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Keynote Speech
Balancing Investor Protection with Capital Formation Needs After the SEC *Chamber of Commerce Case*

David S. Ruder[1]

On June 21, 2005, the District of Columbia Circuit Court of Appeals held that the United States Securities and Exchange Commission had not met its rule making cost justification burden in adopting an important rule under the Investment Company Act of 1940 (the "Investment Company Act").[2] In *Chamber of Commerce of the United States of America v. Securities and Exchange Commission*[3] ("*Chamber of Commerce Case*") the court held that the Commission had violated the Administrative Procedure Act (APA),[4] in two respects when it adopted an Investment Company Act rule requiring seventy-five percent of the members of the board of directors of each registered investment company to be independent of its investment adviser and requiring the chairman of the board to be independent of the adviser.[5]

1. The author is the William W. Gurley Memorial Professor of Law Emeritus at Northwestern University School of Law. He was Chairman of the United States Securities and Exchange Commission from 1987 to 1989. He was ably assisted in preparation of this article by Pamela Hawkins Williams, a 2004 graduate of Northwestern University School of Law. This article is an expansion of the keynote address delivered by Professor Ruder at The Investor Rights Symposium presented by the Pace Investor Rights Project at Pace Law School on March 31 and April 1, 2005. The Symposium brochure raised the topic of securities law investor protections as they affect capital market operation, as follows:

> While the principle that investors should be protected from securities fraud was established with the enactment of federal securities legislation in the 1930s, the optimal manner of protection continues to be hotly debated, as scholars, regulators and policymakers seek the appropriate balance between protecting investors and encouraging capital formation. This symposium will explore the current balance in various areas of the securities industry.

Pace Law School, Investor Rights Symposium, http://www.law.pace.edu/pirp/symposium.html (last visited Nov. 17, 2005).

2. Investment Company Act of 1940 §§ 1-65, 15 U.S.C. §§ 80a-1 to -64 (2005) [hereinafter Investment Company Act].

3. Chamber of Commerce v. SEC, 412 F.3d 133 (D.C. Cir. 2005) ("Chamber of Commerce Case").

4. 5 U.S.C. §§ 551-559, 701-706, 1305, 3105, 3344, 4301, 5335, 5372, 7521 (2005).

5. Investment Company Governance, 69 Fed. Reg. 46,378, 46,381 (Aug. 4, 2004)

The court held that the Commission violated the Investment Company Act by "failing adequately to consider the costs mutual funds would incur"[6] in order to comply with the Investment Company Act requirement that it determine "whether the action will promote efficiency, competition and capital formation"[7] and by "failing adequately to consider a proposed alternative to the independent chairman condition."[8]

The *Chamber of Commerce Case* raises important questions regarding the SEC's dual roles of protecting investors and promoting capital formation. Although the court did not hold that the Commission exceeded its authority in adopting the rule, it remanded the matter to the Commission directing it to show further justification for the rule.[9] Its conclusion that the Commission must "determine as best it can the economic implications"[10] of its rule making means that in subsequent rule making the Commission should take particular care in examining the effects on capital formation of the rule being adopted.

This article discusses the *Chamber of Commerce Case*, examines the Commission's duties to consider the impact of its activities on capital formation, and offers some views regarding the SEC's obligations to determine whether its various programs promote or impede capital formation.

The SEC's Dual Role: Protecting Investors and Facilitating Capital Formation

Wealth creation has long been a central theme of American prosperity. The accumulation of assets made available for investment in business enterprises has been an important factor in the success of the United States economy.

As the United States has grown, the form of ownership of assets has progressed from simple individual ownership of land, buildings, and machinery to sophisticated vehicles for asset accumulation. Productive assets are now owned by individuals, partnerships, limited liability companies, corporations, trusts, and others.

(to be codified at 17 C.F.R. pt. 270).

6. *Chamber of Commerce Case*, 412 F.3d at 136.

7. Investment Company Act § 2(c), 15 U.S.C. § 80a-2(c) (2005).

8. *Chamber of Commerce Case*, 412 F.3d at 136.

9. *Id.* at 145.

10. *Id.* at 143.

Corporations have provided the most dynamic form of ownership, since their artificial form has enabled them to operate large scale enterprises by accumulating assets in greater amounts than can be gathered by an individual or a few individuals. The ability of corporations to accumulate assets in large amounts is increased when corporate shareholders can easily sell their shares to others, allowing them to invest in other enterprises or to make other uses of their assets.

Easy transfer of assets into new enterprises and uses means that the economy can prosper through innovation and growth and that the cost of capital will be lower. Business growth in the United States has in part been due to the availability of securities markets that facilitate these easy transfers. This ease of transfer can be attributed to "liquidity" in the U.S. securities markets where large amounts of securities can be purchased and sold without disrupting the pricing mechanism.

Following the stock market crash in 1929, a series of federal securities statutes were enacted in the United States designed to improve the operation of our securities markets. Today the SEC administers ten major laws designed to protect investors.[11] The Securities and Exchange Commission was created as an independent government agency charged with administration of those statutes.[12]

The federal securities statutes emphasize the need for corporate and market honesty and integrity as a means of protecting investors. They mandate adequate disclosure of information, prohibit dishonesty and fraud in the sale and purchase of securities, and require brokers, dealers, investment advisers and other market professionals to act in the best interests of investors.

Although the primary objective of requiring honesty is to protect investors, honesty also improves market efficiency. Honest markets will be more liquid, since investors will be more likely to risk their resources

11. Securities Act of 1933 §§ 1-28, 15 U.S.C. §§ 77a-77aa (2005) [hereinafter Securities Act]; Securities Exchange Act of 1934 §§ 1-37, 15 U.S.C. §§ 78a-78nn (2005) [hereinafter Exchange Act]; Public Utility Holding Company Act (PUHCA) of 1935, 15 U.S.C. § 79 (2005); Investment Company Act §§ 1-65, 15 U.S.C. §§ 80a-1 to -64 (2005); Investment Advisers Act of 1940, 15 U.S.C. §§ 80b-1 to -21 (2005); Securities Investor Protection Act (SIPA) of 1970, 15 U.S.C. §§ 78aaa-78lll (2005); National Securities Markets Improvement Act (NSMIA) of 1996, 15 U.S.C. §§ 77z-3, 78mm, 80b-3(a) (2005); Gramm-Leach-Bliley Act, Pub. L. No. 106-102, 113 Stat. 1338 (codified in scattered sections of 12 U.S.C. and 15 U.S.C.); Commodity Futures Modernization Act of 2000, Pub. L. No. 106-554, 114 Stat. 2763 (codified in scattered sections of 7 U.S.C., 11 U.S.C., 12 U.S.C., and 15 U.S.C.); Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of 15 U.S.C. and 18 U.S.C.).

12. Exchange Act § 4, 15 U.S.C. § 78d.

in an honest market. Additionally, since in a dishonest market investors will seek higher prices for securities as compensation for the risks of loss due to dishonesty, an honest market will facilitate the transfer of assets at lower prices, thereby lowering the cost of capital.

Securities and Exchange Commission Consideration of Effects on Capital Formation

In its rule making, the Commission routinely conducts analysis as required by statutes, regulations and policies.[13] Typically, the SEC's rulemaking includes an analysis of the effects on "Efficiency, Competition and Capital Formation" and a "Cost-Benefit Analysis."[14] It does not conduct this analysis in its other activities, such as enforcement.

The various securities acts mandate investor protection, but they also recognize that regulation of securities markets should facilitate capital formation. The SEC includes capital formation in its mission statement, which says that: "The mission of the Securities and Exchange Commission is to protect investors; maintain fair, orderly, and efficient markets; and facilitate capital formation."[15]

Statutory imposition of the duty to facilitate market efficiency, competition, and capital formation is contained in various securities acts. The Securities Act and Exchange Act require the Commission, when engaged in rule making, to consider "in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation."[16] The Investment Company Act requires

13. Securities & Exchange Commission, Audit No. 347, Rulemaking Process (July 12, 2002), http://www.sec.gov/about/oig/audit/347fin.htm (discussing the Commission's rulemaking process) [hereinafter Rulemaking Audit].

14. *Id.* In addition, the Commission reviews compliance with the Administrative Procedure Act, 5 U.S.C. §§ 551-559, 701-706, 1305, 3105, 3344, 4301, 5335, 5372, 7521 (2005), the Paperwork Reduction Act of 1995, 44 U.S.C. §§ 3501-3520 (2005), the Regulatory Flexibility Act, 5 U.S.C. §§ 601-612 (2005), and the Small Business Regulatory Enforcement Fairness Act, 5 U.S.C. §§ 657, 801-808 (2005).

15. United States Securities & Exchange Commission, 2004-2009 Strategic Plan (2004), http://www.sec.gov/about/secstratplan0409.pdf [hereinafter SEC Strategic Plan].

16. Securities Act section 2(b) provides:

> Consideration of promotion of efficiency, competition, and capital formation. Whenever pursuant to this subchapter the Commission is engaged in rulemaking and is required to consider or determine whether an action is necessary or appropriate in the public interest, the Commission shall also consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation.

15 U.S.C. § 77b(b) (2005).

consideration of "efficiency, competition, and capital formation" in Commission rule making.[17] These requirements are triggered in each of these statutes when the SEC adopts a rule that requires it to "consider the public interest or to determine that a rule's adoption is necessary or appropriate in the public interest."[18]

Cost-Benefit Analysis

As an independent regulatory agency, the SEC is not required under the Administrative Procedure Act (APA)[19] to conduct a "cost-benefit analysis" when it adopts rules. President Ronald Reagan issued Executive Orders 12,291 and 12,498 in the 1980s requiring federal agencies to conduct a cost-benefit analysis when making rules.[20]

Exchange Act section 3(f) provides:

> Consideration of promotion of efficiency, competition, and capital formation. Whenever pursuant to this title, the Commission is engaged in rulemaking, or in the review of a rule of a self-regulatory organization, and is required to consider or determine whether an action is necessary or appropriate in the public interest, the Commission shall also consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation.

15 U.S.C. § 78c(f) (2005).

See also Exchange Act section 23(a)(2):

> The Commission and the Secretary of the Treasury, in making rules and regulations pursuant to any provisions of this title, shall consider among other matters the impact any such rule or regulation would have on competition. The Commission and the Secretary of the Treasury shall not adopt any such rule or regulation which would impose a burden on competition not necessary or appropriate in furtherance of the purposes of this chapter. The Commission and the Secretary of the Treasury shall include in the statement of basis and purpose incorporated in any rule or regulation adopted under this title, the reasons for the Commission's or the Secretary's determination that any burden on competition imposed by such rule or regulation is necessary or appropriate in furtherance of the purposes of this chapter.

15 U.S.C. § 78w(a)(2) (2005).

17. Investment Company Act section 2(c) provides:

> Consideration of promotion of efficiency, competition, and capital formation. Whenever pursuant to this subchapter the Commission is engaged in rulemaking and is required to consider or determine whether an action is consistent with the public interest, the Commission shall also consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation.

15 U.S.C. § 80a-2(c) (2005).

18. *Id.*; Rulemaking Audit, *supra* note 13.

19. 5 U.S.C. §§ 551-559, 701-706, 1305, 3105, 3344, 4301, 5335, 5372, 7521 (2005).

20. Exec. Order No. 12,498, 50 Fed. Reg. 1,036 (Jan. 4, 1985); Exec. Order No.

However, these orders and their subsequent replacements, Executive Orders 12,866 and 13,258, specifically exempted independent regulatory agencies, such as the SEC, from this requirement.[21] Nevertheless, SEC officials have acknowledged that the cost-benefit analysis is "becoming increasingly significant."[22] When it adopts rules the Commission includes a "Cost-Benefit Analysis," in which it analyzes the "potential costs and benefits" of its rules.[23] Commission officials believe that the cost-benefit analysis represents "accepted standards of good practice in conducting rulemaking proceedings" and that its use aligns with the "best practice principles in Executive Order 12,866."[24]

The Chamber of Commerce Case

The *Chamber of Commerce Case* is extremely important to the SEC because the Circuit Court of Appeals for the D.C. Circuit provided guidance to the Commission regarding the steps it needs to take in order to validate its rule making. The opinion is important not only for the

12,291, 46 Fed. Reg. 13,193 (Feb. 17, 1981); CHARLES H. KOCH, ADMINISTRATIVE LAW AND PRACTICE, 1 Admin L. & Prac. § 4.51 (2d ed. 1997). Executive Order 12,291 specifically required a Regulatory Impact Analysis that was interpreted to require some form of cost-benefit analysis. Frank B. Cross, *Executive Orders 12,291 and 12,498: A Test Case in Presidential Control of Executive Agencies*, 4 J.L. & POL. 483, 496-497 (Winter 1988). This cost-benefit analysis is subject to review by the Office of Management and Budget ("OMB"). Damien Geradin, *The Development of European Regulatory Agencies: What the EU Should Learn From American Experience*, 1 COLUM. J. EUR. L. 1, 44-45 (Winter 2004/2005).

21. Exec. Order No. 13,258, 67 Fed. Reg. 9,385 (Feb. 26, 2002); Exec. Order No. 12,866, 58 Fed. Reg. 51,735 (Sept. 30, 1993). Executive Order 12,866 specifically excludes independent agencies in its definition of "Agency" as "any authority of the United States that is an 'agency' under 44 U.S.C. 3502(1), other than those considered to be independent regulatory agencies, as defined in 44 U.S.C. 3502(10)." *Id.* at 51,735 § 3(b). President Bill Clinton issued Executive Order 12,866 in 1993 to replace Executive Orders 12,291 and 12,498. President George W. Bush later made minor changes to Executive Order 12,866 with the issuance of Executive Order 13,258. Both revisions essentially adopted the main features of the original orders. Geradin, *supra* note 20, at 44-45; *see also* M. Elizabeth Magill, *Agency Choice of Policymaking Form*, 71 U. CHI. L. REV. 1383, 1393, 1447 n.28 (Fall 2004).

22. Rulemaking Audit, *supra* note 13.

23. It does so in part because of a passage in the House Commerce Committee report accompanying the Small Business Regulatory Enforcement Fairness Act (SBREFA) of 1996, which states that "[i]n considering efficiency, competition and capital formation, the Commission shall analyze the potential costs and benefits of any rulemaking initiative, including, whenever practicable, specific analysis of such costs and benefits. The Committee expects that the Commission will engage in rigorous analysis pursuant to this section." H.R. REP. NO. 104-622, at 39 (June 17, 1996).

24. Rulemaking Audit, *supra* note 13.

holdings requiring additional Commission action, but also for its holdings affirming Commission power in Investment Company Act rule making and its confirmations of certain aspects of the SEC's procedures.

In the *Chamber of Commerce Case*, the Chamber attacked two new conditions imposed by the SEC to be used by investment companies (usually called "mutual funds")[25] of ten exemptive rules[26] allowing companies to engage in otherwise prohibited transactions. The challenged provisions inserted into each rule required that in order to engage in certain transactions otherwise prohibited under the Investment Company Act, a mutual fund "must have a board (1) with no less than 75% independent directors and (2) an independent chairman."[27] Independent directors are directors who are not "interested persons" as defined in Section 2(a)(1a) of the Act.[28]

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25. The Investment Company Act regulates "investment companies," as defined in section 3. Investment Company Act, §§ 1, 3, 80a-1 to -3. The Supreme Court has defined "a mutual fund" as "a pool of assets . . . belonging to the individual investors holding shares in the fund." Chamber of Commerce v. SEC, 412 F.3d 133, 136 (D.C. Cir. 2005) (quoting Burks v. Lasker, 441 U.S. 471, 480 (1979)). In this article, most references will be to "mutual funds," which are one type of investment company regulated by the Investment Company Act. *See* Inv. Co. Inst. v. Camp, 401 U.S. 617, 624 (1971).

26. The exemptive rules permit actions otherwise prohibited under the Investment Company Act if the fund directors, including a majority of the independent directors, take appropriate actions. The exemptive rules are:

> Rule 10f-3 (fund purchases of securities underwritten by an affiliated broker-dealer);
>
> Rule 12b-1 (use of fund assets to pay distribution expense);
>
> Rule 15a-4(b)(2) (board approval of an interim advisory contract);
>
> Rule 17a-7 (securities transaction between a fund and a client of its investment adviser);
>
> Rule 17a-8 (mergers between affiliated funds);
>
> Rule 17d-1(d)(7) (purchase of joint liability insurance contracts);
>
> Rule 17e-1 (payment of commissions to affiliated brokers in exchange transactions);
>
> Rule 17g-1 (maintenance of joint insured bonds);
>
> Rule 18f-3 (issuance of multiple classes of voting stock); and
>
> Rule 23c-3 (repurchase of shares in closed end funds).

Investment Company Governance, 69 Fed. Reg. 46,378, 46,381 (Aug. 4, 2004) (to be codified at 17 C.F.R. pt. 270).

27. *Chamber of Commerce Case*, 412 F.3d at 136.

28. The definition of "independent directors" as disinterested persons is discussed in "Best Practices and Practical Guidance for Mutual Fund Directors" as follows:

> Directors of a fund who are, among other things, officers, employees or directors of a fund's adviser are deemed "interested persons" of the fund within the meaning of the 1940 Act. Directors of a fund not having such affiliations with the adviser

In its adopting release the Commission justified the new exemptive conditions primarily on the theory that since inherent conflicts of interests exist between funds and the fund advisers who manage fund assets for fees and who control the fund assets, the "independent judgment and scrutiny of directors, including independent directors" is needed to oversee activities that "involve inherent conflicts between the funds and their managers."[29] Part of the SEC's justification for the new conditions was that enforcement cases involving late trading, market timing, and misuse of portfolio information had revealed "a serious breakdown in management controls."[30]

Two SEC Commissioners dissented from adoption of the revised rules in part because they believed that the Commission had not given

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are typically referred to as "disinterested" directors.

Mutual Fund Directors Forum, Best Practices and Practical Guidance for Mutual Fund Directors, at 5 n.8 (July, 2004), http://www.mfdf.com/PDFs/best_pra.pdf.

Section 1(a)(19)(A) of the Investment Company Act defines an "interested person" of a fund in pertinent part as:

> (i) any affiliated person of the fund; (ii) any member of the immediate family of any natural person who is an affiliated person of the fund; (iii) any interested person of any investment adviser of or principal underwriter for the fund; (iv) any person or partner or employee of any person who at any time since the beginning of the fund's last two completed fiscal years has acted as its legal counsel; (v) any person or any affiliated person of a person (other than a registered investment company) that, at any time during the six month period preceding the date of the determination of whether that person or affiliated person is an interested person, has executed any portfolio transactions for, engaged in any principal transactions with, or distributed shares for the fund, any other fund having the same investment adviser as the fund or holding itself out to investors as a related fund for purposes of investment or investor services, or any account over which the fund's investment adviser has brokerage placement discretion, any person or any affiliated person of a person (other than a registered investment company) that, at any time during the six month period preceding the date of the determination of whether that person or affiliated person is an interested person, has loaned money or other property to (I) the fund; (II) any other fund having the same investment adviser as such fund or holding itself out to investors as a related company for purpose of investment or investor services; (III) any account for which the fund's investment adviser has borrowing authority, or any natural person whom the Commission by order shall have determined to be an interested person by reason of having had, at any time since the beginning of the last two completed fiscal years of the fund, a material business or professional relationship with it or with its principal executive officer, or with any other fund having the same investment adviser or principal underwriter, or with the principal executive officer of such other fund.

Id. at 7 n.15.

29. Investment Company Governance, 69 Fed. Reg. at 46,379.

30. *Chamber of Commerce Case*, 412 F.3d at 137.

adequate consideration to the costs of the two new conditions.[31]

The Chamber of Commerce attacked the rules on the theory that the Commission did not have authority under the Investment Company Act to impose conditions on the exemptions relating to mutual fund governance[32] and on the grounds that the Commission violated the Administrative Procedure Act in its rulemaking.[33] The court rejected the first contention, holding that the Commission's broad exemptive power under Section 6(c) of the Act includes the power to regulate the governance structure of investment companies.[34] It also held that the 75% conditions did not conflict with Section 10(a) of the Act requiring that 40% of the directors of an investment company be independent, because Congress stated only that a fund may have "no more than" 60% non-independent directors.[35] These holdings were favorable to the Commission, because they re-affirmed the Commission's power to regulate mutual fund corporate governance.

In two other aspects of its opinion, the court's rulings were also favorable to the SEC. Both of them addressed contentions that the Commission violated the APA by failing to show sufficient connection between the abuses that prompted the rule making and the new conditions.[36]

First, the court held that the prior existence of rules regulating mutual fund board governance did not prevent the Commission from deciding that "additional regulation was called for as a prophylactic."[37] Importantly, the court reaffirmed the Commission's authority to adopt preventative rules under the 1940 Act by stating that "[i]n sum, the Chamber points to nothing in the ICA to suggest the Congress restricted the authority of the Commission to make 'precautionary or prophylactic responses to perceived risks.'"[38]

Second, the court held that "the Commission's effort to prevent future abuses of exemptive transactions was not arbitrary, capricious, or

31. Investment Company Governance, 69 Fed. Reg. at 46,378-46,393 (Comm'rs Cynthia A. Glassman & Paul S. Atkins, dissenting).

32. *Chamber of Commerce Case*, 412 F.3d at 138.

33. *Id.* at 140.

34. *Id.* at 138.

35. *Id.* at 140 (quoting 15 U.S.C. § 80a-10(a) (2005)).

36. *Id.* at 140.

37. *Id.* at 141.

38. *Id.* (quoting Certified Color Mfrs. Ass'n v. Mathews, 543 F.2d 284, 296 (D.C. Cir. 1976)).

in any way an abuse of discretion, in violation of the APA."[39]

In addition to the favorable rulings, the court provided important guidance to the SEC regarding its obligation to consider costs in its future rule making activities. In considering cost questions, the court referred to Section 2(c) of the Investment Company Act requiring the Commission to consider "whether the action will promote efficiency, competition, and capital formation."[40] It described the Chamber's two contentions in this regard as follows:

> The Chamber argues that the Commission violated this mandate, and hence the APA, by failing (1) to develop new, and to consider extant, empirical data comparing the performance of funds respectively led by inside and by independent chairmen; and (2) to consider the costs of the conditions it was imposing, which costs in turn impede efficiency, competition, and capital formation.[41]

In a section of the opinion highly favorable to the Commission, the court stated that the Commission was not obligated to conduct any empirical study. After noting that "an agency acting upon the basis of empirical evidence may more readily be able to show it has satisfied its obligations under the APA,"[42] it stated that the "Commission's decision not to do an empirical study does not make that an unreasoned decision."[43] It commented that "we are acutely aware that an agency need not—indeed cannot—base its every action upon empirical data,"[44] and it noted that "an agency may be 'entitled to conduct . . . a general analysis based upon informed conjecture.'"[45] The court's holding that a statistical study is not necessary in order to sustain a Commission rule is

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39. *Id.*

40. *Id.* at 142 (quoting Investment Company Act § 2(c)). Notably, the Chamber of Commerce did not assert that the SEC has an obligation to conduct a cost benefit analysis nor did the court discuss "cost-benefit." *See* Cost-Benefit Analysis discussion *supra* pp. 45-46 (noting that the SEC is not obligated to comply with the President's Executive Order mandating such consideration).

41. *Chamber of Commerce Case*, 412 F.3d at 142.

42. *Id.*

43. *Id.*

44. *Id.*

45. *Id.* (quoting Melcher v. FCC, 134 F.3d 1143, 1158 (D.C. Cir 1998)). The court also cited Nat'l Ass'n of Regulatory Util. Comm'rs v. FCC, 737 F.2d 1096, 1124 (D.C. Cir. 1984), for the proposition that parties may bring relevant information to the agency and FCC v. Nat'l Citizens Comm. for Broad., 436 U.S. 775, 813-14 (1978), for the theory that "a forecast of the direction in which future public interest lies necessarily involves deductions based on the expert knowledge of the agency." *Id.* The court also stated that it would not disturb the Commissions' judgment that a statistical study presented to it was unpersuasive. *Chamber of Commerce Case*, 412 F.3d at 143.

very important, since if the SEC were required to support its rule making by statistical data, the effect would be to deny it power to make rules in the absence of available data.

The only cost-related position of the court's opinion that did not support the SEC was the court's holding that the Commission failed adequately to consider the costs of the 75% independent director condition[46] and the costs of the independent chair condition.[47]

With regard to the 75% independent director condition, the court held that the fact that it was difficult to determine the costs associated with electing independent directors "does not excuse the Commission from its statutory obligation to determine as best it can the economic implications of the rule it has proposed."[48]

With regard to the independent chair condition, the court criticized the Commission for its statement that it had no "reliable basis" for estimating the costs of the condition.[49] It noted that although the Commission may not have been able to estimate the aggregate cost to the mutual fund industry, "it readily could have estimated the cost to an individual fund,"[50] and as a result could have made an assessment of the effect of the condition "upon efficiency and competition, if not upon capital formation."[51] It repeated its admonition that uncertainty does not relieve the Commission of its statutory obligations "to apprise itself—and hence the public and the Congress—of the economic consequences of a proposed regulation before it decides whether to adopt the measure."[52]

The court also held that the SEC erred in failing to consider a disclosure alternative that was "neither frivolous nor out of bounds."[53] It remanded the matter to the Commission to address the cost considerations and the disclosure alternative.[54]

Although the *Chamber of Commerce Case* was a partial loss for the Commission, it was not a substantial defeat, because the Commission was required only to make a reasonable estimate of costs and to consider

46. *Chamber of Commerce Case*, 412 F.3d at 143.
47. *Id.* at 143-44.
48. *Id.* at 143.
49. *Id.* at 144.
50. *Id.*
51. *Id.*
52. *Id.*
53. *Id.* at 145.
54. *Id.*

the disclosure alternative. On remand, the Commission considered those questions and determined "not to modify the amendments" to the exemptive rules.[55]

The Commission adopted its response to the court in the *Chamber of Commerce Case*[56] at a meeting held on June 29, 2005, only eight days after the decision. In its response it stated that its consideration and discussion in the response relied upon "the existing record and publicly available information,"[57] that further notice and comment procedures were unnecessary,[58] and that delay risked significant harm to investors.[59]

The Commission discussed the costs and benefits resulting from the rule amendments and "whether they would promote efficiency, competition and capital formation."[60] With regard to Board composition, it observed that based upon the record and publicly available information, it had a "reliable basis upon which to consider the range of costs associated with each of the different ways in which funds may choose to comply with the 75 percent condition."[61] It then presented computations of costs for finding qualified candidates, annual compensation costs, and costs for additional services of independent counsel.[62]

With regard to the independent chairman condition, the Commission concluded that it had "a reliable basis for estimating the costs to an individual fund associated with the independent Chairman condition."[63] It then presented computations regarding costs that a fund might incur for additional staff to support an independent chairman,[64] and for increased compensation.[65]

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55. Investment Company Governance, Commission Response to Remand by Court of Appeals, 70 Fed. Reg. 39,390, 39,398 (July 7, 2005) (to be codified at 17 C.F.R. pt. 270).

56. The response was approved by Commissioners Donaldson, Campos and Goldschmel over the dissents of Commissioners Atkins and Glassman, who complained that the Commission acted hurriedly in order to adopt the response before Chairman Donaldson's last day in office on June 30, 2005. *See* Investment Company Governance, 70 Fed. Reg. at 39,403-05 (Comm'rs Glassman and Atkins, dissenting).

57. *Id.* at 39,391.

58. *Id.*

59. *Id.*

60. *Id.* at 49,392.

61. *Id.*

62. *Id.* at 49,392-93.

63. *Id.* at 49,394.

64. *Id.* at 49,394-96.

65. *Id.* at 49,395.

In considering the cost impacts, the Commission stated:

> We find the costs of the 75 percent condition and of the independent chairman conditions are extremely small relative to the fund assets for which fund boards are responsible, and are also small relative to the expected benefits of the two conditions.[66]

The Commission concluded that compliance with the two rules will increase investor confidence, lead to increased market efficiency, and encourage more efficient capital formation.[67] In addressing benefits, the Commission emphasized the benefits from "strong fund boards that effectively perform their oversight role,"[68] and from an independent chairman who would be "more likely to vigorously represent investor interests when negotiating with the fund adviser on matters such as fees and expenses."[69]

The Chamber of Commerce has filed a petition for review of the Commission re-adoption of the two conditions to mutual fund exempted rules, alleging that the SEC did not have a reliable record upon which to make its determination.[70] The Chamber[71] and the two dissenting SEC Commissioners have also objected to the short time between the court's decision and the final rule.[72]

Whether or not the court holds that the Commission followed the APA in adopting the final rule, the important point for this article is that in future rule making, the Commission will most likely increase its attentions to quantitative examination of costs and benefits, and their impact upon "efficiency, competition, and capital formation." The *Chamber of Commerce Case* makes clear that the Commission need not conduct a statistical analysis in all cases. However, it also seems to suggest that the Commission would be well served to do so when facts are available. The case also provides a warning that although the Commission is not required to conduct a cost benefit analysis under the President's Executive Order, it should consider costs and benefits when

66. *Id.* at 39,395.

67. *Id.*

68. *Id.* at 39,396.

69. *Id.*

70. Chamber of Commerce v. SEC, *petition for review filed* (D.C. Cir. July 7, 2005) (Case No. 05-1240).

71. *Id.*

72. Investment Company Governance, 70 Fed. Reg. at 39,403, 39,405. (Comm'rs Glassman and Atkins, dissenting). This article does not discuss later proceedings relating to the petition for review in the *Chamber of Commerce Case*. These proceedings remain unresolved as of the publication date of this article.

determining whether its actions will promote "efficiency, competition, and capital formation." As noted above, this obligation exists not only under the Investment Company Act, but under the Securities Act and the Exchange Act as well.[73]

The SEC's Rule Making Process

SEC rules usually originate in one of the Commission's rulemaking divisions: Market Regulation, Corporation Finance, or Investment Management.[74] The SEC's Office of the General Counsel and Office of Economic Analysis frequently assist the rulemaking divisions in securing Commission compliance with "applicable statutes, regulations, and Commission policies."[75] The Office of the General Counsel reviews draft rules and may also assist the divisions at the drafting stage.[76] The Office of Economic Analysis "provides advice and technical assistance on the likely economic impacts of rules, on whether the proposed regulatory approach makes economic sense, and on whether proposals and determinations are supported by sound economic reasoning and relevant empirical data."[77]

In a July 2002 audit of the Commission's rulemaking process, the Commission's Inspector General made a number of observations regarding the Commission's rule making process, some of which should provide guidance for the Commission's rule making following the *Chamber of Commerce Case.*

After reviewing twelve rules, the Inspector General noted that Executive Order 12,866[78] requires agencies to assess the costs and benefits of regulatory alternatives. It further noted that although the Commission complies with the order on a voluntary basis, most of the rules reviewed did not discuss the costs and benefits of proposed alternatives.[79]

The audit reported concern by some SEC officials regarding a lack of data and the unpredictable nature of some costs.[80] The audit also reported comments by officials of the Office of Economic Analysis that

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73. *See* discussion *supra* pp. 44-46.
74. Rulemaking Audit, *supra* note 13.
75. *Id.*
76. *Id.*
77. *Id.*
78. Exec. Order No. 12,866, 58 Fed. Reg. 51,735 (Sept. 30, 1993).
79. Rulemaking Audit, *supra* note 13.
80. *Id.*

at times they were not consulted early enough in the rule making process and did not always have time to review and comment on a draft rule.[81] The audit recognized the need to strike a balance between the rule making divisions and recommended better procedures for utilizing the Office of the General Counsel and the Office of Economic Analysis.[82]

The SEC's Regulation NMS

The SEC's recent release of its final rule for Regulation NMS provides a good example of its attempt to conduct a rigorous cost-benefit analysis.[83]

Regulation NMS contains a "series of initiatives" designed to modernize and strengthen the national market system ("NMS") for equity securities.[84] According to the Commission, the initiatives included:

> (1) a new Order Protection Rule, which reinforces the fundamental principle of obtaining the best price for investors when such price is represented by automated quotations that are immediately accessible;
>
> (2) a new Access Rule, which promotes fair and non-discriminatory access to quotations displayed by NMS trading centers through a private linkage approach;
>
> (3) a new Sub-Penny Rule, which establishes a uniform quoting increment of no less than one penny for quotations in NMS stocks equal to or greater than $1.00 per share to promote greater price transparency and consistency;
>
> (4) amendments to the Market Data Rules and joint industry plans that allocate plan revenues to self-regulatory organizations ("SROs") for their contributions to public price discovery and promote wider and more efficient distribution of market data; and;
>
> (5) a reorganization of existing Exchange Act rules governing the NMS to promote greater clarity and understanding of the rules.[85]

The rule, adopted on June 9, 2005,[86] was originally proposed in

81. *Id.*

82. *Id.* The audit noted the existence of a "SEC Compliance Handbook" revised by the Office of the General Counsel in 1999 and recommended that it be updated and expanded. *Id.* This Handbook apparently is not a public document.

83. *See generally* Regulation NMS, 70 Fed. Reg. 37,496, 37,578-94 (June 29, 2005) (to be codified at 17 C.F.R. pts. 200, 201, 230, 240, 242, 249, 270).

84. *Id.* at 37,496.

85. *Id.* at 37,497.

86. *Id.* at 37,632.

February of 2004,[87] was followed by a supplemental request for comment in May of 2004,[88] and was re-proposed in its entirety in December of 2004.[89] As a result of the lengthy comment period, the Commission received substantial public input for its cost benefit and capital formation impact analyses.[90]

In its adopting release, the Commission discussed the benefits and costs of each new or modified rule in a stand-alone section.[91] Among the

87. Regulation NMS, Proposed Rules and Amendments to Joint Industry Plans, 69 Fed. Reg. 11,126 (Mar. 9, 2004).

88. Regulation NMS: Proposed Rule; Extension of Comment Period and Supplemental Request for Comment, Exchange Act, 69 Fed. Reg. 30,142 (May 26, 2004).

89. Regulation NMS, Exchange Act, 69 Fed. Reg. 77,424 (Dec. 27, 2004).

90. The Commission's National Market System release contained the following language justifying its rulemaking process, apparently in an effort to meet challenges of the sort present in the *Chamber of Commerce Case*:

> The Commission has engaged in a thorough, deliberate, and open rulemaking process that has provided at every point an opportunity for public participation and debate. We have actively sought out the views of the public and securities industry participants. Even prior to formulating proposals, our review included multiple public hearings and roundtables, an advisory committee, three concept releases, the issuance of temporary exemptions intended in part to generate useful data on policy alternatives, and a constant dialogue with industry participants and investors. This process continued after the proposals were published for public comment. We held a public hearing on the proposals in April 2004 ("NMS Hearing") that included more than 30 panelists representing investors, individual markets, and market participants from a variety of different sectors of the securities industry. Because we believed that there were a number of important developments at the public hearing, we published a supplemental request for comment and extended the comment period on the proposals in May 2004 to give the public a full opportunity to respond to these developments. We then carefully considered the more than 700 comment letters submitted by the public, which encompassed a wide range of views.

Regulation NMS, Final Rule, 70 Fed. Reg. at 37,497.

It continued:

> In sum, the rules adopted today are the culmination of a long and comprehensive rulemaking process. Reaching appropriate policy decisions in an area as complex as market structure requires an understanding of the relevant facts and of the often subtle ways in which the markets work, as well as the balancing of policy objectives that sometimes may not point in precisely the same direction. Based on the extensive record that we have developed over the course of the rulemaking process, the Commission firmly believes that Regulation NMS will protect investors, promote fair competition, and enhance market efficiency, and therefore fulfills its Exchange Act responsibility to facilitate the development of the NMS.

Id. at 37,498.

91. *See generally id.* at 37,578-94.

five categories covered in the rule,[92] the Order Protection Rule, designed to obtain best prices for investors in automated markets, provides a good example of the manner in which the SEC can protect its rule making by a through cost-benefit analysis.[93]

The SEC first identified both the qualitative benefits and costs of the Order Protection Rule.[94] It identified benefits to investors, such as, "promoting the best execution of customer market orders, promoting the fair treatment of customer limit orders, and strengthening protection of limit orders" which would serve to "minimize investor transaction costs."[95] It noted its expectation that price protections would "increase investor confidence by helping to eliminate the impression of unfairness when a trade occurs at a price that is inferior to the investor's displayed order" and predicted greater "investor confidence in the integrity of the NMS."[96] This increased confidence was expected to increase investors' willingness to invest in the market, and to enhance market depth and liquidity and "the ability of listed companies to raise capital."[97]

The Commission also highlighted benefits to the competitiveness and efficiency of the market itself. For example, it pointed out that the rule protects trades that occur in automated markets by eliminating the need for those markets to wait for responses from non-automated markets.[98] It predicted that as a result the rule will "level the playing field by eliminating the potential competitive advantage the existing ITS rule provides to manual markets" and "accommodate the realities of

92. The SEC divided the rules promulgated in NMS into five general categories: Order Protection, Access, Sub-Penny, Market Data and Plan Amendments, and Regulation NMS. *Id.* at 37,497. Generally, the Order Protection Rule requires a trading center to implement policies to prevent "trade-throughs" of "protected quotations" on that trading center in an effort to protect the "best bids and offers of each exchange." *Id.* at 37,578. The Access Rule governs access to NMS stock quotations in order to promote fairness and non-discriminatory access. *Id.* at 37,497, 37,583. The Sub-Penny Rule limits the increments used in NMS stock quotations to a minimum of $0.01 for stocks that are priced over $1.00. *Id.* at 37,588. The Market Data and Plan Amendments Rule revises the formulas for allocating market data revenues of Self-Regulatory Organizations ("SROs") that participate in joint industry plans, establishes "non-voting advisory committees" comprised of non-SRO interested parties, and modifies the dissemination and display of market information. *Id.* at 37,589. Finally, Regulation NMS makes non-substantive modifications to existing Exchange Act rules. *Id.* at 37,497, 37,593.

93. *See generally id.* at 37,578-83.

94. Regulation NMS, Final Rule, 70 Fed. Reg. at 37,578-83.

95. *Id.* at 37,578.

96. *Id.* at 37,579.

97. *Id.*

98. *Id.*

today's" markets.[99]

The SEC also quantified the benefits of the Order Protection Rule.[100] It expressed its belief that although the rule's price protections of New York Stock Exchange (NYSE) and NASDAQ Stock Market (NASDAQ) stocks are "difficult to quantify," benefits will be substantial.[101] It provided a "conservative" estimate of an annual benefit of $321 million based upon a calculation of the value of the "bypassed limit orders and inferior prices for investors in 2003 that could have been addressed by strong trade through protection."[102] It indicated that since this estimate only represented the "shortage of quoted depth," greater, unquantifiable benefits "can be expected to result from increased use of limit orders, increased depth, and increased order interaction."[103]

The SEC used an indirect approach to quantify an "enormous potential benefit" of the Order Protection Rule.[104] In determining that the rule's projected increase in market depth and liquidity will lower investor transaction costs by $1.5 billion, the SEC focused on a specific category of investors who should benefit from the rule changes and then extrapolated this analysis to cover the overall market.[105] It estimated the expected transaction cost savings and additional returns for equity mutual fund shareholders, and then expanded this analysis to the "holdings of other types of investors, including pension funds, insurance companies, and individuals."[106]

In discussing costs of the Order Protection Rule,[107] the SEC identified implementation costs of $143.8 million and annual maintenance costs of $21.9 million.[108] It said that one-time implementation costs are required to establish and implement the policies and procedures required by the rule and included costs for modifications to and development of various order routing, execution and surveillance

100. *See generally* Regulation NMS, Final Rule, 70 Fed. Reg. at 37,579-81.

101. *Id.* at 37,579.

102. *Id.* To derive the $321 million estimate, the agency focused on the annual amount of quotations that were traded through in 2003. The agency calculated that 12 billion shares were traded through at an average cost of 2.3 or 2.2 cents each for NYSE or NASDAQ stocks, respectively. *Id.*

103. *Id.* at 37,580.

104. *Id.*

105. *See generally id.* at 37,580-81.

106. *Id.*

107. *Id.* at 37,497.

108. Regulation NMS, Final Rule, 70 Fed. Reg. at 37,582.

systems, as well as establishing connectivity to other trading centers.[109] The Commission acknowledged that these costs are substantial, but pointed out that the actual cost per trading center will vary depending on the types of policies that the trading centers choose to implement and the type of systems that they already have in place.[110] It derived the $21.9 million annual maintenance costs by identifying $3.5 million for ongoing monitoring and enforcement activity and $18.4 million for access by trading centers to information databases that will allow them to monitor compliance of individual transactions with the Order Protection Rule.[111]

After identifying costs and benefits of the Order Protection Rule, the SEC in a separate section discussed the rule's impact on the promotion of market efficiency, competition, and capital formation.[112] In conducting this analysis, the Commission sought to consider the impact on market efficiency, competition, and capital formation of each of the costs and benefits identified in the cost-benefit analysis and the issues identified in comments that it received during the rulemaking process.

For example, it indicated that the increased market depth and liquidity, discussed at length in its cost-benefit analysis, will "at a minimum, lower the search costs associated with trying to find liquidity and should lead to improved execution quality."[113] It observed that the Order Protection Rule's protection of trades in automated markets[114] will promote market efficiency "by more effectively linking markets together . . . [by] integrating trading centers . . . and by providing an incentive for non-automated markets to automate."[115] It expected this aspect of the rule to "level" the playing field between automated and non-automated markets leading to increased "intermarket competition" providing "strong incentives to compete and innovate" [116] and to increase the depth and liquidity of the more competitive trading centers.[117] The SEC concluded that the increases in market efficiency, depth and liquidity, coupled with increased investor confidence from the higher quality executions, will allow companies to raise more capital because investors

109. *Id.*
110. *Id.*
111. *Id.* at 37,582-83.
112. *See generally id.* at 37,594-97.
113. *Id.* at 37,594.
114. *Id.* at 37,579; *see also* text accompanying note 96.
115. Regulation NMS, Final Rule, 70 Fed. Reg. at 37,594.
116. *Id.*
117. *Id.*

will be more willing to invest in the capital markets.[118]

As was the case in the adoption of the Mutual Fund Governance rules,[119] Commissioners Cynthia A. Glassman and Paul S. Atkins dissented from adoption of Regulation NMS.[120] In contrast to the governance release, their written dissent was available to the Commission majority prior to the publication of the Regulation NMS, and the Commission release was therefore able to include a response to the dissenting views in the NMS Release.[121] In its response to the dissent, the Commission stated "[b]ecause the dissent appears to have misconstrued a number of the Commission's policy positions and the reasoning underlying them, we are including this section to clarify the record."[122] The response presented rebuttal arguments to the dissent, including a section dealing with "Benefits and Costs of Order Protection Rule."[123] By addressing the dissenting arguments in its adopting release, the Commission increased its ability to contend that it fully considered counter arguments.

Review of the SEC's Investor Protection Activities

The *Chamber of Commerce Case* raises the question whether the Commission should be examining the impact of all of its activities on capital formation. All of the SEC's activities can be classified as providing protection for investors. These activities include programs designed specifically to protect investors, a wide range of enforcement activities, a comprehensive disclosure program, supervision of the mutual fund and investment advisory industry, and detailed regulation of the securities markets. Each of these areas raises questions of the SEC's impact on capital formation.

Investor Education and Assistance

The area that causes the least interference with capital-raising is the

118. *Id.* at 37,595.

119. Investment Company Governance, 69 Fed. Reg. at 46,390-93 (Comm'rs Glassman and Atkins, dissenting).

120. Dissent of Commissioners Cynthia A. Glassman and Paul S. Atkins to the Adoption of Regulation NMS (2005), http://www.sec.gov/rules/final/34-51808dissent.pdf.

121. Regulation NMS, 70 Fed. Reg. at 37,601-09.

122. *Id.* at 37,601.

123. *Id.* at 37,608-09.

Commission's investor education and assistance program. In 2003, forty-three[124] of the Commission's staff of approximately 4,100[125] were engaged in offering investor education and assistance. That staff receives and responds to investor complaints, offers educational events across the country, and provides investor educational literature, such as a series of brochures describing how to make investment choices and warning about potential broker misconduct.[126] The SEC's investor education and assistance program imposes no direct costs on the capital formation process.

Investor Arbitration

Another area of activity that can be classified as "investor protection" arises under the extensive investor securities arbitration programs conducted by the National Association of Securities Dealers, Inc. (NASD), the New York Stock Exchange, and other securities markets.[127] The primary securities arbitration program is conducted by the NASD under the supervision of the SEC[128] through NASD Dispute

124. Securities & Exchange Commission, 2003 Annual Report 30 (2003), http://www.sec.gov/pdf/annrep03/ar03full.pdf [hereinafter SEC 2003 Annual Report].

125. SEC Strategic Plan, *supra* note 15.

126. The Commission publishes and makes available on-line more than 170 brochures offering advice to investors on subjects relating to investing. *See* United States Securities & Exchange Commission, Online Publications for Investors Annotated Subject Guide, http://www.sec.gov/investor/pubs_annote.shtml (last modified July 26, 2005). The only activity in this area that might be regarded as interfering with the markets is the SEC's creation of fake websites offering spectacular returns to investors as a means of investor education. Susan F. Wyderko, Director of the SEC Office of Investor Education and Assistance, Testimony Concerning the Commission's Role in Empowering Americans to Make Informed Financial Decisions Before the Subcommittee on Financial Management, the Budget, and International Securities, Committee on Governmental Affairs, United States Senate (Mar. 30, 1994), http://www.sec.gov/news/testimony/ts033004sfw.htm. Ms. Wyderko discussed the results of a series of SEC "fake investment scams" that were "designed to illustrate the warning signs of an on-line investment fraud." *Id.*

127. The author has a particular interest in this area because he was chair of the Securities Arbitration Task Force of the National Association of Securities Dealers, which conducts approximately 90 percent of investor securities arbitrations. The Task Force published a report in 1996 making approximately 170 major and minor recommendations to the NASD for reform of the NASD's securities arbitration system. *See* NASD, Inc., Securities Arbitration Reform: Report of the Arbitration Policy Task Force to the Board of Governors (Jan. 1996) [hereinafter Securities Arbitration Reform Report].

128. *See generally* Shearson/Am. Express, Inc. v. McMahon, 482 U.S. 220, 233-34 (1987).

Resolution, a subsidiary of the NASD.

The extensive investor arbitration programs conducted by the NASD also do not appear to have negative effects on capital formation. The NASD program is financed by the fees received from litigants, the majority of which are received from the securities industry through process fees, surcharges, and assessments against NASD members.[129] The arbitration process is controlled by the NASD, not by the industry. The brokerage industry has long been a strong supporter of a securities arbitration system, in most cases requiring investors to agree to arbitration as a condition to opening brokerage accounts. The so-called "arbitration waiver clause" placed in customer contracts by broker-dealers was declared valid by the Supreme Court in *Shearson/American Express v. McMahon*.[130] In that case, the court relied upon SEC supervision of the securities arbitration system as a means of protecting investors.[131]

The NASD arbitration system provides a fair venue for resolving investor claims against broker-dealers, and it does so on a cost effective basis. It offers a special system for small claims that does not exist in the federal courts. In cases involving larger claims, experienced arbitration lawyers offset the advantages that repeated defenses of claims might give to brokerage firms. The existence of the arbitration system causes most brokerage firms to settle the more obvious cases of broker misconduct.[132] The public benefits of the system so vastly outweigh the costs to the brokerage industry that evaluating the costs and benefits of that system does not seem warranted.

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129. *See* Securities Arbitration Reform Report, *supra* note 124, at 141; *see also* NASD, Inc., Notices to Members, No. 01-70 (Nov. 2001) (reporting amendments to Rules 10306, 10308, 10319, and 10328 of the NASD Code of Arbitration Procedure), *available at* http://www.nasd.com/web/groups/rulesregs/documents/noticetomembers/nasdw_005064.pdf.

130. *See* McMahon, 482 U.S. at 233-34; *see also* Rodriguez de Quijas v. Shearson/Am. Express, Inc., 490 U.S. 477 (1989).

131. McMahon, 482 U.S. at 233-34.

132. Linda D. Fienberg, President NASD Dispute Resolution, Testimony Before the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, Committee on Financial Services, United States House of Representatives (Mar. 17, 2005) (reporting that only 27 percent of NASD administered arbitration cases were decided by arbitrators. This document also provides a good description of the NASD's dispute resolution process), http://financialservices.house.gov/hearings.asp?formmode=all&comm=1 (follow 3-17-2005 hyperlink entitled "A Review of the Securities Arbitration System").

Commission Enforcement Actions

In many areas in which the Commission acts to protect investors, some interference with business operations may occur. The Commission has strong enforcement powers, including the power to bring investigations, to sue in federal court, and to bring administrative actions against both industry members and other persons for violating the federal securities laws.[133] Sanctions may include restitution, fines, penalties and bars prohibiting defendants from serving as officers or directors of public companies.[134] Although Commission investigations and sanctions clearly impose costs on investigative targets and defendants, these enforcement actions fall in the area of justified interference with business operations.

Corporate Financial Fraud

Recent SEC enforcement cases involving corporate financial fraud have resulted in large monetary penalties and injunctions,[135] including orders prohibiting defendants from serving as officers or directors of companies whose securities are registered with the SEC.[136] When these actions are directed against individuals, they almost surely demonstrate to others the desirability of acting honestly, and in any event the penalties are usually well deserved.

When SEC actions result in penalties on corporations the analysis is not so easy. The problem rests with the fact that in the usual case involving fraudulently inflated earnings the fraud on securities purchasers is perpetrated by corporate officials who make misrepresentations. The purchasing investors have been injured and may recover through private class action litigation or through the Sarbanes-Oxley provisions which permit the SEC to add amounts obtained as civil penalties to disgorgement funds available for the benefit of the victims of securities law violations.[137] Some SEC Commissioners and others have

133. *See generally* DONNA M. NAGY ET AL., SECURITIES LITIGATION AND ENFORCEMENT (2003).

134. *Id.*

135. *See, e.g.*, SEC v. Qwest Commc'ns Int'l, Inc., Litig. Release. No. 18,936 (Oct. 21, 2004), *available at* http://www.sec.gov/litigation/litreleases/lr18936.htm; *see also* cases listed in David S. Ruder, Yuji Sun & Arek Syca, *The Securities and Exchange Commission's Pre- and Post-Enron Responses to Corporate Financial Fraud: An Analysis and Evaluation*, 80 NOTRE DAME L. REV. 1103, 1105-08 (2005).

136. *See, e.g.*, SEC v. Computer Assocs. Int'l, Inc., Litig. Release. No. 18,891 (Sept. 22, 2004), *available at* http://www.sec.gov/litigation/litreleases/lr18891.htm.

137. Sarbanes-Oxley Act of 2002 § 308, 15 U.S.C. § 7246 (2005).

recently raised objections that penalties directed to corporations are too high.[138] Their argument is that if a corporation is required to make payments, innocent shareholders of that corporation who were not responsible for the fraud may indirectly be paying for the fraud because the value of their shares will be lower. This result may be seen as an interference with capital market efficiency, but may be offset by increased shareholder monitoring of behavior by corporate officials.

Broker-Dealer Illegal Conduct

In its enforcement program, the SEC frequently brings many actions against brokerage firms engaged in illegal conduct. For instance, the SEC recently entered into settlements with ten major Wall Street investment firms that had encouraged their financial analysts to make false recommendations to customers regarding securities of corporate clients in order to obtain investment banking fees from those clients. The settlements imposed large fines, mandated use of independent analysts, and imposed conduct restrictions.[139]

The SEC has recently disciplined seven broker-dealers for failure to disclose that they received payments for providing research coverage of certain public companies.[140] It has also disciplined five NYSE specialist

138. *See, e.g.*, Paul S. Atkins, Commissioner SEC, Address at Charles Hamilton Houston Lecture Series (Apr. 4, 2005), http://www.sec.gov/news/speech/spch040405 psa.htm.

139. SEC v. U.S. Bancorp Piper Jaffray, Inc., Litig. Release No. 18,118 (Apr. 28, 2003), *available at* http://www.sec.gov/litigation/litreleases/lr18118.htm; SEC v. Morgan Stanley & Co, Litig. Release No. 18,117 (Apr. 28, 2003), *available at* http://www. sec.gov/litigation/litreleases/lr18117.htm; SEC v. Lehman Bros. Inc., Litig. Release No. 18,116 (Apr. 28, 2003), *available at* http://www.sec.gov/litigation/litreleases/lr18116. htm; SEC v. Merrill Lynch, Litig. Release No. 18,115 (Apr. 28, 2003), *available at* http://www.sec.gov/litigation/litreleases/lr18115.htm; SEC v. Blodget, Litig. Release No. 18,115 (Apr. 28, 2003), *available at* http://www.sec.gov/litigation/litreleases/lr18115. htm; SEC v. J.P. Morgan Sec., Inc., Litig. Release No. 18,114 (Apr. 28, 2003), *available at* http://www.sec.gov/litigation/litreleases/lr18114.htm; SEC v. Goldman, Sachs & Co., Litig. Release No. 18,113 (Apr. 28, 2003), *available at* http://www.sec.gov/ litigation/litreleases/lr18113.htm; SEC v. UBS Warburg LLC, Litig. Release No. 18,112 (Apr. 28, 2003), *available at* http://www.sec.gov/litigation/litreleases/lr18112.htm; SEC v. Citigroup Global Mkts Inc., Litig. Release No. 18,111 (Apr. 28, 2003), *available at* http://www.sec.gov/litigation/litreleases/lr18111.htm; SEC v. Credit Suisse First Boston LLC, Litig. Release No. 18,110 (Apr. 28, 2003), *available at* http://www.sec.gov/ litigation/litreleases/lr18110.htm; SEC v. Bear, Stearns & Co., Litig. Release No. 18,109 (Apr. 28, 2003), *available at* http://www.sec.gov/litigation/litreleases/lr18109.htm; *see also* Stephen M. Cutler & Linda C. Thomsen, Recent SEC Enforcement Cases, Presented at the 32nd Annual Securities Regulation Institute (Jan. 2005) (on file with author).

140. *In re* Needham & Co., Admin. Proc. File No. 3-11,603 (Aug. 25, 2004),

firms for executing orders for their own accounts ahead of executable public customer orders.[141]

Public discipline of brokerage firms engaged in illegal conduct helps to promote market honesty, which in turn promotes market efficiency. The benefits to the markets from SEC disciplinary actions against brokers seem obvious, and it would be a highly unusual case if costs to defendant brokerage firms would outweigh the benefits to the securities markets.

The SEC's Disclosure Requirements

In 2003, 12,830 corporations, each having 500 shareholders and $10 million in total assets, filed annual reports, quarterly reports, and special event reports with the SEC.[142] These reports are made available to the public through the SEC's electronic filing program, EDGAR.[143]

The SEC's disclosure program has been subject to continuous revision, and today imposes considerable burdens on registrants. The

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available at http://www.sec.gov/litigation/admin/33-8474.pdf; *In re* Janney Montgomery Scott LLC, Admin. Proc. File No. 3-11,604 (Aug. 25, 2004), *available at* http://www.sec.gov/litigation/admin/33-8475.pdf; *In re* Morgan Keegan & Co., Admin. Proc. File No. 3-11,600 (Aug. 25, 2004), *available at* http://www.sec.gov/litigation/admin/33-8466.htm; *In re* Prudential Equity Group, LLC, Admin. Proc. File No. 3-11,601 (Aug. 25, 2004), *available at* http://www.sec.gov/litigation/admin/33-8469.htm; *In re* Adams Harkness, Inc., Admin. Proc. File No. 3-11,598 (Aug. 25, 2004), *available at* http://www.sec.gov/litigation/admin/33-8460.htm; *In re* Friedman, Billings, Ramsey & Co., Admin. Proc. File No. 3-11,599 (Aug. 25, 2004), *available at* http://www.sec.gov/litigation/admin/33-8461.htm; *In re* SG Cowen & Co., Admin. Proc. File No. 3-11,602 (Aug. 25, 2004), *available at* http://www.sec.gov/litigation/admin/33-8472.pdf.

141. *In re* Bear Wagner Specialists LLC, Exchange Act Release No. 34-49,498 (Mar. 30, 2004), *available at* http://www.sec.gov/litigation/admin/34-49498.htm; *In re* Fleet Specialist, Inc., Exchange Act Release No. 34-49,499 (Mar. 30, 2004), *available at* http://www.sec.gov/litigation/admin/34-49499.htm; *In re* LaBranche & Co., Exchange Act Release No. 34-49,500 (Mar. 30, 2004), *available at* http://www.sec.gov/litigation/admin/34-49500.htm; *In re* Spear, Leeds & Kellogg Specialists LLC, Exchange Act Release No. 34-49,501 (Mar. 30, 2004), *available at* http://www.sec.gov/litigation/admin/34-49501.htm; *In re* Van der Moolen Specialists USA, LLC, Exchange Act Release No. 34-49,502 (Mar. 30, 2004), *available at* http://www.sec.gov/litigation/admin/34-49502.pdf; *In re* SIG Specialists, Inc., Exchange Act Release No. 34-50,076 (July 26, 2004), *available at* http://www.sec.gov/news/press/200499litigation/admin/34-50076.htm; *In re* Performance Specialist Group, Exchange Act Release No. 34-50,075 (July 26, 2004), *available at* http://www.sec.gov/news/press/200499litigation/admin/34-50075.htm.

142. SEC 2003 Annual Report, *supra* note 124, at 63.

143. *See* SEC Important Information about EDGAR, http://www.sec.gov/edgar/aboutedgar.htm (last modified Feb. 3, 2005).

program seems to have contributed markedly to transparency of corporate operations and to resulting confidence in the United States securities markets. Despite comments made during the rule adoption process that these disclosures impose unnecessary costs on businesses, the benefits to market efficiency from the SEC's required disclosures seem to outweigh their costs, and the effect on capital formation seems to be positive.

Over time, one aspect of the SEC's disclosure program that has attracted substantial negative commentary has been its requirement that businesses must file financial statements prepared in accordance with Generally Accepted Accounting Principles (GAAP). These accounting principals are adopted by the Financial Accounting Standards Board (FASB), an independent private board to which the SEC has delegated authority to create accounting standards.[144] In adopting accounting standards, the FASB engages in extensive efforts to obtain the comments of businesses. It consults with interested parties at all stages through committees, exposure drafts, comment letters, informal contacts, seminars, and open meetings.[145]

Businesses have frequently complained that accounting requirements unduly interfere with business operations and have vigorously attacked required accounting rules in many areas. The FASB is a private organization, not an independent government agency, and is not subject to the Administrative Procedure Act and other legislation applicable to government agencies. Since court challenges to FASB actions are not likely to succeed, disappointed business interests have frequently sought to have Congress interfere with FASB standard-setting. For instance, the FASB's new rule requiring corporations to include the cost of granting employee stock options in their earnings reports has resulted in the introduction of several bills in Congress seeking to revise or delay the FASB action.[146] Business criticism has been led by high-tech Silicon Valley corporations that have become accustomed to using stock options as a means of attracting highly capable employees. They argue that the technological innovations in the United States will suffer if businesses are required to include stock

144. Securities & Exchange Commission, SEC Accounting Series No. 150, 39 C.F.R. § 1260 (1974).

145. *See* discussion of FASB due process in David S. Ruder et al., *Creation of World Wide Accounting Standards: Convergence and Independence*, 25 NW. J. INT'L L. & BUS. 513, 525 (2005).

146. *See id.* at 559-66 (discussing "Stock Options: Political Interferences in the United States").

option grants as an expense. In response, the FASB has defended the new stock option standard as benefiting investors by giving a better indication of real costs. By delegating to the FASB the power to create accounting standards, and by exercising the oversight authority inherent in that delegation, the SEC seems to believe that the FASB's due process procedures provide sufficient protection against undue interference with capital formation.

The area creating the greatest current controversy involves the costs of disclosure requirements adopted following the recent corporate scandals. Following the passage of the Sarbanes-Oxley Act of 2002,[147] the SEC implemented congressionally mandated requirements that corporate officers must certify that their corporations' financial statements are fairly presented[148] and must also certify that their internal controls on financial reporting are reliable.[149] These two disclosure requirements have been intensely criticized by businesses on the grounds of cost. Businesses argue that the new requirements, particularly the Section 404 internal control certifications, unnecessarily impose enormous costs on both large and small businesses.[150] Supporters of the requirements maintain that the new certifications regarding the accuracy of the financial statements are beneficial because they improve corporate disclosures.[151] They also maintain that the certifications mandated by Section 404 will help corporations identify weaknesses in their accounting controls and will result in better internal recording of income and costs, with great benefits to corporate efficiency and market disclosure.[152]

In this highly contentious area, the SEC has postponed the effective date of the internal control certification requirements to a later date for smaller businesses,[153] and has agreed to postpone the effective date of the

147. Sarbanes-Oxley Act of 2002 § 301, 15 U.S.C. § 7201 (2004).

148. Certification of Disclosure in Companies' Quarterly and Annual Reports, 67 Fed. Reg. 57,276 (Sept. 9, 2002); Management's Report on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports, 68 Fed. Reg. 36,636 (June 18, 2003) (to be codified at H.C.F.R. pts. 210, 228, 229, 240, 249, 270, 274) [hereinafter 404 Rule Release].

149. 404 Rule Release, 68 Fed. Reg. at 36,636.

150. *See* SEC, Division of Corporate Finance, Office of the Chief Accountant, Staff Statement on Management's Report on Internal Control Over Financial Reporting (May 16, 2005), http://www.sec.gov/info/accountants/stafficreporting.pdf.

151. *Id.*

152. *Id.*

153. Management's Report on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports of Non-Accelerated Filers

FASB's stock options requirement to help businesses avoid the burden of complying with the Section 404 disclosure requirements and the new stock option accounting requirements at the same time.[154] The SEC has appointed a special "Advisory Committee On Smaller Public Companies" to examine the costs of the certification requirements on small businesses.[155]

It seems likely that, because of the *Chamber of Commerce Case* and business pressures, the Commission will address cost issues in greater detail in future rulemaking related to disclosure matters.

Securities Act Registration Requirements

The Securities Act of 1933[156] requires corporations selling securities to the public to register their securities with the SEC or to find an exemption from registration.[157] For many years the Commission has recognized that costs of registration can be reduced by imposing the same disclosure requirements on corporations selling securities that are imposed upon them in their periodic reports.[158] For two decades, the Commission has allowed larger corporations to incorporate disclosures made in periodic filings into registration statements for sale of securities.[159]

In other areas of the registration process, the SEC has continually been aware of the desirability of easing burdens. In the small business area it has promulgated Regulation S-B, relaxing registration requirements for small businesses,[160] and it has expanded exemption

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and Foreign Private Issuers, 70 Fed. Reg. 11,528 (Mar. 8, 2005) (to be codified at 17 C.F.R. pts. 210, 228, 229, 240, 249).

154. Press Release No. 2005-57, SEC, Commission Amends Compliance Data for FASB Statement No. 123R on Employee Stock Options (Apr. 14, 2005), http:// www.sec.gov/news/press/2005-57.htm.

155. Press Release No. 2004-174, SEC, SEC Establishes Advisory Committee to Examine Impact of Sarbanes-Oxley Act on Smaller Public Companies (Dec. 16, 2004), http://www.sec.gov/news/press/2004-174.htm.

156. Securities Act of 1933 §§ 1-28, 15 U.S.C. §§ 77a-77aa (2005).

157. *E.g.*, *id.* at § 4, 15 U.S.C. § 77b(1) (2005).

158. *See, e.g.*, Proposed Rule Making to Implement the Integrated Disclosure System, Securities Act Release No. 6331-6338 [1981-1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,016 (Aug. 6, 1981).

159. Adoption of Integrated Disclosure System, Securities Act Release No. 6383 (Mar. 3, 1982), 47 Fed. Reg. 11380 (Mar. 16, 1982).

160. Regulation S-B, Integrated Disclosure System for Small Business Issuers, 17 C.F.R. § 228 (2005).

requirements for small offerings.[161] It has made registration easier by adopting shelf registration rules allowing companies to register securities for offering on a delayed basis,[162] and by rules allowing use of term sheets to facilitate the timing of securities offerings.[163] It has also promulgated Rule 144A, allowing sales of unregistered securities to institutional investors in the United States,[164] and Regulation S, clarifying the regulation of overseas offerings.[165]

On July 19, 2005, the Commission issued its long awaited new rules on Securities Offering Reform.[166] The rules involved: 1) increased flexibility in making communications related to registered securities offerings; 2) reduction of procedural restrictions in the registration process; and 3) improvements in the manner of delivery of information to investors.[167] In the portion of its proposing release[168] relating to cost and benefits, and in the portion regarding efficiency, competition and capital formation[169] the SEC made extensive requests for comment regarding costs. In both the proposing and adopting releases, the Commission stated its belief that the proposals would:

- facilitate greater availability of information to investors and the market;

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161. Regulation D, Rules Governing the Limited Offer and Sale of Securities Without Registration Under the Securities Act of 1933, Rules 501-08, 17 C.F.R. §§ 230.501-230.508 (2005); Regulation A, Conditional Small Issues Exemptions, Rules 251-63, 17 C.F.R. §§ 230.251-230.263 (2005).

162. Delayed or Continuous Offering and Sale of Securities, Rule 415, 17 C.F.R. § 230.415 (2005).

163. Prospectus Delivery Requirements in Firm Commitment Underwritten Offerings of Securities for Cash, Rule 434, 17 C.F.R. § 230.434 (2005).

164. Private Resales of Securities to Institutions, Rule 144A, 17 C.F.R. § 230.144A (2005).

165. Regulation S, Rules Governing Offers and Sales Made Outside the United States Without Registration Under the Securities Act of 1933, Rules 901-905 and Preliminary Notes, 17 C.F.R. §§ 230.901-230.905 (2005).

166. Securities Offering Reform, Release Nos. 33-8591, 34-52056, IC-26993, 2005 WL 1692642 (July 19, 2005) (to be codified at 17 C.F.R. pts. 200, 228, 229, 230, 239, 240, 243, 249, 274), *available at* http://www.sec.gov/rules/final/33-8591.pdf [hereinafter SOR Adopting Release].

167. Chairman William H. Donaldson, Speech by SEC Chairman; Securities Offering Reform: Opening Statement Before the SEC Open Meeting (June 29, 2005), http://www.sec.gov/news/speech/spch062905whd.htm.

168. Securities Offering Reform, Proposed Rule, Release Nos. 33-8501, 34-50624, IC-26649, 2004 WL 2610458 at 103 (Nov. 3, 2004). Cost Benefit Analysis (Nov. 3, 2004), 69 Fed. Reg. 67,392, 67,450-56 (Nov. 17, 2004). [hereinafter SOR Proposing Release].

169. Investment Company Act § 2(c), 15 U.S.C. § 80a-2(c) (2005).

- eliminate barriers to open communications;

- reflect the increased importance of electronic dissemination of information;

- make the capital formation process more efficient; and

- define more clearly the information against which seller's statement are evaluated for liability purposes.[170]

Although it might have been expected that in its final release, issued after the *Chamber of Commerce Case* decision, the Commission would have included a greatly expanded quantitative analysis of cost benefits, it did not do so. Instead it emphasized that the offering of reform rules was intended to ease the burden of securities registration, with resulting reductions in costs and improvement in capital formation.[171] In its quantitative analysis, it supported its new approach with summary statistics estimating annual reduction in securities offering compliance costs by \$87,664,000[172] and annual cost savings from the "access equals delivery" provision at \$130,753,000.[173] Since the primary objective of the new rules was to ease burdens on registration, the Commission undoubtedly viewed an attack on its rule-making as remote.

Mutual Fund Enforcement and Rule Making

The mutual fund scandals involving late trading, market timing, and portfolio disclosures caused the SEC to engage in a vigorous mutual fund enforcement program and to adopt new rules developed to foster better fund governance.[174] The most intrusive of these rules requires each fund to have a chief compliance officer and places detailed responsibilities on funds to create programs that will permit them to supervise the compliance programs of their adviser, sub-advisers, and service

170. Cost Benefit Analysis, 69 Fed. Reg. at 67,450; SOR Adopting Release, *supra* note 166, at 274, 298.

171. SOR Adopting Release, *supra* note 166, at 274-97.

172. *Id.* at 290 (utilizing an "average hourly cost of issuers personal time at \$125, without an estimate of the number of hours to be sold").

173. It reached this figure by estimating that in 75% of 232.45 million instances in which broker dealers will be able to rely on the rule, the cost saved will be \$0.75 per prospectus. *Id.* at 290. The assumption that an investor will request a prospectus only 25% of the time may, of course, cast some doubt on the benefits of the reform to investors.

174. Investment Company Governance Release, 69 Fed. Reg. 46,378 (Aug. 4, 2004) (to be codified at 17 C.F.R. pt 270).

providers, such as custodians and shareholder record keepers.[175] Neither the compliance rules nor other rules imposing restrictions on fund and adviser activities have been seriously challenged as failing to make a sufficient cost analysis or as interfering with efficiency, competition, or capital formation. In the future, the court's statement in the *Chamber of Commerce Case* that the SEC should "determine as best it can the economic implications" of its rule making[176] can be expected to cause greater Commission focus on cost and capital formation elements in mutual fund and investment adviser rule making. Nevertheless, successful challenges to mutual fund rules on economic grounds seem unlikely, given the fact that the D.C. Circuit Court has accepted the SEC's position in the mutual fund area and Congress has not restricted the Commission's ability to "make 'precautionary or prophylactic responses to perceived risks.'"[177]

Market Regulation

One of the SEC's primary tasks is to supervise the operations of the securities markets.[178] It has imposed a series of market rules and regulations designed to protect investors. In doing so, the SEC has been rightly concerned that its market regulation activities should not interfere with market efficiency. It has been slow to adopt rules regulating the markets and has been particularly careful not to interfere with technological advances when adopting restrictive rules. Nevertheless, after new technologies emerge, the SEC regularly promulgates rules designed to promote fairness to investors.

The SEC recently introduced order routing reforms requiring broker dealers to include customer limit orders in their quotations and to exercise customer limit orders before filing their own orders.[179] It has recognized special problems associated with the existence of electronic communication networks (ECNs), and has passed regulations relating to oversight of those trading vehicles, including requirements allowing

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175. Compliance Programs of Investment Companies and Investment Advisers, Final Rule, 68 Fed. Reg. 74,714 (Dec. 24, 2003) (to be codified at 17 C.F.R pts. 270, 275, 279).

176. Chamber of Commerce v. SEC, 412 F.3d 133, 143 (D.C. Cir. 2005).

177. *Id.* at 141 (quoting Certified Color Mfrs. Ass'n v. F. David Mathews, 543 F.2d 284, 296 (1976)).

178. In 1975, Congress required the SEC to "facilitate the creation of a National Market System," 1934 Exchange Act § 11A(a)(2), 15 U.S.C. § 78k-1 (2005).

179. Order Execution Obligations, 61 Fed. Reg. 48,290 (Sept. 12, 1996).

investor access to ECNs that maintain high volume markets.[180] The SEC has raised problems relating to market concentration and market fragmentation, and as discussed above, has recently adopted Regulation NMS, which is "designed to modernize and strengthen the national market system . . . for equity securities."[181]

Since technical SEC initiatives may have negative effects on the securities markets, market rules are adopted only after giving the securities industry ample opportunity to comment. These comments usually reveal the intense competitive concerns of the NYSE, the NASDAQ Stock Market, the regional stock exchanges, and the ECNs. Evaluation of the costs of SEC market reforms is extremely difficult, and their effects may not be known until a later time. In this area of SEC activity, the lengthy rule making process is likely to support Commission contentions that securities market rule making reforms promote rather than hinder market efficiency.[182]

Conclusion

When the SEC seeks to protect investors, it also recognizes its obligation to "maintain fair, orderly, and efficient markets" and to "facilitate capital formation."[183] The *Chamber of Commerce Case* and its aftermath undoubtedly will result in greater SEC attention to its duties to facilitate capital formation in the future, not only in its rule making, but also in its other activities. In general, the Commission's activities in pursuit of investor protection are aligned with market efficiency and capital formation, since honest markets are better markets. Capital formation goals seem to be easily met by the SEC's investor education and arbitration supervision activities, because these activities do not interfere with market operations. They also seem to be met by the SEC's anti fraud enforcement, broker dealer discipline, and mutual fund regulation because of the great benefits accruing from honest markets.

Likewise, the benefits accruing to investors and the markets from the Commission's disclosure program, including FASB accounting rules, and the regulation of the securities distribution process seem to promote

180. Regulation of Exchanges and Alternative Trading Systems, 63 Fed. Reg. 70,844-01 (Dec. 22, 1998) (to be codified at 17 C.F.R. pts. 202, 240, 242, 249).

181. Regulation NMS, 70 Fed. Reg. 37,496 (June 29, 2005) (to be codified at 17 C.F.R. pts. 200, 2001, 230, 240, 242, 249, 270).

182. *See id.* at 37,497-98 (Commission's description of its rulemaking process when it adopted Regulation NMS).

183. *See* SEC Strategic Plan, *supra* note 15, at 4.

the Commission's market efficiency and capital formation goals.

The greatest possibility that SEC regulations may impede capital formation may lie in the Commission's oversight of the securities markets. In the market area, the Commission's careful, go slow approach, coupled with the likelihood that market participants will make forceful comments in furtherance of their competitive interests, makes it likely that market efficiency goals will be achieved, and the Commission's statutory obligation to promote capital formation will be met.

In conclusion, the Securities and Exchange Commission's programs promoting honesty and integrity in the securities markets have the effect of enhancing market liquidity, and therefore are likely to meet the Commission's obligations to maintain fair, orderly, and efficient markets and to facilitate capital formation. Nevertheless, given the comment by the District of Columbia Court of Appeals that the Commission must determine the "economic implications" of its rule making, the SEC in the future will be well served in its rule making to demonstrate economic effects through quantitative and statistical analysis of costs and benefits and impacts on capital formation.