'" and the SEC already had a foundation from which to consider them.
- Court did not specify the use of any particular procedures on remand, choosing instead to follow the "'usual rule that a reviewing court should leave the agency free on remand to determine whether supplemental fact-gathering is necessary' to correct the deficiencies identified by the Court."
- "Even where some fact gathering might be necessary, 'on remand, the court leaves 'to the agency the methods, procedures, and time dimension of the needed inquiry....'"
- The two cases cited by the Court which involved additional public comment on remand were cited in order "to explain the circumstances in which a court should remand but not vacate a rule."
- At the oral argument, Mr. Prezioso stressed that on remand in this case, the SEC had not changed any of the Amendments, but rather took no action except to leave them in effect. This, he argued, should be subject to a lower level of scrutiny than situations in which an agency amended its prior action. He added that the Alabama Power case [8] left open the question of the authority of agencies to act prior to issuance of a Court's mandate. Judge Rodgers commented that the SEC would have difficulty in defending its action if it wanted to change the Amendments. She said that there are rushes to judgment every day, for example by the Congress. She also said that she was concerned about unintended consequences of the SEC's actions.

Giving Proper Consideration to the Cost of the Amendments

Chamber's primary arguments include:

- SEC violated the APA and the 1940 Act because its cost analysis was dependent on inadequate and unreliable evidence.
- Examples included the SEC's heavy reliance on "conclusory" newsletters to estimate directors' compensation, "stale" data to estimate the tenure of mutual fund directors and accordingly the frequency with which search costs would be incurred, "suspect" reliance on a newspaper article to estimate recruiting costs for independent directors, reliance on anecdotal evidence from unidentified SEC personnel to estimate additional hours of lawyers' services that independent directors and chairs may demand. At the oral argument, Mr. Scalia asserted that the SEC had cited 17 extra-record sources, and stressed that the SEC had previously told the Court that it had "no reliable basis" for estimating cost, but then, on remand "the scales fell from its eyes" and it decided that it did.
- SEC failed to consider the Amendments' costs relative to the specific mutual fund activities being regulated.

SEC's responses include:

- Costs were indeed minimal.
- Its earlier statements on "no reliable basis" were related to *industry-wide* costs. By focusing on the range of costs associated with each of the ways funds might comply with the 75% independent director amendment and the range of possible costs to an *individual* fund associated with the independent chair amendment, the SEC was "able reasonably to conclude that it did in fact have a reliable basis" for estimating and considering the costs associated with the Amendments.
- Chamber's arguments that the data relied upon by the SEC was unreliable or inadequate

[8] *Alabama Power Co. v. FPC, 511 F2d. 383 (D.C. Cir.1974).*

were "at best, claims of immaterial shortcomings in the Commission's cost estimates."

- SEC's "consideration of the widely used public bulletins from the Management Practice Institute, including the survey of director compensation, was entirely appropriate."

- Versions of the survey had been cited by a broad array of publications as the principal source on fund director compensation over at least the last decade.

- Chamber failed to appreciate the SEC's reliance on information from 2001 regarding the frequency with which independent directors would be replaced.

- Whereas the information from 2001 indicated a typical tenure of ten years, the SEC "conservatively estimated the replacement of directors on average every *five* years."

- SEC's reliance on its experience in regard to the estimates of additional expenses incurred by mutual fund boards for the services of independent legal counsel is not outside the rulemaking record.

- Chamber failed throughout its criticisms to demonstrate that the data relied upon by the SEC was materially inaccurate.

Properly Considering the Amendments' Effects on Efficiency, Competition, and Capital Formation

Chamber's primary arguments include:

- SEC's failure to consider the Amendments' effect on efficiency, competition, and capital formation violated the 1940 Act, the APA, the Small Business Regulatory Enforcement Fairness Act, the Regulatory Flexibility Act, and the Court's remand.

- With "virtually no analysis whatever," the SEC determined that the effects on mutual fund efficiency, competition, and capital formation would be "minimal."

- SEC failed to consider the Amendments' "effects on smaller funds—and the ramifications for competition and capital formation in the industry as whole."

- Using certain data from the Investment Company Institute, the Chamber's economic analysis showed the disproportionate impact that the Amendments would have on 47 fund complexes (out of a total of 360) that had assets under management of less than $50 million.

- The Amendments' "disproportionate effect on smaller funds will translate to higher costs for new entrants to the mutual fund industry, since new fund complexes typically start out with smaller funds."

- Additional costs will "serve as a barrier to entry and will reduce capital formation, competition, and innovation."

- SEC failed to assess the implications for competition in the industry as a whole by ignoring three recent studies that shed light on the impact that cost increases may have on the U.S. mutual fund industry.

- Studies suggested that small funds are vital to mutual fund competition and, unlike Europe, smaller funds still accounted for a significant portion of assets under management in the United States.

SEC's responses include:

- SEC carefully considered the effects of the costs of the Amendments on efficiency, competition, and capital formation "in the light of its more specific findings with respect to the costs associated with the [Amendments]."

- "[T]he cost of compliance, being minimal for any fund, would have little, if any, adverse effect on efficiency, competition and capital formation."

- The Amendments would help increase investor confidence and might thereby lead to increased efficiency and competitiveness of the U.S. capital markets; in turn, increased market efficiency and investor confidence might encourage more efficient capital formation.

- SEC had considered the costs on smaller funds and expressly found that, "'[t]he costs for any fund are sufficiently small that we think any adverse effect on competition will

continue to be minimal and will be justified by the benefits of the rule, especially given our judgment that small funds will choose options for compliance with the conditions at cost levels that do not approach the upper end of the range.'"

- An August 2005 survey of costs incurred by members of the Mutual Fund Directors Forum already operating in compliance with the Amendments showed compliance costs were at the low end of the range of estimates provided by the SEC.

- Chamber's economic analysis of the disproportionate impact that the Amendments would have on the alleged 47 fund complexes with assets less than $50 million was based on the faulty assumption that costs would be high, whereas the SEC found that costs would be minimal with options for compliance that had virtually no cost at all.

- With respect to the three recent studies cited by the Chamber, none of them examined, or even mentioned, the costs of the Amendments.

Adequately Considering the Disclosure Alternative

Chamber's primary arguments include:

- SEC failed to adequately consider the disclosure alternative to the independent chair amendment, thereby violating the APA as well as the Court's mandate.

- SEC majority improperly excluded the dissenting Commissioners (the same members who first suggested a disclosure requirement) from its "reconsideration" of the disclosure alternative.

- Sufficiency of the disclosure alternative was not considered in light of the other changes to mutual funds being implemented, including the 75% independent director amendment.

- SEC gave no consideration to "the public's interest in having management-chaired funds, an interest that the disclosure provision preserved but that the final rule effectively precludes."

SEC's responses include:

- SEC had carefully considered the disclosure alternative and the reasons why it would not sufficiently serve the interests of investors.

- Independent director oversight needed to be enhanced in response to scandals in the fund industry and the independent chair amendment furthered that objective.

- Given the potential for self-dealing by fund managers, disclosure concerning conflicts of interest would not prevent managers from putting their interests ahead of investors' interests

- Meaningful disclosure would be difficult in any event.

- While an agency is not required in informal rulemaking to explain in detail the reasons why certain alternatives were rejected, the SEC had provided sufficient detail to meet the applicable standard and permit judicial review.

Chamber's Standing to Challenge the Amendments

Chamber's primary arguments include:

- Chamber was invested in funds and intended to continue to invest in funds that were management-chaired and had fewer than 75% independent directors.

- Court had previously ruled that the Chamber had standing to challenge the Amendments: "'loss of the opportunity to purchase a desired product'—specifically, a management-chaired fund with a board of directors substantially influenced by the mutual fund adviser—'is a legally cognizable injury.'"

SEC's responses include:

- Court should not base standing on a claim of lost opportunity to purchase a desired product.

- A recent Seventh Circuit decision in which the Seventh Circuit rejected a claim of lost oppor-

tunities to profit through mutual fund investments as a basis for standing.[9]

- Seventh Circuit's decision was in accord with long-established precedent that a petitioner must demonstrate a concrete, particularized injury.

- Accordingly, the Court should not grant the Chamber standing.

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9 *DH2, Inc. v. SEC*, 422 F.3d 591 (7th Cir. 2005).