

July 12, 2006

Memorandum for the Securities and Exchange Commission

From: Peter J. Wallison

Subject: Comment on Release No. IC-27395; File No. S7-03-04

The Commission's request for additional comments on its July 27, 2004, amendments to the Exemptive Rules seriously misstates the opinion of the federal appeals court that invalidated the amendments. In particular, the Commission's request states that "the Court on April 7, 2006, issued an opinion holding that the Commission violated the Administrative Procedure Act by failing to seek comment on the data used to estimate the cost of the two conditions" that the Commission imposed in its rule.

This statement ignores completely the first court decision on June 21, 2004, *Chamber of Commerce v Securities and Exchange Commission*, 412 F.3d 133 DC Cir. 2005) on which the opinion of April 7 was based and reflects a misunderstanding of the Administrative Procedure Act (APA) itself. The first opinion held explicitly that the Commission had violated the APA by failing, in its initial adoption of the rule, to consider whether the action will promote "efficiency, competition and capital formation," as required by 18 U.S.C. 80a-2(c). The court's decision in the second case, on April 7, 2006, was based on the same legal theory. To say now that the Commission violated the APA by failing to seek comment on data is like saying that a company violated the Securities Act by failing to report its earnings correctly. It ignores the underlying statutory duty that makes an otherwise legal act, or failure to act, a violation of law.

Indeed, the court in the first case rejected the Chamber's argument that the new rule was arbitrary and capricious (one basis for violating the APA), and made clear that the Commission had violated the APA because its rule-making process—in failing to consider efficiency, competition and capital formation—was not "in accordance with law." 412 F.3d at 140.

Thus, the court in the first case began its analysis with this statement: "The [Investment Company Act] mandates that when the Commission engages[s] in rulemaking and is required to determine whether an action is consistent with the public interest [it] shall...consider...whether the action will promote efficiency, competition and capital formation." 412 F.3d at 142 (ellipsis in the original)

The court then noted the Commission's admission that it had no reliable basis for estimating the costs to individual funds, and continued: "[A]n estimate [of costs] would be pertinent to its assessment of the effect the condition would have upon efficiency and competition, if not upon capital formation...uncertainty may limit what the Commission can do, but it does not excuse the Commission from its *statutory obligation* to do what it can to apprise itself—and hence the public and Congress—of the *economic consequences* of a proposed regulation before it decides whether to adopt the measure." 412 F.3d at 144 (emphasis added)

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

The court then concluded: "In sum, the Commission violated its obligation under U.S.C. 80a-2(c), *and therefore the APA*, in failing adequately to consider the costs imposed on the funds by the two challenged conditions." 412 F.3d at 144 (emphasis supplied). Thus, the court was very explicit that the Commission violated the Administrative Procedure Act by failing to observe the requirements of U.S.C. 80a-2(c), and *not*—as the Commission said in its current release—by "failing to seek comment on the data used to estimate the costs of the two conditions."

When the second appeals court panel considered the Commission's hasty response, it made clear that its discussion was based on the same rationale as the earlier opinion. Thus, in describing the holding of the court in the first case, the second appeal court opinion stated: "With respect to the independent chair condition, the court noted that the Commission had stated that an independent chair may decide to hire more staff, but that it had no 'reliable basis for estimating...those costs.'" [citations omitted] The court held that although the Commission may not have been able to estimate the aggregate cost to the mutual fund industry of additional staff...it readily could have estimated the cost to an individual fund, which estimate would be pertinent to its assessment of the effect the condition would have upon *efficiency and competition, if not capital formation.*" (*Chamber of Commerce v Securities and Exchange Commission*, 443 F.3<sup>rd</sup> 890, at 894). The court then went on to conclude that the Commission's hasty and *post hoc* attempt to justify its rule was unavailing.

Thus, the second court opinion rested upon the conclusion of the first—that the Commission has a statutory obligation to consider efficiency, competition and capital formation when it makes its rules, and it violated the APA by failing to do so. The question of what information the Commission had when it made its judgment is *subsidiary* to its obligation to consider the economic consequences of its rules, because it was the failure to consider efficiency, competition and capital formation that violated the legal duty created by the APA. In stating in its release that the court had found the Commission in violation of the APA because it had failed to seek comment on data, the Commission is eliding this important distinction and once again opening itself to court correction.

Cc: Chairman Christopher Cox  
General Counsel Brian Cartwright