Blogs
May 15, 2017
Section 848 of the Financial Choice Act 2017: Unwise at any Speed (Part 4)

This series of posts examines the misguided efforts of the House Financial Services Committee to reform the existing process for issuing exemptive orders pursuant to Section 6(c) of the Investment Company Act of 1940 (the "1940 Act"). My first three posts discussed the current exemptive process and some of its significant shortcomings. This post discusses the changes to the process proposed in Section 848 of the pending Financial Choice Act of 2017 and why these proposed changes would undermine investor protections provided by the 1940 Act. It is difficult to overstate what bad public policy Section 848 represents.

Proposed Changes to the Exemptive Process

Section 848 would amend Section 6(c) to require that every application be published on the SEC's website within 5 days after receipt. The SEC would have 45 days after receipt of an application to give substantive comments and request that the application be resubmitted (restarting the review period), otherwise the application would be deemed to have been approved. Both the SEC and the applicant have the right to extend the review period for an additional 45 days. If the SEC were to deny the application, the applicant would have 20 days in which to request a hearing, with the hearing to commence within 30 days after the denial. An application that is neither approved, denied, or set down for a hearing during those time frames would be deemed to have been approved. It is not clear why Section 848 singles out Section 6(c) to the exclusion of the other instances of exemptive authority that the SEC possesses like Section 17(b) of the 1940 Act or Section 206A of the Investment Advisers Act.

An Unfunded Mandate

If one was actually trying to make proposed Section 848 function properly, it should be accompanied by an appropriation that would permit the SEC to hire, let's say, another 100 lawyers whose sole task would be to review applications that are filed under Section 6(c). In addition to being experts in Section 6(c), those lawyers would also have to be capable of mounting an effective case during the subsequent hearing before an SEC administrative law judge (ALJ). If such an appropriation does not accompany Section 848, then the SEC will have to find those resources amongst its existing staff in the Division of Investment Management (the Division) and Office of General Counsel, i.e., Section 848 will be an unfunded mandate but come with statutory deadlines. That means that an applicant with a bad product, or raising serious investor protection concerns, will be pushed to the head of the line, ahead of every other possible investor protection project to which the SEC staff is already committed. That is like to occur because the alternative--allowing any crackpot idea be deemed to be issued an order by lapse of time--will be wholly unacceptable. This would be especially problematic if the reason that the SEC staff is already fully committed to other projects is, for example, attempting to propose and adopt rules or conduct studies that are mandated by the Dodd-Frank Act. It is very hard to understand why an application filed by any single applicant is inherently, in every possible instance, obviously more important and more deserving than any other provision in a statute enacted by Congress.

Subverting the 1940 Act

Perhaps at least as importantly, Section 848 reverses the normal statutory presumption that any transaction that is prohibited by one or more sections of the 1940 Act would pose unacceptable risks for investors and would not be in the public interest. Congress intended that such transactions would occur only if the SEC was able to make those very important findings and issue the exemptive order being sought. Read in that light, Section 848 takes on the flavor of an entitlement: any applicant who is able to file an application will be exempted from those important prohibitions if the Division cannot react promptly within the time frames indicated.

Subverting Due Process

As explained in the first and third posts, the current process allows someone affected by the proposed exemption (an "objector") to request a hearing before an ALJ on the application. The myopic focus of Section 848 on the applicant's right to a hearing fails to consider this right of potential objectors. If the SEC must complete the process in 45 to, at most, 90 days, how much time could be left for potential objectors to be notified of a proposed order and prepare a proper request for a hearing? Section 43(a) of the 1940 Act also permits an objector to challenge an exemptive order in a U.S. Circuit Court of Appeals. Section 43(a) provides, however, that an objector cannot object on any grounds that were not urged before the SEC, although the objector can petition the U.S. Circuit Court of Appeals to allow it to adduce additional evidence. The curtailed timeframe of Section 848 would make it difficult for anyone to establish grounds for review on a timely basis. Even if the court permits additional evidence, this kind of motion practice--which generally occurs before a sitting judge in a trial court before, during, and after the trial has occurred--would have to occur in what are some of the busiest appellate courts in the Federal judiciary.

Explore more in

Investment Management