THREE STRIKES YOU'RE OUT: THE EFFECT AND CONTROVERSIES OF THE SEC'S ATTEMPTED MANDATE FOR GREATER INDEPENDENCE ON MUTUAL FUND BOARDS

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INTRODUCTION

Mutual funds have become the investment of choice for individual investors.[1] They allow investors to build a diverse portfolio at a reasonable price.[2] In America alone, over ninety million people, which equates to half of all households, invest in mutual funds.[3] In 2004, despite the recent multitude of investment company scandals,[4] mutual fund investments reached a record high with $7.6 trillion invested,[5] including twenty-one percent of the $10.2 trillion retirement market.[6] In 2005, mutual fund assets continued to grow and reached a record $8.8 trillion in November.[7]

Despite the rapid and continued growth of mutual funds,[8] the Securities and

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1. Harvey J. Goldschmid, Comm'r, Sec. and Exch. Comm'n, Mutual Fund Regulation: A Time for Healing and Reform, Speech Before the Investment Company Institute 2003 Securities Law Developments Conference (Dec. 4, 2003), 2003 WL 23177225, at *1.

2. Roberta S. Karmel, *Mutual Funds, Pension Funds, Hedge Funds and Stock Market Volatility—What Regulation by the Securities and Exchange Commission Act Is Appropriate?*, 80 NOTRE DAME L. REV. 909, 914 (2005) [hereinafter Karmel, *Mutual Funds*].

3. Mercer E. Bullard, *The Mutual Fund Summit: Context and Commentary*, 73 MISS. L.J. 1129, 1130 (2004).

4. *See* SEC. AND EXCH. COMM'N, EXEMPTIVE RULE AMENDMENTS OF 2004: INDEPENDENT CHAIR CONDITION, A REPORT IN ACCORDANCE WITH THE CONSOLIDATED APPROPRIATIONS ACT, 2005 SEC Lexis 1031, at *3 (2005) [hereinafter REPORT IN ACCORDANCE WITH THE CONSOLIDATED APPROPRIATIONS ACT]. Since 2003, the SEC has acquired over $2.2 billion in disgorgements and civil penalties from enforcement actions brought against investment companies. *Id.* This money is being used to compensate shareholders adversely affected by the mutual fund scandals. *Id.*; *see* Investment Company Governance, 70 Fed. Reg. 39,390, 39,399 (Sec. and Exch. Comm'n July 7, 2005) (Donaldson, concurring) (to be codified at 17 C.F.R. pt. 270) (response to remand).

5. Bullard, *supra* note 3, at 1130.

6. Goldschmid, *supra* note 1, at *1.

7. *Trends in Mutual Fund Investing, November 2005*, INV. CO. INST. (Dec. 29, 2005), http://www.ici.org/stats/mf/arctrends/trends_11_05.html.

8. *See generally* BRIAN REID ET AL., INV. CO. INST., 2005 INVESTMENT COMPANY FACT BOOK (45th ed. 2005), *available at* http://www.ici.org/pdf/2005_factbook.pdf. In 2004, the average household invested 19.5% of its household financial assets in mutual funds compared to only 6.8% of household financial assets invested in 1990. *Id.* at 12. Furthermore, the number of investment companies holding mutual funds has increased from 5725 in 1995 to 8044 in 2004, and the total assets of those investment companies has increased from $2,811 billion in 1995 to $8,107 billion

Exchange Commission (the "SEC") took aggressive action in 2004 to address perceived failures within the corporate structure of investment companies by promulgating new regulations (the "New Rules") under the Investment Company Act of 1940 (the "ICA").[9] The New Rules, which were originally to take effect in January 2006, require a mutual fund's board of directors to be composed of seventy-five percent independent directors, including the chair, as opposed to only a majority of independent directors.[10] Although the perceived failures in the mutual fund industry are based on recent SEC enforcement actions addressing the late trading of mutual fund shares, illegitimate market timing, and the exploitation of undisclosed details about fund portfolios,[11] the New Rules may not have prevented such abuses and do not address many of the recent mutual fund scandals.[12] The SEC, however, believes that the New Rules are a proactive and essential measure to protect shareholders by strengthening the independence of fund boards, thereby reducing inherent conflicts of interest and forcing the fund's management to abide by all compliance standards.[13] In addition, the New Rules are an attempt to restore a perceived lack of integrity, trust, and fairness in the mutual fund industry.[14] The SEC's motivation in passing the New Rules, however, appears to be not only slightly politicized,[15] but also seems to overlook the significant cost that the New Rules will likely impose on investors.[16]

The core of the SEC's New Rules focuses on two extremely controversial provisions that have sparked a firestorm of comments and criticism. Pending the outcome of the New Rules, all investment companies that transact under the Exemptive Rules of the ICA must alter their board of directors to be seventy-five

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in 2004. *Id.* at 3, 9.

9. Investment Company Governance, 69 Fed. Reg. 46,378, 46,378-79 (Sec. and Exch. Comm'n Aug. 2, 2004) (to be codified at 17 C.F.R. pt. 270) (final rule).

10. *Id.*

11. *Id.*

12. *Id.*; Chamber of Commerce v. Sec. and Exch. Comm'n (*Chamber I*), 412 F.3d 133, 141 (D.C. Cir. 2005); *see* Karmel, *Mutual Funds*, *supra* note 2, at 934 (explaining that many of the enforcement actions the SEC has brought against mutual funds have involved hedge funds, which are not regulated by the ICA and thus are not subject to the New Rules).

13. Investment Company Governance, 69 Fed. Reg. at 46,379 (final rule).

14. Goldschmid, *supra* note 1, at *2. Recent studies, however, indicate that investor confidence in the mutual fund industry has risen over the past two years after a decline in 2000 through 2003. *Fundamentals, Investment Company Institute Research in Brief, Shareholder Sentiment About the Mutual Fund Industry, 2005*, 14 INV. CO. INST. 7 (2005), *available at* www.ici.org/stats/res/index.hml (follow "More Issues of Fundamentals" hyperlink; then follow "Shareholder Sentiment About the Mutual Fund Industry, 2005 (pdf) December 2005" hyperlink).

15. Roberta S. Karmel, *Key Outcomes of* "Chamber of Commerce v. SEC," N.Y. L.J., Aug. 18, 2005, at Col. 1, *1 [hereinafter Karmel, *Key Outcomes*]; *see* Jonathan R. Macey, *State-Federal Relations Post-Eliot Spitzer*, 70 BROOK. L. REV. 117, 136-37 (2004).

16. *See* Investment Company Governance, 69 Fed. Reg. at 46,390 (final rule) (Glassman and Atkins, dissenting).

percent independent,[17] as well as elect or nominate an independent chair to the board of directors.[18] Not only did the SEC receive over 200 comments from investors, management companies, directors of mutual funds, and members of Congress,[19] but the New Rules only passed the Commission by a 3-2 vote with Commissioners Cynthia A. Glassman and Paul S. Atkins dissenting.[20] The numerous comments and strong dissent foreshadowed the intensive scrutiny and debate that was to follow, which culminated in a lawsuit brought against the SEC by the Chamber of Commerce.[21] This lawsuit and the subsequent actions of the SEC resulted in the Court of Appeals for the District of Columbia ("D.C. Circuit") remanding the New Rules back to the SEC on two separate occasions.[22]

Part I of this Note sets forth the general corporate structure of mutual funds

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17. An independent director is a director that is non-interested, meaning that he is not affiliated with the investment company, is not an immediate family member of anyone in the investment company, is not affiliated with the investment adviser or principal underwriter, and has not acted as legal counsel for the investment company within the preceding two years. 15 U.S.C. § 80a-2(a)(3) (2000). A person is affiliated with an investment company if he owns over five percent or more of the outstanding voting securities. *Id.*

18. Investment Company Governance, 69 Fed. Reg. at 46,381-82 (final rule); *see generally* Thomas R. Hurst, *The Unfinished Business of Mutual Fund Reform*, 26 PACE L. REV. 133, 143-45, 152 (2005) (summarizing the SEC's New Rules, the controversy surrounding the New Rules, and the possible effects of the New Rules on investor protection); David S. Ruder, *Balancing Investor Protection with Capital Formation Needs After the SEC Chamber of Commerce Case*, 26 PACE L. REV. 39 (2005) (explaining the SEC's analysis of capital formation in passing the seventy-five percent independent board and chair requirements and past efforts of the SEC to analyze the effect that its rules and programs have on capital formation).

19. Investment Company Governance, 69 Fed. Reg. at 46,379 (final rule). Both Congressman Mike Oxley and Senator Paul Sarbanes, authors of the Sarbanes-Oxley Act, support the New Rules due to the added protection afforded to investors. Investment Company Governance, 70 Fed. Reg. 39,390, 39,401 (Sec. and Exch. Comm'n July 7, 2005) (Campos, concurring) (to be codified at 17 C.F.R. pt. 270) (response to remand).

20. Investment Company Governance, 69 Fed. Reg. at 46,390-93 (final rule).

21. *See Chamber I*, 412 F.3d 133 (D.C. Cir. 2005). Any party adversely affected by an SEC rule promulgated under certain sections of the ICA may file suit against the SEC. *See* 15 U.S.C. § 78y(b) (2000); THOMAS LEE HAZEN, 5 LAW OF SECURITIES REGULATION § 16.22 (5th ed. 2000). The Chamber of Commerce is an adversely affected party and has standing to sue because the New Rules will prevent members of the Chamber of Commerce from investing in mutual funds that do not have an independent chair or seventy-five percent independent directors, and thus suffer an "injury-in-fact." *Chamber I*, 412 F.3d at 138. In addition, the historical data showing that management-chaired funds perform slightly better than funds with independent chairs and that the New Rules could prevent small funds from entering the mutual fund market also support the Chamber of Commerce's standing. Chamber of Commerce v. Sec. and Exch. Comm'n (*Chamber II*), 443 F.3d 890, 896-97 (D.C. Cir. 2006).

22. After the D.C. Circuit originally remanded the New Rules in *Chamber I*, the SEC quickly readopted the New Rules. In *Chamber II*, the D.C. Circuit again remanded the New Rules back to the SEC. 443 F.3d at 909.

and the legislative history of mutual fund regulation. This part focuses not only on the relationship between investment companies and their management, but also the inherent conflicts of interest between mutual fund managers and shareholders.

Part II explains the New Rules as originally proposed by the SEC, specifically the seventy-five percent independent board and chair requirements. This section then analyzes the D.C. Circuit's interpretation of the SEC's controversial provisions under the ICA and the Administrative Procedure Act (the "APA") in the case of *Chamber I*, and the SEC's re-adoption of the New Rules only eight days after the D.C. Circuit remanded the provisions back to the SEC. In addition, Part II examines the reaction of both the Chamber of Commerce and the public to the SEC's swift re-adoption of the New Rules and the D.C. Circuit's second remand of the New Rules in *Chamber II*.

Part III analyzes why the New Rules do not optimally achieve the goals of the SEC and examines the effectiveness of the SEC's prior rules that are aimed at protecting investors, including the 2001 amendment to the ICA requiring a majority of independent directors. This section also includes an analysis of the impact that the New Rules would have had on the recent mutual fund scandals, the lack of empirical evidence upon which the SEC based the new rules, and the disclosure alternative. In conclusion, this Note examines the adverse short-term and long-term implications that the holdings in *Chamber I* and *Chamber II* will have on the New Rules and future rule-making procedures of the SEC.

I. THE CORPORATE STRUCTURE AND LEGISLATIVE HISTORY OF MUTUAL FUNDS

A. Corporate Structure of Investment Companies

Conflicts of interest are inherent in mutual funds;[23] therefore, it is vital to understand the corporate structure that causes these problems. A mutual fund is a collection of assets consisting mainly of various and diverse securities owned by individual shareholders that have invested in shares of the mutual fund.[24] Mutual funds are controlled, managed, and formed[25] by investment companies, such as Fidelity Investments ("Fidelity"). These investment companies invest, reinvest, or trade in securities on behalf of the shareholders,[26] and the investments by the shareholders supply the money needed by the investment company to continue investing in the diverse securities.[27] The investment

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23. *See* Karmel, *Mutual Funds*, *supra* note 2, at 914.

24. Burks v. Lasker, 441 U.S. 471, 480 (1979); *Chamber I*, 412 F.3d at 136.

25. *Burks*, 441 U.S. at 481.

26. *See* 15 U.S.C. § 80a-3 (2000); *see also* David J. Oliveiri, Annotation, *What Is an "Investment Company" Under § 3 of Investment Company Act of 1940 (15 U.S.C.A. § 80a-3)*, 64 A.L.R. FED. 337 (1983).

27. INV. CO. INST., A GUIDE TO UNDERSTANDING MUTUAL FUNDS 6 (2004), http://www.ici.org/pdf/bro_understanding_mfs_p.pdf.

company usually has separate underwriters and no employees.[28] In addition, each mutual fund within an investment company has specific goals and is managed by an external entity, called an investment adviser.[29] The investment adviser, pursuant to a contract with the investment company, chooses or recommends all of the mutual fund's investments[30] and provides administrative and management services.[31]

Investment advisers have other goals beyond increasing the shareholder's return, which is where the inherent conflict of interest arises.[32] Because the management company and investment advisers are external from the investment company, the investment adviser's loyalty and monetary gain are outside the fund; thus, their interest in their own profits may be adverse to the interest of the mutual fund and the shareholders.[33] An investment adviser typically profits by receiving a fee based upon a percentage of assets in the mutual fund that is under his management.[34] Consequently, investment advisers are concerned with increasing and maximizing the assets in the mutual funds that they advise, thus increasing their compensation.[35] Shareholders, however, are concerned with

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28. Karmel, *Mutual Funds*, *supra* note 2, at 914.

29. *Burks*, 441 U.S. at 481.

30. 15 U.S.C. § 80a-2 (2000).

31. *Burks*, 441 U.S. at 481 (quoting S. REP. NO. 91-184, at 5 (1969)). For example, Fidelity, an investment company, has over three hundred Fidelity mutual funds, and thousands of non-Fidelity funds, that investors can choose from when investing. Fidelity Research and Management Company ("FMR Co.") manages all of Fidelity's mutual funds. FIDELITY, INSIDE FIDELITY, http://personal.fidelity.com/myfidelity/InsideFidelity/index.html (follow "Company Overview" hyperlink; then follow "Investment Management" hyperlink) (last visited Sept. 18, 2006). FMR Company employs over five hundred investment specialists, including both investment advisers and analysts, that research investment strategies and new investment opportunities. *Id.* For example, Fergus Shiel, an employee of FMR Company and an investment adviser, manages Fidelity's Capital Appreciation Fund, one of Fidelity's top performing mutual funds. The investment advisers often manage more than one mutual fund. FIDELITY, FIDELITY CAPITAL APPRECIATION FUND, http://personal.fidelity.com/products/funds/mfl_frame.shtml?316066109 (last visited Sept. 18, 2006). The Capital Appreciation Fund has the goal of obtaining capital appreciation by investing in securities, which consist of mainly foreign and domestic stock. *Id.* Fergus Shiel and his staff choose the stocks for the mutual fund by analyzing the stock's financial state, industry position, and other market and economic forces. *Id.*

32. *Chamber I*, 412 F.3d 133, 136 (D.C. Cir. 2005). For example, a conflict of interest arises when the investment adviser encourages private investors to deposit new assets into the fund in exchange for abusive market timing privileges. REPORT IN ACCORDANCE WITH THE CONSOLIDATED ACT, *supra* note 4, at *11, 73.

33. Investment Company Governance, 70 Fed. Reg. 39,390, 39,396 (Sec. and Exch. Comm'n July 7, 2005) (to be codified at 17 C.F.R. pt. 270) (response to remand); 15 U.S.C. § 80a-17 (2000).

34. REPORT IN ACCORDANCE WITH THE CONSOLIDATED APPROPRIATIONS ACT, *supra* note 4, at *11.

35. *Id.*

having a profitable mutual fund, as opposed to a large mutual fund.[36] This inherent conflict of interest has led numerous investment advisers to encourage private investors to deposit large sums of money into a mutual fund, thus increasing the mutual funds' assets and the investment adviser's compensation.[37] The investment adviser then gives the private investor illegal or abusive privileges, such as market timing privileges, which harms other shareholders.[38]

Section 17 of the ICA addresses and forbids certain "self-dealing transactions" in order to reduce the inherent conflict of interest that arises between shareholders and mutual fund investment advisers.[39] The ICA, however, does not address all conflicts of interest that can arise, such as "the allocation of brokerage commissions, the use of fund assets for distribution, the allocation of expenses between a fund and its adviser and among funds, responsibility for any pricing errors or violations of investment restrictions, and personal investing by officers and employees of the fund's adviser."[40] Therefore, in order to assure that the mutual fund's investment adviser is acting in the best interest of the shareholder, a board of directors elected by the shareholders governs the mutual fund.[41] The ICA and various SEC regulations, orders, and interpretations stringently govern fund directors, whether independent or affiliated with the management company.[42]

The board of directors has the responsibility of, among other things, valuing the securities held by the fund, approving the fund's investment advisory and principal underwriter contracts, approving distribution plans under Rule 12b-1 of the ICA,[43] and generally overseeing any transaction that the Exemptive Rules govern.[44] The board of director's main goal, however, is to ensure that the fund's

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36. Shareholders would only be concerned with increasing the assets of the mutual fund "to the extent that the increase [in assets] achieves the economies of scale that should reasonably accompany fund growth." *Id.*

37. *Id.*

38. *Id.*

39. INVESTMENT COMPANY INSTITUTE, REPORT OF THE ADVISORY GROUP ON BEST PRACTICES FOR FUND DIRECTORS, ENHANCING A CULTURE OF INDEPENDENCE AND EFFECTIVENESS 8 (1999), *available at* http://www.ici.org (follow "Key Issues" hyperlink; then follow "Directors & Fund Governance" hyperlink; then follow "Report of the Advisory Group on Best Practices for Fund Directors (pdf) June 1999" hyperlink) [hereinafter INVESTMENT COMPANY INSTITUTE, FUND DIRECTORS].

40. *Id.* at 9.

41. *Chamber I*, 412 F.3d 133, 136 (D.C. Cir. 2005).

42. INVESTMENT COMPANY INSTITUTE, FUND DIRECTORS, *supra* note 39, at 6; REPORT IN ACCORDANCE WITH THE CONSOLIDATED APPROPRIATIONS ACT, *supra* note 4, at *12, 14-15.

43. The board of directors should closely monitor the 12b-1 distribution plans because an investment adviser can charge higher 12b-1 fees in order to maximize fund assets, and thus increase the fee paid to the adviser. REPORT IN ACCORDANCE WITH THE CONSOLIDATED APPROPRIATIONS ACT, *supra* note 4, at *12, *14-15; INVESTMENT COMPANY INSTITUTE, FUND DIRECTORS, *supra* note 39, at 6-7.

44. REPORT IN ACCORDANCE WITH THE CONSOLIDATED APPROPRIATIONS ACT, *supra* note 4,

investment adviser is acting in the best interest of the shareholders, and that the shareholders are obtaining the benefits and services they are entitled to under the ICA and the fund's prospectus and disclosure documents.[45]

B. History of Mutual Fund Regulation

The main goal of Congress in passing the ICA was to diminish the inherent conflicts of interest between investment advisers and shareholders.[46] The key provision of the ICA requires a mutual fund's board of directors to be composed of at least forty percent independent directors to serve as "watchdogs" by independently checking and monitoring the mutual fund's management.[47] This independent check works to ensure that the investment advisers are not engaging in transactions for their own self-interest at the detriment of the shareholder.[48] In addition, under the ICA both investment advisers[49] and mutual fund directors owe the fiduciary duties of care, good faith, and loyalty to the shareholders.[50] If an investment adviser or director violates a fiduciary duty, the SEC can bring an action against him resulting in, among other things, permanent or temporary enjoinment of his position within the investment company.[51]

The ICA allows mutual funds to engage in prohibited transactions if the fund adheres to the specific Exemptive Rules set forth in the ICA.[52] Adherence to these rules allows mutual funds to transact with affiliated companies, which is necessary for most mutual funds to conduct business.[53] Because the vast majority of mutual funds must adhere to these rules to thrive,[54] the SEC is able to impose new regulations on virtually all funds by incorporating the regulations into the

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at *129.

45. INVESTMENT COMPANY INSTITUTE, FUND DIRECTORS, *supra* note 39, at 6-7.

46. *See* Burks v. Lasker, 441 U.S. 471, 480-81 (1979); *Chamber I*, 412 F.3d at 136-37; INVESTMENT COMPANY INSTITUTE, FUND DIRECTORS, *supra* note 39, at 6.

47. *Burks*, 411 U.S. at 482, 484. The reference to the independent directors as "watchdogs" by the Supreme Court has been quoted in numerous authorities, many of which are cited in this Note.

48. *Chamber I*, 412 F.3d at 136.

49. *See* 15 U.S.C. § 80b-6 (2000).

50. Goldschmid, *supra* note 1, at *5; *see* Diane E. Ambler, *Roundtable on the Role of Independent Investment Company Directors: Issues for Independent Directors of Bank-Related Funds, Variable Insurance Product Funds, and Closed-End Funds*, 55 BUS. LAW. 205, 210-11 (1999); *see also* Bullard, *supra* note 3, at 1141.

51. 15 U.S.C. § 80a-35 (2000).

52. *Chamber I*, 412 F.3d at 136. Under the ICA, the SEC has the power to exempt any person, security, or transaction from the rules and regulations of the ICA if the exemption is in the best interest of the public and protects investors. 15 U.S.C. § 80a-6(c) (2000); REPORT IN ACCORDANCE WITH THE CONSOLIDATED APPROPRIATIONS ACT, *supra* note 4, at *19.

53. Karmel, *Mutual Funds*, *supra* note 2, at 916.

54. *See* Initial Opening Brief of Petitioner at 9, Chamber of Commerce v. Sec. and Exch. Comm'n, 412 F.3d 133 (D.C. Cir. 2005) (No. 04-1300).

Exemptive Rules.[55]

C. Recent Amendments to the Investment Company Act

In 2001, the SEC amended the ICA by requiring investment companies to have a majority of independent directors on the board, as opposed to only forty percent.[56] The independent directors have the responsibility of, among other things, selecting and nominating new independent directors and hiring attorneys with no connections to the mutual fund's management.[57] While the SEC was passing this amendment, it was simultaneously trying to pass new regulations requiring more independence on corporate boards under the Sarbanes-Oxley Act.[58]

More recently, the SEC has required mutual funds to hire a chief compliance officer ("CCO").[59] The CCO is required to meet with only the independent directors, as opposed to the entire board and submit a report on compliance issues to the full board.[60] Likewise, a mutual fund's attorneys are now required to report any compliance or fiduciary breaches to the independent directors and the CCO.[61] This not only gives the independent directors greater control over the investment advisers, including the ability to solve conflicts of interest and compliance breaches, but also enables the open flow of information.[62]

II. THE SEC'S NEW RULES REQUIRING AN INDEPENDENT CHAIR AND SEVENTY-FIVE PERCENT INDEPENDENCE ON THE BOARD OF DIRECTORS

A. The New Rules as Originally Proposed

The SEC's New Rules require a mutual fund's board of directors to be comprised of at least seventy-five percent independent directors, including an independent chair of the board.[63] The three commissioners that voted in favor of

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55. Investment Company Governance, 69 Fed. Reg. 46,378, 46,390 n.1 (Sec. and Exch. Comm'n Aug. 2, 2004) (Glassman and Atkins, dissenting) (to be codified at 17 C.F.R. pt. 270) (final rule).

56. Investment Company Governance, 69 Fed. Reg. at 46,378 (final rule); Karmel, *Mutual Funds*, *supra* note 2, at 930.

57. Investment Company Governance, 69 Fed. Reg. at 46,378 n.2 (final rule); Karmel, *Mutual Funds*, *supra* note 2, at 931.

58. Karmel, *Mutual Funds*, *supra* note 2, at 930; *see* Hurst, *supra* note 18, at 144, 152.

59. Compliance Programs of Investment Companies and Investment Advisers, 68 Fed. Reg. 74,714, 74,721 (Sec. and Exch. Comm'n Dec. 24, 2003) (to be codified at 17 C.F.R. pts. 270, 275, 279); Goldschmid, *supra* note 1, at *4.

60. Compliance Program of Investment Companies and Investment Advisers, 68 Fed. Reg. at 74,721; *see* Goldschmid, *supra* note 1, at *4; *see* Karmel, *Mutual Funds*, *supra* note 2, at 932.

61. Goldschmid, *supra* note 1, at *4.

62. *See id.*

63. Investment Company Governance, 69 Fed. Reg. 46,378, 46,381-82 (Sec. and Exch. Comm'n Aug. 2, 2004) (to be codified at 17 C.F.R. pt. 270) (final rule). If, however, the board of

the New Rules, Chairman Donaldson, Commissioner Goldschmid, and Commissioner Campos (collectively the "Majority Commissioners"), believe that the amendments will enable the independent directors to take and preserve control over the board, and thus better fulfill their fiduciary duties and address conflicts of interest by monitoring the investment advisers.[64] If the independent directors do not have control over the board nor access to vital information regarding the mutual fund, the directors affiliated with the management company would be in a position to control the agenda of the board[65] and possibly allow or overlook conflicts of interest.

The SEC's independent chair requirement is considered the "capstone" of the 2004 mutual fund reforms.[66] The Majority Commissioners believe that an independent chair can effectively protect the shareholders due to the absence of any conflicts of interest,[67] unlike a chair that also is an executive of the management company.[68] The independent chair can enable an open and beneficial dialogue between the affiliated and independent directors during board meetings and provide another independent check on the fund management; therefore, protecting the long-term interest of the shareholders.[69]

Under the ICA, the SEC has a statutory obligation to ascertain the economic implications of the New Rules, including the effect the New Rules would have on efficiency, competition, and capital formation.[70] In the first proposal of the New Rules, the SEC included a cost-benefit analysis.[71] When analyzing the cost of the seventy-five percent independence requirement, the SEC merely listed the three different ways in which a board could comply with the New Rules.[72] The SEC then stated, "our staff has no reliable basis for determining how funds would choose to satisfy this requirement and therefore it is difficult to determine the costs associated with electing independent directors."[73] Likewise, in requiring an independent chair, the SEC stated, "our staff is not aware of any out-of-pocket costs that would result . . . because these requirements could be satisfied at a

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directors has only three members, two of those three must be independent. *Id.* at 46,386.

64. *Id.* at 46,382.

65. *Id.*

66. Investment Company Governance, 70 Fed. Reg. 39,390, 39,399 (Sec. and Exch. Comm'n July 7, 2005) (Donaldson, concurring) (to be codified at 17 C.F.R. pt. 270) (response to remand).

67. Investment Company Governance, 69 Fed. Reg. at 46,382 (final rule).

68. REPORT IN ACCORDANCE WITH THE CONSOLIDATED APPROPRIATIONS ACT, *supra* note 4, at *133; *see also* Investment Company Governance, 70 Fed. Reg. at 39,399 (Donaldson, concurring) (response to remand).

69. Investment Company Governance, 70 Fed. Reg. at 39,399 (Donaldson, concurring) (response to remand).

70. *Chamber I*, 412 F.3d 133, 142-44 (D.C. Cir. 2005); 15 U.S.C. § 80a-2(c) (2000); *see* Ruder, *supra* note 18, at *passim*.

71. Investment Company Governance, 69 Fed. Reg. at 46,385-87 (final rule).

72. *Id.* at 46,387.

73. *Id.* at 46,387; *Chamber II*, 443 F.3d 890, 894 (D.C. Cir. 2006).

regularly scheduled board meeting."[74]

The SEC, in the first proposal, stated that the New Rules would have no "significant effect" on efficiency, competition, and capital formation because of the perceived minimal economic impact.[75] The Majority Commissioners believe the only impact that the New Rules might have on competition and capital formation is an increase in investor confidence due to the prevention of potential securities fraud, such as late trading and market timing.[76]

B. Chamber I

At issue in the Chamber of Commerce's initial lawsuit were the two controversial provisions.[77] The Chamber of Commerce claimed that by adopting the New Rules, the SEC went beyond its scope of authority under the ICA and abused its rulemaking power under the APA.[78] The D.C. Circuit held that the SEC had the authority to adopt the provisions under the ICA;[79] however, the SEC violated the APA by failing to consider the cost imposed upon shareholders'[80] and failing to consider the disclosure alternative proposed by the dissenting commissioners.[81] The SEC was not required to base its decision on empirical data, including a study conducted by Fidelity, but did have an obligation to estimate the cost to individual mutual funds.[82] Thus, the D.C. Circuit remanded the New Rules back to the SEC for compliance with the ruling.[83] In addition, the SEC also had to justify the New Rules by providing a comprehensive report to the Senate Appropriations Committee.[84]

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74. Investment Company Governance, 69 Fed. Reg. at 46,387 (final rule).

75. *See id.* at 46,388.

76. *Id.* at 46,388-89. Former SEC Commissioner Roberta Karmel, has described late trading as "permitting a purchase or redemption order received after the 4:00 p.m. pricing of a mutual fund's net asset value[,]" and market timing as "the frequent buying and selling of mutual fund shares to take advantage of price disparities between a mutual fund's portfolio securities and the reflection of that change in the fund's share price." Karmel, *Mutual Funds, supra* note 2, at 929-30. Although market timing is not illegal, it can harm shareholders by reducing the value of their shares. *In re* Federated Inv. Mgmt. Co., Federated Sec. Corp. and Federated S'holder Serv. Co., Investment Advisers Act of 1940 Release No. 2448, Investment Company Act of 1940 Release No. 27,167, at *7-8 (Nov. 28, 2005).

77. *Chamber I*, 412 F.3d 133, 136 (D.C. Cir. 2005); Hurst, *supra* note 18, at 143-44.

78. Hurst, *supra* note 18, at 138; *see also* Ruder, *supra* note 18, at 47.

79. *Chamber I*, 412 F.3d at 141; *see also* Ruder, *supra* note 18, at 47.

80. *Chamber I*, 412 F.3d. at 144; Hurst, *supra* note 18, at 143.

81. *Chamber I*, 412 F.3d at 144-45; *see also* Ruder, *supra* note 18, at 49.

82. *Chamber I*, 412 F.3d at 142-44; *see also* Ruder, *supra* note 18, at 48-50 (noting that the D.C. Circuit's holding that the SEC did not need empirical data to base the New Rules was crucial because had the court held otherwise, "the effect would be to deny [the SEC] power to make rules in the absence of available data").

83. *Chamber I*, 412 F.3d at 145.

84. Consolidated Appropriations Act of 2005, Pub. L. No. 108-447, 118 Stat. 2809, 2910

C. *Actions of the SEC After* Chamber I

The SEC typically takes months to respond to a court's ruling; however, the New Rules were re-adopted by the SEC only eight days after *Chamber I* and only one day prior to Chairman Donaldson's planned retirement.[85] Chairman Donaldson believed that the quick re-adoption was not rushed, but rather it protected investors, enhanced investor confidence, and precluded the New Rules from being left in a state of limbo.[86] In addition, the SEC has a reputation for meeting deadlines and in the past has acted with expediency on matters that it believes to be of the utmost importance.[87] Commissioner Glassman, however, stated that the sudden re-adoption was a "rush to judgment" and based on "an assembly of false statements, unsupported assumptions, flawed analysis, and misinterpretations."[88]

The SEC believed that the threshold question from *Chamber I* was whether it was essential to conduct additional fact finding and further notice and comment on the New Rules.[89] The SEC mistakenly concluded that no further public comment was necessary since it had received comments relating to both the cost and disclosure alternative and instead relied on the original record.[90] The SEC also relied on publicly available information.[91] The publicly available information to which the SEC referred included a widely used "industry survey" to estimate the cost of compliance for the independent chair requirement.[92]

Commissioner Glassman and Atkins's strongly worded dissents to the SEC's re-adoption after *Chamber I* highlight both the perceived procedural and

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(2004).

85. Monica Gagnier, *Donaldson's Parting Shot*, BUS. WK., July 4, 2005, at 44; *see* Investment Company Governance, 70 Fed. Reg. 39,390, 39,391 (Sec. and Exch. Comm'n July 7, 2005) (to be codified at 17 C.F.R. pt. 270) (response to remand). Critics viewed the SEC's re-adoption of the New Rules one day prior to Chairman Donaldson's planned retirement as a political maneuver. The Majority Commissioners, however, stated that this rushed re-adoption was necessary because of the familiarity the SEC commissioners had with the New Rules due to the year and a half they had spent studying and researching them. *Id.*

86. Investment Company Governance, 70 Fed. Reg. at *passim* (response to remand).

87. *Id.* at 39,402-03 (Campos, concurring). For example, ten days prior to Chairman Pitt's retirement in 2003, the SEC enacted ten rules, several of them being final rules or comments. *Id.* Moreover, in 2003, due to the Sarbanes-Oxley Act, the SEC conducted more rulemaking in one year than they had done in any other decade. *Id.*

88. Robert Schmidt, *SEC Resuscitates its Mutual Fund Governance Rule Move Rushed by Donaldson, Critics Claim*, GLOBE AND MAIL, June 30, 2005, at B15.

89. Investment Company Governance, 70 Fed. Reg. at 39,390 (response to remand).

90. *Id.* at 39,390-91. The Commission stated that not only was further public comment unnecessary, but it would also harm investors because of the sufficiency of the current information and the cost of additional fact-finding. *Id.* at 39,391.

91. *Id.* at 39,390.

92. *Chamber II*, 443 F.3d 890, 895 (D.C. Cir. 2006).

substantive errors.[93] Both dissents are highly critical of the actions of Chairman Donaldson and the swift re-adoption of the New Rules.[94] On the same day that the D.C. Circuit remanded the New Rules, Chairman Donaldson's staff concluded only hours after the remand that the SEC's previous record was adequate to satisfy the Court's instructions.[95] Commissioner Glassman explained that these actions, along with others taken in the week before the re-adoption, elevated "form over substance once again" and were a result of the Majority Commissioners' fears that the SEC would not re-adopt the New Rules absent Chairman Donaldson.[96] Both Commissioner Atkins and Glassman believe that a more methodical and deliberate approach, such as roundtable discussions, further public comment, and formal or empirical surveys, should have been taken by the SEC in response to *Chamber I*.[97]

When re-adopting the New Rules the SEC was forced to justify why the New Rules were cost-efficient, which it did with information that the SEC claimed to have had in the original record and through publicly available information.[98] The cost of the independent chair cited by the SEC includes hiring additional employees and an independent attorney, recruitment costs, and the increased salary demanded by independent chairs.[99] Mutual funds, however, may lessen this cost by choosing the new independent chair from the currently presiding independent directors.[100] The cost of hiring new independent directors also includes recruitment costs, additional yearly compensation,[101] and additional independent attorneys.[102] According to the Chamber of Commerce, however, the

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93. Investment Company Governance, 70 Fed. Reg. at 39,403, 39,405-06 (Glassman and Atkins, dissenting) (response to remand).

94. *Id.* at 39,403 (Glassman, dissenting).

95. *Id.*

96. *Id.* In addition, Chairman Donaldson elevated form over substance by departing from normal procedures regarding "sunshine notices" of open meetings as proscribed in the Code of Federal Regulations and requiring Commissioners Glassman and Atkins to submit their dissents prior to the meeting. *Id.* Commissioner Glassman and Atkins were also given the final release to be considered at the meeting where the vote for re-adoption would take place the night before the meeting, thus giving them less than twenty-four hours to reconsider the New Rules. *Id.* at 39,406 (Atkins, dissenting).

97. *Id.* at 39,408 (Atkins, dissenting).

98. *Id.* at 39,391.

99. Opening Brief of Petitioner-Appellant at 22, Chamber of Commerce v. Sec. and Exch. Comm'n, 412 F.3d 133 (D.C. Cir. 2005) (No. 05-1240).

100. *See* REPORT IN ACCORDANCE WITH THE CONSOLIDATED APPROPRIATIONS ACT, *supra* note 4, at *146.

101. In 2002, the median compensation for an independent director at a large mutual fund was $113,000 a year, while the compensation at smaller mutual funds was $18,000 a year. Investment Company Governance, 69 Fed. Reg. 46,378, 46,391 n.24 (Sec. and Exch. Comm'n Aug. 2, 2004) (to be codified at 17 C.F.R. pt. 270). This does not include recruitment costs or non-compensation costs. *Id.*

102. Investment Company Governance, 70 Fed. Reg. at 39,392 (response to remand).

SEC based these costs on information that is outside the record, extremely subjective, and in a few instances, even biased.[103]

The monetary cost for replacing an affiliated director with an independent director is approximately $400,000 per mutual fund board for the first year, while the cost of changing the board composition to seventy-five percent independent is approximately $650,000 for the first year.[104] Although nearly sixty percent of mutual fund boards meet the seventy-five percent independent board requirement, eighty percent of mutual fund boards, which is approximately 3700 funds, will have to elect or nominate a new independent chair.[105] This includes the two largest investment companies, Vanguard and Fidelity.[106] This equates to a cost of over one million dollars for a mutual fund that has to change both the board composition and the affiliated chair to an independent chair; a sum which is even more burdensome for smaller mutual funds.[107] Moreover, there are also non-monetary costs such as the knowledge and expertise that is lost by not having an affiliated chair.[108]

D. Reaction of the Chamber of Commerce and the D.C. Circuit to the SEC's Subsequent Actions

On September 21, 2005, the Chamber of Commerce again filed a brief with the D.C. Circuit asking it to review the SEC's re-adoption and strike down the seventy-five percent independent board and chair requirements.[109] The President and CEO of the Chamber of Commerce, Thomas Donahue, was outraged at the SEC's actions and stated "[t]he SEC didn't meet their [sic] legal requirements the

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Although additional staff hired by the independent directors has been said to be an additional cost, the New Rules do not require the hiring of this staff; instead, it is at the discretion of the directors. *See* REPORT IN ACCORDANCE WITH THE CONSOLIDATED APPROPRIATIONS ACT, *supra* note 4, at *147.

103. Opening Brief of Petitioner-Appellant, *supra* note 99, at 22-23.

104. *Id.* at 24.

105. Cynthia A. Glassman, S.E.C. Comm'r, Statement by SEC Commissioner Regarding Investment Company Governance, Statement before the Sec. and Exch. Comm'n Open Meeting (June 23, 2004), http://www.sec.gov/news/speech/spch062304cag.htm [hereinafter Glassman Statement]; Paul S. Atkins, S.E.C. Comm'r, Statement By SEC Commissioner Regarding Investment Company Governance (June 23, 2004), 2004 WL 1571976, *2 [hereinafter Atkins Statement]. Prior to the New Rules original compliance date, several funds already had independent chairs, including Thrivent, One Group, and Goldman Sachs. REPORT IN ACCORDANCE WITH THE CONSOLIDATED APPROPRIATIONS ACT, *supra* note 4, at *156-57. In addition, Scudder, ING, UBS Brinson, and American Century all elected independent chairs prior to the original compliance date. *Id.* at *157.

106. Schmidt, *supra* note 88, at B15.

107. Opening Brief of Petitioner-Appellant, *supra* note 99, at 24-25.

108. Investment Company Governance, 70 Fed. Reg. 39,390, 39,394 (Sec. and Exch. Comm'n July 7, 2005) (to be codified at 17 C.F.R. pt. 270) (response to remand).

109. Opening Brief of Petitioner-Appellant, *supra* note 99, at 30.

first time around and today's effort is no different. . . . It's outrageous that a regulatory agency would deliberately ignore the orders of a U.S. court of appeals and disregard calls for a reasoned rulemaking process."[110] Moreover, former SEC Chairman Harvey L. Pitt originally supported the SEC's adoption of the New Rules, but since has stated:

> If the SEC were evaluating this behavior by the Chairman and two directors of a publicly-held corporation intent on trampling the rule of law and the rights of the minority as lame ducks and expiring terms . . . its Enforcement Staff would be all over the perpetrators of such conduct, as it should be, and the agency would be expressing appropriate pieties about transparency, governance, and protecting the rights of public investors.[111]

On April 7, 2006, the D.C. Circuit vacated the New Rules.[112] In *Chamber II*, the court first upheld the Chamber of Commerce's standing and ruled that the SEC's decision to re-adopt the New Rules prior to the court's mandate in *Chamber I* was permissible.[113] The manner in which the SEC re-adopted the New Rules after *Chamber I*, however, was not permissible and violated section 553 of the APA.[114]

Although the D.C. Circuit in *Chamber I* gave the SEC the discretion to decide whether to take further public comment,[115] the SEC is still obligated under the APA to abide by the notice and comment requirements, even when re-adopting a rule.[116] The SEC failed to abide by these requirements by relying on material, specifically a private survey of mutual fund corporate governance and compensation practices, which was outside the rule-making record.[117] In addition, this new material was the only basis for the SEC's cost estimate when re-adopting the New Rules, and thus the material was "primary," not just "supplementary," information.[118] The Chamber of Commerce, along with other interested parties, should have had the opportunity to review, analyze, and comment on the new information on which the SEC based the re-adoption of the New Rules.[119]

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110. *SEC Again Adopts Mutual-Fund Governance Rule, U.S. Chamber of Commerce v. SEC*, ANDREWS SEC. LITIG. & REG. REP., July 13, 2005, at 3.

111. Opening Brief of Petitioner-Appellant, *supra* note 99, at 44 n.9 (quoting Letter from former Chairman Harvey L. Pitt (June 23, 2005), at 3-4).

112. *Chamber II*, 443 F.3d 890, 909 (D.C. Cir. 2006).

113. *Id.* at 897-99.

114. *Id.* at 908.

115. *Id.* at 900.

116. *Id.* at 899. An agency does not need to have additional notice and comment when additional facts relied on during the re-adoption of a rule merely supplement information in the rule-making record. *Id.* at 900.

117. *Id.* at 901-02.

118. *Id.* at 902-03.

119. *Id.* at 904-06.

Due to the SEC's failure to allow further notice and comment, the D.C. Circuit vacated the New Rules; however, since numerous mutual funds have already come into compliance with the New Rules, the D.C. Circuit is allowing the SEC to have ninety days in which to reconsider and re-adopt the New Rules.[120] Although the future actions of the SEC are unclear, especially since the SEC is now under the new leadership of Chairman Cox,[121] it is imperative that they reopen the rule-making record for comment if the New Rules are re-adopted.[122]

III. THE NEW RULES DO NOT OPTIMALLY ACHIEVE THE GOALS OF THE SEC

A. The New Regulations Might Not Have Prevented Recent Mutual Fund Scandals

The SEC designed the newly required independent chair to provide an additional safeguard against conflicts of interest by vigilantly overseeing fund management, and thus preventing the illegal transactions that have led to the recent mutual fund scandals. The New Rules, however, may not have prevented these scandals.[123] The "documented abuses" of the recent mutual funds scandals have not involved transactions covered by the Exemptive Rules.[124] The SEC, however, believes that the recent mutual fund scandals indicate a "systemic industry problem[,]" which the New Rules address by increasing the accountability of the investment adviser to the independent directors and chair, thus decreasing abusive and illegal practices.[125] The SEC, therefore, considers the New Rules to be "a prophylactic measure, not a response to a present problem involving abuse of the Exemptive Rules."[126]

Proponents of the New Rules stress that eighty percent of boards involved in the recent scandals have had inside chairs; however, this statistic is misleading and does not itself entirely support the independent chair requirement.[127] This is because "approximately eighty percent of *all* fund firms have interested

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120. *Id.* at 909.

121. *See* Lynn Hume, *Judges Side with Chamber: SEC Must Decide on Mutual Fund Rule*, 356 THE BOND BUYER 1 (2006).

122. *Chamber II*, 443 F.3d at 909. The D.C. Circuit reasoned that the SEC is the best judge of whether the New Rules should be re-adopted a second time in order to achieve uniform corporate governance of mutual funds. *Id.*

123. *See* Karmel, *Mutual Funds*, *supra* note 2, at 933.

124. *Chamber I*, 412 F.3d 133, 141 (D.C. Cir. 2005).

125. Brief for CFA Institute as Amici Curiae Supporting Respondents, Chamber of Commerce v. Sec. and Exch. Comm'n, 412 F.3d 133 (D.C. Cir. 2005) (No. 04-1300), *available at* 2005 WL 596760.

126. *Chamber I*, 412 F.3d at 141.

127. *See* Investment Company Governance, 69 Fed. Reg. 46,378, 46,391 (Sec. and Exch. Comm'n Aug. 2, 2004) (Glassman and Atkins, dissenting) (to be codified at 17 C.F.R. pt. 270) (final rule).

chairpersons . . . suggest[ing] only that funds with inside chairs are proportionally implicated in the abusive activity."[128] Because the SEC did not sample mutual funds with independent chairs and inside chairs at the same rate, and the SEC created the enforcement data,[129] the statistics regarding the percentage of inside chairs involved in mutual fund scandals is questionable. By maintaining an inside chair, as opposed to an independent chair, the chair is more likely to be aware of abusive, illegal, or other harmful activities within the management company due to his access to information and the management arrangement.[130] This gives an inside chair a better opportunity to inform the board of abusive or illegal practices, allowing the board to take corrective action.[131]

The New Rules also may not prevent future mutual fund scandals because many of the illegal and abusive transactions have involved mutual funds working with entities that are not subject to the Exemptive Rules.[132] Many of these recent mutual fund scandals have involved hedge funds advisers that have participated in the late trading and market timing of mutual funds.[133] The hedge fund advisers have been able to exploit mutual fund shareholders by agreeing with mutual fund advisers to overlook prohibitions on market timing in order for the investment adviser to receive what has been coined "sticky assets."[134] The SEC stated that almost forty hedge funds and at least eighty-seven hedge fund advisers have been involved in mutual fund scandals or are currently under investigation in connection with these scandals.[135]

One of the most publicized mutual fund scandals involved the hedge fund Canary Capital Partners and its investment adviser Canary Investment Management, LLC (collectively "Canary").[136] By working with numerous mutual funds, Canary was able to partake in late trading and market timing, resulting in Canary receiving tens of millions of dollars, fund managers receiving

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128. *Id.*; Initial Opening Brief of Petitioner, *supra* note 54, at 9 n.14.

129. Initial Opening Brief of Petitioner, *supra* note 54, at 9 n.14.

130. Investment Company Governance, 69 Fed. Reg. at 46,391 (Glassman and Atkins, dissenting) (final rule).

131. *Id.* The dissenting commissioners explained that "[a] common feature of these [scandals] is that boards were not told of the formal or informal arrangements permitting market timing." *Id.*

132. *See Chamber I*, 412 F.3d 133, 140-41 (D.C. Cir. 2005); Reply Brief of Petitioner at 7, Chamber of Commerce v. Sec. and Exch. Comm'n, 412 F.3d 133 (D.C. Cir. 2005) (No. 04-1300).

133. Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72,054, 72,056 (Sec. and Exch. Comm'n Dec. 10, 2004) (to be codified at 17 C.F.R. pts. 275 and 279).

134. *Id.* at 72,056-57. "Sticky assets" occur when hedge fund advisers deposit assets into other funds managed by a mutual fund adviser. *Id.* at 72,057. REPORT IN ACCORDANCE WITH THE CONSOLIDATED APPROPRIATIONS ACT, *supra* note 4, at *73.

135. Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. at 72,057.

136. Registration Under the Advisers Act of Certain Hedge Fund Advisers, Investment Advisers Act of 1940 Release No. 2266, 2004 WL 1636422, *5-6 (proposed July 20, 2004).

substantial management fees, and mutual fund shareholders losing millions of dollars.[137] One such arrangement occurred between Canary and three subsidiaries of Federated Investors, one of America's largest mutual fund managers.[138] In only six months, Canary had $1.6 billion in market timing transactions with Federated Funds and earned a net profit of over $4.9 million.[139] These monetary amounts, however, are small compared to what Canary paid in a settlement with the New York Attorney General due to its involvement in numerous mutual fund scandals.[140]

By intensifying board independence, the SEC brings added scrutiny only to those transactions covered under the Exemptive Rules,[141] such as Rule 17a-7, which allows a mutual fund to conduct securities transactions with other mutual funds that have common officers, directors, or investment advisers, with approval of a majority of the independent directors.[142] Although hedge funds like Canary could not have conducted these abusive and illegal activities without the aid of mutual fund directors and advisers, the added scrutiny brought by the independent directors may not prevent future abuses involving the corroboration of mutual funds and hedge funds until the SEC begins to stringently regulate and monitor hedge funds.[143] This is because hedge fund advisers, until recently, have not been required to register with the SEC, and thus, the SEC has not been able to review their trading activities with respect to mutual funds.[144]

B. Current Regulations Under the Investment Company Act Amply Protect Investors and Address the Issues Raised by the Majority Commissioners

In 2001, less than two years prior to adopting the New Rules, the SEC required that a board of directors consist of a majority of independent

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137. *Id.*

138. *In re* Federated Inv. Mgmt. Co., Federated Sec. Corp. and Federated S'holder Serv. Co., Investment Advisers Act of 1940 Release No. 2448, Investment Company Act of 1940 Release No. 27,167 (Nov. 28, 2005), at *5.

139. *Id.* Canary also entered into abusive or illegal transactions with Invesco, PIMCO, Alliance Capital, and subsidiaries of Bank of America, FleetBoston, Financial Corporation and Banc One. REPORT IN ACCORDANCE WITH THE CONSOLIDATED APPROPRIATIONS ACT, *supra* note 4, at *68.

140. Hurst, *supra* note 18, at 135. "Canary and its managers agree[d] to make restitution of $30 million to the [mutual] funds involved and also to pay a $10 million penalty." *Id.*

141. Reply Brief of Petitioner, *supra* note 132, at 8.

142. 17 C.F.R. § 270.17a-7 (2005).

143. The SEC recently passed rules requiring that investment advisers of hedge funds register with the SEC under the Investment Advisers Act. Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72,054, 72,054 (Sec. and Exch. Comm'n Dec. 10, 2004) (to be codified at 17 C.F.R. pts. 275 and 279). All hedge fund investment advisers were required to register by February 1, 2006. *Id.*

144. Registration Under the Advisers Act of Certain Hedge Fund Advisers, Investment Advisers Act of 1940 Release No. 2266, 2004 WL 1636422, *38 n.44 (proposed July 20, 2004).

directors.[145] When adopting this requirement, the SEC stated that a majority of independent directors is able to "permit, under state law, the independent directors to control the fund's 'corporate machinery' i.e., to elect officers of the fund, call meetings, solicit proxies, and take other actions without the consent of the adviser" and have a "more meaningful influence on fund management and represent shareholders from a position of strength."[146] Moreover, a majority of the independent directors has to approve all underwriting and advisory contracts,[147] allowing the independent directors to have control of one of the most important tasks that the board is statutorily required to undertake.[148]

1. A Majority or Super-Majority of Independent Directors Could Require an Independent Chair.—Under the 2001 amendments, a majority of independent directors could require an independent chair if they felt this would best protect the interest of the shareholders.[149] The proposed requirement of a mandatory independent chair, however, undermines the independent directors' authority to elect a chair of their choice[150] by imposing a "regulatory fiat."[151] Opponents of the New Rules stated that if the SEC succeeds in passing the super-majority requirement, the independent chair requirement is even more unnecessary because a super-majority of independent directors can undoubtedly elect an independent chair.[152] Moreover, a super-majority of independent directors can "determine the outcome of any matter put to a board vote and can effectively control all aspects of the board process, including the scheduling and duration of meetings, [and] the flow of information prior to and during board meetings."[153] The SEC, however, believes that even with a super-majority of independent

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145. 15 U.S.C. § 80a-10 (2000); Investment Company Governance, 69 Fed. Reg. 46,378, 46,390 (Sec. and Exch. Comm'n Aug. 2, 2004) (Glassman and Atkins, dissenting) (to be codified at 17 C.F.R. pt. 270).

146. *Id.* at 46,391 (quoting the 2001 Adopting Release) (Glassman and Atkins, dissenting).

147. *Id.* at 46,390 (Glassman and Atkins, dissenting).

148. *See id.*

149. *Id.* at 46,391 (Glassman and Atkins, dissenting).

150. Letter from Stuart H. Coleman, Chair Comm. on Inv. Mgmt. Regulation, Ass'n of the Bar of the City of New York, to Jonathan G. Katz, Sec'y, Sec. and Exch. Comm'n * 3 (Mar. 9, 2004), 2004 WL 3388074; Investment Company Governance, 69 Fed. Reg. at 46,391 n.26 (explaining that what works well for one mutual fund board may not be the best choice for another, and in some cases the board of directors may want to choose an independent chair).

151. Glassman Statement, *supra* note 105, at *2.

152. Letter from Eric D. Roiter, Senior Vice President and Gen. Counsel, Fidelity Mgmt. and Research Co., to Jonathan G. Katz, Secretary, U.S. Sec. and Exch. Comm'n (Mar. 10, 2004), http://www.sec.gov/rules/proposed/s70304/fidelity031804.htm [hereinafter Roiter Letter]; *see* HAROLD S. BLOOMENTHAL, *Investment Companies and Investment Advisers* (pt. 1), *in* 1 SEC. LAW HANDBOOK § 20:1.10 (2006).

153. Roiter Letter, *supra* note 152. The SEC's Director of the Division of Investment Management, Paul Roye, testified before the House Financial Services Subcommittee on Capital Markets that he did not back the independent chair requirement because it deprived the directors of the ability to make a business judgment that was in the best interest of the shareholders. *Id.*

directors, the board may "not feel sufficiently empowered" to override the powerful objections of the management company by electing an independent chair.[154]

Regardless of whether a majority or super-majority of independent directors is required, by not allowing the board to elect or nominate a chairman of their choice, the new regulations vest less power in the independent directors than they formerly had, and prevents them from making decisions that they believe are in the best interest of the shareholders.[155] The Majority Commissioners, however, explained that the independent directors are not usurped of their power because they can still choose "the most qualified and capable candidate"; however, this candidate "cannot serve two masters."[156]

2. Affiliated Directors Bring Expertise to the Board of Directors.—A super-majority of independent directors is not only unnecessary, but it can harm a mutual fund.[157] A board of directors should be able to work cooperatively and as a team; therefore, a mix of both independent and affiliated directors is required.[158] An affiliated chair or director brings the expertise of the management company to the board meetings that an independent chair or director does not have, or could only have with detailed study of the management company.[159] On the other hand, independent directors may have valuable outside experience and knowledge from their work in business, government, or academia.[160]

In studies evaluating the role of sub-committees within a corporation's board of directors,[161] independent directors have been shown to be essential to the audit and executive compensation committees in order to monitor conflicts of interests.[162] Inside and affiliated directors, however, increase firm performance

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154. REPORT IN ACCORDANCE WITH THE CONSOLIDATED APPROPRIATIONS ACT, *supra* note 4, at *144. This is even more true when the mutual fund's investment adviser sponsored or initially organized the mutual fund. *Id.*

155. *See* Initial Opening Brief of Petitioner, *supra* note 54, at 9, 23.

156. *Id.* (quoting Investment Company Governance, 69 Fed. Reg. 46,378, 46,381 (Sec. and Exch. Comm'n Aug. 2, 2004) (to be codified at 17 C.F.R. pt. 270) (final rule)).

157. *See* Donald C. Langevoort, *The Human Nature of Corporate Boards: Law, Norms, and the Unintended Consequences of Independence and Accountability*, 89 GEO. L.J. 797, 798 (2001).

158. *Id.* at 799. Langevoort, however, does recognize the inherent conflicts of interest in mutual funds and the need for independent directors to provide a check on "managerial overreaching." *Id.* at 814.

159. Investment Company Governance, 69 Fed. Reg. 3472, 3475 n.31 (Sec. and Exch. Comm'n proposed Jan. 23, 2004) (to be codified at 17 C.F.R. pt. 270); *see also* Initial Opening Brief of Petitioner, *supra* note 54, at 9.

160. Investment Company Governance, 69 Fed. Reg. at 46,392 n.35 (Glassman and Atkins, dissenting) (final rule).

161. *See* April Klein, *Firm Performance and Board Committee Structure*, 41 J.L. & ECON. 275, 279 (1998).

162. *Id.* at 279. In order to monitor conflict of interests, the auditing committees of investment companies must nominate an independent auditor, and the independent directors must ratify the

when placed on the finance and long-term investment committees due to their specialized expertise.[163] This again suggests that a board of directors that is composed of both independent and affiliated directors is in the best interest of the shareholder[164] because it monitors conflicts of interest while simultaneously bringing the expertise of the management company and mutual fund industry.

Some supporters of the New Rules, however, argue that an independent chair has enough expertise to lead the board effectively.[165] In addition, even if expertise is lacking, the independent chair can rely on other inside directors or personnel of the management company for information.[166]

Affiliated directors bring tactical decision-making and long term strategic planning to the board.[167] In addition, they also bring personal motivation to a board since their financial wealth and capital and professional reputation are linked to the success and integrity of the mutual fund.[168] This desire for a successful and profitable fund is motivation for directors, both affiliated and independent, to reduce fund advisory fees while compelling integrity and fair dealing within the management company.[169]

3. The New Rules Disregard Market Forces that Influence Investors.—The independent chair and the seventy-five percent independent board requirements disregard market forces that influence investors. Investors often choose a fund based upon the expertise and accomplishments of the mutual fund's adviser and management, not the board of directors.[170] Moreover, investors are also influenced by prior illegal and abusive activities and choose funds that operate legally and in the best interest of the shareholders.[171] It is not difficult for

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nomination. Standards Related to Listed Company Audit Committees, Securities Act Release No. 8220, Exchange Act Release No. 47,654, 68 Fed. Reg. 18,788 (Apr. 16, 2003) (codified at 17 C.F.R. pts. 228-29, 240, 249, 274 (2004)).

163. Klein, *supra* note 161, at 277-78; *see also* Sanjai Bhagat & Bernard Black, *The Non-Correlation Between Board Independence and Long-Term Firm Performance*, 27 J. CORP. L. 231, 264 (2002).

164. *See* Langevoort, *supra* note 157, at 799.

165. REPORT IN ACCORDANCE WITH THE CONSOLIDATED APPROPRIATIONS ACT, *supra* note 4, at *140-45. For example, the American Century (Mountain View) board elected a knowledgeable independent director, Professor Ronald Gilson, who had previously served for ten years as an independent director and is a professor of business law at Columbia Law School and Stanford Law School. *Id.* at *142.

166. *Id.* at *141.

167. *See* Bhagat & Black, *supra* note 163, at 264; Langevoort, *supra* note 157, at 806.

168. *See* Bhagat & Black, *supra* note 162, at 265; Langevoort, *supra* note 157, at 806.

169. Investment Company Governance, 69 Fed. Reg. 46,378, 46,392 (Sec. and Exch. Comm'n Aug. 2, 2004) (Glassman and Atkins, dissenting) (to be codified at 17 C.F.R. pt. 270) (final rule).

170. Investment Company Governance 69 Fed. Reg. 3472, 3473 (Sec. and Exch. Comm'n proposed Jan. 23, 2004) (to be codified at 17 C.F.R. pt. 270).

171. Atkins Statement, *supra* note 105, at *2. For example, in 2003, shareholders pulled $29 billion out of Putnam Investment Management after the SEC revealed abusive and illegal activity. James Glassman, *Fund Follies*, AMERICAN ENTERPRISE INSTITUTE FOR PUB. POL'Y RES., May 24,

disgruntled shareholders of mutual funds to redeem their shares, thereby leaving the investment advisers and management company with fewer assets to manage.[172] In addition, Commissioner Glassman has stated that "many of the top-rated funds today based on high-performance and low fees have inside chairs," and it is therefore not fair for the SEC to tell shareholders "they can no longer have the form of governance that produced this high level of performance[.]"[173] By dictating the structure of the board of directors, the New Rules ignore the market forces that influence the investors to invest in a specific mutual fund.[174]

4. The New Rules Do Not Focus on the Investment Adviser's Fiduciary Duty.—The New Rules de-emphasize the fiduciary obligations of the investment adviser by putting the responsibility of the adviser's actions on the board of directors.[175] Although the board of directors needs to monitor and thwart conflicts of interest, the investment adviser, as a fiduciary of the shareholders, has the ultimate responsibility to protect the shareholders' investments.[176] Considering that the recent mutual fund scandals have almost all involved a breach of the investment adviser's fiduciary duty, the New Rules do not place the proper emphasis on this important legal safeguard.[177]

The SEC's suit against Invesco Funds Group, the investment adviser of the Invesco complex of mutual funds, demonstrates a breach of fiduciary duty.[178] Invesco Funds Group and its CEO allegedly accepted investments from certain investors and, in exchange, permitted the investors to partake in market timing transactions in order to increase the management fees.[179] This market timing was prohibited by the mutual fund's disclosure statements and was injurious to long-term shareholders.[180] By allegedly permitting the market timing transactions and the conflict of interest caused by the increased management fees, Invesco Funds

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2004, http://www.aei.org/publications/pubID.20609,filter.all/pub_detail.asp. In addition, Putnam, Janus, and Amvescap, all fund families involved in mutual fund scandals, lost a total of $52 billion in assets in 2003, while the rest of the mutual fund industry experienced significant gains. *Id.*

172. *See* Mark J. Roe, *Political Elements in the Creation of a Mutual Fund Industry*, 139 U. PA. L. REV. 1469, 1505-06 (1991) (explaining that it is much easier for a mutual fund shareholder to deal with conflicts of interest than a shareholder in a corporation attempting to deal with conflicts of interest involving corporate managers).

173. Glassman Statement, *supra* note 105, at 2.

174. Investment Company Governance, 69 Fed. Reg. at 46,392 (Glassman and Atkins, dissenting) (final rule).

175. Atkins Statement, *supra* note 105, at *3.

176. *Id.*; *see* Burks v. Lasker, 441 U.S. 471, 481 n.10 (1979).

177. Atkins Statement, *supra* note 105, at *3. The New Rules only mention the adviser's fiduciary duties in a footnote. *Id. See* Hurst, *supra* note 18, at 154 (suggesting that an investment adviser's fiduciary duty should be strengthened in order to increase investor protection).

178. Sec. and Exch. Comm'n v. Invesco Funds Group, Inc., Litigation Release No. 18482, 81 SEC Docket 2397, *1 (Dec. 2, 2003).

179. *Id.*

180. *Id.* at *1-2.

Group breached its fiduciary duty to act in the bests interests of the shareholders.[181] This included the duty to act with the utmost good faith and to give full and fair disclosure of all material facts to the investors.[182] The independent directors of the Invesco complex of mutual funds did not fulfill their role as "independent watchdogs" due to their failure to monitor the mutual fund's management and prevent transactions that were detrimental to the shareholders.[183] Nevertheless, this does not excuse the investment adviser and the management company for breaching their fiduciary duties to shareholders.

C. The SEC Has Not Methodically Reviewed Prior Mutual Fund Regulations nor Is There Sufficient Empirical Evidence on Which to Base the New Regulations

The SEC has made no effort to thoroughly and methodically review existing corporate structure regulations, in the context of both corporations and investment companies, in over twenty years.[184] During the two-year interim, between the 2001 amendments and the New Rules, the SEC continued this trend by not examining the effect of the 2001 amendments to determine if the majority of independent directors had gained the desired control over the board of directors and the investment advisers.[185]

In addition, the SEC has not reviewed the fund performance and compliance record of those funds that already have an independent chair compared with those that have an affiliated chair.[186] In response to the SEC's expressed interest in consulting empirical data regarding independent versus affiliated chairs, Fidelity conducted a study, commonly called the Bobroff Mack Report (the "Report"), which indicates that there is a negative correlation between independently chaired funds and overall fund performance.[187] In addition, there is also no

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181. *Id.* at *2.

182. *Id.*

183. *See* Burks v. Lasker, 441 U.S. 471, 482-84 (1979).

184. Joel Seligman, *A Modest Revolution in Corporate Governance*, 80 NOTRE DAME L. REV. 1159, 1185 (2005).

185. Investment Company Governance, 69 Fed. Reg. 46,378, 46,391 (Sec. and Exch. Comm'n Aug. 2, 2004) (Glassman and Atkins, dissenting) (to be codified at 17 C.F.R. pt. 270) (final rule).

186. *Chamber II*, 443 F.3d 890, 905 (D.C. Cir. 2006); Karmel, *Key Outcomes*, *supra* note 15, at *5. The SEC stated that the data they do have relating to the correlation between fund performance and an independent chair is inconclusive. REPORT IN ACCORDANCE WITH THE CONSOLIDATED APPROPRIATIONS ACT, *supra* note 4, at *5.

187. Geoffrey H. Bobroff & Thomas H. Mack, *Assessing the Significance of Mutual Fund Board Independent Chairs, A Study For Fidelity Investments* (Mar. 10, 2004), http://www.sec.gov/rules/proposed/s70304/fidelity031804.htm [hereinafter Bobroff Mack Report]. "Using Morningstar's fund rankings . . . independent chair funds on average rank in the 53rd percentile (100 = best) over the past three years, while management chair funds on average rank in the 58th percentile." *Id.* This statistical variation is even more pronounced when examining fund performance over the past ten years. *Id.* Other corporate studies, however, show that there is no

correlation between independently chaired funds and lower expenses.[188] The Chamber of Commerce believes that the SEC should have given more consideration and weight to the Report.[189]

Reliable and valid empirical studies of the relationship between fund performance and director independence are difficult to create because there are varying assumptions made about "how performance is measured, which expenses should be included, what time period should be examined, and which funds should be examined."[190] In addition, a lack of available information and the multifaceted nature of the conflict of interest between a mutual fund's investment adviser and shareholders make standard methodologies difficult to use in establishing empirical evidence.[191] The SEC chose not to use the Report in its Adopting Release of the New Rules for several reasons.[192] The SEC stated, among other things, that the Report does not examine the future impact that the independent chair requirement will have on fund performance, only the past performance.[193] Furthermore, using the same statistics another commentator found that independently chaired funds performed slightly better than those with affiliated chairs,[194] with the resulting differences attributed to varying sample selections and empirical methods.[195] The SEC also stresses that the purpose of the New Rules is not to increase fund performance, but rather to increase fund compliance and decrease transactions that result from a conflict of interest.[196]

When the Chamber of Commerce brought the issue of the Report and the need for empirical studies before the D.C. Circuit, the court noted that although "acting upon the basis of empirical data may more readily be able to show it [the SEC] has satisfied its obligations under the APA," the empirical data is not necessary to justify a rule-making action.[197] Nevertheless, a comprehensive and

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correlation between the number of independent directors on a board and firm performance. Benjamin E. Hermalin & Michael S. Weisbach, *Board of Directors As An Endogenously Determined Institution: A Survey of The Economic Literature*, FED. RES. BANK N.Y. ECON. POL'Y REV. 8 (Apr. 2003).

188. Bobroff Mack Report, *supra* note 187. Other studies of investment companies, however, have found that boards with more independent directors are likely to have lower fees. Hermalin & Weisbach, *supra* note 187, at 19.

189. Caroline Bradley, *Private International Law-Making for the Financial Markets*, 29 FORDHAM INT'L L.J. 127, 180 n.34 (2005).

190. REPORT IN ACCORDANCE WITH THE CONSOLIDATED APPROPRIATIONS ACT, *supra* note 4, at *159-60.

191. *Id.* at *165-67.

192. Brief of Respondent at 26, Chamber of Commerce v. SEC and Exch. Comm'n, 412 F.3d 133 (D.C. Cir. 2005) (No. 04-1300).

193. *Id.*

194. *Id.*

195. REPORT IN ACCORDANCE WITH THE CONSOLIDATED APPROPRIATIONS ACT, *supra* note 4, at *182.

196. *Id.* at *5, 157-58.

197. *Chamber I*, 412 F.3d 133, 142 (D.C. Cir. 2005); *see* Ruder, *supra* note 18, at 48-49.

statistically sound empirical study of the correlation between independent chairs and fund performance would most likely help the SEC in justifying the New Rules.[198] This is because half of mutual fund investors indicate fund performance as the number one factor in influencing their impression of the mutual fund industry, while two thirds of investors claim that fund performance is very important in shaping their impression of the mutual fund industry.[199] Moreover, sixty-five percent of investors stated that fund performance is the most important reason that they own mutual funds.[200]

In addition to the SEC's lack of strong empirical evidence linking board and chair independence to better fund performance, the SEC also lacks empirical evidence linking board and chair independence to favorable compliance records.[201] The SEC stated, however, that this empirical evidence was impossible to analyze "because there is no clear method for measuring the quality of compliance by funds and their advisers," especially since "enforcement actions are only one indication of compliance."[202] Despite this, the SEC has brought recorded enforcement actions against mutual funds with the corporate structure proposed by the New Rules. Among the funds that have independent chairs, several of them have been involved in enforcement actions involving market-timing abuses.[203] This includes Bank of America, Banc One, and Putnam Investment Management.[204] Moreover, in a recent action that the SEC brought against Banc One, Banc One's board of directors was seventy-five percent independent at all times while the abusive conduct was taking place.[205] In this action, Banc One was alleged of having committed numerous illegal and abusive activities that resulted in prohibited conflicts of interests.[206] This includes, among other things, market timing transactions with hedge fund advisers, failure to charge the hedge fund advisers redemption fees, and improper disclosure of confidential information.[207] Due to these abusive activities of Banc One, hedge

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198. *See* Ruder, *supra* note 18, at 51-52.

199. *Fundamentals*, *supra* note 14, at 7.

200. *Id.*

201. Karmel, *Key Outcomes*, *supra* note 15, at *4.

202. REPORT IN ACCORDANCE WITH THE CONSOLIDATED APPROPRIATIONS ACT, *supra* note 4, at *183.

203. Glassman Statement, *supra* note 105. In addition, "the relative proportion of late trading and market timing cases by funds with independent chairs was roughly equivalent to their relative proportion of all mutual funds." Letter from Cynthia A. Glassman and Paul S. Atkins, Comm'rs, Sec. and Exch. Comm'n, re: Staff Report on the Exemptive Rule Amendments of 2004: The Indep. Chair Condition, to Thad Cochran, Chairman, Comm. on Appropriations, United States Senate (Apr. 29, 2005), 2005 SEC Lexis 1032, at *2-3.

204. Atkins Statement, *supra* note 104, at *3.

205. *In re* Banc One Investment Advisors Corporation and Mark A. Beeson, Investment Advisers Act of 1940 Release No. 2254, Investment Company Act of 1940 Release No. 26,490, 83 S.E.C. Docket 695, 84 S.E.C. Docket 2404, at 17 n.3 (June 29, 2004).

206. *Id.* at 1-3.

207. *Id.*

fund advisers received millions of dollars.[208] Independent directors have also been involved in enforcement actions for failing to meet their legal duties.[209]

D. The Disclosure Alternative

The SEC, in their original adoption of the New Rules, failed to consider the disclosure alternative that the two dissenting commissioners raised, thereby violating the APA.[210] The disclosure alternative would require mandatory disclosure of whether the chair of the board of directors is independent or affiliated with the management company, therefore allowing investors to choose a fund based upon their perceived importance of an independent chair.[211] Although the SEC is not required to analyze every alternative when proposing a new rule, they are required to analyze those alternatives that are not uncommon or frivolous.[212] The SEC originally claimed that they did not need to analyze the disclosure alternative because Congress rejected a "purely disclosure-based approach" to the ICA; however, in *Chamber I*, the D.C. Circuit rejected this argument since Congress does require extensive disclosure for many matters relating to investment companies.[213]

On remand, the SEC reconsidered and rejected the disclosure alternative.[214] They believe that the disclosure of whether the chair was independent would not adequately protect investors from the inherent conflicts of interest that arise from the relationship between the shareholders and the investment adviser.[215] This is because disclosure itself cannot prevent investment advisers and the management company from putting their own interests ahead of the shareholders by engaging in self-dealing, abusive, or illegal transactions.[216] Moreover, disclosure of a management-affiliated chair would not obtain the benefits that the New Rules are attempting to seek, such as encouraging open dialogue and increased oversight

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208. *Id.* at 1-5.

209. REPORT IN ACCORDANCE WITH THE CONSOLIDATED APPROPRIATIONS ACT, *supra* note 4, at *32 n.44. The SEC implicated independent directors of abusive and illegal activities while serving on the boards of Parnassus Investments, Rockies Fund, Inc., and Monetta Financial Services, Inc. *Id.*

210. *Chamber I*, 412 F.3d 133, 145 (D.C. Cir. 2005); *see* Karmel, *Key Outcomes*, *supra* note 15, at *3.

211. Investment Company Governance, 69 Fed. Reg. 46,378, 46,393 (Sec. and Exch. Comm'n Aug. 2, 2004) (Glassman and Atkins, dissenting) (to be codified at 17 C.F.R. pt. 270) (final rule).

212. *Chamber I*, 412 F.3d at 144-45.

213. *Id.* at 144 (explaining that the ICA requires mutual funds to make extensive disclosures, including filing a registration statement with the SEC, sending semiannual reports to investors, and making all filed documents publicly available); *see* 15 U.S.C. §§ 80a-8(b) (2000).

214. Investment Company Governance, 70 Fed. Reg. 39,390, 39,396-97 (Sec. and Exch. Comm'n July 7, 2005) (to be codified at 17 C.F.R. pt. 270) (response to remand).

215. *Id.*

216. *Id.* at 39,397.

by the board of directors.[217]

The SEC also rejected the disclosure alternative due to investors' lack of knowledge about the complex conflicts of interest that are inherent in mutual funds.[218] In order to make the disclosure of an independent or management affiliated chair meaningful, the investor would first have to understand the significance and impact that the chair can have on board and management oversight.[219] Without this understanding, the investor cannot make the proper decisions with the disclosed information. Moreover, disclosure to shareholders by investment advisers about conflicts of interests can increase the shareholders trust in the management and investment adviser, as opposed to making the shareholder more skeptical and cautious.[220] This trust could cause the shareholders to place greater weight on the biased advice.[221] In addition, excessive disclosure could also have a chilling effect on the entry of new mutual funds to the industry.[222]

Commissioners Glassman and Atkins believe that the SEC's reconsideration of the disclosure alternative was inadequate.[223] Their statements highlight one of the many alleged procedural errors demonstrated by the SEC. The SEC originally did not seek specific comment on the disclosure alternative; thus, there was sparse public comment to determine if others, including investors and the mutual funds themselves, believed disclosure to be a viable alternative.[224] Moreover, in *Chamber I*, the D. C. Circuit told the SEC to use its "expertise" and "best judgment" to examine the disclosure alternative; however, the SEC asked neither Commissioners Glassman nor Atkins to comment on or analyze the alternative.[225] The failure of the Majority Commissioners to ask Commissioners Glassman and Atkins about the merits of the disclosure alternative is ironic since they originally proposed the alternative.

The disclosure alternative is parallel to the SEC's goal of providing

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217. *Id.*

218. *Id.*; *see* Bullard, *supra* note 3, at 1148 (asking if "the problem of fund disclosure lay with the complexity of funds themselves"); *see* Barbara Black & Jill Gross, *The Elusive Balance Between Investor Protection and Wealth Creation*, 26 PACE L. REV. 27, 37 (2005) (explaining that many investors are ignorant about basic investment decisions, and thus educating investors is one of the best ways to foster investor protection); *see* Daylian M. Cain et al., *The Dirt on Coming Clean: Perverse Effects of Disclosing Conflicts of Interest*, 34 J. LEGAL STUD. 20-21 (2005).

219. *See* Investment Company Governance, 70 Fed. Reg. at 39,397 (response to remand).

220. *See* Cain et al., *supra* note 218, at 6-7.

221. *See id.* In addition, the requirement of added disclosure can cause investment advisers to embellish "their advice in order to counteract the diminished weight that they expect [shareholders] to place on it." *See id.* at 7. Therefore, the disclosed information is less reliable. *Id.*

222. Bullard, *supra* note 3, at 1148.

223. *See generally* Investment Company Governance, 70 Fed. Reg. at 39,390 (Glassman and Atkins, dissenting) (response to remand).

224. *Id.* at 39,404 (Glassman, dissenting).

225. *Id.* at 39,407-08 (Atkins, dissenting).

transparent markets in order to increase investor protection in the securities arena.[226] Even if the SEC ultimately deems the disclosure alternative to be insufficient due to lack of investor knowledge or the psychological effects that disclosure can have on investors and advisers, the SEC should only make this judgment after serious analysis and consideration. This is because one of the purposes of all the securities statutes, including the Investment Advisers Act, the Securities Act of 1933, the Securities Exchange Act of 1934, and the ICA, is full disclosure in order to obtain ethical business practices within the securities industry.[227]

CONCLUSION

The SEC's New Rules attempt to prevent future mutual fund scandals and increase investor protection and confidence by enhancing the integrity and honesty of the mutual fund industry. Within the past few years, numerous scandals have revealed directors, management companies, and investment advisers engaging in abusive and illegal transactions that adversely affect the interest of shareholders. Although it is imperative that the SEC takes action to correct these wrongdoings and instill an improved sense of trust in investors due to the continued growth of the industry, the adoption of the New Rules may not be the best course of action for the SEC.

The long-term effects of a majority of independent directors are not yet known, and there is a lack of reliable empirical evidence regarding the relationship of board independence and fund performance and compliance. Therefore, it is difficult to tell the impact that a super-majority of independent directors along with an independent chair will have on the oversight of the management company and the protection of investors. Although, the independent directors may be in a better position to promote an open and honest dialogue within the boardroom, the cost to shareholders may be significant and detrimental. This includes not only monetary costs, but also non-monetary costs, such as the loss of expertise, the de-emphasis of market forces and the investment adviser's fiduciary duty, and the lack of choice independent directors will have when nominating a new chair. Furthermore, other recently adopted SEC rules, such as requiring mutual funds to obtain a chief compliance officer[228] and the registration of hedge funds,[229] may provide some of the necessary safeguards to

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226. Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72,054, 72,059 (Sec. and Exch. Comm'n Dec. 10, 2004) (to be codified at 17 C.F.R. pts. 275 and 279).

227. Sec. and Exch. Comm'n v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 186 (1963).

228. *See* Compliance Programs of Investment Companies and Investment Advisers, 68 Fed. Reg. 74,714, 74,721 (Sec. and Exch. Comm'n Dec. 24, 2004) (to be codified at 17 C.F.R. pts. 270, 275, 279).

229. *See* Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. at 72,054.

prevent future illegal and abusive behavior.

The Chamber of Commerce's lawsuits against the SEC challenged both procedural and substantive aspects of the New Rules. Although the future of the New Rules is uncertain due to the D.C. Circuit's second remand, the court made it clear that the SEC has the power to re-adopt the New Rules a third time if the SEC takes the proper procedural steps, including further public comment.[230] Therefore, regardless of whether the SEC re-adopts or vacates the New Rules, it should comprehensively study the arguments for and against board independence since it is an issue that will continue to loom overhead.[231]

Although the Chamber of Commerce's lawsuit against the SEC may not result in the ultimate abandonment of the New Rules, it has given the SEC and other regulatory agencies greater knowledge of the proper procedural processes to be followed when engaging in rule-making. In addition, the SEC is now aware of the public, political, and legal backlash caused by a rushed re-adoption of regulations not based on empirical studies or public comment. Unless the SEC abandons the New Rules, both critics and supporters will be watching and waiting to see if the SEC strikes out for a third time with the D.C. Circuit.

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230. *See Chamber II*, 443 F.3d 890, 909 (D.C. Cir. 2006).

231. *Id.* at 904.