

ORAL ARGUMENT NOT YET SCHEDULED

No. 10-1305

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**IN THE UNITED STATES COURT OF APPEALS  
FOR THE DISTRICT OF COLUMBIA CIRCUIT**

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BUSINESS ROUNDTABLE and CHAMBER OF COMMERCE OF THE  
UNITED STATES OF AMERICA,  
*Petitioners,*

v.

SECURITIES AND EXCHANGE COMMISSION,  
*Respondent.*

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On Petition for Review of Final Rules  
of the Securities and Exchange Commission

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**BRIEF OF AMICI CURIAE INVESTMENT COMPANY INSTITUTE AND  
INDEPENDENT DIRECTORS COUNCIL  
IN SUPPORT OF PETITIONERS AND VACATUR AS APPLIED  
TO REGISTERED INVESTMENT COMPANIES**

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**CERTIFICATE OF PARTIES, RULING UNDER REVIEW,  
AND RELATED CASES**

**(A) Parties and Amici**

All parties, intervenors, and *amici* appearing in this Court are listed in the Brief of Petitioners.

Investment Company Institute (“ICI”) and Independent Directors Council (“IDC”) have no parent corporation and no publicly owned corporation owns ten percent (10%) or more of their stock.

**(B) Rulings Under Review**

References to the rulings at issue appear in the Brief of Petitioners.

**(C) Related Cases**

ICI and IDC are aware of no cases related to the case on review.

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## **GLOSSARY**

APA	Administrative Procedure Act
ETF	Exchange-traded fund
ICA	Investment Company Act of 1940
ICI	Investment Company Institute
IDC	Independent Directors Council
NYSE	New York Stock Exchange
SEC	U.S. Securities and Exchange Commission

## **STATUTES AND REGULATIONS**

All pertinent statutes and regulations are contained in the Brief of Petitioners.

## STATEMENT OF INTEREST OF *AMICI CURIAE*<sup>1</sup>

The Investment Company Institute (“ICI”) is the national association of registered investment companies in the United States. ICI’s members include open-end investment companies (the most common kind of investment company, which includes both mutual funds and most exchange-traded funds (“ETFs”)), closed-end investment companies, and unit investment trusts (hereinafter collectively “funds”). ICI has three core missions: encouraging adherence to high ethical standards by all industry participants; advancing the interests of funds and their shareholders, directors, and investment advisers; and promoting public understanding of funds. As part of these missions, ICI pursues an extensive research program and is the primary source of aggregate industry data relied on by government regulators, industry participants, and independent observers.

ICI’s members collectively manage 97 percent of the approximately \$11.5 trillion in U.S. fund assets on behalf of more than 90 million investors in over 52 million households.<sup>2</sup> Funds are comprehensively regulated and offer investors a high level of protection. Funds, their investors, and their advisers all have benefitted from the strong regulatory scheme set forth in the Investment Company

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<sup>1</sup> No party’s counsel has authored this brief in whole or in part, and no person other than amici or their counsel contributed money intended to fund the preparation or submission of the brief.

<sup>2</sup> See 2010 ICI ANNUAL REPORT TO MEMBERS, *available at* [http://ici.org/pdf/10\\_ici\\_annual.pdf](http://ici.org/pdf/10_ici_annual.pdf).

Act of 1940 (“ICA”), the Investment Advisers Act of 1940, the other major federal securities laws, and related rules of the U.S. Securities and Exchange Commission (“SEC”).

The Independent Directors Council (“IDC”), part of ICI, serves the fund independent director community and provides a venue to advance the education, communications, and policy interests of fund independent directors so as to promote the highest standards of fund governance. The activities of IDC are led by a Governing Council of independent directors from among the nearly 2,000 directors who sit on the boards of the ICI member funds. IDC provides the perspective of fund independent directors on policy matters.

Both ICI and IDC regularly engage in legislative, regulatory, and other initiatives aimed at increasing government and public awareness of issues affecting funds, directors, and their shareholders. In view of their respective constituents, missions, and expertise, ICI and IDC are well-suited to assist the Court in understanding Rule 14a-11’s impact on funds and to explain why the SEC’s decision to sweep funds within the ambit of the rule, as though they were materially identical to operating companies, was arbitrary and capricious in violation of the Administrative Procedure Act (“APA”).

## INTRODUCTION

The SEC adopted its new proxy access rule, Rule 14a-11, in response to perceived problems associated with the “responsiveness of some companies and boards of directors” arising out of the recent financial crisis. *Facilitating Shareholder Director Nominations*, 75 Fed. Reg. 56,668, 56,669 (Sept. 16, 2010). In crafting Rule 14a-11, the SEC focused intently on so-called “operating companies,” paying scant attention to the very different characteristics of funds—special-purpose investment vehicles in which investors entrust their assets to the management of an investment adviser. Indeed, the SEC’s proposing release relied upon empirical studies that expressly excluded the 524 fund complexes and 1,115 registered funds that comprise the \$11.5 trillion fund industry. *See Facilitating Shareholder Director Nominations*, 74 Fed. Reg. 29,024, 29,035 n.129 (June 18, 2009).

Even though funds are structured and regulated in ways vastly different from operating companies, the SEC adopted a “one-size-fits-all” approach, applying the rule to funds and operating companies alike. Yet the SEC provided little explanation for why funds should be swept in under a rule clearly developed with operating companies in mind. Indeed, the SEC’s separate “analysis” consisted of little more than the repetition of its “belie[f]” that because fund shareholders have a state law right to nominate and elect directors, funds are enough like operating

companies to warrant inclusion in the rule for all purposes. 75 Fed. Reg. at 56,684. The SEC admitted that the rule might “increase costs and potentially decrease . . . efficiency” in the fund industry, but then contradicted itself by dismissing those costs as attributable to pre-existing state law voting rights. *Id.*

With these observations, the SEC avoided any reasoned consideration of the many comments that ICI, IDC, and others submitted, explaining why existing federal protections for fund shareholders made Rule 14a-11 less needed, and why funds’ unique governance structures made the rule more costly. The SEC’s ill-conceived regulation of the \$11.5 trillion fund industry was arbitrary and capricious. The fund industry is simply too important, and its structure too distinct, for the SEC to regulate as an afterthought. The petition for review should be granted, and the rule vacated to the extent that it applies to funds.

### **SUMMARY OF ARGUMENT**

In adopting Rule 14a-11, the SEC adopted a “one-size-fits-all” approach that decidedly does not fit the unique structure of fund governance and rests upon reasoning that is arbitrary and capricious. Focusing on how the rule would apply to operating companies, the SEC’s regulatory statement provides no logical explanation for why the SEC deemed the material differences between funds and operating companies to be wholly irrelevant to Rule 14a-11.

The SEC's principal mistake, repeated throughout its analysis, was its reliance on the often-stated syllogism that Rule 14a-11 serves to "facilitate the exercise of shareholders' traditional State law rights to nominate and elect directors," that such "State law rights apply to the shareholders of investment companies," and that any other differences between investment companies and operating companies should not "decrease the importance of the rights that are granted to shareholders under State law." 75 Fed. Reg at 56,684. The SEC offered this justification, or a close variant, nearly a dozen times. Yet no matter how many times repeated, the SEC's explanation still failed to account adequately for the material differences between operating companies and funds in this context.

*First*, the SEC could not properly rely upon the "importance" of state law rights without addressing whether existing federal law protections for fund shareholders reduce the need for Rule 14a-11. Although generally "state law will govern the internal affairs of the corporations," *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 479 (1977) (quotation omitted), Congress in fact pervasively regulates "the internal affairs" of funds. Indeed, funds are regulated far more by federal law than by state law.

The ICA establishes statutory independence requirements for fund directors and imposes upon them an array of specific responsibilities, *see Burks v. Lasker*, 441 U.S. 471, 483 (1979); requires shareholder approval for key fund decisions,

including changes to a fund's fundamental investment policies; creates a shareholder cause of action against the investment adviser, *see Jones v. Harris Assocs. L.P.*, 130 S. Ct. 1418, 1423 (2010); and otherwise constrains fund activities to protect shareholders. These federal requirements supply fund shareholders with protections far beyond, and different in kind than, anything provided under "traditional State law rights."

In view of these comprehensive requirements, the SEC's summary conclusion that the "regulatory protections" of the ICA do not "decrease the importance" of shareholders' state law rights, 75 Fed. Reg. at 56,684, is hard to fathom. The question is not whether, in a vacuum, state rights are important, but whether the ICA's robust federal protections reduce the need for the new federal right embodied in Rule 14a-11, or, at a minimum, call for special tailoring. To this, the SEC offered no answer.

**Second**, the SEC's reliance on state law rights is similarly flawed as a justification for failing to address the distinct burdens that Rule 14a-11 would impose on funds. Unlike operating companies, fund complexes have adopted specific board structures designed to oversee efficiently multiple funds ("unitary" or "cluster" boards). These structures increase the board's knowledge of fund operations across the complex and strengthen the board's oversight of the

investment adviser. Rule 14a-11 threatens these many benefits, however, by inviting the election of different directors for particular funds within the complex.

The SEC admitted that “for fund complexes that utilize unitary or cluster boards,” *i.e.*, virtually all funds, “the election of a shareholder director nominee may, in some circumstances, increase costs and potentially decrease the efficiency of the boards.” *Id.* at 56,684. Rather than considering whether such costs were justified, the SEC simply concluded that “these costs are associated with the State law right to nominate and elect directors,” and not Rule 14a-11. *Id.* Yet state law has not changed. The SEC cannot rationally concede that its rule may “increase costs” and “decrease efficiency,” but then abdicate responsibility for that causal link. Because the rule itself creates the problem, the SEC must explain why such costs would be justified.

***Third***, the SEC’s state law rationale cannot be squared with the position that the SEC adopted as recently as July 2009, in approving an exemption for funds from a New York Stock Exchange (“NYSE”) rule concerning director elections. *See* Order Approving Proposed Rule Change To Eliminate Broker Discretionary Voting for Election of Directors, 74 Fed. Reg. 33,293, 33,303 (July 10, 2009) (the “Broker Voting Release”). Like Rule 14a-11, the NYSE rule was intended to protect shareholders’ voting rights, by preventing brokers from voting shares in their custody, absent express instructions from their customers. In approving the

fund exemption from this restriction, the SEC concluded that such protections were less necessary because, among other reasons, the ICA requires a fund to “obtain the approval of a majority of its voting securities” before taking key actions, and this “different regulatory regime” thus “supports the exemption.” *Id.* In adopting Rule 14a-11, the SEC neither addressed its reasoning in the Broker Voting Release nor sought to reconcile it. The failure to explain such inconsistent reasoning violates the APA.

***Fourth***, the SEC violated the APA by applying Rule 14a-11 to funds based on empirical studies concerning operating companies. While the SEC need not rely upon empirical studies, it cannot rationally rely on those studies to propose a solution for funds without considering whether there are meaningful differences that would require a different analysis.

***Finally***, the SEC failed adequately to consider Rule 14a-11’s effect on efficiency, competition, and capital formation. *See* 15 U.S.C. §§ 77b(b), 78c(f), 80a-2(c). The SEC admitted that Rule 14a-11 would “increase costs and potentially decrease . . . efficiency,” but once again avoided the issue by attributing such costs to pre-existing state law. 75 Fed. Reg. at 56,773. In weighing this statutory factor, the SEC further failed to consider whether “sufficient protections” for shareholders already existed under “the existing regime,” so as to outweigh the

obvious efficiency costs of Rule 14a-11. *Am. Equity Inv. Life Ins. Co. v. SEC* (“*American Equity*”), 613 F.3d 166, 179 (D.C. Cir. 2010).

The SEC then compounded this error by failing “to consider the extent of the existing competition in its analysis.” *Id.* at 178. Had the SEC conducted any such analysis, it would have been obliged to recognize that funds exist in a highly competitive market. Moreover, the SEC would have had to grapple with comments that Rule 14a-11 could have significant anticompetitive effects through its disproportionate impact on small funds. In its explanation, the SEC made only a passing reference to competition, asserting once again that “any decrease in . . . competition” should be attributed to state law. 75 Fed. Reg. at 56,773. That conclusion remains arbitrary and capricious.<sup>3</sup>

## ARGUMENT

### I. THE SEC’S APPLICATION OF RULE 14A-11 TO INVESTMENT COMPANIES WAS ARBITRARY AND CAPRICIOUS.

Despite the material differences between investment companies and operating companies, brought to the SEC’s attention during the comment period, Rule 14a-11 inexplicably treats them the same. When Congress recently authorized the SEC to adopt proxy access rules, it expressly provided that the SEC

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<sup>3</sup> Although urging the SEC to exclude funds from Rule 14a-11, ICI and IDC’s comments did not take the position that funds should not be subject to any proxy access rules, but rather that such rules should reflect consideration of, and tailoring to, the unique circumstances of funds.

may “exempt an issuer or class of issuers” from any new shareholder access requirements, implicitly requiring the SEC to consider the impact of its regulations on unique classes of companies and to provide a reasoned justification for its decision to include them within the rules.<sup>4</sup>

ICI and IDC, together with others from the fund industry and legal community, raised numerous, particularized concerns with applying Rule 14a-11 to funds. *See, e.g.*, Certified Record Index (“CRI”) Doc. Nos. 294 (T. Rowe Price); 389 (ICI); 392 (Sullivan & Cromwell LLP); 424 (Vanguard); 517 (American Bar Association); 648 (ICI/IDC). Commenters explained in detail how the comprehensive federal regulatory scheme governing funds and protecting their shareholders reduces the need for Rule 14a-11. They also explained how their unique governance structure would make Rule 14a-11 more costly in the fund context.

The SEC itself recently admitted, “mutual funds differ significantly from typical operating companies.” Brief for the United States of America in Support of Respondent at 4, *Janus Capital Group, Inc. v. First Derivative Traders*, No. 09-525 (U.S.). Yet the SEC dismissed commenters’ substantial concerns based on the bald assertion that “facilitating the exercise of traditional State law rights to nominate and elect directors is as much of a concern for investment company

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<sup>4</sup> Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”), Pub. L. No. 111-203, § 971(c), 124 Stat. 1376 (2010).

shareholders as it is for shareholders of non-investment companies.” 75 Fed. Reg. at 56,684. The SEC offered this justification to explain why the ICA’s comprehensive regulations did not reduce the need for Rule 14a-11;<sup>5</sup> to dismiss the concern that director elections would undermine funds’ unitary and cluster board structures;<sup>6</sup> and to dismiss the evidence that Rule 14a-11 could decrease both efficiency and competition in the fund sector.<sup>7</sup>

The SEC’s rote explanation is “arbitrary and capricious” under the APA. *See* 5 U.S.C. § 706(2)(A). The APA requires the SEC to provide a “satisfactory explanation” for its decision, “including a rational connection between the facts found and the choice made.” *Chamber of Commerce v. SEC*, 412 F.3d 133, 140 (D.C. Cir. 2005) (quotation marks omitted). To satisfy this burden, the SEC had a duty to consider the alternatives in the administrative record, including the exclusion of funds or the special tailoring of the rule, and to provide a “logical and

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<sup>5</sup> *See* 75 Fed. Reg. at 56,684 (“We also do not believe that the regulatory protections offered by the Investment Company Act . . . serve[] to decrease the importance of the rights that are granted to shareholders under State law.”); *id.* at 56,763 (same).

<sup>6</sup> *See* 75 Fed. Reg. at 56,684 (“These State law rights apply to the shareholders of investment companies, including each investment company in a fund complex, regardless of whether or not the fund complex utilizes a unitary or cluster board.”); *id.* at 56,773 (similar).

<sup>7</sup> *See* 75 Fed. Reg. at 56,684 (“[T]hese costs are associated with the State law right to nominate and elect directors, and are not costs incurred for including shareholder nominees in the company’s proxy statement.”); *id.* at 56,773 (same).

rational” explanation for its choice. *NetCoalition v. SEC*, 615 F.3d 525, 539 (D.C. Cir. 2010). An “attempt to rely on generalized and conclusory policy considerations” is not enough. *Int’l Ladies’ Garment Workers’ Union (“ILGWU”) v. Donovan*, 722 F.2d 795, 818 (D.C. Cir. 1983); *see also United Techs. Corp. v. U.S. Dep’t of Def.*, 601 F.3d 557, 565 (D.C. Cir. 2010) (“A naked conclusion . . . is not enough.”).

In addition, the SEC had the statutory obligation to consider the impact of its rule on “efficiency, competition, and capital formation.” 15 U.S.C. §§ 77b(b), 78c(f), 80a-2(c). In considering these factors, the SEC was obliged to measure the existing regulatory environment against the likely effect of the proposed rules. *See American Equity*, 613 F.3d at 178-79. That analysis too is reviewed under the APA.

**A. The SEC Failed To Explain Adequately Why the ICA’s Protections Did Not Reduce the Need for Rule 14a-11.**

The SEC dismissed the comprehensive federal shareholder protections under the ICA as a reason for exempting funds on the ground that they do not “decrease the importance” of shareholders’ state law rights. 75 Fed. Reg. at 56,684. While no one challenges those rights, the SEC, in making a policy decision to create a new federal right of proxy access, must take responsibility for this choice. In doing so, the SEC cannot ignore the profound way in which federal law takes the lead in regulating the internal governance of funds.

The SEC's reliance on state law rights was particularly flawed given the recognition in state law itself that the ICA constitutes the "principal governing law" in this area. The SEC's claim that Rule 14a-11 simply gives force to state law ignored the distinctive relationship between state and federal law in this area.

**1. Federal Law Provides Comprehensive Protections to Fund Shareholders.**

Federal law sets unique corporate governance standards for funds. In general, when it comes to operating companies, "corporations are creatures of state law, and investors commit their funds to corporate directors on the understanding that," with limited exceptions, "state law will govern the internal affairs of the corporation." *Santa Fe Indus.*, 430 U.S. at 479 (quotation omitted).

By contrast, since 1940, Congress has extensively regulated the internal affairs of funds through the ICA, which "imposes controls and restrictions on the internal management of investment companies" and "a number of controls on the[ir] internal practices." *United States v. Nat'l Ass'n of Sec. Dealers*, 422 U.S. 694, 705 n.13 (1975); *see also Northstar Fin. Advisers Inc. v. Schwab Invs.*, 615 F.3d 1106, 1109 (9th Cir. 2010) ("Congress enacted the ICA in 1940 to provide comprehensive regulation of investment companies and the mutual fund industry.").<sup>8</sup>

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<sup>8</sup> In *Burks*, the Court acknowledged that the ICA had not entirely displaced state law because "[m]utual funds, like other corporations, are incorporated

Federal law contains numerous protections for fund shareholders with no parallel to operating companies. As the Supreme Court has recognized, the ICA grants “the independent directors of investment companies . . . the primary responsibility for looking after the interests of the fund’s shareholders.” *Burks*, 441 U.S. at 485. The ICA and its regulations establish minimum requirements for director independence. *See* 15 U.S.C. § 80a-10(a); Role of Independent Directors of Investment Companies, 66 Fed. Reg. 3735 (Jan. 16, 2001). The ICA also imposes significant federal duties on fund directors, beyond those under state law. Among other obligations, fund directors must annually approve the investment advisory contract, including the adviser’s compensation. *See* 15 U.S.C. § 80a-15(c).<sup>9</sup> Funds must abide by these ICA requirements on top of state or federal requirements applicable to funds and operating companies alike.

In addition to imposing obligations on directors, the ICA directly protects fund shareholders by giving them the right to approve key fund decisions. A majority shareholder vote is required to change the fund from an open-end, closed-

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pursuant to state, not federal, law.” 441 U.S. at 478. The question here is not whether federal law displaces state law, but whether existing federal protections reduce the need for the new federal rule.

<sup>9</sup> In addition, directors must approve underwriting contracts and distribution plans, *see* 15 U.S.C. § 80a-15(c); 17 C.F.R. § 270.12b-1; adopt policies to fair value fund securities, *see* 15 U.S.C. § 80a-2(a)(41); 17 C.F.R. §§ 270.2a-4, 270.22c-1; approve the ethics codes for the fund and adviser, *see* 17 C.F.R. § 270.17j-1; approve written compliance policies, *see id.* § 270.38a-1; and approve fund auditors, *see* 15 U.S.C. § 80a-31.

end, or diversified company; to change fund policies regarding borrowing money, issuing senior securities, underwriting other securities, purchasing or selling real estate or commodities, or making loans to other persons; to deviate from the fundamental investment policies detailed in the fund's registration statement; or to change the nature of its business. *See* 15 U.S.C. § 80a-13(a). Notably, shareholders also have a federal right to elect directors, wholly apart from any state law rights. *See id.* § 80a-16(a).

Finally, Section 36(b) of the ICA provides fund shareholders with a federal cause of action against the company's investment adviser for claims of excessive compensation. *See Jones*, 130 S. Ct. at 1423, 1429; *see also* 15 U.S.C. § 80a-35(b). Again, this unique right has no counterpart outside the fund context.

## **2. State Law Defers to the ICA with Respect to Director Elections and Other Governance Matters.**

It is ironic that the SEC has relied heavily upon the "importance of State law rights" because in practice, state law has deferred to the corporate governance standards of the ICA. Notably, state law defers to federal law with respect to whether funds must have annual meetings (where directors may be elected).<sup>10</sup> Prior to 1986, funds typically conducted annual meetings based on the view that

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<sup>10</sup> By contrast, state corporate law typically requires annual meetings for operating companies. *See, e.g.*, 8 Del. Code § 211(b).

the ICA required them.<sup>11</sup> In 1986, however, the SEC determined that the ICA did not require annual meetings. *See* John Nuveen & Co., Inc., SEC No-Action Letter, No. 801-4535 (Nov. 18, 1986). Since then, funds generally have stopped holding annual meetings, either because state law did not affirmatively require them to do so, *see* Mass. Gen. L., Title 22, Ch. 182, or because the States amended their laws to eliminate the requirement, *see* Md. Code, Corps. & Ass'ns § 2-501(b); 12 Del. Code § 3806; *see also* Cal. Corp. Code § 600(b) (requiring annual meetings for funds only “as required by the Federal Investment Company Act of 1940”).

In amending Maryland law after 1986, the Maryland legislature recognized that federal law supplied the “principal governing law” for fund governance. Maryland’s official legislative history includes written statements from the chairman of the Corporations Section of the Maryland State Bar Association, explaining that “some of the legislative restraints applicable to ordinary business corporations are inappropriate for mutual funds.” *See* Letter from Arthur W. Machen, Jr. to William S. Horne, Chairman of the Maryland House Judiciary Committee (Mar. 13, 1987). Thus, the bill abolished certain requirements of state law

that are an administrative headache and have no meaning, particularly the requirements for shareholder approval to increase authorized shares and the holding of annual shareholder meetings when the

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<sup>11</sup> *See* Sheldon A. Jones et al., *The Massachusetts Business Trust and Registered Investment Companies*, 13 DEL. J. CORP. L. 421, 452-53 (1988).

Federal Act—which is the principal governing law—does not require an election of directors, ratification of advisory contract or similar significant action.

Arthur W. Machen, Jr., Explanation of Investment Company Bill—H.B. 809, at 1.

The SEC staff has endorsed this principle as recently as November 15, 2010, when it interpreted the ICA to prohibit closed-end funds from adopting an anti-takeover provision of Maryland law. *See Boulder Total Return Fund, SEC Response to Request for Interpretive Guidance, No. 811-07390 (Nov. 15, 2010).* There, the SEC staff observed that while use of the Maryland statute “may be permitted for operating companies under state law,” the ICA “with its unique regulatory approach, demands a different result for investment companies.” *Id.*

The ICA “focused on the protection of the rights of investment company shareholders and imposed on investment companies a unique governance system” by granting shareholders broad approval rights. *Id.* These federal protections “are fundamental to the equitable operation of investment companies, and exist in addition to voting rights that are provided under applicable state law.” *Id.* (footnote omitted). Accordingly, rather than deferring to Maryland corporate law, the SEC staff made clear that federal policies should govern.

### **3. The SEC Failed To Account for the Federal Protections Under the ICA.**

In view of this complex federal-state relationship, the SEC was obliged to do more than simply assert that Rule 14a-11 properly applies to funds because the

ICA's "regulatory protections" do not "decrease the importance" of state law rights. 75 Fed. Reg. at 56,684. These kinds of "generalized and conclusory policy considerations," *ILGWU*, 722 F.2d at 818, do not begin to account for the way in which the ICA serves as the principal source of protections for fund shareholders.

The SEC also observed that "investment company boards, like the boards of other companies, have significant responsibilities in protecting shareholder interests," including some specific to funds. 75 Fed. Reg. at 56,763. This may be true, but it demonstrates neither that fund directors have been unresponsive to shareholder interests nor that facilitating state law rights would meaningfully increase their responsiveness. The SEC's failure to consider fund shareholders' need for Rule 14a-11 was arbitrary and capricious.

**B. The SEC Failed To Explain Why Any Benefits Of Rule 14a-11 Outweigh Its Costs to Fund Governance.**

The SEC similarly avoided a reasoned response to commenters' detailed concerns about how Rule 14a-11 would harm fund governance. The SEC recognized that its rules, by promoting the election of directors to particular boards, could "increase costs and potentially decrease the efficiency" of funds that employ unitary or cluster boards. 75 Fed. Reg. at 56,684. Yet incredibly, the SEC determined that it need not weigh these costs because they could be attributed to pre-existing state law. *Id.* The SEC's attempt to avoid this burden is arbitrary and capricious.

**1. Unitary and Cluster Boards Provide Important Efficiencies That Are Unique to Funds.**

As ICI and IDC described in their comments, in adopting Rule 14a-11 the SEC failed to take into account that fund boards operate in a manner very different from operating company boards. To achieve numerous efficiencies, virtually all funds operate as part of complexes where multiple funds are managed by the same investment adviser, subject to the oversight of one or more boards. *See* CRI Doc. Nos. 389, 648.

Fund boards are organized according to one of two models—a unitary board consisting of one group of directors who serve on the board for every fund in the complex, or cluster boards consisting of two or more separate boards of directors within the complex, each of which oversees a different group of funds. *See id.* A recent survey conducted by ICI and IDC showed that 83 percent of the complexes that responded used a unitary board and 17 percent used a cluster board.<sup>12</sup>

The SEC has emphasized that fund boards themselves may best judge how they should be structured. *See* Investment Company Governance Rule, 69 Fed. Reg. 3,472, 3,476 (Jan. 23, 2004) (recognizing that “[i]t would be difficult to

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<sup>12</sup> *See* ICI/IDC OVERVIEW OF FUND GOVERNANCE PRACTICES, 1994-2008, available at [http://www.ici.org/pdf/pub\\_09\\_fund\\_governance.pdf](http://www.ici.org/pdf/pub_09_fund_governance.pdf).

determine the optimum number of funds that a particular director or group of directors can serve”).<sup>13</sup>

Unitary and cluster boards reflect the unique governance challenges in the fund industry. Fund boards not only perform general oversight, but they are required by federal law to perform the many duties imposed under the ICA. *See supra* p. 14 & n.9. For instance, to comply with their annual duty to review agreements with the investment adviser, *see* 15 U.S.C. § 80a-15(c), boards must receive from the adviser all information reasonably necessary to evaluate the advisory contract. While the process typically culminates in one or more board meetings dedicated specifically to the decision, in practice, the board’s work throughout the year—monitoring investment performance, overseeing compliance and risk management, assessing the quality of the adviser’s services, and other matters—informs this approval process. As a consequence of this and other responsibilities, meetings of fund boards are both lengthy (typically lasting an entire day or two) and frequent (sometimes bimonthly and in large complexes, even more frequent), and require review of voluminous and complex board materials (section 15(c) materials alone can run to thousands of pages.)

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<sup>13</sup> *See also* William H. Donaldson, Chairman, SEC, America’s Need for Vigilant Mutual Fund Directors (Jan. 7, 2004) (“Different boards have different needs and different directors have different capabilities and time constraints—and they are in the best position to make these judgments.”), *available at* <http://www.sec.gov/news/speech/spch010704whd.htm>.

In light of the breadth of these responsibilities, and because many issues vital to fund oversight are common across the complex, funds gain tremendous operational efficiencies by allowing one board to serve across multiple funds within a complex. These efficiencies include concurrent meetings, combined board materials, and related economies in meeting fees, travel expenses, and the avoidance of duplication in management presentations. Unitary and cluster boards thus result in lower expenses for shareholders.

In addition to cost savings, unitary and cluster boards enhance fund governance. Because of the complex responsibilities that the ICA imposes on fund directors, experience and knowledge of fund operations are critical. By overseeing multiple funds, directors gain greater familiarity with the aspects of fund operations that are complex-wide. Directors also receive greater access to and influence over the fund's adviser than if there were a separate board for each registrant in the complex.<sup>14</sup>

**2. Rule 14a-11 Would Threaten the Effective Use of Unitary and Cluster Boards.**

Rule 14a-11 would jeopardize efficient fund governance by requiring the seating of one or more elected shareholder directors on the board of a registrant for funds previously overseen by a unitary or cluster board. These “non-conforming”

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<sup>14</sup> Most funds are organized as series of a trust or corporation, where that entity is the registrant.

directors would inherently disrupt the effective functioning of those boards, as the directors must receive highly confidential information relating to proprietary investment strategies, valuation of portfolio holdings, and compliance matters with respect to all of the funds. Sharing this information with individuals who have no fiduciary duty to the fund in question would be highly problematic. Combined meetings and board materials thus would no longer be possible, as the non-conforming directors would have to leave during discussions pertaining to other funds, and customized board materials would have to be provided.

**3. The SEC Failed Adequately To Consider Whether the Benefits of Rule 14a-11 Outweigh These Manifest Costs.**

The SEC admitted that Rule 14a-11 could “increase costs and potentially decrease the efficiency” of unitary or cluster boards. 75 Fed. Reg. at 56,684. The SEC made no effort, however, to weigh those costs beyond summarily asserting that the “policy goals and the benefits of the rule justify these costs.” *Id.* Such an *ipse dixit* cannot stand on its own. *See ILGWU*, 722 F.2d at 818. And the reasons the SEC provided for avoiding this cost-benefit analysis do not withstand even cursory scrutiny.

The SEC principally relied upon the proposition that the costs of the rule “are associated with the State law right to nominate and elect directors,” and not imposed by Rule 14a-11. 75 Fed. Reg. at 56,684. Yet state law has not changed. Having admitted that the rule would increase costs, the SEC cannot sidestep the

problem by blaming state law. Rather, the SEC must provide its own analysis and explain why those costs are justified.

In *American Equity*, this Court similarly rejected as “flawed” the SEC’s effort to justify a rule by claiming that it would provide greater “clarity” to a previously unregulated area. 613 F.3d at 177. Because any rule would provide more clarity, the SEC had failed to explain why it adopted “the specific rule.” *Id.* at 178. Similarly here, the SEC avoided grappling with Rule 14a-11’s burdens by reasoning that, no matter how costly it could prove to be, state law was at fault. The SEC’s attempt to blame state law—which has not changed—for the resulting disruption, and thus to avoid further analysis, is arbitrary and capricious.

The SEC also proposed “that a fund complex can take steps to minimize the cost and burden of a shareholder-nominated director by . . . entering into a confidentiality agreement in order to preserve the status of confidential information regarding the fund complex.” *Id.* at 56,685. Yet as ICI/IDC’s counsel explained during the comment period, the non-conforming directors would have no fiduciary duty to the other funds; they could not be legally obliged to sign a confidentiality agreement; and generalized confidentiality agreements may not be enforceable. *See* Attachment to CRI Doc. No. 648. The SEC summarily dismissed these valid concerns with the comment that they were “either not compelling or speculative in nature.” 75 Fed. Reg. at 56,768. Such conclusory reasoning is plainly inadequate.

Furthermore, although the SEC stated that its proposal to rely upon confidentiality agreements was “only one method of preserving the confidentiality of information revealed,” the only other alternative it offered was for the board to “have separate meetings and board materials for the board with the shareholder-nominated director.” *Id.* at 56,685 n.145. Yet this “alternative” does not preserve unitary and cluster boards at all, but merely reflects that under Rule 14a-11, the benefits of those structures are sure to be lost.

**4. The SEC Also Failed To Consider Whether, in View of the Funds’ Retail Shareholder Base, Rule 14a-11 Would Impose Disparate Costs.**

The SEC also failed to consider the additional costs that Rule 14a-11 would impose on funds because of the potential that a shareholder-nominated director could cause an election to be deemed “contested” under NYSE rules. In July 2009, the SEC approved an amendment to NYSE Rule 452 (later codified by section 957 of Dodd-Frank), which prohibited brokers from voting shares in their custody in “uncontested” director elections for all issuers *except* funds. *See* 74 Fed. Reg. at 33,293. In the Broker Voting Release, the SEC recognized that funds often have difficulty in achieving a quorum for shareholder meetings because of their “disproportionately large,” and heavily retail, shareholder base. *Id.* at 33,303.

Accordingly, the SEC recognized that eliminating broker voting could jeopardize funds' ability to achieve a quorum and thus impose unwarranted costs. *Id.*<sup>15</sup>

In adopting Rule 14a-11, the SEC similarly admitted that “it may be more costly for investment companies to achieve a quorum at shareholder meetings if a shareholder director nomination causes an election to be ‘contested’” under these circumstances. 75 Fed. Reg. at 56,684. Rather than viewing this as a reason to exempt funds from Rule 14a-11 (as it had for Rule 452), the SEC again dismissed these costs as “associated with the State law right to nominate and elect directors.” *Id.* As discussed, state law did not change, and the SEC’s reasoning remains inadequate.

**C. The SEC Failed To Explain Its Change in Policy Between the Broker Voting Release and Rule 14a-11.**

The SEC’s assertion that funds are materially indistinguishable from operating companies also conflicts with the policy embodied in the Broker Voting Release. An agency may reverse its position, but must give a “satisfactory” explanation for doing so. *See, e.g., Motor Vehicle Mfrs. Ass’n v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29, 43 (1983). Here, the SEC reversed its policy position

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<sup>15</sup> ICI has calculated that multiple proxy solicitations (required if a quorum failed) would raise average costs on each shareholder account from \$1.65 to \$3.68 and increase expense ratios between one to two basis points. *See* ICI, COSTS OF ELIMINATING DISCRETIONARY BROKER VOTING ON UNCONTESTED ELECTIONS OF INVESTMENT COMPANY DIRECTORS (Dec. 18, 2006) at 3-4, *available at* [http://www.ici.org/pdf/wht\\_broker\\_voting.pdf](http://www.ici.org/pdf/wht_broker_voting.pdf).

over the course of just one year without providing any explanation at all. For this reason, too, the SEC's reasoning was arbitrary and capricious.

Only one month after proposing its new proxy access rules, the SEC approved the exemption for funds in the Broker Voting Release. In so doing, the SEC embraced the reasoning of the NYSE's working group on the subject, which had concluded that banning broker discretionary voting in director elections, whether or not contested, was worth the costs because "directors are simply too important to the corporation for their election ever to be considered routine." 74 Fed. Reg. at 33,295. At the same time, the SEC rejected the notion that such "important" shareholder protections were necessary for funds, which operate under a "unique regulatory scheme" with substantive shareholder protections. *Id.* Thus, "the different regulatory regime for registered investment companies supports the exemption." *Id.*

In issuing Rule 14a-11, the SEC made no effort to explain its departure from the Broker Voting Release. The SEC did not explain why the "regulatory protections offered by the Investment Company Act" would "support[] the exemption" in the Broker Voting Release, yet would "decrease the importance" of state law if relied on to modify Rule 14a-11. Whether or not the SEC could rationally explain this change of heart, its failure even to address it was arbitrary and capricious. *See ILGWU*, 722 F.2d at 818.

**D. The SEC Relied Upon Empirical Data That Excluded Funds.**

The SEC also violated the APA by imposing Rule 14a-11 on the fund sector without conducting studies assessing its impact on the industry. It is true that the “Commission’s decision not to do an empirical study does not make [a rule] an unreasoned decision.” *Chamber of Commerce*, 412 F.3d at 142. But where, as here, the SEC does rely upon empirical data to justify its decision, the SEC is obliged to draw “a rational connection between the facts found and the choice made.” *Id.* at 140.

Here, the SEC relied upon certain studies that either excluded funds or, while potentially including them, did so in such a way as to make it impossible to measure the impact of the rule on the fund industry.<sup>16</sup> The SEC’s regulatory statements contain virtually no data to justify the SEC’s policy decision to extend Rule 14a-11 to funds. Given the unique features of funds, as well as the size of the fund industry, the SEC could not rationally lump in funds with operating companies under its proposal. Such rule-making by default is the antithesis of reasoned decision-making.

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<sup>16</sup> Several of the SEC’s datasets excluded funds (such as the analysis of holdings information to determine eligibility thresholds). *See* 74 Fed. Reg. at 29,035 n.129 (“The sample excludes mutual funds.”); *see also* 75 Fed. Reg. 56,690 at n.221. Others, while potentially including funds, did so in such a way as to make it impossible to disaggregate the empirical effect of the rule on the fund industry. *See id.* (relying on Form 13F data that omits shares of mutual funds held by large institutional investors).

**E. The SEC Failed To Consider the Rule’s Effects on Efficiency and Competition in the Fund Industry.**

The SEC’s adoption of Rule 14a-11 was also arbitrary and capricious because the SEC failed to provide any reasoned consideration of the rule’s impact on efficiency and competition in the fund sector. *See, e.g., American Equity*, 613 F.3d at 176-77; *see also* 15 U.S.C. §§ 77b(b), 78c(f), 80a-2(c).

**1. The SEC Avoided Considering Efficiency.**

As discussed above, the SEC acknowledged that the rule “may, in some circumstances, increase costs and potentially decrease the efficiency of the boards,” but sought to deflect responsibility by attributing such costs to “the State law right to nominate and elect directors.” 75 Fed. Reg. at 56,773. That state law right, however, exists today. It is the SEC’s creation of a federal right to proxy access that could cause some funds to lose their efficient unitary or cluster board structure. The SEC abdicated its responsibility to consider the impact of its rule on efficiency.

**2. The SEC Failed To Compare the Existing Efficiency in the Fund Market to the Future Impact of the Rule.**

The SEC also failed adequately to consider efficiency by not making a baseline comparison between the current efficiency of the fund industry and the expected future impact of its rule. As this Court recently recognized, the SEC’s analysis is “arbitrary and capricious” where “it fails to determine whether, under the existing regime, sufficient protections existed” so as to reduce the need for the

rule. *American Equity*, 613 F.3d at 179. Here, too, the SEC failed to consider whether the existing regime under the ICA contained “sufficient protections” for shareholders to achieve Rule 14a-11’s policy goals without the costs to efficient fund governance. *Id.* In its discussion of efficiency, the SEC merely conflated funds and operating companies without attending to the significant differences between them. Rather than dismissing efficiency based upon the existence of state law rights, the SEC was obliged to evaluate the benefits of Rule 14a-11 for funds against the baseline protections of the ICA.

### **3. The SEC Failed To Consider Competition.**

The SEC compounded this error by failing to conduct any real competition analysis for funds. This Court has recognized that the SEC must make some “finding on the existing level of competition in the marketplace under the state law regime.” *American Equity*, 613 F.3d at 178. The SEC made a passing reference to competition, returning to the now-familiar refrain that “any decrease in efficiency and competition” should be attributed to the “State law right,” not the disruptions caused by the new federal mandate. 75 Fed. Reg. at 56,773.

Had the SEC conducted any real competition analysis, it would have been obliged to recognize that funds exist in a highly competitive market that has demonstrated effective corporate governance. The fund industry is highly competitive, as indicated by the large numbers of firms and more than 90 million

shareholders, the absence of dominance by a single firm or group of firms, and low barriers to entry and exit.<sup>17</sup> Moreover, the SEC would have had to grapple with record evidence signaling that Rule 14a-11 could have significant anticompetitive effects by raising the costs of fund governance and driving small funds out of the industry. *See* CRI Doc. No. 389.

Rather than addressing ICI's competition concerns, the SEC once again attributed any decrease in competition to the impact of existing state law. *See* 75 Fed. Reg. at 56,773. The SEC's failure to consider competition, or to address ICI's concerns, provides yet another basis for setting aside Rule 14a-11 as arbitrary and capricious.

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<sup>17</sup> *See, e.g.*, John C. Coates & R. Glenn Hubbard, *Competition in the Mutual Fund Industry: Evidence and Implications for Policy*, 33 J. CORP. L. 151, 180 (2007) (“[T]he market structure and performance of the mutual fund industry is consistent with strong competition among funds.”); Brief for ICI in Support of Respondent at 23, *Jones*, 130 S. Ct. 1418 (2010); *see also id.* at 24 n.15 (fund industry is not concentrated based on the DOJ's measure of concentration).

## CONCLUSION

For the reasons stated, the petition for review should be granted and Rule 14a-11 vacated as applied to registered investment companies.

Respectfully submitted,

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### **CERTIFICATE OF COMPLIANCE**

This brief complies with the type-volume limitation of Fed. R. App. P. 29(d) because the brief contains 6,991 words, excluding the parts of the brief exempted by Fed. R. App. P. 32(a)(7)(B)(iii). The brief complies with the typeface requirements of Fed. R. App. P. 32(a)(5) and the type style requirements of Fed. R. App. P. 32(a)(6), because this brief has been prepared in a proportionally spaced typeface using 14-point Times New Roman font.

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**CERTIFICATE OF SERVICE**

I hereby certify that on December 9, 2010, I caused the foregoing Brief of *Amici Curiae* Investment Company Institute and Independent Directors Council in Support of Petitioners and Vacatur as Applied to Registered Investment Companies to be electronically filed with the Clerk of Court for the United States Court of Appeals for the District of Columbia Circuit by using the CM/ECF system, and caused 5 printed copies to be hand delivered to the Clerk's Office.

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