Analysis

DC Circ. Decision Highlights SEC's Oversight Tightrope

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Law360, New York (August 9, 2017, 11:01 PM EDT) -- After a highly critical D.C. Circuit decision Tuesday found the U.S. Securities and Exchange Commission "abdicated" its responsibility to review a capital plan submitted by the Options Clearing Corp., experts said the agency will need to step up its oversight of the organizations that handle swaths of the financial system, even as that oversight becomes more difficult.

Writing for a three-judge panel, Chief Judge Merrick Garland **minced no words** in finding the SEC failed to undertake the analysis required by the Securities Exchange Act of 1934 when the agency approved a capital plan that top options trading firms and securities exchanges said would pay millions in dividends and rebates to the five exchanges that own the OCC.

"Instead, the SEC effectively abdicated that responsibility to OCC — the proponent of the plan and the entity whose rule changes the SEC is statutorily obligated to approve or disapprove," Judge Garland wrote.

While the decision concerned the SEC's review of the OCC's plan, experts said it could have major implications for the agency's review of rule changes and plans submitted by the many other self-regulatory organizations it oversees, from major stock exchanges like the New York Stock Exchange and the Nasdaq to quasi-regulators like the Financial Industry Regulatory Authority and the Municipal Securities Rulemaking Board.

Benjamin Edwards, a professor at the University of Nevada's William S. Boyd School of Law, noted that critics have suggested in recent years that the SEC is too deferential to self-regulatory organizations.

He pointed to the words of former SEC Chairman and later U.S. Supreme Court Justice William O. Douglas, who said the agency should allow the exchanges to lead on the regulatory front while maintaining vigorous oversight and stepping in as necessary. Government in the form of the SEC "would keep the shotgun, so to speak, behind the door,

loaded, well-oiled, cleaned, ready for use but with the hope it would never have to be used," Douglas said.

"What the D.C. Circuit decision reveals is that the SEC's shotgun may be in disrepair, rusted out and broken down," Edwards said.

Self-regulatory organizations are exchanges and associations made up of industry members charged with monitoring markets, disciplining members and making referrals to the SEC, among other things. They are funded through member fees and set their own rules and regulations, subject to SEC approval and oversight.

The opinion focuses on the SEC's review of a plan submitted by one self-regulatory organization: the Options Clearing Corp., which bills itself as the world's largest clearinghouse for trades in equity derivatives and was labeled a "systemically important" utility in 2012 by the Financial Stability Oversight Council.

The OCC first proposed the capital plan in January 2015 in an effort to strengthen its capital reserves to buffer against big market shocks. The plan sets a target capital amount each year funded by immediate capital contributions from the five exchanges that own the OCC, in exchange for dividends from fees charged to the OCC's clearing members. Although the OCC previously refunded excess fees to its members, under the new plan, roughly half of the unused fees would be used to pay the dividends.

The SEC's Division of Trading and Markets, which oversees the self-regulatory organizations' rulemaking, initially approved the plan in March 2015, but after several of the exchanges that don't own the OCC filed petitions for review, the commission issued its own order in February 2016 that set aside the division's approval.

But in the same order, the commission approved the OCC's plan on its own initiative, saying that after "carefully considering the entire record" it had determined the plan complied with the Exchange Act.

Trading firms Susquehanna International Group LLP and KCG Holdings Inc. and Bats Global Markets Inc. **filed a suit** against the SEC over its approval of the plan in the D.C. Circuit the day the order was filed in the Federal Register, arguing that the dividend payments had the potential to accumulate into billions of dollars in the coming years and

that the SEC's approval was "fundamentally flawed."

After initially denying a motion for an emergency stay of the plan last year, the appellate court on Tuesday said that it agreed with the petitioners, which were later joined by Miami International Securities Exchange LLC and BOX Options Exchange LLC, while Bats left the suit earlier this year.

The panel said that although the petitioners had argued the plan was inconsistent with Exchange Act requirements that a clearing agency's rules not burden competition or permit unfair discrimination, the SEC's approval failed "in a more basic respect": The agency didn't determine the plan met those requirements itself.

Judge Garland was particularly scathing regarding the SEC's claim that it had trusted the OCC's "process" in developing the plan. He said that "'trust the process' may be a reasonable slogan for the hometown basketball team of lead petitioner Susquehanna International Group," referring to the efforts of the Philadelphia 76ers to climb out of a rut of losses.

"But the process alone cannot justify the dividend rate in this case," Judge Garland added.

The D.C. Circuit faulted the SEC for accepting that the dividend payments were reasonable by relying on the analysis of the clearinghouse's board without identifying the consultants used by the board or examining the substance of the plan in greater detail.

Although the SEC argued that the structure of the capital plan guaranteed the dividends would be reasonable, the opinion noted that the agency had not analyzed whether it was reasonable to allocate half of the unused fees to dividends, as opposed to using some other formula.

"In other words, the SEC defends its unquestioning reliance on OCC's claim that the dividend rate is reasonable by its unquestioning reliance on OCC's claim that the plan's structure is reasonable," the opinion said. "That is no defense at all."

Discussing other flaws in the SEC's review, Judge Garland said the agency had failed to provide "any explanation at all" of why it rejected claims a feature of the plan was discriminatory.

The petitioners had argued the plan was unfair because it called for permanently ending refunds if one of the capital funds created by the plan was used and not repaid within two years, while dividends could resume. Not only did the SEC not explain why it disagreed with the criticisms, the opinion said, the agency's order actually got the facts wrong, incorrectly saying that both refunds and dividends would end permanently if the capital went unpaid.

"Hence, not only does the order give no indication that the SEC analyzed this plan feature for compliance with the act, but it instead suggests that the SEC may have misunderstood the feature entirely," Judge Garland wrote. "That double deficiency demonstrates a lack of reasoned decision-making."

Judge Garland noted that this isn't the first time the D.C. Circuit has taken issue with the agency's approval of an SRO rulemaking. In 2010, the appellate court ordered the SEC to rethink its approval of fees NYSE Arca proposed charging for a proprietary product after finding there was little supporting value in the "self-serving views of the regulated entit[y]" on which the SEC based its decision.

"Here, too, the SEC's unquestioning reliance on OCC's defense of its own actions is not enough to justify approving the plan," the opinion said. "Instead, the SEC should have critically reviewed OCC's analysis or performed its own."

And Judge Garland isn't the first to note that a self-regulatory organization, made up of industry members seeking to regulate themselves, may be self-serving. The SEC was created in 1934 in part to police SROs amid intense criticism of the stock exchanges and their perceived inability to prevent manipulation in the lead-up to the 1929 market crash and ensuing Great Depression.

Jordan Belfort also hit on the issue in his memoir "The Wolf of Wall Street," writing that he had observed the National Association of Securities Dealers — a precursor to FINRA, the organization responsible for regulating broker-dealers — had created a playing field that was clearly unfair to customers.

"I'd come to the conclusion that it was because the NASD was a self-regulatory agency, 'owned' by the very brokerage firms themselves," Belfort said, noting his own firm was a member.

Meanwhile, the SEC has been criticized for its oversight of the organizations. A 2007 report by the U.S. Government Accountability Office found that inspections of SROs by the SEC's Office of Compliance Inspections and Examinations — a separate function from the rule reviews conducted by the Division of Trading and Markets — had room for improvement, while later GAO reviews in 2012 and 2015 found the agency could particularly enhance its oversight of FINRA.

As for the D.C. Circuit's latest decision, Edwards said the "blistering" opinion demonstrates that the SEC is not doing a thorough, independent review of the rules promulgated by self-regulatory organizations, especially in complex areas, and may prompt the agency to change its procedures in response.

"This decision may make it so that the SEC is less likely to rely entirely on self-serving representations from self-regulatory organizations," Edwards said.

Ira Matetsky, a partner at Ganfer & Shore LLP, emphasized that despite the criticism, the D.C. Circuit did not vacate the OCC's plan, which has already gone into effect. The panel acknowledged in the decision that even the challengers said in their motion for an emergency stay that unwinding the plan would be a "logistical nightmare" and suggested it would be better to wait in case the SEC approves the plan on the second go-round.

"It's a signal that the court is making a point about procedure and process and thoughtfulness and maybe resource allocation; the court is not making a point that, economically or financially, this is the wrong way to run an SRO," Matetsky said.

If the SEC does firm up its review of SRO rulemaking, it could help not only the exchanges and firms that challenged the capital plan but also regular investors who typically don't have the resources to challenge a rule themselves, Georgia State University College of Law Professor Nicole G. Iannarone said.

"That's what makes Garland's opinion so important," said Iannarone, who runs Georgia State's Investor Advocacy Clinic. "It's telling the SEC upfront: 'We want you to really evaluate and make your own findings as to what a rule change will mean for all the impacted constituents.'"

A robust review of SRO rulemaking is especially important today, Iannarone said, when few investors have access to pension plans and instead must plan their own retirement investments. She noted that when her clinic helps investors mediate problems with investment professionals, they're often "shocked that the industry gets to make its own rules and propose them through these SROs."

Iannarone said she hopes to see more public participation in rulemaking, but that as long as regular investors remain unaware of regulatory investments, the SEC will need to look even more carefully at the findings it makes and the evidence it bases decisions on in order to protect investors.

Even with the aid of investor clinics and advocacy groups, however, the agency may face an uphill battle. The notice-and-comment period for rulemaking often generates "a stacked or slanted record," Edwards said, as the industry — including SRO members — is able to fund comment letters while the public remains minimally involved.

Duke Law professor James D. Cox identified another issue with the comment process: Stakeholders sometimes "lay traps" for the SEC by withholding critical information.

"The SEC in lots of areas proposes rules and gets some comments, changes rules in response to those comments, finalizes rules, then gets challenged in court with lots of specific information and data that was never produced during the comment period that the industry holds back, and just sandbags them, essentially," Cox said.

Although Cox emphasized it was unclear if that was the issue in this case — if the agency was aware of the issues highlighted in the D.C. Circuit's opinion, at least some of which were brought up in comments, that would be "really unforgivable on the part of the SEC," he said — he questioned whether the agency could reasonably be found to have acted arbitrarily or capriciously if issues with an approved rule weren't raised during the comment period.

Beyond industry scheming, Cox said another challenge for the SEC is the increasing complexity of the rules its overseeing, submitted by organizations with more expertise in their respective areas.

"As these products and organizations become more and more complex, it's less and less

likely that the SEC can do anything other than act arbitrarily and capriciously, and we have to figure out how better to handle that," Cox said.

In the case of the OCC's capital plan, Cox said, the SEC would have essentially needed a crystal ball to figure out how much capital the clearinghouse needed to operate, which would be "an impossible determination" for the agency.

"My question to Garland would be: What the hell do you expect them to do now?" Cox added.

As the agency reviews rules submitted by the SROs, it also must balance its limited resources while focusing on avoiding glaring errors, Matetsky said, calculations that may have motivated the commission to approve a rule they viewed as reasonable while saving effort for more problematic regulatory proposals.

"It's not like somebody woke up and said, 'Let's mail it in today,'" Matetsky said. "I suspect that what happened here is that the SEC said to themselves, 'This looks perfectly reasonable, the SRO within reason should be capable of governing itself.'"

Moving forward, Matetsky said, the type of review the D.C. Circuit is looking for will take more time and more resources on the part of the SEC, but he said the agency is otherwise capable of performing that analysis.

But Cox said that the appellate court is essentially asking the SEC to "paper the case," allocating its funding to retain experts and lawyers who can justify an approval in the same way the SRO did when it filed the proposal.

Meanwhile, the more information put on the record during the public process, the more targets critics of the rule have to seize upon in a legal challenge, Edwards said.

"A lot more information is going to have to come through the process in order for the SEC to approve rules like this in the future," he said.

As for the plan at issue at the D.C. Circuit, a statement issued Tuesday by OCC Executive Chairman and CEO Craig Donohue said the clearinghouse intends to "submit underlying data and any other information the SEC may request as it further evaluates the capital plan

in consideration of the statements made by the D.C. Circuit in its opinion."

"We remain confident that the SEC will once again approve the capital plan," Donohue said.

An attorney for the petitioners, David H. Thompson of Cooper & Kirk PLLC, told Law360 that they were "very pleased that the court has set aside the SEC's approval of a plan that would convert the OCC in to a profit maximizing monopoly at the expense of options customers across the country."

A representative for the SEC declined to comment on Tuesday.

The petitioners are represented by David H. Thompson, Howard C. Nielson Jr., Peter A. Patterson and Harold S. Reeves of Cooper & Kirk PLLC.

The SEC is represented by Tracey A. Hardin, Anne K. Small, Sanket J. Bulsara, Michael A. Conley and Emily T. P. Rosen.

The OCC is represented by William J. Nissen, Steven E. Sexton and Kristen E. Rau of Sidley Austin LLP.

The case is Susquehanna International Group et al. v. SEC, case number 16-1061, in the U.S. Court of Appeals for the District of Columbia Circuit.

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