**IN THE UNITED STATES COURT OF APPEALS**
**FOR THE DISTRICT OF COLUMBIA CIRCUIT**

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**No. 14-1142**
**ORAL ARGUMENT NOT YET SCHEDULED**

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COPLEY FUND, INC.,

*Petitioner*,

v.

UNITED STATES SECURITIES AND EXCHANGE COMMISSION,

*Respondent*.

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ON PETITION FOR REVIEW OF FINAL ORDER OF
THE SECURITIES AND EXCHANGE COMMISSION
(Release No. 31088, dated June 19, 2014)

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# BRIEF OF PETITIONER COPLEY FUND, INC.

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## CORPORATE DISCLOSURE STATEMENT

Pursuant to Federal Rule of Appellate Procedure 26.1 and Circuit Rule 26.1, Petitioner Copley Fund, Inc. states as follows: Copley is a Nevada corporation and is registered under the Investment Company Act of 1940, as amended, as a diversified, open-end management company. Copley's general nature and purpose is dividend accumulation and long-term capital appreciation. Copley does not have a parent company and no publicly held company has ten (10) percent or greater ownership interest in it.

Respectfully submitted,

/s/ Paul M. Honigberg

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## CERTIFICATE AS TO PARTIES, RULINGS, AND RELATED CASES

Pursuant to Circuit Rule 28(a)(1), Petitioner Copley Fund, Inc. states as follows:

### A. Parties and Amici

The parties in this case are Copley and the United States Securities and Exchange Commission. There are currently no intervenors or amici.

### B. Order Under Review

Under review in this case is the Commission's final order denying Petitioner's request for an exemption under Section 6(c) of the Investment Company Act of 1940 (the "Company Act"), 15 U.S.C. § 80a-6(c), from Rule 22c-1, promulgated under the Act, and Rule 4-01(a)(1) of Regulation S-X, which would permit Petitioner to alter the manner in which it currently accounts for and reports its contingent liability for deferred taxes on unrealized gains. The Commission issued its final order by Release No. 31088, dated June 19, 2014.

### C. Related Cases:

There are no related cases.

Respectfully submitted,

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# GLOSSARY

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|---|---|
| APA | Administrative Procedure Act |
| ASC | Accounting Standards Codification |
| Company Act | Investment Company Act of 1940 |
| DIM | Division of Investment Management |
| FASB | Financial Accounting Standards Board |
| GAAP | Generally Accepted Accounting Principles |
| NAV | Net Asset Value |
| REIT | Real Estate Investment Trust |
| SEC | Securities and Exchange Commission |

## JURISDICTIONAL STATEMENT

1. This case is before the Court on a petition to review a final order of the Securities and Exchange Commission denying the request by Copley Fund, Inc.[1] for an exemption under Section 6(c) of the Investment Company Act of 1940 (the "Company Act"), 15 U.S.C. § 80a-6(c), from Rule 22c-1, promulgated under the Company Act, and Rule 4-01(a)(1) of Regulation S-X. *See* 17 C.F.R. § 270.22c-1; 17 C.F.R. § 210.4-01(a)(1).[2] The exemption, had it been granted, would have permitted Copley to alter the manner in which it currently accounts for, and reports, its contingent liability for deferred taxes on unrealized gains, by reverting to the more accurate method that it had used prior to 2007.

2. This Court therefore has jurisdiction over this case under Section 43(a) of the Company Act, which provides, in pertinent part:

> Any . . . party aggrieved by an order issued by the Commission . . . may obtain a review of such order in . . . the United States Court of Appeals for the District of Columbia, by filing in such court, within sixty days after the entry of such order, a written petition praying that the order of the Commission be modified or set aside in whole or in part.

15 U.S.C. § 80a-42(a).

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[1] Petitioner Copley Fund, Inc. shall be referred to herein as "Copley" or the "Fund." Respondent Securities Exchange Commission shall hereinafter be referred to as the "Commission" or the "SEC."

[2] These rules shall be referred to herein as "Rule 22c-1" and "Rule 4-01(a)(1)," respectively.

3. The SEC issued the final order under review by Release No. 31088, dated June 19, 2014. *See* JA 237-38.

4. Copley timely filed its petition for review on July 28, 2014.

5. This case concerns a final agency order that disposes of all parties' claims, and is properly before this Court. 15 U.S.C. § 80a-42(a).

## ISSUES PRESENTED FOR REVIEW[3]

1. Whether the Commission acted in a manner that was arbitrary and capricious, an abuse of discretion, or otherwise unlawful within the meaning of the Administrative Procedure Act ("APA"), 5 U.S.C. § 706(2)(A), when it denied Copley's request for an exemption from Rule 22c-1 and Rule 4-01(a)(1), which would have allowed Copley to alter the manner in which it currently accounts for, and reports, its contingent liability for deferred taxes on unrealized gains, and revert to its prior and more accurate method of accounting for such contingent liability, when the Commission's decision was based upon an unrealistic hypothetical that presumed the Fund's imminent liquidation.

[3] The parties have elected to defer preparation of the appendix pursuant to Rule 30(c) of the Federal Rules of Appellate Procedure. Pending submission of final briefs, documents listed in the Commission's Certificate Listing and Describing the Documents, Transcripts of Testimony, Exhibits and Other Materials in the Record Before the Securities and Exchange Commission, dated September 2, 2014, shall be cited by document number as follows: "Doc. [number] at [page]."

2. Whether the Commission acted in a manner that was arbitrary and capricious, an abuse of discretion, or otherwise unlawful within the meaning of the APA, in determining that "granting the requested exemption is not necessary or appropriate in the public interest and is not consistent with the protection of investors and the purposes fairly intended by the policy and provisions of the [Company] Act[,]" *see* JA 237-38, when the method of accounting required by the Commission has resulted in, and continues to be, a misleading representation of the value of the Fund and the results of its operations, which has caused harm to its shareholders and the investing public and is inconsistent with the basic purpose of the securities laws, in general, and the Company Act, in particular.

## STATEMENT OF THE CASE

### I. PRELIMINARY STATEMENT

This case involves a challenge by Copley to a regulatory edict issued by the Commission in 2007, requiring Copley to alter its long-standing method of accounting for potential deferred tax liability. Although the SEC had been fully informed of the method used by Copley for 29 years prior to 2007 and never took any adverse action, it has never explained its rationale for ordering the change in 2007. Despite Copley's repeated requests ***over six years*** for a reasoned explanation of the Commission's edict, the SEC steadfastly refused to provide one. Only after Copley filed suit in federal court did the Commission finally respond

to Copley's requests for an explanation. But the Commission's reasoning is deeply flawed and bears no relation to the record. Instead, the SEC manufactured an unreasonable hypothetical to force Copley to continue to use a method that contravenes the underlying purpose of the securities law and principles of GAAP, to the detriment of Copley, its investors, and the investing public.

Copley is a mutual fund that has a unique corporate structure and business model, which has resulted in substantial gains for its shareholders since its founding in 1978. Copley is organized as a C Corporation, which means that 70% of dividend income received from its portfolio investments (or 70% of the taxable income of the Fund) is exempt from federal taxation under the Internal Revenue Code. Unlike most funds, the taxable income generated by the Fund is not passed on to the shareholders. Rather, dividends and capital gains are accumulated within the Fund, thus increasing the value of Copley's shares. Shareholders are not subject to any income tax unless and until they redeem shares.

Copley is unaware of any mutual fund in America that is set up in the same way. While Copley's unique structure has been acknowledged by the SEC, the Commission has steadfastly refused to consider any of these unique circumstances when determining how Copley must account for, and report, its reserve for deferred taxes on unrealized gains. Instead, the SEC rigidly adheres to an unreasonably narrow view of a single accounting standard that, when applied

to Copley's unique circumstances, is inconsistent with the basic principles of GAAP.

Even though the Commission knew for decades about Copley's method of accounting for deferred tax liability, the SEC ordered Copley in 2007 to change immediately the method it had used for almost 30 years to account for, and report, these potential liabilities. The Commission's methodology requires Copley to value its tax liability as if it had to liquidate its entire portfolio in a single day and cease operations altogether, an assumption that contravenes the basic tenet of GAAP that Copley must be considered a going concern.

The calculation of a reserve for taxes on unrealized gains pursuant to this "full liquidation methodology" harms Copley, its shareholders, and the investing public in several ways. Not only does this calculation cause Copley to report artificially low earnings and net asset value, but it reduces the price at which Copley can issue and redeem its shares. Any shareholder who elects to redeem while Copley is forced to use the full liquidation methodology receives an artificially low price for his or her shares (meaning, the share price reflects the full value of potential tax liability that may never become actual tax liability).

Under explicit threats of enforcement actions against the Fund and its founder, Copley reluctantly complied with the SEC's demand. Since then, and over the course of the next six years, Copley sought some reasoned

explanation as to why it was forced to alter its accounting methodology. Copley's efforts to engage the Commission were met with years of stonewalling and silence. Instead of providing a substantive response to Copley's entreaties, the Commission replied, in essence, that "GAAP is GAAP," even though the accounting method mandated by the SEC requires that basic principles of GAAP be ignored in Copley's case.

When Copley, at the Commission's suggestion, filed an application for an exemption from Rule 22c-1 and Rule 4-01(a)(1),[4] which would have permitted it to revert to the method of accounting it employed prior to 2007, the Commission ignored the application, refusing multiple requests for a reasoned response. In its application for an exemption, Copley not only explained why its historic method of accounting was more accurate and transparent, but it also offered two alternative accounting methods, both of which represented a conservative approach based on the historical performance of the Fund over the preceding 36 years. Either of these alternative methods would have resulted in more accurate accounting than the Commission's method. Also, consistent with the principle of full disclosure to investors that underlies the securities laws, Copley offered to disclose in its

[4] Rule 22c-1 governs the manner in which Copley must calculate its net asset value ("NAV") for the purpose of pricing its redeemable securities. 17 C.F.R. § 270.22c-1. Rule 4-01(a)(1) governs the reporting of Copley's NAV in its financial statements and reports. 17 C.F.R. § 210.4-01(a)(1).

financial reports a comparison of its preferred accounting method with the SEC's full liquidation method, which would provide investors with information that would enable them to make fully informed decisions. Any investor or prospective investor disappointed with Copley's performance under either method could simply sell their shares in Copley or not buy shares in Copley in the first place.

The Commission refused to provide any meaningful response to these proposals or any of Copley's other arguments and requests, and refused to allow Copley the same discretion in calculating its deferred tax liability that the Commission has allowed several other companies in recent years.[5] Indeed, for years, the Commission even refused to enter a final appealable order, despite several requests that it do so to allow Copley the opportunity to seek judicial review.

As a result, Copley was forced to file a lawsuit under the APA in the United States District Court for the District of Columbia in March of 2014. Only thereafter did the Commission finally respond in any meaningful way to Copley's requests for an explanation. But in denying Copley's application, the Commission

[5] *See* Argument, Section III. C., *infra*. As set forth herein, the Commission has granted to a growing number of companies significant discretion concerning the manner in which they calculate and report their liability for deferred taxes on unrealized gains. The likelihood of any of these companies needing to sell assets for which they have *not* reserved taxes is much greater than Copley having to liquidate in the unrealistic and unfounded hypothetical circumstances on which the Commission based its Order.

simply parroted its position that "GAAP is GAAP." *See* JA 237-38. In so doing, the Commission stated that it should be presumed, against all reason, that the entire Fund could be liquidated in one day, thus violating the presumption that the Fund would remain a going concern. JA 228, ¶ 12. The Commission sought to bolster its denial by relying on a hypothetical divorced from the reality of the Fund's 36 years of continuous operation, positing that 60 percent of the Fund's shares could theoretically be presented for redemption in one day. JA 229-33, ¶¶ 13-15. This has ***never*** even been close to reality, as it would reflect a one-day redemption rate substantially higher than the highest redemptions in the Fund's history. Moreover, in rejecting Copley's offer to present investors with a comparison of its preferred accounting method with the Commission's full liquidation method, the Commission contravened yet another basic presumption underlying the securities laws, that investors have the right and the ability to evaluate non-misleading financial information and make informed investment decisions based on that information.

Ironically, in forcing Copley to account for this contingent liability based on the SEC's misapplication of GAAP requirements, the Commission has mandated a method of accounting ***contrary*** to GAAP's basic principles and the core purposes underlying the United States' securities laws, rules, and regulations.

## II. STATEMENT OF FACTS

### A. Overview of Copley's Business and Investment Strategy

Copley is an open-end, investment management company (*i.e.*, a mutual fund) under the Company Act that issues redeemable securities.[6] *See* JA 69. Copley's portfolio securities are all highly liquid and are marked to market daily. JA 69-70. Thus, any increase or decrease in the value of Copley's portfolio investments is reflected in the Fund's per-share price, which is publicly available after the close of business every day on which The New York Stock Exchange is open. *Id.*

Copley was founded by Irving Levine in 1978, and Mr. Levine has managed the Fund ever since. *See* JA 69; Copley Fund, Inc. Form N-CSR, dated Feb. 28, 2014 ("2014 N-CSR"), at JA 262.[7] From 1978 to 2007, the Fund's NAV, as that

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[6] Section 4(3) of the Company Act defines a "management company" as any investment company other than a face-amount certificate company or a unit investment trust. 15 U.S.C. § 80a-4(3). Section 5(a)(1) of the Company Act defines an "open-end company" as a management company that is offering for sale or has outstanding any redeemable security of which it is the issuer. 15 U.S.C. § 5(a)(1). Section 2(a)(32) of the Company Act defines "redeemable security" to mean any security, other than short term paper, under the terms of which the holder, upon presentation to the issuer or to a person designated by the issuer, is entitled (whether absolutely or only out of surplus) to receive approximately his proportionate share of the issuer's current net assets, or the cash equivalent thereof. 15 U.S.C. § 80a-2(a)(32).

[7] Copley's Form N-CSR, dated February 28, 2014, is available online at www.sec.gov/Archives/edgar/data/721291/000114420414027945/v376099_ncsr.htm. This Court may take judicial notice of Copley's publicly available filings with

term is defined in 17 C.F.R. § 270.2a-4, grew from just over $3.00 per share to more than $54.00 per share. *See* JA 80-81.

Key to the Fund's investment objective is its strategy of not distributing dividends and capital gains to shareholders but, rather, accumulating them within the Fund and then adding them to the value of each share on a daily basis. *See* JA 80-81. A critical component of this strategy is the Fund's organization as a C Corporation for federal income tax purposes. JA 69. Accordingly, any taxable income generated by the Fund is subject to taxation at the corporate level and is not passed on to the individual shareholders. Shareholders are not subject to taxes until redemption, when they will incur a loss or realize a gain depending upon the Fund's per-share value at the time of redemption. This not only defers taxes until the shareholders elect to redeem Copley shares, but also permits the accumulated dividends and capital gains to remain invested under Copley's investment strategies. By retaining dividends and capital gains, Copley leaves its income "at work" in the Fund. *See* JA 70.

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the SEC. *See Marshall Cnty. Health Care Auth. v. Shalala*, 988 F.2d 1221, 1222 (D.C. Cir. 1993).

In this and other aspects, Copley is unique among open-end mutual funds and distinct from other C Corporations generally.[8] All other open-end funds known to Copley elect to be "regulated investment compan[ies]" ("RIC") under subchapter M of the Internal Revenue Code. JA 220-21, ¶ 2. RICs may escape full corporate taxation because, unlike ordinary corporations, they are entitled to claim a deduction for dividend payments against ordinary income and net capital gains. In order to qualify for RIC election, Copley would be required, among other things, to distribute to shareholders its undistributed earnings and profits, effectively destroying the very basis upon which Copley was formed and has operated since its inception.

Copley's structure and investment strategy has benefited its shareholders with consistent, increasing returns. Indeed, Copley has recorded double-digit increases in NAV in most of its 36 years of operations. *See* JA 242-45 (letter to shareholders). Moreover, Copley's conservative investment strategy of purchasing and holding stable stocks that yield dividends in increasing amounts, is reflected in the Fund's low turnover rate (*i.e.*, the percentage of the Fund's

[8] Indeed, the Commission has acknowledged that Copley Fund is uniquely structured as compared to other open-end mutual funds. *See* JA 134 (SEC acknowledging that the Fund "has really unusual tax issues").

investment holdings that change year-over-year).[9] The historic average five-year turnover rate of the Fund for the period from February 29, 2008 through February 28, 2013, was 1.62%; the average ten-year turnover rate was 1.48%. *See* JA 257.

Finally, the satisfaction of Copley shareholders with the Fund's investment strategy and performance is reflected in Copley's history of low shareholder redemptions, *i.e.*, when a shareholder presents the shareholder's shares in the Fund to Copley and demands cash payment for their value. As Copley stated in its request for an exemption, the highest daily redemption in the history of the Fund was $1,000,000, which represented 23,260 shares or approximately 1.6% of the total outstanding shares on the date of the redemption. JA 16. Copley redeemed these shares in the ordinary course of business and did not require any liquidation of securities. *Id.*[10]

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[9] Copley's portfolio includes investments in such stable, dividend paying stocks as those issued by J.P. Morgan Chase & Company, ExxonMobil Corp., and Verizon Communications, Inc. JA 248-50.

[10] Since the Commission issued its Order, Copley has identified a redemption of approximately 73,000 shares, worth approximately $3.7 million, made in April 2012. This represented 5.65% of Copley's then-outstanding shares. This redemption was made pursuant to the estate plan of a former shareholder who had passed away. Importantly, the shares were redeemed in the ordinary course and did not require any liquidation of securities or use of Copley's tax reserve. Even with this isolated redemption in excess of Copley's prior historical record, the Commission's unreasonable assumption of a one-day 60% redemption request remains counterfactual and grossly speculative. Indeed, the Commission's

### B. Copley's Method of Accounting for Taxes Before SEC Intervention

For financial reporting, the Company Act requires open-end funds, like Copley, to file with the Commission a registration statement and annual reports, which must contain Copley's financial statements. 15 U.S.C. § 80a-8(b). The form and content of and requirements for the financial statements filed pursuant to the Company Act are set forth in Regulation S-X. *See* 17 C.F.R. § 210.1-01 *et seq.* Rule 4-01(a)(1) of Regulation S-X states, in relevant part, that "[f]inancial statements filed with the Commission which are not prepared in accordance with [GAAP] will be presumed to be misleading or inaccurate, despite footnote or other disclosures, unless the Commission has otherwise provided." 17 C.F.R. § 210.4-01(a)(1).

Rule 22c-1 requires open-end funds to issue and redeem shares "at a price based on the current net asset value of such security . . . ." 17 C.F.R. § 270.22c-1(a). Rule 2a-4(a) defines "current net asset value" as the "amount which reflects calculations, whether or not recorded in the books of account, made substantially in accordance with the following, *with estimates used where necessary*

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hypothetical would still be over ten times the size of this unprecedented redemption. Therefore, Copley's arguments regarding the accuracy and reasonableness of its preferred method of accounting for and reporting its contingent liability for deferred taxes on unrealized gains and the arbitrary and capricious nature of the Commission's action are unaffected by this unusual one-time redemption.

*or appropriate*." 17 C.F.R. § 270.2a-4(a) (emphasis added). Rule 2a-4(a)(4) provides that in calculating "current net asset value" for use in computing the current price of redeemable securities, "*[a]ppropriate provision* shall be made for Federal income taxes if required." 17 C.F.R. § 270.2a-4(a)(4) (emphasis added). Rule 2a-4(a)(4) does not define "if required."

The calculation of a tax reserve affects an open-ended investment company, like Copley, and its shareholders and prospective shareholders, in several ways. It affects reported earnings, which, in turn, affect reported operating expense ratios and reports on performance (gains or losses as a percentage of net assets), as well as the price at which shares may be issued and redeemed.

Before late 2007, Copley accrued a reserve for contingent tax liability by setting aside a stated reserve amount, which started at $422,000 and was gradually increased to approximately $1 million over time. *See* JA 70. This amount was determined by Copley's Board of Directors in an exercise of their good faith business judgment and based on a seven-factor test. *See* JA 71 (listing the seven-factor test). Among other things, this Board-approved formula considered the Fund's investment strategy and historic performance. *Id.* The formula also reflected Copley's good-faith business judgment that the contingent liability for deferred taxes on unrealized capital gains should be based on a reasonable estimate of future tax obligations associated with any required

liquidation of portfolio securities necessary to raise cash to meet foreseeable requirements of the Fund. *Id.*

Over the course of the Fund's history, Copley has only on rare occasion had to rely on any portion of the reserve for deferred tax liability, as the Fund's tax liability was almost always covered by either capital losses or capital loss carry forwards. *Id.* In those rare instances, Copley's reserve was always more than sufficient to cover any actual tax liability, and Copley never had to use the entire reserve. Even during the financial crisis of 2008 through 2009, Copley's reserve for deferred tax liability on unrealized gains was always in excess of the Fund's actual tax liability and Copley never came close to using even a significant portion of the tax reserve. JA 73.

Further, Copley has always been subject to regulation and review by the Commission and outside audits of its financial and accounting practices. JA 140. Before 2007, neither the SEC nor outside auditors had ever demanded that Copley alter its method of accounting for deferred tax liability on unrealized gains as contrary to Company Act rules or any accounting principle or standard, even though they knew that Copley set the reserve using a Board-determined methodology. *Id.* Indeed, just months before the SEC demanded that Copley change its reserve accounting method, the Public Company Accounting Oversight

Board examined the Fund's financials and issued an affirming clean report for the period ended February 28, 2006. *Id.*

### C. The SEC Abruptly Demands that Copley Alter its Method of Accounting for NAV

In a comment letter, dated September 26, 2007, the SEC's Division of Investment Management ("DIM") alleged that Copley had failed to account properly for deferred tax liabilities, as allegedly required by Rule 22c-1 and Financial Accounting Standard 109 ("FAS 109"), and in violation of financial reporting requirements allegedly mandated by Rule 4-01(a)(1) of Regulation S-X. JA 24-33. The DIM demanded that Copley abandon its longstanding method of accounting for deferred taxes in favor of a method that assumes the full immediate liquidation of Copley's portfolio of assets. *Id*. Under this method, Copley must account for its NAV as if it had to liquidate its *entire* portfolio each day, pay taxes on all investment gains, and cease operations as a going concern. The DIM erroneously asserted this change was required, without exception, under Company Act Rules and GAAP principles for C Corporations generally. *Id.*

The Commission did not offer any further explanation for its abrupt about-face. Indeed, to this very day, the SEC has never provided any reasonable explanation for its demand that Copley abandon its proven method of establishing a reserve for its contingent liability of deferred taxes on unrealized gains.

Following the DIM's letter, the Boston Regional Office of the SEC's Division of Enforcement sent a letter to Copley, dated November 30, 2007, expressing its intent to seek immediate injunctive relief against the Fund if it did not adjust its per-share NAV to account for the full liquidation liability for deferred taxes on unrealized capital gains. JA 35-36. Under this threat of enforcement, Copley promptly – but reluctantly – complied with this demand. JA 5.

Notwithstanding Copley's compliance, on March 21, 2008, the Division of Enforcement informed Copley that it was conducting an informal investigation into possible violations of the securities laws based on the tax-reserve calculations that had been used ***without objection*** for the preceding 30 years. JA 5. The Division of Enforcement further requested that Copley provide certain information on a voluntary basis. *Id.* The SEC later converted the proceeding into a formal investigation against Copley and Mr. Levine for potential violations of certain antifraud provisions of the securities laws, as well as a books and records violation. *Id.* Copley and Mr. Levine fully cooperated with the investigation and no further enforcement or administrative action was taken against them. *Id.*

On July 18, 2008, as a result of the SEC's demands, Copley restated its earnings for 2007 to account for the full liquidation methodology mandated by the SEC and filed an amended Form N-CSR/A containing a Restated Annual Report to its shareholders. JA 38-65. The SEC's demand for full liquidation value

accounting of the Fund's contingent liability for deferred taxes on unrealized gains caused Copley's shareholders immediate harm. In one day, the Fund's per share NAV plummeted from $60.17 to $46.28, a decline of 23%, as a result of increasing the deferred tax liability to a level that would be realized only if Copley ceased being a going concern and its entire appreciated portfolio were liquidated immediately. JA 40.

### D. Copley Fund's Six-Year Pursuit of Relief from the SEC and the SEC's Failure to Provide Any Meaningful Response

In response to the SEC's unexplained and abrupt change in position, Copley presented multiple arguments to the SEC *over the next six years* as to why it should be permitted to revert to its prior method of accounting for this contingent liability. *See* JA 4-9 (setting forth the procedural history of Copley's pursuit of relief from the SEC over six years). From November 2008 through August 2013, Copley submitted multiple requests for relief, including confirmation from the SEC that the Commission would not take action against Copley if the Fund were to revert to its prior method of accounting. *Id.* All such requests were either ignored completely or denied after long periods of time; some of the SEC's responses to Copley's requests did not come for over a year. *Id.* On those rare occasions when the Commission deigned to respond, it merely restated its interpretation of the rules from which Copley sought relief without responding substantively to Copley's requests or analyses. *Id.*; *see also* JA 101-27, JA 195-98, and JA 204-05.

Moreover, the Commission's staff impeded Copley's right and ability to obtain an appealable final order from the Commission. By letter dated March 12, 2012, Copley proffered its various arguments against the full liquidation method and in favor of reversion to its prior method of accounting for deferred tax liability. JA 179-94. In addition, Copley specifically requested a written opinion from the SEC addressing its request for no-action relief so that it might seek judicial review in case of an adverse ruling. *Id*. The SEC did not respond for over a year. When it did respond on April 5, 2013, the SEC's staff failed to address Copley's arguments, merely recited general rules and accounting principles of general application, and, again refused to issue a final order. JA 195-98.

Copley next sought *de novo* review from the full panel of Commissioners by letter dated April 12, 2013. JA 199-203. This time, the Commission's staff intercepted Copley's letter to the Commissioners and refused to bring Copley's letter to their attention. JA 204-05. In a letter dated July 15, 2013, Copley objected to the staff's intervention and demanded that the staff permit the Fund to obtain review by the Commissioners. JA 206-09.

On August 2, 2013, the Commission's staff again denied Copley's request for Commission review of Copley's prior no-action requests, declaring that the Fund had no recourse to a full review by the full panel of the Commissioners. JA 20-22. All the while, Copley's shareholders continued to suffer harm and potential

investors in the Fund continued to be misled because of the Fund's artificially depressed share value and grossly overstated operating expense ratio under the SEC's mandated full liquidation method.

Although the Commission had rejected Copley's requests to allow it to exercise its business judgment and discretion in setting a tax reserve that would fairly and accurately reflect its potential tax liability, *see*, *e.g.*, JA 66-100 (Copley letter dated November 19, 2008); JA 135-45 (Copley letter dated September 28, 2011), the Commission permitted other similarly situated companies to do just that. Several entities, including Weyerhaeuser, American Tower Corp., and CyrusOne, converted from C Corporations into real estate investment trusts ("REITs") between 2010 and 2013.[11] Following their conversions to REITS, the SEC allowed these entities to exercise management discretion to account for deferred tax liabilities on unrealized gains at a value other than the fully liquidated value. Like Copley, these REITs are subject to theoretical economic risks that could possibly require them to sell assets and pay taxes

[11] *See* Weyerhaeuser Company 2013 Form 10-K at 43 (http://www.sec.gov/Archives/edgar/data/106535/000010653514000010/wy-123113x10k.htm); American Tower Corp. 2013 Form 10-K at 1 (http://www.sec.gov/Archives/edgar/data/1053507/000119312514068001/d636311d10k.htm); CyrusOne, Inc. 2013 Form 10-K ("Explanatory Note" thereto) (http://www.sec.gov/Archives/edgar/data/1553023/000155302314000037/cone-20131231x10k.htm).

on gains from these sales notwithstanding the apparent plan and policy not to make such tax-triggering sales.

This is no different than Copley's plan and policy, as demonstrated over its 36-year history. Because the Commission had shown flexibility with respect to these other companies' accounting for deferred tax liability on unrealized gains, Copley sent new requests for relief to the Commission, explaining that it, too, was entitled to such flexibility. JA 179-94; JA 199-203. As before, Copley's requests were denied and its arguments ignored. JA 195-98; JA 204-05. To Copley's knowledge, the Commission has never challenged the manner in which these other entities account for deferred taxes on unrealized gains.

## III. COPLEY'S EXEMPTION APPLICATION AND PROCEDURAL HISTORY

### A. Copley's Application for Exemption

Although the Commission's August 2, 2013 letter rejected Copley's request for *de novo* review by the full panel of Commissioners, the DIM suggested that Copley, as a last resort for possibly obtaining SEC review, submit "a request for exemptive relief pursuant to Section 36 of the Securities Exchange Act of 1934." JA 21. The DIM added, however, that it "would not support such relief" and warned that it could "give no assurances that the Commission will entertain the request." JA 22.

Copley followed the DIM's suggestion and submitted its application for exemptive relief on September 4, 2013. *See* JA 1-19 and accompanying Exhibits A through R, JA 20-214 (the "Application"). Pursuant to Section 36, the Commission "may conditionally or unconditionally exempt" Copley from Rule 22c-1 and Rule 4-01(a)(1) of Regulation S-X "to the extent that such exemption is necessary or appropriate in the public interest, and is consistent with the protection of investors." 15 U.S.C. § 78mm(a)(1). Copley's Application sought conditional exemptions from Rule 22c-1 and Rule 4-01(a)(1) of Regulation S-X, which would permit Copley to alter the manner in which it must account for and report its contingent deferred tax liability on unrealized gains.

As a condition to, and limitation on, the requested exemption, Copley proposed to account for its deferred tax liability by establishing a tax reserve based on a pre-set formula designed to present a more accurate disclosure to the investing public of the Fund's invested assets and NAV than the method mandated by the SEC in 2007. In its Application, Copley presented the same arguments that it had repeatedly attempted to present to the Commission for the preceding five years. Copley also described in detail several limitations and conditions it would put in place to advise and protect investors should the SEC grant its request for exemption. JA 15- 19.

Copley asserted that its request for an exemption promoted the public interest and protected investors for the following reasons:

- Copley's proposed pre-set formula for calculating a reserve for contingent, deferred tax liability on unrealized gains benefits current and future investors by accurately presenting the Fund's NAV, as compared to the SEC's full liquidation method, which artificially depresses the Fund's value, causes the Fund to issue and redeem shares at misleadingly low prices, overstates investment results as a percentage of assets under management, and overstates Copley's expenses as a percentage of net assets;

- The Fund's unique structure and operations among open-end funds makes the risk of the Fund incurring a tax liability in excess of the proposed pre-set reserve exceedingly remote;

- Copley's proposed reserve methodology was consistent with the fundamental GAAP principle that the business will continue as a going concern, whereas the full liquidation method assumes a "doomsday" scenario under which the Fund would have to liquidate its entire portfolio each and every day;

- Copley proposed to make full disclosures comparing the Fund's NAV under its preferred methodology with the SEC's full liquidation method so that the investing public could see both analyses and be fully informed; and

- Copley's proposals comported with the SEC's history of permitting departures from inappropriately rigid interpretations of regulations and accounting rules when doing so would lead to more accurate disclosure to investors.

JA 1-19.

Copley's Application also presented two alternative formulas for calculating a reserve for deferred tax liability on unrealized gains, along with additional measures for the protection and benefit of investors. JA 15-19. As its first alternative, Copley proposed a method for establishing a reserve for deferred tax

liability on unrealized gains based on the Fund's historic turnover rate. Under this alternative, at the end of each calendar quarter, Copley would calculate its average historical turnover rate over the previous five or ten years. JA 15-16. In calculating its NAV on a daily basis, Copley would use a tax reserve calculated at a tax rate equal to a percentage of the statutory corporate tax rate determined at four times the average historical turnover rate. *Id.* The historic, average five-year turnover rate of the Fund for the period from February 29, 2008 through February 28, 2013, was 1.62%; the average ten-year turnover rate was 1.48%. JA 257.[12]

Under Copley's second alternative method, Copley would determine at the end of each trading day the highest daily redemption of its shares (as a percentage of shares outstanding) during the previous five years. JA 16. In calculating its NAV on a daily basis, Copley would use a tax reserve calculated at a tax rate equal

[12] To illustrate, if the unrealized gain at the close of business is $50,000,000, the deferred tax liability under the full liquidation value approach would be $17,500,000 (*i.e.*, the corporate tax rate of 35% applied to the gains from a full liquidation of Copley's entire investment portfolio). Under either the historical, five-year rate turnover rate of 1.62% or the historical ten-year turnover rate of 1.48% (both rounded to 1.7%), Copley would set a reserve at four times that 1.7%, or approximately 7%, of the $17,500,000, *i.e.*, $1,225,000. JA 15-16. In this way, Copley would have established a tax reserve four times in excess of what it might reasonably anticipate based on its historical average portfolio turnover.

to a percentage of the statutory corporate tax rate determined at four times the highest daily redemptive rate. *Id.*[13]

### B. The SEC Failed to Respond to Copley's Application, Compelling Copley to File Suit in District Court

Copley's Application was again met with silence from the Commission, thus leaving Copley without a remedy after having exhausted all available channels for administrative review. After the Commission failed to respond to Copley's Application for six months, Copley filed suit in the United States District Court for the District of Columbia on March 19, 2014. *See Copley Fund, Inc. v. SEC*, No. 1:14-cv-00445 (RC) (D.D.C.), ECF No. 1 (the "District Court Litigation"). On April 23, 2014, the Commission filed a motion to transfer the action to this Court or to stay the action until the SEC issued a final, appealable order. *See* District Court Litigation, D.E. No. 10. Since Copley had been seeking final agency action for over six years, it opposed the SEC's attempt to further delay the entry of such an order.

[13] For example, if the unrealized gain at the close of business is $50,000,000, the deferred tax liability under the full liquidation value approach would be $17,500,000. Given that the historically highest daily redemptive rate of the Fund was 5.6%, Copley Fund would set a reserve at four times that 5.6%, or 22.4%, of the $17,500,000, *i.e.*, $3,920,000. JA 16. Thus, use of this method would have established a tax reserve four times in excess of what it might reasonably anticipate based on its highest daily redemptive rate.

On May 15, 2014, the SEC, finally, issued a "Notice of Application," in which it announced that it would, at some unknown point in the future, "issue an order under the Company Act denying the Application." *See* JA 219-235 (Release No. 34-72173, hereinafter, the "Notice"). The Commission then filed a Motion to Dismiss for Lack of Jurisdiction in the District Court Litigation, asserting again that the case should be before this Court under the applicable direct review statute, 15 U.S.C. § 80a-42(a), even though the SEC still had not issued a final order denying the Application. *See* District Court Litigation, ECF No. 13. Copley also opposed this motion, arguing that it could not seek redress in the courts of appeals under the direct review statute unless and until the SEC issued a final order on Copley's Application, which it had refused to do for six years. *See* District Court Litigation, ECF No. 15.

While these motions were pending, the Commission, at long last, issued its final written order denying Copley's Application on June 19, 2014 (discussed below). JA 237-38 (Release No. 31088) (the "Order"). On July 22, 2014, the SEC and Copley filed a Stipulated Order to Transfer Action, in which they agreed that the SEC's final order on Copley's Application vested proper jurisdiction over their dispute in the courts of appeals under Section 43(a) of the Company Act, 15 U.S.C. § 80a-43(a). The District Court subsequently transferred the parties' dispute to this

Court on July 24, 2014. *See* District Court Litigation, ECF No. 19. Copley filed a timely Petition for Review with this Court on July 28, 2014.

## IV. RULING PRESENTED FOR REVIEW

The Commission's one-page Order adopted in full the Commission's analysis and conclusions set forth in its Notice dated May 15, 2014. The Order and the Notice it adopted are premised, in part, on the SEC's rigid adherence to a single accounting standard, Financial Accounting Standards Board ("FASB") Accounting Standards Codification Topic 740 ("ASC 740"). ASC 740 requires C Corporations generally to account for deferred taxes on unrealized gains on investments as if the gains were all realized at once and the taxes immediately due and payable. JA 221-23.

In so concluding, the Commission ignored Copley's unique structure as a C Corporation that is also an open-end mutual fund dedicated to dividend accumulation and long-term capital appreciation. This structure renders the Commission's "one size fits all" approach of ASC 740 inappropriate here. The Commission further ignored Copley's arguments that its preferred accounting method was more faithful to GAAP principles than is the Commission's method. Specifically, GAAP's "going concern principle" assumes that the Fund will continue to operate and not fully liquidate its holdings, while the Commission's

required accounting method requires Copley to assume that it will fully liquidate its holdings at the end of each trading day.

The Order is also premised on an unrealistic hypothetical "doomsday" scenario in which Copley would be required to liquidate its entire portfolio on a single day. JA 228-33. Under this scenario, the Commission concluded that Copley's proposed reserve methodologies "would result in a provision for Copley's federal income tax liability that is less than the full amount of federal income tax that would be due *if the full amount of Copley's existing unrealized gains were realized*. . . ." JA 222-23 (emphasis added). The Commission theorized:

> If Copley were to experience a high level of redemptions necessitating liquidation of a large portion of its portfolio with significant unrealized gains, Copley's pricing of its redeemable securities based on the Proposed Method NAV *could* result in the redeeming shareholders receiving a price for their shares that reflects more than their pro-rata share of the net asset value of the Fund, while the price of the shares held by the remaining shareholders would reflect less than their pro-rata share of the net asset value of the Fund.

JA 229 (emphasis added). The SEC then illustrated its concern through a hypothetical scenario under which Copley would be required to redeem 60% of its outstanding shares in one day – *a rate substantially higher than the highest one-day redemption rate in Copley's 36 years of operations*. JA 229-30.

The Commission acknowledged that "Copley has been operating for several decades" and that the Fund's "highest daily redemption in the history of the Fund since inception was . . . approximately 1.6% of the total outstanding shares." JA 228. The Commission nevertheless concluded that Copley's proposed alternative methodologies were insufficient because "[h]owever unlikely it may seem to Copley that it may need to liquidate its entire portfolio to meet redemption requests, that is a possibility that Copley may not rule out. . . ." *Id.* And because this was theoretically possible, the Commission mandated that this must be presumed to occur each and every day.

Simply put, the Commission's hypothetical wholly disregards Copley's decades-long operations, including its historically low turnover and redemption rates, which show the Commission's scenario to be entirely divorced from reality. The Commission also ignored Copley's arguments that the full liquidation method caused actual harm to investors by artificially depressing the value of the Fund and materially overstating the Fund's operating expense ratio, as opposed to the purely hypothetical harm to investors on which the Commission relied. *See* Argument, Section III. B., *infra* (describing the harm to Copley's current and potential investors caused by the full liquidation methodology).

Having rejected Copley's request to use any of its proposed methods of calculating its NAV for the purpose of pricing its redeemable securities under

Rule 22c-1, the SEC concluded that it could not grant Copley's request to use its proposed methodologies of calculating its NAV for financial reporting purposes under Rule 4-01(a)(1) of Regulation S-X. *See* JA 235 ("If Copley were to use two different methods in calculating its net asset value [*i.e.*, one for pricing its redeemable securities and one for financial reporting] . . . the result may be unnecessarily confusing to investors and contrary to the policy behind the Company Act's disclosure requirements.").

The SEC also rejected Copley's proposal to provide investors with a comparison of its calculation of NAV under either of its preferred methods with the SEC's full liquidation method. In so doing, the Commission contravened a fundamental presumption underlying the securities laws, i.e., that investors have the ability and the right to evaluate non-misleading financial information and make informed investment decisions.

## SUMMARY OF ARGUMENT

The Commission's Order, which it issued only after years of ignoring altogether, or failing to respond to, the substance of Copley's arguments in support of relief, and only after Copley was compelled to sue the Commission in federal court, must be vacated as arbitrary, capricious, and an abuse of discretion. The Order meets the arbitrary and capricious standard because it "offer[s] an explanation for its decision that runs counter to the evidence before the agency"

and "entirely fail[s] to consider an important aspect of the problem." *See Motor Vehicle Mfrs. Ass'n v. State Farm Mut. Auto Ins. Co.*, 463 U.S. 29, 43 (1983). The Commission based its denial of Copley's Application on an extreme hypothetical of mass redemptions, which has no basis whatsoever in the administrative record. Moreover, over the course of Copley's six-year pursuit of relief from the Commission, the SEC never considered or responded to arguments that use of the full liquidation method in Copley's unique case actually misleads and harms investors or that it, in fact, violates fundamental tenets of GAAP.

First, the Commission's denial of Copley's Application for Exemption is arbitrary, capricious, and an abuse of discretion because the Commission disregarded Copley's 36-year history of consistent operation in which it only rarely needed to use its reserve for deferred taxes on unrealized gains to meet its actual tax obligations (and, even in those rare instances, Copley never needed the entire reserve). Rather, the Commission based its denial on an assumption that 100% of the fund would be liquidated every day. It attempted to justify its decision through a hypothetical "doomsday" scenario, in which 60% of the Fund's shares are presented for redemption in a single day – a rate many times higher than the highest single reported redemption in the Fund's history.

Contrary to the Commission's assumptions and rationale, the administrative record unequivocally demonstrates Copley's decades-long history of low rates of redemption and portfolio turnover while also producing substantial returns to its investors, which, under Copley's unique structure, are not subject to tax unless and until shares are redeemed. It is likewise undisputed that Copley never exhausted its management-determined tax reserve and only rarely required those funds to pay any actual taxes due. Despite this uncontroverted record, the Commission denied Copley's Application because it could not "rule out" a theoretical scenario that could *possibly* result in disparate treatment of investors. The Commission's disregard of record evidence and reliance instead on an extreme hypothetical scenario with no rational connection to the facts epitomizes arbitrary and capricious administrative decisionmaking. *See State Farm*, 463 U.S. at 43; *Freeman Eng'g Assocs., Inc. v. FCC*, 103 F.3d 169, 178 (D.C. Cir. 1997).

Second, the Commission's Order must be vacated as arbitrary, capricious, and an abuse of discretion because it is not consistent with GAAP or otherwise in the public interest. While the Commission insists its full liquidation method is required under its rigid interpretation of a solitary provision issued by FASB, in practice its prescribed method contravenes fundamental tenets of GAAP. A bedrock GAAP principle is that Copley must be considered to continue in business as a going concern. Instead, the SEC's full liquidation method requires

Copley to assume that it is going out of business at the end of each day by assuming that it must liquidate its portfolio and account for all taxes that would be due in calculating the Fund's NAV and setting the price of its shares.

Further, the use of the full liquidation method is contrary to the principle of adequate, non-misleading disclosure under GAAP because it causes Copley to misrepresent the Fund's true value, performance, and share price to current and potential investors. It is also contrary to the basic mission of the securities laws of protecting investors. Copley's proposed alternative methods of calculating a reserve for deferred taxes would accurately and transparently present an estimate of the Fund's potential tax liability based on its 36-year history. Copley nevertheless included in its Application a proposal to disclose fully both its method of calculating a reserve for deferred taxes and the SEC's full liquidation method, thus offering present and potential investors a transparent comparison. The SEC rejected this proposal, too, as "confusing" to investors, even though it is common for businesses, including mutual funds, to present financial information differently for tax and financial reporting purposes.

The Commission never addressed these arguments, even though Copley had made them in its Application and in several prior written submissions over many years. Consequently, the Commission's disregard for Copley's arguments

is likewise arbitrary, capricious, and an abuse of discretion. *See Dickson v. Sec'y of Def.*, 68 F.3d 1396, 1404-05 (D.C. Cir. 1995).

While the Commission denied Copley's Application over its expressed concern for some potential harm that might befall investors in the event of a hypothetical mass redemption of Copley shares, the Commission never addressed the actual harm caused to investors by the full liquidation method. The SEC's mandated full liquidated method misrepresents the true value of the Fund to current and potential investors. Moreover, those shareholders who have retained their shares since the Commission's abrupt intervention in 2007 have suffered a material loss in value, not because of any real event or diminution in value, but because of a forced change in accounting. Furthermore, because the full liquidation method artificially depresses the Fund's NAV, it understates the assets actually under management, overstates investment results as a percentage of assets, and overstates Copley's operating expense as compared to average net assets. Thus, the Commission's Order disregarded the actual harm to investors by its mandated change in accounting methods and focused instead on purely hypothetical harm to investors without any justifiable support in the administrative record.

Finally, the Commission's position that the Company Act Rules and accounting standards and principles do not allow for any discretion

or flexibility with respect to accounting for deferred tax liability on unrealized gains is belied by the Commission's recent treatment of other companies in similar circumstances. The Commission has allowed several companies that have converted from C Corporations into REITs significant discretion with respect to their accounting for deferred tax liability, even though they face the same (or greater) risk of an unexpectedly large tax liability. The Commission's treatment of these companies illustrates that it has taken a flexible view of accounting principles and permitted management discretion when appropriate and when investors are adequately protected. The Commission's steadfast refusal to consider or allow the same discretion here, or to grant an exemption in light of Copley's uniqueness, long history of solid performance and benefit to investors is arbitrary, capricious, and an abuse of discretion.

## STANDING

This case is before the Court on a petition to review the Order denying Copley's request for an exemption under Section 6(c) of the Company Act, 15 U.S.C. § 80a-3(c), from Rule 22c-1 and Rule 4-01(a)(1) of Regulation S-X. Because Copley is the "object of the action" under review, there is "little question" about standing. *Sierra Club v. EPA*, 292 F.3d 895, 900 (D.C. Cir. 2002) (citations omitted).

# ARGUMENT

## I. STANDARD OF REVIEW

The question before the Commission on Copley's Application was whether Copley's proposals for conditional exemptions from Rule 22c-1 and Rule 4-01(a)(1) of Regulation S-X were "necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of" the Company Act. 15 U.S.C. § 80a-6(c).[14] This Court reviews the Commission's denial of Copley's Application "under the [Administrative Procedure Act's] arbitrary and capricious standard, *i.e.*, we 'hold unlawful and set aside agency action' that is 'arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law' or 'unsupported by substantial evidence.'" *NetCoalition v. SEC*, 615 F.3d 525, 532 (D.C. Cir. 2010) (citing 5 U.S.C. §§ 706(2)(A), (E)). "The findings of the Commission as to the facts, if supported by substantial evidence, shall be conclusive." 15 U.S.C. § 80a-42(a). This Court reviews the Commission's conclusions of law *de novo*. *Orkin v. SEC*, 31 F.3d 1056, 1063 (11th Cir. 1994).

[14] The Company Act's exemption statute provides that the Commission "may conditionally or unconditionally exempt any person, security, or transaction . . . from any provision or provisions of" the Company Act "if and to the extent that such exemption is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of" the Company Act. *Id.*

## II. THE SEC'S ORDER IS ARBITRARY, CAPRICIOUS, AND AN ABUSE OF DISCRETION BECAUSE IT IS BASED SOLELY ON HYPOTHETICAL SPECULATION AND NOT REALITY

The Commission's denial of Copley's Application is arbitrary, capricious, and an abuse of discretion because it was based entirely on a hypothetical scenario that bears no reasonable relation to the facts before the Commission or Copley's 36-year history. An agency's action is arbitrary, capricious, and an abuse of discretion if it "entirely fail[s] to consider an important aspect of the problem, offer[s] an explanation for its decision that runs counter to the evidence before the agency, or [if it] is so implausible that it could not be ascribed to a difference in view or the product of agency expertise." *State Farm*, 463 U.S. at 43. While the scope of review under the "arbitrary and capricious" standard is narrow, *see Air Transp. Ass'n of Can. v. FAA*, 254 F.3d 271, 278 (D.C. Cir. 2001), this Court still "must assure [itself] the agency has 'examine[d] the relevant data and *articulate[d] a satisfactory explanation for its action including a rational connection between the facts found and the choices made.*'" *Business Roundtable v. SEC*, 647 F.3d 1144, 1148 (D.C. Cir. 2011) (citing *State Farm*, 463 U.S. at 43) (emphasis added); *Chamber of Commerce of U.S. v. SEC*, 412 F.3d 133, 140 (D.C. Cir. 2005) (same). Moreover, this Court must "look to see 'whether the decision was based on a consideration of the relevant factors and whether there has been a clear error of judgment.'" *Freeman*, 103 F.3d at 178 (citing *State Farm*,

463 U.S. at 43); *see Tripoli Rocketry Ass'n v. BATFE*, 437 F.3d 75, 77 (D.C. Cir. 2006) ("In order to survive judicial review in a case arising under § 706(2)(A), an agency action must be supported by reasoned decisionmaking . . . [and the] process by which it reaches the result must be logical.") (internal citations and quotations omitted). "An agency decision will be considered arbitrary if it 'runs counter to the evidence before the agency.'" *Freeman*, 103 F.3d at 178 (quoting *State Farm*, 463 U.S. at 43).

The Commission's actions here epitomize arbitrary and capricious agency action because the record does not support the Commission's decision and shows only that the Commission failed to consider or give any weight to Copley's long operating history, an important aspect of the issue before the Commission. *See State Farm*, 463 U.S. at 43; *Beno v. Shalala*, 30 F.3d 1057, 1074 (9th Cir. 1994) (reversing an agency determination where "the record contains a rather stunning lack of evidence" that the agency considered or refuted arguments and evidence pertinent to the issue before the agency).

Here, the record demonstrates that Copley's long-established investment philosophy of purchasing and holding highly viable, dividend paying stocks has resulted in extraordinarily low rates of redemptions and portfolio turnover while also producing solid returns to its investors, which, of course, are not subject to tax unless and until shares are redeemed. The non-taxable nature of the

increases in Copley's share value is responsible, at least in part, for Copley's low redemption rate and the remote possibility of a sudden mass redemption. The administrative record contains undisputed evidence of Copley's low average turnover rate of 1.48%, and its highest one-day redemption of 1.6%.[15] It is also undisputed that Copley never depleted its management-determined tax reserve and only rarely needed to use any of its funds to pay any actual tax liability, as the Fund's tax liability for capital gains was almost always covered by either capital losses or capital loss carry forwards. JA 16; JA 71; JA 257.

Despite Copley's undisputed history of stability, low redemptions, and low portfolio turnover, the Commission rejected Copley's proposals based on a highly speculative theory of a one-day mass liquidation without any basis in the factual record. The Commission acknowledged that the record does not support its hypothetical, stating:

> Although Copley has been operating for several decades and the Application states that "the highest daily redemption in the history of the Fund since inception was . . . approximately 1.6% of the total outstanding shares on the date of the redemption," Copley cannot control or fully anticipate the level and amounts of shareholder redemptions and the resulting need to sell its portfolio investments to satisfy the redemption requests.

JA 228.

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[15] *But see* n.10, *supra* (noting isolated one-day redemption of 5.65% of Copley's then-outstanding shares).

The Commission then illustrated its concern through a hypothetical scenario in which 60% of Copley's outstanding shares are presented for redemption in a single day – a rate that is many times Copley's highest ever daily redemption in its 36-year history. JA 229-32. Under the Commission's extraordinary hypothetical, the NAV of the shares held by the holders of the remaining 40% of Copley's outstanding shares would be reduced to reflect the federal income tax accrual on gains realized by Copley selling securities with unrealized gains to pay the redeeming shareholders. JA 229.[16] Stated differently, the Commission posited that in the event of such an unprecedented redemption, the value of the remaining shareholders' shares of Copley's NAV may be less than that received by the redeeming shareholders because of unanticipated tax liability for which there would not be an adequate reserve. *Id.*

While the Commission may be able to conjure an extreme hypothetical to demonstrate how Copley's proposed alternative methods might result

[16] According to the Commission, "[i]f Copley were to experience a high level of redemptions necessitating liquidation of a large portion of its portfolio with significant unrealized gains, Copley's pricing of its redeemable securities based on the Proposed Method NAV could result in the redeeming shareholders receiving a price for their shares that reflects more than their pro-rata share of the net asset value of the Fund, while the price of the shares held by the remaining shareholders would reflect less than their pro-rata share of the net asset value of the Fund. Copley's use of the Proposed Method could produce this disparate result because only the net asset value per share of the shares held by the remaining, non-redeeming shareholders would reflect the full actual federal income tax expense incurred as a result of the liquidation of the portfolio . . . ." *Id.*

in disparate treatment of investors, the Commission cannot point to ***any*** evidence in the record to support its theory. Indeed, the Commission relies solely on an article, posted on Morningstar.com on February 7, 2008, to support its proposition that it "cannot rule out" a theoretical scenario that could ***possibly*** result in the disparate treatment of shareholders if Copley were to use one of its preferred methods of calculating its NAV. JA 228 n.16.

The differences between Copley and the funds analyzed in the Morningstar.com article are stark. First, all of the funds in the article had investments in mortgage and housing-related stocks and bonds, which made them vulnerable to the subprime-mortgage meltdown in 2008. *Id.* Second, the funds also held illiquid assets, such as shaky mortgage-backed securities, which they could not sell in the market turmoil of 2008. Unlike these funds, Copley invests in highly viable and highly liquid, dividend-paying stocks, such as J.P. Morgan Chase & Company, ExxonMobil Corp., and Verizon Communications, Inc. JA 248-50. This strategy allowed it to weather the recent financial crisis of 2008 and 2009, as well as other market downturns in Copley's long history, without significant redemptions.

Rather than consider the unique facts of Copley's situation, the Commission denied its Application based on an unrealistic hypothetical liquidation scenario and fears about other, differently situated funds. *See KCST-TV, Inc. v. FCC*,

699 F.2d 1185, 1191-92 (D.C. Cir. 1983) (setting aside and remanding an agency order when it failed to "take a 'hard look' at meritorious applications for waiver" and to "consider all relevant factors.") (internal citation omitted). Moreover, the Commission's hypothetical disregards the likelihood that, in an unprecedented situation of a devastating market drop to levels lower than any experienced in Copley's history, any unrealized gains or appreciation in Copley's investments would evaporate as would any related tax liability. Because there is no rational connection between the factual record and the reasoning on which the Commission based its rejection of Copley's Application, the Commission's Order is arbitrary, capricious, and an abuse of discretion, and must therefore be vacated. *See Business Roundtable*, 647 F.3d at 1148; *Chamber of Commerce*, 412 F.3d at 140.

## III. THE SEC'S ORDER IS ARBITRARY, CAPRICIOUS, AND AN ABUSE OF DISCRETION BECAUSE THE FULL LIQUIDATION METHOD CONFLICTS WITH FUNDAMENTAL GAAP PRINCIPLES AND CAUSES ACTUAL HARM TO INVESTORS AND THE INVESTING PUBLIC

### A. The SEC's Full Liquidation Method Contradicts Basic Tenets of GAAP, While Copley's Proposals Are Consistent with GAAP Principles and Company Act Rules

In addition to its lack of any reasoned rationale, the Commission's decision should be set aside because it is neither consistent with GAAP nor otherwise in the public interest. Quite simply, because of the Fund's unique structure, any of its proposed alternative methods of accounting for deferred tax liability

on unrealized gains are consistent with GAAP. By contrast, the Commission's full liquidation method actually *contradicts* fundamental GAAP tenets, such as the going concern assumption and adequate disclosure principle. *See* JA 9-15; JA 113-19; JA 139-45; JA 185-88.

In over six years, the Commission has never addressed any of these arguments. Instead, time and again, including in its Notice, the Commission has merely parroted its interpretation of ASC 740 as applied to C Corporations generally. *See* JA 25 ("FAS 109 provides that, with respect to recognition and measurement, '[a]n enterprise shall recognize a deferred tax liability or asset for all temporary differences and operating loss and tax credit carryforwards….'") (referring to ASC 740 by its former designation as FAS 109) (emphasis in original); JA 197 (citing ASC 740 and stating that "[u]nrealized gains on investments, which are taxable after they are recognized in the financial statements, represent a temporary difference on which a deferred tax liability must be recognized"); and JA 222 n. 6 (same).

The Commission's failure to address Copley's arguments – to the exclusion of objective and historical fact – and its mere repetition of a singular accounting provision to support its demand that Copley adhere to the full liquidation methodology is arbitrary, capricious, and an abuse of discretion. "When an agency merely parrots the language of a statute without providing an account of how

it reached its results, it has not adequately explained the basis for its decision." *See Dickson*, 68 F.3d at 1404-1405 (vacating and remanding an agency determination and holding that "[t]he requirement that agency action not be arbitrary and capricious includes a requirement that the agency adequately explain its result . . . ." ).[17]

Moreover, the Order violates important accounting principles. A basic tenet of GAAP is the assumption that a business will continue to operate as a going concern. Thus, the Commission was required to assume that Copley will continue to operate in the ordinary course unless there was actual evidence of its illiquidity. JA 12 (citing *Accounting Research Bulletin 43, Chapter 3: Working Capital*, Section A: "It should be emphasized that financial statements of a going concern are prepared on the assumption that the company will continue in business.").[18]

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[17] ASC 740, of course, is not even a statute or regulation.

[18] *See also* Financial Accounting Standards Board, Statement of Financial Accounting Concepts (SFAC) 1 (1978), *Objectives of Financial Reporting by Business Enterprises*, at ¶ 42, n. 10 ("Investors and creditors ordinarily invest in or lend to enterprises that they expect to continue in operation – an expectation that is familiar to accountants as "the going concern" assumption."); Int'l Auditing and Assurance Standards Bd., Staff Audit Practice Alert, January 2009, *Audit Considerations in Respect of Going Concern in the Current Economic Environment*, at 2 ("The going concern assumption is a fundamental principle in the preparation of financial statements. Under the going concern assumption, an entity is ordinarily viewed as continuing in business for the foreseeable future with neither the intention nor the necessity of liquidation, ceasing trading or seeking protection from creditors pursuant to laws or regulation.").

Here, there is no evidence of Copley's illiquidity. In requiring the full liquidation method, however, the SEC specifically assumes that Copley will liquidate its portfolio of investments all at once and cease operations. Based on Copley's 36 years of stable operations, low redemptions, low portfolio turnover, and strong returns to its investors, this simply has no basis in fact.

Further, the use of the full liquidation method is contrary to the principle of adequate, non-misleading disclosure under GAAP. This method causes Copley to present financial information, including its daily NAV and financial statements, in a misleading manner because it inaccurately conveys the true value of Copley's shares, its operating expense ratio, and its performance. *See* Argument, Section III.C., *infra* (explaining how the full liquidation method causes actual harm to investors, as opposed to the speculative harm on which the Commission based its determination).

By compelling Copley to present incomplete and misleading information to investors concerning the value and performance of the Fund, and to issue and redeem shares at artificially low prices, the SEC is, in fact, facilitating and causing actual harm to present and potential investors in Copley, which is contrary to the underlying purposes of the securities laws to protect investors. *See Pinter v. Dahl*, 486 U.S. 622, 638 (1988) ("The primary purpose of the Securities Act is to protect investors by requiring publication of material

information thought necessary to allow them to make informed investment decisions concerning public offerings of securities in interstate commerce."); *Basic, Inc. v. Levinson*, 485 U.S. 224, 230 (1988) ("This Court repeatedly has described the fundamental purpose of the [Security Exchange Act of 1934] as implementing a philosophy of full disclosure.") (internal quotations and citation omitted). In fact, to provide investors with the most complete information possible concerning the Fund's value and performance, Copley offered to include disclosures comparing its NAV as determined under its proposed alternative methods with the SEC's full liquidation method. This complete and transparent disclosure, too, was summarily rejected by the Commission.

The alternatives proposed by Copley would give investors the full information needed to make informed decisions. Any investor or prospective investor who did not accept Copley's method of calculation – being fully informed of how it was made and the difference between it and the Commission's preferred method – could simply decline to purchase Copley shares or sell those already purchased.

Even assuming, *arguendo*, the Fund's proposed reserve methodologies were inconsistent with a rigid interpretation of ASC 740 on which the SEC has singularly relied, GAAP allows for certain flexibility when, for instance, strict adherence to GAAP appears unreasonable under the circumstances or would

produce unjustifiable results. *See, e.g.* SEC Release No. 33-8176, dated Jan. 22, 2003 (adopting new rules and amendments to address public companies' disclosure or release of certain financial information that is calculated and presented on the basis of methodologies other than in accordance with GAAP). For all of the reasons stated above, such flexibility is warranted here. *See* Statement of the Case, Section II.A., *supra* (discussing Copley's historic performance and payment of actual liability for taxes on gains in its investment portfolio).

Indeed, the full liquidation method demanded by the SEC actually harms Copley, its current investors, and potential investors because, unlike a typical C Corporation whose shares are valued by the market, Copley is required to calculate its price daily with respect to its redeemable shares. Thus, the full liquidation method is not only misleading and in violation of basic securities law principles, it puts Copley at a disadvantage relative to its peer funds because it artificially deflates the Fund's NAV and thereby makes it appear to the investing public to be a less-attractive investment opportunity compared to its competitor funds. *See* Argument, Section III.C., *infra* (addressing the full liquidation method's misleading representations to investors concerning Copley's NAV, investment returns, and operating expenses).

Additionally, strict adherence to ASC 740 is not required by Company Act Rules. Copley's issuance and redemption of shares based on a NAV that reflects

a management-determined tax reserve would not violate the Company Act Rules. Rule 22c-1 requires open-end funds to issue and redeem shares "at a price based on the current net asset value of such security. . . ." 17 C.F.R. § 270.22c-1(a). In turn, the rules define "current net asset value" as the "amount which reflects calculations, whether or not recorded in the books of account, made substantially in accordance with the following, *with estimates used where necessary or appropriate*." 17 C.F.R. § 270.2a-4(a) (emphasis added). Rule 2a-4(a)(4) explicitly states that in calculating "current net asset value" for use in computing the current price of redeemable securities: "*Appropriate provision* shall be made for Federal income taxes *if required*." (emphasis added). Rule 2a-4(a)(4) does not define "if required."

When read together, the above two Company Act Rules do not require sales or redemptions at a net asset value reflecting the full liquidation value of deferred taxes on unrealized gains. Rather, Rule 22c-1(a) requires sales or redemptions to be at a price *based on* current net asset value. Rule 2a-4(a) directs how to calculate net asset value for use "in computing periodically the current price for the purpose of" sales and redemptions. Simply put, using "net asset value" to compute a price *based on* net asset value is not the same as requiring net asset value to be the price. In sum, Copley's proposed alternative methods

of accounting for deferred tax liability on unrealized gains in calculating its NAV is entirely consistent with the requirements of these Company Act Rules.

Nor is strict adherence with ASC 740 required by Rule 4-01(a)(1) of Regulation S-X. For financial reporting, the Company Act requires open-end funds, like Copley, to file with the Commission a registration statement and annual reports, which must contain Copley's financial statements. 15 U.S.C. § 80a-8(b). The form and content of, and requirements for, the financial statements filed pursuant to the Company Act are set forth in Regulation S-X. *See* 17 C.F.R. § 210.1-01 *et seq.* Rule 4-01(a)(1) of Regulation S-X states, in relevant part, that "[f]inancial statements filed with the Commission which are not prepared in accordance with [GAAP] will be presumed to be misleading or inaccurate, despite footnote or other disclosures, unless the Commission has otherwise provided." 17 C.F.R. § 210.4-01(a)(1).

In sum, Copley's proposed methods of calculating NAV and accounting for deferred taxes on unrealized gains are in the public interest and protect investors because, *inter alia*, they are consistent with GAAP and Company Act Rules. Conversely, the SEC's mandated full liquidation method in fact contravenes basic tenets of GAAP in Copley's unique case. The Commission has never explained this inconsistency. Therefore, the Commission's Order

is arbitrary, capricious, and an abuse of discretion, and must therefore be vacated and set aside.

### B. The SEC's Full Liquidation Method Causes Actual Harm to Investors, as Opposed to the Purely Hypothetical Harm to Investors on which the SEC Based its Decision

The Commission's rejection of Copley's proposed alternative methods for calculating its NAV was arbitrary, capricious, and an abuse of discretion because the accounting method mandated by the Commission has caused actual harm to investors. The full liquidation method artificially depresses the value of the Fund and materially overstates the Fund's operating expense ratio and performance, as opposed to the purely hypothetical harm to investors on which the Commission based its determination. The Commission's failure to address this issue requires that its Order be set aside.

The full liquidation methodology harms investors in several ways. First, accounting for a tax reserve at a value that would occur only if the Fund were required to liquidate its entire investment portfolio presents a misleading picture of the Fund's true value. *See* JA 10-11 (explaining the harm to investors caused by the full liquidation methodology); JA 138 (explaining the same with tables comparing Copley's historic NAV using the SEC's full liquidation method to Copley's preferred, historic method of accounting for deferred tax liability). Copley's current shareholders, especially those who have held shares since the

SEC's intervention in 2007, have suffered a material loss in the value of their investment, not because of any real event or diminution in value of Copley's assets, but because of a mandated change in methods to account for a hypothetical full liquidation of the Fund. As for potential investors in Copley, many may forego investing in the Fund and thereby lose the opportunity for solid future returns on investment merely because of the artificial presentation of the Fund's NAV mandated by the SEC.

Second, calculating NAV under the SEC's mandated full liquidation method materially understates the amounts of assets actually under management, and thereby overstates investment results as a percentage of assets in both good years and bad. Because NAV under the SEC's mandated methodology must include a deduction for deferred taxes based on a hypothetical total liquidation of Copley's portfolio, Copley's annual returns on its actual investments are always overstated as compared to what they would be using Copley's historic method or one of its proposed alternative methodologies.[19] Such a skewed presentation materially misrepresents the Fund's performance to current and potential investors.

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[19] To illustrate, under the full liquidation method, investment results as a percentage of assets are calculated as follows: investment returns divided by total assets under management less expenses, *including the taxes due on investment gains assuming a full liquidation of the Fund*. Under either Copley's historic method or its proposed alternative methods, investment results as a percentage of assets are calculated as follows: investment returns divided by total assets under management less expenses, *including some lesser amount for a reasonable*

Third, calculating NAV under the full liquidation method materially overstates Copley's operating expense ratio. As of February 28, 2014, the Fund's ratio of total annual operating expenses to average net assets, using the SEC's full liquidation method, was 6.18%. JA 257. Without including these deferred taxes, which are not an actual operating expense of the Fund, but including a management determined reserve, the ratio would be approximately 1.69%, which is more appropriate for comparison to other funds. *See* JA 139 (chart describing historic operating expense ratio using the SEC's mandated method and Copley's preferred, historic method). Because the SEC's mandated method materially misstates Copley's actual expenses, it misleads both current and potential investors as to the Fund's actual performance as compared to competitor funds.

Copley has presented the foregoing arguments to the Commission multiple times over the past several years, including in its Application, and the Commission never responded to them. *See, e.g.*, JA 137-39; JA 10-11. Because the Commission's paramount concern is supposed to be fairness to and protection of investors, its Order was wrongly decided and must be vacated to prevent further harm to investors in Copley. JA 228-34.

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*estimate of potential tax liability on unrealized gains*. Investment returns under the former calculation will always be higher.

### C. The SEC's Order is Arbitrary, Capricious, and an Abuse of Discretion Because It Denies Copley the Discretion that the SEC Has Permitted Other, Similarly Situated Companies

With respect to Copley, the Commission has adopted the position that Rule 22c-1 and Rule 4-01(a)(1) of Regulation S-X do not allow for *any* discretion or flexibility with respect to accounting for deferred tax liability. This position is inconsistent with the discretion and flexibility in accounting practices, including with respect to deferred tax liability on unrealized gains, which the Commission has accorded to other entities when the circumstances warranted it and doing so was appropriate and would lead to more accurate reporting.

Several entities, including Weyerhaeuser, American Tower Corp., CyrusOne, Penn National Gaming, Empire State Realty, CoreSight, and Ryman Hospitality, converted from C Corporations into REITs. *See* Statement of the Case, Section II.D., *supra*. These entities have been permitted to exercise management discretion to account for deferred tax liabilities in a manner that, while possibly inconsistent with ASC 740, reflects a good faith business determination of their anticipated tax liabilities. JA 13-14. Upon conversion to REIT status, those entities are subject to a tax on any "built-in gains" that had accrued as of the conversion date, if they disposed of any assets with such built-in gains owned at the time of the conversion during the 10-year period following the conversion. Nevertheless, none of these entities has accounted for deferred tax

liabilities associated with such "built-in gains" – presumably concluding that their likelihood of disposing of such assets within the 10-year recognition period is exceedingly remote. JA 142-43. To Copley's knowledge, the Commission has *never* challenged the approaches of these entities.

Copley does not disagree with these companies' financial reporting or the flexibility accorded to them by the Commission. Copley simply seeks equal treatment; the likelihood of it liquidating is much less than any of these companies suffering an unexpected "tax-triggering" event.

Notably, these REIT conversions all took place after 2010, years after the Commission refused – under threat of enforcement action – to permit Copley to exercise similar management discretion with respect to its deferred tax liability accounting. Although the Fund's situation is not entirely equivalent to that of Weyerhaeuser, American Tower, and the other REIT-converted entities, it is sufficiently analogous because, like those entities, Copley is seeking to exercise discretion not to account for the full amount of liabilities that are contingent and highly remote. *See*, *e.g.*, JA 79 n.5 (citing SEC Release Nos. 33-8176, 34-17226, dated January 22, 2003, in which the Commission allowed for flexibility when strict adherence to GAAP appears unreasonable under the circumstances or would produce unjustifiable results). Moreover, like Copley, these REITs are subject to certain economic risks that could possibly require them

to sell inventory before the expiration of the 10-year recognition period, thus requiring them to pay taxes on any gains. Nevertheless, the Commission still rejected Copley's requests even after Copley brought to the Commission's attention its disparate treatment of these other companies. There is no reasonable justification for the SEC to prohibit Copley from exercising similar management discretion here.

The SEC claims in its Notice that the discretion it grants to REITs is distinguishable because they "do not issue redeemable securities and therefore do not face the associated potential need to sell portfolio assets to satisfy redemption requests." JA 234 n.39. In making this assertion, the SEC misses the point. As opposed to the rigid interpretation of one GAAP principle in the case of Copley, its actions with respect to the REITs demonstrates that accounting principles and standards are flexible, requiring business judgments and assessments, and, consistent with the basic objectives of securities laws, must be adjusted to meet the facts and circumstances of the given case to provide transparency and full disclosure to investors.

In sum, the SEC has taken a flexible view of accounting principles and permitted management discretion in the past when appropriate in the circumstances and when investors are adequately protected. The SEC's absolute

and inexplicable inflexibility with respect to Copley is arbitrary, capricious, and an abuse of discretion.

## CONCLUSION

For the foregoing reasons, Petitioner requests that the Court vacate and set aside the Commission's Order, dated June 19, 2014.

Respectfully submitted,

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December 23, 2014

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By: /s/ Paul M. Honigberg
Paul M. Honigberg

December 23, 2014

## CERTIFICATE OF SERVICE

Pursuant to Rule 25(d)(1)(B) of the Federal Rules of Appellate Procedure, I hereby certify that on this date I caused one copy of the foregoing Brief of Petitioner Copley Fund, Inc., to be served electronically using the Court's CM/ECF system on the following counsel of record:

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December 23, 2014

**STATUTORY AND REGULATORY ADDENDUM TO**

**THE BRIEF OF PETITIONER, COPLEY FUND, INC.**

**15 U.S.C. § 80a-6**

§ 80a-6. Exemptions

(a) Exemption of specified investment companies
The following investment companies are exempt from the provisions of this supchapter:

(1) Any company organized or otherwise created under the laws of and having its principal office and place of business in Puerto Rico, the Virgin Islands, or any other possession of the United States; but such exemption shall terminate if any security of which such company is the issuer is offered for sale or sold after the effective date of this title, by such company or an underwriter therefor, to a resident of any State other than the State in which such company is organized.

(2) Any company which since the effective date of this title or within five years prior to such date has been reorganized under the supervision of a court of competent jurisdiction, if (A) such company was not an investment company at the commencement of such reorganization proceedings, (B) at the conclusion of such proceedings all outstanding securities of such company were owned by creditors of such company or by persons to whom such securities were issued on account of creditors' claims, and (C) more than 50 per centum of the voting securities of such company, and securities representing more than 50 per centum of the net asset value of such company, are currently owned beneficially by not more than twenty-five persons; but such exemption shall terminate if any security of which such company is the issuer is offered for sale or sold to the public after the conclusion of such proceedings by the issuer or by or through any underwriter. For the purposes of this paragraph, any new company organized as part of the reorganization shall be deemed the same company as its predecessor; and beneficial ownership shall be determined in the manner provided in section 80a-3(c)(1) of this title.

(3) Any issuer as to which there is outstanding a writing filed with the Commission by the Federal Savings and Loan Insurance Corporation stating that exemption of such issuer from the provisions of this title is consistent with the public interest and the protection of investors and is necessary or appropriate by reason of the fact that such issuer holds or proposes to acquire any assets or any product of any assets which have been segregated (A) from assets of any company which at the filing of such writing is an insured institution within the meaning of section 401(a) of the National Housing Act, as heretofore or hereafter amended, or (B) as a part of or in

connection with any plan for or condition to the insurance of accounts of any company by said corporation or the conversion of any company into a Federal savings and loan association. Any such writing shall expire when canceled by a writing similarly filed or at the expiration of two years after the date of its filing, whichever first occurs; but said corporation may, nevertheless, before, at, or after the expiration of any such writing file another writing or writings with respect to such issuer.

(4) Any company which prior to March 15, 1940, was and now is a wholly-owned subsidiary of a registered face-amount certificate company and was prior to said date and now is organized and operating under the insurance laws of any State and subject to supervision and examination by the insurance commissioner thereof, and which prior to March 15, 1940, was and now is engaged, subject to such laws, in business substantially all of which consists of issuing and selling only to residents of such State and investing the proceeds from, securities providing for or representing participations or interests in intangible assets consisting of mortgages or other liens on real estate or notes or bonds secured thereby or in a fund or deposit of mortgages or other liens on real estate or notes or bonds secured thereby or having outstanding such securities so issued and sold.

(5) (A) Any company that is not engaged in the business of issuing redeemable securities, the operations of which are subject to regulation by the State in which the company is organized under a statute governing entities that provide financial or managerial assistance to enterprises doing business, or proposing to do business, in that State if--

(i) the organizational documents of the company state that the activities of the company are limited to the promotion of economic, business, or industrial development in the State through the provision of financial or managerial assistance to enterprises doing business, or proposing to do business, in that State, and such other activities that are incidental or necessary to carry out that purpose;

(ii) immediately following each sale of the securities of the company by the company or any underwriter for the company, not less than 80 percent of the securities of the company being offered in such sale, on a class-by-class basis, are held by persons who reside or who have a substantial business presence in that State;

(iii) the securities of the company are sold, or proposed to be sold, by the company or by any underwriter for the company, solely to accredited investors, as that term is defined in section 77b(a)(15) of this title, or to such other persons that the Commission, as necessary

or appropriate in the public interest and consistent with the protection of investors, may permit by rule, regulation, or order; and

(iv) the company does not purchase any security issued by an investment company or by any company that would be an investment company except for the exclusions from the definition of the term "investment company" under paragraph (1) or (7) of section 80a-3(c) of this title, other than--

(I) any debt security that meets such standards of credit worthiness as the Commission shall adopt; or

(II) any security issued by a registered open-end investment company that is required by its investment policies to invest not less than 65 percent of its total assets in securities described in subclause (I) or securities that are determined by such registered open-end investment company to be comparable in quality to securities described in subclause (I).

(B) Notwithstanding the exemption provided by this paragraph, section 80a-9 of this title (and, to the extent necessary to enforce section 80a-9 of this title, sections 80a-37 through 80a-50 of this title) shall apply to a company described in this paragraph as if the company were an investment company registered under this title.

(C) Any company proposing to rely on the exemption provided by this paragraph shall file with the Commission a notification stating that the company intends to do so, in such form and manner as the Commission may prescribe by rule.

(D) Any company meeting the requirements of this paragraph may rely on the exemption provided by this paragraph upon filing with the Commission the notification required by subparagraph (C), until such time as the Commission determines by order that such reliance is not in the public interest or is not consistent with the protection of investors.

(E) The exemption provided by this paragraph may be subject to such additional terms and conditions as the Commission may by rule, regulation, or order determine are necessary or appropriate in the public interest or for the protection of investors.

(b) Exemption of employees' security company upon application; matters considered

Upon application by any employees' security company, the Commission shall by order exempt such company from the provisions of this title and of the rules and regulations hereunder, if and to the extent that such exemption is consistent with the protection of investors. In determining the provisions to which such an order of exemption shall apply, the Commission shall give due weight, among other things,

to the form of organization and the capital structure of such company, the persons by whom its voting securities, evidences of indebtedness, and other securities are owned and controlled, the prices at which securities issued by such company are sold and the sales load thereon, the disposition of the proceeds of such sales, the character of the securities in which such proceeds are invested, and any relationship between such company and the issuer of any such security.

(c) Exemption of persons, securities or any class or classes of persons as necessary and appropriate in public interest

The Commission, by rules and regulations upon its own motion, or by order upon application, may conditionally or unconditionally exempt any person, security, or transaction, or any class or classes of persons, securities, or transactions, from any provision or provisions of this title or of any rule or regulation thereunder, if and to the extent that such exemption is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of this subchapter.

(d) Exemption of closed-end investment companies

The Commission, by rules and regulations or order, shall exempt a closed-end investment company from any or all provisions of this title, but subject to such terms and conditions as may be necessary or appropriate in the public interest or for the protection of investors, if--

(1) the aggregate sums received by such company from the sale of all its outstanding securities, plus the aggregate offering price of all securities of which such company is the issuer and which it proposes to offer for sale, do not exceed $ 10,000,000, or such other amount as the Commission may set by rule, regulation, or order;

(2) no security of which such company is the issuer has been or is proposed to be sold by such company or any underwriter therefor, in connection with a public offering, to any person who is not a resident of the State under the laws of which such company is organized or otherwise created; and

(3) such exemption is not contrary to the public interest or inconsistent with the protection of investors.

(e) Application of certain specified provisions of this title to otherwise exempt companies. If, in connection with any rule, regulation, or order under this section exempting any investment company from any provision of section 80a-7 of this title, the Commission deems it necessary or appropriate in the public interest or for the protection of investors that certain specified provisions of this subchapter pertaining to registered investment companies shall be applicable in respect of such company, the provisions so specified shall apply to such company, and to other persons in their transactions and relations with such company, as though such company were a registered investment company.

(f) Exemption of closed-end company treated as business development company. Any closed-end company which--

(1) elects to be treated as a business development company pursuant to section 80a-53 of this title; or

(2) would be excluded from the definition of an investment company by section 80a-3(c)(1) of this title, except that it presently proposes to make a public offering of its securities as a business development company, and has notified the Commission, in a form and manner which the Commission may, by rule, prescribe, that it intends in good faith to file, within 90 days, a notification of election to become subject to the provisions of sections 80a-54 through 80a-64 of this title, shall be exempt from sections 80a-1 through 80a-52 of this title, except to the extent provided in sections 80a-54 through 80a-64 of this title.

**15 U.S.C. § 78mm**

§ 78mm. General exemptive authority

(a) Authority

(1) In general

Except as provided in subsection (b) of this section, but notwithstanding any other provision of this chapter, the Commission, by rule, regulation, or order, may conditionally or unconditionally exempt any person, security, or transaction, or any class or classes of persons, securities, or transactions, from any provision or provisions of this title or of any rule or regulation thereunder, to the extent that such exemption is necessary or appropriate in the public interest, and is consistent with the protection of investors.

(2) Procedures

The Commission shall, by rule or regulation, determine the procedures under which an exemptive order under this section shall be granted and may, in its sole discretion, decline to entertain any application for an order of exemption under this section.

(b) Limitation

The Commission may not, under this section, exempt any person, security, or transaction, or any class or classes of persons, securities, or transactions from section 78o-5 of this title or the rules or regulations issued thereunder or (for purposes of section 78o-5 of this title and the rules and regulations issued thereunder) from any definition in paragraph (42), (43), (44), or (45) of section 78c(a) of this title.

(c) Derivatives

Unless the Commission is expressly authorized by any provision described in this subsection to grant exemptions, the Commission shall not grant exemptions, with respect to amendments made by subtitle B of the Wall Street Transparency and Accountability Act of 2010, with respect to paragraphs (65), (66), (68), (69), (70), (71), (72), (73), (74), (75), (76), and (79) of section 78c(a) of this title, and sections 78j-2(a), 78j-2(b), 78j-2(c), 78m-1, 78o-10, 78q-1(g), 78q-1(h), 78q-1(i), 78q-1(j), 78q-1(k), and 78q-1(l) of this title; provided that the Commission shall have exemptive authority under this title with respect to security-based swaps as to the same matters that the Commodity Futures Trading Commission has under the Wall Street Transparency and Accountability Act of 2010 with respect to swaps, including under section 6(c) of title 7.

**15 U.S.C. § 80a-42**

§ 80a-42. Court review of orders

(a) Any person or party aggrieved by an order issued by the Commission under this title may obtain a review of such order in the circuit court of appeals of the United States within any circuit wherein such person resides or has his principal place of business, or in the United States Court of Appeals for the District of Columbia, by filing in such court, within sixty days after the entry of such order, a written petition praying that the order of the Commission be modified or set aside in whole or in part. A copy of such petition shall be forthwith transmitted by the clerk of the court to any member of the Commission or any officer thereof designated by the Commission for that purpose, and thereupon the Commission shall file in the court the record upon which the order complained of was entered, as provided in section 2112 of title 28, United States Code. Upon the filing of such petition such court shall have jurisdiction, which upon the filing of the record shall be exclusive, to affirm, modify, or set aside such order, in whole or in part. No objection to the order of the Commission shall be considered by the court unless such objection shall have been urged before the Commission or unless there were reasonable grounds for failure so to do. The findings of the Commission as to the facts, if supported by substantial evidence, shall be conclusive. If application is made to the court for leave to adduce additional evidence, and it is shown to the satisfaction of the court that such additional evidence is material and that there were reasonable grounds for failure to adduce such evidence in the proceeding before the Commission, the court may order such additional evidence to be taken before the Commission and to be adduced upon the hearing in such manner and upon such terms and conditions as to the court may seem proper. The Commission may modify its findings as to the facts by reason of the additional evidence so taken, and it shall file with the court such modified or new findings, which, if supported by substantial evidence, shall be conclusive, and its recommendation, if any, for the modification or setting aside of the original order. The judgment and decree of the court affirming, modifying, or setting aside, in whole or in part, any such order of the Commission shall be final, subject to review by the Supreme Court of the United States upon certiorari or certification as provided in section 1254 of title 28, United States Code.
(b) The commencement of proceedings under subsection (a) to review an order of the Commission issued under section 80a-8(e) of this title shall operate as a stay of the Commission's order unless the court otherwise orders. The commencement of proceedings under subsection (a) to review an order of the Commission issued

under any provision of this title other than section 80a-8(e) of this title shall not operate as a stay of the Commission's order unless the court specifically so orders.

**15 U.S.C. § 78y**

§ 78y. Court review of orders and rules

(a) Final Commission orders; persons aggrieved; petition; record; findings; affirmance, modification, enforcement, or setting aside of orders; remand to adduce additional evidence

(1) A person aggrieved by a final order of the Commission entered pursuant to this title may obtain review of the order in the United States Court of Appeals for the circuit in which he resides or has his principal place of business, or for the District of Columbia Circuit, by filing in such court, within sixty days after the entry of the order, a written petition requesting that the order be modified or set aside in whole or in part.

(2) A copy of the petition shall be transmitted forthwith by the clerk of the court to a member of the Commission or an officer designated by the Commission for that purpose. Thereupon the Commission shall file in the court the record on which the order complained of is entered, as provided in section 2112 of title 28, United States Code, and the Federal Rules of Appellate Procedure.

(3) On the filing of the petition, the court has jurisdiction, which becomes exclusive on the filing of the record, to affirm or modify and enforce or to set aside the order in whole or in part.

(4) The findings of the Commission as to the facts, if supported by substantial evidence, are conclusive.

(5) If either party applies to the court for leave to adduce additional evidence and shows to the satisfaction of the court that the additional evidence is material and that there was reasonable ground for failure to adduce it before the Commission, the court may remand the case to the Commission for further proceedings, in whatever manner and on whatever conditions the court considers appropriate. If the case is remanded to the Commission, it shall file in the court a supplemental record containing any new evidence, any further or modified findings, and any new order.

(b) Commission rules; persons adversely affected; petition; record; affirmance, enforcement, or setting aside of rules; findings; transfer of proceedings

(1) A person adversely affected by a rule of the Commission promulgated pursuant to section 6, 9(h)(2), 11, 11A, 15(c)(5) or (6), 15A, 17, 17A, or 19 of this title may obtain review of this rule in the United States Court of Appeals for the circuit in which he resides or has his principal place of business or for the District of Columbia Circuit, by filing in such court,

within sixty days after the promulgation of the rule, a written petition requesting that the rule be set aside.

(2) A copy of the petition shall be transmitted forthwith by the clerk of the court to a member of the Commission or an officer designated for that purpose. Thereupon, the Commission shall file in the court the rule under review and any documents referred to therein, the Commission's notice of proposed rulemaking and any documents referred to therein, all written submissions and the transcript of any oral presentations in the rulemaking, factual information not included in the foregoing that was considered by the Commission in the promulgation of the rule or proffered by the Commission as pertinent to the rule, the report of any advisory committee received or considered by the Commission in the rulemaking, and any other materials prescribed by the court.

(3) On the filing of the petition, the court has jurisdiction, which becomes exclusive on the filing of the materials set forth in paragraph (2) of this subsection, to affirm and enforce or to set aside the rule.

(4) The findings of the Commission as to the facts identified by the Commission as the basis, in whole or in part, of the rule, if supported by substantial evidence, are conclusive. The court shall affirm and enforce the rule unless the Commission's action in promulgating the rule is found to be arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law; contrary to constitutional right, power, privilege, or immunity; in excess of statutory jurisdiction, authority, or limitations, or short of statutory right; or without observance of procedure required by law.

(5) If proceedings have been instituted under this subsection in two or more courts of appeals with respect to the same rule, the Commission shall file the materials set forth in paragraph (2) of this subsection in that court in which a proceeding was first instituted. The other courts shall thereupon transfer all such proceedings to the court in which the materials have been filed. For the convenience of the parties in the interest of justice that court may thereafter transfer all the proceedings to any other circuit court of appeals.

(c) Objections not urged before Commission; stay of orders and rules; transfer of enforcement or review proceedings

(1) No objection to an order or rule of the Commission, for which review is sought under this section, may be considered by the court unless it was urged before the Commission or there was reasonable ground for failure to do so.

(2) The filing of a petition under this section does not operate as a stay of the Commission's order or rule. Until the court's jurisdiction becomes exclusive, the Commission may stay its order or rule pending judicial review if it finds

that justice so requires. After the filing of a petition under this section, the court, on whatever conditions may be required and to the extent necessary to prevent irreparable injury, may issue all necessary and appropriate process to stay the order or rule or to preserve status or rights pending its review; but (notwithstanding section 705 of title 5, United States Code) no such process may be issued by the court before the filing of the record or the materials set forth in subsection (b)(2) of this section unless: (A) the Commission has denied a stay or failed to grant requested relief, (B) a reasonable period has expired since the filing of an application for a stay without a decision by the Commission, or (C) there was reasonable ground for failure to apply to the Commission.

(3) When the same order or rule is the subject of one or more petitions for review filed under this section and an action for enforcement filed in a district court of the United States under section 78u(d) or (e) of this title, that court in which the petition or the action is first filed has jurisdiction with respect to the order or rule to the exclusion of any other court, and thereupon all such proceedings shall be transferred to that court; but, for the convenience of the parties in the interest of justice, that court may thereafter transfer all the proceedings to any other court of appeals or district court of the United States, whether or not a petition for review or an action for enforcement was originally filed in the transferee court. The scope of review by a district court under section 78(u)(d) or (e) of this title is in all cases the same as by a court of appeals under this section.

(d) Other appropriate regulatory agencies

(1) For purposes of the preceding subsections of this section, the term "Commission" includes the agencies enumerated in section 78c(a)(34) of this title insofar as such agencies are acting pursuant to this title and the Secretary of the Treasury insofar as he is acting pursuant to section 78o-5 of this title.

(2) For purposes of subsection (a)(4) of this section and section 706 of title 5, United States Code, an order of the Commission pursuant to section 78s(a) of this title denying registration to a clearing agency for which the Commission is not the appropriate regulatory agency or pursuant to section 78s(b) of this title disapproving a proposed rule change by such a clearing agency shall be deemed to be an order of the appropriate regulatory agency for such clearing agency insofar as such order was entered by reason of a determination by such appropriate regulatory agency pursuant to section 78s(a)(2)(C) or 78s(b)(4)(C) of this title that such registration or proposed rule change would be inconsistent with the safeguarding of securities or funds.

**17 C.F.R. § 270.22c-1**

§ 270.22c-1. Pricing of redeemable securities for distribution, redemption, and repurchase

(a) No registered investment company issuing any redeemable security, no person designated in such issuer's prospectus as authorized to consummate transactions in any such security, and no principal underwriter of, or dealer in, any such security shall sell, redeem, or repurchase any such security except at a price based on the current net asset value of such security which is next computed after receipt of a tender of such security for redemption or of an order to purchase or sell such security: Provided, That:

(1) This paragraph shall not prevent a sponsor of a unit investment trust (hereinafter referred to as the "Trust") engaged exclusively in the business of investing in eligible trust securities (as defined in Rule 14a-3(b) (17 CFR 270.14a-3(b))) from selling or repurchasing Trust units in a secondary market at a price based on the offering side evaluation of the eligible trust securities in the Trust's portfolio, determined at any time on the last business day of each week, effective for all sales made during the following week, if on the days that such sales or repurchases are made the sponsor receives a letter from a qualified evaluator stating, in its opinion, that:

(i) In the case of repurchases, the current bid price is not higher than the offering side evaluation, computed on the last business day of the previous week; and

(ii) In the case of resales, the offering side evaluation, computed as of the last business day of the previous week, is not more than one-half of one percent ($5.00 on a unit representing $1,000 principal amount of eligible trust securities) greater than the current offering price.

(2) This paragraph shall not prevent any registered investment company from adjusting the price of its redeemable securities sold pursuant to a merger, consolidation or purchase of substantially all of the assets of a company which meets the conditions specified in §270.17a-8.

(b) For the purposes of this section,

(1) The current net asset value of any such security shall be computed no less frequently than once daily, Monday through Friday, at the specific time or times during the day that the board of directors of the investment company sets, in accordance with paragraph (e) of this section, except on:

(i) Days on which changes in the value of the investment company's portfolio securities will not materially affect the current net asset value of the investment company's redeemable securities;

(ii) Days during which no security is tendered for redemption and no order to purchase or sell such security is received by the investment company; or

(iii) Customary national business holidays described or listed in the prospectus and local and regional business holidays listed in the prospectus; and

(2) A "qualified evaluator" shall mean any evaluator which represents it is in a position to determine, on the basis of an informal evaluation of the eligible trust securities held in the Trust's portfolio, whether --

(i) The current bid price is higher than the offering side evaluation, computed on the last business day of the previous week, and

(ii) The offering side evaluation, computed as of the last business day of the previous week, is more than one-half of one percent ($5.00 on a unit representing $1,000 principal amount of eligible trust securities) greater than the current offering price.

(c) Notwithstanding the provisions above, any registered separate account offering variable annuity contracts, any person designated in such account's prospectus as authorized to consummate transactions in such contracts, and any principal underwriter of or dealer in such contracts shall be permitted to apply the initial purchase payment for any such contract at a price based on the current net asset value of such contract which is next computed:

(1) Not later than two business days after receipt of the order to purchase by the insurance company sponsoring the separate account ("insurer"), if the contract application and other information necessary for processing the order to purchase (collectively, "application") are complete upon receipt; or

(2) Not later than two business days after an application which is incomplete upon receipt by the insurer is made complete, Provided, That, if an incomplete application is not made complete within five business days after receipt,

(i) The prospective purchaser shall be informed of the reasons for the delay, and

(ii) The initial purchase payment shall be returned immediately and in full, unless the prospective purchaser specifically consents to the insurer retaining the purchase payment until the application is made complete.

(3) As used in this section:

(i) Prospective Purchaser shall mean either an individual contractowner or an individual participant in a group contract.

(ii) Initial Purchase Payment shall refer to the first purchase payment submitted to the insurer by, or on behalf of, a prospective purchaser.

(d) The board of directors shall initially set the time or times during the day that the current net asset value shall be computed, and shall make and approve such changes as the board deems necessary.

**17 C.F.R. § 270.2a-4**

§ 270.2a-4. Definition of "current net asset value" for use in computing periodically the current price of redeemable security

(a) The current net asset value of any redeemable security issued by a registered investment company used in computing periodically the current price for the purpose of distribution, redemption, and repurchase means an amount which reflects calculations, whether or not recorded in the books of account, made substantially in accordance with the following, with estimates used where necessary or appropriate.

(1) Portfolio securities with respect to which market quotations are readily available shall be valued at current market value, and other securities and assets shall be valued at fair value as determined in good faith by the board of directors of the registered company.

(2) Changes in holdings of portfolio securities shall be reflected no later than in the first calculation on the first business day following the trade date.

(3) Changes in the number of outstanding shares of the registered company resulting from distributions, redemptions, and repurchases shall be reflected no later than in the first calculation on the first business day following such change.

(4) Expenses, including any investment advisory fees, shall be included to date of calculation. Appropriate provision shall be made for Federal income taxes if required. Investment companies which retain realized capital gains designated as a distribution to shareholders shall comply with paragraph (h) of §210.6-03 of Regulation S-X.

(5) Dividends receivable shall be included to date of calculation either at ex-dividend dates or record dates, as appropriate.

(6) Interest income and other income shall be included to date of calculation.

(b) The items which would otherwise be required to be reflected by paragraphs (a) (4) and (6) of this section need not be so reflected if cumulatively, when netted, they do not amount to as much as one cent per outstanding share.

(c) Notwithstanding the requirements of paragraph (a) of this section, any interim determination of current net asset value between calculations made as of the close of the New York Stock Exchange on the preceding business day and the current business day may be estimated so as to reflect any change in current net asset value since the closing calculation on the preceding business day.

**17 C.F.R. § 210.4-01**

§ 210.4-01. Form, order, and terminology

(a) Financial statements should be filed in such form and order, and should use such generally accepted terminology, as will best indicate their significance and character in the light of the provisions applicable thereto. The information required with respect to any statement shall be furnished as a minimum requirement to which shall be added such further material information as is necessary to make the required statements, in the light of the circumstances under which they are made, not misleading.

(1) Financial statements filed with the Commission which are not prepared in accordance with generally accepted accounting principles will be presumed to be misleading or inaccurate, despite footnote or other disclosures, unless the Commission has otherwise provided. This article and other articles of Regulation S-X provide clarification of certain disclosures which must be included in any event, in financial statements filed with the Commission.

(2) In all filings of foreign private issuers (see §230.405 of this chapter), except as stated otherwise in the applicable form, the financial statements may be prepared according to a comprehensive set of accounting principles, other than those generally accepted in the United States or International Financial Reporting Standards as issued by the International Accounting Standards Board, if a reconciliation to U.S. Generally Accepted Accounting Principles and the provisions of Regulation S-X of the type specified in Item 18 of Form 20-F (§249.220f of this chapter) is also filed as part of the financial statements. Alternatively, the financial statements may be prepared according to U.S. Generally Accepted Accounting Principles or International Financial Reporting Standards as issued by the International Accounting Standards Board.

(3)

(i) Notwithstanding the effective dates set forth in FASB ASC Topic 718, Compensation--Stock Compensation, financial statements shall be prepared in accordance with FASB ASC Topic 718 beginning with:

(A) The first interim or annual reporting period of the registrant's first fiscal year beginning on or after June 15, 2005, provided the registrant does not file as a smaller reporting company; and

(B) The first interim or annual reporting period of the registrant's first fiscal year beginning on or after December 15, 2005, provided the registrant files as a smaller reporting company.

(ii) For periods prior to the effective dates set forth in this paragraph, FASB ASC Topic 718 and prior authoritative guidance, shall be considered to be generally accepted accounting principles.

(b) All money amounts required to be shown in financial statements may be expressed in whole dollars or multiples thereof, as appropriate: Provided, That, when stated in other than whole dollars, an indication to that effect is inserted immediately beneath the caption of the statement or schedule, at the top of the money columns, or at an appropriate point in narrative material.

(c) Negative amounts (red figures) shall be shown in a manner which clearly distinguishes the negative attribute. When determining methods of display, consideration should be given to the limitations of reproduction and microfilming processes.

**5 U.S.C. § 706**

§ 706. Scope of Review

To the extent necessary to decision and when presented, the reviewing court shall decide all relevant questions of law, interpret constitutional and statutory provisions, and determine the meaning or applicability of the terms of an agency action. The reviewing court shall--

(1) compel agency action unlawfully withheld or unreasonably delayed; and

(2) hold unlawful and set aside agency action, findings, and conclusions found to be--

(A) arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law;

(B) contrary to constitutional right, power, privilege, or immunity;

(C) in excess of statutory jurisdiction, authority, or limitations, or short of statutory right;

(D) without observance of procedure required by law;

(E) unsupported by substantial evidence in a case subject to sections 556 and 557 of this title or otherwise reviewed on the record of an agency hearing provided by statute; or

(F) unwarranted by the facts to the extent that the facts are subject to trial de novo by the reviewing court.

In making the foregoing determinations, the court shall review the whole record or those parts of it cited by a party, and due account shall be taken of the rule of prejudicial error.