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Landmark Ruling: Could the Court's Decision in *Chamber v. SEC* Be a Turning Point in Securities Regulation?

By Peter J. Wallison

In early April, the United States Court of Appeals for the District of Columbia vacated and sent back to the Securities and Exchange Commission (SEC) a controversial rule requiring mutual funds to have a board of directors in which both the chairman and 75 percent of the directors are independent of the fund's investment adviser. The decision was not only a rare defeat for the SEC, but it also confirmed that the commission is required by law to consider "efficiency, competition and capital formation"—in addition to the protection of investors—in connection with its rule-making. This decision, and an earlier one challenging the same rule, could mark a turning point in the commission's administration of the securities laws.

Mutual funds are corporations in which the investors are shareholders. In most cases, the funds retain an investment adviser to manage the fund's portfolio, and the fund's board of directors—with fiduciary responsibilities to the shareholders—generally oversees the adviser's activities on behalf of the investor-shareholders. In September 2004, the SEC adopted a rule that required all mutual funds—if they wished to make use of some valuable exemptions from the Investment Company Act (ICA)—to have a board of directors in which the chairman and 75 percent of the members are independent of the investment adviser. The rule was challenged by the United States Chamber of Commerce and was considered on two different occasions by the United States Court of Appeals for the D.C. Circuit. In the court's first decision, on June 21, 2005, the rule was sent back to the commission for further consideration; in the second decision, on April 7, 2006, the court vacated the rule entirely, but gave the commission ninety days to correct the rule's deficiencies and issue a new rule.

It is rare that the SEC is challenged in court, and rarer still that its regulations are overturned, but this case—because of the legal grounds on which the court rested its decisions—could mark a turning point in the SEC's regulation of the securities markets.

The SEC had adopted the rule over the dissenting votes of two commissioners, Paul Atkins and Cynthia Glassman, who argued that the new independence requirement imposed unnecessary costs on mutual funds, did not effectively address the problems it was intended to solve (the late trading and market timing scandals of the previous year), and was adopted without considering less expensive alternatives. In adopting the rule, the commission admitted that it was unable to determine the costs that the independence requirement would impose on individual funds, noting that it "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."¹ This statement would prove critical when the SEC's rule was subjected to court review.

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The First Court Decision

In the court's first exposure to the rule, it sent the rule back to the SEC for further action, citing the following provision of the ICA as the basis for its action:

Whenever pursuant to this title the Commission is engaged in rulemaking and is required to consider and determine whether an action is necessary or appropriate in the public interest, the Commission shall also consider, *in addition to the protection of investors*, whether the action will promote efficiency, competition and capital formation."² (emphasis added)

This must have been a surprise to the commission and its lawyers; this provision of the ICA had never before been cited by any court, and since its adoption in the National Securities Market Improvement Act of 1996 (NSMIA) had been largely ignored by the commission. Now, for the first time, a court was holding the commission to compliance with this statutory requirement.

As the court apparently recognized, however, Congress had been serious about this SEC obligation. In NSMIA, it had inserted virtually the same requirement as in the two other major statutes that the SEC administers: the Securities Act of 1933 and the Securities Exchange Act of 1934. The fact that Congress saw fit to add this language to each of the major securities laws illustrates the importance it attached to the idea that the SEC should consider—in addition to the protection of investors—factors that have to do with cost, industry structure, and the ease with which companies could obtain capital through the securities markets.

Despite these facts, the SEC has generally relegated the NSMIA language to the last few paragraphs of the explanatory release that accompanies a new rule. In the case of the independent chair rule, the commission's discussion of efficiency, competition, and capital formation consisted of a single paragraph at the very end of the release, after the commission's discussion of the Paperwork Reduction Act, its required cost-benefit analysis, and its discussion of the Regulatory Flexibility Act. In that paragraph, the commission stated:

We do not expect these amendments to have a significant effect on efficiency, competition and capital formation with regard to funds because the costs associated with the amendments are minimal

and many funds have already adopted the required practices. To the extent that these amendments do affect competition or capital formation, we believe that the effect will be positive because the amendments are likely to reduce the risk of securities law violations such as late trading in mutual funds and market timing violations, and thus increase investor confidence in mutual funds.³

The chamber's challenge to the commission's rule was brought on as a violation of the Administrative Procedure Act (APA), which specifies how administrative and regulatory agencies are to consider and adopt rules and regulations. The APA provides two grounds for overturning a rule—that it is "arbitrary, capricious, an abuse of discretion" or "otherwise not in accordance with law." The court rejected the chamber's argument on the first ground ("the Commission's effort to prevent future abuses of exemptive transactions was not arbitrary, capricious or in any way an abuse of its discretion"⁴), but rested its decision on the second ground—that the SEC's action was not "in accordance with law."

Thus, the court began its analysis with this statement: "The ICA mandates that when the Commission engage[s] in rulemaking and is required to determine whether an action is consistent with the public interest [it] shall . . . consider . . . whether the action will promote efficiency, competition and capital formation"⁵ (ellipsis in the original). The court noted the commission's admission that it had no reliable basis for estimating the costs to individual funds, and continued: "[A]n estimate [of costs] would be pertinent to its assessment of the effect the condition would have upon efficiency and competition, if not upon capital formation . . . uncertainty may limit what the Commission can do, but it does not excuse the Commission from its *statutory obligation* to do what it can to apprise itself—and hence the public and Congress—of the *economic consequences* of a proposed regulation before it decides whether to adopt the measure"⁶ (emphasis added).

The court's reference to "economic consequences" makes clear that it recognized the connection between the SEC's statutory obligation to consider "efficiency" and "competition" and the rule's potential effect on competition in the mutual fund industry. A failure to consider the costs of a rule could have major effects on industry structure, since large fund groups—which might have the same board overseeing fifty funds—would have

lower costs per fund for complying with the rule, giving the large funds a competitive advantage. The court then concluded: “In sum, the Commission violated its obligation under U.S.C. 80a-2(c) [the requirement that the SEC consider the promotion of efficiency, competition, and capital formation], and therefore the APA, in failing adequately to consider the costs imposed upon funds by the two challenged conditions.”⁷

Thus, the court is saying that the SEC violated the APA because it *failed to perform its statutory duty* to consider efficiency, competition, and capital formation in connection with this rule-making. It would not be an exaggeration to say that this holding, if implemented by the SEC in its future actions, may portend a major change in the commission’s administration of the securities laws. Prior to this decision, the SEC could credibly argue that its one responsibility was the protection of investors, and the legitimacy of all its rules rested ultimately on the commission’s expert judgment that the rule in question was necessary to meet that objective. In this case, however, the commission has been told by the preeminent court for delineating the scope of administrative agency authority that statutory language also imposes a responsibility for determining whether the rule is an efficient way to accomplish the commission’s purpose, whether it will adversely affect the competitive structure of the industry involved, and whether it will impair the ability of companies to obtain capital through the securities markets.

This is an important point to keep in mind because, when the rule came before the same court for a second time, the court’s analysis focused primarily on whether it had made a sufficient record on the question of costs in order to satisfy the APA. Because of this highly detailed discussion—which will not be covered in this essay—there will be a tendency for lawyers and others to believe that the SEC’s violation of the APA consisted of its failure to have a sufficient record of costs. But as we have seen, that is not the court’s actual holding. The court made clear in its first ruling that the violation of the APA was caused by the SEC’s failure to consider the effect of the rule’s costs on efficiency and competition—two of the three elements in the NSMIA language. The commission would have had no statutory obligation to consider the costs of the rule without the NSMIA requirement.

Having found the SEC in violation of the law, the court sent the matter back to the SEC “to address the deficiencies with the 75 percent independent

director and independent chairman condition identified herein.”

The Commission Acts in Haste

A bizarre set of events then ensued, which seems to have affected the remainder of the litigation. The court’s decision in the first case was made public on June 21, 2005, a little more than a week before the commission’s chair, William Donaldson, was to leave office. Since the rule was initially issued over the dissents of two commissioners, Donaldson’s vote was necessary to reissue the rule, and there was no time for the commission to seek public comment on the cost question before Donaldson’s departure. Under pressure from its outgoing chairman, the commission then embarked on an effort to address the court’s concerns and reissue the rule in a single week.

In attempting this somewhat reckless course, the commission majority and its staff apparently failed to recognize the seriousness of their problem. The court’s point was that the commission was required to consider the effect of the rule on efficiency and competition in the mutual fund industry, but to do so it should have assembled and analyzed the necessary data. When the commission stated in adopting the rule that it did not have any reliable way to decide what the rule’s cost effects might be on individual funds, it was admitting that it had not complied with the statutory requirement. This was a demonstration of the fact that the SEC—although it paid lip service to the language in NSMIA—had not felt bound to take the NSMIA language seriously or to consider any objective other than the protection of investors when it adopted its rules. It is thus likely that the court, in remanding the case, wanted a demonstration from the commission that it understood the nature of its statutory obligations.

The Second Court Decision

Accordingly, once it decided to respond to the court’s criticism in a single week, the commission’s rule was doomed. Its rush to judgment would appear on cool review as evidence that the commission was not taking seriously the question of whether efficiency and competition in the mutual fund industry would be impaired by its action. As a result, when the chamber again challenged the commission’s decision, the court noted in its second decision that the commission had forfeited the presumption of regularity in its procedures. This, in effect, raised the standard the

SEC was required to meet. Not only was the commission required to show that it had the information necessary to decide the efficiency and competition question, but now it also had to show that the process was fair—that there was a reasonable chance it would have decided the matter differently had that been what the data had shown. This was not a test the commission could meet when it had acted so hastily.

In the end, the court never reached the question of whether the commission had considered the impact of its rule on efficiency and competition. The court was clearly not persuaded that the commission had satisfied the *first* requirement—that it had the data necessary to make the decision. Although the commission cited some information outside the administrative record to support its initial decision, the court was skeptical that the commission’s data was sufficient for making the decision. There are also passages in the decision that suggest the court doubted the commission’s objectivity, even if it had had the necessary data.

Ultimately, the court determined to vacate the independent chairman rule and send it back to the commission, but withheld the issuance of its mandate for ninety days in order to give the commission time to seek the necessary data.⁸ The fact that the commission then had new leadership—which might be more objective in deciding the question of the impact of the rule—was probably an unspoken factor in the court’s decision.

What the Decision Means for the SEC

Because of the court’s detailed treatment of the data necessary for an administrative decision, the case will probably be pored over by specialists in administrative law. Agencies cannot be expected to have empirical data for all their decisions, and the courts have always granted a degree of latitude to administrative agencies in making discretionary decisions in rule-making under the APA. The case may initially be read as restricting that latitude, but because of its peculiar facts—particularly the unbecoming conduct of the SEC in trying hastily to reassert the same rule that the court had remanded for insufficient consideration—it is unlikely that the decision marks the beginning of a significant trend.

However, the case is very important and may ultimately be seen as having landmark status because of its new delineation of the SEC’s statutory obligations. The court’s requirement that the commission consider

the promotion of “efficiency, competition and capital formation” when it makes its rules is likely to have an enduring effect. This was the first time that any federal court had cited these words as binding the SEC to a particular regulatory objective other than the protection of investors, and the agency must now take this directive seriously. The Court of Appeals for the D.C. Circuit, after all, is the most important court in the United States—short of the Supreme Court itself—for deciding the scope of the authority and obligations of federal government agencies. Moreover, the first and second cases in *Chamber v. SEC* were heard and decided by two separate three-judge panels, so six judges on this court have now said that the commission will violate the APA if it does not consider efficiency, competition, and capital formation—in addition to the protection of investors—in connection with its rule-making.

With the commission now under new leadership, it has an opportunity to abandon the narrow vision of its role that had caused it to ignore a clear mandate from Congress for almost ten years. In NSMIA, Congress directed the commission to consider other, broader factors—including cost, industry structure, and the need to encourage capital formation—in addition to the protection of investors. Now that the courts and civil litigants have discovered the NSMIA language, it is unlikely that the commission will ever be able to return to a time when it could gain the acceptance of its rules simply by asserting that they are necessary to protect investors.

AEI staff assistant Daniel Geary and AEI editorial assistant Nicole Passan worked with Mr. Wallison to edit and produce this *Financial Services Outlook*.

Notes

1. Release no. IC-26520, “Investment Company Governance,” *Federal Register* 69, no. 46 (September 7, 2004): 378, 387.
2. 15 USC 80a-2(c).
3. Release no. IC-26520, “Investment Company Governance,” 388.
4. *Chamber of Commerce v. Securities and Exchange Commission*, 412 F.3d 133, 141 (D.C. Cir. 2005).
5. *Ibid.*, 142.
6. *Ibid.*, 144.
7. *Ibid.*
8. *Chamber v. SEC*, April 2, 2006, slip opinion, 19.