WHAT ROUGH BEAST… SLOUCHES TOWARDS BETHLEHEM:[1] *BUSINESS ROUNDTABLE V. SEC* AND THE SEC'S DELEGATED RULEMAKING AUTHORITY

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[1] W.B. Yeats, *The Second Coming* (1921).

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Introduction

In the summer of 1990, the Court of Appeals for the District of Columbia issued *Business Roundtable v. SEC*,[3] invalidating SEC Rule 19c-4 as outside of the Agency's rulemaking authority.[4] *Business Roundtable* was notable when handed down because the decision took place during a pro-regulatory period in which an activist SEC was accustomed to courts sustaining its rules.[5] Currently, however, the atmosphere in the public law area has changed, and courts have held the SEC to a textualist interpretation of its authorizing statutes. This trend is most noticeable with respect to private enforcement of the securities laws,[6] but other developments suggest that the SEC's ability to promulgate *ultra vires*

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[3] 905 F.2d 406 (D.C. Cir. 1990).

[4] 17 C.F.R. § 240.19c-4 (1993). The SEC had promulgated Rule 19c-4 under section 19 of the 1934 Act to bar self-regulatory organizations from listing securities of issuers who take actions "nullifying, restricting or disparately reducing the per share voting rights of holders of an outstanding class . . . of common stock."

[5] *See* James D. Cox, *The Future Content of the U.S. Securities Laws: Premises for Reforming the Regulation of Securities Offerings*, 63 LAW & CONTEMP. PROBS. 11, 37 (terming the *Business Roundtable* decision "the most serious reversal in the SEC's long history of rule making"); *see also* Robert D. Hershey Jr., *U.S. Court Overturns S.E.C. Rule*, N.Y. TIMES, June 13, 1990, at D1 (calling the ruling "a blow to the commission"); *see also* Interview with Merritt Fox, Michael E. Patterson Professor of Law, Columbia Law School (November 2, 2004) (discussing the "many areas in which the SEC has enormous discretion" and the tendency of the SEC to "play fast and loose, viewing its authorizing statutes as very elastic").

[6] *See infra* text at Section I.

rules has also narrowed.[7] This shift in the legal landscape has made *Business Roundtable* a "case whose time has come."[8]

Another development, however, reveals an expansion of *Chevron* deference theory. Courts have invoked *Chevron* to uphold agency regulations.[9] Recent cases blending the *Chevron* approach with that of *Skidmore* to create a broad theory of agency deference would appear to offer the SEC more leeway in crafting enforcement regulations.

Current challenges to SEC rulemaking push the resolution of this tension to the foreground. On September 2, 2004, the U.S. Chamber of Commerce, a national federation of business companies and associations with a membership of over three million organizations,[10] sued the SEC[11] to overturn its new regulation requiring mutual funds to hire independent chairmen and maintain boards that are at least seventy-five percent independent.[12] The case is widely viewed[13] as a prelude to a Chamber fight against an SEC proposal to mandate increased shareholder access to shareholder ballots.[14] The outcome of the controversy and the cases it spawns will delineate the latitude that courts will allow the SEC in regulating the securities markets, an increasingly crucial task in the wake of Enron, WorldCom, and other corporate scandals.[15]

Resolution of the conflict will also have implications for reconciling the position of independent regulatory agencies such as the SEC within the tripartite separation of powers framework.[16]

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[7] *See infra* text at Section II.

[8] For a counterargument, outside the scope of this article, see Daniel J. Meltzer, *The Supreme Court's Judicial Passivity*, 2002 SUP. CT. REV. 343 (2002) (discussing the extent to which the Supreme Court uses federal law to preempt state law).

[9] *See* Smith v. City of Jackson, 544 U.S. 228 (2005).

[10] *See* http://www.uschamber.com/about/default.

[11] *See* Complaint of the U.S. Chamber of Commerce, Chamber of Commerce of the United States of America v. United States Securities and Exchange Commission (D.C. Cir. 2004) (No. 04-1300).

[12] Investment Company Governance Rule, 17 C.F.R. pt. 270 (2004).

[13] *See* John C. Coffee, *The SEC Under Attack*, 26 NAT'L L.J. 61 (2004).

[14] Security Holder Director Nominations, 68 Fed. Reg. 60784 (proposed October 23, 2003) (to be codified at 17 C.F.R. pt. 240, 249, & 274).

[15] Discussion of these issues is outside the scope of this article.

[16] The anomalous position of regulatory agencies has long been a challenge. *See, e.g.*, KENNETH CULP DAVIS, ADMINISTRATIVE LAW TREATISE (1958); LOUIS JAFFE, JUDICIAL CONTROL OF ADMINISTRATIVE ACTION, (1965); David L. Shapiro, *Choice of Rulemaking or Adjudication in Administrative Policy*, 78 Harv. L. Rev. 921 (1965); Richard B. Stewart, *The Reformation of American Administrative Law*, 88 Harv. L.

Article I, Section 1 of the Constitution states that, "All legislative Powers herein granted shall be vested in a Congress of the United States, which shall consist of a Senate and House of Representatives."[17] A postulate termed the Exclusive Delegation Doctrine derives from this Constitutional mandate and states that Congress can delegate rulemaking power to agencies in discrete grants.[18] Thus, agencies may promulgate rules pursuant to specific Congressional delegations of authority; in the absence of such delegations, however, they possess no inherent legislative power.[19]

This article argues against increased deference in judicial review of the scope of agency rulemaking delineated by Congressional statute. Part I begins with an examination of the Supreme Court's textualist approach to private enforcement of the securities laws. Part II elucidates the Court's text-based review of the Congressional delegations pursuant to which the SEC promulgates *ultra vires* rules. It describes the decision in *Business Roundtable* and traces its reasoning through more recent limitations on the Agency's delegated authority. Part III looks to the *Chevron* case and its progeny to assess whether SEC rulemaking might be preserved by recent transformations in theories of agency deference. Part IV evaluates current challenges to the SEC, drawing on comparisons to *Business Roundtable*, in light of these opposing developments. Part V suggests that courts follow *Business Roundtable* and restrict SEC action to the text of its authorizing statutes, in order to anchor the Agency within the separation of powers framework. The article is intended to stimulate dialogue regarding the appropriate scope of the SEC's power and the proper role of Congress as "first mover" in the modern administrative state.

Rev. 1667; STEPHEN G. BREYER & RICHARD B. STEWART, ADMINISTRATIVE LAW AND REGULATORY POLICY (1979).

[17] U.S. CONST. art. I, § 1.

[18] *See* Thomas W. Merrill, *Rethinking Article 1, Section 1: From Nondelegation to Exclusive Delegation*, 104 COLUM. L. REV. 2097, 2101 (2004) (discussing the doctrine and describing the necessary "interpretive moves").

[19] *See* Bowen v. Georgetown Univ. Hosp., 488 U.S. 204, 208 (1988) ("It is axiomatic that an administrative agency's power to promulgate legislative regulations is limited to the authority delegated by Congress."); *see also* Chrysler Corp. v. Brown, 441 U.S. 281, 302 (1979) ("The legislative power of the United States is vested in the Congress, and the exercise of quasi-legislative authority by governmental departments and agencies must be rooted in a grant of such power by the Congress and subject to limitations which that body imposes.").

I. The Problem of Private Enforcement and the Triumph of Textualism

Although this article is primarily focused on the SEC's *ultra vires* rules, the SEC's narrowing rulemaking authority is best understood against the backdrop of developments in the enforcement sphere. The textualist tenor of judicial review is most clearly evidenced in the judicial approach to private enforcement of the securities laws. Part I begins with *Alexander v. Sandoval*, which, while not an SEC case, set out the current methodology for determining the existence of a private right. The Second Circuit has applied *Sandoval's* reasoning to invalidate private rights of action under sections 26(f) and 27(i) of the 1940 Act[20] and section 13(d) of the 1934 Act.[21] Restrictions on fraud on the market theory have also impeded the certification of class action lawsuits that have supplemented the SEC's monitoring of behavior within the securities markets.[22]

A. Alexander v. Sandoval

Alexander v. Sandoval[23] underscored the Supreme Court's evolution since *J.I. Case Co. v. Borak*[24] regarding private rights of action.[25] The question in *Sandoval* concerned the validity of a

[20] *See infra* note 35.
[21] *See infra* note 37.
[22] *See* Bateman, Eichler, Hill Richards, Inc. v. Berner, 472 U.S. 299, 310 ("We repeatedly have emphasized that implied private actions provide . . . 'a necessary supplement to Commission action.'"); *see also infra* text at Section I.C.
[23] 532 U.S. 275 (2001).
[24] *See id.* at 287 ("Respondents would have us revert in this case to the understanding of private causes of action that held sway 40 years ago when Title VI was enacted. That understanding is captured by the Court's statement in *J.I. Case Co. v. Borak*, 377 U.S. 426, 422 (1964), that 'it is the duty of the courts to be alert to provide such remedies as are necessary to make effective the congressional purpose' expressed by a statute. We abandoned that understanding in *Cort v. Ash*, 422 U.S. 66, 78 (1975)—which itself interpreted a statute enacted under the ancient regime—and have not returned to it since. Not even when interpreting the same Securities Exchange Act of 1934 that was at issue in *Borak* have we applied *Borak*'s method for discerning and defining causes of action … Having sworn off the habit of venturing beyond Congress's intent, we will not accept respondents' invitation to have one last drink.").
[25] *Borak*,377 U.S. 426 (1964), may be viewed as paradigm of the court's early permissive approach to recognizing implied rights of action. Under *Borak*, the Court

private right for enforcing disparate-impact regulations[26] promulgated pursuant to Title VI of the Civil Rights Act of 1964.[27] Writing for the majority, Justice Scalia described the textualist framework to be used to determine the existence of a private right of action[28] and concluded that the relevant statutory text of Title VI lacked the "so critical" rights-creating language found in other sections.[29]

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allowed an implied right of action so long as Congress had not evidenced the intent to deny one. *See id.* at 430-33 (allowing an implied private right of action under section 14(a) because section 27 of the 1934 Act, 15 U.S.C. § 78aa (1988), conferred upon federal courts "exclusive jurisdiction of violations" and of "all suits in equity and actions at law brought to enforce any liability or duty created" by the Act, making the implication of a private right of action "necessary to make effective the congressional purpose.") *Cort v. Ash,* 422 U.S. 66 (1975), followed *Borak* and limited the *Borak* holding by propounding a more restrictive, four-part test for determining whether to imply a private right of action under a federal statute. *See* Merrill Lynch, Pierce, Fenner & Smith v. Curran, 456 U.S. 353, 377 (1982) ("the effect of *Cort v. Ash* was to 'modify [this Court's] approach to the question whether a federal statute includes a private right of action.'"). The test asked, "does the statute create a federal right in favor of the plaintiff . . . is there any indication of legislative intent, explicit or implicit, either to create such a remedy or to deny one . . . is it consistent with the underlying purposes of the legislative scheme to imply such a remedy for the plaintiff . . . finally, is the cause of action one traditionally relegated to state law?" *Cort*, 422 U.S. at 78. *Touche Ross & Co. v. Redington,* 442 U.S. 560 (1979), further reduced the *Cort* framework to the sole factor of congressional intent in evaluating whether section 17(a) of the 1934 Act supported a private cause of action. *See id.* at 562-67. The Court considered the first two prongs of the *Cort* test and deemed them to militate against the implication of a private right. It then eschewed analysis of the third and fourth *Cort* factors. *See id.* at 575-76 ("The [*Cort*] Court did not decide that each of these factors is entitled to equal weight. The central inquiry remains whether Congress intended to create, either expressly or by implication, a private cause of action."). In issuing its ultimate holding invalidating the private cause of action under section 17(a), the Court characterized the first three prongs of the *Cort* test as serving the unified purpose of "determining legislative intent." *Id.* at 576. In *Transamerica Mortgage Advisors, Inc. v. Lewis,* 444 U.S. 11 (1979), a case handed down the same year as *Touche Ross*, the Supreme Court confirmed that the implication of private rights would rest solely on congressional intent, stating plainly, "what must ultimately be determined is whether Congress intended to create the private remedy asserted." *Id.* at 15-16.

[26] *Id.* at 278-79.

[27] 42 U.S.C.A. § 2000d et seq.

[28] *Id.* at 286 ("Implicit in our discussion thus far has been a particular understanding of the genesis of private causes of action.").

[29] *Sandoval*, 532 U.S. at 286. ("It is immediately clear that the 'rights-creating' language so critical to the Court's analysis in Cannon of section 601 is completely absent from section 602. Whereas section 601 decrees that '[n]o person . . . shall . . . be subjected to discrimination, . . . section 602 limits agencies to 'effectuating' rights already created by section 601."). The Court characterized section 602 as simply

Private actions, he wrote, "[m]ust be created by Congress." The Court must analyze Congressional statutes to determine whether Congress intended a private remedy,[30] looking only at statutory language and structure.[31] Courts may not create private rights of action "[n]o matter how desirable that might be as a policy matter."[32]

B. *Sandoval* and Private Enforcement of the Securities Laws

Sandoval's congressional intent requirement confirmed a sea-change in implied right of action jurisprudence.[33] Subsequent courts have invoked *Sandoval's* reasoning to overturn private rights of action under the securities regulations.

1. Olmsted v. Pruco Life Ins. Co.

In *Olmsted v. Pruco Life Ins. Co.*,[34] the Second Circuit barred holders of "variable annuity" insurance contracts from bringing a class action suit under sections 26(f) and 27(i) of the 1940 Act.[35] Citing *Sandoval*, the Court used statutory interpretation to discern Congressional intent.[36] Because the 1940 Act did not explicitly address the existence of a private right of action under sections 26(f) and 27(i),[37] the Court held that Congress must not

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authorizing executive agencies to regulate to "effectuate" the purposes of section 601.

[30] *Id.* at 286.

[31] *Id.* at 285-86. ("Having sworn off the habit of venturing beyond Congress's intent, we will not accept respondents' invitation to have one last drink.").

[32] *Id.* at 286-87.

[33] *See supra* note 25.

[34] 283 F.3d 429 (2d. Cir. 2002).

[35] *Id.* at 430-31.

[36] *See id.* at 432.

[37] Section 26(f) provides:

> It shall be unlawful for any . . . account funding variable insurance contracts, or for the sponsoring insurance company of such account, to sell any such contract (A) unless the fees and charges deducted under the contract, in the aggregate, are reasonable . . .

15 U.S.C. § 80a-26(f).

Section 27(i)(2) provides:

> It shall be unlawful for any . . . account funding variable insurance contracts, or for the sponsoring insurance company of

have meant for there to be private enforcement.[38] Writing for the majority, Judge Sack buttressed the Court's position with three additional observations related to the text of the statute: the statute's omission of any reference to investors,[39] the statute's express inclusion of SEC enforcement mechanisms[40] and Congress's express creation of a private right of action elsewhere in the 1940 Act, in section 35(b).[41]

Olmsted failed to find a private right of action under sections 26(f) and 27(i) even though courts in prior cases had affirmed the existence of a private right.[42] It dismissed the consideration of legal context and legislative history as interpretive tools from the "ancient regime" that *Sandoval* replaced.[43]

> such account, to sell any such contract unless. . . . (B) the insurance company complies with section 80a-26(f) of this title and any rules or regulations issued by the Commission under section 80a-26(f) of this title.

15 U.S.C. § 80a-27(i)(2).

[38] *See Olmsted*, 283 F.2d at 432 ("No provision of the [1940 Act] explicitly provides for a private right of action for violations of either § 26(f) or § 27(i), and so we must presume that Congress did not intend one.").

[39] *Id.* at 433, quoting *Sandoval*, 532 U.S. at 289 ("Statutes that focus on the person regulated rather than the individuals protected create 'no implication of an intent to confer rights on a particular class of persons.'").

[40] *Id.*, quoting *Sandoval* 532 U.S. at 290 ("The express provision of one method of enforcing a substantive rule suggests that Congress intended to preclude others. . . . [S]ometimes the suggestion is so strong that it precludes a finding of congressional intent to create a private right of action, even though other aspects of the statute . . . suggest the contrary.").

[41] *Id.*, quoting 15 U.S.C. § 80a-35(b); *see also Touche Ross*, 442 U.S. at 572 ("Obviously . . . when Congress wished to provide a private damage remedy, it knew how to do so and did so expressly.").

[42] *See* Bancroft Convertible Fund, Inc. v. Zico Inv. Holdings, Inc., 825 F.2d 731, 736 (3d Cir. 1987) (recognizing implied private right of action for violations of § 12(d)(1)(A) of the 1940 Act); Meyer v. Oppenheimer Mgmt. Corp., 764 F.2d 76, 88 (2d Cir. 1985) (recognizing implied right of action under § 15(f) of the 1940 Act); Strougo v. Scudder, Stevens, & Clark, Inc., 964 F. Supp. 783, 798 (S.D.N.Y. 1997) (recognizing implied right of action under § 35(a) of the 1940 Act); Langner v. Brown, 913 F. Supp. 260, 267 (S.D.N.Y. 1996) (recognizing implied right of action under § 10(a) of the 1940 Act).

[43] *Olmsted*, 283 F.2d at 434 (quoting *Sandoval* 532 U.S. at 287).

2. Hallwood Realty Partners, L.P. v. Gotham Partners, L.P.

Similarly, in *Hallwood Realty Partners, L.P. v. Gotham Partners, L.P.*[44] the Second Circuit held that no private right of action existed for damages under section 13(d) of the 1934 Act.[45] Thus, while Hallwood asserted Gotham had formed a group to purchase and amass Hallwood units for the purpose of affecting a takeover of Hallwood without disclosing its intentions in public filings, as required under section 13(d), the Court allowed Hallwood no claim for monetary relief. [46]

The Court had previously upheld private enforcement under 13(d) for injunctive relief in *GAF Corp. v. Milstein*.[47] Writing for the majority, however, Judge Calabresi noted that no rights-creating language inheres in the statute, while an express remedy under section 18(a) of the Williams Act[48] is already available to shareholders.[49] For these reasons found in the text, he concluded that "a damages remedy for issuers contravenes the congressional purposes underlying the statute of which § 13(d) is a part," and therefore, "the general rule that federal courts award all appropriate relief does not apply."[50]

3. 14d-10

This development has not yet run out in the securities arena. This article argues in Section II that SEC Rule 14d-10 is invalid. Even if Rule 14d-10 is upheld, *Sandoval*'s textualist analysis further calls into question the existence of a private right under the Rule.

The SEC promulgated Rule 14d-10, the All Holders-Best Price Rule, pursuant to Section 14(d)(7) of the 1934 Act.[51] The

[44] 286 F.3d. 613 (2d Cir. 2002).
[45] 15 U.S.C. § 78m(d).
[46] *Hallwood,* 286 F.3d at 615.
[47] 453 F.2d 709, 720 (2d Cir. 1971).
[48] 15 U.S.C. § 78r(a).
[49] *See Hallwood,* 286 F.3d at 619.
[50] *Id.* at 621.
[51] Section 14(d)(7) of the 1934 Act states that:

> Where any person varies the terms of a tender offer . . . before the expiration thereof by increasing the consideration offered to holders of such securities, such person shall pay the increased

Sandoval Court made clear that statutes, not rules, create private rights of action. According to *Sandoval*, "language in a regulation may invoke a private right of action that Congress through statutory text has created, but it may not create a right that Congress has not."[52] Thus, a private right of action under Rule 14d-10 must be grounded in a prohibition found in Section 14(d)(7). Rule 14d-10, however, prohibits more behavior than section 14(d)(7). This is because 14d-10 does not restrict its application to situations in which there has been a variance in "the terms of a tender offer" or "increased consideration" during the tender offer period, while section 14(d)(7) does.[53] Thus, a private right of action to enforce 14(d)(7) may not properly be grounded in rule 14d-10, since a private right under 14d-10 would enforce acts not already prohibited by 14(d)(7).

C. Fraud on the Market Theory

Hostility towards private enforcement of securities laws is also evidenced in judicial antagonism towards utilizing fraud on the market theory to imply reliance in Rule 10b-5 fraud enforcement actions.[54] To plead a Rule 10b-5 cause of action, plaintiffs must

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> consideration . . . whether or not such securities have been taken up . . . before the variation of the tender offer . . .

15 U.S.C. s78n(d)(7)(1997).

Rule 14d-10 provides:

> No bidder shall make a tender offer unless: (1) the tender offer is open to all security holders of the class of securities subject to the tender offer; and (2) the consideration paid to any security holder pursuant to the tender offer is the highest consideration paid to any other security holder during such tender offer.

17 C.F.R. § 240.14(d)-10(a).

[52] *Sandoval*, 532 U.S. at 291.

[53] *See* Lerro v. Quaker Oats Co., 84 F.3d 239, 240 (7th Cir. 1996) ("Section 14(d)(7) provides that when a bidder 'varies the terms of a tender offer . . . before the expiration thereof by increasing the consideration offered to holders of such securities,' it must apply the increase to all shares acquired under the offer. The Distributor Agreement, which was in place from the start, is hard to characterize as an "increase" in compensation. Rule 14d-10(a)(2), adopted in 1986, is broader. It forbids any tender offer that does not satisfy this condition: [t]he consideration paid to any security holder pursuant to the tender offer is the highest consideration paid to any other security holder during such tender offer.").

[54] Rule 10b-5, 17 C.F.R. § 240.10b-5 (2006), promulgated pursuant to section 10(b) of the 1934 Act, 15 U.S.C. § 78j (2000), prohibits a person from employing a deceptive device, making an untrue statement of material fact or omitting one, or engaging in fraudulent practices. Though no express private cause of action is

show materiality, scienter, reliance, and loss causation.[55] Drawing on the Efficient Capital Markets Hypothesis, the fraud on the market theory serves to create a rebuttable presumption of reliance without actual evidence that reliance has occurred.[56] The theory presumes

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embodied in section 10(b) or Rule 10b-5, *see, e.g.*, Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 729-30 (1975) ("Section 10(b) of the 1934 Act does not by its terms provide an express civil remedy for its violation. Nor does the history of this provision provide any indication that Congress considered the problem of private suits under it at the time of its passage. . . . Similarly, there is no indication that the Commission in adopting Rule 10b-5 considered the question of private civil remedies under this provision."), courts have implied a private right since 1946, s*ee* Kardon v. Nat'l Gypsum Co., 69 F. Supp. 512, 513-14 (E.D. Pa. 1946) ("It is also true that there is no provision in Sec. 10 or elsewhere expressly allowing civil suits by persons injured as a result of violation of Sec. 10 or of the Rule. However, . . . the disregard of the command of a statute is a wrongful act and a tort.").

Rule 10b-5 provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,
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> (1) to employ any device, scheme, or artifice to defraud,
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> (2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statement made, in the light of the circumstances under which they were made, not misleading, or
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> (3) to engage in any act, practice or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale or any security.
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> Section 10(b) of the 1934 Act provides:
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> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange-
>
> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, or any securities-based swap agreement, any manipulative or deceptive device or contrivance of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

[55] *See* TSC Indus. v. Northway, Inc., 426 U.S. 438, 449 (1976) (materiality); Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 (1976) (scienter); Basic Inc. v. Levinson, 485 U.S. 224, 243 (1988) (reliance); and 15 U.S.C. § 78u-4(b)(4) (2000) (loss causation); *see also* RESTATEMENT (SECOND) OF TORTS § 525 (1977).

[56] *See, e.g.*, In re LTV Securities Litigation, 88 F.R.D. 134, (N.D.Tex., 1980), explaining the Efficient Capital Markets Hypothesis in relation to fraud on the market theory ("In more technical terms: Basically, efficient capital markets exist when security prices reflect all available public information about the economy,

that the price of stock in the securities markets is based upon the information a company has presented about its business. Consequently, false statements inflate the price of the stock, and its purchasers are defrauded even when they may not have directly relied on the information.[57]

The fraud on the market doctrine has proved indispensable for the certification of a class in securities fraud lawsuits.[58] Class certification requires a showing that "common questions of law and fact" predominate.[59] Without the fraud on the market theory, individual plaintiffs would need to prove their individual reliance, arguably destroying the existence of a "common question."[60]

1. *Basic, Inc. v. Levinson* and Supreme Court Acceptance of the Theory

For this reason, the Supreme Court endorsed the fraud on the market theory in *Basic, Inc. v. Levinson*.[61] Writing for a split Court, Justice Blackmun stated that, "requiring proof of individualized reliance from each member of the proposed plaintiff class effectively would have prevented respondents from proceeding with a class

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about financial markets, and about the specific company involved. Implied is that market prices of individual securities adjust very rapidly to new information. As a result, security prices are said to fluctuate randomly about their 'intrinsic' values. To be sure, new information can result in a change in the 'intrinsic' value of a stock, but subsequent stock price movements will follow what is known as a random walk.")

[57] *See, e.g.*, Peil v. Speiser, 806 F.2d 1154, 1160-1161 (3d Cir. 1986) ("The fraud on the market theory is based on the hypothesis that, in an open and developed securities market, the price of a company's stock is determined by the available material information regarding the company and its business . . . Accordingly, we hold that plaintiffs who purchase . . . need not prove direct reliance on defendants' misrepresentations . . . [T]he court will presume that the misrepresentations occasioned an increase in the stock's value that, in turn, induced the plaintiffs to purchase the stock.").

[58] The fraud on the market doctrine was recognized by a court for the first time in the Ninth Circuit case of Blackie v. Barrack, 524 F.2d 891 (9th Cir. 1975). The *Blackie* court used the theory to certify a class for a securities fraud lawsuit involving open-market securities transactions. *See id.* at 905-06.

[59] Fed. R. Civ. P. 23 (a) ("One or more members of a class may sue . . . only if (1) the class is so numerous that joinder of all members is impracticable, (2) there are questions of law or fact common to the class, (3) the claims or defenses of the representative parties are typical of the claims or defenses of the class, and (4) the representative parties will fairly and adequately protect the interests of the class.").

[60] *See Blackie*, 524 F.2d at 905-06.

[61] 485 U.S. 224 (1988).

action, since individual issues then would have overwhelmed the common ones."[62] Adoption of the theory was proper, therefore, because it furthered disclosure, the Congressional purpose of the 1934 Act.[63]

Those who are against using the fraud on the market doctrine in Rule 10b-5 actions, including the dissenting justices in the *Basic* case, have argued that this theory eviscerates the reliance requirement of the Rule 10b-5 fraud claim. Justice White specifically warned of the "dangers when economic theories replace legal rules" without the prior consent of Congress.[64] He argued that the fraud on the market theory expressly derogated from Congressional prerogatives. An early draft of the 1934 Act allowed plaintiffs "who shall have purchased or sold a security the price of which may have been affected by such [misleading] statement" to recover in a civil action.[65] After the provision was criticized in congressional hearings, Congress chose to bolster its reliance requirement; the final draft expressly requires reliance.[66] Finally, Justice White argued that the fraud on the market theory impeded Congress's goal of disclosure in the securities markets.[67] He maintained that "allowing monetary recovery to those who refuse to look out for themselves" is not a valid policy; "if we say that a plaintiff may recover in some circumstances even though he did not

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[62] *Id.* at 242. Justice Blackmun continued, "[t]he District Court found that the presumption of reliance created by the fraud-on-the-market theory provided 'a practical resolution to the problem of balancing the substantive requirement of proof of reliance in securities cases against the procedural requisites of [Fed. Rule Civ. Proc.] 23.'" *Id.*

[63] *See id*. at 246 ("No investor, no speculator, can safely buy and sell securities upon the exchanges without having an intelligent basis for forming his judgment as to the value of the securities he buys or sells. The idea of a free and open public market is built upon the theory that competing judgments of buyers and sellers as to the fair price of a security brings [sic] about a situation where the market price reflects as nearly as possible a just price. Just as artificial manipulation tends to upset the true function of an open market, so the hiding and secreting of important information obstructs the operation of the markets as indices of real value." (quoting H. R. REP. NO. 73-1383, at 11 (1934)).

[64] *Id.* at 253.

[65] *Id*. at 257 (citing S. 2693, 73d Cong. § 17(a) (2d Sess. 1934)).

[66] *Id.* at 257-58 ("[T]he 'bill as originally written was very much challenged on the ground that reliance should required. This objection has been met.'" (quoting Representative Sam Rayburn in 78 Cong. Rec. 7701 (1934)).

[67] *Id.* at 259 (citing Shores v. Sklar, 647 F.2d 462 (5th Cir. 1981) (Randall, J., dissenting)).

read and rely on the defendants' public disclosure, then no one need pay attention to those disclosures and the method employed by Congress to achieve the object of the 1934 Act is defeated."[68]

2. Restrictions on the Theory

In the aftermath of *Basic*, the fraud on the market doctrine has been challenged and narrowed. In *In re Merrill Lynch & Co., Inc.*,[69] a plaintiff class brought suit against research analysts at Merrill Lynch who published misleading ratings for internet stocks in order to attract investment banking clients.[70] The plaintiffs did not allege that they had read the analyst reports or that they had been customers of Merrill Lynch. Rather, they pled reliance under the fraud on the market theory on the grounds that the analysts' reports had affected the price of stock in the marketplace.[71] While this was sufficient to show reliance,[72] the Court ultimately dismissed the complaint of the plaintiff class.[73] The Court held that the plaintiffs failed to show that the analysts' actions had caused them to lose money. "Alleging 'artificial inflation,'" Judge Milton Pollack opined, "is not sufficient"; the plaintiff must also show actual loss.[74] In fact, according to Judge Pollack, the intervening burst of the internet bubble was proximately responsible for the plaintiffs' loss, not the analysts' deceptions.[75]

In *Hevesi v. Citigroup*, part of the *WorldCom* litigation,[76] District Judge Cote used the fraud on the market doctrine to imply reliance on analyst reports.[77] The Second Circuit granted an interlocutory appeal to rule on the applicability of the fraud on the

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[68] *Id.*.
[69] *In re* Merrill Lynch & Co. Inc. Research Reports Sec. Litig., 273 F. Supp. 2d 351 (S.D.N.Y. 2003).
[70] *Id.* at 359.
[71] *Id.*
[72] *Id.* at 365.
[73] *Id.* at 382.
[74] *Id.* at 365.
[75] *Id.* at 362. But see Demarco v. Robertson Stephens Inc., 318 F. Supp. 2d 110 (S.D.N.Y. 2004), a case in which defendants allegedly used analyst reports to inflate stock prices in order to sell their stock at the high price. Again, plaintiffs did not claim to have read the research reports and used the fraud on the market theory to imply their reliance. Judge Gerald Lynch ruled the doctrine could apply to research reports since their content had been known to move markets.
[76] *In re* WorldCom, Inc. Sec. Litig., 219 F.R.D. 267 (S.D.N.Y. 2003).
[77] *Id.* at 294-95.

market theory.[78] Although *Basic* involved an issuer's own false statements, the Court did not limit its holding to particular market players.[79] Instead, the majority asserted that "the market price of shares traded on well-developed markets reflects all publicly available information, and, hence, any material misrepresentations . . . Because most publicly available information is reflected in market price, an investor's reliance on any public material misrepresentations, therefore, may be presumed."[80] Thus, reports interpreting public information would also appear to affect the price of securities in the market. In accepting review of the *WorldCom* certification, however, the Second Circuit cited *West v. Prudential Securities, Inc.*,[81] in which the Seventh Circuit declined to apply the fraud on the market theory to a stockbroker's statements and, consequently, decertified a class.[82] The Seventh Circuit maintained that there was no clear causation between "non-public information" articulated by a broker and "securities prices."[83]

3. *Dura Pharmaceuticals v. Broudo* and the Theory under Attack

Against this background, the Supreme Court granted *certiorari* in *Dura Pharmaceuticals v. Broudo*,[84] a class action brought on behalf of investors because of misleading press releases issued by Dura Pharmaceuticals.[85] In contrast to the *In re Merrill Lynch* decision, the Ninth Circuit held in *Broudo* that the plaintiffs sufficiently pled reliance under the fraud on the market theory by showing that misrepresentations inflated the price of Dura

[78] *See* Hevesi v. Citigroup, 366 F.3d 70 (2d Cir. 2004).
[79] *Basic*, 485 U.S. at 242.
[80] *Id.* at 246.
[81] 282 F.3d 935 (7th Cir. 2002).
[82] *Hevesi*, 366 F.3d at 78.
[83] *Id*. (quoting *West*, 282 F.3d at 938.)
[84] 339 F.3d 933 (9th Cir. 2003), *cert. granted,*124 S.Ct. 1625 (2004).
[85] *See Dura*, 339 F.3d at 935-36 ("Dura issued several press releases indicating satisfactory development and testing of the Albuterol Spiros Device and claiming rising sales of Ceclor CD, both of which Appellants allege were known to Dura and individual defendants as untrue . . . . Dura's stock reached a high of $53 per share. On . . . February 24, 1998, Dura revealed that it expected lower-than-forecast 1998 revenues and 1998 earnings per share . . . Dura's stock then . . . [experienced] a 47% one-day loss.").

Pharmaceuticals stock when they purchased it.[86] The Ninth Circuit clearly stated that, "it is not necessary that a disclosure and subsequent drop in the market price of the stock have actually occurred."[87] A successful claim "merely requires pleading that the price at the time of purchase was overstated and sufficient identification of the cause."[88]

The Supreme Court is expected to overturn this application of the fraud on the market theory.[89] In *Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson*,[90] the Supreme Court turned to sections 9[91] and 18[92] of the 1934 Act in order to determine the appropriate statute of limitations in a Rule 10b-5 action.[93] The Court noted that while it had upheld private rights of action under 10b-5, 10b-5 claims are of "nontraditional origin," since "such claims are of judicial creation" and "the text of § 10(b) does not provide for [them]."[94] Therefore, it was necessary to use sections 9 and 18 of the 1934 Act as a template, and the *Lampf* Court imputed their statutes of limitation to Rule 10b-5 actions.[95]

Applying the text of sections 9 and 18 to the pleading requirements of a 10b-5 claim appears to mandate the curtailment of fraud on the market theory. Section 18 requires a plaintiff who sues over a misleading SEC filing to have "in reliance upon such statement . . . purchased or sold a security at a price which was affected by such statement."[96] This language seems to require both actual reliance and a change in price brought about by the misstatement. Section 18 also limits damages to the amount "caused

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[86] *See id.* at 938.
[87] *Id.*
[88] *Id.*
[89] *See, e.g.*, John C. Coffee Jr., *Causation by Presumption? Why the Supreme Court Should*
Reject Phantom Losses and Reverse Broudo, 60 BUS. LAW. 533 (Feb. 2005).
[90] 501 U.S. 350 (1991).
[91] 15 U.S.C. § 78i (2004).
[92] 15 U.S.C. § 78r (2004).
[93] *Lampf,* 501 U.S. at 395 ("There can be no doubt that the contemporaneously enacted express remedial provisions represent 'a federal statute of limitations actually designed to accommodate a balance of interests very similar to that at stake here.'").
[94] *Id.* at 358-59.
[95] *Id.* at 362 ("Where, as here, the claim asserted is one implied under a statute that also contains an express cause of action with its own time limitation, a court should look first to the statute of origin to ascertain the proper limitations period.").
[96] 15 U.S.C. § 78r (2004).

by such reliance,"[97] further implying that a plaintiff must show actual loss.

II. *Business Roundtable* and the Delegated Authority of the SEC

Parallel to the cutbacks in private enforcement of securities laws, courts have demonstrated increasing hostility towards SEC regulations not specifically grounded in statutory text. *Business Roundtable*[98] appears to have presaged the current attitude towards SEC rulemaking. The *Business Roundtable* Court read the SEC's authority to adopt a "one-share, one vote" rule under section 14 (a) of the 1934 Act strictly, to hold that section 14 (a) only granted the SEC power to regulate disclosure.[99] Since Rule 19c-4 regulated substantive matters of corporate governance, the SEC acted outside the scope of its authority by promulgating it.[100] This textual reading of the SEC's delegated authority is in accord with recent non-securities jurisprudence related to disparate-impact regulations.[101] These developments make SEC Rule 14d-10, the SEC's mutual fund governance rule, and the SEC's proposed proxy access rule problematic.[102] Part II of this article contends that the *Business Roundtable* holding appears more likely today than it did fourteen years ago when the case was decided.

A. *Business Roundtable* in Focus

In 1984, General Motors announced that it would issue a dual class of stock with only one-half vote per share.[103] The New York Stock Exchange already mandated that listed companies grant one vote per share of common stock, but it petitioned the SEC for permission to waive its own requirement.[104] The SEC denied the petition and instead enacted Rule 19c-4, prohibiting stock exchanges from listing securities of companies "with the effect of nullifying,

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[97] *Id.* at § 78r.
[98] 905 F.2d at 407.
[99] *See infra* text at Section II.A.
[100] *See infra* note 119 and accompanying text.
[101] *See infra* text at Section II.B.
[102] *See inra* text at Section II.C-D.
[103] *Business Roundtable*, 905 F.2d at 407.
[104] *Id.* at 407.

restricting, or disparately reducing the per share voting rights of holders of an outstanding class or classes of common stock."[105]

At issue in *Business Roundtable* was whether the SEC had authority to promulgate the Rule, which it had adopted pursuant to section 19(c) of the 1975 Securities Acts Amendments to the 1934 Act.[106] Section 19(c) provides, "The Commission . . . may abrogate, add to and delete from . . . the rules of a self-regulatory organization . . . in furtherance of the purpose of this chapter."[107]

The SEC asserted that the one share-one vote listing requirements were within the scope of its rulemaking powers under section 19(c).[108] Specifically, the SEC argued that Rule 19c-4 "furthered" section 14(a) of the 1934 Act,[109] which granted the SEC authority to regulate proxy voting.[110]

The D.C. Circuit disagreed with the SEC's arguments. Holding that Rule 19c-4 "directly controls the substantive allocation of powers among classes of shareholders . . . in excess of the Commission's authority under § 19 of the Securities Exchange Act of 1934," the Court invalidated the Rule.[111] Writing for the majority, Judge Williams characterized the primary goal of the 1934 Act in section 14(a) narrowly, as regulating disclosure in proxy solicitations and proxy voting procedures.[112] Rule 19c-4, he stated, rather than promoting disclosure, "much more directly interferes with the substance of what the shareholders may enact."[113] The Court concluded that the purpose of section 14(a) did not extend to issues of substantive governance.[114]

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[105] 17 C.F.R. § 240.19c-4 (1993).
[106] 15 U.S.C. § 78s (2004).
[107] *Id.* at § 78s(c) (2004).
[108] 53 Fed. Reg. 26,376 (1988).
[109] *Id*.
[110] 15 U.S.C. § 78n(a) (2004). This section states:
It shall be unlawful for any person, by the use of the mails or by any means or instrumentality of interstate commerce or of any facility of a national exchange or otherwise, in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors, to solicit or to permit the use of his name to solicit any proxy or consent or authorization in respect of any security (other than an exempted security) registered pursuant to section 781 of this title.
[111] *Business Roundtable*, 905 F.2d at 407.
[112] *Id.* at 410.
[113] *Id.* at 411.
[114] *Id.* at 411-12.

Rule 19c-4 thus exceeded the SEC's authority by attempting "to interfere in the management of corporations."[115] Congress, the Court stated, had restricted regulation of the substantive rights of shareholders to the state regulatory domain, rather than delegating that power to the SEC.[116] Furthermore, the Court rejected attempts by the SEC to appeal to public interest considerations for upholding its Rule, stating that public interest considerations could not override the intention of Congress evidenced in the statutory text.[117] The SEC, according to the D.C. Circuit Court, could promulgate only regulations closely connected to the 1934 Act's core principles of disclosure and the creation of a national market.[118]

B. Disparate-Impact Regulations and the Court's Narrow Reading of Statutory Grants

Although Justice Scalia made clear in his majority opinion in *Sandoval* that "we do not inquire here whether the DOJ [disparate-impact] regulation was authorized," a subtext echoing *Business*

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[115] *Id.*at 411.

[116] *See id*. Under "our federalism," Younger v. Harris, 401 U.S. 37, 40-45 (1971), state governments exercise jurisdiction in areas of corporate governance. *See, e.g.*, Santa Fe Industries v. Green, 430 U.S. 462, 478 (1977) (holding that that without express federal regulation, a state has authority over corporate affairs). Each state maintains its own system of corporate laws regulating the internal affairs of companies. Corporations may incorporate under the laws of any state they choose. *See, e.g.,* CTS Corp. v. Dynamics Corp. of Am., 481 U.S. 69 (1987); *see also* RESTATEMENT OF CONFLICTS § 302 (1971).

The Securities Act of 1933 and the 1934 Act specifically eschewed the creation of a federal corporations regime. *See* James M. Landis, *The Legislative History of the Securities Act of 1933*, 28 Geo. Wash. L. Rev. 29, 34-35 (1959) (describing the Act's focus on disclosure). Instead, federal law supplements state laws concerning the duties and responsibilities of corporate directors and the rights of shareholders with disclosure requirements aimed at protecting shareholders. *See* 15 U.S.C. § 77g (1988). United States courts carefully police the line between state regulation of corporate governance and federal regulation of securities. *See Cort*, 422 U.S. at 84 (stating that corporations are "creatures of state law"); *see also Santa Fe Industries*, 430 U.S. at 474-76 (holding that Rule 10b-5 reaches manipulations and deceptions in the sale or trading of securities, but without either of these, breaches of fiduciary duty in the corporate field remain a matter of state, not federal, law); *see also CTS Corp.*, 481 U.S. at 89 (stating that "no principle of corporation law and practice is more firmly established than a State's authority to regulate domestic corporations").

[117] *See Business Roundtable*, 905 F.2d at 413.

[118] *Id.* at 410, 415.

Roundtable runs through the decision.[119] *Sandoval* suggests that agency adoption of disparate-impact regulations, like SEC Rule 19c-4, may go beyond the text of Congress's delegation of rulemaking power.[120] Justice Scalia's *Sandoval* logic, applied to SEC Rule 14d-10, would appear to compel the Rule's invalidation.

1. *Sandoval*'s Subtext

Title VI of the Civil Rights Act of 1964 bars the use of federal funds in discriminatory programs.[121] Section 601 of the Act states, "no person in the United States shall, on the grounds of race, color or national origin, be excluded from participation in, be denied the benefits of, or be subjected to discrimination under any program or activity receiving federal financial assistance."[122] Section 602 further provides, "each Federal department and agency which is empowered to extend Federal financial assistance to any program or activity . . . is authorized and directed to effectuate the provisions of section 601 . . . by issuing rules, regulations, or orders of general applicability . . . consistent with achievement of the objectives of the statute."[123]

The Department of Justice promulgated regulations forbidding federally-funded programs from engaging in disparate-impact discrimination pursuant to section 602 of Title VI.[124] The regulations banned agencies receiving federal monies from "utiliz[ing] criteria or methods of administration which have the effect of subjecting individuals to discrimination because of their race, color, or national origin."[125]

In holding in *Sandoval* that Title VI disparate-impact regulations could not be enforced through a private right of action, Justice Scalia, writing for the majority, "assume[d] for purposes of deciding that regulations promulgated under § 602 of Title VI may validly proscribe activities that have a disparate impact on racial

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[119] *Sandoval*, 532 U.S. at 279.
[120] The agency adopted disparate-impact regulations under 42 U.S.C. § 2000d-1 (stating "each Federal department and agency which is empowered to extend Federal financial assistance to any program or activity . . . is authorized and directed to effectuate the provisions of section 601").
[121] 42 U.S.C. § 2000d et seq.
[122] *Id.* at 2000d.
[123] *Id.* at 2000d-1.
[124] *Id.*; 28 C.F.R. § 42.104(b)(2) (2003).
[125] 28 C.F.R. § 42.104 (b) (2) (2003).

groups, even though such activities are permissible under § 601."[126] In contrast to this assumed validation of the regulations, the majority endorsed two other proposals. It made clear that section 601 prohibits only intentional discrimination and confirmed that a private right of action exists under section 601 allowing for individual enforcement of the section.[127] These two endorsements, as well as other parts of the opinion to be discussed, imply that the Court might overturn the disparate-impact regulations if the specific question were to come before it.

While two previous opinions had affirmed the validity of disparate-impact regulations promulgated under section 602, the *Sandoval* majority dismissed the thrust of their holdings. In *Guardians Ass'n v. Civil Service Commission*,[128] Justices White, Marshall, Stevens, Brennan, and Blackmun separately resolved that "federal agencies may adopt regulations under section 602 that 'effectuate the provisions' of section 601 by banning federally funded actions that, while not intentionally discriminatory, disproportionately affect minorities."[129] Justice O'Connor disagreed in her concurrence,[130] joined by Chief Justice Burger and Justices Powell and Rehnquist.[131] Two years later, in *Alexander v. Choate*,[132] the Court characterized the *Guardians* decision as holding "that actions having an unjustifiable disparate impact on minorities could be redressed through agency regulations designed to implement the

[126] *Sandoval*, 532 U.S. at 281.
[127] *See id.* at 279-281 (terming the two propositions "beyond doubt" and "beyond dispute").
[128] 463 U.S. 582 (1983).
[129] J. White in the opinion, *Guardians*, 463 U.S. at 591-93; J. Marshall in dissent, *id.* at 617-23; and J. Stevens, joined by J. Brennan and J. Blackmun in dissent, *id.* at 644-45.
[130] *Id.* at 612 ("I would address two further questions: (1) whether proof of purposeful discrimination is a necessary element of a valid Title VI claim, and (2) if so, whether administrative regulations incorporating an impact standard may be upheld as within the agency's statutory authority. My affirmative answer to the first question leads me to conclude that regulations imposing an impact standard are not valid.").
[131] *Id*. at 611 ("For the reasons stated by Justice O'Connor, *post*, at 612-615, I reject Justice Stevens' novel argument that an administrative agency is free to adopt any regulation that may be said to further the purposes of an enabling statute. Administrative agencies do not have – and should not have – such lawmaking power.").
[132] 469 U.S. 287 (1985).

purposes of Title VI."[133] The *Sandoval* court, however, recharacterized *Guardians* as leaving the validity of the regulations unsettled and dismissed *Alexander*'s clear statement as "dictum."[134] Justice Scalia wrote that the notion that regulations promulgated under section 602 barred disparate-impact discrimination would be "in considerable tension with the rule of *Bakke* and *Guardians* that § 601 forbids only intentional discrimination."[135]

A footnote included in the majority opinion implies that the majority would invalidate the disparate-impact regulations if afforded the opportunity. Citing Justice O'Connor's opinion in *Guardians*, Justice Scalia wrote, "we cannot help observing . . . how strange it is to say that disparate-impact regulations are 'inspired by, at the service of, and inseparably intertwined with' section 601 . . . when section 601 permits the very behavior that the regulations forbid."[136] Justice Scalia suggests that an agency acting to proscribe disparate-impact discrimination may not "effectuate" a statute that does not itself prohibit disparate-impact discrimination.

2. The SEC and 14d-10

Sandoval also calls into question the validity of SEC Rule 14d-10 (a), promulgated pursuant to the 1934 Act.[137] Under rigorous statutory analysis, Rule 14d-10 (a), like Rule 19c-4 in *Business Roundtable*, would appear to exceed the regulatory authority granted the SEC by Congress to foster disclosure. Rule 14d-10 (a) states:

> No bidder shall make a tender offer unless: (1) The tender offer is open to all security holders of the class of securities subject to the tender offer; and (2) The consideration paid to any security holder pursuant to the tender offer is the highest

[133] *Id.* at 293.
[134] *Sandoval*, 532 U.S. at 281-82. ("Though no opinion of this Court has held that [regulations promulgated under section 602 of Title VI may validly proscribe activities that have a disparate impact on racial groups], five Justices in *Guardians* voiced that view of the law at least as alternative grounds for their decisions . . . and dictum in *Alexander v. Choate* is to the same effect . . . ").
[135] *Id.* at 282.
[136] *Id.* at 286.n. 6.
[137] 15 U.S.C. § 78a.

> consideration paid to any other security holder during such tender offer.[138]

In response to the use of tender offers to effect corporate mergers, Rule 14d-10 was promulgated pursuant to section 14(d) of the Williams Act amendments[139] to the 1934 Act.[140] Before the enactment of the Williams Act, no disclosure provisions applied to tender offers, and shareholders sometimes made investment decisions without adequate information.[141]

In *WHX v. SEC*,[142] the D.C. Circuit questioned whether "the SEC lacked statutory authority to promulgate the All Holders-Best Price Rule in the first place."[143] Like the Court in *Sandoval*, the D.C. Circuit did not address the issue in its opinion,. However, from the tenor of this comment, it appears certain that Rule 14d-10 (a) will face a renewed challenge and likely invalidation.

The legislative history of the Williams Act amendments indicates that Congress intended to authorize SEC regulations that would increase disclosure.[144] The amendments did not confer upon the SEC power to impose "fairness" requirements.[145]

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[138] *Id.*

[139] Pub.L. No. 90-439, 82 Stat. 454 (1968) (codified at 15 U.S.C. §§ 78m(d)-(e), n(d)-(f)).

[140] 15 U.S.C. § 78n(d).

[141] *See* 113 CONG. REC. 24664 (1967). (Senator Williams, the bill's sponsor, stated in Senate debate: "Today, the public shareholder in deciding whether to accept or reject a tender offer possesses limited information. No matter what he does, he acts without adequate knowledge to enable him to decide rationally what is the best course of action. This is precisely the dilemma which our securities laws are designed to prevent.").

[142] 362 F.3d 854 (D.C. Cir. 2004).

[143] *Id.* at 858-59.

[144] *See* Schreiber v. Burlington Northern, Inc., 472 U.S. 1, 9 (1985) ("The process through which Congress developed the Williams Act also suggests a calculated reliance on disclosure, rather than court-imposed principles of 'fairness' or 'artificiality,' as the preferred method of market regulation. For example, as the bill progressed through hearings, both Houses of Congress became concerned that corporate stock repurchases could be used to distort the market for corporate control. Congress addressed this problem with § 13(e), which imposes specific disclosure duties on corporations purchasing stock and grants broad regulatory power to the Securities and Exchange Commission to regulate such repurchases. Congress stopped short, however, of imposing specific substantive requirements forbidding corporations to trade in their own stock for the purpose of maintaining its price. The specific regulatory scheme set forth in § 13(e) would be unnecessary if Congress at

Rather than regulating disclosure, the all-holders and best-price requirements purport to "assure fair and equal treatment of all holders of the class of securities that is the subject of a tender offer."[146] The offeror of a tender can disclose all the information he has and still violate the rule.

C. Current Challenges to SEC Rulemaking

The SEC currently faces numerous attacks from business groups based on arguments derived from *Business Roundtable* and *Sandoval*, [147] including: (1) litigation to overturn the SEC's mutual fund governance rule as outside the bounds of the SEC's delegated authority[148] and (2) opposition to the SEC's proposed proxy access rule.[149]

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the same time had endowed the term 'manipulative' in § 14(e) with broad substantive significance.").

[145] *See* United States v. O'Hagan, 521 U.S. 642, 668 (1997) ("Congress designed the Williams Act to make 'disclosure, rather than court-imposed principles of "fairness" or "artificiality," . . . the preferred method of market regulation.'").

[146] 51 Fed. Reg. 25,873 (July 17, 1986) (to be codified at 17 C.F.R. pts. 200 and 240).

[147] In addition to the controversy surrounding the SEC's new mutual fund rules and proposed proxy regulations discussed *infra*, Siebel Systems has contested SEC Regulation FD, 17 C.F.R. §§ 243.100-103 (2000) (barring companies from giving information to stock analysts before it is made public), as in contravention of the First Amendment. S*ee* Siebel System's Motion to Dismiss, Securities and Exchange Commission v. Siebel Systems, Inc., Kenneth A. Goldman and Mark D. Hanson (S.D.N.Y. 2004) (No. 14-5130) (saying the SEC "grossly exceeded its statutory and constitutional authority in . . . promulgating Regulation FD." "Regulation FD works an unprecedented and remarkably sweeping infringement of corporate speech."). Hedge fund trade associations also indicate they plan to oppose new SEC registration requirements for hedge funds. S*ee* Deborah Solomon and Michael Schroeder, *Back Off! Businesses Go Toe to Toe With SEC—Lawyers and Lobbyists Criticize Agency Proposals About Options, Proxies, Hedge and Mutual Funds,* WALL ST. J., Oct. 24, 2004, at C1.

[148] Complaint of the U.S. Chamber of Commerce, Chamber of Commerce of the United States of America v. United States Securities and Exchange Commission (D.C. Cir. 2004) (No. 04-1300).

[149] Security Holder Director Nominations, 68 Fed. Reg. 60784 (proposed October 23, 2003) (to be codified at 17 C.F.R. pt. 240, 249, & 274); *see* John C. Coffee, *The SEC Under Attack*, 26 NAT'L L.J. 61 (2004).

1. Mutual Fund Litigation

On June 23, 2004, the SEC promulgated a regulation pursuant to the Investment Company Act of 1940 ("1940 Act"),[150] requiring mutual funds to hire independent chairs and to maintain boards that are at least seventy-five percent independent.[151] The regulation also calls for outside directors to hold quarterly meetings without fund executives and for boards to justify the retention of non-independent fund managers.[152] The SEC observed the propensity of fund advisers to dominate board agendas. It noted its skepticism about whether management-dominated boards can negotiate advisory fees and resolve conflicts between funds and their management companies in the best interests of shareholders.[153]

Currently, nearly eighty percent of mutual funds have chairs affiliated with their advisers.[154] The new SEC regulation calls for these funds to appoint new chairs. Additionally, the regulation would require that roughly half of all mutual funds make changes in the composition of their boards of directors to satisfy the requirement of seventy-five percent independent directors.[155]

On September 2, 2004, the U.S. Chamber of Commerce sued the SEC to overturn the regulation. Its complaint alleged that the SEC had overstepped the legal authority granted by Congress to govern mutual funds under the 1940 Act.[156]

2. The Proxy Contest

Under new rule 14a-11, proposed by the SEC in October of 2003, if more than thirty-five percent of shareholders communicate their intention to withhold their votes in a directors' election or if more than fifty percent of shareholders vote to access proxy statements to nominate directors, the SEC would allow shareholders

[150] 15 U.S.C. § 80a-1 et seq.
[151] *See* 17 C.F.R. pt. 270 (June 23, 2004).
[152] *See id.*
[153] *See id.*
[154] *See* Lynn Hume, *National Chamber of Commerce Files Suit Against the SEC Over New Rule*, The Bond Buyer, Sept. 7, 2004, at 33.
[155] *See* Complaint of the U.S. Chamber of Commerce, Chamber of Commerce of the United States of America v. United States Securities and Exchange Commission (D.C. Cir. 2004) (No. 04-1300).
[156] *See id*.

access to proxy statements for two years. Additionally, shareholders who own more than five percent of a company's stock for over two years would be eligible to nominate directors.[157] Business groups are expected to challenge the validity of Rule 14a-11, using the *Business Roundtable* argument that the Rule represents an impermissible departure from the disclosure-based regulation authorized under section 14(a).[158]

III. On the Other Side of the Street: *Chevron* and Its Progeny

Although challenges to the SEC's actions and the disparate-impact cases, viewed against the backdrop of private enforcement jurisprudence, suggest a restricted scope for SEC rulemaking authority in line with *Business Roundtable*,[159] recent Supreme Court decisions delineating the apportionment of interpretational authority between courts and agencies appear to advance the opposite outcome. Section III of this Article examines the role of recent developments in *Chevron* deference theory in upholding regulations promulgated by the SEC. The framework created by *Chevron*, coupled with recent cases blending the *Chevron* approach with *Skidmore* deference, would appear to invalidate the conclusions of *Business Roundtable*.

A. *Chevron* Deference

In *Chevron v. National Resources Defense Council, Inc.*,[160] the Supreme Court set out a new reading of when courts will defer to agency interpretations of the statutes granting them rulemaking authority.[161] *Chevron* concerned whether the Environmental Protection Agency could promulgate a regulation under the Clean Air Act Amendments of 1977[162] interpreting the Act's phrase "stationary source" to mean the emissions of an entire plant rather

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[157] Security Holder Director Nominations, 68 Fed. Reg. 60784 (proposed October 23, 2003) (to be codified at 17 C.F.R. pt. 240, 249, & 274).
[158] *See* John C. Coffee, *Corporate Securities; Federalism and the SEC's Proxy Proposals*, 231 N.Y.L.J. 5 (March 18, 2004).
[159] 42 U.S.C. § 7411 (2004).
[160] *Chevron*, 467 U.S. at 840.
[161] *Id.* at 851.
[162] 42 U.S.C. § 7411 (2004).

than of an individual smokestack.[163] Recognizing that the Clean Air Act did not define the meaning of "stationary source," and that the legislative history of the Act provided no guidance,[164] the Court held that, if Congress had not "directly spoken to the precise question at issue," the Court would look to "whether the agency's answer is based on a permissible construction of the statute."[165]

The Supreme Court thereby established a formal, two-part test for judicial review of agency regulations. First, a court should consider whether Congress had directly excluded the agency's interpretation. If, instead, a court found the statute to be "silent" or "ambiguous," only then would it consider whether the agency interpretation was a reasonable construction of the statute.[166] The test assumed Congressional delegation of interpretative authority to an agency, in the absence of a clearly expressed intent to the contrary.[167]

The tone of Justice Stevens's majority opinion in *Chevron* intimates support for agency flexibility. The Supreme Court presented the agency as chief policy-maker: "in contrast [to courts], an agency to which Congress has delegated policymaking responsibilities may, within the limits of that delegation, properly rely upon the incumbent administration's views of wise policy to inform its judgments."[168] According to *Chevron*, the agency rulemaking process required the consideration of "varying interpretations and the wisdom of its policy on a continuing basis."[169] Thus, *Chevron* appears to champion a broad vision of agency discretion.

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[163] *Chevron,* 467 U.S. at 840.
[164] *Id.* at 831.
[165] *Id.* at 842-43.
[166] *See id.* at 843-44. ("Sometimes a legislative delegation to an agency on a particular question is implicit rather than explicit. In such a case, a court may not substitute its own construction of a statutory provision for a reasonable interpretation made by the administrator of an agency.").
[167] *Id.* at 865-66.
[168] *Id.* at 863-64.
[169] *See* Cass R. Sunstein, *Law and Administration After Chevron*, 90 Colum L. Rev. 2071, 2075 (1990). ("[*Chevron*] has become a kind of *Marbury*, or counter-*Marbury*, for the administrative state."). *But see, e.g.,* Dole v. United Steelworkers of America, 494 U.S. 26 (1990); Adams Fruit Company, Inc. v. Barrett, 484 U.S. 638 (1990); FDA v. Brown & Williamson Tobacco Corp., 529 U.S. 120 (2000) (reversing agency interpretations at step one of the *Chevron* test).

The formal, two-part test and the default presumption of agency delegation set out in *Chevron* combine to grant greater latitude to the ability of an agency to regulate.[170] *Chevron* left unclear, however, the fate of the preceding "multifactoral approach" to agency rulemaking review typified by *Skidmore*-style deference.

B. *Skidmore*'s Sliding Scale

At issue in the 1944 case of *Skidmore v. Swift & Co.*[171] was "what, if any, deference courts should pay" to the conclusions of the Administrator of the Fair Labor Standards Act ("FLSA").[172] Firefighters had asserted that the FLSA mandated overtime compensation for their hours on call.[173] Although Congress had not delegated the power to decide "whether particular cases fall within or without the Act,"[174] the FLSA Administrator had made known his position against such compensation in an interpretive bulletin and in informal rulings.[175]

Skidmore "set forth a sliding scale of deference owed an agency's interpretation of a statute."[176] Even though the Administrator had engaged in merely informal actions,[177] the Court held that "the rulings, interpretations and opinions of the Administrator under this Act, while not controlling upon the courts by reason of their authority, do constitute a body of experience and informed judgment to which courts and litigants may properly resort for guidance."[178] *Skidmore* empowered courts to embark on a case-by-case consideration of agency actions, guided by "the thoroughness evident in the agency's consideration, the validity of its reasoning, its consistency with earlier and later pronouncements, and

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[170] *See, e.g.,* INS v. Aguirre-Aguirre, 526 U.S. 415 (1999) (overturning Ninth Circuit invalidation of a Board of Immigration Appeals determination and applying *Chevron* to a deportation decision); NationsBank of N.C., N.A. v. Variable Annuity Life Ins. Co., 513 U.S. 251 (1995) (overturning Fifth Circuit and applying *Chevron* to a letter of the Comptroller of Currency); Young v. Cmty. Nutrition Inst., 476 U.S. 974 (1986) (overturning D.C. Circuit and applying *Chevron* to FDA no-action letter).
[171] 323 U.S. 134.
[172] *Id.* at 139.
[173] *Id.* at 135-36.
[174] *Id.* at 137.
[175] *Id.* at 137-38.
[176] United States v. Mead Corp., 533 U.S. 218, 250 (2001) (describing *Skidmore*).
[177] *Skidmore,* 323 U.S. at 140.
[178] *Id*.

all those factors which give it power to persuade, if lacking power to control."[179]

In *United States v. Mead Corp.*, the Supreme Court declined to extend application of the *Chevron* doctrine to "ruling letters" issued by the Customs Service and instead applied *Skidmore* deference.[180] *Chevron* deference, said the Court, was to apply to "[a]dministrative implementation of a particular statutory provision . . . when it appears that Congress delegated authority to the agency generally to make rules carrying the force of law, and that the agency interpretation claiming deference was promulgated in the exercise of that authority."[181] The Court made clear that where *Chevron* was inapplicable, it would be permissible to invoke *Skidmore* deference to an agency interpretation, giving weight to agency expertise. Justice Souter wrote for the majority, "[w]hether or not they enjoy any express delegation of authority on a particular question, agencies charged with applying a statute necessarily make all sorts of interpretive choices, and while not all of those choices bind judges to follow them, they certainly may influence courts facing questions the agencies have already answered."[182]

C. *Chevron* and *Skidmore*

In the wake of *Mead*, therefore, it appeared that courts faced a choice in which form of deference they would use in evaluating agency judgments, based upon whether a Congressional delegation of power to the agency had been made. The two forms of deference, *Chevron* and *Skidmore*, appeared distinct from each other:[183] for *Chevron* to apply, Congress must have made a delegation of power to an agency;[184] *Skidmore*, on the other hand, required only that an agency have "specialized experience,"[185] and applied even where

[179] *Mead*, 533 U.S. at 250 (quoting *Skidmore*, 323 U.S. at 140).
[180] *Mead*, 533 U.S. 218.
[181] *Id.* at 226-27.
[182] *Id.* at 227-28; *but see id.* at 250 (J. Scalia, in dissent, terming *Skidmore* an "anachronism").
[183] *See generally* Thomas W. Merrill and Kristin E. Hickman, *Chevron's Domain*, 89 Geo. L.J. 833, 854-56 (2001).
[184] *Adams Fruit*, 494 U.S. at 649 ("a precondition to deference under Chevron is a congressional delegation of administrative authority"); *see also Chevron,* 467 U.S. at 843-44.
[185] *Skidmore*, 323 U.S. at 139.

"Congress . . . put responsibility [for construing a statute] on the courts."[186]

Chevron deference, furthermore, seemed a zero-sum game. If a court interpreted the statutory text to contain no ambiguity or gap, "that [was] the end of the matter."[187] The court would undertake *de novo* review to carry out the express intent of Congress.[188] If the court deemed the statute to be ambiguous, *Chevron* applied, and the agency's understanding prevailed so long as it was reasonable.[189] *Skidmore*, by contrast, afforded varying degrees of deference. Courts assessed the proper level by evaluating "the degree of the agency's care, its consistency, formality, and relative expertness, and the persuasiveness of the agency's position."[190] This resulted in a "spectrum" of deference, "from great respect at one end . . . to near indifference at the other."[191]

The multitude of factors considered under *Skidmore*[192] bore no importance under *Chevron*. In undertaking a *Chevron* analysis at step one, a court was to consider only the statutory text and whether Congress had created an ambiguity that an agency therefore had the authority to fill.[193] Under *Chevron* step two, the court was required to defer to "reasonable" agency interpretation,[194] even if it might have deemed the agency interpretation unreasonable under the more extensive *Skidmore* considerations.

D. *Chevron* and *Skidmore* merging?

Despite these differences, several Supreme Court opinions handed down in the wake of *Mead* suggest a unification of *Chevron* and *Skidmore*-style deference. In *Christensen v. Harris County*, a pre-*Mead* decision, Justice Breyer wrote a dissenting opinion, joined by Justice Ginsburg, in which he argued that *Chevron* and *Skidmore*, far from being in conflict, represent two variations on the general

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[186] *Id.* at 137.
[187] *Chevron*, 467 U.S. at 842.
[188] *Id.*
[189] *Id.*
[190] *Mead*, 533 U.S. at 228 (describing *Skidmore*).
[191] *Id.*
[192] *Skidmore*, 323 U.S. at 140 ("the thoroughness evident in its consideration, the validity of its reasoning, its consistency with earlier and later pronouncements, and all those factors which give it power to persuade").
[193] *Chevron*, 467 U.S. at 842.
[194] *Id*. at 843-44.

principle that deference turns on the credibility of an agency's interpretation.[195] While in *Mead*, all eight justices but Scalia joined the majority opinion holding that tariff classifications are entitled to *Skidmore* rather than *Chevron* deference,[196] later cases show a movement towards the possibility that Justice Breyer's initial *Christensen* dissent holds sway; the court applies a general deference to agency discretion regardless of whether or not Congress has delegated power to an agency to resolve a statutory ambiguity.[197]

In *Barnhart v. Walton*,[198] a post-*Mead* opinion by Justice Breyer concerning the length of time an individual must remain disabled by a medical impairment to qualify for Social Security benefits, the Supreme Court applied *Chevron* deference because of "the interstitial nature of the legal question, the related expertise of the Agency, the importance of the question to administration of the statute, the complexity of that administration, and the careful consideration the Agency has given the question over a long period of time."[199] The evaluation of such factors, rather than switching deference "on or off" in response to the presence or absence of delegations inherent in the statutory text, appeared more characteristic of a *Skidmore* than a *Chevron* analysis.[200] Indeed, in *Krzalic v. Republic Title Co.*,[201] Judge Posner characterized *Barnhart v. Walton* as suggesting "a merger between *Chevron* deference and *Skidmore*'s and *Glover*'s approach of varying the deference that agency decisions receive in accordance with the circumstances."[202]

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[195] Christensen v. Harris County, 529 U.S. 576, 596 (2000) ("Chevron made no relevant change [from Skidmore]. It simply focused upon an additional, separate legal reason for deferring to certain agency determinations, namely, that Congress had delegated to the agency the legal authority to make those determinations.").

[196] *Mead*, 533 U.S. 218.

[197] *See generally* Henry Paul Monaghan, *Supreme Court Review of State-Court Determinations of State Law in Constitutional Cases*, 103 COLUM. L. REV. 1919, 1988 n.338 (2003); *see also* John F. Manning, *Nonlegislative Rules*, 72 GEO. WASH. L. REV. 893, 945 n. 227 (2004); *but see* Thomas W. Merrill, *Rethinking Article I, Section 1: From Nondelegation to Exclusive Delegation*, 104 COLUM. L. REV. 2097, 2181 n. 290 (2004).

[198] 535 U.S. 212 (2002).

[199] *Id.* at 222.

[200] *See supra* text at Section III.C.

[201] 314 F.3d 875 (7th Cir. 2002).

[202] *Id.* at 879; *but see id.* at 882 (Easterbrook, J., concurring in part and concurring in the judgment) ("Agencies' interpretive role stems from delegation of authority, not raw ambiguity.").

Subsequent cases further suggest that the Supreme Court accords deference based on the consideration an agency has given an issue, rather than on the delegation by Congress of interpretive power to the agency, through an ambiguous statute. *Meyer v. Holley* concerned the question whether the Fair Housing Act imposed vicarious liability upon the officer of a real estate corporation for infractions made by an agent employed by the company.[203] Writing for the majority, Justice Breyer deferred to the Department of Housing and Urban Development's specification "that ordinary vicarious liability rules apply."[204] In holding that this was a "reasonable interpretation of the [Fair Housing] statute," he cited both *Chevron* and *Skidmore*, without highlighting any differences between them.[205] In *Boeing Co. v. United States*, the Court seemed to grant *Chevron*-style deference to an interpretive tax regulation promulgated under a "general rulemaking grant," despite the absence of a specific grant of authority.[206] In *Wash. State Dep't of Soc. & Health Servs. v. Guardianship Estate of Keffeler*, the Court relied on *Skidmore* to uphold regulations adopted by the Department of Health and Human Services of the state of Washington that enabled the agency to use the Old-Age, Survivors, and Disability insurance and Social Security benefits of foster children to pay for their care.[207]

The Court deferred to administrative interpretations of practices banned by the Social Security Act to hold that this use of benefits fell outside any statutory prohibitions.[208] Later in the opinion, the Court invoked *Chevron* to defer to the agency's determination that such use of funds fell within the agency's grant of authority to act in the "best interests" of a beneficiary.[209] Although one analysis proceeded under *Skidmore* and the other under *Chevron*, the Court appeared to consider in both analyses only the "reasonableness" of the agency's interpretation.[210]

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[203] 537 U.S. 280 (2003).
[204] *Id.* at 287-288.
[205] *See id.*
[206] 123 S. Ct. 1099, 1107 (2003).
[207] 537 U.S. 371 (2003).
[207] *See id.* at 385-86 (citing *Skidmore*: "[w]hile these administrative interpretations are not products of formal rulemaking, they nevertheless warrant respect . . . ").
[208] *Id.* at 389-90.
[209] *See id.* at 387 ("reasonable interpretation"); *id.* at 390 ("within the bounds of the reasonable").

E. Application to *Business Roundtable*

If *Skidmore* and *Chevron* deference are considered to be equivalent, the ability of the SEC to promulgate rules will be broadened. Under the hybrid *Skidmore-Chevron* analyses illustrated by *Meyer*, *Boeing*, and *Washington State Dep't of Health*, any "persuasive" rulemaking by the SEC is likely to be upheld, whether or not the rule is promulgated pursuant to a specific grant of legislative authority.[211]

Viewed from this perspective, the decision in the *Business Roundtable* case seems unwarranted. In 1991, at the time the case was decided, the D.C. Circuit Court deemed the SEC's "one share, one vote" rule to fail step one of the *Chevron* analysis.[212] The Court found that there was no statutory ambiguity implying a delegation to the agency to fill, in writing that "here . . . *Chevron* deference does not allow an agency 'to alter the clearly expressed intent of Congress.'"[213] Under a revised, unified *Chevron-Skidmore* analysis, however, it would be plausible for a court to regard the SEC's promulgation of Rule 19c-4[214] in response to concerns over shareholder vote dilution as a legitimate exercise of its grant of authority under section 14(a).[215] Utilizing a loose style of review, equal voting rights for shareholders could be viewed not only as a "persuasive" articulation of agency expertise[216] but also as a "reasonable" interpretation of the text of section 14(a) of the 1934 Act, which authorizes SEC regulation of proxy voting procedures.[217]

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210 *See supra* text at Section III.D.
211 *See Business Roundtable*, 905 F.2d at 408.
212 *Id.*
213 17 C.F.R. § 240.19c-4 (1993).
214 15 U.S.C. § 78n(a) (2004).
215 *Mead*, 533 U.S. at 221 ("We agree that a tariff classification has no claim to judicial deference under *Chevron*, there being no indication that Congress intended such a ruling to carry the force of law, but we hold that under *Skidmore v. Swift & Co.*, 323 U.S. 134 . . . (1944), the ruling is eligible to claim respect according to its persuasiveness.").
216 *See Chevron*, 467 U.S. at 865 ("the Administrator's interpretation represents a reasonable accommodation of manifestly competing interests and is entitled to deference . . . ").

IV. The SEC's Mutual Fund Rule and Proxy Proposal at the Intersection of *Sandoval* and *Chevron*

The SEC's new mutual fund rule and proposed proxy regulation implicate the scope of its delegated authority. The SEC promulgated its requirements for independent chairmen and seventy-five percent independent boards under section 6(c) of the 1940 Act, which endows the SEC with power to further the purposes of the Act.[218] The Agency has proposed its new proxy rule, Rule 14a-11, pursuant to section 14(a) of the 1934 Act, the same disclosure-based grant of rulemaking power at issue in *Business Roundtable*.[219] The U.S. Chamber of Commerce has challenged the mutual fund rule as outside the scope of the SEC's rulemaking authority,[220] and similar opposition to the proxy rule will likely result if it becomes final.[221] In both areas, courts will therefore face the question of whether the SEC's authorizing statutes are susceptible to the broad readings the SEC has employed in promulgating such regulations.

A. Should the mutual fund rule be upheld?

In challenging the SEC's mandate of independent mutual fund chairmen and board members as outside the scope of its authority, the Chamber of Commerce has argued that under *Burks v. Lasker*,[222] state corporate law, not federal agencies, properly regulates mutual funds.[223] Combined with the holding in *Business Roundtable* that the SEC may not intrude into areas of state corporate governance,[224] the Chamber of Commerce appears to have a persuasive argument.

Furthermore, *Business Roundtable* set out a distinction between "substance and procedure."[225] It invalidated Rule 19c-4 because it "directly interferes with the substance of what the shareholders may enact."[226] The 1934 Act, said the D.C. Circuit,

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[217] *See* Investment Company Governance Rule, 17 C.F.R. pt. 270 (2004).
[218] *See* Security Holder Director Nominations, 68 Fed. Reg. 60784 (proposed October 23, 2003) (to be codified at 17 C.F.R. pt. 240, 249, & 274).
[219] *See supra* note 155.
[220] *See supra* note 164.
[221] 441 U.S. 471 (1979).
[222] *See generally* John C. Coffee, *The SEC Under Attack*, 26 NAT'L L.J. 61 (2004).
[223] *Business Roundtable*, 905 F.2d at 411.
[224] *Id.*
[225] *Id.*

granted the SEC "control of voting procedure" but not the "distribution of voting power."[227] Mandating the character of mutual fund directors appears an intrusion into the substance of corporate governance.

On the other hand, section 6(c) of the 1940 Act would seem to grant the SEC broader authority than does section 19(c) of the 1934 Act. Section 6(c) empowers the SEC to "conditionally or unconditionally exempt any person, security, or transaction, or any class of persons, securities or transactions, from any provision of this title . . . to the extent that such exemption is in the public interest and consistent with the purposes fairly intended by the policy and provisions of this title."[228] While *Business Roundtable* read the 1934 Act as a narrow tool for effecting disclosure,[229] the D.C. Circuit is likely to construe the 1940 Act as geared towards the reduction of conflicts of interest.[230] Raising the current independent membership requirement from forty percent under section 10(a) to seventy-five percent of a mutual fund board seems but a minor adjustment in advancement of the underlying purpose of the 1940 Act, rather than a recalibration of the balance of power between the SEC and the states.

The success of these arguments in favor of SEC authority depends in part upon how courts resolve the tension between the narrowed view of agency power reflected in *Sandoval* and the deferential view under *Chevron*.[231] While *Sandoval*-style reasoning would impel a strict textual reading of section 6(c), hybrid *Chevron-Skidmore* analysis would find the lack of Congressional delegation to the SEC in the form of a gap in the securities statute immaterial, and a court could deem the SEC's rule a "persuasive" response to recent scandals in the industry.[232]

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[226] *Id.*
[227] 15 U.S.C. § 80a-6 (2004).
[228] *Business Roundtable*, 905 F.2d at 410.
[229] *See* 15 U.S.C. §80a-10 (2004) (setting out the waivable requirement: "No registered investment company shall have a board of directors more than sixty percent of the members of which are persons who are interested persons of such registered company.").
[230] *See supra* text at Sections II and III.
[231] *See supra* text at Section III.D.

B. Should the proposed proxy rule survive judicial challenge?

The SEC carefully framed proposed Rule 14a-11 to avoid the appearance of intruding into state law areas of corporate governance. According to the proposal, "a company would become subject to . . . Rule 14a-11 only where the company's security holders have an existing, applicable state law right to nominate a candidate or candidates for election as a director."[233] "The proposed rule would state that the security holder nomination procedure would be available unless applicable state law prohibits the company's security holders from nominating a candidate or candidates for election as a director."[234] The legitimacy of Rule 14a-11, therefore, will depend on a court's analysis of the scope of authority granted the SEC under section 14(a) of the 1934 Act.[235]

While *Business Roundtable* characterized the chief purpose of proxy regulation pursuant to section 14(a) to be disclosure,[236] it allowed that "disclosure is [not] necessarily the sole subject of section 14."[237] The Court reasoned that Rule 19(c) should fail not only because it did not advance the goal of disclosure, but also because it regulated the "substantive allocation of powers among classes of shareholders," rather than simply promulgating procedural requirements.[238] The proxy rule may be distinguished from the *Business Roundtable* holding because Rule 14a-11 falls on the procedural side of the procedure-substance divide suggested in *Business Roundtable*.

In addition, Rule 14a-11 seems but a limited extension of Rule 14a-8, a rule that has remained in place since the SEC promulgated it in 1947.[239] Rule 14a-8 is not a rule premised on disclosure. Rather, it permits shareholders to put proposals on a corporation's agenda so that they may be voted on at shareholder meetings.[240] Furthermore, the SEC used disclosure discourse to

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232 68 FR at 60787.
233 *Id.*
234 The SEC promulgated Rule 14a-11 pursuant to section 14(a) of the 1934 Act.
235 *Business Roundtable*, 905 F.2d at 410 ("proxy regulation bears almost exclusively on disclosure").
236 *Id.* at 411.
237 *Id.* at 407.
238 17 C.F.R. § 240.14a-8 (2004).
239 *See id.*

justify its promulgation of the Rule.[241] The SEC may similarly argue that shareholder access under Rule 14a-11 would improve communication.[242] Disclosure regarding shareholder-nominated candidates in proxy statements would enhance the ability of proxy voters to "control the corporation."[243] Finally, *Business Roundtable* specifically upheld the validity of Rule 14a-4(b)(2),[244] which allows shareholders to deny consent to individual nominees, even though the Rule is not directly tied to disclosure.[245]

As in the Chamber of Commerce challenge to the SEC's new mutual fund regulation, these arguments will succeed or fail depending on the breadth of a court's reading of section 14(a) and the form of *Chevron* deference it invokes.[246]

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[240] *See* John C. Coffee, *Corporate Securities; Federalism and the SEC's Proxy Proposals*, 231 N.Y.L.J. 5 (March 18, 2004) (citing *Hearings on SEC Proxy Rules Before the House Comm. On Interstate and Foreign Commerce*, 78 Cong., 1st Sess., 169-70 (1943) for the idea: "If management knows that a shareholder proposal will be made at an annual meeting, it is arguably misleading for management to seek shareholder proxy voting authority without disclosing the proposal and a fair summary of the proponent's justifications for the proposal. By analogy, one can similarly argue that if management knows that shareholders will nominate one or more candidates for the board at the annual meeting, management should not seek proxy authority for its own candidates without disclosing these other candidates and some background data on them.").

[241] *See Business Roundtable*, 905 F.2d at 410 ("Proxy solicitations are, after all, only *communications* with potential absentee voters. The goal of federal proxy regulation was to improve those communications and thereby to enable proxy voters to control the corporation as effectively as they might have by attending a shareholder meeting.").

[242] *Id.* at 410.

[243] 17 C.F.R. § 240.14a-4(b)(2) (2004).

[244] *See Business Roundtable,* 905 F.2d at 411. ("For example, the Commission's Rule 14a-4(b)(2) requires a proxy to provide some mechanism for a security holder to withhold authority to vote for each nominee individually. See 17 CFR § 240.14a-4(b)(2) (2004). It thus bars a kind of electoral tying arrangement, and may be supportable as a control over management's power to set the voting agenda, or, slightly more broadly, voting procedures . . . While Rule 14a-4(b)(2) may lie in a murky area between substance and procedure, Rule 19c-4 much more directly interferes with the substance of what the shareholders may enact.").

[245] *See supra* text at Section III.D.

V. Should the scope of SEC rulemaking authority be narrowed?

Faced with the confluence of these two competing trends in jurisprudence, courts should follow the auguries of *Business Roundtable*[247] and police the boundaries of legitimate administrative rulemaking. Courts should continue the textualist interpretations of statutory grants of power to the SEC[248] and reject the expansion of deference theory to accord legitimacy to SEC actions in the absence of Congressional delegation of power.[249]

Congress is properly the "first mover" in the legislative process. It may endow agencies such as the SEC with the authority to act, but without such delegation, agencies possess no intrinsic power to promulgate rules on their own.[250] Statutes enacted by Congress according agencies the ability to make rules result from a complicated process of compromise and bargain. The text of the statutes reflects the best approximation of the "carefully wrought . . . legislative deal."[251] If courts permit the SEC to act beyond its authorizing statutes, they allow the SEC to undermine the democratic process and grow into an all-powerful entity, unfettered by a robust framework of checks and balances.

Congress appears more responsible to the electorate than executive agencies, such as the SEC, in a system of direct democracy. Its members face periodic reelection. The constitutional requirements of bicameralism and presentment in enacting legislation foster fair deliberation. Thus, administrative policy is better initiated by Congress, rather than by bureaucratic administrators.[252]

Some have argued that the SEC and other agencies possess greater expertise from which to formulate policy and can act with greater speed to coordinate a complex regulatory scheme,[253] but these claims are overstated. First, the Vesting Clause of the Constitution

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246 905 F.2d 406.

247 *See supra* text at Section II.

248 *See supra* text at Section III.D.

249 *See generally* Thomas W. Merrill, *Rethinking Article 1, Section 1: From Nondelegation to Exclusive Delegation*, 104 COLUM. L. REV. 2097 (2004).

250 John F. Manning, *The Absurdity Doctrine*, 116 HARV. L. REV. 2387, 2412 (2003).

251 The debate surrounding whether Congress or Executive Agencies are more accountable to the electorate is outside the scope of this article. *See* M. Elizabeth Magill, *The Real Separation in Separation of Powers Law*, 86 VA. L. REV. 1127, 1180-81 (2000) (discussing various ways of defining "accountability").

252 *See supra* note 249 at 2151-53 for a discussion of these arguments.

mandates that Congress must delegate its legislative authority in order for an agency to hold rulemaking power.[254] Second, Congress can and will legislate to address novel realities as they emerge in the marketplace, as seen in Congress's recent enactment of the Sarbanes Oxley Act.[255] This Act amended supervision of the accounting industry, augmented securities law requirements for disclosure, formulated new crimes, increased the penalties for corporate fraud, prohibited corporate loans to officers and directors, and mandated independent audit committees charged with broad responsibilities.[256]

Courts do not need to contradict constitutional mandates and permit agencies to exceed their authorizing statutes in order to effect positive change. While the SEC's attempt to require equal voting rights for shareholders failed as outside the scope of its authority,[257] equal voting rights do exist as a vibrant feature of current securities markets. Despite the outcome of *Business Roundtable*, the NYSE, AMEX, and the NASD jointly adopted a minimum voting rights rule in 1994.[258]

Conclusion

This article has suggested that *Business Roundtable* presaged a current trend in securities jurisprudence. *Sandoval's* textualist framework for considering private enforcement has permeated the securities field. Courts have recently applied rigorous statutory construction to deny the existence of various private rights of action under securities statutes, and the liberal interpretation of fraud on the market theory used to certify a class in fraud actions is currently in doubt. *Sandoval* also reflects the textualism that *Business Roundtable* invoked in reviewing the Congressional statutes delegating authority to the SEC to promulgate regulations. This

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[253] *See supra* notes 16-19 and accompanying text.

[254] Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified in §§ 11, 15, 118, 28, and 29 U.S.C.). The Sarbanes-Oxley Act includes four laws: The Public Company Accounting Reform and Issuer Protection Act of 2002, the Corporate and Criminal Fraud Accountability Act of 2002, the White-Collar Crime Penalty Enhancement Act of 2002, and the Corporate Fraud Accountability Act of 2002.

[255] *See id.*

[256] *See Business Roundtable*, 905 F.2d 406.

[257] *See* LOUIS LOSS & JOEL SELIGMAN, VI SECURITIES REGULATION 2770 (3d ed. 1990).

attitude calls into question disparate-impact regulations, SEC Rule 14d-10, and the SEC's new mutual fund and proposed proxy access regulations.

In contrast, courts have broadened the deference with which they approach review of agency rulemaking. Cases evidencing a merger between *Chevron* and *Skidmore* deference suggest that courts will likely defer to agency actions based on an agency's expertise rather than searching for an explicit grant of authority from Congress in the form of an ambiguous statute. If this is so, judicial deference could be invoked to save the scope of SEC rulemaking power from the threat of strict statutory interpretation.

This article has argued against this use of deference theory. Allowing administrative agencies, such as the SEC, unbounded rulemaking authority would frustrate the democratic framework of checks and balances. Members of Congress, directly responsible to the electorate via individual elections, engage in a complicated process of negotiation and compromise in drafting legislation. If the SEC strays from the textual directives provided by Congress, the SEC risks aggrandizing itself without the warrant of popular legitimation.

Restricting the SEC's actions to the text of Congressional authorizing statutes need not result in obstruction of the regulatory scheme. Congress can expand agency power by enacting new legislation, such as the Sarbanes Oxley Act, and individual stock exchanges can independently adopt enhanced regulatory measures.

Ultimately, courts will be impelled to delineate clearly the breadth with which the SEC may construe its statutory grants to promulgate regulations. Opposition to the SEC's new mutual fund requirements and proposed proxy regulation implicates the proper scope of the SEC's statutory authority. The latitude courts accord the SEC will shape its ability to regulate the securities markets in the future, in order to increase investor confidence and prevent corporate malfeasance.

Fourteen years ago, *Business Roundtable* invalidated an SEC regulation as outside the bounds of the SEC's statutory power. Perhaps the lessons of the case will "slouch towards Bethlehem" and be invoked to strike the SEC's new, disputed regulations.