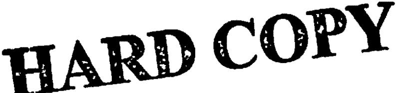

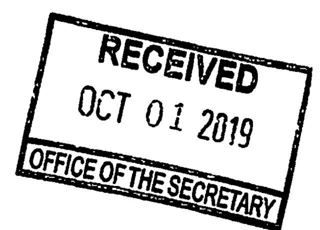

UNITED STATES OF AMERICA
before the
SECURITIES AND EXCHANGE COMMISSION

In The Matter of:

The Application of TREEHOUSE REAL ESTATE INVESTMENT TRUST,

For Review of Action Taken by New York Stock Exchange

Admin. Proc. File. No. 3-19192

REPLY BRIEF IN FURTHER SUPPORT OF APPLICATION FOR REVIEW OF ACTION BY THE NEW YORK STOCK EXCHANGE

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PRELIMINARY STATEMENT

Treehouse Real Estate Investment Trust ("TREIT" or the "Company") respectfully submits this reply brief in further support of its application for review of action by the NYSE denying TREIT the opportunity to apply to have its shares listed on the NYSE.

The NYSE's response to TREIT's initial brief is simply that the NYSE has broad discretion provided by its listing rules and it appropriately exercised that discretion in denying TREIT's listing. While the NYSE's broad discretion is undisputed, that discretion still has limits which were vastly exceeded here. Pursuant to the Exchange Act, the NYSE cannot implement policies that impose an inappropriate burden on competition, which it has done here; it cannot circumvent the formal rule-making process by engaging in clandestine policy changes, which it has done here; it cannot inconsistently and arbitrarily apply a blanket policy to listing decisions, which it has done here; and it cannot deny listing applications without developing a record for the Commission's review, which it has done here.

Further, the NYSE's attempt to demonstrate that its denial was a "necessary and appropriate response" to TREIT's listing request must also be rejected. The NYSE's rationale for continuing to list Innovative Industrial Properties, Inc. ("IIPR") while denying listing to TREIT, is insufficient and unconvincing. Moreover, the NYSE has chosen not to even address the several exchange-traded funds ("ETFs") focused on the cannabis industry that it listed *after* denying TREIT's application which has the effect of actually increasing investment and distribution channels for IIPR and other companies doing business with the cannabis industry that are similarly situated to TREIT. For these reasons, and those set forth below, the Commission should set aside the NYSE's listing decision.

ARGUMENT

A. The NYSE's Decision Exceeds the Statutory Limitations on its Discretion

The NYSE's discretion is not absolute nor limitless. Section 19(f) of the Exchange Act provides a check on the NYSE's undisputedly broad discretion by requiring the Commission to review any NYSE decision to ensure that (1) it does not impose any burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act; (2) the specific grounds for the determination exist in fact; (3) the determination was in accordance with the NYSE's rules; and (4) that the rules are, and were applied in a manner, consistent with the Exchange Act. 15 U.S.C. § 78s(f).

The NYSE's discretion does not permit the NYSE to engage in *ad hoc* and behind the scenes rule-making, nor does it permit the exchange to establish and implement what it claims to be a new policy prohibiting the listing of entities indirectly involved in the cannabis industry that, as has been demonstrated by TREIT in its opening brief ("Opening brief" or "Br."), has been applied in a discriminatory and unfair manner. Through the subsequent listing of ETFs that track the cannabis industry and the continued listing of IIPR, as well as other companies such as Scotts Miracle-Gro, HP, Inc., and Salesforce.com, the NYSE has acted in an arbitrary and capricious manner.[1] Br. at 9-13.

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[1] In other contexts, an inconsistent and vague application of discretion would be subject to review and set aside or remanded for further consideration. An agency decision is arbitrary and capricious "if the agency has relied on factors which Congress has not intended it to consider, entirely failed to consider an important aspect of the problem, offered an explanation for its decision that runs counter to the evidence before the agency, or is so implausible that it could not be ascribed to a difference in view or the product of agency expertise." *Motor Vehicle Mfrs. Ass'n of U.S., v. State Farm Mutual,* 463 U.S. 29, 43, 56, 57 (1983) (remanding to agency because "[a]n agency's view of what is in the public interest may change" but the agency must explain the evidence which is available, and must offer a "rational connection between the facts found and the choice made."); *N.W. Envtl. Def. Ctr. v. Bonneville Power Admin.*, 477 F.3d 668, 690 (9th Cir. 2007) (setting aside the decision because the agency changed its course of view

B. The NYSE Has Applied Its "Policy" in a Discriminatory and Inconsistent Fashion

The NYSE's justification for its policy change does not withstand close scrutiny, and even if it did, the NYSE fails to address the listing of the ETFs that confirm it is acting in a discriminatory and inconsistent manner.

i. Legal and Regulatory Landscape

Confronted with the overwhelming record showing a continuing trend toward a more favorable legal and regulatory landscape for cannabis-related companies, the NYSE points to the memorandum drafted by former Attorney General Jeff Sessions (the "Sessions Memo"), as evidence that the legal environment is "markedly different" from when the NYSE listed IIPR. Resp. at 4. The Sessions Memo revised the August 2013 memorandum drafted by former Deputy Attorney General James Michael Cole, which "deprioritized" federal enforcement related to state-legal cannabis operations (the "Cole Memo"). To be clear, companies facing criminal exposure under federal law before the Cole Memo still faced criminal exposure after the Cole Memo. The Cole Memo was a statement of priorities, not a change in the law.

Even though the Sessions Memo rescinded that guidance, federal prosecutors are still guided by the Justice Manual, which recommends that federal enforcement agents "give careful consideration to the extent to which prosecution would accord with [] national and local priorities, as well as federal law enforcement initiatives or operations designed to accomplish them, whether on a national level or by important impact on local law enforcement needs."[2]

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without "cogently explain[ing] its decision" and "the record does not indicate that that decision was the output of a rational decision-making process.").

[2] *See* U.S. Dep't of Justice, Justice Manual § 9-27.260, *available at* https://www.justice.gov/jm/jm-9-27000-principles-federal-prosecution#9-27.260.

Other federal actions demonstrate that marijuana enforcement continues to be deprioritized on a national and local level, including Congress's annual renewal of the Rohrabacher-Farr Amendment since 2014 which blocks the Department of Justice ("DOJ") from using federal funds to prosecute state-legal medical marijuana programs. TREIT Memo at 13-14. In addition, the Department of the Treasury Financial Crimes Enforcement Network issued its own guidance in January 2014 in response to the Cole Memo that established a SAR reporting regime for the cannabis industry. TREIT Memo at 12. Despite the rescission of the Cole Memo, that guidance is still in effect. *Id.* at 13.

Moreover, the NYSE seeks to freeze time to January 2018, when the Sessions Memo was issued, and does not address the fact that since then the DOJ has not prosecuted *any* state-law compliant cannabis operators. TREIT Memo at 12. Nor does it address that Jeff Sessions resigned in November 2018. Most importantly, the NYSE does not address the public statements made by current Attorney General William Barr during his confirmation regarding his intention to not pursue enforcement against state-legal cannabis businesses. Br. at 5-6 (citing TREIT Memo at 13).

The NYSE claims that it will not accept cannabis-related companies for listing "unless and until there [are] further material developments in the legal and regulatory environment." Resp. at 4-5. The resignation of Jeff Sessions in November 2018, the public statements made by Attorney General Barr, the growing momentum in Congress, and the continued applicability of the FinCEN guidance notwithstanding the withdrawal of the Cole Memo, all of which occurred prior to TREIT's application for listing, are among the material developments that the NYSE has failed to appropriately consider, not to mention the complete absence of any federal prosecutions targeting state-law compliant cannabis operators based solely on their violations of the

Controlled Substances Act ("CSA") before, during, or after Sessions' brief tenure.[3] In any event, the NYSE's recent listing of three cannabis-focused ETF's with holdings that include IIPR, a company with an identical business model to TREIT, is flatly inconsistent with its professed belief that the legal and regulatory climate has deteriorated since the listing of IIPR.

ii. *Ad Hoc*, Inconsistent, and Unfair Application of Policy

The NYSE attempts to justify its decision to maintain IIPR's listing while denying one to TREIT by asserting that it "also considered the fact that a delisting would cause harm to shareholders in IIPR who had acquired their shares on the basis that IIPR was listed on the Exchange." TREIT is not advocating for the delisting of IIPR (or any of the similarly situated companies) but, it is well settled that harm to future prospective investors must be prioritized over harm to current investors. *See, e.g., In the Matter of the Application of Creative Medical Development, Inc.,* Release. No. 37611, Admin. Proc. File No. 3-8871 (August 27, 1996), at 7 ("Though exclusion from the system may hurt existing investors, primary emphasis must be placed on the interests of prospective future investors. The latter group is entitled to assume that the securities in the system meet the system's standards."); *In the Matter of the Application of KLH Engineering Group, Inc.*, Release No. 36422, Admin. Proc. File No. 3-8574 (October 26, 1995), at 4 ("The minimum listing requirements are meant to protect investors and the integrity of the market, and are non-discriminatory. Public investors rely on the standards provided by Nasdaq, and are entitled to assume that listed securities meet its minimum listing requirements."); *In the Matter of the Application of Biorelease Corporation,* Release No. 35575,

[3] Indeed, as discussed in Section D, had the NYSE undergone the appropriate rule-making process, this policy would have been subject to notice and comment, allowing for interested individuals to comment on the implications.

Admin. Proc. File No. 3-8448 (April 6, 1995). The fact that NYSE continues to list IIPR demonstrates that this concern is not so significant after all.[4] And, while the NYSE focuses on IIPR in its Response, NYSE also lists several other companies that "could be found to violate the CSA or other federal criminal laws and give rise to a risk that the company might be subject to criminal prosecution," such as Scotts Miracle-Gro, HP, Inc., and Salesforce.com – all of which continue to be listed. *See* Resp. at 3 and Br. at 10-13.

Significantly, the NYSE has also failed to address its initial listing of three ETFs with holdings in the cannabis industry in May and July 2019. *See* Br. at 1, 11-12. These entities were listed after the NYSE denied TREIT the opportunity to list, after the NYSE's asserted conversations with the SEC concerning its new policy in September 2018, and long after the legal environment purportedly became "markedly different" as a result of the Sessions Memo. Resp. at 4. These cannabis-focused ETFs invest in companies like IIPR and Greenlane that provide services to the cannabis industry and as such, these ETFs pose the same purported public policy risk to investors as TREIT. Resp. at 3. In fact, by listing the three ETFs, the NYSE is expanding distribution channels for IIPR which is flatly contrary to its expressed concern about the public interest and changed circumstances. If such concerns, in fact, led the NYSE to deny TREIT's listing application, as NYSE claims, the same concerns would have applied equally to the listing of the three ETFs whose holdings consist of companies that also violate the CSA.[5]

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[4] As noted in TREIT's Opening brief, the Commission, which also has an investor protection function, has declared effective the registration statements of companies who operate in the cannabis industry. Br. at 23.

[5] For example, YOLO and THCX have holdings in Greenlane, a company that specifically targets the cannabis industry and its clients include licensed cannabis cultivators, processors, and dispensaries in the United States and Canada. TREIT Motion, Ex. B, C, and E.

C. Any Burden on Competition Must be Tied To A Regulatory Purpose

The NYSE has not cited any regulatory purpose to justify the burden on competition imposed by its inconsistent application of its policy to listing cannabis companies, as required under the Exchange Act. Br. at 14-15. Because of its NYSE listing, TREIT's competitor, IIPR, is afforded an opportunity for growth through its superior visibility on a leading global listing exchange, increased volume-based liquidity, and trading at significantly higher rates than other REITs. Br. at 16-18. IIPR recognizes these competitive advantages and publicly touts its monopoly as the only listed cannabis REIT to further attract investors. *Id.* These are facts that the NYSE does not dispute and likely did not even consider when making TREIT's listing determination. *See* Resp. at 6 ("The Exchange does not express any view as to the effect of its listing determination on the Company's competitive position."). The NYSE does not, however, have the luxury of declining to express a view of its new policy's effect on TREIT's competitive position where the Exchange Act mandates that any policy that imposes a burden on competition not necessary or appropriate must be set aside. Br. at 15. The NYSE must weigh the competitive injuries to TREIT flowing from its new policy, and there is no indication in the record or in the Response that it has done so. *See* Section 6(b) of the Exchange Act; *see Saad v. SEC,* 718 F.3d 904, 914 (D.C. Cir. 2013) (review of SEC review of NASD sanction consisting of a lifetime bar, remanding for further review and finding that the Commission abused its discretion by failing to address mitigating circumstances and reasoning that the Commission could not "use a blanket statement to disregard potentially mitigating factors").

D. The NYSE is Operating Outside Rule Making Requirements

The NYSE's Response confirms that it has circumvented the rule-making process by adopting a new policy barring companies indirectly engaged in the cannabis industry from

listing. According to the NYSE, the decision was based on a review of its approach to "the listing of companies that conduct business with entities involved in the production or distribution of cannabis products in the United States" after a "change in approach at DOJ," referring to the rescission of the Cole Memo and issuance of the Sessions Memo. Resp. at 4-5.

Even assuming the NYSE's statement of the reasons for its change of policy (for which there is no record evidence) are accurate, this new policy—applicable to the entire cannabis industry and those doing business with it—is precisely the type of action that must be promulgated through the formal rule-making process. Br. at 20-23. Because the NYSE's new listing policy for cannabis-related companies is not reasonably or fairly implied by an existing NYSE rule, the NYSE was required to seek SEC approval for a new rule under Exchange Act Rule 19b-4(c). 15 U.S.C. § 78s(b); Br. at 21-22 (discussing *In the Matter of the Applications of William Higgins*, Release No. 34-24429, Admin. Proc. File No. 3-6609 (May 6, 1987)). This approval process would have included a notice and comment period, which would have allowed for a more fully developed record of the considerations in making such a blanket policy, including the legal and regulatory landscape at issue.

In its Response, the NYSE describes for the first time a call with SEC staff on September 6, 2018, on which the NYSE purportedly outlined its revised approach to new cannabis-related listings and its decision that the new approach did not require it to delist IIPR.[6] Resp. at 5. Such routine regulatory communications cannot take the place of the required rule-making procedures. The NYSE does not provide any detail on what the Staff was told during this call. We are

[6] As a procedural matter, this call is not included in the record and thus, the Commission should not consider it in making its determination. *See* SEC Rules of Practice, R. 460; *In the Matter of the Application of Capwest Securities, Inc.*, Release No. 71340, Adm. Proc. No. 3-15259 (January 17, 2014) at 5 n.43.

confident, however, that the SEC staff would not approve of any new policy or change in policy that violated the rulemaking requirements or Section 19(f), just as the Staff would not give blanket preclearance to any application of such a policy that would violate Section 19(f).

This circumvention of the rulemaking process has led to confusion by cannabis-related companies regarding the NYSE's position and standards on listing such companies. In April and May 2019, respectively, two of the ETFs listed on the NYSE, YOLO and MJ, submitted legal opinion letters representing NYSE's position with respect to cannabis listings as follows:

> The NYSE Exchanges are open to listing companies involved in the cannabis industry who are involved in biotech (22nd Century Group: XXII); investment in the industry outside of United States (Canopy Growth Corp.: CGC; the Fund: MJ); the agricultural sector (Scott's Miracle Grow Co.: SMG); and the real estate sector (Industrial Properties, Inc.: IIPR). United States based companies that "touch the plant" (i.e., those that grow or distribute cannabis) are not eligible to list at this time. Br. at 24.[7]

This summary of the NYSE's position is clearly inconsistent with the NYSE's stated policy for denying TREIT's listing application. This confusion in the market is a direct result of the NYSE's clandestine rule-making process in violation of the Exchange Act, which the NYSE does not even bother to address in its Response.

E. The Basis for the NYSE Determination Does Not Exist in Fact

As detailed in TREIT's Opening brief, because there is no record of the NYSE's listing determination, the NYSE's decision should be set aside. Br. at 28. The NYSE does not respond to this argument, but instead compounds its problem by referring to several events outside of the record in its Response without any support or motion to adduce additional evidence, as required by Commission rules. *See, e.g.,* Resp. at 4-5. Given the complete lack of record demonstrating

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[7] This articulation of the NYSE's "policy" would permit TREIT to list, as TREIT does not "touch the plant" but instead is a company in the real estate sector that provides services to companies that do.

that the NYSE's determination was based on specific facts, the Commission must set aside the NYSE's decision denying TREIT a listing. *See* Br. at 29 (discussing *In the Matter of the Application of CleanTech Innovations, Inc.,* Release No. 69968, Admin. Proc. File No. 3-14640 (July 11, 2013); *In the Matter of the Application of Eagle Supplv Group, Inc.,* Release No. 34-39800, Admin. Proc. File No. 3-9313 (Mar. 25, 1998)).

CONCLUSION

Accordingly, TREIT requests that the Commission set aside the NYSE action and require NYSE to consider and review TREIT's listing application in accordance with the requirements of Section 19(f) of the Exchange Act and NYSE rules.

Dated: September 30, 2019

Respectfully submitted,

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CERTIFICATE OF SERVICE

I, Carmen J. Lawrence, Esquire, hereby certify that on September 30, 2019, I caused a true and correct copy of the foregoing reply brief in further support of application for review to be served on the following via hand delivery (Office of the Secretary, NYSE), email (NYSE), and facsimile (Office of the Secretary).

Vanessa Countryman
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100 F Street, N.E.
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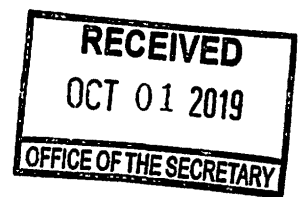

ADDENDUM OF AUTHORITIES

Release No. 35575 (S.E.C. Release No.), Release No. 34-35575, 59 S.E.C. Docket 68, 1995 WL 217682

S.E.C. Release No.
Securities Exchange Act of 1934

SECURITIES AND EXCHANGE COMMISSION (S.E.C.)

IN THE MATTER OF THE APPLICATION OF BIORELEASE CORPORATION
8A Industrial Way, Suite 3
Salem, New Hampshire 03079
FOR REVIEW OF ACTION TAKEN BY THE NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.

Admin. Proc. File No. 3-8448
April 6, 1995

OPINION OF THE COMMISSION

REGISTERED SECURITIES ASSOCIATION—DELISTING FROM THE NASDAQ SMALLCAP MARKET

Financial Condition

*1 Where registered securities association removed a security from its automatic quotation system because the issuer of the security was not in compliance with the maintenance standards for total assets and capital and surplus requirements, held, review proceeding dismissed.

APPEARANCES:

R. Bruce Reeves, President and Chief Executive Officer of Biorelease Corporation, for the Corporation.

T. Grant Callery, John J. Flood, and Susan L. Beesley, for the National Association of Securities Dealers, Inc.

Appeal filed: August 9, 1994

Last brief received: December 12, 1994

I.

Biorelease Corporation ("Biorelease" or the "Company"), an issuer formerly listed on the Nasdaq SmallCap Market ("Nasdaq SmallCap"), appeals the decision of the National Association of Securities Dealers, Inc. ("NASD") to delist the Company's securities. The NASD found that Biorelease was not in compliance with the requirements that it maintain $2 million total assets and $1 million in capital and surplus. [1]

II.

Biorelease is engaged in efforts to market a cell culture product and in the research and development of drug delivery products and blood substitutes. The Company was incorporated in Delaware in 1986 under the name OIA, Inc. The Company had no substantive operations until June 1992, when it acquired a majority of the ownership of a second company. During the summer of 1992, the Company changed its name to Biorelease. Biorelease became listed on Nasdaq SmallCap in October 1992.

On November 19, 1993, Biorelease filed a Form 10–QSB for the period ended September 30, 1993, which reported that the Company had $1,390,790 in assets and $942,814 in capital and surplus. [2] By letter dated November 29, 1993, the NASD advised

Biorelease that the Company's total assets and capital and surplus, as reflected in its Form 10–QSB, were below the amount required for continued inclusion in Nasdaq SmallCap.

On December 9, 1993, the Company by letter requested an exception to the listing requirements. In a subsequent letter dated December 22, 1993, the Company stated that its public offering during the summer of 1993 had been unsuccessful because of market conditions, and that normal continuing development expenses had caused a shortfall in assets and capital. The Company asserted that it planned to reestablish compliance with the Nasdaq SmallCap maintenance standards by February 1994, through the exercise of certain outstanding warrants, effecting a private placement of approximately $800,000 on or before February 15, 1994, and closing an additional off-shore Regulation S offering totaling $3.5 million in the third and fourth quarters of its fiscal year, together with the exercise of additional warrants.

*2 By letter dated January 13, 1994, the Nasdaq Listing Qualifications Committee ("Qualifications Committee") granted the Company an exception until February 15, 1994. The Qualifications Committee stated that Biorelease should file a Form 8–K evidencing compliance with the listing maintenance criteria by that date. The Committee made clear that it was granting the exception in reliance on the representations that warrants in the amount of $300,000 would be exercised and that $800,000 would be obtained in a private placement by February 15, 1994. A symbol "C" was added to the Company's trading symbol on Nasdaq SmallCap, to indicate to market participants that the Company had received a temporary exception to the Nasdaq qualifications requirements. The exception was subsequently extended until February 18, 1994.

The Company thereafter represented that, prior to February 15, 1994, it had received $501,032 from the exercise of warrants and had closed a private placement of 2.8 million shares of its common stock with an offshore investor group pursuant to which the Company received demand notes in the total face amount of $2,100,000 due by May 15, 1994. On February 17, 1994, the Company submitted a Form 10–QSB for the quarter ended December 31, 1993. The Company claimed that, in its auditors' view, the demand notes could properly be included as an asset in the Company's subsequent March 31, 1994 financial statement, if the notes were paid by the date that the later statements were released, i.e. May 15, 1994.[3] Because the Company expected to be paid by May 15, 1994, it asserted that the notes receivable were currently recordable, and, accordingly, the Company was in compliance with Nasdaq SmallCap standards for continued listing.

By letter dated February 25, 1994, the NASD informed Biorelease that the Qualifications Committee had determined that the Company was not in compliance with the terms of Nasdaq's January exception, and Biorelease would therefore be delisted on February 28th.[4] The NASD delisted the Company's securities from Nasdaq SmallCap on February 28, 1994.

On March 1, 1994, the Company submitted a letter requesting that it be relisted, pending receipt of its financial statements for the quarter ending March 31, 1994. In addition to its reiterated assertions that it met the requirements for continued inclusion in Nasdaq SmallCap, Biorelease stated that the delisting jeopardized negotiations for a pending financing arrangement.[5]

By letter dated March 15, 1994, the NASD staff informed the Company that the Qualifications Committee had granted Biorelease an additional 30–day extension, on the condition that, by April 18 Biorelease would file a Form 8–K, using as a base, financials dated on or after January 31, 1994, showing compliance with all maintenance criteria for continued inclusion in Nasdaq SmallCap. The company was relisted on March 18, 1994.[6]

On April 1, 1994, Biorelease filed a Form 8–K containing a pro forma balance sheet dated as of February 28, 1994. The Form 8–K showed that the Company had total assets of $4,385,303 and capital and surplus of $4,097,300. The assets listed included the shareholder notes receivable, revalued at $1,450,000, and a new asset, 150,000 shares of preferred stock of Genesis Capital Corporation ("GCC"), valued at $1,500,000. Biorelease stated that it had purchased the GCC stock on March 31, 1994, in exchange for 1.5 million shares of newly-issued Biorelease common stock, and that the $1,500,000 valuation was based on the March 31 closing date. In letters dated April 7 and 25, 1994, the Company urged that compliance had been demonstrated and asked that the symbol "C" be removed from the Company's trading symbol.[7]

*3 The Qualifications Committee considered the matter on the basis of the written record and delisted Biorelease on April 27, 1994. Biorelease appealed the Qualifications Committee's decision to the Nasdaq Hearing Review Committee ("Hearing Review Committee"), requesting a further exception to the total assets and capital and surplus maintenance requirements for continued inclusion in Nasdaq SmallCap. [8] The Hearing Review Committee denied Biorelease's request and affirmed the Qualification Committee's decision to delist Biorelease in a decision dated July 28, 1994. The Hearing Review Committee noted that the Company repeatedly stated that it would submit audited statements of GCC, demonstrating that GCC had a liquidation value of at least $10 per share, but had failed to do so. [9]

III.

Biorelease requests that we overturn the Company's delisting by the NASD and order reinstatement of its Nasdaq SmallCap listing. In general, we determine whether the specific grounds on which such action is based exist in fact, whether such action is in accordance with the applicable NASD rules, and whether these applicable rules are, and were, applied in a manner consistent with the purposes of the securities laws. [10]

We believe that the NASD acted properly when it delisted Biorelease. [11] Biorelease asserts that GCC stock should have been valued at $1.5 million. [12] Biorelease now suggests that it needed to demonstrate only that the GCC stock was worth $546,000 to comply with Nasdaq maintenance standards, and that there is nothing to suggest the GCC was not worth at least this amount. [13]

Biorelease misperceives its role. The burden is not on the NASD to determine a value for the GCC stock. The burden is on the Company to demonstrate its compliance with Nasdaq listing requirements, and the Company failed to meet this burden. The NASD's request for contemporaneous audited financial statements supporting the valuation of GCC, a newly acquired asset that represented more than 60 percent of Biorelease's total assets of $2.29 million, was well within the Association's discretion and consistent with the NASD's obligation to protect investors and the public interest. [14]

Biorelease, however, did not produce audited financial statements with a valuation for GCC until after the NASD held its final hearing. These statements were for the period ending September 30, 1993, six months before the alleged purchase occurred. Accompanying GCC documents indicated, moreover, that GCC had minimal operations, was selling its chief asset (a farm), had acquired an entirely new line of business, and was proposing to purchase a Panamanian plantation. [15]

The NASD's doubts about the proper valuation of the GCC stock were subsequently confirmed. The Company's Form 10–KSB, for the year ended June 30, 1994, filed on November 14, 1994, indicates that the Company reduced the cost of the GCC investment by $375,000 and stated that the investment was permanently impaired. [16]

*4 In addition, that Form 10–KSB reports that the transactions giving rise to the shareholder demand notes that Biorelease claimed should be considered as current assets were rescinded. [17] The Company nonetheless appears to argue that, although these transactions were subsequently rescinded, we should nonetheless include these demand notes as of the date the NASD considered the Company's financials. [18] The Company also asserts that, absent the delisting, the Company could have had sufficient cash from the demand notes to be in compliance with the Nasdaq SmallCap maintenance standards. We have previously rejected such arguments. [19]

Although exclusion from the system may hurt existing investors, primary emphasis must be placed on the interests of prospective future investors. Prospective investors are entitled to assume that the securities listed in Nasdaq SmallCap meet the system's listing standards. [20]

IV.

Biorelease contends that the NASD acted arbitrarily and in bad faith when it delisted Biorelease. We disagree. The record shows that the NASD gave Biorelease a series of opportunities to resolve its non-compliance with the Nasdaq SmallCap maintenance standards, granted it repeated exceptions, and engaged in ongoing dialogue with the Company through the delisting process, both by phone and in writing.

Biorelease also asserts that the NASD failed to provide it with adequate notice and an opportunity to be heard. In November 1993, when the NASD initially notified Biorelease that the Company was not in compliance, the NASD informed the Company that it could request either an oral hearing or a hearing by written submission. [21] In a letter dated December 9, 1993, Biorelease requested a hearing by written submission and enclosed a check for $500, the fee for such a hearing. At that time, the Company stated that it might subsequently request an oral hearing. [22] While Biorelease indicated on several occasions that it wanted an opportunity to discuss its position before any action by the NASD, [23] it never expressly requested an oral hearing, nor paid the increased fee for such a hearing.

Subsequently, in a letter dated May 26, 1994, the Company asked that its delisting be reviewed by the Hearing Review Committee, and stated that the "company wishes to present its evidence of compliance at such hearing." Although Biorelease did not make its request within 15 days of issuance of the decision, as required by the NASD's Code of Procedure, [24] the Hearing Review Committee nevertheless agreed to review the matter on the basis of the written record. [25] Biorelease did not object to a review of the matter on the basis of the record or make a request for oral argument. We find that Biorelease was afforded an ample opportunity to present its views.

We find that a sufficient factual basis existed to delist Biorelease, that the NASD acted fairly and in accordance with its Rules which are, and were applied in a manner, consistent with the purposes of the securities laws. Accordingly, this review proceeding should be dismissed.

*5 An appropriate order will issue. [26]

By the Commission (Chairman LEVITT and Commissioners ROBERTS and WALLMAN).
Jonathan G. Katz
Secretary

Footnotes

1 Sections 1(c)(2) and 1(c)(3) of Part II of Schedule D to the NASD's By–Laws provide that, for continued inclusion on the Nasdaq SmallCap Market, an issuer must have total assets of at least $2 million and capital and surplus of at least $1 million. When an issuer does not comply with these standards it can be "delisted," that is, the issuer's security will no longer be quoted on the automated quotation system. NASD Manual (CCH) ¶ 1803.

2 The Company's Form 10–QSB is not included in the record. However, Biorelease has never contested that the Company's total assets and capital and surplus, as reflected in the Company's Form 10–QSB for the period ended September 30, 1993, were below the minimum requirements for continued inclusion in Nasdaq SmallCap. We take official notice of this Form 10–QSB, which is in the Commission's official files.

3 The Company had agreed that payment on these notes would be contingent on its continued listing on Nasdaq SmallCap. Subsequently, counsel for the Company represented that that condition had been deleted from the notes.

4 The NASD noted that the Form 10–QSB for the quarter ended December 31, 1993, did not show that any proceeds had been received from the private placement completed February 14th.

5 The Company was delisted from Nasdaq SmallCap from February 28, 1994 through March 18, 1994. While delisted from Nasdaq SmallCap, the Company's stock-price declined. Biorelease renegotiated terms with its private placement investors, resulting in a reduction of the total amount of notes receivable to approximately $1,450,000.

6 On March 22, 1994, the NASD staff informed the Company that it was in arrears in the filing of "Listing of Additional Shares" forms and the payment of related fees. In early April, the Company complied by filing the appropriate forms and paying the associated fees. After being delisted on April 28, 1994, the Company requested that the fees be returned. That request was denied.

7 During this period, Biorelease asserted that the GCC shares had been properly valued at their liquidation value and that audited statements of GCC would soon be issued. The Company also indicated that it would like to discuss other means of proving the valuation of GCC shares, including "possibly independent appraisals of GCC's two principal assets." However, independent appraisals were never submitted.

Biorelease also reiterated that the demand notes should be treated as assets, since they were expected to be paid by May 15.

8 Biorelease filed the Form 10–QSB for the quarter ended March 31, 1994, on May 19, 1994, after the Qualifications Committee had issued its decision delisting the Company. The Form 10–QSB indicated that, on March 31, 1994, the Company had acquired 150,000 shares of convertible preferred stock in GCC, in exchange for 1,500,000 shares of stock in Biorelease, that the "stated value" of GCC preferred stock was $10 per share, and that the Company's total assets were $2,290,387 (comprised of $1,500,000 in GCC stock and $790,387 in other assets).

The Form 10–QSB, however, noted that the treatment of the $1,400,000 in demand notes was being changed from an asset to stockholder subscription receivable (which was deducted from capital), that total capital and surplus were $1,894,036 (after deducting the demand notes), that the collection of these notes was "unlikely," and that the Company would be forced to suspend operations if it could not obtain funds from some other source.

9 In a June 3, 1994 letter to the NASD, the Company stated that it expected to receive copies of GCC's audited financial statements by June 10, 1994, showing liquidation value of approximately $14.86. On June 14, 1994, the Company's president transmitted by facsimile a draft of the GCC audit, without notes, to the NASD and stated that audited statements should be available within a few days. No signed audit opinion reflecting the current value of the GCC stock was presented on or before the date of the formal Hearing Review Committee meeting. After the Hearing Review Committee meeting, but prior to the issuance of the NASD's final written decision, Biorelease submitted audited statements of GCC dated September 30, 1993 (six months before GCC's transaction with Biorelease).

10 See Section 19(f) of the Securities Exchange Act of 1934, 15 U.S.C. § 78s(f).

11 Biorelease contends that the exceptions from the listing requirement granted to it by the NASD somehow limited the NASD's discretion. The Company is incorrect. The exceptions were granted for limited duration and on specific conditions. Nothing in the NASD's letters suggests that the NASD's discretion was circumscribed.

In its letters, both granting an exception to Biorelease and extending it, the NASD "reserve[d] the right to reconsider the terms of" the exception in the event of any "material change in the company's financial ... character." In addition, the NASD stated in these letters that "any compliance document will be subject to review by the Committee, which may at its discretion request additional information before approving the Company's compliance document." Biorelease's repeated attempts on various bases to demonstrate compliance were never successful.

12 Biorelease argues that its common stock was worth at least $1.00 a share (based on then-current Nasdaq quotations) and that, since it had issued 1.5 million shares of Biorelease stock for the GCC preferred stock, the value of the GCC stock must have been $1.5 million. However, there is no evidence in the record that any arm's-length transaction in Biorelease stock occurred at the quoted price. Furthermore, we note that the shares transferred to GCC were restricted and, accordingly, would likely be less valuable than freely tradable stock. Moreover, the Company's Regulation S offerings, which were subsequently rescinded, were made at the negotiated price of $.50.

13 It is unclear why Applicant argues that the Company needed only an additional $546,000 in assets to be in compliance with Nasdaq SmallCap standards, or which of Biorelease's remaining assets the Company believes should have been included to bring its total assets to the requisite $2 million.

14 The NASD may request additional information or documentation deemed necessary to make a determination regarding a security's continued inclusion in the Nasdaq System. See Section 3(c) of Part II of Schedule D to the NASD's By–Laws, NASD Manual (CCH) ¶ 1805.

15 The Company claims that, using any reasonable valuation for its GCC stock, Biorelease was in compliance. As stated previously, it was Biorelease's burden to prove valuation, and the Company failed to produce probative evidence of that valuation.

16 The Company stated in its Reply Brief that "[f]or each of the last three quarters the company's filings have exhibited compliance under its listing requirements ...," referring to its Form 10–KSB, which was due to be filed at the end of September 1994. We construe Applicant's reference to the recent financials to be a motion to take official notice of the filing. Although the NASD opposed our

consideration of the Company's most recent financials, which include the Company's Forms 10–KSB, for the year ended June 30, 1994, and 10–QSB, for the quarter ended September 30, 1994, the NASD and the Company both discuss these filings. Accordingly, we take official notice of these filings.

17 The Company also rescinded the exercise of certain options, returning $600,000 to investors.

18 Biorelease also argues that its Form 10–KSB for the period ending June 30, 1994 and subsequent filings demonstrate its compliance with the maintenance standards, based on yet another mix of assets. These documents were not before the NASD at the time that it made the decision before us. In our view, the Company must present to the NASD in the first instance the question of whether it has in fact subsequently demonstrated compliance, in accordance with generally accepted accounting principles, with those standards.

19 In Tassaway, Inc., 45 S.E.C. 706, 709 (1975), a company initially represented that it was on the verge of effecting an acquisition that would permit it to meet the Nasdaq minimum maintenance criteria. We noted that the acquisition was subsequently rescinded and that, since the company's petition for review turned entirely on that failed agreement, the review proceeding should be dismissed.

In ORS Automation, Inc., 48 S.E.C. 490, 493 (1986), we rejected an issuer's request for a stay because the company would be prevented from raising capital to meet the maintenance criteria. We determined that it would not be proper to permit noncomplying issuers to retain listing merely because they were attempting to raise capital.

20 Tassaway, supra, 45 S.E.C. at 709. See also Exchange Act Rel. No. 34151 (June 3, 1994), 56 SEC Docket 2654.

21 Article IX, Sections 3 and 4, respectively, of the Code of Procedure, NASD Manual (CCH) ¶¶ 3103 and 3104, provide that:

Upon request, the applicant shall be granted a hearing after reasonable notice. In the absence of such request for a hearing, the Corporation may, in its discretion, have any application set down for hearing or consider the matter on the basis of the application and supporting documents.

All applications shall be considered by a hearing panel designated by the Board of Governors. The applicant shall be entitled to be heard in person and by counsel and to submit any relevant matter. In any such proceeding a record shall be kept.

The NASD further informed Biorelease that the fee for a hearing by written submission was $500 and the fee for an oral hearing was $1,000.

22 In a letter dated December 22, 1993, the Company requested that it be informed of the hearing date, stating that it "may request to meet in person to present additional information orally (emphasis added)." There is nothing to suggest that the Company in fact thereafter requested an oral hearing on the exception. In any event, the Company was granted the requested exception on January 13, 1994.

23 Biorelease claims, and letters dated February 17 and March 1, 1994 from counsel state, that the Company wanted to discuss any possible non-compliance, apparently with the NASD staff, before the issuance of any adverse decision. Again, the Company did not request an oral hearing. The Company argues that the NASD's Qualifications Committee met on February 24th, without notifying Applicant, and made a decision to delist Biorelease. The Company immediately requested reconsideration of the decision and a continuing exception. The Company's request for review was granted, it was relisted on March 18, 1994, and received an additional 30–day exception.

24 Article IX, Section 6 of the Code of Procedure provides that:

[t]he decision shall be subject to review by the NASDAQ Hearing Review Committee on its own motion within 45 calendar days after issuance of the written decision. Any such decision shall also be subject to review upon application of any person aggrieved thereby, filed within 15 calendar days after issuance....

NASD Manual (CCH) ¶ 3106.

25 Article IX, Section 7 of the Code of Procedure provides that:

[u]pon consideration of the record, and after such further hearings as it shall order, the NASDAQ Hearing Review Committee shall affirm, modify, reverse, dismiss, or remand the decision. The NASDAQ Hearing Review Committee shall set forth specific grounds upon which its determination is based.

NASD Manual (CCH) ¶ 3107.

26 All of the contentions advanced by the parties have been considered. The contentions are rejected or sustained to the extent that they are inconsistent or in accord with the views expressed herein.

Release No. 35575 (S.E.C. Release No.), Release No. 34-35575, 59 S.E.C. Docket 68, 1995 WL 217682

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Release No. 71340 (S.E.C. Release No.), Release No. 34-71340, 108 S.E.C. Docket 111, 2014 WL 198188

S.E.C. Release No.
Securities Exchange Act of 1934

SECURITIES AND EXCHANGE COMMISSION (S.E.C.)

IN THE MATTER OF THE APPLICATION OF CAPWEST SECURITIES, INC.
FOR REVIEW OF DISCIPLINARY ACTION TAKEN BY FINRA
c/o H. Thomas Fehn, Esq.
Fields, Fehn & Sherwin
1175 Wilshire Boulevard, 15th Floor
Los Angeles, CA 90025

Administrative Proceeding File No. 3-15259
January 17, 2014

SUMMARY

The Securities and Exchange Commission (SEC) issued an order concluding that the sanctions issued by FINRA were justified under Sanction Guidelines with respect to CapWest. FINRA sanctioned CapWest because they found CapWest violated NASD Conduct Rules 2210 and 2110 through its use of violative public communications.

REGULATION
17 C.F.R.
Appeal filed: March 29, 2013
Last brief received: June 21, 2013
*1 APPEARANCES:
H. Thomas Fehn, Gregory J. Sherwin, and Orly Davidi, of Fields, Fehn, & Sherwin, for CapWest Securities, Inc.
Alan Lawhead, Andrew Love, and Gary J. Dernelle, for the Financial Industry Regulatory Authority, Inc.

OPINION OF THE COMMISSION

REGISTERED SECURITIES ASSOCIATION—REVIEW OF DISCIPLINARY PROCEEDING

Failure to Comply with Advertising Rules

Failure to Supervise

Conduct Inconsistent with Just and Equitable Principles of Trade

Former member firm of registered securities association violated content standards applicable to communications with the public, in that the communications: (1) were not fair and balanced and failed to provide a sound basis for evaluating the products and services being promoted; (2) used exaggerated and/or misleading statements; (3) used prohibited statements projecting results of the services or products being promoted; and (4) used customer testimonials without the requisite disclosures. Former member firm also violated supervisory standards by failing to implement effectively the firm's supervisory procedures. As a result of these violations, former member firm engaged in conduct inconsistent with just and equitable principles of trade. *Held*, association's findings of violations and the sanctions it imposed are *sustained*.

I.

CapWest Securities, Inc., formerly a FINRA member firm, [1] seeks review of FINRA disciplinary action. FINRA found that, during the period from October 1, 2006 to March 31, 2007, CapWest violated NASD Conduct Rules 2210 and 2110 through its use of violative public communications, [2] for which FINRA fined CapWest $25,000 and censured the Firm. FINRA further found that CapWest failed to implement its supervisory system effectively with regard to reviewing the communications at issue, in violation of NASD Conduct Rules 3010 and 2110, [3] for which FINRA fined CapWest $25,000. [4] We base our findings on an independent review of the record.

II.

A. Section 1031 Exchanges and TIC investments proliferated in the early 2000s, prompting NASD to issue *Notice to Members 05-18*.

This matter relates to public communications that CapWest used to promote tax-deferred exchanges of real property under Section 1031 of the Internal Revenue Code ("Section 1031 Exchanges"), as well as tenancy-in-common ("TIC") investments. Section 1031 of the IRC permits an investor to defer paying capital gains tax otherwise due on the sale of real estate held for productive use in a trade or business or for investment by exchanging the investment for "like-kind" property of equal or greater value. [5] One of the ways that a Section 1031 Exchange can be accomplished, subject to certain requirements, is through a TIC, in which an investor obtains an undivided fractional interest in real property. [6]

*2 The sales volume of TICs grew significantly during the early 2000s, from approximately $150 million in 2001 to approximately $2 billion in 2004. [7] Given the growth in use of these products and some of the risks involved in TIC investments, NASD issued *Notice to Members 05-18*, which noted that TICs are illiquid investments for which no secondary market exists and that subsequent sales of the investment property may occur at a discount to the value of the real property interest underlying the TIC. [8] NASD further pointed out the risk that the fees and expenses charged by the TIC sponsor have the potential to outweigh the tax benefits associated with a Section 1031 Exchange. [9] NASD warned its members of their obligation to comply with all applicable conduct rules when selling TICs, specifically highlighting the obligation to "ensure that promotional materials used by the member are fair, accurate, and balanced." [10]

B. FINRA Advertising Regulation conducted a sweep of certain member firms' public communications related to the sale of TICs, including those of CapWest, resulting in disciplinary proceedings.

Approximately two years after the issuance of *Notice to Members 05-18*, FINRA's Department of Advertising Regulation conducted a "sweep," in which it requested that a group of thirty member firms, including CapWest, produce all of the public communications the firms used in promoting 1031 Exchanges and TICs during the six-month period from October 2006 through March 2007 (the ""Sweep Period"). [11] In response to the sweep, CapWest produced 268 documents, which took multiple forms, including newsletters, websites, seminar presentations, newspaper and magazine advertisements, form letters, a radio interview script, brochures, and postcards. After reviewing the materials CapWest submitted, Advertising Regulation referred the Firm to FINRA's Department of Enforcement for disciplinary action. On March 4, 2010, FINRA's Department of Enforcement filed a complaint against CapWest, charging that 166 of the 268 communications violated NASD conduct rules regarding public communications and that the Firm had violated NASD's supervisory standards with respect to the communications at issue. On April 12, 2011, a FINRA Hearing Panel conducted a one-day hearing.

FINRA presented its case through a single witness, J. Martin Levine, the FINRA Advertising Regulation investigator responsible for reviewing the communications CapWest submitted in response to the sweep. Levine testified with respect to the procedures FINRA followed in conducting the sweep, and he reviewed the communications at issue to explain the basis for the proceeding.

FINRA also introduced each of the allegedly violative communications as hearing exhibits. As CapWest stipulated, at the time of the sweep, its "supervisory system required registered representatives to submit proposed advertisements and sales literature to the firm's Compliance Department and obtain approval for those materials prior to use," and "CapWest supervisory personnel approved all of the 166 pieces of advertising and sales literature related to TICs ... filed in this disciplinary proceeding." [12]

*3 CapWest also presented only one witness, its president and chief executive officer, who testified regarding his purchase of the Firm around the time of the violations, and about the remedial steps the Firm subsequently took to comply with the applicable conduct rules. Among other things, the CEO conceded that he was not fully aware of "what the rules were" with respect to advertising content until the time of the sweep, after which the Firm attempted to "get things done the right way." [13] The Hearing Panel found that CapWest had committed the violations as charged in the complaint, censured CapWest, and fined the Firm $150,000 for the content standards violations.

CapWest did not appeal the Hearing Panel's decision. FINRA's National Adjudicatory Council ("NAC"), however, called the matter to review the appropriateness of the fine the Hearing Panel imposed for the Rule 2210 and 2110 violations. [14] The NAC determined that the $150,000 fine was excessive because, it found, a majority of the violations were "inadvertent" and the result of a systemic problem in the Firm's implementation of its supervisory system, many of the communications were targeted to accredited investors, and several of the communications were repeated multiple times in identical form. As a result, the NAC reduced the fine from $150,000 to $25,000. The NAC further affirmed the Hearing Panel's findings that CapWest violated Rules 3010 and 2110 by failing to implement effectively its supervisory procedures, in that all 166 violative communications were approved by supervisory personnel of the Firm. The NAC found that, while CapWest ""reasonably designed" its supervisory system to ensure compliance—and it was undisputed that the Firm's supervisory personnel reviewed the violative communications—the Firm "did not provide [its] principals, or the Firm's registered representatives, with adequate training and guidance concerning these standards." It also affirmed the $25,000 fine the Hearing Panel imposed for the supervisory violations. [15] CapWest subsequently filed this appeal. [16]

III.

NASD Rule 2210(d)(1) contained conduct standards applicable to all member firm communications with the public, including the requirements that such communications: (i) "shall be based on principles of fair dealing and good faith, must be fair and balanced, and must provide a sound basis for evaluating the facts in regard to any particular security or type of security, industry, or service;" [17] (ii) shall not contain "any false, exaggerated, unwarranted or misleading statement or claim;" [18] and (iii) "may not predict or project performance, imply that past performance will recur or make any exaggerated or unwarranted claim, opinion or forecast." [19] Rule 2210(d)(2) required that advertisements or sales literature "providing any testimonial ... must prominently disclose ...: (i) the fact that the testimonial may not be representative of the experience of other clients; [and] (ii) the fact that the testimonial is no guarantee of future performance or success." [20] FINRA found that CapWest violated NASD Rules 2210(d)(1) and 2210(d)(2), as well as NASD Rule 2110. [21]

*4 FINRA found that some of the communications violated multiple NASD Rule provisions, for multiple reasons, while other communications violated only one provision. The following discussion analyzes CapWest's violative communications under each of the FINRA Rule provisions at issue. [22]

A. CapWest violated NASD Rules 2210(d)(1)(A) and 2110 because certain communications promoted the use of Section 1031 Exchanges or TICs without including an explanation of their features or without any mention of the potential risks, including the lack of liquidity, involved in TIC investments.

We sustain FINRA's findings that 154 of CapWest's 166 violative communications violated NASD Rules 2210(d)(1)(A) and 2110. [23] Certain communications promoted the use of 1031 Exchanges or TICs without providing a sound basis for evaluating

the facts regarding them, as required by NASD Rule 2210(d)(1)(A).[24] For example, a CapWest registered representative in San Luis Obispo, California, used an advertisement in real estate industry publications on four occasions during the Sweep Period,[25] which included a photograph of pieces on a chess board with the question, "What's Your Next Move?" in large bold type. The advertisement stated in large print, "1031 Exchanges might just be the best kept secret in the Internal Revenue Code." It also touted several benefits of 1031 Exchanges. The advertisement did not, however, include any discussion of how 1031 Exchanges work or the requirements for a given investment to qualify as a like-kind exchange.

Other CapWest communications promoted positive features of TICs in a way that was not fair and balanced, as required under NASD Rule 2210(d)(1)(A).[26] For example, one advertisement was published in identical form seventeen separate times in regional magazines, including *BrokerAgent, Haven, Central Coast*, and *Vintages*, a wine magazine.[27] It showed a photograph of a man and woman smiling as they open their home mailbox. The text reads, "I used to manage my investment property ... now I manage my mailbox." The advertisement touts the "simplicity" of TIC investments, as well as their ability to "eliminate time intensive property management burdens associated with being a landlord." But the advertisement does not mention any of the negative attributes of such investments. Under NASD Rule 2210(d)(1)(A), sales literature used by member firms must "disclose in a balanced way the risks and rewards of the touted investment."[28] For example, the risk inherent in illiquid investments, such as the TIC investments being promoted here, must be disclosed,[29] as well as a downside risk analysis to balance statements about the investment's rewards.[30] Touting the benefits of the TIC investments without a balanced presentation of the risks entailed in the investment renders the communications misleading under NASD Rules.[31] The record here supports FINRA's finding that CapWest failed to provide the requisite balanced disclosure of the risks associated with TIC investments.

B. CapWest violated NASD Rules 2210(d)(1)(B) and 2110 by using communications that made exaggerated claims pertaining to the protection afforded to TIC investors by regulatory oversight or the tax benefits of 1031 Exchanges.

*5 We sustain FINRA's findings that nine of the communications used by CapWest violated Rule 2210(d)(1)(B)'s prohibition against exaggerated or false and misleading claims. Six of these communications exaggerated the protection and security that TIC investors could expect as a result of regulatory oversight of the TIC industry. The advertisements in question described oversight by the Commission and other regulatory authorities as "an added benefit for investors" and suggested that oversight "guides [TIC sponsors] in straightforward practices that reflect ethics and disclosure." In a series of brochures touting the benefits of TICs, a CapWest registered representative in Seminole, Florida stated, among other things, "The SEC advocates full disclosure, and the sponsors ... must follow many rules to be in compliance ...."[32] One of these brochures stated that a TIC investor receives protection from the "extensive" due diligence on such investments conducted by "the securities industry" which, the Firm asserted, "perform[s] thorough analysis to determine if the ownership structure is viable and whether the property is physically sound, economically profitable, has a likelihood of increasing in value, and can generate sufficient income to repay the debt obligation."[33] One page on the website of a realestate company owned by this registered representative stated, "The real goal [of] all of this [oversight and regulation] is to make the sales and offerings and their regulations [sic] as secure as possible for investors, and bring clarity to any vague issues."[34]

CapWest disputes FINRA's finding that these six communications violated Rule 2210(d)(1)(B). The Firm argues that none of the communications contains the suggestion that a regulatory authority "approved" TIC investments, and further claims, without authority, that "a typical offering memorandum read by the investor will disclaim any such approval." The Firm argues that the statements found to be violative "in no way imply an increased likelihood of a successful investment." According to the Firm, "They simply make the observation that the securities industry is well regulated." The Firm correctly notes that regulatory oversight, in general, provides "investor protection," but this does not permit the Firm, as FINRA found, to make exaggerated claims regarding the "degree of oversight and safety afforded to" TIC investors as a result of such oversight.[35] For example, the statements that TICs are subject to "thorough analysis" by "the securities industry" regarding, among other things, "whether the property is ... economically profitable, has a likelihood of increasing in value, and can generate sufficient income to repay

the debt obligation"[36] exaggerate the level of protection that industry and regulatory oversight provide to TIC investors, as well as the likelihood of a successful investment.

*6 FINRA also found, and we agree, that CapWest violated Rule 2210(d)(1)(B) in three communications that included misleading and exaggerated statements indicating that 1031 Exchanges permit the investor to avoid taxes altogether when they merely allow taxes to be deferred. For example, a two-page brochure used by a CapWest registered representative in Sherwood, Oregon stated that a 1031 Exchange allows an investor to sell a property and purchase another "without a tax consequence."[37] The Sherwood registered representative also used a presentation that claimed, "By taking advantage of a § 1031 exchange, you may conserve equity by not paying tax on realized gain."[38]

NASD Rule 2210(d)(1)(B) prohibits member firms from making "any false, exaggerated, unwarranted, or misleading statement or claim in any communication with the public." CapWest does not address on appeal FINRA's findings of violation of Rule 2210(d)(1)(B) with respect to these three communications. Even if certain of these statements (such as the statement that a 1031 Exchange may be executed "without a tax consequence") may be literally true with respect to the initial transaction, the failure of the advertisement to explain the ultimate tax effect of a 1031 Exchange gave the misleading impression that taxes could be avoided altogether. The Firm's misleading and exaggerated statements regarding the regulatory protections afforded to TIC investments and its misleading and exaggerated statements regarding the tax consequences of TIC investments were material because there is a substantial likelihood that a reasonable investor would have considered the information important in the context of the communication.[39]

C. CapWest violated NASD Rules 2210(d)(1)(D) and 2110 because it used communications including improper performance predictions, performance claims, and forecasts.

We sustain FINRA's findings that thirteen of CapWest's communications violated NASD Rule 2210(d)(1)(D)'s prohibition on performance predictions and unwarranted forecasts. The communications included statements predicting that investors would realize positive returns on their investments, often citing specific percentage returns without including any explanation of the historical basis for these claims or any proviso that past results are no guarantee of future performance. One CapWest registered representative used several handouts which described TICs as having a "long term income stream," producing ""effortless cash flow," and, on her realestate website, stated that "TICs are popular because ... the returns are generally projected and estimated. No management, no fuss, no tenant problems—simply a return on the investment— this is appealing to more and more people."[40] Other CapWest communications included specific percentage return projections. In a script for radio interviews,[41] a CapWest registered representative acknowledged that "each TIC deal will vary," but then stated that a "typical apartment deal today starts with a cash-on-cash return of about 6% to 6.9%;" "typical office and retail deals vary from 6.5% to 7.5%;" and "some of the other asset classes may pay higher, maybe 7.5% to 8%." An advertisement approved for use on Google stated that TICs could provide "potential monthly cash flow over 8%," while another advertisement, approved the same day for use on Yahoo stated, "TIC properties can potentially [provide] cash flow over 10%,"[42] without any explanation for the different figures in the two advertisements. None of these communications cited a basis for these projections.

*7 CapWest defends the performance projections it used as "not promissory" and further states that they "appear to be true," citing only a book written by one of its registered representatives.[43] But the descriptions of the returns as "typical" and statements that TIC investments produce "simply a return on the investment" do not refer to past performance. None of the thirteen communications found to have violated this provision includes any disclosure or cautionary language that the results being cited do not guarantee future performance.

Without the requisite qualifying language and the historical basis for such claims and figures, the overall effect of these projections was to imply that an investor in TICs could expect the returns predicted in the communications.[44] As we have

previously held, "the blanket nature of the statements made in the advertisements, appearing as they did with neither detail nor qualification, renders them violative of NASD Rules." [45]

D. CapWest violated NASD Rules 2210(d)(2)(A)(i) and (ii) and 2110 by using a communication that included a customer testimonial without the requisite disclosures.

We sustain FINRA's finding that one CapWest communication violated NASD Rule 2210(d)(2)(A)(i) and (ii)'s requirement to include certain disclosures when using customer testimonials in public communications. The communication was in the form of a promotional postcard from a registered representative in Yorba Linda, California, that included three customer testimonials speaking to the representative's "character," "integrity," and his "keen interest in the financial welfare of his clients." [46] A third testimonial in the postcard stated, "every way you measure [him], on a scale of 1 to 10, he gets a 10!" The postcard did not include the disclosures required under Rule 2210: "that the testimonial may not be representative of the experience of other clients" and "that the testimonial is no guarantee of future performance or success."

In response to FINRA's finding, the Firm argues only that "it must be remembered that all of the 166 allegedly violative communications ... do not relate to particular products or services." CapWest cites no authority to support its apparent position that these requirements apply only to testimonials in advertisements related to specific products or services, and there is nothing in Rule 2210 that would suggest that its scope is so limited. Rule 2210 applies equally to all member firm communications with the public.

E. CapWest's argument that the communications relating to TICs should be viewed in conjunction with the disclosures made in TIC offering documents is without merit because, under NASD Rules, advertisements must "stand on their own."

***8** CapWest's primary argument in opposition to FINRA's findings of Rule 2210 violations is that its communications should not be viewed in isolation, but rather in conjunction with the disclosures provided in the private placement memoranda ("PPMs") that the Firm claims would always be provided to investors in connection with a TIC offering. [47] CapWest complains that "the NAC abandons rationality and common sense, because it isolates each communication from the context in which it is made." But, in determining whether an advertisement violated NASD Rule 2210, we look to the content of the advertisement alone, and not to other documents associated with the offering. As we have stated, "Advertisements must stand on their own when judged against the standards of [Rule 2210]." [48] Providing customers with PPMs for certain of the TICs that CapWest sold would not cure the Firm's failure to provide a balanced presentation in the communications. [49] Communications must include a balanced discussion of the risks of an investment and may not depend "on scattered information available to the customer" (including in PPMs and other offering documents) for the requisite disclosure of such risks. [50] We therefore reject CapWest's general argument that its communications did not violate Rule 2210 since the PPMs would include risk and other disclosures that were not included in the communications themselves. [51]

F. CapWest violated NASD Rules 3010 and 2110 because it failed to implement its supervisory system effectively.

NASD Conduct Rule 3010 requires member firms to "establish and maintain" a supervisory system "reasonably designed to achieve" regulatory compliance. FINRA found that, although CapWest had "adequate" procedures in place during the Sweep Period, which required that all public communications be reviewed and approved by Firm supervisory personnel prior to being used by the Firm, the Firm violated Rule 3010 by failing to implement these procedures effectively, in that the supervisory-personnel did not have an adequate understanding of the Firm's obligations under Rule 2210.

On appeal, CapWest does not directly address the supervisory violations FINRA found, but states merely that "if the communications ... are not violative, supervision is not relevant." As discussed above, we find that the record amply supports FINRA's findings of Rule 2210 violations. In his testimony, CapWest's CEO acknowledged that, at the time of the sweep, he

was not fully aware of ""what the rules were" with respect to the Firm's compliance with NASD advertising requirements. His acknowledgment supports FINRA's finding that the supervisory system had not been implemented effectively at the time the Firm used the violative communications. Further, we agree with FINRA that the approval of all 166 violative communications by CapWest principals shows that those principals did not understand the content standards under Rule 2210 and thus could not effectively execute their supervisory duties. [52] Although the Firm had adequate supervisory procedures in place, it did not effectively implement them, which allowed the Firm to disseminate 166 violative public communications during a six-month period. The changes to the Firm's policies after the sweep, which were discussed by the Firm's CEO during his testimony, although commendable, do not excuse the violations. [53] Thus, we affirm FINRA's finding that CapWest violated NASD Rule 3010 by failing to implement its supervisory procedures effectively.

IV.

*9 Under Exchange Act Section 19(e)(2), we sustain FINRA sanctions unless we find that, giving due regard to the public interest and the protection of investors, the sanctions are excessive, oppressive, or impose an unnecessary or inappropriate burden on competition. [54] CapWest takes the position that it committed no violations and thus no sanction is warranted.

A. The $25,000 fine FINRA imposed for CapWest's Rule 2210 violations is not excessive or oppressive.

In assessing the appropriate sanction to impose on CapWest, FINRA looked to its Sanction Guidelines, which it promulgated to achieve greater consistency, uniformity, and fairness in its sanctions. [55] Although the Guidelines do not bind us, they serve as a benchmark for our review under Exchange Act Section 19(e)(2). [56] The Guidelines provide "Principal Considerations in Determining Sanctions," which apply to sanctions for any violation of FINRA Rules. [57] The Principal Considerations applicable to all violations identify several factors to be weighed, including: whether the respondent engaged in numerous acts or a pattern of misconduct; whether the respondent voluntarily employed subsequent corrective measures, prior to detection or intervention by a regulator, to revise general or specific procedures to avoid recurrence of misconduct; whether the respondent's misconduct was the result of an intentional act, recklessness, or negligence; and the level of sophistication of the injured or affected customer. [58] The Principal Considerations specifically applicable to Rule 2210 violations require adjudicators to weigh whether the violative communications were circulated widely. [59]

As discussed above, many of the advertisements and sales literature at issue here were widely circulated, in magazines and other publications that were available to the general public or on websites that were unrestricted. The NAC correctly found the wide circulation of many of the communications to be an aggravating factor in its sanction determination. [60] The NAC also noted as aggravating that the Firm's misconduct would not have stopped absent FINRA's sweep and its subsequent enforcement action against the Firm. [61] Further, because CapWest did not make changes to its supervisory system until after FINRA detected and intervened to stop the violations, the improvements the Firm made to its supervisory system are not mitigating in assessing the appropriate sanction for the Firm's violations. [62]

The Principal Considerations for Rule 2210 violations also recommend differing sanctions depending on whether the adjudicator finds that the violations were "inadvertent," as opposed to finding them to have been ""intentional or reckless." We agree with FINRA that CapWest's use of thirteen separate communications that included improper performance projections was egregious. Without providing the historical basis for such statements and without warning potential investors that past results do not guarantee future performance, the Firm misled the potential investors who received these communications by suggesting that they too could expect such returns. We also agree with FINRA that the Firm's use of six communications that touted the investor protections that regulatory oversight provides for TIC investments was misleading and egregious. By giving the impression that investors could rely on such protections to add "security" to their investments, the Firm made a highly misleading presentation. We find that the violations concerning these nineteen communications were at least reckless. For "intentional or reckless"

violations, the Guidelines recommend a fine of at least $10,000 per violation, and as much as $100,000 per violation.[63] For these egregious violations alone, FINRA could have imposed a $190,000 fine, at the minimum sanction level of $10,000 per violation authorized by the Guidelines.

*10 In addition to the egregious violations, FINRA found that CapWest committed at least 157 "inadvertent" violations of Rule 2210(d)(1)(A) and one ""inadvertent" violation of Rule 2210(d)(2)(a)(i) and (ii). We agree that these 158 violations were committed inadvertently. Under the Guidelines, FINRA could have imposed a minimum fine of $1,000 each for these violations for a total fine of $158,000.[64]

We have previously held that an NYSE Rule, analogous to Rule 2210, "serves an important policy objective by encouraging NYSE members and their associated persons to provide full and fair disclosure to their investors."[65] CapWest thwarted this policy goal through its use of 166 violative communications. The NAC exercised its discretionary authority, resulting in a significant reduction of the $150,000 fine the Hearing Panel imposed, even though the NAC concurred with the Hearing Panel's findings of violation.[66] FINRA's fine of $25,000 for *all* of the Firm's violations is not excessive or oppressive.

B. The $25,000 fine FINRA imposed for the Firm's violations of Rule 3010 is neither excessive nor oppressive.

FINRA's Sanction Guidelines set out sanctions recommendations for violations of Rule 3010 for failure to supervise. The Guidelines recommend a fine of $5,000 to $50,000. The Guidelines recognize the following principal considerations in determining sanctions for a failure to supervise: (1) whether the respondent ignored "red flag" warnings that should have resulted in additional supervisory scrutiny and whether individuals responsible for underlying misconduct attempted to conceal misconduct from the respondent; (2) the nature, extent, size, and character of the underlying misconduct; and (3) the quality and degree of the supervisor's implementation of the firm's supervisory procedures and controls. Although there is no evidence of any red flags or attempts to conceal the misconduct here, CapWest's CEO acknowledged that he did not realize "what the rules were" regarding the Firm's communications with the public, which indicates that the Firm had failed to address its supervisory responsibilities regarding regulatory compliance in an appropriate manner. Given the large number of violative communications over a relatively short six-month period and the apparent failure of Firm supervisors to recognize these violations, a fine of $25,000, in the middle of the recommended range, is neither excessive nor oppressive.

Under these circumstances, we conclude that FINRA's sanctions are justified under its Sanction Guidelines, result from a thoughtful weighing of the relevant facts, and are appropriately remedial because they will serve as a reminder that member firms must comply with the advertising rules and deter others from engaging in similar misconduct.[67]

*11 *****

We find that the sanctions imposed against CapWest are neither excessive nor oppressive and are appropriate remedial sanctions for the violations, and we sustain FINRA's findings of violations.

An appropriate order will issue.[68]

By the Commission (Chair WHITE and Commissioners AGUILAR, GALLAGHER, STEIN and PIWOWAR).
Elizabeth M. Murphy
Secretary

APPENDIX

NASD Rule Provision	Communications Violating the Provision

2210(d)(1)(A) - failure to make disclosures necessary for the communication to provide a fair and balanced presentation of the products and services being promoted or to provide a sound basis for evaluating such products or services	**154 Separate Communications**
	Referenced 1031 Exchanges without explaining their workings and features (127 distinct communications): CX-1, CX-2, CX-3, CX-4, CX-5, CX-6, CX-7, CX-30, CX-34, CX35, CX-36, CX-37, CX-39, CX-42, CX-43, CX44, CX-45, CX-47, CX-48, CX-49, CX-50, CX51, CX-52, CX-53, CX-54, CX-55, CX-56, CX57, CX-58, CX-59, CX-60, CX-61, CX-62, CX65, CX-66, CX-67, CX-69, CX-70, CX-71, CX72, CX-73, CX-76, CX-77, CX-78, CX-79, CX80, CX-81, CX-83, CX-84-157, CX-158, CX159, CX-160, CX-161, CX-162
	Referenced TIC investments without explaining their workings and features (84 communications, 2 distinct): CX-30, CX-46, CX-61, CX-76, CX-80, CX-81, CX-82, CX-84-157, Cx-160, CX-161, CX-162
	Touted benefits of TIC investments without balancing presentation of risks, such as illiquidity, risk of principal loss, and potential that management fees will outweigh potential tax benefits (126 communications, 25 distinct): CX-4, CX-9, CX-11, CX-12-29, CX-30, CX-33, CX-34-36, CX-37, CX-38, CX-39, CX-40, CX41, CX-42-45, CX-47, CX-48, CX-49, CX-58, CX-59, CX-61, CX-62, CX-65, CX-67CX-69, CX-70, CX-71, CX-72, CX-76, CX-77, CX-79, CX-80, CX-81, CX-82, CX-83, CX-84-157, CX159, CX-160, CX-162
2210(d)(1)(B) - communications that included exaggerated, unwarranted, or misleading statements.	**9 Total Communications**
	Exaggerated the protection afforded to investors by regulatory oversight of TIC investments: CX-5, CX-6, CX-8, CX-68, CX-76, CX-165
	Exaggerated the tax benefits of TIC investments: CX-9, CX-164, CX-167
2210(d)(1)(D) - communications that predicted or projected performance or implied that past performance will recur.	**13 Total Communications:**

	CX-5, CX-6, CX-31, CX-32, CX-38, CX-63, CX-64, CX-73, CX-74, CX-75, CX-76, CX-158, CX-166
2210(d)(2)(A)(i) and (ii) - use of customer testimonials without the required disclosures.	**1 Communication:** CX-62

In the Matter of the Application of CAPWEST SECURITIES, INC. c/o H. Thomas Fehn, Esq. Fields, Fehn & Sherwin 11755 Wilshire Blvd., 15th Floor Los Angeles, CA 90025

For Review of Disciplinary Action Taken by FINRA

ORDER SUSTAINING DISCIPLINARY ACTION TAKEN BY FINRA

On the basis of the Commission's opinion issued this day, it is

ORDERED that the disciplinary action, and the sanctions imposed, by FINRA on Cap West Securities, Inc. be, and they hereby are, sustained.

By the Commission.
Elizabeth M. Murphy
Secretary

Footnotes

1 CapWest became a FINRA member in 1992. The Firm's headquarters were in Lakewood, Colorado, and it maintained thirty branch offices with forty-five total registered representatives nationwide. On September 23, 2011, FINRA cancelled CapWest's registration because of the Firm's failure to pay outstanding fees, and the Firm is no longer in business. CapWest filed a brief in support of its appeal, but never filed a reply brief, as permitted by the briefing order.

2 On July 26, 2007, the Commission approved a proposed rule change that NASD filed seeking to amend its Certificate of Incorporation to reflect its name change to the Financial Industry Regulatory Authority, Inc. ("FINRA"), in connection with the consolidation of its member firm regulatory functions with NYSE Regulation, Inc. *See* Securities Exchange Act Release No. 56148, 2007 SEC LEXIS 1648 (July 26, 2007). Following the consolidation, FINRA began developing a new "Consolidated Rulebook" of FINRA Rules. The first phase of the new consolidated rules became effective on December 15, 2008. *See* Exchange Act Release No. 58643 (Sept. 25, 2008), 73 Fed. Reg. 57,174 (Oct. 1, 2008).

NASD Conduct Rule 2210 set forth content standards for member communications with customers or the public. On March 29, 2012, the Commission approved new FINRA rules governing member firm communications with the public, consolidated in FINRA Rule 2210, which became effective February 4, 2013. The new rules do not alter, in any material respect, the standards that FINRA applied in this case. *See FINRA Regulatory Notice 12-29*, 2012 FINRA LEXIS 36, at *40-43 (June 2012).

NASD Conduct Rule 2110 required members to "observe high standards of commercial honor and just and equitable principles of trade" in the conduct of their business. In September 2008, the Commission approved the new FINRA Rule 2010, which replaced NASD Rule 2110. The new rule, which became effective December 15, 2008, does not alter, in any material respect, the prior rule. *See FINRA Regulatory Notice 08-57*, 2008 FINRA LEXIS 50 (Oct. 2008).

FINRA's disciplinary action here was instituted after the consolidation of NASD and NYSE, but the conduct at issue took place before the relevant consolidated rules took effect. Accordingly, NASD conduct rules apply.

3 NASD Conduct Rule 3010 required, among other things, that members "establish and maintain a system to supervise the activities of" registered representatives and other associated persons "that is reasonably designed to achieve compliance with applicable securities laws and regulations, and with applicable NASD Rules." In July 2013, FINRA noticed a proposed new consolidated rule regarding supervision. Exchange Act Release No. 69902 (July 1, 2013), 78 FR 40792 (July 8, 2013) (Notice of Filing of a Proposed Rule Change to Adopt Rules Regarding Supervision in the Consolidated FINRA Rulebook).

4 FINRA also assessed hearing costs in the amount of $2,867.75.

5 26 U.S.C. § 1031(a)(1).

6 In a typical TIC, the profits (if any) are derived mostly through the efforts of the sponsor and the management company, which manage and lease the acquired property. *NASD Notice to Members 05-18*, 2005 NASD LEXIS 25, at *6 (Mar. 2005). The sponsor also ordinarily structures the TIC, including the up-front fees and expenses charged to the tenants-in-common, and negotiates the sale price and loan for the acquired property. *Id.* A TIC, standing alone, would not ordinarily constitute a security. *See id.*, at *6 n.5. But when a TIC is sold by a sponsor pursuant to a contractual arrangement and involves pooling assets and sharing the risks and rewards of the investment with other tenants-in-common, this generally constitutes an investment contract and, thus, a security. *See, e.g., SEC v. Edwards,* 540 U.S. 389, 394 (2004) (defining ""investment contract" as depending on "whether the scheme involves an investment ... with profits to come solely from the efforts of others" (citing *SEC v. W.J. Howey Co.*, 328 U.S. 293, 301 (1946)); *Anthony H. Barkate*, Exchange Act Release No. 49542. 2004 SEC LEXIS 806, at *10 (Apr. 8, 2004) (finding "an investment in a common enterprise with a reasonable expectation of profits to be derived from the entrepreneurial efforts of others" to be an investment contract).

7 2005 NASD LEXIS 25, at *4.

8 *Id.* at *10.

9 *Id.* at *11.

10 *Id.* at *8.

11 During the Sweep Period, CapWest sold 111 TIC securities to its customers, for a total value of $31.6 million.

12 The Firm's Written Supervisory Policies and Procedures regarding communications with the public, in effect at the time of the sweep, stated, "The [CapWest] Home Office or your [Office of Supervisory Jurisdiction] must pre-approve and receive final copies of *ALL* advertising done by registered representatives." (Emphasis in original.)

13 Some of the new procedures CapWest implemented after the sweep included tracking each individual piece of advertising, hiring a new compliance officer experienced with the advertising rules, sending the compliance officer to FINRA's annual advertising conferences, and tasking the compliance officer with ensuring that all communications with the public contain the appropriate disclosures identified by FINRA examiners in the sweep.

14 FINRA Rule 9312 authorizes the NAC to call for review on its own motion the disciplinary decisions of a FINRA hearing panel. Both parties submitted briefs and appeared at oral argument before the NAC.

15 CapWest did not appeal the Hearing Panel's decision to the NAC, nor did the NAC call for review on its own motion the portion of the Hearing Panel's decision in which it found Rule 3010 violations and imposed sanctions for those violations. Nonetheless, the NAC determined to "address [the supervisory] issues ... to provide the parties with a final FINRA decision that addresses all aspects of the case."

16 FINRA claims that CapWest "waived all claims to contest the Hearing Panel's findings that the Firm violated FINRA rules [by failing to appeal the Hearing Panel's decision to the NAC]." It is, however, the decision of the NAC, not the Hearing Panel, that is before us on appeal. In any event, when affirming a final FINRA disciplinary action, we must determine whether the FINRA member engaged in the acts or practices found by FINRA, and whether those acts or practices violated FINRA's Rules. *See* 15 U.S.C. § 78s(e)(1)(A) (directing the Commission to affirm FINRA disciplinary sanctions if it finds, among other things, that the applicant "has engaged in such acts or practices ... as the self-regulatory organization has found him to have engaged in [and] that such acts or practices ... are in violation of such provisions of ... the rules of the self-regulatory organization").

17 NASD Rule 2210(d)(1)(A). This subsection of the Rule further states, "No member may omit any material fact or qualification if the omission, in light of the context of the material presented, would cause the communications to be misleading."

18 NASD Rule 2210(d)(1)(B).

19 NASD Rule 2210(d)(1)(D). This provision permits "a hypothetical illustration of mathematical principles ... provided that it does not predict or project the performance of an investment or investment strategy."

20 NASD Rule 2210(d)(2)(A)(i) and (ii).

21 We have held that a violation of another NASD rule constitutes a violation of NASD Rule 2110. *See, e.g., Stephen J. Gluckman*, Exchange Act Release No. 41628, 54 SEC 175, 1999 SEC LEXIS 1395, at *22 (July 20, 1999).

22 The specific communications that we have found violative, which mirror those found by FINRA, are listed in the attached Appendix.

23 Specifically, 127 of the 154 communications referenced, in a promotional manner, 1031 Exchanges without providing any explanation of their workings and features; 84 of the 154 communications referenced TICs without providing an explanation of their workings and features; and 126 of the 154 communications promoted positive features of TICs without including a balancing disclosure regarding the potential risks of such investments. At least one of these failures applied to each of the 154 communications.

24 *See Pac. On-Line Trading & Sec., Inc.*, Exchange Act Release No. 48473, 56 SEC 1111, 2003 SEC LEXIS 2164. at *14 (Sept. 10, 2003) (holding that member firm's statement on its website that the firm provided the "fastest access to the market today" violated Rule 2210(d)(1)(A) because, without additional information, "it did not provide a basis for investors to evaluate the assertion").

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25 CX-42-CX-45. Each of the 166 communications that FINRA found violated NASD Rules was introduced as a hearing exhibit by FINRA's Department of Enforcement. We refer to them by their exhibit numbers, which are designated as "CX-__."

26 Some such risks, as discussed in *Notice to Members 05-18*, include the illiquidity of TIC securities (and the lack of a secondary market for such investments), the investor's loss of day- today control over property management decisions, the constraints resulting from the need for approval by other tenants-in-common regarding significant issues, such as upgrades or refurbishments to the property, the potentially significant management fees associated with a sponsored TIC investment, and the risk of loss of the principal invested. As Levine testified, "When you get into securitized tenant-in-common [investments], you don't have a direct say over day-to-day property management decisions. So if somebody wants to paint the building or something and cause you $30-80,000 in paint costs or something like that, if a majority votes on it, then it's done."

27 CX-12-CX-29.

28 *Jay Michael Fertman*, Exchange Act Release No. 33479, 51 SEC 943, 1994 SEC LEXIS 149, at *17 (Jan. 14, 1994). In order for an advertisement to be considered fair and balanced, it must include disclosure of relevant risks, including the risk of loss from the investment. *Pac. On-Line*, 2003 SEC LEXIS 2164, at *13-14 (citing *Fertman*).

29 *Philippe N. Keyes*, Exchange Act Release No. 54723, 2006 SEC LEXIS 2631, at *12 (Nov. 8, 2006) (finding that advertisement, which touted the ""solid growth" and "reliable income" of certain notes, was misleading and violated Rule 2210 because it did not disclose the risks caused by the illiquidity of the investments).

30 *Philip L. Spartis*, Exchange Act Release No. 64489, 2011 SEC LEXIS 1693, at *29-30 (May 13, 2011) (finding a violation of NASD Rule 2210(d)(1)(A) where the firm "fail[ed] to include any downside risk analysis").

31 *See Excel Fin., Inc.*, Exchange Act Release No. 39296, 53 SEC 303, 1997 SEC LEXIS 2292, at *16 (Nov. 4, 1997) (noting two-page summary's failure to include discussion of "the offering's contingent and speculative nature, including the possibility of an adverse tax ruling, the lack of liquidity in the securities, and the potential fluctuations of real estate values").

32 CX-5-CX-8.

33 CX-8.

34 CX-76.

35 *Cf. Pac. On-Line*, 2003 SEC LEXIS 2164, at *14 (finding that ""[i]mplying NASD endorsement" of a seminar, by stating that the principal leading the seminar had passed an NASD Series 24 exam, violated NASD rules); NASD Rule 2210 Interpretive Material ("IM") 2210-4 (stating, in connection with limitations on member firms' use of FINRA's name in public communications, that the member must "neither state nor imply that ... NASD or any other regulatory organization endorses, indemnifies or guarantees the member's business practices, selling methods, the class or type of securities offered, or any specific security").

36 CX-8, CX-68, and CX-165.

37 CX-9.

38 CX-164.

39 *Cf. Basic, Inc. v. Levinson*, 485 U.S. 224, 240 (1988) (stating that "materiality depends on the significance the reasonable investor would place on the withheld or misrepresented information," which is a fact-specific determination).

40 CX-5, 6, 76, 158.

41 CX-64. This document, entitled "Radio Interview Questions," is a seven-page suggested set of questions and answers for radio interviews related to a book about 1031 Exchanges and TICs written by the registered representative. The introduction to the document states, "The following questions are suggestions of those that may be asked in an interview - the structure and choice is up to the host."

42 CX-75.

43 Attached to its brief on appeal, CapWest included two exhibits. Exhibit A is an 87-page (not inclusive of introductory summary and exhibits) private placement memorandum, dated January 9, 2007, offering TIC securities in an entity called Cabot Turfway Ridge Acquisition, LLC, which was the owner of a 14.57-acre office park, including two office buildings, in Kentucky. Exhibit B is a full copy of a 2007 book "Effortless Cash Flow," authored by Kathy Heshelow.

Rule of Practice 452, 17 C.F.R. § 201.452, permits the submission of additional evidence based on a motion "show[ing] with particularity that such additional evidence is material and that there were reasonable grounds for failure to adduce such evidence previously." We exclude these two exhibits because CapWest did not file a motion to introduce the exhibits, and it neither explains why it did not adduce them previously, as both exhibits were available prior to the commencement of FINRA's disciplinary proceeding, nor shows their materiality. *See, e.g., Joseph S. Amundsen*, Exchange Act Release No. 69406, 2013 SEC LEXIS 1148, at *46 n.83 (Apr. 18, 2013) (declining to admit evidence attached to applicant's brief where applicant failed to file a motion to adduce the evidence and where the evidence applicant sought to adduce was irrelevant to the matters at issue) (citing *Robert D. Tucker*, Exchange Act Release No. 68210, 2012 SEC LEXIS 3496, at *58-60 (Nov. 9, 2012)). CapWest contends that anyone who ultimately invested in a TIC would receive a PPM including risk and other disclosures similar to those in Exhibit A. As discussed above, however, Rule 2210 does not

permit a member firm to rely on disclosures in other documents to fulfill its obligation to provide investors with a fair and balanced presentation. According to CapWest, Exhibit B (the "Effortless Cash Flow" book) establishes the "typical" rate of return for TICs during the period preceding the Firm's use of the communications at issue. Thus, according to the Firm, the advertisements projecting rates of return for TICs were based on historically accurate data, since the figures cited by the book roughly match those used in the violative communications. We first note that the book contains no support for the rates of return cited therein. Further, as discussed, it is not the historical rate of returns for TIC investments that is at issue here, but rather the Firm's failure to include information in the communications explaining the basis for the claims and noting that past performance is not necessarily predictive of future results.

44 *Daniel C. Montano*, Exchange Act Release No. 40243, 53 SEC 681, 1998 SEC LEXIS 2874, at *14 (July 22, 1998) (finding that registered representative's predictions in television advertisements of specific results and returns on investment implied to investors that they could expect to achieve such results, notwithstanding the representative's use of couching statements such as "you stand a chance" and "I think").

45 *Sheen Fin. Resources, Inc.*, Exchange Act Release No. 35477, 52 SEC 185, 1995 SEC LEXIS 613, at *12 (Mar. 13, 1995) (finding claims that investors in the products being touted could achieve specific returns and specific tax advantages by using the strategies discussed in the violative advertisements "imply that any investor may expect such results").

46 CX-62.

47 CapWest contends that the communications should be viewed "in the context of the total mix of information available to the prospective investor," the materiality standard articulated by the Supreme Court in *Basic*, 485 U.S. at 231-32, and *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 448-49 (1976). This misapprehends Rule 2210's focus. NASD Rule 2210 focuses not on all information that is available to a potential investor, but on the content of the communication itself, requiring that the communication on its own be "fair and balanced" and "provide a sound basis for evaluating the facts in regard to any particular security or type of security, industry, or service." It is in this context that the NASD Rule introduces the concept of materiality: "No member may omit any material fact or qualification if the omission, in light of the context of the material presented, would cause the communications to be misleading." *See supra* note 17. As a result, we determine materiality here by looking to whether a fact is substantially likely to be considered important by a reasonable person reading the communication. Further, in its argument that "by the end of the disclosure process CapWest provided investors with all the [risk] factors" associated with a TIC investment, CapWest essentially acknowledges that the communications at issue omitted material information regarding the workings, features, and risk factors associated with the investments.

48 *Sheen*, 1995 SEC LEXIS 613, at *12 (holding that "defects in the advertisements" cannot be cured through detailed explanations elsewhere of the risks of the investments being promoted).

49 *Excel*, 1997 SEC LEXIS 2292, at *19 (finding that member firm communications, including those aimed at accredited investors, must "contain a balanced statement of the benefits of the investment and its risks").

50 *Spartis*, 2011 SEC LEXIS 1693, at *39 n.43 (citing *Pac. On-Line*, 2003 SEC LEXIS 2164, at *15 ("disclaimers of the risks of online trading provided to customers at ... seminars and when ... customers opened new accounts" failed to cure firm's misleading advertisement because "[a]dvertisements must stand on their own" under NASD's public communications rule); *Donner Corp. Int'l*, Exchange Act Release No. 55313, 2007 WL 516282, at *10 (Feb. 20, 2007) ("The research reports themselves needed to convey a complete and accurate picture and could not depend on information available to investors."); and other cases).

51 In addition to the arguments discussed above, CapWest contests the qualifications of FINRA's sole hearing witness, investigator Levine. CapWest contends that Levine "is not a lawyer, not an accountant, not a real estate licensee, not securities licensed and had never testified before" and "has never owned an interest in commercial real estate." On these bases, CapWest claims that Levine "was not qualified to provide any expert opinion." Because CapWest claims that the NAC "relied solely upon" Levine's testimony, it argues that "the decision is not supported by any substantial evidence in the record."

We find that FINRA did not, as CapWest suggests, rely solely on Levine's testimony to reach its conclusion that CapWest had violated NASD Rules. Instead, FINRA reviewed each of the communications and made its own findings of violation based on that review. Further, as noted above, the Firm did not call a witness of its own, as it was permitted to do, to rebut Levine's testimony. In addition, Levine testified not, as CapWest contends, "about the intricacies of TICs or 1031 exchanges," but rather about whether the 166 communications complied with NASD advertising rules, with which Levine was extensively familiar. We previously have considered similar testimony in finding violations of SRO rules. *See, e.g., John R. D'Alessio*, Exchange Act Release No. 47627, 56 SEC 396, 2003 SEC LEXIS 806, at *37 (Apr. 3, 2003) (citing, in support of findings, hearing testimony of NYSE staff member that NYSE's regulatory position that sharing in profits and losses created an interest in an account). *Cf. Calais Res., Inc.*, Exchange Act Release No. 67312, 2012 SEC LEXIS 2023, at *8 (June 29, 2012) (citing Declaration of Commission staff member identifying material deficiencies in Commission filings in support of findings of violations). In any event, we have reviewed FINRA's findings *de novo* and agree, as discussed, that the communications violated the NASD Rules as alleged.

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52 *See Richard F. Kresge*, Exchange Act Release No. 55988, 2007 SEC LEXIS 1407, at *35 (June 29, 2007) (finding that NASD supervisory rules require members to ensure that supervisors understand and can effectively conduct their duties); *see also* NASD Rule 3010(a)(6) (requiring member firms to make "[r]easonable efforts to determine that all supervisory personnel are qualified by virtue of experience or training to carry out their assigned responsibilities").

53 *Cf. John B. Busacca III*, Exchange Act Release No. 63312, 2010 SEC LEXIS 3787, at *43 (Nov. 12, 2010) ("Reasonable supervision ... required Busacca ... to address known deficiencies promptly ... not only after regulatory action had commenced."); *Kresge*, 2007 SEC LEXIS 1407, at *37 ("Kresge's [remedial] actions occurred months after the misconduct at issue already had transpired and after [FINRA] began its investigation.").

54 15 U.S.C. § 78s(e)(2). CapWest does not claim, nor does the record show, that FINRA's action imposed an unnecessary or inappropriate burden on competition.

55 *Richard A. Neaton*, Exchange Act Release No. 65598, 2011 SEC LEXIS 3719, at *39 n. 38 (Oct. 20, 2011).

56 *Jason A. Craig*, Exchange Act Release No. 59137, 2008 SEC LEXIS 2844, at *18 n.27 (Dec. 22, 2008).

57 *Guidelines*, at 6-7.

58 In addition, under the General Principles Applicable to All Sanction Determinations, adjudicators are instructed that they "must always exercise judgment and discretion and consider appropriate aggravating and mitigating factors in determining remedial sanctions in each case." *Guidelines*, at 3.

59 *Id.* at 79.

60 It is an aggravating factor when the communications at issue are "freely available on [the member firm's] website and access to them [is] not restricted in any manner." *Donner*, 2007 WL 516282, at *13 n.64.

61 *Guidelines*, at 6 (consideration 3: "whether [a] ... member firm respondent voluntarily employed subsequent corrective measures, prior to detection or intervention ... by a regulator, to revise general and/or specific procedures to avoid recurrence of misconduct").

62 *Cf. Saad v. SEC*, 718 F.3d 904, 913-14 (D.C. Cir. 2013) (remanding proceeding where Commission did not fully address, in its sanctions analysis, the mitigative impact of the termination of applicant's employment before detection of the underlying misconduct by FINRA).

63 *Guidelines*, at 80.

64 *Id.* at 79.

65 *Spartis*, 2011 SEC LEXIS 1693, at *47-48.

66 Citing the *Guidelines*' statement that adjudicators, in assessing sanctions, should consider "the level of sophistication of the ... affected customer," the NAC noted, as mitigating, that "the target audience ... generally comprised accredited investors that already owned incomeproducing real estate and the ... financial professionals who advise them." While such circumstances are not relevant to the determination of liability, they can be considered in assessing sanctions, as was done here.

67 *See McCarthy v. SEC*, 406 F.3d 179, 189 (2d Cir. 2005) ("[G]eneral deterrence ... may be considered as part of the overall remedial inquiry.").

68 We have considered all the arguments advanced by the parties. We reject or sustain them to the extent that they are inconsistent or in accord with the views expressed herein.

Release No. 71340 (S.E.C. Release No.), Release No. 34-71340, 108 S.E.C. Docket 111, 2014 WL 198188

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SECURITIES AND EXCHANGE COMMISSION
Washington, D.C.

SECURITIES EXCHANGE ACT OF 1934
Rel. No. 37611 \ August 27, 1996

Admin. Proc. File No. 3-8871

In the Matter of the Application of

CREATIVE MEDICAL DEVELOPMENT, INC.
870 Gold Flat Road
Nevada City, CA 95959

For Review of Action Taken By the

NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.

OPINION OF THE COMMISSION

REGISTERED SECURITIES ASSOCIATION -- DENIAL OF TEMPORARY EXCEPTION FROM NASDAQ SMALLCAP MARKET CONTINUED INCLUSION STANDARDS

Financial Condition

Where registered securities association properly concluded that issuer of securities included on association's automated quotation system did not qualify for temporary exception to capital and surplus requirement held, review proceeding dismissed.

APPEARANCES:

John E. Hart, for Creative Medical Development, Inc.

T. Grant Callery and Shirley H. Weiss, for the National Association of Securities Dealers, Inc.

Appeal Filed: October 24, 1995
Last Brief Received: February 6, 1996

I.

Creative Medical Development, Inc. ("CMD" or "Company"), an issuer of securities formerly included in the Nasdaq SmallCap Market ("Nasdaq SmallCap"), appeals from a decision of the National Association of Securities Dealers, Inc. ("NASD" or "Association") denying the Company a temporary exception from Nasdaq SmallCap's requirement that an issuer maintain at least $1

million in capital and surplus. 1/ Our findings are based on

an independent review of the record.

II.

Until recently, CMD was a company that developed, manufactured, and marketed ambulatory infusion therapy products, such as electronic pumps, used for the injection of fluids by home health care providers and health care professionals in nursing homes and clinics. 2/ CMD's securities first were included in Nasdaq SmallCap in May 1994.

From its inception in 1992, and throughout the period during which its stock was included in Nasdaq SmallCap, the Company sustained continuing losses. CMD experienced a loss from operations of $587,224 for the nine-month period ended on September 30, 1993, and an additional loss from operations and a net loss of $1,900,785 and $2,140,498, respectively, for fiscal year 1994. Although the Company attributed these losses to development stage costs and other costs associated with producing its initial products, it continued to experience losses from operations throughout fiscal year 1995. For the first six months of that year alone, CMD suffered a loss from operations of $957,287, and a net loss of $1,027,758.

1/ Part II, Section 1(c)(3) of Schedule D to the NASD's By-Laws provides that, for continued inclusion on Nasdaq SmallCap, an issuer must have capital and surplus of at least $1 million. If a company's capital and surplus falls below the minimum required, and the company does not qualify for a temporary exception to that requirement, the NASD can "delist" the company's securities, i.e., remove them from Nasdaq's automated quotation system. See Biorelease Corporation, Securities Exchange Act of 1934 Rel. No. 35575 (April 6, 1995), 59 SEC Docket 84, 85 n.1.

2/ On September 13, 1995, CMD executed an Asset Purchase Agreement with Gish Biomedical, Inc. ("Gish"), by which it agreed to sell all of the Company's manufacturing and related assets, other than the Company's real estate. As of September 13, 1995, the Company's manufacturing business has been "operated for the benefit of and at the risk of Gish," and the Company since has treated its manufacturing business as a discontinued operation. See the Company's Form 10-KSB for fiscal year 1995 at 7, its Form 10-QSB for the period ended December 31, 1995, at 6, and its Proxy Statement for Special Meeting of Stockholders To Be Held February 21, 1996, dated January 31, 1996, at 37. We take official notice of these documents, all of which were filed with us after the NASD's decision. See, e.g., Gunther International Ltd., Exchange Act Rel. No. 37073 (April 5, 1996), 61 SEC Docket 2081, 2085; Biorelease Corporation, 59 SEC Docket at 91 n.16.

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As a result, CMD's capital and surplus decreased from $1,310,373 for fiscal year 1994 to $831,935 by December 31, 1994, the end of the first quarter of fiscal year 1995. This decrease was accompanied by a corresponding drop in CMD securities' Nasdaq SmallCap bid price from a high of 4.75 at the start of the first

quarter of fiscal year 1995 to a low of 1.12 during the second quarter of that year.

After reviewing the Company's Form 10-QSB for the quarter ended December 31, 1994, the NASD notified CMD by letter dated February 27, 1995 that the Company's capital and surplus had fallen below the minimum $1,000,000 required for continued inclusion. The NASD also advised that it would delist CMD's common stock on March 11, 1995 unless CMD demonstrated by that date that the Company complied with the minimum capital and surplus requirement. The NASD further explained that the Company could request a temporary exception from the requirement by submitting by March 11, 1995 a plan of action that would enable the Company to achieve full compliance.

CMD responded to this letter by requesting a temporary exception to the capital and surplus requirement. CMD thereafter provided two written submissions to the Nasdaq Listing Qualifications Committee ("Qualifications Committee").

In the first submission, dated April 10, 1995, CMD explained that its capital deficiency was "directly related to delays in product introduction" that "resulted in lower sales income and commensurately higher losses eroding" the Company's capital. The Company further explained that it was pursuing a private placement "of approximately one million dollars" that would bring it into compliance with the minimum capital and surplus requirement. CMD also advised that it was about to sign a new distribution arrangement that would "ensure operating revenues sufficient to maintain compliance."

In its second submission, dated April 19, 1995, CMD stated that, in addition to proceeding with the $1,000,000 private placement offering, it had "been in serious negotiations with several potential strategic partner/national distributors for transactions that would involve cash infusions of $1,000,000 or more." The Company explained that, although it had anticipated consummating one of the transactions that week, the other party had placed the negotiations on hold. Because the Company was optimistic that this or one of the other transactions under negotiation would be completed by June 30, 1995, it requested a temporary exception until that time.

On May 10, 1995, the Qualifications Committee denied CMD's request for a temporary exception. The Committee based its denial on two grounds. First, the Committee stated that "there was no evidence ensuring the completion of the company's proposed plan in the immediate future." Second, in the Committee's view, even if the Company consummated its proposed plan, "it was

doubtful that the proceeds from the proposed transaction would be sufficient to demonstrate compliance on a current basis, given the company's history of operating losses." Accordingly, on May 11, 1995, the NASD removed CMD's securities from Nasdaq SmallCap.

The Company thereafter requested that the Nasdaq Hearing Review Committee ("Review Committee") review the Qualifications Committee's denial of its request for a temporary exception. The NASD informed CMD that the Review Committee would consider the

Company's appeal based on the written record, "including any submission [the Company] may wish to make," and instructed CMD to submit such additional information by June 30, 1995. The NASD further informed the Company that the Review Committee would issue its decision following the September 1995 meeting of the NASD's Board of Governors.

On the morning of September 18, 1995, the Company sent by facsimile transmission to the NASD its only submission on appeal, a letter that provided the following additional information, with certain supporting documentation:

> On September 13, 1995, the Company entered into a definitive agreement with Gish Biomedical, Inc. for sale of substantially all of its assets. The consideration to the Company is $2,000,000 value of Gish common stock and $600,000 cash. The Company will retain its real estate asset [sic] and, after the closing of the transaction, have a net worth of approximately $2,000,000. 3/

On September 21, 1995, the Review Committee issued its decision affirming the Qualifications Committee's denial of the Company's temporary exception request. The Review Committee explained that its decision was based on the information in the record before the Qualifications Committee, as the Company had provided no additional submission on appeal -- including no information regarding proposed equity infusions. 4/ The Review Committee

3/ The Company attached to its letter a copy of its Form 10-QSB, for the period ended June 30, 1995. This filing disclosed that the Company had continued to experience losses, including a loss from operations of $197,228 and a net loss of $233,833 for the reporting period. See the Company's Form 10-QSB, for the period ended June 30, 1995, at 2. This filing further disclosed that, for the first three quarters of fiscal year 1995, the Company had suffered a loss from operations totaling $1,154,514 and a net loss of $1,261,590.

4/ The Review Committee observed in its decision that the Company's capital and surplus had plummeted to $313,215 by the end of the second quarter of fiscal year 1995. The Review Committee further observed that, for the second (continued...)

did not acknowledge in its decision the Company's September 18, 1995 letter. Indeed, the NASD specified in the Amended Certification of the Record filed in this matter that the letter was not part of the record before the Review Committee.

III.

Section 19(f) of the Securities Exchange Act of 1934 (the "Exchange Act") governs our review. Under Section 19(f), if we determine that the specific grounds on which the NASD's action is based exist in fact, that such action is in accordance with applicable NASD rules, and that these rules are and were applied in a manner consistent with the purposes of the Exchange

Act, we must dismiss this appeal unless we find that the NASD's action imposes an unnecessary or inappropriate burden on competition. 5/

We conclude that the NASD reasonably determined, in accordance with its applicable rules, to deny the Company a temporary exception to the Nasdaq SmallCap continued inclusion requirements. CMD was provided an opportunity to establish that in the near term it would satisfy the minimum capital and surplus requirement. Having failed to make that showing, it could receive an exception only if CMD provided timely documentation to the Review Committee to demonstrate that it would achieve the requisite minimum capital and surplus levels.

The Company, however, failed to submit any such documentation by the June 30, 1995 deadline imposed by the Review Committee, or to request an extension of that deadline. The Review Committee acted reasonably in closing the record when it did and concluding, based on the record before it, that the Qualifications Committee acted properly in denying CMD a temporary exception. 6/

4/(...continued)
quarter ended March 31, 1995, (1) product sales were $140,000 less than those reported for the preceding quarter, and $11,000 less than those reported for the quarter ended on March 31, 1994, and (2) the Company reported a total net loss of $1,027,758 for the first two quarters of fiscal year 1995.

5/ See Biorelease Corporation, 59 SEC Docket at 89 n.10; see also KLH Engineering Group, Inc., Exchange Act Rel. No. 36422 (October 26, 1995), 60 SEC Docket 1714, 1718 n.8.

6/ The company's filings confirm that none of the Company's capital raising proposals in fact were successful by either the June 30, 1995 deadline for compliance that the Company itself proposed, or the date the Review Committee's decision issued (September 21, 1995).

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We reject CMD's sole argument on appeal that, because on September 18, 1995 the Company sent by facsimile transmission to the NASD information regarding the sale of its business assets to Gish Biomedical, Inc. ("Gish"), the Review Committee erred when that Committee found, in its decision issued three days later, that the Company had failed to provide an additional submission on appeal including information regarding proposed equity infusions. We conclude that the information about the Gish transaction was provided too late and, in any event, was insufficient to establish the appropriateness of an exception.

CMD's Commission filings reveal that: (1) by the end of July 1995, the Company had reached an agreement with Gish concerning the terms of the transaction discussed in its September 18 letter, and (2) on September 13, 1995, the Company executed its final written agreement with Gish embodying those terms. The Company has offered no explanation for its delay in providing the

NASD with information about the Gish transaction; it appears that CMD did not take seriously its burden of demonstrating its qualification for a temporary exception.

Moreover, the September 18, 1995 letter represented only that the Company had reached a definitive agreement with Gish and that, after the transaction closed, the Company would have a net worth of approximately $2,000,000. The Company submitted no documentation in support of its representations, and failed even to state when the transaction would close. Subsequent filings with this Commission reflect that the Company consummated the Gish transaction eight months after the September 18th letter, and eleven months after the Qualifications Committee's decision denying a temporary exception. 7/

We accordingly reject CMD's request that we vacate the Review Committee's decision and remand this proceeding to the NASD for the Association's consideration of evidence that, the Company proffers, establishes that "the Company now is in compliance and will have the ability to maintain compliance." We agree with the NASD that the Company should not be permitted to use its appeal to demonstrate that it now is in compliance with the Nasdaq SmallCap maintenance requirements. 8/

7/ The Company represents in a supplemental filing that the Gish transaction closed on April 17, 1996. We have considered this filing, as well as the NASD's responsive filing.

8/ Should the Company determine again to seek inclusion on Nasdaq SmallCap, it will be required to meet the initial inclusion requirements of at least $4 million in total assets and $2 million in capital and surplus. See Part II, Section 1(c)(2) and (3) of Schedule D to the NASD By-Laws.

We find that, in this matter, the NASD applied its rules in a manner consistent with the purposes of the securities laws. As we have stated previously:

> Though exclusion from the system may hurt existing investors, primary emphasis must be placed on the interests of prospective future investors. The latter group is entitled to assume that the securities in the system meet the system's standards. Hence, the presence in NASDAQ of non-complying securities could have a serious deceptive effect. 9/

In this case, the Company was afforded substantial leeway to demonstrate that it qualified for a temporary exception, but failed to make this showing. We conclude that the NASD's decision to deny the Company a temporary exception comported with investor protection. 10/

IV.

For the foregoing reasons, we find that the NASD's

determination to deny CMD a temporary exception from Nasdaq SmallCap's continued inclusion criteria comported with Section 19(f) of the Exchange Act. Accordingly, we dismiss this review proceeding.

An appropriate order will issue.

By the Commission (Chairman LEVITT and Commissioners WALLMAN, JOHNSON, and HUNT).

Jonathan G. Katz
Secretary

9/ Tassaway, Inc., 45 S.E.C. 706, 709 (1975). Tassaway also involved a company that claimed to be "on the verge of effecting an acquisition" that would cure its capital and surplus deficiency.

10/ See id.; see also ORS Automation, Inc., 48 S.E.C. 490, 494 (1986); Biorelease Corporation, 59 SEC Docket at 92; KLH Engineering Group, Inc., 60 SEC Docket at 1720.

UNITED STATES OF AMERICA
before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Rel. No. 37611 \ August 27, 1996

Admin. Proc. File No. 3-8871

In the Matter of the Application of

CREATIVE MEDICAL DEVELOPMENT, INC.
870 Gold Flat Road
Nevada City, CA 95959

For Review of Action Taken By the

NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.

ORDER DISMISSING REVIEW PROCEEDING

On the basis of the Commission's opinion issued this day, it is

ORDERED that the application for review filed by Creative Medical Development, Inc. be, and it hereby is, dismissed.

By the Commission.

Jonathan G. Katz
Secretary

Release No. 36422 (S.E.C. Release No.), Release No. 34-36422, 60 S.E.C. Docket 1460, 1995 WL 630915

S.E.C. Commission (S.E.C.)
Securities Exchange Act of 1934

SECURITIES AND EXCHANGE COMMISSION (S.E.C.)

IN THE MATTER OF THE APPLICATION OF KLH ENGINEERING GROUP, INC.
7400 EAST CALEY AVENUE, SUITE 210
ENGLEWOOD, COLORADO 80111
FOR REVIEW OF ACTION TAKEN BY THE NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.

Admin. Proc. File No. 3-8574
October 26, 1995

OPINION OF THE COMMISSION

*1 REGISTERED SECURITIES ASSOCIATION -- DELISTING FROM THE NASDAQ SMALLCAP MARKET
Financial Condition
Where registered securities association revoked an exception permitting a security to remain on its automated quotation system notwithstanding the issuer's noncompliance with the required standards for capital and surplus, held, review proceeding dismissed.

APPEARANCES:
Michael A. Cederstrom, General Counsel of KLH Engineering Group, Inc., for the Corporation.
T. Grant Callery and Norman Sue, Jr., for the National Association of Securities Dealers, Inc.
Appeal filed: December 9, 1994

Last brief received: February 23, 1995

I.

KLH Engineering Group, Inc. ("KLH" or the "Company"), an issuer formerly listed on the Nasdaq SmallCap Market ("SmallCap"), appeals from a decision of the National Association of Securities Dealers, Inc. ("NASD"). KLH had received an exception from the Nasdaq SmallCap listing requirements because the Company had failed to maintain $1 million in capital and surplus. [1] The NASD subsequently revoked its grant to KLH of an exception from the SmallCap listing requirements and delisted the Company's securities. In revoking the exception, the NASD found that material changes had occurred after it had granted KLH an exception. Our findings are based on an independent review of the record.

II.

KLH provides civil engineering design and related services. Until August 1994, its securities traded on the Nasdaq SmallCap Market. In May 1994, the NASD notified KLH that the Company was delinquent in filing its report on Form 10-K or the equivalent for the calendar year 1993. The NASD warned KLH that its securities would be delisted within 10 business days if the NASD did not receive the Company's Form 10-K evidencing compliance with Nasdaq SmallCap listing criteria. The NASD's letter also stated that, if KLH were unable to report in a timely fashion, it could seek a temporary exception from the listing requirements.

In response, KLH asked for a temporary exception from those requirements. In materials submitted by KLH, KLH admitted that its stock price was then under $1.00 per share and that the Company had less than $1 million in capital and surplus. KLH

also stated that it had not yet filed reports on Form 10-K for the calendar year ended 1993, or Form 10-Q for the first quarter of 1994. KLH included an unaudited balance sheet, as of March 31, 1994, that showed that the Company had capital and surplus of $781,257, less than the required $1 million maintenance SmallCap listing requirement.

KLH also briefly set forth its plan to achieve compliance. The Company explained that it planned to cure its deficiencies through an "acquisition" of Tomahawk Construction Company ("Tomahawk), a privately-held corporation that was much larger than KLH. Under the proposed acquisition, Tomahawk would be a wholly-owned subsidiary of KLH, and the owner of Tomahawk, Delmar Janovec, would own 70% of the post-combination KLH.

*2 At the oral hearing before the Nasdaq Listing Qualifications Committee ("Qualifications Committee"), the NASD staff noted that, pursuant to NASD By-Laws, [2] if a Nasdaq-listed company merged with a privately-held company, and the merger resulted in a change in control and a change of financial structure or business plan, the post-combination entity would be required to meet the criteria for initial inclusion on Nasdaq. Under the initial Nasdaq SmallCap listing criteria, an issuer must have, among other things, at least $4 million in assets and at least $2 million in capital and surplus to be listed on the quotation system. [3] KLH management represented that the acquisition of Tomahawk would remedy the Company's capital and surplus deficiency, and that the new KLH would "absolutely" meet the initial listing criteria. [4] Management also represented that Tomahawk had advanced the funds necessary to complete KLH's 1993 financial audit and the filing of its overdue disclosure reports.

Following the hearing, on June 23, 1994, the Qualifications Committee granted KLH an exception from the listing requirements, subject to certain conditions. The Committee required KLH to file both its Form 10-K for calendar year 1993, and its first quarter 1994 Form 10-Q by June 30, 1994. The Committee further required that the first quarter Form 10-Q evidence compliance with all criteria necessary for continued inclusion on the Nasdaq SmallCap Market, with the exception of the capital and surplus requirement. If KLH complied with these requirements, the exception would permit it to remain listed and complete the combination with Tomahawk. The Committee required KLH, by September 12, 1994, to file a Form 8-K evidencing compliance with all Nasdaq SmallCap initial inclusion criteria. The Committee further required KLH promptly to notify the NASD of any significant events that occurred during the exception period. The Committee reserved the right to reconsider the terms of the exception if a material change occurred in KLH's financial or operational character.

In a Form 8-K dated June 27, 1994, four days after it was granted the exception, KLH disclosed the resignations of two of its officers and directors as a result of disputes arising from KLH's proposed combination with Tomahawk. [5] The Form revealed that, on June 26, Randall Hilton, the corporate secretary, had resigned, stating, in his resignation letter attached to the 8-K, that "[d]isagreement with the goals and philosophy of the company will hinder my performance as a director." Hilton referred to the issuance of certain stock options in connection with the Tomahawk acquisition and that the executed acquisition agreement between Tomahawk and KLH did "not reflect . . . verbal agreements."

The Form further revealed that, on June 27, KLH had terminated Richard Kendall, its president and chief executive officer. Kendall had also submitted a letter of resignation, attached to the 8-K, detailing his concerns about the proposed issuance of stock options to certain parties, referred to as "consultants." Kendall questioned the extent of the consultants' resulting ownership and involvement in KLH's financing and business operations. Kendall also suggested that issuance of the options was an attempt to gain control of the Company and circumvent the securities registration requirements. In the Form 8-K disclosing the resignations, KLH denied any wrongdoing.

*3 On June 30, 1994, KLH filed its 1994 first quarter Form 10-QSB and its Form 10-KSB for the year ending December 31, 1993. The 10-QSB disclosed capital and surplus of $435,799, well below the Company's earlier unaudited estimate. On July 22, 1994, the Qualifications Committee informed KLH that, based on the June 27 Form 8-K, the Committee believed the status of KLH had materially changed and that it was therefore reviewing the exception.

The NASD staff submitted to the Qualifications Committee and to KLH a memorandum outlining its concerns. The staff noted both the two resignations disclosed in the June 28, 1994 Form 8-K, and the accession of Janovec, the president of Tomahawk, as KLH's new president. The staff's memorandum also raised concern over the involvement with KLH of one Alan Wolfson. Wolfson, while acting as a consultant to Tomahawk, had introduced Tomahawk to KLH. Wolfson previously had been convicted of, among other things, making a false statement on a bank loan, and had been placed on probation, subject to certain conditions restricting his involvement in business activities. At the initial hearing before the Committee, KLH had represented that Wolfson would be issued a number of options sufficient to become a 10% shareholder in KLH following the combination with Tomahawk. The NASD staff's memorandum noted that Kendall's resignation letter suggested that Wolfson would actually become a much larger owner of KLH stock. In addition, the NASD staff noted that this Commission's Division of Enforcement was conducting an investigation of KLH.

KLH submitted a response explaining its position and rebutting the NASD staff's memorandum. [6] Among other things, KLH noted that Hilton, although he had resigned as corporate secretary, remained an employee, that KLH had terminated Kendall based on several problems regarding his management, and that Wolfson would have a 12.8% beneficial interest in KLH, which was in line with the 10% representation made at the hearing. KLH also stated that Wolfson's shares would be restricted, and that the Company did not desire any further relationship with Wolfson. On August 3, the Qualifications Committee revoked the exception and delisted KLH securities as of August 4, 1994.

KLH appealed its delisting to the Nasdaq Hearing Review Committee ("Review Committee") on August 15, 1994. Soon thereafter, KLH filed its report on Form 10-QSB for the second quarter of 1994. The unaudited report disclosed that KLH had only $670,410 in capital and surplus. The report also attached an unaudited pro forma consolidated balance sheet showing the combined financial condition of Tomahawk and KLH, including approximately $3.5 million in capital and surplus. [7]

In September, while its appeal to the Review Committee was pending, KLH filed a Form 8-K disclosing that, on September 15, 1994, Tomahawk Construction Company filed a bankruptcy petition pursuant to Chapter 11 of the Bankruptcy Code. On December 2, 1994, the Review Committee issued its decision. The Review Committee noted that KLH had emphasized the benefits of its merger with Tomahawk and had proffered the merger as the means for the Company's compliance with Nasdaq SmallCap listing criteria. In light of Tomahawk's bankruptcy and the uncertainty of its continued viability, the Review Committee stated that it "would be inadvisable to grant KLH an exception to the capital and surplus requirement." The Review Committee also noted its concern over the extent of Wolfson's ownership interest in KLH, a matter that had not been investigated "definitively" at the time of the Committee's decision. The Review Committee therefore denied KLH's request for an exception to the capital and surplus requirement.

III.

*4 KLH seeks reversal of the NASD's action and reinstatement of its Nasdaq SmallCap listing. In general, we determine whether the specific grounds on which such NASD action is based exist in fact, whether such action is in accordance with applicable NASD rules, and whether these rules are and were applied in a manner consistent with the purpose of the securities laws. [8]

We believe that the NASD acted properly when it revoked KLH's exception. The Qualifications Committee had placed express conditions on the exception that it gave KLH. Those conditions were never fulfilled. Moreover, material changes that were clearly matters for concern were disclosed only four days after the Qualifications Committee had granted the exception. [9]

The Review Committee's subsequent decision that KLH failed to demonstrate its ability to meet minimum capital and surplus requirements is amply supported by the record. The most recent filing by KLH at the time of the Review Committee's decision showed capital and surplus of only $670,410. [10] Thus, KLH's capital and surplus, excluding the bankrupt Tomahawk

Construction Company, was below the maintenance listing requirement of $1 million, let alone the initial listing requirement of $2 million.

The NASD further properly excluded Tomahawk's balance sheet in its consideration of KLH's compliance with the listing requirements. KLH received its original exception to the capital and surplus requirements based on its representations regarding the effect that the proposed combination with Tomahawk would have on its financial condition. [11] Tomahawk's bankruptcy filing, at a minimum, created very serious uncertainty regarding Tomahawk's actual financial condition and the extent of its obligations to creditors. [12] Therefore, the NASD reasonably excluded the bankrupt Tomahawk's contribution to KLH's capital when it determined KLH's compliance with the minimum listing requirements. [13]

KLH argues that the NASD's action violates Section 525 of the Bankruptcy Code, [14] which generally prohibits disparate treatment of an entity that has filed bankruptcy. We disagree. Section 525 states, in pertinent part, that
a governmental unit may not deny, revoke, suspend, or refuse to renew a license, permit, charter, franchise, or other similar grant to, condition such a grant to, discriminate with respect to such a grant against, . . . a person that is or has been a debtor under this title or a bankrupt or a debtor under the Bankruptcy Act, or another person with whom such bankrupt or debtor has been associated, solely because such bankrupt or debtor is or has been a debtor under this title. [15]

The legislative history explains that this provision "does not prohibit consideration of other factors, such as future financial responsibility or ability, and does not prohibit imposition of requirements such as net capital rules, if applied non-discriminatorily." [16]

Under the circumstances, no prohibited discrimination has occurred. KLH itself has not filed a bankruptcy petition. The minimum listing requirements are meant to protect investors and the integrity of the market, and are non-discriminatory. [17] Public investors rely on the standards provided by Nasdaq, and are entitled to assume that listed securities meet its minimum listing requirements. As the Commission has previously recognized, the presence of non-complying securities has the potential to cause serious deception. [18] In our view, the NASD's minimum listing requirements are a broad, nondiscriminatory regulatory scheme that provide protection to the public, like the net capital requirements to which Congress referred. The NASD delisted KLH because of its deficient capital and surplus position, not because of the bankrupt status of its subsidiary. KLH was in a deficient position before the acquisition of Tomahawk. KLH continued in a deficient capital and surplus position and was properly delisted. [19] KLH's arguments to the contrary are not convincing. [20]

IV.

*5 We find that a sufficient factual basis existed to delist KLH, that the NASD acted fairly and in accordance with its Rules which are, and were applied in a manner, consistent with the purposes of the securities laws. Accordingly, this review proceeding should be dismissed. [21]

By the Commission (Chairman LEVITT and Commissioner WALLMAN).
Jonathan G. Katz
Secretary

Footnotes

1 Section 1(c)(3) of Part II of Schedule D to the NASD's By-Laws provides that, for continued inclusion on the Nasdaq SmallCap Market, an issuer must maintain capital and surplus of at least $1 million. NASD Manual (CCH) ¶1803, p. 1568.

2 Section 3(f) of Part II of Schedule D to the NASD By-Laws. NASD Manual (CCH) ¶1803, pp. 1574-5.

3 Sections 1(c)(2) and (3) of Part II of Schedule D to the NASD By-Laws. Among the other requirements for initial inclusion, the issuer's securities must have a minimum bid price of $3 per share. Id. at Section 1(c)(4). NASD Manual (CCH) ¶1803, p. 1568.

4 KLH submitted an unaudited pro forma balance sheet showing that the post-combination entity would meet required initial capital and surplus criteria.

5 Although KLH filed the Form 8-K prior to the Qualifications Committee's June 30 deadline for filing the periodic disclosure statements, the Company did not send the Form 8-K directly to the NASD staff, as the Committee had required.

6 KLH did not request, and the Committee did not hold, an oral hearing on this determination.

7 While this document contained figures that, if accurate, demonstrated assets and capital and surplus sufficient to meet Nasdaq SmallCap initial listing requirements, the filing did not demonstrate that the combination of KLH and Tomahawk was in fact completed, as required by the exception.

8 See Section 19(f) of the Securities Exchange Act of 1934; Biorelease Corporation, Securities Exchange Act Release No. 35575 (April 6, 1995), 59 SEC Docket 84, 89.

9 The Qualifications Committee's decision revoking the previously granted exception did not contain the reasons supporting the panel's conclusion, as required by Section 5 of Article IX of the NASD's Code of Procedure. NASD Manual (CCH) ¶3105, p. 3043. The Review Committee's decision, however, provided a detailed explanation of its reasoning, and it is the Review Committee's decision that now is before us. KLH had adequate opportunity to present its position before both Committees, and any omission by the Qualifications Committee was harmless.

10 This figure was unaudited.

11 KLH relied on unaudited pro forma statements showing the combined capital and surplus of the entities. The record before the NASD contains no audited financial statements for Tomahawk.

12 KLH argues that it completed the merger with Tomahawk prior to August, and that the company met the capital requirements prior to being delisted. Although public documents on file with the Commission, of which we take official notice, indicate that the merger was consummated on July 27, 1994, without a general shareholder vote, KLH has not included in the record any proof of the actual date of the acquisition, nor any proof of formal shareholder action, if any, on the transaction. The Company also has not complied with the terms of the original conditional exception. It has failed to file a Form 8-K evidencing compliance with all Nasdaq initial inclusion requirements, as specified in the exception.

13 We note, in this regard, that NASD rules allow for delisting from Nasdaq of a company that has filed for bankruptcy. Section 3(a) of Part II of Schedule D to the NASD By-Laws. NASD Manual (CCH) ¶1805, p. 1574.

14 11 U.S.C. Section 525(a).

15 Id.

16 S. Rep. No. 95-989, 95th Cong., 2nd Sess. 81 (1978).

17 See Biorelease Corp., Securities Exchange Act Release No. 35575 (April 6, 1995), 59 SEC Docket 84; Tassaway, Inc., 45 S.E.C. 706, 709 (1975).

18 ORS Automation, Inc., 48 S.E.C. 490, 494 (1986).

19 Prior to the 1978 amendments to the bankruptcy laws, decisions to delist securities were within the primary jurisdiction of the self-regulatory organizations and the Commission, notwithstanding an issuer's bankruptcy. See Cavanaugh Communities Corp. v. NYSE, 422 F.Supp. 382 (S.D.N.Y. 1976). No authority holds that the amendments altered this.

20 KLH also has argued that the NASD improperly considered the involvement of the consultant Wolfson in the affairs of KLH. We need not reach this argument because we have found sufficient other grounds existed to support the NASD's decision.

21 All of the contentions advanced by the parties have been considered. They are rejected or sustained to the extent that they are inconsistent or in accord with the views expressed in this opinion.

Release No. 36422 (S.E.C. Release No.), Release No. 34-36422, 60 S.E.C. Docket 1460, 1995 WL 630915

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103 S.Ct. 2856
Supreme Court of the United States

MOTOR VEHICLE MANUFACTURERS ASSOCIATION OF the UNITED STATES, INC., et al., Petitioners
v.
STATE FARM MUTUAL AUTOMOBILE INSURANCE COMPANY et al.
CONSUMER ALERT, et al., Petitioners
v.
STATE FARM MUTUAL AUTOMOBILE INSURANCE COMPANY et al.
UNITED STATES DEPARTMENT OF TRANSPORTATION, et al., Petitioners
v.
STATE FARM MUTUAL AUTOMOBILE INSURANCE COMPANY et al.

Nos. 82–354, 82–355 and 82–398.
|
Argued April 26, 1983.
|
Decided June 24, 1983.

Synopsis
Insurance companies petitioned for review of an order of the National Highway Traffic Safety Administration rescinding crash protection requirements of federal motor vehicle safety standard. The Court of Appeals, 680 F.2d 206, held that the rescission was arbitrary and capricious. On petition for writ of certiorari, the Supreme Court, Justice White, held that the National Highway Traffic Safety Administration acted arbitrarily and capriciously in revoking the requirement in motor vehicle safety standard 208 that new motor vehicles produced after September of 1982 be equipped with passive restraints to protect the safety of the occupants of the vehicle in the event of a collision; the agency failed to present an adequate basis and explanation for rescinding the passive restraint requirement, and the agency thus either had to consider the matter further or adhere to or amend standard 208 along lines which its analysis supported.

Vacated and remanded.

Justice Rehnquist filed an opinion concurring in part and dissenting in part, in which Chief Justice Burger, Justice Powell, and Justice O'Connor joined.

West Headnotes (23)

[1] **Automobiles**
Subjects of regulations in general
National Highway Traffic Safety Administration acted arbitrarily and capriciously in revoking the requirement in motor vehicle safety standard 208 that new motor vehicles produced after September of 1982 be equipped with passive restraints to protect the safety of the occupants of the vehicle in the event of a collision; the agency failed to present an adequate basis and explanation for rescinding the passive restraint requirement, and the agency thus either had to consider the matter further or adhere to or amend standard 208 along lines which its analysis supported. National Traffic and Motor Vehicle Safety Act of 1966, §§ 1 et seq., 103(a, b), (f)(1, 3, 4), as amended, 15 U.S.C.A. §§ 1381 et seq., 1392(a, b), (f)(1, 3, 4); 5 U.S.C.A. § 706.

19 Cases that cite this headnote

[2] **Automobiles**
Subjects of regulations in general
Both the Motor Vehicle Safety Act and the 1974 amendments concerning occupant crash protection standards indicate that motor vehicle safety standards are to be promulgated under the informal rulemaking procedures of the Administrative Procedure Act. National Traffic and Motor Vehicle Safety Act of 1966, § 1 et seq., as amended, 15 U.S.C.A. § 1381 et seq.; 5 U.S.C.A. § 553.

2 Cases that cite this headnote

[3] **Automobiles**
Subjects of regulations in general

National Highway Traffic Safety Administration's action in promulgating occupant crash protection standards may be set aside if found to be "arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law." National Traffic and Motor Vehicle Safety Act of 1966, § 1 et seq., as amended, 15 U.S.C.A. § 1381 et seq.; 5 U.S.C.A. § 706(2)(A).

217 Cases that cite this headnote

[4] **Automobiles**
Subjects of regulations in general
Rescission of a motor vehicle occupant crash protection standard is subject to the same standard of judicial review—the "arbitrary and capricious" standard—as is the promulgation of such a standard, and should not be judged by the standard used to judge an agency's refusal to promulgate a rule in the first place. National Traffic and Motor Vehicle Safety Act of 1966, § 103(b), as amended, 15 U.S.C.A. § 1392(b).

92 Cases that cite this headnote

[5] **Automobiles**
Subjects of regulations in general
Motor Vehicle Safety Act expressly equates orders "revoking" and "establishing" safety standards; neither that Act nor the Administrative Procedure Act suggests that revocations are to be treated as refusals to promulgate standards. National Traffic and Motor Vehicle Safety Act of 1966, §§ 1 et seq., 103(b), as amended, 15 U.S.C.A. §§ 1381 et seq., 1392(b).

1 Cases that cite this headnote

[6] **Automobiles**
Subjects of regulations in general
View of Motor Vehicle Manufacturers Association, viz., that the rescission of a rule of the National Highway Traffic Safety Administration should be judged by the same standard a court would use to judge an agency's refusal to promulgate a rule in the first place, would render meaningless Congress' authorization for judicial review of orders revoking safety rules; moreover, the revocation of an extant regulation is substantially different than a failure to act.

16 Cases that cite this headnote

[7] **Administrative Law and Procedure**
Change of policy; reason or explanation
An agency changing its course by rescinding a rule is obligated to supply a reasoned analysis for the change beyond that which may be required when an agency does not act in the first instance.

246 Cases that cite this headnote

[8] **Administrative Law and Procedure**
Amendment, Repeal, Expiration, or Change of Policy
Regulatory agencies do not establish rules of conduct to last forever, and an agency must be given ample latitude to adapt its rules and policies to the demands of changing circumstances, but the forces of change do not always or necessarily point in the direction of deregulation; in the abstract, there is no more reason to presume that changing circumstances require the rescission of prior action, instead of a revision in or even the extension of current regulation.

136 Cases that cite this headnote

[9] **Administrative Law and Procedure**
Amendment, repeal, expiration, or change of policy
Administrative Law and Procedure
Scope and Extent of Review of Regulations, Rules, and Other Policies
While the removal of a regulation may not entail the monetary expenditures and other costs of enacting a new standard, and accordingly, it may be easier for an agency to justify a deregulatory action, the direction in which an agency chooses

to move does not alter the standard of judicial review established by law.

24 Cases that cite this headnote

[10] **Constitutional Law**
Limitations of Rules and Special Circumstances Affecting Them

Presumption of constitutionality afforded legislation drafted by Congress is not equivalent to the presumption of regularity afforded an agency in fulfilling its statutory mandate.

13 Cases that cite this headnote

[11] **Administrative Law and Procedure**
Review for arbitrary, capricious, unreasonable, or illegal actions in general

Administrative Law and Procedure
Wisdom, judgment, or opinion in general

While the scope of review under the "arbitrary and capricious" standard is narrow and a court is not to substitute its judgment for that of the agency, the agency nevertheless must examine the relevant data and articulate a satisfactory explanation for its action; and in reviewing that explanation, a court must consider whether the decision was based on a consideration of the relevant factors and whether there was a clear error of judgment.

4042 Cases that cite this headnote

[12] **Administrative Law and Procedure**
Arbitrariness and capriciousness; reasonableness

Normally, an agency rule would be arbitrary and capricious if the agency relied on factors which Congress has not intended it to consider, entirely failed to consider an important aspect of the problem, offer an explanation for its decision that runs counter to the evidence before the agency, or is so implausible that it could not be ascribed to a difference in view or the product of agency expertise.

2925 Cases that cite this headnote

[13] **Administrative Law and Procedure**
Amendment, repeal, expiration, or change of policy

While the Court of Appeals correctly found that the arbitrary and capricious test applies to rescissions of prior agency regulations, the court erred in intensifying the scope of its review based upon its reading of legislative events.

80 Cases that cite this headnote

[14] **Automobiles**
Subjects of regulations in general

While an agency's interpretation of a statute may be confirmed or ratified by subsequent congressional failure to change that interpretation, in the instant case, even an unequivocal ratification of the passive restraint requirement would not connote approval or disapproval of the National Highway Traffic Safety Administration's later decision to rescind the requirement; that decision remained subject to the "arbitrary and capricious" standard.

165 Cases that cite this headnote

[15] **Automobiles**
Subjects of regulations in general

National Highway Traffic Safety Administration's rescission of modified standard 208, requiring new motor vehicles produced after September 1982 to be equipped with passive restraints to protect the safety of occupants in the event of a collision, was arbitrary and capricious in that NHTSA apparently gave no consideration to modifying the standard to require that airbag technology be utilized; moreover, even if the agency's conclusion that detachable automatic seatbelts will not attain anticipated safety benefits because so many individuals will detach the mechanism were acceptable in its entirety, it would not, standing alone, justify any more than an amendment of the standard to disallow compliance by means of one technology which will not provide effective passenger protection; it did not cast doubt on the need for a passive restraint requirement or on the efficacy of airbag technology.

37 Cases that cite this headnote

[16] **Automobiles**
Subjects of regulations in general
Given the effectiveness ascribed to airbag technology by the National Highway Traffic Safety Administration, the mandate of the Motor Vehicle Safety Act to achieve traffic safety would suggest that the logical response to the faults of detachable seatbelts would be to require the installation of airbags. National Traffic and Motor Vehicle Safety Act of 1966, § 1 et seq., as amended, 15 U.S.C.A. § 1381 et seq.

4 Cases that cite this headnote

[17] **Administrative Law and Procedure**
Report or opinion; reasons for decision
An agency must cogently explain why it has exercised its discretion in a given manner.

166 Cases that cite this headnote

[18] **Automobiles**
Subjects of regulations in general
If, under the Motor Vehicle Safety Act, the National Highway Traffic Safety Administration should not defer to the automobile industry's failure to develop safer cars, which it surely should not do, a fortiori it may not revoke a safety standard which can be satisfied by current technology simply because the industry has opted for an ineffective seatbelt design. National Traffic and Motor Vehicle Safety Act of 1966, § 1 et seq., as amended, 15 U.S.C.A. § 1381 et seq.

2 Cases that cite this headnote

[19] **Administrative Law and Procedure**
Timing of theory and grounds asserted
Courts may not accept appellate counsel's post hoc rationalizations for agency action; such action must be upheld, if at all, on the basis articulated by the agency itself.

1205 Cases that cite this headnote

[20] **Automobiles**
Subjects of regulations in general
Given the judgment made by the National Highway Traffic Safety Administration in 1977 that airbags are an effective and cost-beneficial life-saving technology, the mandatory passive-restraint rule of the agency could not be abandoned without any consideration whatsoever of an airbags-only requirement.

4 Cases that cite this headnote

[21] **Automobiles**
Subjects of regulations in general
The National Highway Traffic Safety Administration, which rescinded the requirement that new motor vehicles produced after September 1982 be equipped with passive restraints to protect the safety of occupants in the event of a collision, was too quick to dismiss the safety benefits of automatic seatbelts; its explanation for rescission of the passive restraint requirement was not sufficient to enable the Supreme Court to conclude that the rescission was the product of reasoned decisionmaking.

25 Cases that cite this headnote

[22] **Administrative Law and Procedure**
Power and authority of agency
Just as an agency reasonably may decline to issue a safety standard if it is uncertain about its efficacy, an agency may also revoke a standard on the basis of serious uncertainties if supported by the record and reasonably explained.

29 Cases that cite this headnote

[23] **Automobiles**
Subjects of regulations in general
National Highway Traffic Safety Administration, which rescinded a requirement that new motor vehicles produced after September 1982 be equipped with passive restraints, took no account of the critical

difference between detachable automatic seatbelts and current manual seatbelts, failed to articulate a basis for not requiring nondetachable belts, and thus failed to offer the rational connection between facts and judgment required to pass muster under the "arbitrary and capricious" standard.

404 Cases that cite this headnote

2859 *Syllabus

*29 The National Traffic and Motor Vehicle Safety Act of 1966 (Act) directs the Secretary of Transportation to issue motor vehicle safety standards that "shall be practicable, shall meet the need for motor vehicle safety, and shall be stated in objective terms." In issuing these standards, the Secretary is directed to consider "relevant available motor vehicle safety data," whether the proposed standard is "reasonable, practicable and appropriate" for the particular type of motor vehicle for which it is prescribed, and "the extent to which such standards will contribute to carrying out the purposes" of the Act. The Act authorizes judicial review, under the Administrative Procedure Act, of "all orders establishing, amending, or revoking" a motor **2860 vehicle safety standard. The National Highway Traffic Safety Administration (NHTSA), to which the Secretary has delegated his authority to promulgate safety standards, rescinded the requirement of Modified Standard 208 that new motor vehicles produced after September 1982 be equipped with passive restraints (automatic seatbelts or airbags) to protect the safety of the occupants of the vehicle in the event of a collision. In explaining the rescission, NHTSA maintained that it was no longer able to find, as it had in 1977 when Modified Standard 208 was issued, that the automatic restraint requirement would produce significant safety benefits. In 1977, NHTSA had assumed that airbags would be installed in 60% of all new cars and automatic seatbelts in 40%. But by 1981 it became apparent that automobile manufacturers planned to install automatic seatbelts in approximately 99% of the new cars and that the overwhelming majority of such seatbelts could be easily detached and left that way permanently, thus precluding the realization of the life-saving potential of airbags and requiring the same type of affirmative action that was the stumbling block *30 to achieving high usage of manual belts. For this reason, NHTSA concluded that there was no longer a basis for reliably predicting that Modified Standard 208 would lead to any significant increased usage of restraints. Hence, in NHTSA's view, the automatic restraint requirement was no longer reasonable or practicable. Moreover, given the high expense of implementing such a requirement and the limited benefits arising therefrom, NHTSA feared that many consumers would regard Modified Standard 208 as an instance of ineffective regulation. On petitions for review of NHTSA's recission of the passive restraint requirement, the Court of Appeals held that the rescission was arbitrary and capricious on the grounds that NHTSA's conclusion that it could not reliably predict an increase in belt usage under the Standard was an insufficient basis for the rescission, that NHTSA inadequately considered the possibility of requiring manufacturers to install nondetachable rather than detachable passive belts, and that the agency failed to give any consideration to requiring compliance with the Standard by the installation of airbags. The Court found that congressional reaction to various versions of the Standard "raised doubts" that NHTSA's rescission "necessarily demonstrates an effort to fulfill its statutory mandate" and that therefore the agency was obligated to provide "increasingly clear and convincing reasons" for its action.

Held: NHTSA's rescission of the passive restraint requirement in Modified Standard 208 was arbitrary and capricious; the agency failed to present an adequate basis and explanation for rescinding the requirement and must either consider the matter further or adhere to or amend the Standard along lines which its analysis supports. Pp. 2865 – 2873.

(a) The rescission of an occupant crash protection standard is subject to the same standard of judicial review—the "arbitrary and capricious" standard—as is the promulgation of such a standard, and should not be judged by, as petitioner Motor Vehicle Manufacturers Association contends, the standard used to judge an agency's refusal to promulgate a rule in the first place. The Act expressly equates orders "revoking" and "establishing" safety standards. The Association's view would render meaningless Congress' authorization for judicial review of orders revoking safety standards. An agency changing its course by rescinding a rule is obligated to supply a reasoned analysis for the change beyond that which may be required when an agency does not act in the first instance. While the scope of review under the "arbitrary and capricious" standard is narrow and a court is not to substitute its judgment for that of the agency, the agency nevertheless must examine the relevant data and articulate a satisfactory explanation for its action. In reviewing that

explanation, a court must consider whether the decision was based on a ***31** consideration of the relevant factors and ****2861** whether there was a clear error of judgment. Pp. 2865 – 2867.

(b) The Court of Appeals correctly found that the "arbitrary and capricious" standard of judicial review applied to rescission of agency regulations, but erred in intensifying the scope of its review based upon its reading of legislative events. While an agency's interpretation of a statute may be confirmed or ratified by subsequent congressional failure to change that interpretation, here, even an unequivocal ratification of the passive restraint requirement would not connote approval or disapproval of NHTSA's later decision to rescind the requirement. That decision remains subject to the "arbitrary and capricious" standard. Pp. 2867 – 2868.

(c) The first reason for finding NHTSA's rescission of Modified Standard 208 was arbitrary and capricious is that it apparently gave no consideration to modifying the Standard to require that airbag technology be utilized. Even if NHTSA's conclusion that detachable automatic seatbelts will not attain anticipated safety benefits because so many individuals will detach the mechanism were acceptable in its entirety, standing alone it would not justify any more than an amendment of the Standard to disallow compliance by means of one technology which will not provide effective passenger protection. It does not cast doubt on the need for a passive restraint requirement or upon the efficacy of airbag technology. The airbag is more than a policy alternative to the passive restraint requirement; it is a technology alternative within the ambit of the existing standard. Pp. 2868 – 2870.

(d) NHTSA was too quick to dismiss the safety benefits of automatic seatbelts. Its explanation for rescission of the passive restraint requirement is not sufficient to enable this Court to conclude that the rescission was the product of reasoned decisionmaking. The agency took no account of the critical difference between detachable automatic seatbelts and current manual seatbelts, failed to articulate a basis for not requiring nondetachable belts, and thus failed to offer the rational connection between facts and judgment required to pass muster under the "arbitrary and capricious" standard. Pp. 2870 – 2873.

220 U.S.App.D.C. 170, 680 F.2d 206, vacated and remanded.

Attorneys and Law Firms

***32** *Solicitor General Lee* argued the cause for petitioners in No. 82-398. With him on the briefs were *Assistant Attorney General McGrath, Deputy Solicitor General Geller, Edwin S. Kneedler, Robert E. Kopp, Michael F. Hertz, Frank Berndt, David W. Allen, Enid Rubenstein,* and *Eileen T. Leahy. Lloyd N. Cutler* argued the cause for petitioners in No. 82-354. With him on the briefs were *John H. Pickering, William R. Perlik, Andrew B. Weissman, William R. Richardson, Jr., Milton D. Andrews, Lance E. Tunick, William H. Crabtree, Edward P. Good, Henry R. Nolte, Jr., Otis M. Smith, Charles R. Sharp,* and *William L. Weber, Jr. Raymond M. Momboisse, Sam Kazman,* and *Ronald A. Zumbrun* filed briefs for petitioners in No. 82-355.

James F. Fitzpatrick argued the cause for respondents in all cases. With him on the brief for respondents State Farm Mutual Automobile Insurance Co. et al. were *Michael N. Sohn, John M. Quinn,* and *Merrick B. Garland. Robert Abrams,* Attorney General of New York, *Robert S. Hammer,* Assistant Attorney General, *Peter H. Schiff, Martin Minkowitz,* and *Milton L. Freedman* filed a brief for respondent Superintendent of Insurance of the State of New York. *Raymond J. Rasenberger, Lawrence C. Merthan, Jerry W. Cox,* and *Lowell R. Beck* filed a brief for respondents National Association of Independent Insurers et al.†>>

† Briefs of *amici curiae* urging affirmance were filed by *Dennis J. Barbour* for the American College of Preventive Medicine et al.; by *Nathan Lewin* for the American Insurance Association; by *Philip R. Collins* and *Thomas C. McGrath, Jr.,* for the Automotive Occupant Protection Association; by *Alexandra K. Finucane* for the Epilepsy Foundation of America et al.; by *Katherine I. Hall* for the Center for Auto Safety et al.; by *Simon Lazarus III* for Mothers Against Drunk Drivers; and by *John H. Quinn, Jr.,* and *John Hardin Young* for the National Association of Insurance Commissioners.

Opinion

Justice WHITE delivered the opinion of the Court.

The development of the automobile gave Americans unprecedented freedom to travel, but exacted a high price for ***33** enhanced mobility. Since 1929, motor vehicles have been the leading cause of accidental deaths and injuries in the United States. In 1982, 46,300 Americans died in motor vehicle accidents and hundreds of thousands more were maimed and injured.[1] While a consensus exists that

the current loss of life on our highways is unacceptably high, improving safety does not admit to easy solution. In 1966, Congress decided that at least part of the answer lies in improving the design and safety features of the vehicle itself.[2] But much of the technology for building safer cars was undeveloped or untested. Before changes in automobile design could be mandated, the effectiveness of these changes had to be studied, their costs examined, and public acceptance **2862 considered. This task called for considerable expertise and Congress responded by enacting the National Traffic and Motor Vehicle Safety Act of 1966, (Act), 15 U.S.C. §§ 1381 *et seq.* (1976 and Supp. IV 1980). The Act, created for the purpose of "reduc[ing] traffic accidents and deaths and injuries to persons resulting from traffic accidents," 15 U.S.C. § 1381, directs the Secretary of Transportation or his delegate to issue motor vehicle safety standards that "shall be practicable, shall meet the need for motor vehicle safety, and shall be stated in objective terms." 15 U.S.C. § 1392(a). In issuing these standards, the Secretary is directed to consider "relevant available motor vehicle safety data," whether the proposed standard "is reasonable, practicable and appropriate" for the particular type of motor vehicle, and the "extent to which *34 such standards will contribute to carrying out the purposes" of the Act. 15 U.S.C. § 1392(f)(1), (3), (4).[3]

[1] The Act also authorizes judicial review under the provisions of the Administrative Procedure Act (APA), 5 U.S.C. § 706 (1976), of all "orders establishing, amending, or revoking a Federal motor vehicle safety standard," 15 U.S.C. § 1392(b). Under this authority, we review today whether NHTSA acted arbitrarily and capriciously in revoking the requirement in Motor Vehicle Safety Standard 208 that new motor vehicles produced after September 1982 be equipped with passive restraints to protect the safety of the occupants of the vehicle in the event of a collision. Briefly summarized, we hold that the agency failed to present an adequate basis and explanation for rescinding the passive restraint requirement and that the agency must either consider the matter further or adhere to or amend Standard 208 along lines which its analysis supports.

I

The regulation whose rescission is at issue bears a complex and convoluted history. Over the course of approximately 60 rulemaking notices, the requirement has been imposed, amended, rescinded, reimposed, and now rescinded again.

As originally issued by the Department of Transportation in 1967, Standard 208 simply required the installation of seatbelts in all automobiles. 32 Fed.Reg. 2408, 2415 (Feb. 3, 1967). It soon became apparent that the level of seatbelt use was too low to reduce traffic injuries to an acceptable level. The Department therefore began consideration of "passive occupant restraint systems"—devices that do not depend for their effectiveness *35 upon any action taken by the occupant except that necessary to operate the vehicle. Two types of automatic crash protection emerged: automatic seatbelts and airbags. The automatic seatbelt is a traditional safety belt, which when fastened to the interior of the door remains attached without impeding entry or exit from the vehicle, and deploys automatically without any action on the part of the passenger. The airbag is an inflatable device concealed in the dashboard and steering column. It automatically inflates when a sensor indicates that deceleration forces from an accident have exceeded a preset minimum, then rapidly deflates to dissipate those forces. The life-saving potential of these devices was immediately recognized, and in 1977, after substantial on-the-road experience with both devices, it was estimated by NHTSA that passive restraints could prevent approximately 12,000 deaths and over 100,000 serious injuries annually. 42 Fed.Reg. 34,298.

In 1969, the Department formally proposed a standard requiring the installation of passive restraints, 34 Fed.Reg. 11,148 (July 2, 1969), thereby commencing a lengthy series of proceedings. In 1970, the agency revised **2863 Standard 208 to include passive protection requirements, 35 Fed.Reg. 16,927 (Nov. 3, 1970), and in 1972, the agency amended the standard to require full passive protection for all front seat occupants of vehicles manufactured after August 15, 1975. 37 Fed.Reg. 3911 (Feb. 24, 1972). In the interim, vehicles built between August 1973 and August 1975 were to carry either passive restraints or lap and shoulder belts coupled with an "ignition interlock" that would prevent starting the vehicle if the belts were not connected.[4] On review, the *36 agency's decision to require passive restraints was found to be supported by "substantial evidence" and upheld. *Chrysler Corp. v. Dep't of Transportation,* 472 F.2d 659 (CA6 1972).[5]

In preparing for the upcoming model year, most car makers chose the "ignition interlock" option, a decision which was highly unpopular, and led Congress to amend the Act to prohibit a motor vehicle safety standard from requiring or permitting compliance by means of an ignition interlock or a continuous buzzer designed to indicate that safety belts were not in use. Motor Vehicle and Schoolbus Safety Amendments of 1974, Pub.L. 93–492, § 109, 88 Stat. 1482, 15 U.S.C. § 1410b(b). The 1974 Amendments also provided that any safety standard that could be satisfied by a system other than seatbelts would have to be submitted to Congress where it could be vetoed by concurrent resolution of both houses. 15 U.S.C. § 1410b(b)(2).[6]

The effective date for mandatory passive restraint systems was extended for a year until August 31, 1976. 40 Fed.Reg. 16,217 (April 10, 1975); *id.*, at 33,977 (Aug. 13, 1975). But in June 1976, Secretary of Transportation William Coleman initiated a new rulemaking on the issue, 41 Fed.Reg. 24,070 (June 9, 1976). After hearing testimony and reviewing written comments, Coleman extended the optional alternatives indefinitely and suspended the passive restraint requirement. Although he found passive *37 restraints technologically and economically feasible, the Secretary based his decision on the expectation that there would be widespread public resistance to the new systems. He instead proposed a demonstration project involving up to 500,000 cars installed with passive restraints, in order to smooth the way for public acceptance of mandatory passive restraints at a later date. Department of Transportation, The Secretary's Decision Concerning Motor Vehicle Occupant Crash Protection (December 6, 1976).

Coleman's successor as Secretary of Transportation disagreed. Within months of assuming office, Secretary Brock Adams decided that the demonstration project was unnecessary. He issued a new mandatory passive restraint regulation, known as Modified Standard 208. 42 Fed.Reg. 34,289 (July 5, 1977); 42 CFR § 571.208 (1977). The Modified Standard mandated the phasing in of passive restraints beginning with large cars in model year 1982 and extending to all cars by model year 1984. The two principal systems that would satisfy the Standard were airbags and passive belts; the choice of which system to install was left to the manufacturers. In **2864 *Pacific Legal Foundation v. Dep't of Transportation,* 593 F.2d 1338 (CADC), cert. denied, 444 U.S. 830, 100 S.Ct. 57, 62 L.Ed.2d 38 (1979), the Court of Appeals upheld Modified Standard 208 as a rational, nonarbitrary regulation consistent with the agency's mandate under the Act. The standard also survived scrutiny by Congress, which did not exercise its authority under the legislative veto provision of the 1974 Amendments.[7]

Over the next several years, the automobile industry geared up to comply with Modified Standard 208. As late as July, 1980, NHTSA reported:

> *38 "On the road experience in thousands of vehicles equipped with airbags and automatic safety belts has confirmed agency estimates of the life-saving and injury-preventing benefits of such systems. When all cars are equipped with automatic crash protection systems, each year an estimated 9,000 more lives will be saved and tens of thousands of serious injuries will be prevented." NHTSA, Automobile Occupant Crash Protection, Progress Report No. 3, p. 4 (App. 1627).

In February 1981, however, Secretary of Transportation Andrew Lewis reopened the rulemaking due to changed economic circumstances and, in particular, the difficulties of the automobile industry. 46 Fed.Reg. 12,033 (Feb. 12, 1981). Two months later, the agency ordered a one-year delay in the application of the standard to large cars, extending the deadline to September 1982, 46 Fed.Reg. 21,172 (April 9, 1981) and at the same time, proposed the possible rescission of the entire standard. 46 Fed.Reg. 21,205 (April 9, 1981). After receiving written comments and holding public hearings, NHTSA issued a final rule (Notice 25Notice 25) that rescinded the passive restraint requirement contained in Modified Standard 208.

II

In a statement explaining the rescission, NHTSA maintained that it was no longer able to find, as it had in 1977, that the automatic restraint requirement would produce significant safety benefits. Notice 25Notice 25, 46 Fed.Reg. 53,419 (Oct. 29, 1981). This judgment reflected not a change of opinion on the effectiveness of the technology, but a change in plans by the automobile industry. In 1977, the agency had assumed that airbags would be installed in 60% of all new cars and automatic seatbelts in 40%. By 1981 it became apparent that automobile manufacturers planned to install the automatic seatbelts in approximately 99% of the new cars. For this reason, the life-saving potential of airbags would not be realized. Moreover, it now appeared that the overwhelming

majority of passive belts *39 planned to be installed by manufacturers could be detached easily and left that way permanently. Passive belts, once detached, then required "the same type of affirmative action that is the stumbling block to obtaining high usage levels of manual belts." 46 Fed.Reg., at 53421. For this reason, the agency concluded that there was no longer a basis for reliably predicting that the standard would lead to any significant increased usage of restraints at all.

In view of the possibly minimal safety benefits, the automatic restraint requirement no longer was reasonable or practicable in the agency's view. The requirement would require approximately $1 billion to implement and the agency did not believe it would be reasonable to impose such substantial costs on manufacturers and consumers without more adequate assurance that sufficient safety benefits would accrue. In addition, NHTSA concluded that automatic restraints might have an adverse effect on the public's attitude toward safety. Given the high expense and limited benefits of detachable belts, NHTSA feared that many consumers would regard the standard as an instance of ineffective regulation, adversely affecting the public's view of safety regulation and, in particular, "poisoning popular sentiment toward **2865 efforts to improve occupant restraint systems in the future." 46 Fed.Reg., at 53424.

State Farm Mutual Automobile Insurance Co. and the National Association of Independent Insurers filed petitions for review of NHTSA's rescission of the passive restraint standard. The United States Court of Appeals for the District of Columbia Circuit held that the agency's rescission of the passive restraint requirement was arbitrary and capricious. 680 F.2d 206 (1982). While observing that rescission is not unrelated to an agency's refusal to take action in the first instance, the court concluded that, in this case, NHTSA's discretion to rescind the passive restraint requirement had been restricted by various forms of congressional "reaction" to the passive restraint issue. It then *40 proceeded to find that the rescission of Standard 208 was arbitrary and capricious for three reasons. First, the court found insufficient as a basis for rescission NHTSA's conclusion that it could not reliably predict an increase in belt usage under the Standard. The court held that there was insufficient evidence in the record to sustain NHTSA's position on this issue, and that, "only a well-justified refusal to seek more evidence could render rescission non-arbitrary." 680 F.2d, at 232. Second, a majority of the panel [8] concluded that NHTSA inadequately considered the possibility of requiring manufacturers to install nondetachable rather than detachable passive belts. Third, the majority found that the agency acted arbitrarily and capriciously by failing to give any consideration whatever to requiring compliance with Modified Standard 208 by the installation of airbags.

The court allowed NHTSA 30 days in which to submit a schedule for "resolving the questions raised in the opinion." 680 F.2d, at 242. Subsequently, the agency filed a Notice of Proposed Supplemental Rulemaking setting forth a schedule for complying with the court's mandate. On August 4, 1982, the Court of Appeals issued an order staying the compliance date for the passive restraint requirement until September 1, 1983, and requested NHTSA to inform the court whether that compliance date was achievable. NHTSA informed the court on October 1, 1982, that based on representations by manufacturers, it did not appear that practicable compliance could be achieved before September 1985. On November 8, 1982, we granted certiorari, 459 U.S. 987, 103 S.Ct. 340, 74 L.Ed.2d 382 (1982), and on November 18, the Court of Appeals entered an order recalling its mandate.

III

[2] [3] [4] Unlike the Court of Appeals, we do not find the appropriate scope of judicial review to be the "most troublesome *41 question" in the case. Both the Motor Vehicle Safety Act and the 1974 Amendments concerning occupant crash protection standards indicate that motor vehicle safety standards are to be promulgated under the informal rulemaking procedures of § 553 of the Administrative Procedure Act. 5 U.S.C. § 553 (1976). The agency's action in promulgating such standards therefore may be set aside if found to be "arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law." 5 U.S.C. § 706(2)(A). *Citizens to Preserve Overton Park v. Volpe*, 401 U.S. 402, 414, 91 S.Ct. 814, 822, 28 L.Ed.2d 136 (1971); *Bowman Transportation, Inc. v. Arkansas-Best Freight System, Inc.*, 419 U.S. 281, 95 S.Ct. 438, 42 L.Ed.2d 447 (1974). We believe that the rescission or modification of an occupant protection standard is subject to the same test. Section 103(b) of the Motor Vehicle Safety Act, 15 U.S.C. § 1392(b), states that the procedural and judicial review provisions of the Administrative Procedure Act "shall apply

to all orders establishing, amending, or revoking a Federal motor vehicle safety standard," and suggests no difference in the scope of judicial review depending upon the nature of the agency's action.

**2866 [5] [6] [7] Petitioner Motor Vehicle Manufacturers Association (MVMA) disagrees, contending that the rescission of an agency rule should be judged by the same standard a court would use to judge an agency's refusal to promulgate a rule in the first place—a standard Petitioner believes considerably narrower than the traditional arbitrary and capricious test and "close to the borderline of nonreviewability." Brief of Petitioner MVMA, at 35. We reject this view. The Motor Vehicle Safety Act expressly equates orders "revoking" and "establishing" safety standards; neither that Act nor the APA suggests that revocations are to be treated as refusals to promulgate standards. Petitioner's view would render meaningless Congress' authorization for judicial review of orders revoking safety rules. Moreover, the revocation of an extant regulation is substantially different than a failure to act. Revocation constitutes a reversal of the agency's former views as to the proper course. A "settled course of behavior embodies the agency's informed judgment that, by pursuing that course, it will carry out the policies *42 committed to it by Congress. There is, then, at least a presumption that those policies will be carried out best if the settled rule is adhered to." *Atchison, T. & S.F.R. Co. v. Wichita Bd. of Trade*, 412 U.S. 800, 807–808, 93 S.Ct. 2367, 2374–2375, 37 L.Ed.2d 350 (1973). Accordingly, an agency changing its course by rescinding a rule is obligated to supply a reasoned analysis for the change beyond that which may be required when an agency does not act in the first instance.

[8] [9] In so holding, we fully recognize that "regulatory agencies do not establish rules of conduct to last forever," *American Trucking Assoc., Inc. v. Atchison, T. & S.F.R. Co.*, 387 U.S. 397, 416, 87 S.Ct. 1608, 1618, 18 L.Ed.2d 847 (1967), and that an agency must be given ample latitude to "adapt their rules and policies to the demands of changing circumstances." *Permian Basin Area Rate Cases*, 390 U.S. 747, 784, 88 S.Ct. 1344, 1368–1369, 20 L.Ed.2d 312 (1968). But the forces of change do not always or necessarily point in the direction of deregulation. In the abstract, there is no more reason to presume that changing circumstances require the rescission of prior action, instead of a revision in or even the extension of current regulation. If Congress established a presumption from which judicial review should start, that presumption—contrary to petitioners' views—is not *against* safety regulation, but *against* changes in current policy that are not justified by the rulemaking record. While the removal of a regulation may not entail the monetary expenditures and other costs of enacting a new standard, and accordingly, it may be easier for an agency to justify a deregulatory action, the direction in which an agency chooses to move does not alter the standard of judicial review established by law.

[10] [11] [12] The Department of Transportation accepts the applicability of the "arbitrary and capricious" standard. It argues that under this standard, a reviewing court may not set aside an agency rule that is rational, based on consideration of the relevant factors and within the scope of the authority delegated to the agency by the statute. We do not disagree with *43 this formulation.[9] The scope of review under the "arbitrary and capricious" standard is narrow and a court is not to substitute its judgment for that of the agency. Nevertheless, the agency must examine the relevant data and articulate a satisfactory explanation for its action including a "rational connection between the facts found and the choice made." *Burlington Truck Lines v. United States*, 371 U.S. 156, 168, 83 S.Ct. 239, 245–246, 9 L.Ed.2d 207 (1962). In reviewing that explanation, we must "consider whether the decision was based on a consideration of the relevant **2867 factors and whether there has been a clear error of judgment." *Bowman Transp. Inc. v. Arkansas-Best Freight System, supra*, 419 U.S., at 285, 95 S.Ct., at 442; *Citizens to Preserve Overton Park v. Volpe, supra*, 401 U.S., at 416, 91 S.Ct., at 823. Normally, an agency rule would be arbitrary and capricious if the agency has relied on factors which Congress has not intended it to consider, entirely failed to consider an important aspect of the problem, offered an explanation for its decision that runs counter to the evidence before the agency, or is so implausible that it could not be ascribed to a difference in view or the product of agency expertise. The reviewing court should not attempt itself to make up for such deficiencies: "We may not supply a reasoned basis for the agency's action that the agency itself has not given." *SEC v. Chenery Corp.*, 332 U.S. 194, 196, 67 S.Ct. 1575, 1577, 91 L.Ed. 1995 (1947). We will, however, "uphold a decision of less than ideal clarity if the agency's path may reasonably be discerned." *Bowman Transp. Inc. v. Arkansas-Best Freight System, supra*, 419 U.S., at 286, 95 S.Ct., at 442. See also *Camp v. Pitts*, 411 U.S. 138, 142–143, 93 S.Ct. 1241, 1244, 36 L.Ed.2d 106 (1973) (per curiam). For purposes of these

cases, it is also relevant that Congress required a record of the rulemaking proceedings to be compiled *44 and submitted to a reviewing court, 15 U.S.C. § 1394, and intended that agency findings under the Act would be supported by "substantial evidence on the record considered as a whole." S.Rep. No. 1301, 89th Cong., 2d Sess. 8 (1966); H.R.Rep. No. 1776, 89th Cong., 2d Sess. 21 (1966).

IV

[13] The Court of Appeals correctly found that the arbitrary and capricious test applied to rescissions of prior agency regulations, but then erred in intensifying the scope of its review based upon its reading of legislative events. It held that congressional reaction to various versions of Standard 208 "raise[d] doubts" that NHTSA's rescission "necessarily demonstrates an effort to fulfill its statutory mandate," and therefore the agency was obligated to provide "increasingly clear and convincing reasons" for its action. 680 F.2d, at 222, 229. Specifically, the Court of Appeals found significance in three legislative occurrences:

> "In 1974, Congress banned the ignition interlock but did not foreclose NHTSA's pursuit of a passive restraint standard. In 1977, Congress allowed the standard to take effect when neither of the concurrent resolutions needed for disapproval was passed. In 1980, a majority of each house indicated support for the concept of mandatory passive restraints and a majority of each house supported the unprecedented attempt to require some installation of airbags." 680 F.2d, at 228.

From these legislative acts and non-acts the Court of Appeals derived a "congressional commitment to the concept of automatic crash protection devices for vehicle occupants." *Ibid.*

[14] This path of analysis was misguided and the inferences it produced are questionable. It is noteworthy that in this Court Respondent State Farm expressly agrees that the post-enactment legislative history of the Motor Vehicle Safety Act does not heighten the *45 standard of review of NHTSA's actions. Brief for Respondent State Farm Mutual Automobile Insurance Co. 13. State Farm's concession is well-taken for this Court has never suggested that the *standard* of review is enlarged or diminished by subsequent congressional action. While an agency's interpretation of a statute may be confirmed or ratified by subsequent congressional failure to change that interpretation, *Bob Jones University v. United States,* — U.S. —, —, 103 S.Ct. 2017, 2033, 75 L.Ed.2d — (1983); *Haig v. Agee,* 453 U.S. 280, 291–300, 101 S.Ct. 2766, 2774–2778, 69 L.Ed.2d 640 (1981), in the case before us, even an unequivocal ratification—short of statutory **2868 incorporation—of the passive restraint standard would not connote approval or disapproval of an agency's later decision to rescind the regulation. That decision remains subject to the arbitrary and capricious standard.

That we should not be so quick to infer a congressional mandate for passive restraints is confirmed by examining the post-enactment legislative events cited by the Court of Appeals. Even were we inclined to rely on inchoate legislative action, the inferences to be drawn fail to suggest that NHTSA acted improperly in rescinding Standard 208. First, in 1974 a mandatory passive restraint standard was technically not in effect, see n. 6, *supra;* Congress had no reason to foreclose that course. Moreover, one can hardly infer support for a mandatory standard from Congress' decision to provide that such a regulation would be subject to disapproval by resolutions of disapproval in both houses. Similarly, no mandate can be divined from the tabling of resolutions of disapproval which were introduced in 1977. The failure of Congress to exercise its veto might reflect legislative deference to the agency's expertise and does not indicate that Congress would disapprove of the agency's action in 1981. And even if Congress favored the standard in 1977, it—like NHTSA—may well reach a different judgment given changed circumstances four years later. Finally, the Court of Appeals read too much into floor action on the 1980 authorization bill, a bill which was not enacted into law. Other *46 contemporaneous events could be read as showing equal congressional hostility to passive restraints. [10]

V

The ultimate question before us is whether NHTSA's rescission of the passive restraint requirement of Standard 208 was arbitrary and capricious. We conclude, as did the Court of Appeals, that it was. We also conclude, but for somewhat different reasons, that further consideration of the issue by the agency is therefore required. We deal separately with the rescission as it applies to airbags and as it applies to seatbelts.

A

[15] The first and most obvious reason for finding the rescission arbitrary and capricious is that NHTSA apparently gave no consideration whatever to modifying the Standard to require that airbag technology be utilized. Standard 208 sought to achieve automatic crash protection by requiring automobile manufacturers to install either of two passive restraint devices: airbags or automatic seatbelts. There was no suggestion in the long rulemaking process that led to Standard 208 that if only one of these options were feasible, no passive restraint standard should be promulgated. Indeed, the agency's original proposed standard contemplated the installation of inflatable restraints in all cars.[11] Automatic belts *47 were added as a means of complying with the standard because they were believed to be as effective as airbags in achieving the goal of occupant crash protection. 36 Fed.Reg. 12,858, 12,859 (July 8, 1971). At that time, the passive belt approved by the agency could not be detached.[12] Only later, **2869 at a manufacturer's behest, did the agency approve of the detachability feature—and only after assurances that the feature would not compromise the safety benefits of the restraint.[13] Although it was then foreseen that 60% of the new cars would contain airbags and 40% would have automatic seatbelts, the ratio between the two was not significant as long as the passive belt would also assure greater passenger safety.

[16] [17] The agency has now determined that the detachable automatic belts will not attain anticipated safety benefits because so many individuals will detach the mechanism. Even if this conclusion were acceptable in its entirety, see *infra*, at 2871 – 2872, standing alone it would not justify any more than an amendment of Standard 208 to disallow compliance by means of the one technology which will not provide effective passenger protection. It does not cast doubt on the need for a passive restraint standard or upon the efficacy of airbag technology. In its most recent rule-making, the agency again acknowledged the life-saving potential of the airbag:

> *48 "The agency has no basis at this time for changing its earlier conclusions in 1976 and 1977 that basic airbag technology is sound and has been sufficiently demonstrated to be effective in those vehicles in current use...." NHTSA Final Regulatory Impact Analysis (RIA) at XI–4 (App. 264).

Given the effectiveness ascribed to airbag technology by the agency, the mandate of the Safety Act to achieve traffic safety would suggest that the logical response to the faults of detachable seatbelts would be to require the installation of airbags. At the very least this alternative way of achieving the objectives of the Act should have been addressed and adequate reasons given for its abandonment. But the agency not only did not require compliance through airbags, it did not even consider the possibility in its 1981 rulemaking. Not one sentence of its rulemaking statement discusses the airbags-only option. Because, as the Court of Appeals stated, "NHTSA's ... analysis of airbags was nonexistent," 680 F.2d, at 236, what we said in *Burlington Truck Lines v. United States,* 371 U.S., at 167, 83 S.Ct., at 245, is apropos here:

> "There are no findings and no analysis here to justify the choice made, no indication of the basis on which the [agency] exercised its expert discretion. We are not prepared to and the Administrative Procedure Act will not permit us to accept such ... practice.... Expert discretion is the lifeblood of the administrative process, but 'unless we make the requirements for administrative action strict and demanding, *expertise,* the strength of modern government, can become a monster which rules with no practical limits on its discretion.' *New York v. United States,* 342 U.S. 882, 884 [72 S.Ct. 152, 153, 96 L.Ed. 662] (dissenting opinion)." (footnote omitted).

We have frequently reiterated that an agency must cogently explain why it has exercised its discretion in a given manner, *49 *Atchison, T & S.F.R. Co. v. Wichita Bd. of Trade,* 412 U.S. 800, 806, 93 S.Ct. 2367, 2374, 37 L.Ed.2d 350 (1973); *FTC v. Sperry & Hutchinson Co.,* 405 U.S. 233, 249, 92 S.Ct. 898, 907, 31 L.Ed.2d 170 (1972); *NLRB v. Metropolitan Ins. Co.,* 380 U.S. 438, 443, 85 S.Ct. 1061, 1064, 13 L.Ed.2d 951 (1965); and we reaffirm this principle again today.

[18] The automobile industry has opted for the passive belt over the airbag, but surely it is not enough that the regulated industry has eschewed a given safety device. For nearly a decade, the automobile industry waged the regulatory equivalent **2870 of war against the airbag[14] and lost—the inflatable restraint was proven sufficiently effective. Now the automobile industry has decided to employ a seatbelt system which will not meet the safety objectives of Standard

208. This hardly constitutes cause to revoke the standard itself. Indeed, the Motor Vehicle Safety Act was necessary because the industry was not sufficiently responsive to safety concerns. The Act intended that safety standards not depend on current technology and could be "technology-forcing" in the sense of inducing the development of superior safety design. See *Chrysler Corp. v. Dept. of Transp.*, 472 F.2d, at 672–673. If, under the statute, the agency should not defer to the industry's failure to develop safer cars, which it surely should not do, *a fortiori* it may not revoke a safety standard which can be satisfied by current technology simply because the industry has opted for an ineffective seatbelt design.

[19] Although the agency did not address the mandatory airbags option and the Court of Appeals noted that "airbags seem to have none of the problems that NHTSA identified in passive seatbelts," petitioners recite a number of difficulties that they ***50** believe would be posed by a mandatory airbag standard. These range from questions concerning the installation of airbags in small cars to that of adverse public reaction. But these are not the agency's reasons for rejecting a mandatory airbag standard. Not having discussed the possibility, the agency submitted no reasons at all. The short—and sufficient—answer to petitioners' submission is that the courts may not accept appellate counsel's *post hoc* rationalizations for agency action. *Burlington Truck Lines v. United States, supra*, 371 U.S., at 168, 83 S.Ct., at 245. It is well-established that an agency's action must be upheld, if at all, on the basis articulated by the agency itself. *Ibid.*; *SEC v. Chenery*, 332 U.S. 194, 196, 67 S.Ct. 1575, 1577, 91 L.Ed. 1995 (1947); *American Textile Manufacturers Inst. v. Donovan*, 452 U.S. 490, 539, 101 S.Ct. 2478, 2505, 69 L.Ed.2d 185 (1981).[15]

[20] Petitioners also invoke our decision in *Vermont Yankee Nuclear Power Corp. v. NRDC*, 435 U.S. 519, 98 S.Ct. 1197, 55 L.Ed.2d 460 (1978), as though it were a talisman under which any agency decision is by definition unimpeachable. Specifically, it is submitted that to require an agency to consider an airbags-only alternative is, in essence, to dictate to the agency the procedures it is to follow. Petitioners both misread *Vermont Yankee* and misconstrue the nature of the remand that is in order. In *Vermont Yankee*, we held that a court may not impose additional procedural requirements upon an agency. We do not require today any specific procedures ***51** which NHTSA must follow. Nor do we broadly require an agency to consider all policy alternatives in reaching decision. It is true that a rulemaking "cannot be found wanting simply because the agency failed to include every alternative device and ****2871** thought conceivable by the mind of man ... regardless of how uncommon or unknown that alternative may have been...." 435 U.S., at 551, 98 S.Ct., at 1215–1216. But the airbag is more than a policy alternative to the passive restraint standard; it is a technological alternative within the ambit of the existing standard. We hold only that given the judgment made in 1977 that airbags are an effective and cost-beneficial life-saving technology, the mandatory passive-restraint rule may not be abandoned without any consideration whatsoever of an airbags-only requirement.

B

[21] Although the issue is closer, we also find that the agency was too quick to dismiss the safety benefits of automatic seatbelts. NHTSA's critical finding was that, in light of the industry's plans to install readily detachable passive belts, it could not reliably predict "even a 5 percentage point increase as the minimum level of expected usage increase." 46 Fed.Reg., at 53,423. The Court of Appeals rejected this finding because there is "not one iota" of evidence that Modified Standard 208 will fail to increase nationwide seatbelt use by at least 13 percentage points, the level of increased usage necessary for the standard to justify its cost. Given the lack of probative evidence, the court held that "only a well-justified refusal to seek more evidence could render rescission non-arbitrary." 680 F.2d, at 232.

[22] Petitioners object to this conclusion. In their view, "substantial uncertainty" that a regulation will accomplish its intended purpose is sufficient reason, without more, to rescind a regulation. We agree with petitioners that just as an agency reasonably may decline to issue a safety standard if it is uncertain about its efficacy, an agency may also revoke a ***52** standard on the basis of serious uncertainties if supported by the record and reasonably explained. Rescission of the passive restraint requirement would not be arbitrary and capricious simply because there was no evidence in direct support of the agency's conclusion. It is not infrequent that the available data does not settle a regulatory issue and the agency must then exercise its judgment in moving from the facts and probabilities on the record to a policy conclusion. Recognizing that policymaking in a complex society must account for uncertainty, however, does not imply that it is

sufficient for an agency to merely recite the terms "substantial uncertainty" as a justification for its actions. The agency must explain the evidence which is available, and must offer a "rational connection between the facts found and the choice made." *Burlington Truck Lines, Inc. v. United States, supra,* 371 U.S., at 168, 83 S.Ct., at 246. Generally, one aspect of that explanation would be a justification for rescinding the regulation before engaging in a search for further evidence.

In this case, the agency's explanation for rescission of the passive restraint requirement is *not* sufficient to enable us to conclude that the rescission was the product of reasoned decisionmaking. To reach this conclusion, we do not upset the agency's view of the facts, but we do appreciate the limitations of this record in supporting the agency's decision. We start with the accepted ground that if used, seatbelts unquestionably would save many thousands of lives and would prevent tens of thousands of crippling injuries. Unlike recent regulatory decisions we have reviewed, *Industrial Union Department v. American Petroleum Institute,* 448 U.S. 607, 100 S.Ct. 2844, 65 L.Ed.2d 1010 (1980); *American Textile Manufacturers Inst., Inc. v. Donovan,* 452 U.S. 490, 101 S.Ct. 2478, 69 L.Ed.2d 185 (1981), the safety benefits of wearing seatbelts are not in doubt and it is not challenged that were those benefits to accrue, the monetary costs of implementing the standard would be easily justified. We move next to the fact that there is no direct evidence in support of the agency's finding that detachable automatic belts cannot be predicted ***53** to yield a substantial increase in ****2872** usage. The empirical evidence on the record, consisting of surveys of drivers of automobiles equipped with passive belts, reveals more than a doubling of the usage rate experienced with manual belts.[16] Much of the agency's rulemaking statement—and much of the controversy in this case—centers on the conclusions that should be drawn from these studies. The agency maintained that the doubling of seatbelt usage in these studies could not be extrapolated to an across-the-board mandatory standard because the passive seatbelts were guarded by ignition interlocks and purchasers of the tested cars are somewhat atypical.[17] Respondents insist these studies demonstrate that Modified Standard 208 will substantially increase seatbelt usage. We believe that it is within the agency's discretion to pass upon the generalizability of these field studies. This is precisely the type of issue which rests within the expertise of NHTSA, and upon which a reviewing court must be most hesitant to intrude.

[23] But accepting the agency's view of the field tests on passive restraints indicates only that there is no reliable real-world experience that usage rates will substantially increase. To be sure, NHTSA opines that "it cannot reliably predict even a 5 percentage point increase as the minimum level of ***54** increased usage." Notice 25Notice 25, 46 Fed.Reg., at 53,423. But this and other statements that passive belts will not yield substantial increases in seatbelt usage apparently take no account of the critical difference between detachable automatic belts and current manual belts. A detached passive belt does require an affirmative act to reconnect it, but—unlike a manual seat belt—the passive belt, once reattached, will continue to function automatically unless again disconnected. Thus, inertia—a factor which the agency's own studies have found significant in explaining the current low usage rates for seatbelts[18]—works in *favor* of, not *against,* use of the protective device. Since 20 to 50% of motorists currently wear seatbelts on some occasions,[19] there would seem to be grounds to believe that seatbelt use by occasional users will be substantially increased by the detachable passive belts. Whether this is in fact the case is a matter for the agency to decide, but it must bring its expertise to bear on the question.

The agency is correct to look at the costs as well as the benefits of Standard 208. The agency's conclusion that the incremental costs of the requirements were no longer reasonable was predicated on its prediction that the safety benefits of the regulation ****2873** might be minimal. Specifically, the ***55** agency's fears that the public may resent paying more for the automatic belt systems is expressly dependent on the assumption that detachable automatic belts will not produce more than "negligible safety benefits." 46 Fed.Reg., at 53,424. When the agency reexamines its findings as to the likely increase in seatbelt usage, it must also reconsider its judgment of the reasonableness of the monetary and other costs associated with the Standard. In reaching its judgment, NHTSA should bear in mind that Congress intended safety to be the preeminent factor under the Motor Vehicle Safety Act:

> "The Committee intends that safety shall be the overriding consideration in the issuance of standards under this bill. The Committee recognizes ... that the Secretary will necessarily consider reasonableness of cost, feasibility and adequate leadtime." S.Rep. No. 1301, at 6, U.S.Code Cong. & Admin.News6, U.S.Code Cong. & Admin.News 1966, p. 2714.

> "In establishing standards the Secretary must conform to the requirement that the standard be practicable. This would require consideration of all relevant factors, including technological ability to achieve the goal of a particular standard as well as consideration of economic factors. Motor vehicle safety is the paramount purpose of this bill and each standard must be related thereto." H.Rep. No. 1776, at 16.

The agency also failed to articulate a basis for not requiring nondetachable belts under Standard 208. It is argued that the concern of the agency with the easy detachability of the currently favored design would be readily solved by a continuous passive belt, which allows the occupant to "spool out" the belt and create the necessary slack for easy extrication from the vehicle. The agency did not separately consider the continuous belt option, but treated it together with the ignition interlock device in a category it titled "option of use-compelling features." 46 Fed.Reg., at 53,424. ***56** The agency was concerned that use-compelling devices would "complicate extrication of [a]n occupant from his or her car." *Ibid.* "To require that passive belts contain use-compelling features," the agency observed, "could be counterproductive [given] ... widespread, latent and irrational fear in many members of the public that they could be trapped by the seat belt after a crash." *Ibid.* In addition, based on the experience with the ignition interlock, the agency feared that use-compelling features might trigger adverse public reaction.

By failing to analyze the continuous seatbelts in its own right, the agency has failed to offer the rational connection between facts and judgment required to pass muster under the arbitrary and capricious standard. We agree with the Court of Appeals that NHTSA did not suggest that the emergency release mechanisms used in nondetachable belts are any less effective for emergency egress than the buckle release system used in detachable belts. In 1978, when General Motors obtained the agency's approval to install a continuous passive belt, it assured the agency that nondetachable belts with spool releases were as safe as detachable belts with buckle releases. 43 Fed.Reg. 21,912, 21,913–14 (1978). NHTSA was satisfied that this belt design assured easy extricability: "the agency does not believe that the use of [such] release mechanisms will cause serious occupant egress problems ..." 43 Fed.Reg. 52,493, 52,494 (1978). While the agency is entitled to change its view on the acceptability of continuous passive belts, it is obligated to explain its reasons for doing so.

The agency also failed to offer any explanation why a continuous passive belt would engender the same adverse public reaction as the ignition interlock, and, as the Court of Appeals concluded, "every indication in the record points the other way." 680 F.2d, at 234.[20] ***57** We ****2874** see no basis for equating the two devices: the continuous belt, unlike the ignition interlock, does not interfere with the operation of the vehicle. More importantly, it is the agency's responsibility, not this Court's, to explain its decision.

VI

"An agency's view of what is in the public interest may change, either with or without a change in circumstances. But an agency changing its course must supply a reasoned analysis ..." *Greater Boston Television Corp. v. FCC,* 444 F.2d 841, 852 (CADC), cert. denied, 403 U.S. 923, 91 S.Ct. 2233, 29 L.Ed.2d 701 (1971). We do not accept all of the reasoning of the Court of Appeals but we do conclude that the agency has failed to supply the requisite "reasoned analysis" in this case. Accordingly, we vacate the judgment of the Court of Appeals and remand the case to that court with directions to remand the matter to the NHTSA for further consideration consistent with this opinion.[21]

So ordered.

Justice REHNQUIST, with whom THE CHIEF JUSTICE, Justice POWELL, and Justice O'CONNOR join, concurring in part and dissenting in part.

I join parts I, II, III, IV, and V–A of the Court's opinion. In particular, I agree that, since the airbag and continuous ***58** spool automatic seatbelt were explicitly approved in the standard the agency was rescinding, the agency should explain why it declined to leave those requirements intact. In this case, the agency gave no explanation at all. Of course, if the agency can provide a rational explanation, it may adhere to its decision to rescind the entire standard.

I do not believe, however, that NHTSA's view of detachable automatic seatbelts was arbitrary and capricious. The agency adequately explained its decision to rescind the standard insofar as it was satisfied by detachable belts.

The statute that requires the Secretary of Transportation to issue motor vehicle safety standards also requires that "[e]ach

such ... standard shall be practicable [and] shall meet the need for motor vehicle safety." 15 U.S.C. § 1392(a). The Court rejects the agency's explanation for its conclusion that there is substantial uncertainty whether requiring installation of detachable automatic belts would substantially increase seatbelt usage. The agency chose not to rely on a study showing a substantial increase in seatbelt usage in cars equipped with automatic seatbelts *and* an ignition interlock to prevent the car from being operated when the belts were not in place *and* which were voluntarily purchased with this equipment by consumers. See *ante,* at 2870, n. 15. It is reasonable for the agency to decide that this study does not support any conclusion concerning the effect of automatic seatbelts that are installed in all cars whether the consumer wants them or not and are not linked to an ignition interlock system.

The Court rejects this explanation because "there would seem to be grounds to believe that seatbelt use by occasional users will be substantially increased by the detachable passive belts," *ante,* at 2872, and the agency did not adequately explain its rejection of these grounds. It seems to me that the agency's explanation, while by **2875 no means a model, is adequate. The agency acknowledged that there would probably be some increase in belt usage, but concluded that the increase would be small and not worth the cost of mandatory *59 detachable automatic belts. 46 F.R. 53421–54323 (1981). The agency's obligation is to articulate a "rational connection between the facts found and the choice made." *Ante,* at 2866–2867, 2871, quoting *Burlington Truck Lines v. United States,* 371 U.S. 156, 168, 83 S.Ct. 239, 246, 9 L.Ed.2d 207 (1962). I believe it has met this standard.

The agency explicitly stated that it will increase its educational efforts in an attempt to promote public understanding, acceptance, and use of passenger restraint systems. 46 F.R. 53425 (1981). It also stated that it will "initiate efforts with automobile manufacturers to ensure that the public will have [automatic crash protection] technology available. If this does not succeed, the agency will consider regulatory action to assure that the last decade's enormous advances in crash protection technology will not be lost." *Id.,* at 53426.

The agency's changed view of the standard seems to be related to the election of a new President of a different political party. It is readily apparent that the responsible members of one administration may consider public resistance and uncertainties to be more important than do their counterparts in a previous administration. A change in administration brought about by the people casting their votes is a perfectly reasonable basis for an executive agency's reappraisal of the costs and benefits of its programs and regulations. As long as the agency remains within the bounds established by Congress,* it is entitled to assess administrative records and evaluate priorities in light of the philosophy of the administration.

All Citations

463 U.S. 29, 103 S.Ct. 2856, 77 L.Ed.2d 443, 13 Envtl. L. Rep. 20,672

Footnotes

* The syllabus constitutes no part of the opinion of the Court but has been prepared by the Reporter of Decisions for the convenience of the reader. See *United States v. Detroit Lumber Co.,* 200 U.S. 321, 337, 26 S.Ct. 282, 287, 50 L.Ed. 499.

1 National Safety Council, 1982 Motor Vehicle Deaths By States, (May 16, 1983).

2 The Senate Committee on Commerce Reported:
"The promotion of motor vehicle safety through voluntary standards has largely failed. The unconditional imposition of mandatory standards at the earliest practicable date is the only course commensurate with the highway death and injury toll." S.Rep. No. 1301, 89th Cong., 2d Sess., p. 4 (1966), U.S.Code Cong. & Admin.News 1966, pp. 2709, 2712.

3 The Secretary's general authority to promulgate safety standards under the Act has been delegated to the Administrator of the National Highway Traffic Safety Administration (NHTSA). 49 CFR § 1.50(a) (1979). This opinion will use the terms NHTSA and agency interchangeably when referring to the National Highway Traffic Safety Administration, the Department of Transportation, and the Secretary of Transportation.

4 Early in the process, it was assumed that passive occupant protection meant the installation of inflatable airbag restraint systems. See 34 Fed.Reg. 11,148. In 1971, however, the agency observed that "some belt-based concepts have been

advanced that appear to be capable of meeting the complete passive protection options," leading it to add a new section to the proposed standard "to deal expressly with passive belts." 36 Fed.Reg. 12,858, 12,859 (July 8, 1971).

5 The court did hold that the testing procedures required of passive belts did not satisfy the Safety Act's requirement that standards be "objective." 472 F.2d, at 675.

6 Because such a passive restraint standard was not technically in effect at this time due to the Sixth Circuit's invalidation of the testing requirements, see n. 5 *supra*, the issue was not submitted to Congress until a passive restraint requirement was reimposed by Secretary Adams in 1977. To comply with the Amendments, NHTSA proposed new warning systems to replace the prohibited continuous buzzers. 39 Fed.Reg. 42,692 (Dec. 6, 1974). More significantly, NHTSA was forced to rethink an earlier decision which contemplated use of the interlocks in tandem with detachable belts. See n. 13, *infra*.

7 No action was taken by the full House of Representatives. The Senate committee with jurisdiction over NHTSA affirmatively endorsed the standard, S.Rep. No. 481, 95th Cong., 1st Sess. (1977), and a resolution of disapproval was tabled by the Senate. 123 Cong.Rec. 33,332 (1977).

8 Judge Edwards did not join the majority's reasoning on these points.

9 The Department of Transportation suggests that the arbitrary and capricious standard requires no more than the minimum rationality a statute must bear in order to withstand analysis under the Due Process Clause. We do not view as equivalent the presumption of constitutionality afforded legislation drafted by Congress and the presumption of regularity afforded an agency in fulfilling its statutory mandate.

10 For example, an overwhelming majority of the members of the House of Representatives voted in favor of a proposal to bar NHTSA from spending funds to administer an occupant restraint standard unless the standard permitted the purchaser of the vehicle to select manual rather than passive restraints. 125 Cong.Rec. H12285, H12287 (daily ed. Dec. 19, 1979).

11 While NHTSA's 1970 passive restraint requirement permitted compliance by means other than the airbag, 35 Fed.Reg. 16,927 (1970), "[t]his rule was [a] de facto air bag mandate since no other technologies were available to comply with the standard." J. Graham & P. Gorham, NHTSA and Passive Restraints: A Case of Arbitrary and Capricious Deregulation, 35 Admin.L.Rev. 193, 197 (1983). See n. 4, *supra*.

12 Although the agency suggested that passive restraint systems contain an emergency release mechanism to allow easy extrication of passengers in the event of an accident, the agency cautioned that "[i]n the case of passive safety belts, it would be required that the release not cause belt separation, and that the system be self-restoring after operation of the release." 36 Fed.Reg. 12,866 (July 8, 1971).

13 In April 1974, NHTSA adopted the suggestion of an automobile manufacturer that emergency release of passive belts be accomplished by a conventional latch—provided the restraint system was guarded by an ignition interlock and warning buzzer to encourage reattachment of the passive belt. 39 Fed.Reg. 14,593 (April 25, 1974). When the 1974 Amendments prohibited these devices, the agency simply eliminated the interlock and buzzer requirements, but continued to allow compliance by a detachable passive belt.

14 See, *e.g.*, Comments of Chrysler Corp., Docket No. 69–07, Notice 11 (August 5, 1971)Notice 11 (August 5, 1971) (App. 2491); Chrysler Corp. Memorandum on Proposed Alternative Changes to FMVSS 208, Docket No. 44, Notice 76–8 (1976)Notice 76–8 (1976) (App. 2241); General Motors Corp. Response to the Dept. of Transportation Proposal on Occupant Crash Protection, Docket No. 74–14, Notice 08 (May 27, 1977)Notice 08 (May 27, 1977). See also *Chrysler Corp. v. Dept. of Transp., supra*.

15 The Department of Transportation expresses concern that adoption of an airbags-only requirement would have required a new notice of proposed rulemaking. Even if this were so, and we need not decide the question, it would not constitute sufficient cause to rescind the passive restraint requirement. The Department also asserts that it was reasonable to withdraw the requirement as written to avoid forcing manufacturers to spend resources to comply with an ineffective safety initiative. We think that it would have been permissible for the agency to temporarily suspend the passive restraint requirement or to delay its implementation date while an airbags mandate was studied. But, as we explain in text, that option had to be considered before the passive restraint requirement could be revoked.

16 Between 1975 and 1980, Volkswagen sold approximately 350,000 Rabbits equipped with detachable passive seatbelts that were guarded by an ignition interlock. General Motors sold 8,000 1978 and 1979 Chevettes with a similar system, but eliminated the ignition interlock on the 13,000 Chevettes sold in 1980. NHTSA found that belt usage in the Rabbits averaged 34% for manual belts and 84% forpassive belts. Regulatory Impact Analysis (RIA) at IV–52, App. 108. For the 1978–1979 Chevettes, NHTSA calculated 34% usage for manual belts and 71% for passive belts. On 1980 Chevettes, the agency found these figures to be 31% for manual belts and 70% for passive belts. *Ibid.*

17 "NHTSA believes that the usage of automatic belts in Rabbits and Chevettes would have been substantially lower if the automatic belts in those cars were not equipped with a use-inducing device inhibiting detachment." Notice 25Notice 25, 46 Fed.Reg., at 53,422.

18 NHTSA commissioned a number of surveys of public attitudes in an effort to better understand why people were not using manual belts and to determine how they would react to passive restraints. The surveys reveal that while 20% to 40% of the public is opposed to wearing manual belts, the larger proportion of the population does not wear belts because they forgot or found manual belts inconvenient or bothersome. RIA at IV–25; App. 81. In another survey, 38% of the surveyed group responded that they would welcome automatic belts, and 25% would "tolerate" them. See RIA at IV–37. App. 93. NHTSA did not comment upon these attitude surveys in its explanation accompanying the rescission of the passive restraint requirement.

19 Four surveys of manual belt usage were conducted for NHTSA between 1978 and 1980, leading the agency to report that 40% to 50% of the people use their belts at least some of the time. RIA, at IV–25 (App. 81).

20 The Court of Appeals noted previous agency statements distinguishing interlocks from passive restraints. 42 Fed.Reg., at 34,290; 36 Fed.Reg., at 8296 (1971); RIA, at II–4, App. 30.

21 Petitioners construe the Court of Appeals' order of August 4, 1982, as setting an implementation date for Standard 208, in violation of *Vermont Yankee*'s injunction against imposing such time constraints. *Vermont Yankee Nuclear Power Corp. v. NRDC,* 435 U.S., at 544–545, 98 S.Ct., at 1211–1212. Respondents maintain that the Court of Appeals simply stayed the effective date of Standard 208, which, not having been validly rescinded, would have required mandatory passive restraints for new cars after September 1, 1982. We need not choose between these views because the agency had sufficient justification to suspend, although not to rescind, Standard 208, pending the further consideration required by the Court of Appeals, and now, by us.

* Of course, a new administration may not choose not to enforce laws of which it does not approve, or to ignore statutory standards in carrying out its regulatory functions. But in this case, as the Court correctly concludes, *ante,* at 2867 – 2868, Congress has not required the agency to require passive restraints.

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477 F.3d 668
United States Court of Appeals,
Ninth Circuit.

NORTHWEST ENVIRONMENTAL DEFENSE CENTER, Public Employees for Environmental Responsibility; Northwest Sportfishing Industry Association, Petitioners,
Northwest Power and Conservation Council, Intervenor,
v.
BONNEVILLE POWER ADMINISTRATION, Respondent.
Confederated Tribes and Bands of the Yakama Indian Nation, Petitioner,
v.
Bonneville Power Administration, Respondent.

Nos. 06–70430, 06–71182.
|
Argued and Submitted Sept. 12, 2006.
|
Filed Jan. 24, 2007.

Synopsis

Background: Environmental groups and others petitioned for judicial review of actions of federal power marketing agency that operated dams on river in transferring to two contractors the functions of fish passage center (FPC), which provided technical assistance and information on matters related to passage of salmon and steelhead through river and its tributaries to wildlife agencies, Indian tribes, and general public.

Holdings: The Court of Appeals, Gould, Circuit Judge, held that:

[1] subject matter jurisdiction existed over petitions for review;

[2] agency acted contrary to law when agency concluded, based solely on committee report language, that it was bound to transfer FPC's functions to contractors; and

[3] agency's decision to transfer FPC's functions to contractors was arbitrary and capricious.

Petition for review granted.

West Headnotes (24)

[1] **Federal Courts**
Jurisdiction

Court of Appeals considers challenges to its subject matter jurisdiction de novo.

Cases that cite this headnote

[2] **Electricity**
Environmental considerations in general

Pursuant to its original and exclusive subject matter jurisdiction over challenges to final actions and decisions taken under Northwest Power Planning and Conservation Act by federal power marketing agency, or the implementation of such final actions, Court of Appeals had subject matter jurisdiction over petitions for review challenging both agency's solicitation of contractors to take over functions of fish passage center (FPC) and its transfer of FPC's functions to selected contractors, given that solicitation was part of process that led to agency's admittedly final actions in selecting contractors and transferring FPC's functions. Pacific Northwest Electric Power Planning and Conservation Act, § 9(e)(5), 16 U.S.C.A. § 839f(e)(5).

2 Cases that cite this headnote

[3] **Environmental Law**
Organizations, associations, and other groups

Administrative Procedure Act (APA) gave Court of Appeals the equitable power to set aside action of federal power marketing agency in transferring functions of fish passage center (FPC) to contractors if court determined that

agency's action was arbitrary, capricious, or contrary to law, and therefore court had ability to redress claimed injuries required for environmental groups and others to have Article III standing to seek judicial review. U.S.C.A. Const. Art. 3, § 2, cl. 1; 5 U.S.C.A. § 706(2)(A).

5 Cases that cite this headnote

[4] **Federal Civil Procedure**
In general; injury or interest
Federal Civil Procedure
Causation; redressability

To have Article III standing to challenge agency action, petitioners must satisfy three-part test under which petitioners must have suffered an injury in fact which is both (1) concrete and particularized and (2) actual or imminent, petitioners must show a causal connection between their injury and the conduct complained of, and it must be likely, as opposed to merely speculative, that petitioners' injury will be redressed by a favorable decision. U.S.C.A. Const. Art. 3, § 2, cl. 1.

Cases that cite this headnote

[5] **Contracts**
Rewriting, remaking, or revising contract

Court will not create new obligations that do not exist within the four corners of a contract.

Cases that cite this headnote

[6] **Contracts**
Rewriting, remaking, or revising contract

In a contract case between two private parties, court's remedial power is limited to enforcing the obligations to which the private parties agreed.

Cases that cite this headnote

[7] **Administrative Law and Procedure**
Power and authority of reviewing court in general

When a public law has been violated, court is not bound to stay within the terms of a private agreement negotiated by the parties, and may exercise its equitable powers to ensure compliance with the law.

Cases that cite this headnote

[8] **Equity**
Grounds of jurisdiction in general

When the public interest is involved, court's equitable powers assume an even broader and more flexible character than when only a private controversy is at stake.

4 Cases that cite this headnote

[9] **Equity**
Grounds of jurisdiction in general

Unless Congress provides otherwise, courts of equity may go much farther both to give and withhold relief in furtherance of the public interest than they are accustomed to go when only private interests are involved.

Cases that cite this headnote

[10] **Administrative Law and Procedure**
Power and authority of reviewing court in general

Court of Appeals, as a court of equity conducting judicial review under Administrative Procedure Act (APA), has broad powers to order mandatory affirmative relief, if such relief is necessary to accomplish complete justice. 5 U.S.C.A. § 551 et seq.

2 Cases that cite this headnote

[11] **Statutes**
Reports and analyses

Congressional committee report language unconnected to the text of an enacted statute has no binding legal import.

1 Cases that cite this headnote

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[12] **Electricity**
Environmental considerations in general

Federal power marketing agency acted contrary to law when, based solely on language in congressional committee reports that was unconnected to text of enacted statute, agency concluded that it was bound to transfer functions of fish passage center (FPC) that it funded to contractors, contrary to dictates of Northwest Power Planning and Conservation Act; since committee reports were not subject to process outlined in United States Constitution for altering legal duties of persons outside the legislative branch, agency could not give reports binding effect. U.S.C.A. Const. Art. 1, § 7, cl. 2; 5 U.S.C.A. § 706(2); Pacific Northwest Electric Power Planning and Conservation Act, §§ 2(3), 4(d)(2), (h)(10)(A), 5(d)(3), 6(b, c), 16 U.S.C.A. §§ 839(3), 839b(d)(2), (h)(10)(A), 839c(d)(3), 839d(b, c).

1 Cases that cite this headnote

[13] **Statutes**
Particular Kinds of Legislative History

Legislative history, untethered to text in an enacted statute, has no compulsive legal effect.

Cases that cite this headnote

[14] **Statutes**
Legislative History

Principles in legislative history that have no statutory reference point and do not purport to explain any part of an enacted law do not carry the force of law, and thus do not bind anyone, including administrative agencies.

Cases that cite this headnote

[15] **Administrative Law and Procedure**
Annulment, Vacatur, or Setting Aside of Administrative Decision

It is "contrary to law," for purposes of provision of Administrative Procedure Act (APA) empowering courts to set aside an agency decision that is contrary to governing law, for an agency to conclude that it is legally bound by language in a congressional committee report. 5 U.S.C.A. § 706(2).

1 Cases that cite this headnote

[16] **Statutes**
Plain, literal, or clear meaning; ambiguity

When legislative history is tied directly to statutory language and that language is ambiguous, the legislative history may permissibly inform judgment about interpreting ambiguous statutory terms.

Cases that cite this headnote

[17] **Statutes**
Particular Kinds of Legislative History

When legislative history is not tied to any statutory text, court should give it no weight.

1 Cases that cite this headnote

[18] **Constitutional Law**
Nature and scope in general

Constitutional Law
Encroachment on Executive

If Congress wishes to alter the legal duties of persons outside the legislative branch, including administrative agencies, it must use the process outlined in the United States Constitution. U.S.C.A. Const. Art. 1, § 7, cl. 2.

1 Cases that cite this headnote

[19] **Administrative Law and Procedure**
Theory or grounds not provided or relied upon by agency

Court may only sustain an agency's action on the grounds actually considered by the agency.

8 Cases that cite this headnote

[20] **Administrative Law and Procedure**
Review for correctness or error

Administrative Law and Procedure

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Sufficiency of theory or grounds provided by agency

Under arbitrary and capricious standard of review established by Administrative Procedure Act (APA), agency must cogently explain why it has exercised its discretion in a given manner, and, in reviewing that explanation, court must consider whether the decision was based on a consideration of the relevant factors and whether there has been a clear error of judgment. 5 U.S.C.A. § 706(2).

13 Cases that cite this headnote

[21] **Administrative Law and Procedure**
Review for arbitrary, capricious, unreasonable, or illegal actions in general

An agency decision is "arbitrary and capricious," within meaning of Administrative Procedure Act (APA), if the agency has relied on factors which Congress has not intended it to consider, entirely failed to consider an important aspect of the problem, offered an explanation for its decision that runs counter to the evidence before the agency, or is so implausible that it could not be ascribed to a difference in view or the product of agency expertise. 5 U.S.C.A. § 706(2).

10 Cases that cite this headnote

[22] **Administrative Law and Procedure**
Change of policy; reason or explanation
Administrative Law and Procedure
Grounds for change
Administrative Law and Procedure
Explanation or reasons for change

An agency is entitled to change its course when its view of what is in the public's interest changes; however, an agency changing its course must supply a reasoned analysis indicating that prior policies and standards are being deliberately changed, not casually ignored, and if an agency glosses over or swerves from prior precedents without discussion, it may cross the line from the tolerably terse to the intolerably mute.

13 Cases that cite this headnote

[23] **Administrative Law and Procedure**
Theory or grounds not provided or relied upon by agency

In reviewing agency action, court must look to agency's reasoning in making its decision, and not to other reasons for its decision that agency might marshal before the court.

8 Cases that cite this headnote

[24] **Electricity**
Environmental considerations in general

Decision of federal power marketing agency to transfer functions of fish passage center (FPC) that it funded to two contractors was arbitrary and capricious under Administrative Procedure Act (APA), given that decision was departure from agency's two-decades-old precedent and agency did not provide reasoned analysis for its change in course, or show how it determined that transfer of FPC's functions was exercise of its authority consistent with fish and wildlife program adopted by interstate compact agency and with purposes of Northwest Power Planning and Conservation Act. 5 U.S.C.A. § 706(2); Pacific Northwest Electric Power Planning and Conservation Act, § 4(h)(10)(A), 16 U.S.C.A. § 839b(h)(10)(A).

9 Cases that cite this headnote

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On Petition for Review of a Final Action of the Bonneville Power Administration.

Before MICHAEL DALY HAWKINS, BARRY G. SILVERMAN, and RONALD M. GOULD, Circuit Judges.

Opinion

***672** GOULD, Circuit Judge.

Salmon and steelhead [1] are two of the great natural resources of the Columbia River. Their continued existence has been threatened by the construction of dams to capture a third great natural resource of the Columbia River, its water power. As these dams were constructed, the number of salmon and steelhead migrating up the Columbia River to reproduce at its headwaters dropped. At one time, an estimated ten to sixteen million adult fish returned to the Columbia River basin each year. Today, only about one million fish return for spawning that is essential to the species' survival in the Columbia River system.

In response to declining salmon and steelhead runs, Congress passed the Northwest Power Planning and Conservation Act of 1980. The Act created the Northwest Power and Conservation Council, an interstate compact agency, and directs the Council to prepare programs to protect and enhance the fish and wildlife of the Columbia River basin while also assuring the Pacific Northwest an adequate, efficient, economical, and reliable power supply. The Act also instructs the Bonneville Power Administration, the federal agency that operates the dams on the Columbia River, to use its authority in a manner consistent with the programs developed by the Council.

In 1982, the Council called for the creation of what would eventually become the Fish Passage Center. The Fish Passage Center provides technical assistance and information to fish and wildlife agencies, Indian tribes, and the general public on matters related to juvenile and adult salmon and steelhead passage through the Columbia River and its tributaries. Since 1987, the Bonneville Power Administration has funded the Fish Passage Center, and the Fish Passage Center has gathered, analyzed, and publicly-disseminated data regarding fish passage. The Bonneville Power Administration has used this information, in consultation with fisheries and Indian tribes and in conjunction with its control over water flow past the dams, to help improve the survival rates of fish migrating up and down the Columbia River.

In light of language in two 2005 congressional committee reports, however, the Bonneville Power Administration decided to transfer the functions performed by the Fish Passage Center to Battelle Pacific Northwest Laboratory and Pacific States Marine Fisheries Commission. In this consolidated case, Northwest Environmental Defense Center, Public Employees for Environmental Responsibility, Northwest Sportsfishing Industry Association, and the Confederated Tribes and Bands of the Yakama Nation (collectively, "petitioners") petition for review of the Bonneville Power Administration's action transferring the functions of the Fish Passage Center to Battelle Pacific Northwest Laboratory and Pacific States Marine Fisheries Commission and creating a new model Fish Passage Center ("new model").

I

A

Created by the Bonneville Project Act of 1937, 16 U.S.C. §§ 832–832m, the Bonneville Power Administration ("BPA") is a federal agency within the Department of Energy. BPA sells and transmits wholesale electricity from thirty-one federal hydroelectric ***673** plants, one non-federal nuclear power plant in Hanford, Washington, and other non-federal power plants in the Columbia River basin. About BPA Home, http://www.bpa.gov/corporate/About_BPA/ (last visited Jan. 17, 2007). BPA's customers include federal agencies, public and private utility companies, and direct service industrial

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customers. *See Kaiser Aluminum & Chem. Corp. v. BPA,* 261 F.3d 843, 845 (9th Cir.2001). BPA does not receive annual appropriations, as is the case with most federal agencies. Rather, the revenue that BPA obtains from its sales and transmission of electricity is deposited in the Bonneville Power Administration fund ("BPA fund"). 16 U.S.C. § 838i(a). BPA then uses the fund to finance its operations. *Id.* § 838i(b).

As a self-financing power marketing agency, BPA must set its prices high enough to cover its costs. *Indus. Customers of Nw. Utilities v. BPA,* 408 F.3d 638, 641 (9th Cir.2005); *Ass'n of Public Agency Customers, Inc. v. BPA,* 126 F.3d 1158, 1164 (9th Cir.1997) [hereinafter *APAC*]. BPA must also sell power to consumers "at the lowest possible rates." 16 U.S.C. § 838g. At the same time, BPA must be environmentally conscious, supporting energy conservation and protecting the fish and wildlife of the Columbia River basin. *APAC,* 126 F.3d at 1164; *see, e.g.,* 16 U.S.C. § 839b(h)(10)-(11) (providing that BPA must use the BPA fund and its statutory authority in a manner that protects and enhances fish and wildlife).

In 1980, to assist BPA in balancing its responsibilities to provide low-cost energy while protecting fish and wildlife, Congress passed the Pacific Northwest Power Planning and Conservation Act ("Northwest Power Act" or "Act"), Pub.L. No. 96–501, 94 Stat. 2697 (1980) (codified at 16 U.S.C. §§ 839–839h). The Act authorized state governments to form what is now called the Northwest Power and Conservation Council ("Council"), an interstate compact agency[2] comprised of members from Idaho, Montana, Oregon, and Washington. 16 U.S.C. § 839b(a)(2)(B); *see Seattle Master Builders Ass'n v. Pac. Nw. Elec. Power & Conservation Council,* 786 F.2d 1359, 1366 (9th Cir.1986) (upholding the constitutionality of the Council). Each state has agreed to participate in the Council, *see* Idaho Code § 61–1201; Mont.Code Ann. § 90–4–401; Or.Rev.Stat. § 469.803; Wash. Rev.Code Ann. § 43.52A.010, and has enacted legislation authorizing its governor to appoint two members to the Council, *see* Idaho Code § 61–1202; Mont.Code Ann. § 90–4–402; Or.Rev.Stat. § 469.805; Wash. Rev.Code Ann. § 43.52A.030.

The Act charges the Council with two tasks fundamental to this case: (1) preparing and periodically reviewing a regional conservation and electric power plan to aid BPA in acquiring and developing power resources ("Power Plan" or "Plan") and (2) preparing and periodically reviewing a program to protect, mitigate, and enhance fish and wildlife ("Fish and Wildlife Program" or "Program"). 16 U.S.C. § 839b(a)(1).

The current composition of the Council reflects the varied constituencies it serves. The Council is chaired by an expert in natural resource economics. Many Council members are former business persons or practicing attorneys. Indian tribes and *674 fishing enthusiasts are also represented on the Council. Four of the eight current Council members have served as state senators or state representatives in the Pacific Northwest.[3]

The Council submits each project proposed for funding under its Fish and Wildlife Program for review by the Independent Scientific Review Panel, an eleven-member panel of independent scientists appointed by the Council from the recommendations of the National Academy of Scientists. *See id.* § 839b(h)(10)(D). The Act obliges BPA to consult with state fish and wildlife agencies and Indian tribes in carrying out its responsibilities under the Act. *See id.* § 839b(h)(11)(B). In short, the Act "establishes an innovative system of cooperative federalism under which the states, within limits provided in the Act, can represent their shared interests in the maintenance and development of a power supply in the Pacific Northwest and in related environmental concerns." *Seattle Master Builders,* 786 F.2d at 1366.

B

Section 839b(h)(10)(A) of the Act explains how the views of the Council guide BPA's actions. It provides:

> The Administrator [of BPA] shall use the Bonneville Power Administration fund and the authorities available to the Administrator under this chapter and other laws administered by the Administrator to protect, mitigate, and enhance fish and wildlife to the extent affected by the development and operation of any hydroelectric project of the Columbia River and its tributaries in a manner consistent with the plan, if in existence, the program

> adopted by the Council under this subsection, and the purposes of this chapter.

16 U.S.C. § 839b(h)(10)(A). In other words, the Act requires BPA's fish and wildlife protection, mitigation, and enhancement actions to be consistent with (1) the Council's Power Plan; (2) the Council's Fish and Wildlife Program; and (3) the purposes of the Act.[4] Section 839b(h)(10)(A) is thus referred to as the Act's "consistency requirement."

The Council adopted its first Fish and Wildlife Program in 1982. Since 1982, the Council has reviewed and reformulated its Program five times. The current version of the Program was adopted in 2000 ("2000 Program") and amended in 2003 by the Mainstem Amendments ("2003 Amendments").

In preparing the 2000 Program, the Council consulted with the Pacific Northwest's fish and wildlife agencies, Indian tribes, and other interested members of the public, as required by the Act. *See id.* § 839b(g). After considering these parties' recommendations, the Council prepared *675 a draft Program and conducted a public comment period before preparing the final version of the 2000 Program. The Program "expresses goals and objectives for the entire [Columbia River] basin based on a scientific foundation of ecological principles." Nw. Power & Conservation Council, *Columbia River Basin Fish and Wildlife Program* 9 (2000) [hereinafter 2000 Program], *available at* http://www.nwcouncil.org/library/2000/2000–19/ FullReport.pdf. These objectives apply to all fish and wildlife projects implemented in the basin. *Id.* The objectives crucial to this case include mitigating the adverse effects to salmon and steelhead caused by the Columbia River's hydropower system and ensuring sufficient populations of salmon and steelhead for both Indian tribal-trust and treaty-right fishing and non-tribal fishing. *Id.* at 16. A goal of the Program is to increase total adult salmon and steelhead runs on the Columbia River from about one million annually today to an average of five million annually by 2025. *Id.* at 7, 17.

The Fish Passage Center ("FPC") has been a part of the Council's Fish and Wildlife Program since 1982. Originally called the Water Budget Center, it consisted of two managers who oversaw the annual water budget the Council adopted as part of the Program. The water budget provided for additional releases of water from federal dams each spring to facilitate the migration of juvenile salmon and steelhead to the Pacific Ocean. The Water Budget Center's two managers recommended to federal agencies how they could use the water budget to improve the survival rate of fish passing through the dams during their downstream migration. *See Pub. Utility Dist. No. 1 v. BPA,* 947 F.2d 386, 389 (9th Cir.1991) (discussing FPC's oversight of the annual water budget contained in the 1987 Program).

The FPC's responsibilities under the Program have expanded considerably since its days as the Water Budget Center. The Council's 1987 Program provided that BPA "shall fund the establishment and operation of a Fish Passage Center." The Council envisioned that the FPC would assist the dams' fish passage managers in planning and implementing a smolt[5] monitoring program, developing and implementing flow and spill requests, and monitoring and analyzing research results to assist in implementing the water budget and spill planning.

The Council's 2000 Program "continues the operation of the Fish Passage Center." 2000 Program, *supra,* at 28. The 2003 Amendments to the Program elaborate on the Council's vision of the FPC's role, stating that "[t]he mainstem plan calls for the continued operation of the Fish Passage Center," and listing specific tasks the Council expects the FPC to perform in helping implement the water management measures in the Council's Fish and Wildlife Program. Nw. Power & Conservation Council, *Mainstem Amendments to the Columbia River Basin Fish and Wildlife Program* 27 (2003) [hereinafter 2003 Amendments], *available at* http://www.nwcouncil.org/library/2003/2003–11.pdf.

The 2003 Amendments provide that "[t]he primary purpose of the [FPC] is to provide technical assistance and information to fish and wildlife agencies and [Indian] tribes in particular, and the public in general, on matters related to juvenile and *676 adult salmon and steelhead passage through the mainstem hydrosystem." *Id.* The 2003 Amendments require the FPC to (1) plan and implement a smolt monitoring program; (2) gather, organize, analyze, store, and make widely-available monitoring and research information about fish passage and the implementation of water management and fish passage measures contained in the Council's Program; (3) provide technical information to assist fish and wildlife agencies and Indian tribes requesting the federal dams to spill water; and (4) provide technical assistance to ensure the recommendations for river operations avoid conflicts between anadromous[6] and resident fish. *Id.* at 27–28.

To carry out these responsibilities, the FPC monitors more than twenty dams and fish traps; collects data on chinook, steelhead, coho, shad, sockeye, pink salmon, and lamprey; and monitors river conditions, including temperature, dissolved gases, fish hatchery releases, and dam flows and spills. The FPC makes information it gathers available on its website. Fishery managers and Indian tribes use this information to make flow and spill requests to BPA and the operators of the dams, who, by controlling the water flow past the dams, can improve the survival rates of fish migrating downstream. [7]

From the administrative record it appears that the FPC operates independently of BPA and the Council. However, nothing in the record indicates that the FPC is a distinct legal entity. BPA funds the FPC through grants administered by master contracts with the Pacific States Marine Fisheries Commission ("Pacific States"). BPA specifies tasks for the FPC to perform in annual statements of work within BPA's master contract with Pacific States.

D

Conflict between environmental and energy interests in the Columbia River basin has on occasion played out in the courtroom, as shown in BPA-related cases decided by us. *See, e.g., Confederated Tribes of the Umatilla Indian Reservation v. BPA,* 342 F.3d 924 (9th Cir.2003); *Nw. Envtl. Def. Ctr. v. BPA,* 117 F.3d 1520 (9th Cir.1997); *Nw. Res. Info. Ctr., Inc. v. Nw. Power Planning Council,* 35 F.3d 1371 (9th Cir.1994) [hereinafter, *NRIC*]; *Nw. Res. Info. Ctr., Inc. v. Nat'l Marine Fisheries Serv.,* 25 F.3d 872 (9th Cir.1994). In this case, however, an issue over how to balance fish survival and recovery with the inexpensive production of hydropower was raised in the legislative committee process.

*677 In June 2005, the United States Senate Appropriations Subcommittee on Energy and Water Development issued its report on House Resolution 2419, the resolution that would become the Energy and Water Development Appropriations Act of 2006 ("2006 Appropriations Act"). The subcommittee report stated that BPA "may make no new obligations from the Bonneville Power Administration Fund in support of the Fish Passage Center" because "there are universities in the Pacific Northwest that already collect fish data for the region" and can carry out the FPC's responsibilities "at a savings to the region's ratepayers." S.Rep. No. 109–84, at 179 (2005).

On November 19, 2005, Congress passed the 2006 Appropriations Act. Pub.L. No. 109–103, 119 Stat. 2247 (2005). The 2006 Appropriations Act makes no reference to the FPC. The Conference Committee Report of the Congress accompanying the Act, however, states that

> The Bonneville Power Administration may make no new obligations in support of the Fish Passage Center. The conferees call upon Bonneville Power Administration and the Northwest Power and Conservation Council to ensure that an orderly transfer of the Fish Passage Center functions (warehouse of smolt monitoring data, routine data analysis and reporting and coordination of the smolt monitoring program) occurs within 120 days of enactment of this legislation. These functions shall be transferred to other existing and capable entities in the region in a manner that ensures seamless continuity of activities.

H.R.Rep. No. 109–275, at 174 (2005)H.R.Rep. No. 109–275, at 174 (2005) (Conf.Rep.).

On December 8, 2005, in response to the committee reports, BPA issued a "Program Solicitation for Key Functions previously performed by the Fish Passage Center" ("Program Solicitation"). The Program Solicitation states that "[i]n November 2005, the U.S. Congress passed legislation (House Report 109–275)House Report 109–275), which forbids BPA from making additional obligations in support of the Fish Passage Center." The Program Solicitation further states that "BPA has decided to implement this requirement thru [sic] the issuance of this Program Solicitation."

BPA received five responses to its Program Solicitation. On January 26, 2006, BPA announced, in a press release, its decision to award contracts for the functions formerly performed by the FPC to Battelle Pacific Northwest National Laboratory ("Battelle") and Pacific States. [8] The new model

divides between Battelle and Pacific States a number of the functions that had been wholly the responsibility of the FPC. According to the press release, under this new model, Pacific States will "coordinate implementation of the Smolt Monitoring Program, manage the real-time database of the monitoring program and related data, and perform routine analysis and reporting of that data." On the other hand, Battelle will "serve a coordinating function, relying on experts in the field to provide in-depth analysis of the data." Battelle executed its contract with BPA on February 28, 2006, and Pacific States executed its contract on March 16, 2006.

E

Northwest Environmental Defense Center, Public Employees for Environmental Responsibility, and Northwest Sportsfishing Industry Association (collectively, "NEDC") filed a petition for review with ***678** us on January 23, 2006 and an amended petition for review on February 6, 2006, challenging BPA's decision to transfer the functions of the FPC to Pacific States and Battelle, alleging that the transfer of the functions of the FPC ran afoul of BPA's duties under the Northwest Power Act. The Confederated Tribes and Bands of the Yakama Nation ("Yakama") filed a petition for review on March 3, 2006, also challenging BPA's decision to transfer the functions of the FPC.

On March 17, 2006, we granted the petitioners' request for a stay pending our review of BPA's action. We ordered BPA to "continue, pending resolution of [the petition for review] and/or further order of the court, its existing contractual arrangement to fund and support the Fish Passage Center under the existing terms and conditions." On April 7, 2006, we consolidated NEDC's petition with the petition filed by Yakama.

The petitioners ask us to set aside BPA's decision to transfer the functions of the FPC and to use our equitable authority to order BPA to fund the FPC. Before we address the merits of their petitions for review, we must determine whether we have jurisdiction. *See* *Steel Co. v. Citizens for a Better Env't,* 523 U.S. 83, 94–95, 118 S.Ct. 1003, 140 L.Ed.2d 210 (1998).

II

[1] BPA raises two challenges to our jurisdiction. First, BPA argues that we lack statutory jurisdiction to adjudicate the petitioners' challenge to BPA's decision to transfer the functions of the FPC because BPA's December 8, 2005 Program Solicitation is not a "final action" of BPA. *See* 16 U.S.C. § 839f(e)(5) (permitting judicial review of "final actions" of BPA and the Council). Second, BPA asserts that the petitioners do not have standing to challenge BPA's action in this case because a decision in favor of the petitioners will not be likely to redress the petitioners' injury, as required for us to exercise jurisdiction under Article III of the United States Constitution. We consider these challenges to our subject-matter jurisdiction de novo. *Indus. Customers of Nw. Utils.,* 408 F.3d at 644.

A

[2] The Northwest Power Act vests us with original and exclusive subject-matter jurisdiction over challenges to "final actions and decisions taken pursuant to [the Act] by the Administrator [of BPA] or the Council, or the implementation of such final actions." 16 U.S.C. § 839f(e)(5). We have interpreted § 839f(e)(5)'s judicial review provision "with a broad view of this Court's jurisdiction." *Transmission Agency of N. Cal. v. Sierra Pac. Power Co.,* 295 F.3d 918, 925 (9th Cir.2002) (internal quotation omitted).

BPA argues that we lack jurisdiction over the petitioners' challenge to the December 8, 2005 Program Solicitation because the Program Solicitation was not a "final action." But in its brief BPA concedes that its January 26, 2006 decision, selecting the successors to the FPC, is a final agency action subject to judicial review under § 839f(e)(5). While BPA's issuance of the Program Solicitation alone might not have been a final action subject to our review, BPA's initial decision to create a new model Fish Passage Center and to issue the Program Solicitation was part of the process BPA used to set its course, leading to what BPA concedes was its final action transferring the functions of the FPC to Pacific States and Battelle. Because both NEDC's and Yakama's petitions for review directly challenge the January 26, 2006 final action, and BPA's December 8, 2005 action was simply a part of the process that led to BPA's final action, ***679** we have statutory jurisdiction over both NEDC's and Yakama's petitions for review.

B

[3] [4] BPA next argues that we lack Article III jurisdiction over these petitions for review. To have constitutional standing to challenge BPA's action, the petitioners must satisfy a familiar three-part test established by the Supreme Court. First, the petitioners must have suffered an "injury in fact" which is (a) concrete and particularized and (b) actual or imminent. *Lujan v. Defenders of Wildlife,* 504 U.S. 555, 560, 112 S.Ct. 2130, 119 L.Ed.2d 351 (1992). Second, the petitioners must show a causal connection between the injury and the conduct complained of. *Id.* Finally, "it must be likely, as opposed to merely speculative, that the injury will be redressed by a favorable decision." *Id.* at 561, 112 S.Ct. 2130 (internal quotations omitted). BPA argues that the petitioners have failed to satisfy the final element of the test, claiming that the remedy that the petitioners seek is beyond our authority.

The petitioners ask that we set aside BPA's final action transferring the functions of the FPC to Pacific States and Battelle and order BPA to continue the FPC's funding until it can reconsider, in accordance with any opinion of this court, its decision to transfer the functions of the FPC. BPA contends that we have no authority to order BPA to fund the FPC, making it impossible for us to redress any injury suffered by the petitioners and leaving the petitioners without standing. BPA points out that it funded the FPC through an annual grant that expired and was renewed every year. BPA argues that to order it to continue to fund the FPC requires us to force BPA to contract against its will, an action beyond the authority of the judiciary.

[5] [6] The cases BPA relies on are cases stating the unremarkable proposition of contract law that a court will not create new obligations that do not exist within the four corners of a contract. *See* *Imperial Fire Ins. Co. of London v. Coos County,* 151 U.S. 452, 462, 14 S.Ct. 379, 38 L.Ed. 231 (1894) (rejecting jury instructions contrary to the unambiguous language of an insurance policy); *City of New Orleans v. New Orleans Waterworks Co.,* 142 U.S. 79, 91, 12 S.Ct. 142, 35 L.Ed. 943 (1891) (refusing to construe a decision of the Louisiana Supreme Court as creating a new contract between the parties); *Jaeger v. Canadian Bank of Commerce,* 327 F.2d 743, 745 (9th Cir.1964) (stating that courts have no power to make new contracts); *Peterson v. Noots,* 255 F. 875, 880 (9th Cir.1919) (refusing to read additional provision into a liquidated damages clause where the liquidated damages clause was unambiguous). In a contract case between two private parties, our remedial power is no doubt limited to enforcing the obligations to which the private parties agreed. *See* 25 Richard A. Lord, *Williston on Contracts* § 67:30 (4th ed.2006) (stating that a court, in granting equitable relief "is curtailed to the extent that it must generally act within the framework of the contract").

[7] This case presents a different situation. Rather than asking us to remedy a violation of private law (e.g., a breach of contract), the petitioners ask us to remedy the violation of a public law—the Administrative Procedure Act ("APA")[9]—by contending ***680** that BPA acted arbitrarily, capriciously, and contrary to law in transferring the functions of the FPC. *See* 5 U.S.C. § 706(2)(A); *see also* 16 U.S.C. § 839(f)(e)(2) (directing that courts review final actions of BPA under the APA). When a public law has been violated, we are not bound to stay within the terms of a private agreement negotiated by the parties, and may exercise our equitable powers to ensure compliance with the law. *See* *Nat'l Wildlife Fed'n v. Espy,* 45 F.3d 1337, 1343 (9th Cir.1995) ("The court's decision to grant or deny injunctive or declaratory relief under[the] APA is controlled by principles of equity.").

[8] [9] Moreover, "[w]here the public interest is involved, 'equitable powers assume an even broader and more flexible character than when only a private controversy is at stake.' " *United States v. Alisal Water Corp.,* 431 F.3d 643, 654 (9th Cir.2005) (quoting *Porter v. Warner Holding Co.,* 328 U.S. 395, 398, 66 S.Ct. 1086, 90 L.Ed. 1332 (1946)). Unless Congress provides otherwise, " '[c]ourts of equity may, and frequently do, go much farther both to give and withhold relief in furtherance of the public interest than they are accustomed to go when only private interests are involved.' " *United States v. Coca-Cola Bottling Co. of L.A.,* 575 F.2d 222, 228 (9th Cir.1978) (quoting *United States v. First Nat'l City Bank,* 379 U.S. 378, 383, 85 S.Ct. 528, 13 L.Ed.2d 365 (1965)).

For example, in *FTC v. H.N. Singer, Inc.,* 668 F.2d 1107, 1109 (9th Cir.1982), the FTC sought a permanent injunction under the Federal Trade Commission Act. In comparing the scope of the equitable powers of federal courts in private law matters versus public law matters, we wrote:

> "Unless otherwise provided by statute, all the inherent equitable powers of the District Court are available for the proper and complete exercise of [its] jurisdiction. And since the public interest is involved in a proceeding of this nature, those equitable powers assume an even broader and more flexible character than when only a private controversy is at stake. Power is thereby resident in the District Court, in exercising [its] jurisdiction, to do equity and to mould each decree to the necessities of the particular case."

Id. at 1112 (quoting *Porter,* 328 U.S. at 398, 66 S.Ct. 1086) (citation and internal quotation omitted). We concluded that, in the absence of congressional directive, federal courts retain broad equitable powers in public law matters, including the "authority to grant any ancillary relief necessary to accomplish complete justice." *Id.* at 1113. We thus affirmed the district court's injunction freezing the assets of certain defendants. *Id.*

[10] *Section 706(2) of the APA gives us the equitable power* to "set aside" BPA's action transferring the functions of the FPC, if we determine that BPA's action was arbitrary, capricious, or contrary to law. *See* 5 U.S.C. § 706(2)(A); *Tinoqui–Chalola Council of Kitanemuk & Yowlumne Tejon Indians v. U.S. Dep't of Energy,* 232 F.3d 1300, 1305 (9th Cir.2000) (holding that, under the APA, a court has authority to order recision of a contract for sale if the federal agency "acted in excess of statutory authority or without observance of the procedures required by law"). As shown by our prior order mandating that BPA continue to fund the FPC until we rule on the merits of the petitions for review, this court, as a court of equity conducting judicial review under the APA, has broad powers to order "mandatory ***681** affirmative relief,"[10] *Adams v. Witmer,* 271 F.2d 29, 38 (9th Cir.1958), if such relief is "necessary to accomplish complete justice," *H.N. Singer, Inc.,* 668 F.2d at 1113. Stated another way, if we conclude that BPA violated the APA by acting arbitrarily, capriciously, or contrary to law, we have the ability and indeed the juristic duty to remedy BPA's violation. Viewed in this light, we are confident that we retain the power to require BPA to fund the FPC, at least for a period of time in which BPA can reconsider its action in accordance with our opinion. Because we have the power to redress the injury suffered by the petitioners if they prevail on their legal theory, we hold that, under *Lujan,* the petitioners have standing to pursue their petitions for review.

III

As we discussed above, the Northwest Power Act dictates that our review of BPA's final agency action is governed by § 706 of the APA, 5 U.S.C. § 706. 16 U.S.C. § 839f(e)(2). Under the APA, we must set aside BPA's action if it was "arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law." 5 U.S.C. § 706(2)(A); *see NRIC,* 35 F.3d at 1383. The petitioners contend that BPA violated the APA in two ways. First, the petitioners contend that BPA acted "not in accordance with law" by transferring the functions of the FPC based on its belief that language in a committee report had a binding legal effect on the agency. Second, the petitioners argue that BPA acted arbitrarily and capriciously because it did not employ a rational decision-making process in deciding to transfer the functions of the FPC to Pacific States and Battelle. We address those arguments in turn.

A

The petitioners first contend that BPA's decision to transfer the functions of the FPC was "not in accordance with law," 5 U.S.C. § 706(2), because BPA gave legally-binding effect to a passage of legislative history. BPA counters by asserting that it engaged in the rational decision-making process that the APA requires by observing the language contained in the congressional committee reports regarding the 2006 Appropriations Act and implementing the directives in the reports.

1

Though the text of the 2006 Appropriations Act itself made no reference to the FPC, its accompanying conference committee

report stated that "[t]he Bonneville Power Administration may make no new obligations in support of the Fish Passage Center." H.R.Rep. No. 109–275, at 174 (2005)H.R.Rep. No. 109–275, at 174 (2005) (Conf.Rep.). The committee report language also instructed BPA and the Council "to ensure an orderly transfer of the Fish Passage Center functions ... within 120 days of enactment of this legislation." *Id.* The report issued by the Senate Appropriations Subcommittee on Energy and Water Development on House Resolution 2419, the resolution that would become the 2006 Appropriations Act, contained similar language, indicating that ***682** BPA "may make no new obligations from the Bonneville Power Administration Fund in support of the Fish Passage Center." S.Rep. No. 109–84, at 179 (2005).

It is an understatement to say that BPA gave great weight to these reports; more accurate is the observation that BPA slavishly deferred to what it thought the reports commanded. As one example, BPA's Program Solicitation states that "[i]n November 2005, the U.S. Congress passed legislation (House Report 109–275)House Report 109–275), which forbids BPA from making additional obligations in support of the Fish Passage Center." A September 20, 2005 email written by a Vice President of BPA, Gregory K. Delwiche, also reflects BPA's view of the importance of the Senate subcommittee report. Michelle DeHart, Manager of the FPC, had asked Delwiche his thoughts on the future of the FPC. After Delwiche responded that he would have to wait and see "how this is playing out in our nation's capitol [sic]," DeHart replied, "I was really not thinking about talking about the language [in the subcommittee report] but in getting an idea from you as to what your thinking was on the Fish Passage Center in the future." Delwiche responded:

> "[T]he reason the language is important is that what my thinking is on the Fish Passage Center really isn't relevant, what's relevant is what the direction from Wash DC [sic] is. We are merely the implementer of guidance from back there."

Delwiche again indicated his belief that BPA had no choice but to follow the committee report language in a declaration filed in our court, characterizing the language in the committee reports as "unambiguous Congressional direction." Delwiche explained BPA's decision to transfer the FPC by stating that "I did not think that, as an Executive Branch agency, accountable to Congress, BPA could ignore this unambiguous Congressional direction." Finally, in BPA's brief, BPA states that it interpreted the conference committee report as "the unambiguously expressed will of the Congress."

[11] In summary, BPA treated the committee report language as if the language placed a legal obligation on BPA to transfer the functions of the FPC. However, as we explain in the next section, committee report language unconnected to the text of an enacted statute has no binding legal import, and it was contrary to law for BPA to base its decision to transfer the FPC on its belief that "the U.S. Congress passed legislation (House Report 109–275)House Report 109–275) ... forbid[ding] BPA from making additional obligations in support of the Fish Passage Center."

2

[12] **[13]** The APA empowers us to set aside an agency decision that is contrary to governing law. 5 U.S.C. § 706(2); *see* *Lands Council v. Powell,* 395 F.3d 1019, 1026 (9th Cir.2005). The case law of the Supreme Court and our court establishes that legislative history, untethered to text in an enacted statute, has no compulsive legal effect. It was thus contrary to law for BPA to conclude, from committee report language alone, that it was bound to transfer the functions of the FPC.

In *Shannon v. United States,* 512 U.S. 573, 579, 114 S.Ct. 2419, 129 L.Ed.2d 459 (1994), the petitioner, a criminal defendant, argued that the district court erred by failing to instruct the jury about the consequences of finding him not guilty by reason of insanity. The petitioner argued that Congress, in enacting the Insanity Defense Reform Act of 1984 ("IDRA"), intended to require that district courts instruct the jury as to the consequences of ***683** an insanity acquittal. *Id.* at 583, 114 S.Ct. 2419. The text of IDRA was silent on the matter. *Id.* at 580, 114 S.Ct. 2419; *see* 18 U.S.C. § 4242(b) (stating that "the jury shall be instructed to find ... the defendant—(1) guilty; (2) not guilty; or (3) not guilty only by reason of insanity"). In support of his argument that IDRA required the district court to instruct the jury about the consequences of an insanity acquittal, the petitioner in *Shannon* pointed to language in the Senate Report on IDRA,

which stated that "[t]he Committee endorses the procedure used in the District of Columbia whereby the jury, in a case in which the insanity defense has been raised, may be instructed on the effect of a verdict of not guilty by reason of insanity." *Shannon,* 512 U.S. at 583, 114 S.Ct. 2419 (internal quotation omitted).

[14] The United States Supreme Court refused to give weight to this passage of legislative history unattached to the text of IDRA: "We are not aware of any case ... in which we have given authoritative weight to a single passage of legislative history that is in no way anchored in the text of the statute." *Id.* The Court emphasized that the passage of legislative history Shannon identified "[did] not purport to explain or interpret any provision of the IDRA." *Id.* The Court concluded by stating that " 'courts have no authority to enforce [a] principl[e] gleaned solely from legislative history that has no statutory reference point.' " *Id.* at 584, 114 S.Ct. 2419 (alterations in original) (quoting *Int'l Bhd. of Elec. Workers, Local Union No. 474 v. NLRB,* 814 F.2d 697, 712 (D.C.Cir.1987)); *see also* *Abrego v. Dow Chem. Co.,* 443 F.3d 676, 686 (9th Cir.2006) (per curiam) (holding that statutory silence, "coupled with a sentence in a legislative committee report untethered to any statutory language," did not bring about a change in governing law). The Supreme Court thus made clear that principles in legislative history that have no statutory reference point and do not purport to explain any part of an enacted law do not carry the force of law. As such, they do not bind *anyone*—administrative agencies included.

[15] **[16]** **[17]** *Shannon* is not the only case illustrating that it is contrary to law for an agency to conclude that it is legally bound by language in a congressional committee report. In *Cherokee Nation of Oklahoma v. Leavitt,* 543 U.S. 631, 646, 125 S.Ct. 1172, 161 L.Ed.2d 66 (2005), the Secretary of Health and Human Services argued that unambiguous statutory language, when paired with conflicting legislative history, rendered a statute ambiguous. The Court held that the statute was not ambiguous, stating that "[t]he relevant case law makes clear that restrictive language contained in Committee Reports is not legally binding." *Id.* at 646, 125 S.Ct. 1172 (citing *Lincoln v. Vigil,* 508 U.S. 182, 192, 113 S.Ct. 2024, 124 L.Ed.2d 101 (1993); *UAW v. Donovan,* 746 F.2d 855, 860–61 (D.C.Cir.1984) (Scalia, J.); *Blackhawk Heating & Plumbing Co. v. United States,* 224 Ct.Cl. 111, 622 F.2d 539, 552 & n. 9 (1980)); *see also* *Lincoln,* 508 U.S. at 192, 113 S.Ct. 2024 ("[I]ndicia in committee reports and other legislative history as to how ... funds should or are expected to be spent do not establish any legal requirements on [an] agency." (internal quotation omitted)).[11]

***684** **[18]** The principle that committee report language has no binding legal effect is grounded in the text of the Constitution and in the structure of separated powers the Constitution created. Article I, section 7, clause 2 of the Constitution is explicit about the manner in which Congress can take legally binding action.[12] Members of Congress cannot use committee report language to make an end run around the requirements of Article I. If Congress wishes to alter the legal duties of persons outside the legislative branch, including administrative agencies, it must use the process outlined in Article I. *See* *INS v. Chadha,* 462 U.S. 919, 952, 103 S.Ct. 2764, 77 L.Ed.2d 317 (1983); *see also* *Clinton v. City of New York,* 524 U.S. 417, 439–40, 118 S.Ct. 2091, 141 L.Ed.2d 393 (1998) (holding that "the power to enact statutes may only be exercised in accord with a single, finely wrought and exhaustively considered, procedure" outlined in Article I (internal quotation omitted)). BPA acted contrary to law by treating committee report language—language that was not subjected to the bicameralism and presentment requirements of Article I—as imposing upon BPA a legal duty to transfer the functions of the FPC. Because the committee reports in this case were not subject to the "finely wrought" process in Article I, BPA erred by giving the reports binding effect.

Treating legislative reports as binding law also undermines our constitutional structure of separated powers, because legislative reports do not come with the traditional and constitutionally-mandated political safeguards of legislation. As noted above, legislative reports are not acts of law satisfying the precise requirements of Article I, which were devised by the Framers to ensure separation of powers and a careful legislative process. By contrast, legislative reports may in some cases be written by an individual legislator, congressional staffers, or even lobbyists.[13] ***685** Giving binding effect to passages in legislative reports may thus give binding legal effect to the unchecked will of a lone person, and that is not what our Constitution envisions.

The statements of BPA Vice President Delwiche illustrate how BPA's reliance on legislative history undermined separation of powers in this case. Delwiche said that BPA, the agency he led, was "an Executive Branch agency, accountable to Congress." It is certainly true that Congress through legislation may direct how BPA shall operate. But an executive branch agency which views itself as subservient to a sentence in a legislative report undermines the distribution of authority in our federal government in which every exercise of political power is checked and balanced.

BPA's treatment of legislative history as binding law also frustrated the statutory design of the Northwest Power Act. Rather than adhering to the Act's carefully-tailored requirement that BPA take actions consistent with the guidance provided by the Plan and Program crafted by the Council as well as the purposes of the Act, BPA simply gave conclusive weight to what might have been the view of a lone legislator, staffer, or lobbyist. That the Council, and guidance from it, derives from political and expert representatives from four Pacific Northwest states, affected Indian tribes, and groups with interest in fisheries only intensifies BPA's error in relying so heavily on congressional report statements that might have been penned by a single legislator or single lobbyist, and that do not satisfy Article I's requirements and do not have force of law. The Act contemplates a participatory process in which the varied constituencies of the Pacific Northwest advise BPA on how it should exercise its discretion. By following congressional committee report language as if it were mandatory law, BPA ignored the opinions of those individuals and groups directly affected by its policy choices and circumvented the unique structure of cooperative federalism created by the Act.

Delwiche incorrectly believed that the dominant factors in his decision about the continued operation of the FPC were statements in legislative history, untied to the legislative commands of Congress, when, to the contrary, his agency's organic statute, the Northwest Power Act, states that one of its purposes is to allow the States, local governments, and citizens of the Pacific Northwest (including fish and wildlife agencies and Indian tribes) to participate in the development of regional energy conservation plans, plans for renewable resources, and plans for environmental ***686** protection and enhancement. 16 U.S.C. § 839(3).[14]

The Act also requires BPA to exercise its authority in a manner consistent with the Council's Fish and Wildlife Program, *see id.* § 839b(h)(10)(A), the most recent version of which called for the continued operation of the FPC. Indeed, the Act makes no secret that BPA's actions "shall be consistent with the [Council's Fish and Wildlife] plan and any amendment thereto," *id.* § 839b(d)(2), as the Act recites the consistency requirement numerous times, *see id.* §§ 839b(h), 839c(d)(3), 839d(b)-(c). Possibly, BPA could exercise some discretion to depart from its prior practice of funding the FPC in accordance with the Council's Fish and Wildlife Program, if such a departure was necessary for BPA to comply with its statutory obligation to use its authority in a manner consistent with the Council's Power Plan or purposes of the Act. But no nice question of balancing potentially conflicting obligations is presented when BPA adopts a slavish adherence to a sentence in a legislative committee report.

[19] We may only sustain an agency's action on the grounds actually considered by the agency. As the Supreme Court explained in *SEC v. Chenery Corp.*, 318 U.S. 80, 95, 63 S.Ct. 454, 87 L.Ed. 626 (1943), "an administrative order cannot be upheld unless the grounds upon which the agency acted in exercising its powers were those upon which its action can be sustained." In other words, the APA obliges us to set BPA's action aside unless the record demonstrates that, because BPA considered some other basis for its action, BPA's decision to transfer the functions of the FPC was not arbitrary, capricious, or contrary to law. *See* *SEC v. Chenery Corp.*, 332 U.S. 194, 196, 67 S.Ct. 1575, 91 L.Ed. 1995 (1947) ("[A] reviewing court, in dealing with a determination or judgment which an administrative agency alone is authorized to make, must judge the propriety of such action solely by the grounds invoked by the agency. If those grounds are inadequate or improper, the court is powerless to affirm the administrative action by substituting what it considers to be a more adequate or proper basis.").

B

BPA argues that, even if language in the congressional committee reports did not provide a rational basis for its action transferring the functions of the FPC, its decision can be upheld as a reasonable application of the Act's requirement that it exercise its authority in a manner consistent with the Council's Fish and Wildlife Program. BPA contends that it carefully considered the issues before it and therefore we should let stand its decision to transfer the functions of the FPC. The petitioners contend, by contrast, that BPA never considered the consistency provision of the Act in deciding to

transfer the functions of the FPC and insufficiently analyzed the issues before it. Thus, petitioners urge that BPA acted arbitrarily and capriciously.

1

[20] Before further evaluating BPA's decision to transfer the functions of the *687 FPC to Pacific States and Battelle, we outline the principles governing the scope of our review under the arbitrary and capricious standard of § 706(2) of the APA. The Supreme Court has explained:

> The scope of review under the "arbitrary and capricious" standard is narrow and a court is not to substitute its judgment for that of the agency. Nevertheless, the agency must examine the relevant data and articulate a satisfactory explanation for its action including a "rational connection between the facts found and the choice made."

Motor Vehicle Mfgs. Ass'n v. State Farm Mutual Auto. Ins. Co., 463 U.S. 29, 43, 103 S.Ct. 2856, 77 L.Ed.2d 443 (1983) (quoting *Burlington Truck Lines v. United States*, 371 U.S. 156, 168, 83 S.Ct. 239, 9 L.Ed.2d 207 (1962)); *see* *Natural Res. Def. Council v. U.S. Forest Serv.*, 421 F.3d 797, 806 (9th Cir.2005). That is, an agency must "cogently explain why it has exercised its discretion in a given manner," and "[i]n reviewing that explanation, we must 'consider whether the decision was based on a consideration of the relevant factors and whether there has been a clear error of judgment.' " *State Farm*, 463 U.S. at 43, 48, 103 S.Ct. 2856 (quoting *Bowman Transp., Inc. v. Ark.-Best Freight Sys.*, 419 U.S. 281, 285, 95 S.Ct. 438, 42 L.Ed.2d 447 (1974)).

[21] An agency decision is arbitrary and capricious "if the agency has relied on factors which Congress has not intended it to consider, entirely failed to consider an important aspect of the problem, offered an explanation for its decision that runs counter to the evidence before the agency, or is so implausible that it could not be ascribed to a difference in view or the product of agency expertise." *State Farm*, 463 U.S. at 43, 103 S.Ct. 2856. [15]

[22] In this case, BPA departed from its long-standing practice of funding a unitary Fish Passage Center and transferred the FPC's functions to two separate entities. An agency is entitled to change its course when its view of what is in the public's interest changes. However, "an agency changing its course must supply a reasoned analysis indicating that prior policies and standards are being deliberately changed, not casually ignored, and if an agency glosses over or swerves from prior precedents without discussion it may cross the line from the tolerably terse to the *688 intolerably mute." *Greater Boston Television Corp. v. FCC*, 444 F.2d 841, 852 (D.C.Cir.1970) (footnotes omitted), *quoted in* *State Farm*, 463 U.S. at 57, 103 S.Ct. 2856; *see also* *Atchison, Topeka & Santa Fe Ry. v. Wichita Bd. of Trade*, 412 U.S. 800, 808, 93 S.Ct. 2367, 37 L.Ed.2d 350 (1973) (plurality opinion) ("Whatever the ground for the [agency's] departure from prior norms, ... it must be clearly set forth so that the reviewing court may understand the basis of the agency's action and so may judge the consistency of that action with the agency's mandate."); *W. States Petroleum Ass'n v. EPA*, 87 F.3d 280, 284 (9th Cir.1996) (stating that an agency "must clearly set forth the ground for its departure from prior norms").

[23] Moreover, in reviewing BPA's action, we must look to BPA's reasoning in making its decision to transfer the functions of the FPC, and not to other reasons for its decision that BPA might marshal before us. As the Supreme Court has explained, we "may not accept appellate counsel's post hoc rationalizations for agency action," *Burlington Truck Lines*, 371 U.S. at 168, 83 S.Ct. 239, and we "may not supply a reasoned basis for the agency's action that the agency itself has not given," *Bowman Transp., Inc.*, 419 U.S. at 285–86, 95 S.Ct. 438 (citing *Chenery*, 332 U.S. at 196, 67 S.Ct. 1575). [16]

2

[24] In arguing that it sufficiently assessed the issues before it, BPA defends its decision as the outcome of "a public process within the confines of the 120–day transition period set by Congress." However, the administrative record does not show that BPA, as required by *State Farm*, considered the relevant facts and used a rational process to decide to transfer the functions of the FPC to other entities. Apart from the evidence in the record reflecting BPA's incorrect belief that it was required to follow the congressional committee report language, there is no evidence showing how BPA

decided to transfer the functions of the FPC and to issue the December 8, 2005 Program Solicitation. This failure presents itself in high relief in light of the Council's program calling for the continued operation of the FPC. So far as the record is concerned, we have no explanation for why BPA would abandon the FPC in the face of its inclusion in the Council's Program, beyond the mistaken belief of BPA that statements in legislative reports were mandatory and foreclosed the continued funding of the FPC.

As evidence of the decision-making process BPA used to decide to award the contract for the functions formerly performed by the FPC to Pacific States and Battelle, BPA points to a PowerPoint slide from a presentation dated January 26, 2006, the same day BPA issued a press release announcing that it decided to transfer the FPC's functions to Pacific States and Battelle. In the slide BPA ***689** prepared, each bidder received an "X" for each of eight specified tasks[17] BPA determined the bidder could satisfactorily perform. In other words, a bidder who BPA concluded could perform all eight tasks satisfactorily would receive eight Xs, a bidder who could perform four of the eight tasks satisfactorily would receive four Xs, and so on. But there is no evidence in the record of how BPA determined whether a bidder would get an X or be left blank for each specified task. And even if the PowerPoint presentation did contain evidence of a rational decision-making process, it is uncertain whether BPA actually relied on that process in making its decision to transfer the functions of the FPC to Pacific States and Battelle because the PowerPoint slide was prepared on January 26, 2006, the very same day BPA announced it decided to award Pacific States and Battelle the contracts to perform the functions formerly performed by the FPC.

As further purported evidence of the process which led BPA to decide to transfer the functions of the FPC to Pacific States and Battelle, BPA presents a memorandum comparing the functions of the FPC with the functions of the new model. However, the memorandum giving this comparison was drafted on March 13, 2006, a month and a half after BPA awarded the contracts for the functions formerly performed by the FPC to two other entities. BPA thus could not have relied on this memorandum in deciding to transfer the functions of the FPC and in awarding the contracts to Pacific States and Battelle.

BPA also indicated, in a letter to the Yakama tribe and a similar letter to five members of the Pacific Northwest's congressional delegation, that it believed the Program Solicitation complied with its duty, under the Act, to "mitigate the impact on salmon and steelhead in a manner consistent with the Program." But again, the letter does not reflect any rational decision-making process that BPA relied upon to conclude that transferring the functions of the FPC was in accord with its statutory duty to use its authority in a manner consistent with the Council's Fish and Wildlife Program.

In *Confederated Tribes,* 342 F.3d at 933, we held that BPA provided a reasoned explanation for its decision that implementing certain biological opinions was consistent with BPA's statutory mandate to treat fish and wildlife equitably with power because the record elaborated BPA programs, decisions, and opinions reflecting how BPA gave equitable treatment to fish and wildlife. By contrast, in this case, the only reference in the administrative record to the Act's consistency requirement is the letter from BPA to Yakama and the similar letter from BPA to five members of the Pacific Northwest's congressional delegation baldly asserting that BPA is transferring the functions of the FPC to comply with its statutory mandate to protect fish and wildlife consistent with the Program. But the record does not show the process, if there was one, that BPA used to determine that its decision to transfer the functions of the FPC was consistent with BPA's statutory mandate to use its authority in a manner consistent with the Council's Fish and Wildlife Program. Because the 2003 Amendments to the Council's Program describe the functions ***690** the FPC should perform, BPA's record of decision should have shown reasons for its decision to transfer the FPC's functions elsewhere and how this would be consistent with the Council's Fish and Wildlife Program.

This case is more similar to *State Farm* than it is to *Confederated Tribes.* In *State Farm,* the Supreme Court held that the National Highway Traffic Safety Administration's ("NHTSA") decision to rescind a rule requiring automobile manufacturers to include passive restraints in their cars was arbitrary and capricious because the NHTSA provided " 'no findings and no analysis here to justify the choice made, no indication of the basis on which the [agency] exercised its expert discretion.' " *State Farm,* 463 U.S. at 48, 103 S.Ct. 2856 (alteration in original) (quoting *Burlington Truck Lines,* 371 U.S. at 167, 83 S.Ct. 239). Just as the NHTSA had the authority to use its discretion to rescind the passive restraint rule in *State Farm,* so too BPA possibly may have the ability rationally to conclude that the continued operation of the FPC in its present state was no longer in the public interest, after giving due weight to the

Act's requirement that its actions be consistent with what the Council said in the Program and Plan, and the purposes of the Northwest Power Act. "But an agency changing its course must supply a reasoned analysis...." *Id.* at 57, 103 S.Ct. 2856 (internal quotation omitted). BPA has not cogently explained its decision to transfer the functions of the FPC, and the record does not indicate that that decision was the output of a rational decision-making process. Instead, BPA departed from its two-decade-old precedent without supplying a reasoned analysis for its change of course. [18] BPA's decision to transfer the functions of the FPC was arbitrary and capricious. [19]

***691 IV**

The United States Supreme Court has declared that we must require that an agency "cogently explain why it has exercised its discretion in a given manner." *State Farm,* 463 U.S. at 48, 103 S.Ct. 2856. The only explanation shown in BPA's record for why it transferred the functions of the FPC was that it was responding to congressional committee report language that BPA believed created a binding obligation on it. That is not a cogent explanation because BPA acted contrary to law in concluding that congressional committee report language carried the force of law and bound BPA to transfer the functions of the FPC. Because BPA has not shown a rational basis for its decision to transfer the functions of the FPC to Pacific States and Battelle, we grant the petition for review. We hold that BPA's decision to transfer the functions of the FPC to Pacific States and Battelle was arbitrary, capricious, and contrary to law. We set aside BPA's decision to transfer the functions of the FPC to Pacific States and Battelle and order that BPA continue its existing contractual arrangement to fund and support the FPC unless and until it has established a proper basis for displacing the FPC.

PETITION FOR REVIEW GRANTED.

All Citations

477 F.3d 668, 07 Cal. Daily Op. Serv. 858, 2007 Daily Journal D.A.R. 1109

Footnotes

1 A steelhead is a rainbow trout which has spent part of its life at sea. Alaska Dep't of Fish & Game, *Steelhead Trout,* http://www.adfg. state.ak.us/pubs/notebook/fish/steelhd.php (last visited Jan. 17, 2007).

2 For a landmark discussion of the use of the Compact Clause, article I, section 10, clause 3 of the Constitution, to permit agreements by states on a regional basis, including the need to do so to promote sound development of electrical power and conservation of natural resources, see Felix Frankfurter & James M. Landis, *The Compact Clause of the Constitution —A Study In Interstate Adjustments,* 34 Yale L.J. 685 (1925).

3 For biographical information on the Council's current members, see Council Members, http://www.nwcouncil.org/contact/members.asp (last visited Jan. 17, 2007).

4 In 16 U.S.C. § 839, Congress listed the purposes of the Act: (1) to encourage electricity conservation and the development of renewable resources in the Pacific Northwest; (2) "to assure the Pacific Northwest of an adequate, efficient, economical, and reliable power supply"; (3) to allow the States, local governments, and citizens of the Pacific Northwest (including fish and wildlife agencies and Indian tribes) to participate in the development of regional energy conservation plans, plans for renewable resources, and plans for environmental protection and enhancement; (4) to ensure that BPA's customers cover the costs necessary to meet the region's electricity needs; (5) to ensure that non-federal entities continue to regulate, plan, conserve, supply, and distribute electricity; and (6) "to protect, mitigate and enhance the fish and wildlife ... of the Columbia River and its tributaries."

5 A smolt is a juvenile salmon in the stage where it becomes covered with silvery scales and first embarks on its journey to salt water. *See* John V. Byrne, *Salmon Is King—Or Is It?,* 16 Envtl. L. 343, 352–53 (1986).

6 An anadromous fish lives in the sea but breeds in freshwater. *See* 50 C.F.R. § 401.2(g) (defining anadromous fish as "[a]quatic, gill breathing, vertebrate animals bearing paired fins which migrate to and spawn in fresh water, but which spend part of their life in an oceanic environment"); *see also* Convention for the Conservation of Anadromous Stocks of the North Pacific Ocean, art. II.1, annex pt. I, Feb. 11, 1992, T.I.A.S. No. 11,465 (classifying the following species as anadromous fish: chum salmon, coho salmon, pink salmon, sockeye salmon, chinook salmon, cherry salmon, and steelhead trout); 16 U.S.C. §§ 5001–12 (implementing the Convention).

7 Fish migrating down the stream of a dammed river encounter a series of dangers. The fish must navigate the reservoir of standing water maintained behind the dam. The standing water slows the migration of the fish and exposes the fish to

predators. After navigating the reservoir, the fish must then pass the dam safely. Fish may pass a dam by being spilled over the dam, by passing through the turbines of the dam, or by being transported around the dam. *See* *Nat'l Wildlife Fed'n v. Nat'l Marine Fisheries Serv.*, 422 F.3d 782, 788–89 (9th Cir.2005). The data gathered by the FPC is used to measure the success that fish have passing dams.

8 Pacific States is the entity that now contracts with BPA to receive the grants that Pacific States in turn uses to fund the operations of the FPC. *See supra* at 677.

9 Public law is the body of law regulating relations between private parties and the government and regulating the structure and operation of the government itself. *See Black's Law Dictionary* 1267 (8th ed.2004). Public law consists of the fields of constitutional law, criminal law, and administrative law. *Id.*

10 In *Norton v. Southern Utah Wilderness Alliance*, 542 U.S. 55, 64, 124 S.Ct. 2373, 159 L.Ed.2d 137 (2004), the Supreme Court held that, when a party seeks redress because an agency has failed to act, a court may only require the agency to perform non-discretionary actions that the agency is required by law to undertake. *Norton* is distinguishable from the instant case because *Norton* dealt with the power of courts to "compel agency action unlawfully withheld" under 5 U.S.C. § 706(1). The petitioners here do not seek redress for agency inaction under § 706(1), but rather challenge a final agency action under the § 706(2) and the Northwest Power Act.

11 The utility of legislative history stands on a different footing when it is tied directly to statutory language and that language is ambiguous. In such a case, the legislative history may permissibly inform judgment about interpreting ambiguous statutory terms. For example, in *Northwest Forest Resource Council v. Glickman*, we stated, "a congressional conference report is recognized as the most reliable evidence of congressional intent because it 'represents the final statement of the terms agreed to by both houses.' " 82 F.3d 825, 835 (9th Cir.1996) (quoting *Dep't of Health & Welfare v. Block*, 784 F.2d 895, 901 (9th Cir.1986)). However, in that case, the statutory language was not silent on the relevant issue. *See id.* Here, by contrast, the passage of legislative history in question is unrelated to any provision of the statute that Congress has enacted. When legislative history is not tied to any statutory text, we properly should give it no weight. *See* *Abrego*, 443 F.3d at 683 ("[C]onsideration of legislative history is appropriate where statutory language is ambiguous. Ambiguity, however, is at least a necessary condition. In this instance, the statute is not ambiguous. Instead, it is entirely silent as to the burden of proof on removal." (citations omitted))

12 Article I, section 7, clause 2 of the United States Constitution provides:

> Every bill which shall have passed the House of Representatives and the Senate shall, before it become a law, be presented to the President of the United States; if he approve; he shall sign it; but if not, he shall return it, with his objections, to that House in which it shall have originated, who shall enter the objections at large on their journal, and proceed to reconsider it. If after such reconsideration two thirds of that House shall agree to pass the bill, it shall be sent, together with the objections, to the other House, by which it shall likewise be reconsidered, and if approved by two thirds of that House, it shall become a law. But in all such cases the votes of both Houses shall be determined by yeas and nays, and the names of the persons voting for and against the bill shall be entered on the journal of each House respectively. If any bill shall not be returned by the President within ten days (Sundays excepted) after it shall have been presented to him, the same shall be a law in like manner as if he had signed it, unless the Congress by their adjournment prevent its return, in which case it shall not be a law.

13 The Supreme Court has cautioned:

> [L]egislative materials like committee reports, which are not themselves subject to the requirements of Article I, may give unrepresentative committee members—or, worse yet, unelected staffers and lobbyists—both the power and the incentive to attempt strategic manipulations of legislative history to secure results they were unable to achieve through the statutory text.

Exxon Mobil Corp. v. Allapattah Servs., Inc., 545 U.S. 546, ——, 125 S.Ct. 2611, 2626, 162 L.Ed.2d 502 (2005).

Judge Kozinski has likewise observed:

> Reports are usually written by staff or lobbyists, not legislators; few if any legislators read the reports; they are not voted on by the committee whose views they supposedly represent, much less by the full Senate or House of Representatives; they cannot be amended or modified on the floor by legislators who may disagree with the views expressed therein.

Wallace v. Christensen, 802 F.2d 1539, 1560 (9th Cir.1986) (en banc) (Kozinski, J., concurring).

Committee reports often contain "what some committee members wanted in the bill, but did not get," and are often written before the bill is drafted, *Puerta v. United States,* 121 F.3d 1338, 1344 (9th Cir.1997), or after a bill is passed, *Lao v. Wickes Furniture Co., Inc.,* 455 F.Supp.2d 1045, 1051 (C.D.Cal.2006) (refusing to give weight to committee report issued ten days after the passage of a law).

14 In *NRIC,* 35 F.3d at 1388, we recognized that the Council must give "due weight" to views of fishery managers, state and federal wildlife agencies, and Indian tribes in formulating the Fish and Wildlife Program. *See* 16 U.S.C. § 839b(h)(7). It follows with stronger logic that when the final Fish and Wildlife Program, the product of a collaborative process, calls for the continued operation of the FPC, BPA cannot then disregard the Council's view without giving the Council's view due weight. The Northwest Power Act requires BPA to act in a manner *consistent* with the Fish and Wildlife Program. *Id.* § 839b(h)(10)(A).

15 "Some courts have held that agency action is arbitrary and capricious if 'the agency has not really taken a "hard look" at the salient problems and has not genuinely engaged in reasoned decision-making.' " *Riverbend Farms, Inc. v. Madigan,* 958 F.2d 1479, 1488 (9th Cir.1992) (quoting *Greater Boston Television Corp. v. FCC,* 444 F.2d 841, 851 (D.C.Cir.1970)). Accordingly, some commentators have suggested that our task in reviewing agency action under § 706(2) of the APA is to "look[ ] closely at whether the agency has taken a hard look at the question" before it, 33 Charles Alan Wright & Charles H. Koch, Jr., *Federal Practice and Procedure* § 8335 (2006) (emphasis omitted), though other commentators decline to adopt the "hard look" phraseology, *see* 2 Richard J. Pierce, Jr., *Administrative Law Treatise* § 11.4 (4th ed. 2002) ("In order to avoid judicial reversal of its action as arbitrary and capricious, an agency must engage in 'reasoned decisionmaking,' defined to include an explanation of how the agency proceeded from its findings to the action it has taken."). Because the Supreme Court has never explicitly embraced the "hard look" approach to judicial review under the arbitrary and capricious standard of the APA, *cf.* *Indus. Union Dep't, AFL–CIO v. Am. Petroleum Inst.,* 448 U.S. 607, 695 n. 9, 100 S.Ct. 2844, 65 L.Ed.2d 1010 (1980) (Marshall, J., dissenting) (stating that the arbitrary and capricious "inquiry is designed to require the agency to take a 'hard look' " at the issues before it), we adhere to the Supreme Court's explicit guidance in *State Farm* that an agency must cogently explain its actions and demonstrate a rational connection between the facts it found and the choice it made.

16 BPA argues that its interpretation of the Northwest Power Act and its decision to transfer the functions of the FPC are entitled to substantial deference under *Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc.,* 467 U.S. 837, 842–45, 104 S.Ct. 2778, 81 L.Ed.2d 694 (1984), *Aluminum Co. of America v. Central Lincoln Peoples' Utility District,* 467 U.S. 380, 389, 104 S.Ct. 2472, 81 L.Ed.2d 301 (1984), and their progeny in our court, *see, e.g.,* *APAC,* 126 F.3d at 1164. Perhaps BPA might be entitled to deference in this case if it was actually interpreting the Act, one of its organic statutes. However, as we discuss in the next section, there is scant evidence in the record that BPA, in deciding to transfer the functions of the FPC, was interpreting the Act's provision that it exercise its authority in a manner consistent with the Council's Fish and Wildlife Program, *see* 16 U.S.C. § 839b(h)(10)(A), or was interpreting any other provision of the Act.

17 The specified tasks were: database management; routine analysis and reporting; coordination of the smolt monitoring program; miscellaneous additional technical tasks; expanded, non-routine analysis; independent technical review; policy oversight and guidance; and coordination with other contractors.

18 In its brief, BPA argues that it consulted with various fishery managers, one scientist, and the public in making its decision to transfer the functions of the FPC. BPA asserts that, in deciding which proposals to accept, it "consulted with tribal, state and federal fisheries managers"; "provided a forum in which to hold public discussion and debate on this issue"; "considered and largely followed the recommendations" of a group of Indian tribes and an association of fisheries; ensured that the Program Solicitation complied with the 2003 Amendments to the Fish and Wildlife Program; "followed the general principles from the U.S. National Academies scientific reporting process" in preparing the technical services agreement with the entities replacing the FPC; obtained "expert scientific review of the proposals" from the former executive director of the Columbia Basin Fish and Wildlife Authority; and "relied on the advice provided in letters from members of the Northwest congressional delegation, as well as the report language and the Program amendments." However, as we discussed, it does not appear from the record that BPA actually relied upon any of these rationales in deciding to transfer the functions of the FPC, and BPA may not justify its decision to our court based on these post-hoc rationalizations for its action. *See* *Burlington Truck Lines,* 371 U.S. at 168, 83 S.Ct. 239.

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19 BPA argues that its decision to transfer the functions of the FPC complies with its substantive obligation to exercise its authority "in a manner consistent with the plan, ... the program adopted by the Council ..., and the purposes of [the Northwest Power Act]," 16 U.S.C. § 839b(h)(10)(A), even though the 2000 Program and the 2003 Amendments "call [ ] for the continued operation of the Fish Passage Center." 2003 Amendments, *supra,* at 27. Because we hold that BPA's decision to transfer the functions of the FPC was not the output of a reasoned decision-making process, as the APA requires, we need not determine whether, on a proper record with factual determinations and an adequate explanation of a rational connection between facts determined and action taken, a decision of BPA to transfer the functions of the FPC is consistent with the Council's Fish and Wildlife Program and with the Plan and the objectives of the Northwest Power Act.

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Distinguished by IN THE MATTER OF THE APPLICATION OF DENISE M. OLSON C/O BRUCE M. BETTIGOLE, ESQ. SUTHERLAND ASBILL & BRENNAN LLP 700 SIXTH STREET, NW, SUITE 700 WASHINGTON, DC 20001-3980 FOR REVIEW OF DISCIPLINARY ACTION TAKEN BY FINRA, S.E.C. Release No., September 3, 2015

718 F.3d 904
United States Court of Appeals,
District of Columbia Circuit.

John M.E. SAAD, Petitioner
v.
SECURITIES AND EXCHANGE COMMISSION, Respondent.

No. 10–1195.
|
Argued Jan. 9, 2013.
|
Decided June 11, 2013.

Synopsis
Background: Registered representative of securities broker-dealer that belonged to Financial Industry Regulatory Authority (FINRA) petitioned for review of an order of the Securities and Exchange Commission (SEC), 2010 WL 2111287, which upheld FINRA's lifetime bar against representative's association in any capacity with any FINRA member firm as sanction for representative's filing of false reimbursement claim and misappropriation of broker-dealer's funds.

Holdings: The Court of Appeals, Edwards, Senior Circuit Judge, held that:

[1] SEC acted within its discretion in relying on sanction guideline for conversion or improper use of funds, but

[2] SEC abused discretion in failing to consider mitigating circumstances when upholding FINRA's imposition of lifetime bar.

Petition granted.

West Headnotes (10)

[1] **Securities Regulation**
⇨ Proceedings and review

In reviewing a disciplinary sanction imposed by the Financial Industry Regulatory Authority (FINRA), the Securities and Exchange Commission (SEC) must carefully consider whether there are any aggravating or mitigating factors that are relevant to the determination of an appropriate sanction, and this review is particularly important when the sanction is a lifetime bar from association with any FINRA member firm, which is the securities industry equivalent of capital punishment. Securities Exchange Act of 1934, § 19(e)(2), 15 U.S.C.A. § 78s(e)(2).

2 Cases that cite this headnote

[2] **Securities Regulation**
⇨ Proceedings and review

Court of Appeals reviews the Securities and Exchange Commission's (SEC's) conclusions regarding sanctions imposed by a self-regulatory organization (SRO) to determine whether those conclusions are arbitrary, capricious, or an abuse of discretion. Securities Exchange Act of 1934, § 19(e)(2), 15 U.S.C.A. § 78s(e)(2).

Cases that cite this headnote

[3] **Administrative Law and Procedure**
⇨ Review for arbitrary, capricious, unreasonable, or illegal actions in general

Court is bound to reverse an administrative action if the agency has entirely failed to consider an important aspect of the problem or has offered an explanation for its decision that runs counter to the evidence before the agency.

Cases that cite this headnote

[4] **Securities Regulation**
⇨ Proceedings and review

Securities and Exchange Commission (SEC) acted within its discretion in relying on sanction guideline for conversion or improper use of funds when upholding Financial Industry Regulatory Authority (FINRA) sanction against broker-dealer's registered representative for misappropriating his employer's funds by intentionally falsifying receipts and submitting fraudulent expense report; FINRA sanction guidelines did not purport to prescribe fixed sanctions for particular violations, and SEC reasonably analogized misappropriation to conversion in absence of particular sanction for misappropriation. Securities Exchange Act of 1934, § 19(e)(2), 15 U.S.C.A. § 78s(e)(2).

1 Cases that cite this headnote

[5] **Securities Regulation**
Proceedings and review

Securities and Exchange Commission (SEC) abused discretion in failing to consider mitigating circumstances when upholding Financial Industry Regulatory Authority's (FINRA's) imposition of lifetime bar against broker-dealer's registered representative as sanction for representative's misappropriation of employer's funds; SEC ignored that representative had been fired before FINRA detected his misconduct, which was explicit mitigating factor set out in FINRA sanction guidelines, and SEC also failed to address argument representative was under severe stress with hospitalized infant and stressful job. Securities Exchange Act of 1934, § 19(e)(2), 15 U.S.C.A. § 78s(e)(2).

Cases that cite this headnote

[6] **Securities Regulation**
Proceedings and review

In reviewing the Securities and Exchange Commission's (SEC's) determination regarding sanctions imposed by a self-regulatory organization (SRO), Court of Appeals does not limit the discretion of the SEC to choose an appropriate sanction so long as its choice meets the statutory requirements that a sanction be remedial and not excessive or oppressive. Securities Exchange Act of 1934, § 19(e)(2), 15 U.S.C.A. § 78s(e)(2).

1 Cases that cite this headnote

[7] **Securities Regulation**
Proceedings and review

On judicial review of the Securities and Exchange Commission's (SEC's) determination regarding sanctions imposed by a self-regulatory organization (SRO), the SEC's burden is to provide a convincing explanation of its rationale in light of the governing law. Securities Exchange Act of 1934, § 19(e)(2), 15 U.S.C.A. § 78s(e)(2).

Cases that cite this headnote

[8] **Securities Regulation**
Revocation, Suspension, or Other Discipline

Securities and Exchange Commission (SEC) may approve self-regulatory organization's (SRO's) imposition of the sanction of expulsion not as a penalty but as a means of protecting investors. Securities Exchange Act of 1934, § 19(e)(2), 15 U.S.C.A. § 78s(e)(2).

Cases that cite this headnote

[9] **Securities Regulation**
Proceedings and review

In reviewing sanctions imposed by a self-regulatory organization (SRO), Securities and Exchange Commission (SEC) is not under any obligation to explain why it found a lesser sanction inappropriate. Securities Exchange Act of 1934, § 19(e)(2), 15 U.S.C.A. § 78s(e)(2).

Cases that cite this headnote

[10] **Securities Regulation**
Proceedings and review

In reviewing sanctions imposed by a self-regulatory organization (SRO), the Securities and Exchange Commission (SEC) cannot use a blanket statement to disregard potentially

mitigating factors, especially those that are specifically enumerated in the SRO's own sanction guidelines. Securities Exchange Act of 1934, § 19(e)(2), 15 U.S.C.A. § 78s(e)(2).

Cases that cite this headnote

***906** On Petition for Review of an Order of the Securities & Exchange Commission.

Attorneys and Law Firms

Steven N. Berk argued the cause for petitioner. With him on the briefs was Matthew J. Bonness. Michael S. Gulland entered an appearance.

Christopher Paik, Special Counsel, Securities and Exchange Commission, argued the cause for respondent. With him on the brief were Michael A. Conley, Deputy General Counsel, and John W. Avery, Deputy Solicitor.

Before: HENDERSON and ROGERS, Circuit Judges, and EDWARDS, Senior Circuit Judge.

Opinion

Opinion for the Court filed by Senior Circuit Judge EDWARDS.

EDWARDS, Senior Circuit Judge:

****256** This case involves a disciplinary action brought against John M.E. Saad by the Financial Industry Regulatory Authority, Inc. ("FINRA"), which is the successor to the National Association of Securities Dealers ("NASD"). From January 2000 to October 2006, Saad was a regional director in the Atlanta, Georgia, office of Penn Mutual Life Insurance Company ("Penn Mutual"). He was also registered with Penn Mutual's broker-dealer affiliate, Hornor, Townsend & Kent, Inc. ("HTK"), which is a FINRA-member firm. In September 2007, FINRA filed a complaint with its Office of Hearing Officers charging that, in July 2006, Saad had violated FINRA rules by submitting false expense reports for reimbursement for nonexistent business travel and for a fraudulently purchased cellular telephone. After a hearing, the Hearing Panel found that Saad had violated NASD Conduct Rule 2110 and sanctioned him with a permanent bar against his association with a member firm in any capacity. This sanction was affirmed by FINRA's National Adjudicatory Counsel ("NAC") and by the U.S. Securities and Exchange Commission ("SEC" or "Commission").

[1] In his petition for review to this court, Saad does not contest his culpability, but instead argues only that the SEC abused its discretion in upholding the lifetime bar. In reviewing a disciplinary sanction imposed by FINRA, the SEC must determine whether, with "due regard for the public interest and the protection of investors," that sanction "is excessive or oppressive." 15 U.S.C. § 78s(e)(2). As part of that review, the SEC must carefully consider whether there are any aggravating or mitigating factors that are relevant to the agency's determination of an appropriate sanction. *See* *PAZ Sec., Inc. v. SEC,* 494 F.3d 1059, 1065 (D.C.Cir.2007) ("*PAZ I* "). This review is particularly important when the respondent faces a lifetime bar, which is "the securities industry equivalent of capital punishment." *Id.*

Saad has consistently advanced a number of mitigating factors that he claims should militate against a lifetime bar. The SEC addressed several of these factors ****257 *907** and chose not to credit them. However, the agency plainly ignored two important considerations: (1) the extreme personal and professional stress that Saad was under at the time of his transgressions; and (2) the fact that Saad's misconduct resulted in his termination *before* FINRA initiated disciplinary proceedings. The latter consideration is particularly significant because it is specifically listed in FINRA's Sanction Guidelines as a potential mitigating factor. SANCTION GUIDELINES 7 (2011) *available at* http://www.finra.org. In light of this record, we agree with Saad that the SEC abused its discretion in failing to adequately address all of the potentially mitigating factors that the agency should have considered when it determined the appropriate sanction. We take no position on the proper outcome of this case. That is for the SEC to consider in the first instance, after it has assessed all potentially mitigating factors that might militate against a lifetime bar. We therefore remand to the SEC for further consideration of its sanction in light of this opinion.

I. Background

A. Regulatory Overview

FINRA is an association of securities broker-dealers registered with the Commission pursuant to Section 15A(a) of the Securities Exchange Act of 1934. 15 U.S.C. § 78*o*–3(a). It is a self-regulatory organization empowered to

adopt rules governing the conduct of its members and of persons associated with its members, such as Saad. FINRA enforces compliance with the Securities Exchange Act, SEC regulations, and FINRA's own rules. *See id.* § 78*o*–3(b)(2). FINRA does so by bringing disciplinary proceedings to adjudicate violations, which are subject to review by the Commission. FINRA brought such a proceeding against Saad based on his conduct in 2006 and 2007.

During 2006 and much of 2007, Saad's activities as a securities dealer were subject to regulation by the NASD. However, by the time Saad's disciplinary proceeding was formally initiated in September 2007, the SEC had approved the consolidation of NASD with certain functions of the New York Stock Exchange to create a new self-regulatory organization: FINRA. Thus, while Saad's misconduct occurred prior to the creation of FINRA, FINRA's Department of Enforcement with the FINRA Office of Hearing Officers initiated proceedings against Saad.

Generally, the references to NASD and FINRA are interchangeable throughout this opinion. The charge against Saad was for a violation of NASD Conduct Rule 2110, which requires that members "observe high standards of commercial honor and just and equitable principles of trade."*See* *John M.E. Saad,* S.E.C. Release No. 62178, 2010 WL 2111287, at *4 (May 26, 2010). NASD Conduct Rule 2110 is comparable to the current, superseding FINRA Conduct Rule 2010. *See* NASD to FINRA CONVERSION CHART SPREADSHEET,*available at* http://www.finra.org. In sanctioning Saad, FINRA and the SEC applied the FINRA Sanction Guidelines, as opposed to the predecessor NASD Sanction Guidelines. *See* *Saad,* 2010 WL 2111287, at *4.

B. Facts

The facts in this case are undisputed. Br. of Pet'r at 17. At the relevant time, Saad was employed by Penn Mutual and registered with its broker-dealer affiliate HTK, a FINRA-member firm. Saad was registered as an investment company products and variable contracts limited representative, a general securities representative, and a general securities principal.

***908 **258** This case centers on Saad's submission of several false expense claims to his employer and Saad's subsequent attempts to conceal his misconduct. In July 2006, when a scheduled business trip from his home base in Atlanta to Memphis, Tennessee, was cancelled, instead of staying home, Saad checked into an Atlanta hotel for two days. He later submitted to his employer a false expense report claiming expenses for air travel to Memphis and a two-day hotel stay in that city. Saad forged an airline travel receipt and a Memphis hotel receipt and attached those receipts to his expense report. Saad also submitted another false expense claim, unrelated to the fictional Memphis trip. He claimed an expense for the replacement of his business cellular telephone when in fact he had not replaced his own telephone but rather had purchased a telephone for an insurance agent who was employed at another firm. Saad testified at the disciplinary hearing that his employer probably would not have approved his purchase of a cell phone if he had submitted an accurate expense claim. *See* *Saad,* 2010 WL 2111287, at *2.

At his disciplinary hearing, Saad also explained that this conduct occurred during a period when he was under a great deal of professional and personal stress. Toward the end of 2005, Saad's sales declined and he virtually halted business travel, which was considered a significant aspect of his professional responsibilities. In June 2006, Saad's superiors at Penn Mutual issued a production warning to him and admonished him to increase his sales of Penn Mutual products. During this same time period, Saad and his wife were caring for one-year old twins, one of whom had undergone surgery and was frequently hospitalized for a significant stomach disorder.

Saad's false travel expense report was discovered by the Atlanta office administrator, who noticed that Saad had attached to the report an unaltered receipt for four drinks purchased at an Atlanta hotel lounge on the same day when, according to the expense report, Saad was supposed to be in Memphis. When the office administrator questioned him about the receipt for the drinks, Saad withdrew the receipt and threw it away. The office administrator retrieved the receipt from the trash and submitted it to Penn Mutual's home office, thus alerting Saad's employer to the falsity of the travel expense report. In September 2006, Saad was discharged by both Penn Mutual and HTK for his misdeeds.

C. Proceedings Below

Approximately two months after Saad was terminated, NASD investigators questioned him about the reasons for his discharge and his false expense reports. During this investigation, Saad repeatedly attempted to mislead NASD by providing investigators with false information. In a November 2006 email, Saad told NASD that the expenses claimed on the

fabricated trip report were "for a business trip that had yet to occur," although in fact the expenses were for a trip that had been cancelled and had not been rescheduled. *Saad,* 2010 WL 2111287, at *3. In April 2007, Saad misrepresented to a FINRA examiner that he did not know the person for whom he had purchased a cell phone. *Id.* And in testimony delivered in May 2007, Saad contended that he could not recall whether he had purchased a plane ticket for the July 2006 trip to Memphis. *John M. Saad,* Compl. No. 2006006705601, 9 (NAC Oct. 6, 2009) ("NAC Decision"), *reprinted in* Deferred Joint Appendix ("D.A.") 206, 214.

FINRA brought a disciplinary proceeding against Saad in September 2007, alleging "Conversion of Funds" in violation of NASD Conduct Rule 2110. A disciplinary **259 *909 hearing before a FINRA Hearing Panel was held in April 2008. The Hearing Panel found that Saad had deliberately deceived his employer both with regard to the travel report and the cell phone purchase; that this deception constituted conversion of his employer's funds; and that this misconduct violated NASD Conduct Rule 2110. The Hearing Panel assessed costs against Saad and imposed a permanent bar against his association with a member firm in any capacity, noting that "according to the *FINRA Sanction Guidelines,* a bar is standard for conversion regardless of the amount converted." *John M.E. Saad,* Compl. No. 2006006705601, 8 (Office of Hr'g Officers Aug. 19, 2008), *reprinted in* D.A. 189, 196.

Saad appealed to the NAC, which affirmed the Hearing Panel. However, the NAC characterized Saad's actions as "misappropriation" of his employer's funds, not "conversion." The NAC found that there were no mitigating factors and that there were a number of aggravating factors, including "the intentional and ongoing nature of Saad's misconduct, Saad's efforts to deceive HTK and Penn Mutual, [and] Saad's initial instinct to conceal the extent of his actions from state and FINRA examiners." NAC Decision at 10, *reprinted in* D.A. 215. Because there is no specific sanction guideline for misappropriation, the NAC applied the guideline for conversion or improper use of funds and found that a permanent bar was an appropriate sanction.

On its review, the Commission agreed that Saad, by intentionally falsifying receipts, submitting a fraudulent expense report, and accepting reimbursement to which he was not entitled, had misappropriated his employer's funds in violation of NASD Conduct Rule 2110. The Commission found that Saad's dishonesty with his employer "reflect[ed] negatively on both Saad's ability to comply with regulatory requirements and his ability to handle other people's money." *Saad,* 2010 WL 2111287, at *5. The Commission also rejected Saad's claims that the sanction against him, a permanent bar, was improper because (a) there were inconsistencies between the sanction here and FINRA sanctions in other cases; (b) FINRA had employed the wrong sanction guideline; (c) there were mitigating circumstances; and (d) the sanction was unduly punitive rather than remedial in nature. Instead, the Commission found that the sanction was appropriate because it was not "excessive or oppressive." 15 U.S.C. § 78s(e)(2).

With regard to the contention that there were inconsistencies between the sanction here and the sanctions applied in other cases, the Commission stated that "[i]t is well established ... that the appropriateness of a sanction depends on the facts and circumstances of each particular case and cannot be precisely determined by comparison with action taken in other proceedings." *Saad,* 2010 WL 2111287, at *6. Likewise, the Commission declined to credit Saad's argument that FINRA applied the wrong provisions of its Sanction Guidelines, noting, *inter alia,* that the Guidelines "merely provide a starting point in the determination of remedial sanctions." *Id.*

The Commission also rejected Saad's claim that there existed circumstances sufficient to mitigate Saad's misconduct, noting that the Hearing Panel and the NAC had addressed and specifically rejected many of Saad's mitigation claims, including the claims that his misconduct was a onetime lapse in judgment, that he had an otherwise clean disciplinary history, and that his wrongdoing did not involve customer funds or securities. *See* *Saad,* 2010 WL 2111287, at *7. With respect to the allegedly "aberrant" nature of Saad's conduct, the SEC explained that its focus was **260 *910 less on the short time period during which the expense reports were submitted, than on Saad's "ongoing and intentional charade in support of which he fabricated documents." *Id.* The SEC referred to the NAC decision, which recounts Saad's conduct in submitting the expense reports in July 2006 and then repeatedly misleading investigators over the course of several months. *Id.* (citing NAC Decision at 9, *reprinted in* D.A. 214).

The SEC refused to be swayed by Saad's years of honest service because, the SEC explained, "an otherwise clean disciplinary history [is] not mitigating." *Id.* (citing *Daniel D. Manoff,*S.E.C. Release No. 46708, 2002 WL 31769236, at *5 (Oct. 23, 2002)). The SEC also referenced the NAC's discussion of this factor, which explained that a violator "should not be rewarded because he may have previously acted appropriately as a registered person." *Id.* (citing D.A. 213).

The SEC additionally declined to credit Saad's argument that his conduct did not affect customers. The SEC relied on FINRA's conclusion that "[a]lthough Saad's wrongdoing in this instance did not involve customer funds or securities, Saad's willingness to lie ... and obtain funds to which he was not entitled indicates a troubling disregard for fundamental ethical principles which, on other occasions, may manifest itself in a customer-related or securities-related transaction." *Id.* The SEC decision then cited cases in which the Commission rejected assertions by respondents who sought mitigation because their wrongful conduct had not directly targeted customers. *See id.* at *7 n. 30 (collecting cases).

The Commission further found that the sanction imposed had a remedial purpose that served the public interest. The Commission explained that a lifetime bar was warranted to protect customers from any future misconduct by Saad. *See id.* at *7–8. The Commission believed that Saad's conduct "raises serious doubts about his fitness to work in the securities industry, a business that is rife with opportunities for abuse." *Id.* at *8. His actions "reveal a willingness to construct false documents and then lie about them," all of which "suggests that his continued participation in the securities industry poses an unwarranted risk to the investing public." *Id.* The SEC also believed that his behavior, particularly his repeated efforts to conceal his misconduct, "provides no assurance he will not repeat his violations." *Id.* The Commission also briefly explained that Saad's punishment was intended "as a deterrent to others in the securities industry who might engage in similar misconduct." *Id.*

II. Analysis

A. Standard of Review

[2] [3] "The SEC reviews sanctions imposed by the NASD to determine whether they 'impose[ ] any burden on competition not necessary or appropriate' or are 'excessive or oppressive.' " *Siegel v. SEC,* 592 F.3d 147, 155 (D.C.Cir.2010) (quoting 15 U.S.C. § 78s(e)(2)); *see also PAZ I,* 494 F.3d at 1065–66. "This court reviews the SEC's conclusions regarding sanctions to determine whether those conclusions are arbitrary, capricious, or an abuse of discretion." *Siegel,* 592 F.3d at 155;*see also PAZ Sec., Inc. v. SEC,* 566 F.3d 1172, 1174 (D.C.Cir.2009) ("*PAZ II* "). "The agency's choice of remedy is peculiarly a matter for administrative competence, and we will reverse it only if the remedy chosen is unwarranted in law or is without justification in fact." *Siegel,* 592 F.3d at 155. Nevertheless, this court is bound to reverse an administrative action if the agency has "entirely failed to consider an important aspect of the problem" or has "offered an explanation for its decision that runs counter **261 *911 to the evidence before the agency." *Motor Vehicle Mfrs. Ass'n of U.S., Inc. v. State Farm Mut. Auto. Ins. Co.,* 463 U.S. 29, 43, 103 S.Ct. 2856, 77 L.Ed.2d 443 (1983); *see also Allentown Mack Sales & Serv., Inc. v. NLRB,* 522 U.S. 359, 374–75, 118 S.Ct. 818, 139 L.Ed.2d 797 (1998) (discussing the importance of "reasoned decisionmaking" in the review of agency adjudications).

B. The Sanction Guidelines

[4] Saad argues that the SEC erred when it sustained a lifetime bar from the securities industry predicated on an application of the wrong FINRA sanction guideline. FINRA's most recent Sanction Guidelines were issued in 2006 "for use by the various bodies adjudicating disciplinary decisions ... in determining appropriate remedial sanctions." SANCTION GUIDELINES 1 (2011), *available at* http://www.finra.org. The Guidelines include specific provisions covering conversion or improper use of funds or securities and for forgery and/or falsification of records. The former contains two prongs: one for conversion, which advises adjudicators to "[b]ar the respondent regardless of amount converted," and one for improper use, which advises them to "[c]onsider a bar." *Id.* at 36. The guideline for forgery and/or falsification advises adjudicators to "consider" a bar in "egregious cases." *Id.* at 37.

Saad claims that the SEC improperly applied the guideline for conversion or improper use, rather than the guideline for forgery and/or falsification. Saad contends that the SEC's

reliance on the guideline for conversion or improper use was inappropriate for two reasons. First he argues that, because the SEC found him guilty of misappropriation, the guideline's conversion prong was inapposite. Second, he argues that the guideline's improper use prong applies only to the misuse of *customer* funds, not an employer's funds. Therefore, Saad continues, the Commission should have considered only the guideline for forgery and/or falsification, pursuant to which a lifetime bar would be inappropriate. Saad's arguments are unpersuasive.

The SEC did not err when it upheld a sanction pursuant to the guideline for conversion or improper use. The FINRA Sanction Guidelines do not purport to "prescribe fixed sanctions for particular violations." *Id.* at 1. "Rather, they provide direction for Adjudicators in imposing sanctions consistently and fairly." *Id.* The Guidelines do not enumerate sanctions for every conceivable securities-industry violation; they merely address sanctions for "some typical securities-industry violations." *Id.* The SEC's decision correctly notes that the Guidelines "are not intended to be absolute" and, "[f]or violations that are not addressed specifically, Adjudicators are encouraged to look to the guidelines for analogous violations." *Saad,* 2010 WL 2111287, at *6 (quoting SANCTION GUIDELINES 1). The SEC reasonably concluded that "misappropriation is doubtless analogous to conversion." Br. of SEC at 19. Because the Guidelines do not list a particular sanction for misappropriation, it was not arbitrary and capricious for the Commission to analogize to the guideline's conversion prong in this way. This is wholly consistent with the SEC's repeatedly stated view that the Guidelines do not specify required sanctions but "merely provide a 'starting point' in the determination of remedial sanctions." *Saad,* 2010 WL 2111287, at *6 & n. 23 (quoting *Hattier, Sanford & Reynoir,* S.E.C. Release No. 39543, 1998 WL 7454, at *4 n. 17 (Jan. 13, 1998)), *aff'd,* 163 F.3d 1356 (5th Cir.1998).

Saad is similarly unpersuasive in his assertion that the guideline's improper use prong only applies to the misuse of customer funds—and thus would not apply to Saad's misconduct which involved claiming ****262 *912** fraudulent reimbursements from his employer. The guideline for conversion and improper use refers to several FINRA and NASD rules, including FINRA Conduct Rule 2010 (the successor to NASD Conduct Rule 2110 at issue here). *See*SANCTION GUIDELINES 36. Saad points out that, "[w]ith the exception of FINRA Rule 2010 ... each of the referenced rules concerns the improper use of (and potentially the conversion of) *customers'* funds or securities." Br. of Pet'r at 25. This assertion obviously does not advance Saad's position because it acknowledges that FINRA Conduct Rule 2010 is not limited to misconduct relating to customer funds. Although Saad's briefing on this point is far from clear, he seems to make a sort of *in pari materia* argument that, in light of the other rules referenced, the SEC was required to import the "customers' funds" limitation into FINRA Conduct Rule 2010. The argument is patently flawed, and Saad cites no authority to support his claim. We therefore reject it.

Even if we were to accept Saad's argument that the SEC should have applied the guideline for forgery and/or falsification, that error by itself would not require a reversal or remand. The Commission reasonably concluded that "FINRA's decision to impose a bar is consistent with either guideline." *Saad,* 2010 WL 2111287, at *7. Indeed, both guidelines suggest that FINRA at least consider a bar. *See*SANCTION GUIDELINES 36–37. Saad objects because the guideline for conversion or improper use "*emphasizes* a permanent bar, while the sanction guideline for Forgery and/or Falsification *emphasizes* suspension." Br. of Pet'r at 23 (emphasis added). But the fact remains—as the SEC correctly noted—both guidelines expressly contemplate the possibility of a lifetime bar. Given the deference that we owe to SEC sanction decisions, *see Siegel,* 592 F.3d at 155, we decline to disturb the SEC's decision on this basis.

C. The Lifetime Bar

[5] Saad also argues that the Commission abused its discretion when it affirmed FINRA's imposition of a lifetime bar. He contends that the SEC failed to consider certain mitigating factors and to articulate a remedial rather than punitive purpose for the sanction. As a result, in Saad's view, the SEC erred by upholding a sanction that was "excessive or oppressive." 15 U.S.C. § 78s(e)(2). The Commission responds that it considered all of the necessary factors and reasonably concluded that a lifetime bar was appropriate under the circumstances. For reasons described below, we agree with Saad that the Commission abused its discretion in failing to address several potentially mitigating factors.

[6] [7] Under 15 U.S.C. § 78s(e)(2), the Commission reviews a disciplinary sanction imposed by FINRA to determine whether, "having due regard for the public interest and the protection of investors," that sanction "is excessive or oppressive." *See also* *PAZ I,* 494 F.3d at 1064 (SEC

reviews NASD sanctions *de novo*). In our review of SEC actions, "[w]e do not limit the discretion of the Commission to choose an appropriate sanction so long as its choice meets the statutory requirements that a sanction be remedial and not 'excessive or oppressive.' " *PAZ II,* 566 F.3d at 1176. The SEC's burden is to provide a convincing explanation of its rationale in light of the governing law. As we explained in *PAZ I:*

> When evaluating whether a sanction imposed by [FINRA] is excessive or oppressive, as we have stated before, the Commission must do more than say, in effect, petitioners are bad and must be punished; at the least it must give some explanation addressing the nature of the violation and the mitigating factors presented in the record. The Commission **263 *913 must be particularly careful to address potentially mitigating factors before it affirms an order ... barring an individual from associating with a [ ] ... member firm—the securities industry equivalent of capital punishment.

494 F.3d at 1064–65 (citations omitted).

[8] [9] Furthermore, the Commission may approve "expulsion not as a penalty but as a means of protecting investors.... The purpose of the order [must be] remedial, not penal." *Id.* at 1065. If the Commission upholds a sanction as remedial, it must explain its reasoning in so doing; "as the circumstances in a case suggesting that a sanction is excessive and inappropriately punitive become more evident, the Commission must provide a more detailed explanation linking the sanction imposed to those circumstances." *Id.* at 1065–66. That is not to say, however, that the Commission is under any obligation to explain why it found a lesser sanction inappropriate. *See Siegel,* 592 F.3d at 157 ("[B]eyond mak[ing] the necessary findings regarding the protective interests to be served by expulsion, the agency need not state why a lesser sanction would be insufficient.").

After careful review of the record before us, we conclude that the case must be remanded for further consideration by the SEC. Remand is warranted because the decision of the Commission—as well as those of the FINRA Hearing Panel and the NAC—ignores several potentially mitigating factors asserted by Saad and supported by evidence in the record. We have previously cautioned that the SEC "must be particularly careful to address potentially mitigating factors" before affirming a permanent bar. *PAZ I,* 494 F.3d at 1065. The SEC has failed to do so in this case. In particular, Saad correctly notes that FINRA and the SEC failed to consider that "Mr. Saad's firm, HTK[,] disciplined him by terminating his employment in September of 2006, prior to regulatory detection." Br. of Pet'r at 34; *see also* Reply Br. at 12–13. Under the FINRA Sanction Guidelines, number fourteen of the "Principal Considerations in Determining Sanctions" is "[w]hether the member firm with which an individual respondent is/was associated disciplined the respondent for the same misconduct at issue prior to regulatory detection." SANCTION GUIDELINES 7. The SEC's decision acknowledges this argument: "[Saad] claims FINRA also failed to consider that HTK had fired him before FINRA detected his misconduct...." *Saad,* 2010 WL 2111287, at *7. However, the SEC's decision says nothing more regarding this issue, nor do the decisions issued by the Hearing Panel and the NAC. When questioned about this point at oral argument, SEC counsel mistakenly argued that the termination was "irrelevant" because it occurred after the violation. *See* Oral Arg. at 19:45–23:40. The Guidelines say otherwise.

Similarly, the SEC's decision noted, but did not address, Saad's argument that "he was under severe stress with a hospitalized infant and a stressful job environment." *Saad,* 2010 WL 2111287, at *7. The Guidelines do not expressly mention personal stress as a mitigating factor, but they are by their own terms "illustrative, not exhaustive; as appropriate, Adjudicators should consider case-specific factors in addition to those listed." SANCTION GUIDELINES 6.

In response to Saad's argument that the SEC ignored these potentially mitigating factors, the Commission weakly responds that it "implicitly denied that they were [mitigating] when it stated that it denied all arguments that were inconsistent with the views expressed in the decision." Br. of SEC at 24. This contention is not an acceptable explanation for the SEC's failure **264 *914 to provide

"reasoned decisionmaking" in support of a lifetime bar. *See Allentown Mack*, 522 U.S. at 374–75, 118 S.Ct. 818.

[10] When we explained in *PAZ I* that the SEC "must be particularly careful to address potentially mitigating factors," we meant that the Commission should carefully and thoughtfully address each potentially mitigating factor supported by the record. The Commission cannot use a blanket statement to disregard potentially mitigating factors —especially those, like an employee's termination, that are specifically enumerated in FINRA's own Sanction Guidelines. Because the SEC failed to address potentially mitigating factors with support in the record, it abused its discretion by "fail[ing] to consider an important aspect of the problem." *See State Farm*, 463 U.S. at 43, 103 S.Ct. 2856. We must remand on that basis.

We take no position on the proper outcome of this case. We leave it to the Commission in the first instance to fully address *all* potentially mitigating factors that might militate against a lifetime bar.

III. Conclusion

The petition for review is granted. The case is remanded to the Commission for further consideration consistent with this opinion.

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