American Enterprise Institute for Public Policy Research

October 2005

Financial Services Outlook

Buried Treasure: A Court Rediscovers a Congressional Mandate the SEC Has Ignored

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As new leadership moves into place at the Securities and Exchange Commission, a federal appeals court has given life to language in a 1996 congressional enactment that the SEC has largely ignored. That language, in the National Securities Market Improvement Act of 1996, requires the SEC—in addition to protecting investors—to promote "efficiency, competition and capital formation." If the SEC now takes this congressional directive seriously, it will have to weigh the effect of its rules on the securities market and the firms that operate within it.

On June 21, 2005, the United States Court of Appeals for the District of Columbia, at the request of the U.S. Chamber of Commerce, remanded a highly controversial rule to the Securities and Exchange Commission (SEC) for further consideration. The rule in question, issued under the Investment Company Act of 1940 (the 1940 Act), would have required mutual funds—in order to make use of certain exemptions in the act—to have board chairmen who are independent of the fund's investment adviser and boards of directors at least 75 percent of whom are also similarly independent.[1]

The remand and the ensuing events were remarkable for several reasons. The SEC's rules are seldom challenged in court, and even less often turned back for further consideration; the rule was adopted over the dissents of two commissioners, who argued among other things that the commission was imposing unnecessary costs on the mutual fund industry;[2] and the decision came down a little more than a week before the end of William H. Donaldson's term as SEC chairman. Since the vote to adopt the rule was 3-2, the departure of Donaldson might have resulted in the rule's abandonment, but Donaldson ordered the reconsideration of the rule during his remaining week. On Donaldson's last day in office, over the objections of many former commissioners who considered the action unseemly and disrespectful of the court,[3] the SEC pushed through a re-adoption of the same rule, again on a 3-2 vote. The Chamber of Commerce then sought a stay, which was granted by the court even before the chamber had submitted its reply brief, suggesting that the court was exasperated with the SEC's behavior.

All of this made for fascinating news copy, but neither the commentators nor the SEC itself seemed to understand the real significance of the case. In sending the case back to the SEC, the court focused its attention on 15 U.S.C. 80a-2(c), language added to the 1940 Act by the National Securities Market Improvement Act of 1996 (NSMIA). NSMIA also added identical language to the Securities Act of 1933, which governs the issuance and sale of securities, and to the Securities Exchange Act of 1934, which is the SEC's principal statutory authority for regulating the securities markets and the trading in securities. That language is as follows:

> 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,

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> *in addition to the protection of investors, whether the action will promote efficiency, competition and capital formation*.[4] (emphasis added)

With this instruction, Congress was clearly directing the SEC to broaden its focus beyond simply the protection of investors; in other words, the commission's decisions should also be influenced by a consideration of economic factors that affect the condition and operation of the securities market itself, specifically the broad concepts "efficiency, competition and capital formation." The fact that Congress added the same language to the three principal statutes for which the SEC is responsible is a strong indication that it did not expect a limited or narrow reading of its intent.

Nevertheless, the commission has never acknowledged the significance of this language, preferring to describe its regulatory role solely as protecting investors. In its rulemaking, it has relegated the NSMIA language to the last few pages of the explanatory release, just after the discussion of the Paperwork Reduction Act, the commission's required cost-benefit analysis, and its required regulatory flexibility analysis. This is indeed where the discussion of "efficiency, competition and capital formation" appears in the rule challenged by the Chamber of Commerce—a few paragraphs as the last item in the release.[5] In other words, the commission has treated this clear direction from Congress much as it treats the requirement for cost-benefit analysis—as a pro forma base to be touched on the way to adopting a rule or regulation, but not as an independent basis for making or not making a rule, equal in importance to the protection of investors.

The Chamber of Commerce case[6] should now change all that. In the course of remanding the independent chairman rule to the SEC, the court—in its first review of the NSMIA language—concluded that it placed an independent duty on the SEC to consider economic factors, in addition to the protection of investors, in adopting its rules.

Because the court discussed the costs of the rule to mutual funds, and the failure of the SEC to take these costs into consideration, some commentators have considered the court's ruling to be founded on some kind of cost-benefit analysis. However, this is certainly wrong. The court made clear that its decision was based on the specific language of NSMIA, codified as section 80a-2(c) of the 1940 Act:

> Although the Commission may not have been able to estimate the aggregate cost to the mutual fund industry of additional staff to the mutual fund industry . . . it readily could have estimated the cost to an individual fund, which estimate would be pertinent to its assessment of *the effect the condition would have upon efficiency and competition, if not upon capital formation*. . . . [U]ncertainty 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 the Congress—of *the economic consequences* of a proposed regulation before it decides to adopt the measure.[7] (emphasis added)

"In sum," the court then concluded, "the Commission violated its obligation under 15 U.S.C. 80q-2(c), and therefore the APA [the Administrative Procedure Act], in failing to consider the costs imposed upon the funds by the two challenged conditions." This is not simply cost-benefit analysis; it is a clear requirement that the Commission consider other economic factors concerning the competitiveness and efficiency of mutual fund operations before making a rule that might impair these elements of a competitive capital market.

The SEC did not get the message. It seemed to see the court's analysis in purely cost-benefit terms. In its hurried re-adoption of the same rule, there was no reference, for example, to the effect of the costs of the rule on competition among mutual funds, or on their competition as an industry with other forms of investment. Thus, in its brief in opposition to the chamber's request for a stay, the SEC described its analysis in this way:

> Building on more than a year's work by the Commission and its staff, including an extensive rulemaking record after full notice and comment, the Commission set forth a detailed analysis of the likely costs and a careful consideration of the disclosure alternative [proposed by the dissenting commissioners]. Consistent with its conclusions at the time it adopted the amendments, the Commission found that the costs of the two conditions were minimal, that the benefits far outweigh these costs, and that the proposed disclosure alternative would not afford adequate protection to investors.[8]

It is little wonder, then, that the court gave back-of-the-hand treatment to the SEC's opposition to the stay request. The SEC's failure to take the court's reasoning on board speaks eloquently of the mindset that has caused the agency to ignore the NSMIA language for almost ten years.

A Landmark Case

The Chamber of Commerce case is thus a landmark decision in securities law; it establishes for the first time that the NSMIA language has real meaning and is not—as the commission has treated it since its enactment—simply another pro forma requirement it must discuss on the way to a rule-making. By requiring the commission to go back to the drawing board and consider less expensive alternatives to a rule that the commission regarded as necessary for the protection of investors, the court made clear that investor protection is not the only duty of the commission; it must also give serious consideration to other objectives specified by Congress—its "statutory obligation" in the court's words—to promote efficiency, competition, and capital formation.

Now that the commission has new leadership, there is an opportunity for a new and more broad-based administration of the securities laws—one that accepts the commission's responsibility for healthy and competitive capital markets as well as investor protection.

Although this might require balancing of the two goals in some cases, they are certainly not always in conflict. For example, over many years—asserting that it was acting to protect investors—the SEC has placed obstacles in the way of creating an international securities market. It has refused to authorize foreign securities markets, particularly those in Europe, to accept orders from U.S. investors unless these markets were registered as exchanges in the United States, thus leaving the implication that these markets would be violating U.S. law if they allowed U.S. investors to trade on their facilities. Yet, the best way for investors to protect themselves against market volatility is through diversification, and one of the best means of diversification would be adding foreign securities to a portfolio.

Is it in fact really "investor protection" to deny U.S. investors this opportunity? The answer to this question is clearly no, demonstrating that the commission's concern for efficiency, competition, and capital formation—in addition to advancing the growth and quality of the U.S. securities market—would also fulfill the SEC's obligation to protect investors.

What Will Change?

The NSMIA language does not require the commission to change anything specific, but simply to recognize that, in addition to protecting investors, it must pay attention to economic factors. If the commission takes this direction seriously, it will broaden its focus to consider the health of the capital markets and whether any proposed action will foster the objectives Congress obviously had in mind.

Two good examples of how this broader focus might change SEC decisions are provided by the independent chairman rule itself and by Regulation NMS, which was adopted in December 2004. The court decision that remanded the independent chairman rule to the SEC for further consideration, based on the NSMIA language, will probably require some further action by the commission before it reappears in court to oppose the stay. In its hasty re-adoption of the original rule, the commission obviously misunderstood the court's direction and will have to go back now and consider whether the economic consequences of its rule for the mutual fund industry are consistent with fostering efficiency, competition, and capital formation. The original rule arose out of the late-trading and market-timing scandals in 2003 and was based on the idea of protecting investors against such misconduct in the future. But the wrongdoing that gave rise to those scandals was wrongdoing by the investment advisers of the funds, not the boards of directors, who apparently were unaware of the activity and were never charged by the commission with dereliction. Thus, it was never clear how an independent chair or a larger majority of independent directors on a mutual fund board would have stopped late-trading or market-timing. Indeed, it was likely that the independent chair and fellow directors would have less access to what was happening at the level of the investment adviser than a director who was not independent. If the commission now has to consider whether the limited protection it was providing for investors with the independent chairman rule is worth the adverse competitive and economic consequences for the mutual fund industry, its decision may be different.

Regulation NMS involves a similar calculation. Although there is no precipitating cause such as a court remand or stay to require the reconsideration of Regulation NMS, that rule, too, was based on very limited evidence that it was necessary to protect investors. The most controversial part of the regulation was the so-called trade-through rule, which requires every buyer or seller of shares to take the best price offered in any market.[9] The SEC's argument for the regulation was that unless a trade-through rule was extended to all the electronic markets, investors would not post limit orders. There was very little empirical support for this position.

The SEC's own economic study, when finally published, showed that trade-throughs occurred in less than 2 percent of all trades in markets without such a rule, and it seemed highly unlikely that this small number would discourage investors from placing limit orders. Yet the rule will have major adverse effects on efficiency, competition, and ultimately capital formation, and the commission—under new leadership—may want to reconsider the rule now that a court has pointed out that its responsibilities include such things as the economic consequences of its actions.

Notes

1. Investment Company Governance, Release No. IC-26520; File No. S7-03-04, July 27, 2004; Fed. Reg. 69, no. 147 (August 2, 2004): 46,378.

2. Ibid., 46,392.

3. Letters to the SEC commissioners by Joseph Grundfest, dated June 23, 2005; Harvey Pitt, dated June 23, 2005; and Bevis Longstreth, dated June 24, 2005.

4. Public Law 104-290, October 11, 1996, 110 Stat. 3424 (1996), Sections 106(a), (b), and (c).

5. Fed. Reg. 69, no. 147 (August 2, 2004): 46,388.

6. Slip opinion, June 21, 2005, 17.

7. Ibid., 16–17.

8. SEC brief, "Response of Securities and Exchange Commission in Opposition to Motion for Stay of Commission Order and in Support of Expedited Consideration of Petition for Review," 2005.

9. For a full description and discussion of the trade-through rule, see "Reform of Securities Market Structure: The SEC Rejects Competition," *Financial Services Outlook*, December 2004, available at www.aei.org/publication21577.

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