CENTER FOR CAPITAL MARKETS COMPETITIVENESS
OF THE
UNITED STATES CHAMBER OF COMMERCE

DAVID T. HIRSCHMANN
PRESIDENT AND CHIEF EXECUTIVE OFFICER

1615 H STREET, NW
WASHINGTON, DC 20062-2000
202/463-5609 • 202/955-1152 FAX
david.hirschmann@uschamber.com

April 16, 2012

The Honorable Timothy F. Geithner
Secretary
Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

Re: Notice of Proposed Rulemaking; Notice of Public Hearing; and Withdrawal of Previously Proposed Rulemaking Guidance on Reporting Interest Paid to Nonresident Aliens REG 146097-09

Dear Secretary Geithner:

The U.S. Chamber of Commerce ("Chamber") is the world's largest business federation representing over three million companies of every size, sector and region. The Chamber created the Center for Capital Markets Competitiveness ("CCMC") to promote a modern and effective regulatory structure for capital markets to fully function in a 21st century economy.

The CCMC welcomes the opportunity to comment on the proposed rulemaking on reporting of interest paid to nonresident aliens ("proposal"). While the Chamber strongly supports efforts to combat money laundering and tax evasion, we must raise serious concerns regarding the adverse impacts of the proposal upon capital formation in the United States which is a necessary component of business expansion and job creation. Accordingly, the Chamber respectfully requests that the proposal, in its current form, be withdrawn and any future rulemakings contain a rigorous public cost-benefit analysis that will allow commenters to have actual estimates that they may comment on. The Chamber has also submitted a comment letter on an earlier release of the proposal.

If the proposal is finalized in its current form, trillions of dollars of foreign capital deposited in U.S. financial institutions will be at risk of being moved abroad. Such an exodus of capital will constrain domestic lending by financial institutions needed to fuel business expansion, economic recovery and job creation. Additionally, a flight of capital of this size could undermine the ability of many institutions to comply with the enhanced capital and liquidity requirements currently being negotiated through the Basel III process or mandated through the Dodd-Frank Wall Street Reform and Consumer Protection Act.

Given the fragile state of America's economic recovery, it would appear that the proposal is a prescription of the wrong medicine at the wrong time.

Because of the significant adverse effects of this proposed regulation, it is critical that the proposed benefits outweigh the burden on the U.S. economy, and that the regulations are narrowly tailored to serve their regulatory purpose in a manner that poses the least burden on the U.S. economy as is practicable. While the Notice of Proposed Rulemaking has a discussion of the potential compliance burdens, as required under the Paperwork Reduction Act, there is no provision of an economic analysis quantifying the costs involved, or the potential outflows of capital from U.S. financial institutions and the resulting impacts associated with such activity. Analysis of that sort is critical for commenters to fully understand the potential costs of the proposal and to provide the Treasury with informed feed-back needed to develop a final rule. Also, because of the lack of an economic analysis it is unclear if the proposal is an economically significant rulemaking.

Furthermore, complying with the proposed regulation places additional reporting requirements and expenses upon financial firms. Without any real benefit stemming from the collection of this information, imposition of this reporting requirement seems to be a solution in search of a problem.

Finally, for these reasons, the Chamber has also supported the introduction of legislation, S. 1506, sponsored by Senator Marco Rubio, and H.R. 2568, sponsored by Representative Bill Posey, to prevent the finalization of the proposal in its final form.

The Chamber looks forward to working with the Treasury Department on efforts to prevent money laundering and tax evasion. However, given the significant costs of these proposed regulations and their potential negative effect on the fragile economic recovery, we respectfully request that Treasury withdraw the proposal, conduct a rigorous and transparent cost benefit analysis and not move forward with these or any substitute regulations without demonstrating that the proposed benefits of these regulations outweigh their significant costs to the American economy.

Sincerely,

David Hirschmann

CENTER FOR CAPITAL MARKETS COMPETITIVENESS

TOM QUAADMAN
VICE PRESIDENT

1615 H STREET, NW
WASHINGTON, DC 20062-2000
(202) 463-5540
tquaadman@uschamber.com

April 30, 2013

Mr. Robert deV. Frierson
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue NW
Washington, DC 20551

Re: **Enhanced Prudential Standards and Early Remediation Requirements for Foreign Banking Organizations and Foreign Nonbank Financial Companies; FR Doc 1438 and RIN-7100-AD-86**

Dear Mr. deV. Frierson:

The U.S. Chamber of Commerce ("Chamber") is the world's largest business federation, representing over three million companies of every size, sector and region. The Chamber created the Center for Capital Markets Competitiveness ("CMCC") to promote a modern and efficient regulatory structure for capital markets to fully function in the 21st Century economy. The CMCC welcomes the opportunity to comment on the proposed rule: *Enhanced Prudential Standards and Early Remediation Requirements for Foreign Banking Organizations and Foreign Nonbank Financial Companies* ("Proposal") published by the Board of Governors of the Federal Reserve ("Board") on December 14, 2012, regarding the supervision of foreign banking organizations and foreign nonbank financial companies (interchangeably referred to as "FBOs") designated by the Financial Stability Oversight Council ("FSOC") for supervision by the Board as systemically important financial institutions ("SIFIs").

The CCMC believes that the current Proposal—and potential overseas retaliatory actions—will place American businesses at a competitive disadvantage, harming economic growth and job creation.

The CMCC supports the efforts by federal regulators to monitor and address systemic risk. However, the CMCC is deeply concerned that the Proposal appears to be a significant change in how U.S. operations of FBOs are regulated, presenting

highly problematic issues not only for these U.S. based operations of FBOs, but also for their U.S. counterparts operating overseas. Accordingly, the Proposal may have the unintended consequence of causing FBOs to retrench from operations in the United States, leading to less capital formation for American businesses. Additionally, foreign governments may place similar restrictive measures on American banks operating overseas, making it more difficult for American businesses to have the access to resources needed to operate internationally, and thus causing them to face a competitive disadvantage overseas.

Specifically, the Chamber is concerned that the Proposal:

1) Fails to consider impacts on Main Street businesses and the economy;

2) Lacks appropriate cost-benefit analysis;

3) Subjects FBOs to disparate treatment by setting up a ring-fence approach that requires the establishment of an Intermediate Holding Company ("IHC") and applies discriminatory treatment to IHCs, as domestic counterparts are not required to meet the same capital, liquidity and other regulatory requirements; and

4) Places U.S.-owned subsidiaries operating abroad at risk of retaliatory disparate treatment as foreign governments may seek to impose reciprocal requirements on U.S. banks operating in their countries. This may undermine the global financial system.

These concerns are discussed in more detail below.

Discussion

In an effort to mitigate risks to the financial stability of the United States, Congress directed the Board in the Dodd Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") to establish heightened capital, liquidity, and other prudential requirements for designated SIFIs and bank holding companies with total consolidated assets of $50 billion or more ("Large BHCs"). Congress also directed the Board to: 1) give due regard to the principle of national treatment and equity of

competitive opportunity; and 2) take into account the extent to which the FBO is subject on a consolidated basis to comparable home country regulation.

I. The Proposal Fails to Consider Impacts Upon Main Street Businesses

The Board, in proposing, finalizing, and implementing the Proposal, must take into account the impact the rulemaking will have upon liquidity and capital formation for non-financial businesses. Financial institutions provide capital to businesses and serve as a conduit to match investors and lenders with entities that need funding. Banks, in particular, provide credit and lending that businesses use to expand and create jobs. Foreign capital is an important source of liquidity for Main Street businesses.[1]

Therefore, how the Proposal impacts the ability of financial institutions to lend and extend credit will have a direct bearing upon the ability of non-financial businesses to access the resources needed to operate and expand. For example, many American corporations rely on a syndicate of banks—comprised of both domestic and foreign banks—to support their credit facilities needed to finance operations. Without the participation of foreign banks, risk will be more highly concentrated in the remaining domestic banks, and domestic banks may not be willing to make up the shortfall left by foreign banks.[2] Furthermore, the Proposal may impact varying levels of activities such as having a counterparty needed to clear a transaction. In studying the Proposal it seems that the Board has not taken these non-financial business and economic impacts into account.

A contemplation of these issues is critical to insure that financial institutions are acting as the conduit needed to prime the pump of economic growth. Ring fencing FBOs may create overly prescriptive rules and restrictive capital standards for a particular segment of the financial sector that can dry up credit and lead to a similar inefficient allocation of capital, harming Main Street businesses and economic growth.

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[1] *See* letter of U.S. Chamber of Commerce to Treasury Secretary Timothy Geithner, April 16, 2012, regarding Reporting on Interest Paid to Nonresident Aliens REG 146097-09.

[2] *See* attachment: ***How Main Street Businesses Use Financial Services***. This survey of interviews, with 219 CFO's and corporate treasurers, explores the financial needs of mid-cap and large cap and how these Main Street businesses use commercial banking and other financial institutions to meet those capital and liquidity demands.

This is particularly true with the fragile economic and job growth market that we currently have.

II. Cost-Benefit Analysis

The Board is an independent Agency, but it has avowed that it will seek to abide by Executive Order 13563. Consistent with this approach, the Board has stated that it "continues to believe that [its] regulatory efforts should be designed to minimize regulatory burden consistent with the effective implementation of [its] statutory responsibilities."[3]

Executive Order 13563 places upon agencies the requirement, when promulgating rules, to:

1) Propose or adopt a regulation only upon a reasoned determination that its benefits justify its costs (recognizing that some benefits and costs are difficult to justify);

2) Tailor regulations to impose the least burden on society, consistent with obtaining regulatory objectives, taking into account, among other things, and to the extent practicable, the costs of cumulative regulations;

3) Select, in choosing among alternative regulatory approaches, those approaches that maximize net benefits (including potential economic, environmental, public health and safety and other advantages; distributive impacts; and equity);

4) To the extent feasible, specify performance objectives, rather than specifying the behavior or manner of compliance that regulated entities must adopt; and

5) Identify and assess available alternatives to direct regulation, including providing economic incentives to encourage the desired behavior, such as

[3] *See*, November 8, 2011, letter from Chairman Ben Bernanke to OIRA Administrator Cass Sunstein.

> user fees or marketable permits, or providing information upon which choices can be made to the public.[4]

Additionally, Executive Order 13563 states that "[i]n applying these principles, each agency is directed to use the best available techniques to quantify anticipated present and future benefits and costs as accurately as possible."

Conducting the rulemaking and its economic analysis under this unifying set of principles will facilitate a better understanding of the rulemaking and its impact on businesses and the American economy, and give stakeholders a better opportunity to provide regulators with informed comments and information. In studying the Proposal, the CCMC believes that such a rigorous cost-benefit and economic analysis is needed for commenters to fully understand the Proposal and analyze its impacts on the economy. Some sections of the Proposal state that such an analysis will only be undertaken after commenters have submitted comments.

Commenters have been deprived of the chance to provide regulators with the informed commentary needed for effective and efficient regulations. In March 2013, the CCMC released the attached report[5] on the role of cost-benefit analysis in financial services rulemaking and how those legal requirements lead to smarter regulation. We hope the Board provides commenters with a rigorous cost-benefit analysis to better understand the proposal and its impact upon the financial services industry and economy.

III. Creation of a New IHC, Disparate and Discriminatory Treatment

To comply with the Proposal, FBOs with total consolidated assets of $50 billion or more including at least $10 billion in U.S. based operations, must house all non-branch and non-agency U.S. operations, such as investment advisory, broker-dealer or insurance subsidiaries, in an IHC. Such a move would require significant internal reorganization that is costly, complex and difficult. This legal reorganization will no doubt create tax implications, the cost of which will likely be passed on to customers and borne by shareholders. Additionally, FBOs may face logistical challenges moving some of their U.S.-based subsidiaries into the IHC because, while

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[4] Executive Order 13563

[5] *See* attachment, *The Importance of Cost Benefit Analysis in Financial Regulation.*

the FBO may control 25% or more of the voting securities of a subsidiary, it may not have enough control over a subsidiary to make it a part of the IHC. This could lead many FBOs to consider curtailing their U.S. activities, ultimately limiting products and services available to U.S. customers.

Under the Proposal, U.S. subsidiaries of FBOs reorganized into an IHC are placed at a significant competitive disadvantage, some of which is discriminatory. First, regardless of whether the IHC includes a banking subsidiary of an FBO, it is subject to the same risk-based and leverage capital requirements that apply to Large BHCs. This means that for those IHC operations that are not banking related, they would be subject to enhance prudential regulation by the Board in addition to regulations by their primary regulator, such as the Securities and Exchange Commission.

Second, beyond discrimination, the supervisory structure outlined in the Proposal would also seem to undermine the role of the primary regulator and its regulations. In effect, the Proposal would force separate new requirements onto the subsidiaries of foreign-owned banks that similarly situated subsidiaries of U.S.-owned banks are not subjected to. In particular, the Board will be imposing its leverage requirements directly onto foreign owned-subsidiaries through an IHC while permitting U.S.-owned banking organizations to consolidate their subsidiaries under the parent's global capital without a separate IHC leverage requirement.

Third, because the threshold for requiring reorganization under an IHC is only $10 billion in total consolidated assets, IHCs will face significantly higher regulatory burdens and compliance costs from dual regulation than their U.S. competitors of equivalent size that face only their primary regulator. Some FBOs are estimating that compliance costs from the dual regulatory regime will individually exceed over $100 million with little to gain from the duplicative yet potentially conflicting regulatory regimes. Moreover, the Proposal permits U.S. firms to rely on their global balance sheet and capital while an FBO owning a U.S. nonbank subsidiary in the IHC is forced to apply U.S. bank capital and leverage ratios to its U.S. subsidiary on top of the subsidiary's capital requirements from its functional regulator.

Finally, the Proposal is being considered at the same time regulators are contemplating the proposed rulemaking to implement the Basel III capital agreements

("Basel III NPRs"). In our October 22, 2012 comment letter on the Basel III NPR's, the CCMC stated that there must be uniform application of Basel III for an international system of capital standards to work. At that time the CCMC expressed concerns that the European Union and member nations were taking steps to undermine such a uniform application. We have the same concerns with the Proposal, which places IHCs at a different capital level than their domestic counterparts. The Proposal therefore violates the principles of international consistency of global capital standards as articulated by the CCMC.

Given these concerns and those expressed by other commenters, the CCMC believes the Board should modify the Proposal in the following ways making it more effective and less burdensome:

1) Contingent convertible capital provided by a parent FBO to an IHC – including subordinated debt subject to "bail in"—should be counted as equity in that IHC.

2) While the proposal should also make clear that, so long as adequate capital and liquidity are kept in the U.S. to support the operating subsidiaries where losses may occur, structuring flexibility is appropriate.

3) Even where U.S. capital and other BHC requirements are deemed to apply to an IHC, we believe that greater flexibility should be provided to rely on a robust home country's supervisory and governance regime for calculating and implementing these requirements, especially under the Advanced Approaches of the Basel Agreements.

4) Any final rule should make clear that excess liquidity above the minimum amounts required should be permitted to flow freely outside of the U.S. to address needs in other parts of an FBO's operations.

5) To the extent that a substantially higher leverage ratio would be imposed on the IHC than would otherwise be required, that requirement should be phased in over time consistent with the Basel III timetable for phasing in the international leverage ratio.

IV. International Considerations

During the consideration of Dodd-Frank, Congress clearly expressed its intent on how FBOs are to be regulated in the U.S. It explicitly directed the Board to heed deference to an FBO's home country supervision, particularly when there is comparable consolidated supervisory regime.

By now requiring FBOs to reorganize U.S. operations under an IHC, the Board is undermining the home country supervisory regime that has been the cornerstone of financial services regulation. The CCMC has and continues to support efforts for increased coordination and communication amongst regulators through the G-20 process, which is also based upon the home country supervisory approach. By creating IHCs, it is reasonable to infer that two consequences will occur:

1) Foreign nations will require American banks to face similar or more restrictive ring fenced capital structures that will impede the operation of American banks overseas; and

2) The global financial framework will be Balkanized to such an extent that the efficient and effective flow of capital on a global basis will be impeded. This will have broader capital formation and liquidity impacts harming sectors such as trade, thereby impeding economic growth and financial stability.

Because of these concerns, the CCMC believes that a more appropriate way to address systemic risk posed by U.S. operations of FBOs is to address these issues on a global level, to ensure that a level playing field is set for all domestic and global entities worldwide. Accordingly, the talks to devise systems to monitor and regulate Globally Systemically Important Financial Institutions ("G-SIFIs") should also be used to deal with the FBO issues in the context of increased coordination and communication amongst the appropriate national regulators.

Conclusion

The CCMC is concerned that the Proposal fails to take into account the impacts upon Main Street businesses, and may harm the domestic and global financial systems that can harm the competitiveness of American non-financial—as well as financial—firms. The lack of an appropriate cost-benefit analysis also prevents commenters from providing the Board with informed commentary needed for appropriate rulemaking.

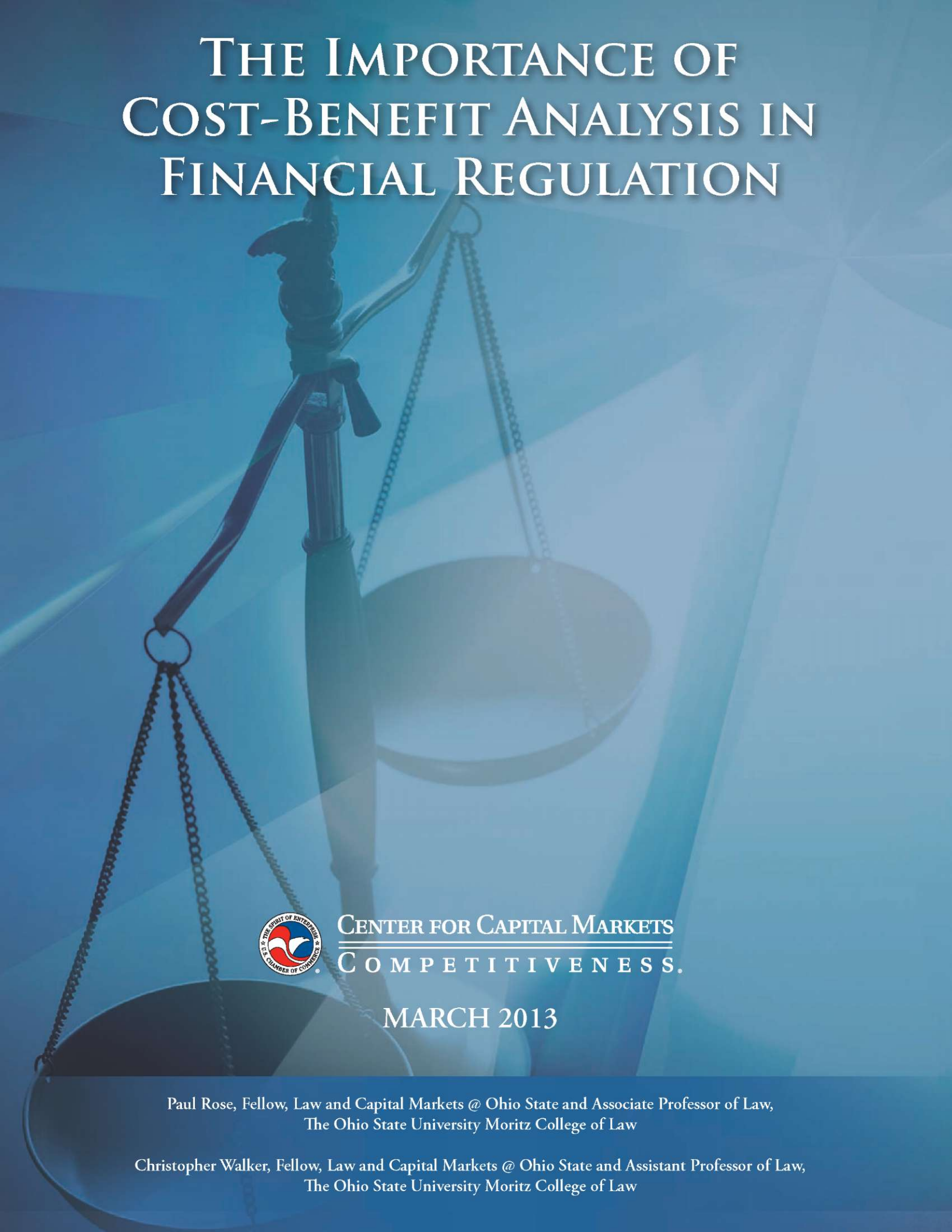
The CCMC also believes that the current Proposal will also prompt other nations to adopt similar ring-fencing rules for U.S. banks' foreign operations, which will tear apart the sinews of the modern global financial networks.

Rather than follow the approach put forward in the Proposal, we believe that the Board should engage with its international counterparts to use the existing home country supervisory system and mechanisms for dealing with G-SIFIs as the means for addressing risks posed by FBOs. Enhanced cross-border regulatory cooperation, coordination and communication is a preferable means to dealing with FBO issues rather than the construction of new regulatory systems and subsequent international responses that may cause more economic harm and threaten the global financial system.

Sincerely,

Tom Quaadman

The Importance of Cost-Benefit Analysis in Financial Regulation



Center for Capital Markets Competitiveness.

MARCH 2013

Paul Rose, Fellow, Law and Capital Markets @ Ohio State and Associate Professor of Law,
The Ohio State University Moritz College of Law

Christopher Walker, Fellow, Law and Capital Markets @ Ohio State and Assistant Professor of Law,
The Ohio State University Moritz College of Law

About the Authors

Paul Rose is an Associate Professor of Law at The Ohio State University Moritz College of Law and a fellow at Law and Capital Markets @ Ohio State. Professor Rose's research focuses on comparative corporate law, corporate finance, and securities regulation. He has been published in the Vanderbilt Law Review, the Georgetown Journal of International Law, and the North Carolina Law Review, among others. Prior to joining the Moritz faculty, Professor Rose held an appointment as the Visiting Assistant Professor in Securities and Finance at Northwestern University School of Law. He also practiced law in the corporate and securities practice group of Covington & Burling LLP's San Francisco office. Prior to attending law school, he worked as an assistant trader in equity and emerging market derivatives at Citibank, N.A. in New York.

Christopher Walker is an Assistant Professor of Law at The Ohio State University Moritz College of Law and a fellow at Law and Capital Markets @ Ohio State. Professor Walker's research focuses on administrative law, regulation, and the intersection of law and policy at the agency level. His work has appeared in the Stanford Law Review, Administrative Law Review, and Houston Law Review, among others. Prior to joining the Moritz faculty, Professor Walker clerked for Justice Anthony M. Kennedy of the U.S. Supreme Court and Judge Alex Kozinski of the U.S. Court of Appeals for the Ninth Circuit. He also previously worked in private practice as a trial and appellate litigator, where he represented plaintiffs and defendants in securities, antitrust, accounting fraud, and other commercial litigation, as well as on the Civil Appellate Staff at the U.S. Department of Justice, where he represented federal agencies and defended federal regulations in a variety of contexts.

Law and Capital Markets @ Ohio State is a program of The Moritz College of Law at The Ohio State University. The nonpartisan program aims to further the study of capital markets and corporate law, to enhance their regulation and operation.

CENTER FOR CAPITAL MARKETS COMPETITIVENESS.

Since its inception, the U.S. Chamber's Center for Capital Markets Competitiveness (CCMC) has led a bipartisan effort to modernize and strengthen the outmoded regulatory systems that have governed our capital markets. Ensuring an effective and robust capital formation system is essential to every business from the smallest start-up to the largest enterprise.

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The Importance of Cost-Benefit Analysis in Financial Regulation

Paul Rose & Christopher J. Walker

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The Importance of Cost-Benefit Analysis in Financial Regulation

Paul Rose & Christopher J. Walker

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EXECUTIVE SUMMARY

This report reviews the role, history, and application of cost-benefit analysis in rulemaking by financial services regulators.

For more than three decades—under both Democratic and Republican administrations—cost-benefit analysis has been a fundamental tool of effective regulation. There has been strong bipartisan support for ensuring regulators maximize the benefits of proposed regulations while implementing them in the most cost-effective manner possible. In short, it is both the right thing to do and the required thing to do.

Through the use of cost-benefit analysis in financial services regulation, regulators can determine if their proposals will actually work to solve the problem they are seeking to address. Basing regulations on the best available data is not a legal "hurdle" for regulators to overcome as they draft rules, as some have described it, but rather a fundamental building block to ensure regulations work as intended.

Not only do history and policy justify the use of cost-benefit analysis in financial regulation, but the law requires its use. In a trio of decisions culminating in its much-publicized 2011 decision in *Business Roundtable and U.S. Chamber of Commerce v. SEC*, the D.C. Circuit has interpreted the statutes governing the Securities and Exchange Commission (SEC) to require the agency to consider the costs and benefits of a proposed regulation. Thus, the SEC's failure to adequately conduct cost-benefit analysis, the D.C. Circuit has held, violates the Administrative Procedure Act. These judicial decisions have supporters as well as critics. However, the SEC's response is telling: the SEC did not seek further judicial review, but instead issued a guidance memorandum in March 2012 that embraced virtually all of the instructions the D.C. Circuit had provided in its decisions. It remains to be seen whether the SEC will put its new guidance memorandum into practice.

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank) only elevates the importance of cost-benefit analysis in financial regulation. By requiring nearly 400 rulemakings spread across more than 20 regulatory agencies, implementing Dodd-Frank is an unprecedented challenge for both regulators and regulated entities. The scale and scope of regulations have made it even more important, despite the short deadlines, for regulators to ensure they adequately consider the effectiveness and consequences of their proposals.

Accordingly, we recommend that all financial services regulators should follow similar protocols found in the SEC guidance memorandum and apply rigorous cost-benefit analysis to improve rulemaking and put in place more effective regulations. These steps also promote good government and improve democratic accountability.

There is widespread agreement that ineffective and outdated financial regulation contributed to the financial crisis. As regulators seek to address that, they must take every reasonable step to ensure that their proposals work. This starts with grounding all proposals in an economic analysis to better achieve the desired benefits and better understand the possible consequences and costs that may result from their actions.

INTRODUCTION

For more than three decades, under both Democratic and Republican administrations, cost-benefit analysis has been a fundamental tool in the modern administrative state. Both Congress and the Executive have taken numerous steps over the years to require federal agencies to engage in cost-benefit analysis when deciding how to regulate. Led by Cass Sunstein, who recently stepped down as President Obama's head of the Office of Information and Regulatory Affairs (OIRA), the Obama Administration has promoted the use of cost-benefit analysis—just like every administration since the Reagan Administration.

The Obama Administration continues to adhere to the standards for cost-benefit analysis set forth by the Reagan Administration and reconfirmed by the Clinton Administration, which require an executive agency to "adopt a regulation only upon a reasoned determination that the benefits of the intended regulation justify its costs"; "base . . . decisions on the best reasonably obtainable scientific, technical, economic, and other information concerning the need for, and consequences of, the intended regulation"; and "tailor its regulations to impose the least burden on society."[1] Indeed, by issuing Executive Order 13,563, the Obama Administration has strengthened the use of cost-benefit analysis—underscoring that the benefits must justify the costs of the proposed agency action, that unless the law provides otherwise the chosen approach must maximize net benefits, and that the agency must "use the best available techniques to quantify anticipated present and future benefits and costs as accurately as possible."[2]

Despite bipartisan support for the rigorous use of cost-benefit analysis in the modern administrative state—and its general acceptance by all three branches of the federal government—financial market regulators have been slower and more haphazard in adopting this method than their executive agency counterparts. At first blush, this failure may seem puzzling. These agencies are charged with regulating the financial markets and thus should be staffed with economists and analysts with extensive expertise in quantifying the economic effects of proposed market interventions. But, as discussed in Part I of this report, the reasons for this failure are largely historical, in that the executive orders requiring cost-benefit analysis by federal agencies expressly do not apply to independent agencies such as many financial regulators.

Critically, with respect to proposed and final rulemakings under the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd- Frank),[3] the absence or inadequacy of cost-benefit analysis is well documented. For instance, the Committee on Capital Markets Regulation has reviewed 192 proposed and final rules under Dodd-Frank and found that more than a quarter have no cost-benefit analysis at all, more than a third have entirely nonquantitative cost-benefit analysis, and the majority of the rules that have quantitative analysis limit it to administrative and similar costs (ignoring the broader economic impact).[4] Similarly, the

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[1] Exec. Order No. 12,866, 3 C.F.R. 638 (1993), *reprinted as amended in* 5 U.S.C. § 601 (2006).

[2] Exec. Order No. 13,563, 76 Fed. Reg. 3821 (Jan. 18, 2011).

[3] Pub. L. No. 111-203, 124 Stat. 1376 (2010).

[4] Letter to Congress from the Comm. on Cap. Mkt. Reg. Lack of Cost-Benefit Analysis in Dodd-Frank Rulemaking, at 3 (Mar. 7, 2012) [hereinafter COMM. CAPITAL MARKETS REG. REPORT], *available at* http://capmktsreg.org/2012/03/lack-of-cost-benefit-analysis-in-dodd-frank-rulemaking/. The rules analyzed were issued by 18 different federal agencies, commissions, and departments—including the independent financial

Inspectors General of the Securities and Exchange Commission (SEC) and the Commodity Futures Trading Commission (CFTC) have found serious deficiencies in the financial regulators' use of cost-benefit analysis after Dodd-Frank,[5] and the Government Accounting Office (GAO)—Congress's investigative arm—has faulted financial regulators for failing to monetize or quantify costs and benefits.[6] Finally, over the past decade the D.C. Circuit has repeatedly faulted the SEC's cost-benefit analysis in rulemaking, remarking most recently that the SEC had "neglected its statutory obligation to assess the economic consequences of its rule" and that the reason given for applying the rule in question to a particular group of financial institutions was "unutterably mindless."[7]

In response to this recent and widespread criticism of the Dodd-Frank regulators' failure to adequately conduct cost-benefit analysis in financial regulation, some have suggested that requiring financial regulators to conduct a proper cost-benefit analysis is wrong as a matter of policy and/or law. This report considers these arguments and concludes that the history and policies that motivate the use of cost-benefit analysis generally apply with equal (if not greater) force in the financial regulation context. Moreover, the law requires it. Financial regulators, especially in the context of Dodd-Frank, can and should ground their rulemaking in robust cost-benefit analysis in order to arrive at more rational decision-making and efficient regulatory action as well as to promote good governance and democratic accountability.

This report proceeds as follows: Part I introduces the history and importance of cost-benefit analysis in the modern administrative state, detailing how it has become a bipartisan, fundamental tool in agency rulemaking. Part I then examines the use of cost-benefit analysis in the context of financial markets regulation, where the Executive has not taken as many steps to encourage cost-benefit analysis due to the independent nature of the agencies that regulate the financial markets. This part explores how the SEC and other financial regulators have conducted (or failed to conduct) cost-benefit analysis before and after Dodd-Frank and reviews the recent reports and findings by the Inspector Generals of both the SEC and CFTC as well as by the GAO with respect to the use of cost-benefit analysis of rules proposed under Dodd-Frank.

Part II sets forth the policy considerations that motivate the use of cost-benefit analysis in the administrative state generally. These considerations include how cost-benefit analysis contributes to, among other things, more efficient regulations due to consideration of costs, benefits, and competing alternatives; a more rational and informed rulemaking process due to

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regulators discussed in this report. The summary of these rules is available at http://capmktsreg.org/pdfs/2012.03.06_CBA_chart.pdf.

[5] OFFICE OF THE INSPECTOR GEN. OF THE SEC, REPORT OF REVIEW OF ECONOMIC ANALYSES CONDUCTED BY THE SECURITIES AND EXCHANGE COMMISSION IN CONNECTION WITH DODD-FRANK ACT RULEMAKINGS (June 13, 2011) [hereinafter SEC IG 2011 REPORT], *available at* http://www.sec-oig.gov/Reports/AuditsInspections/2011/Report_6_13_11.pdf; OFFICE OF THE INSPECTOR GEN. OF THE CFTC, A REVIEW OF COST-BENEFIT ANALYSES PERFORMED BY THE COMMODITY FUTURES TRADING COMMISSION IN CONNECTION WITH RULEMAKINGS UNDERTAKEN PURSUANT TO THE DODD-FRANK ACT (June 13, 2011) [hereinafter CFTC IG REPORT], *available at* http://www.cftc.gov/ucm/groups/public/@aboutcftc/documents/file/oig_investigation_061311.pdf.

[6] GAO REPORT GAO-13-101, DODD-FRANK ACT REGULATIONS: AGENCIES' EFFORTS TO ANALYZE AND COORDINATE THEIR RULES (Dec. 2012) [hereinafter GAO 2012 REPORT], *available at* http://www.gao.gov/assets/660/650947.pdf.

[7] Bus. Roundtable & U.S. Chamber of Commerce v. SEC, 647 F.3d 1144, 1150, 1156 (D.C. Cir. 2011).

better consideration of costs, benefits, and alternatives; and a more transparent and thus politically accountable administrative state. Part II then turns to financial regulation in particular and concludes that the general policy considerations for cost-benefit analysis apply with equal force in the financial markets regulatory context. Indeed, some of the major criticisms of cost-benefit analysis in other contexts are of lesser relevance in the financial markets context. This part also responds to arguments against cost-benefit analysis in financial regulation, including claims that the use of cost-benefit analysis under Dodd-Frank is not possible or practical either because of the time-sensitive and critical nature of the financial regulations at issue or because of the agencies' inability to calculate the costs at issue. Such complications are not unique to Dodd-Frank or financial regulation, but arise in a variety of regulatory contexts where cost-benefit analysis is performed on a routine basis for the policy reasons discussed in this part.

Part III sets forth the law on the use of cost-benefit analysis in financial regulation. While the executive orders that require executive agencies to engage in cost-benefit analysis have not been extended to independent agencies such as the SEC and CFTC, the D.C. Circuit in a trio of opinions has interpreted the SEC's organic statutes to require the SEC to consider the costs and benefits of a proposed regulation.[8] Thus, the D.C. Circuit has held repeatedly that the failure to adequately conduct cost-benefit analysis constitutes arbitrary and capricious agency action, which the Administrative Procedure Act prohibits. This reading of the organic statutes to require cost-benefit analysis is consistent with the statutory text, which requires the agency to consider "the public interest," "investor protection," and "efficiency, competition, and capital formation."[9] Such a reading is reinforced by the policy considerations set forth in Part II, and the SEC's response indicates that it has accepted its responsibilities to conduct robust cost-benefit analysis in financial markets rulemaking.

I. THE HISTORY OF COST-BENEFIT ANALYSIS IN FEDERAL RULEMAKING

A. Cost-Benefit Analysis in the Modern Administrative State

Cost-benefit analysis ranks among the most important decision-making tools in the modern regulatory state. As early as 1902, Congress asked federal agencies to compare costs and benefits of proposed action,[10] and the New Deal saw the first large-scale deployment of the method, when the Flood Control Act of 1936 required that the Army Corps of Engineers take action only where benefits outweighed the costs.[11] The practice became more widespread in the 1950s and 1960s with the growth of the administrative state and the development of welfare economics concepts that supported the use of cost-benefit analysis in determining how to implement government policies.[12] In the past 30 years in particular, cost-benefit analysis has

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[8] *See Bus. Roundtable*, 647 F.3d at 1156; Am. Equity Inv. Life Ins. Co. v. SEC, 613 F.3d 166, 179 (D.C. Cir. 2010); Chamber of Commerce v. SEC, 412 F.3d 133, 136 (D.C. Cir. 2005).

[9] *See, e.g.*, 15 U.S.C. §§ 78c(f), 80a-2(c) (2012) ("Whenever pursuant to this chapter the [Securities Exchange] Commission is engaged in rulemaking . . . and is required to consider or determine whether an action is necessary or appropriate in the public interest, the Commission shall also consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation.").

[10] *See* River and Harbor Act of 1902, ch. 1079, § 3, 32 Stat. 331, 372 (1902).

[11] Daniel H. Cole, *Law, Politics, and Cost-Benefit Analysis*, 64 ALA. L. REV. 55, 56 (2012).

[12] *See* Matthew D. Adler & Eric A. Posner, *Rethinking Cost-Benefit Analysis*, 109 YALE L.J. 165, 169 (1999).

become a fundamental part of how federal agencies think about and ultimately select regulatory approaches, with all three branches of government participating in the creation of what Cass Sunstein has approvingly called "the cost-benefit state."[13]

1. Bipartisan Use of Cost-Benefit Analysis by Executive Agencies

The prominence of cost-benefit analysis owes primarily to a series of executive orders beginning with President Reagan in 1981. Executive Order 12,291 created a new procedure whereby the Office of Management and Budget (OMB) would review proposed agency regulations, and was intended to give the president greater control over agencies and improve the quality and consistency of agency rulemaking. Cost-benefit analysis formed the core of the review process: in "major" rulemakings,[14] agencies were required to weigh costs and benefits and submit their analyses to the OMB for review. The order made clear that the requirement was not merely procedural: "Regulatory action shall not be undertaken unless the potential benefits to society for the regulation outweigh the potential costs to society."[15] When an agency regulates, it must find that the benefits justify the costs of its chosen action.

Although President Clinton superseded President Reagan's order in 1993 with Executive Order 12,866,[16] cost-benefit analysis remained the central requirement of the new order. The Clinton Administration's adoption of cost-benefit analysis represented a remarkable rejection of claims that the review process was merely a partisan maneuver by the Reagan Administration aimed at delaying regulation rather than improving it.[17] The order begins with the statement that citizens deserve a regulatory system that provides public goods such as health, safety, and a clean environment "without imposing unacceptable or unreasonable costs on society."[18] Under Executive Order 12,866, "in deciding whether and how to regulate, agencies should assess all costs and benefits of available regulatory alternatives, including the alternative of not regulating."[19] Like its predecessor, Executive Order 12,866 declares that agencies must perform their analysis and choose the regulatory approach that maximizes net benefits.[20]

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[13] *See* CASS R. SUNSTEIN, THE COST-BENEFIT STATE: THE FUTURE OF REGULATORY PROTECTION (2002) [hereinafter SUNSTEIN, COST-BENEFIT STATE].

[14] "Major" rules are defined as "any regulation that is likely to result in: (1) An annual effect on the economy of $100 million or more; (2) A major increase in costs or prices for consumers, individual industries, Federal, State, or local government agencies, or geographic regions; or (3) Significant adverse effects on competition, employment, investment, productivity, innovation, or on the ability of United States-based enterprises to compete with foreign-based enterprises in domestic or export markets." 46 Fed. Reg. 13193, 13193 (Feb. 17, 1981).

[15] *Id.*

[16] Exec. Order No. 12,866, 3 C.F.R. 638 (1993).

[17] *See* Richard H. Pildes & Cass R. Sunstein, *Reinventing the Regulatory State*, 62 U. CHI. L. REV. 1, 6 (1995).

[18] Exec. Order No. 12,866.

[19] *Id.* § 1(a).

[20] *Id.* The Reagan and Clinton executive orders differ in several important respects, including that the Reagan order required that the benefits "outweigh" the costs whereas the Clinton order required only that the benefits "justify" the costs. *See generally* Peter M. Shane, *Political Accountability in a System of Checks and Balances: The Case of Presidential Review of Rulemaking*, 48 ARK. L. REV. 161, 176-78 (1994) (comparing the Reagan and Clinton executive orders in more detail and concluding that "[t]he Clinton order focuses on a similar mandate, but describes it with greater nuance").

The OMB has provided agencies with extensive guidance on performing cost-benefit analysis, particularly in Circular A-4.[21] Circular A-4 identifies three key elements to a sound regulatory analysis: (1) a statement of the need for the proposed regulation; (2) discussion of alternative regulatory approaches; and (3) an analysis of both qualitative and quantitative costs and benefits of the proposed action and the leading alternatives. The analysis should attempt to express both benefits and costs in a common measure—monetary units—to facilitate the assessment. When benefits or costs cannot be quantified in monetary terms or in some other quantitative measure, the agency should describe them qualitatively. To ensure that agencies properly perform cost-benefit analysis and select the most cost-effective regulatory options, OMB and OIRA review agency cost-benefit analysis before proposed regulations take effect.[22]

President Obama has reaffirmed the importance of cost-benefit analysis. In January 2011, he issued Executive Order 13,563, which reiterated the principles of Executive Order 12,866 as well as a mandate that "each agency must . . . propose or adopt a regulation only upon a reasoned determination that its benefits justify its costs (recognizing that some benefits and costs are difficult to quantify)."[23] In sum, with the bipartisan support of five presidential administrations, cost-benefit analysis has become an essential aspect of federal regulation.

2. Congressional and Judicial Support of Cost-Benefit Analysis

Both Congress and the courts have also embraced cost-benefit analysis. Several notable statutes—including the Toxic Substances Control Act; the Federal Insecticide, Fungicide and Rodenticide Act; and the Safe Drinking Water Act amendments—have explicitly required cost-benefit analysis for certain kinds of rulemaking.[24] Since the mid-1990s, Congress has exhibited some interest in a broader mandate that would apply to all rulemaking. In 1995, through the passage of the Unfunded Mandates Reform Act, Congress required agencies to prepare "a qualitative and quantitative assessment of the anticipated costs and benefits of the Federal mandate" when any rule might cause $100 million or more expenditures in a year.[25] The next year, the Congressional Review Act asked agencies to report any cost-benefit analysis they prepared to Congress and required agencies to determine whether each rule is likely to produce a $100 million impact on the economy. Congress has considered across-the-board cost-benefit analysis mandates for all rulemaking, but has so far not taken so dramatic a step. For their part, federal courts have both upheld an agency's prerogative to apply cost-benefit analysis even when

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[21] Office of Mgmt. & Budget, Circular No. A-4, Regulatory Analysis (Sept. 17, 2003) [hereinafter OMB Circular A-4], *available at* http:// www.whitehouse.gov/OMB/circulars/a004/a-4.pdf. This 48-page circular was subject to public comment in draft form, contains detailed instructions on how to conduct cost-benefit analysis, and provides a standard template for running the analysis.

[22] Exec. Order No. 12,866, § 2(b) (mentioning that normally the review process only covers "significant regulatory actions," which the order variously defines).

[23] Exec. Order 13,563, § 1(b), 76 Fed. Reg. 3821 (Jan. 18, 2011); *see also id.* ("[E]ach agency is directed to use the best available techniques to quantify anticipated present and future benefits and costs as accurately as possible."). For an early analysis of President Obama's approach to cost-benefit analysis, see Helen G. Boutrous, *Regulatory Review in the Obama Administration: Cost-Benefit Analysis for Everyone*, 62 ADMIN. L. REV. 243, 260 (2010).

[24] *See* SUNSTEIN, COST-BENEFIT STATE, *supra* note 13, at 14-15.

[25] 2 U.S.C. § 1532(a)(2).

it is not explicitly required by statute,[26] and carefully reviewed the quality of agency cost-benefit analysis when they are required by statute.[27]

B. Use of Cost-Benefit Analysis in Financial Regulation

Although financial market regulators have not entirely avoided the influence of cost-benefit analysis, for largely historical reasons they have adopted the method both more slowly and more haphazardly than many other agencies. The history of cost-benefit analysis by financial regulators begins with the early presidential orders requiring cost-benefit analysis for nonindependent agencies, and culminates in recent legal challenges to financial regulations that were not the product of a rigorous cost-benefit analysis.

Beginning with President Reagan's 1981 order, executive orders requiring cost-benefit analysis by federal agencies have specifically exempted independent agencies, including most of the major financial regulators, such as the SEC, CFTC, Federal Deposit Insurance Corporation (FDIC), and the Federal Reserve. Despite assurances from the Department of Justice that he could legally require independent agencies to perform cost-benefit analysis and conform their decisions to its results,[28] President Reagan excluded independent agencies perhaps out of fear of congressional backlash or out of an abundance of caution to preserve the agencies' independent status.[29] Subsequent administrations have also stopped short of requiring independent agencies to engage in cost-benefit analysis, though President Obama encouraged these agencies to perform the same analysis in Executive Order 13,579. As a result, these financial regulators have not developed cost-benefit analysis as rigorously as Executive Order 12,866 requires of executive agencies.[30]

1. Congressional Efforts to Require Cost-Benefit Analysis

Congress, however, has placed some economic analysis requirements on independent agencies.[31] For example, the National Securities Market Improvement Act of 1996 requires that in certain rulemaking the SEC consider not only investor protection—the driving purpose behind the statute—but also whether its proposed rule would "promote efficiency, competition, and capital formation."[32] The legislative history indicates that Congress intended to require cost-benefit analysis. For example, during markup one member of the House approvingly referred to a

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[26] *See, e.g.*, Michigan v. EPA, 213 F.3d 663, 677-78 (D.C. Cir. 2000).

[27] *See, e.g.*, Bus. Roundtable & U.S. Chamber of Commerce v. SEC, 647 F.3d 1144 (D.C. Cir. 2011). Judicial review of cost-benefit analysis in the financial regulation context is explored further in Part III.

[28] *See* PETER M. SHANE & HAROLD M. BRUFF, THE LAW OF PRESIDENTIAL POWER 355-60 (1988) (discussing issue and reprinting the memorandum on point issued by the Justice Department's Office of Legal Counsel).

[29] *See, e.g.*, Pildes & Sunstein, *supra* note 17, at 15; Peter L. Strauss, *The Place of Agencies in Government: Separation of Powers and the Fourth Branch*, 84 COLUM. L. REV. 573, 592-93 (1984).

[30] Edward Sherwin, *The Cost-Benefit Analysis of Financial Regulation: Lessons from the SEC's Stalled Mutual Fund Reform Effort*, 12 STAN. J.L. BUS. & FIN. 1, 17 (2006).

[31] For an overview, see GAO REPORT GAO-12-151, DODD-FRANK ACT REGULATIONS: IMPLEMENTATION COULD BENEFIT FROM ADDITIONAL ANALYSES AND COORDINATION (Nov. 2011) [hereinafter GAO 2011 REPORT], *available at* http://www.gao.gov/new.items/d12151.pdf.

[32] Securities Exchange Act of 1934, 15 U.S.C. §§ 77b(b), 78c(f), 80a-2(c) (2012).

"provision requiring cost benefit analysis in SEC rulemaking."[33] Moreover, the House Committee Report states that "[t]he Committee expects that the Commission will engage in rigorous analysis pursuant to this section" and that "the Commission shall analyze the potential costs and benefits of any rulemaking initiative, including, whenever practicable, specific analysis of such costs and benefits."[34] And, as discussed in Part III, the D.C. Circuit has interpreted the statutory language to impose on the SEC a "statutory obligation to do what it can to apprise itself—and hence the public and the Congress—of the economic consequences of a proposed regulation before it decides whether to adopt the measure."[35]

In 2012, Congress enacted the JOBS Act, in which it placed a similar requirement on the Public Company Accounting Oversight Board (PCAOB)—a self-regulated organization whose proposed rules are subject to SEC approval before taking effect. The JOBS Act provides that any PCAOB rules adopted after its enactment "shall not apply to an audit of any emerging growth company, unless the Commission determines that the application of such additional requirements is necessary or appropriate in the public interest, after considering the protection of investors and whether the action will promote efficiency, competition, and capital formation."[36]

The Commodity Exchange Act, as amended in 2000,[37] similarly requires the CFTC to consider the economic consequences of its rulemaking. Indeed, the CFTC expressly "shall consider the costs and benefits of the action of the Commission,"[38] including a number of explicit costs and benefits in addition to "efficiency, competitiveness, and financial integrity of future markets."[39]

Congress has further imposed cost-benefit analysis requirements on the newly created Consumer Financial Protection Bureau (CFPB). Dodd-Frank provides that the CFPB "shall consider—(i) the potential benefits and costs to consumers and covered persons, including the potential reduction of access by consumers to consumer financial products or services resulting

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[33] Opening Statement of Rep. Thomas J. Bliley, Jr., 1996 WL 270857 (F.D.C.H. May 15, 1996); *see also* Anthony W. Mongone, Note, Business Roundtable*: A New Level of Judicial Scrutiny and Its Implications in A Post-Dodd-Frank World*, 2012 COLUM. BUS. L. REV. 746, 755 ("The statute's legislative history makes clear that this enigmatic clause actually commands the SEC to perform a traditional cost-benefit analysis whenever it engages in rulemaking.").

[34] H.R. Rep. No. 104-622, at 39 (1996); *see also* James D. Cox & Benjamin J.C. Baucom, *The Emperor Has No Clothes: Confronting the D.C. Circuit's Usurpation of SEC Rulemaking Authority*, 90 TEX. L. REV. 1811, 1821 (2012) ("What is stated in the legislative history is that the SEC's 'consideration' is to entail rigorous analysis and evaluation of the potential costs and benefits of the proposed rule.").

[35] Chamber of Commerce v. SEC, 412 F.3d 133, 144 (D.C. Cir. 2005).

[36] Jumpstart Our Business Startups Act (JOBS Act), Pub. L. No. 112-106, § 104, 126 Stat 306 (Apr. 5, 2012).

[37] Commodity Futures Modernization Act of 2000, Pub. L. No. 106-554, 114, § 1(a)(5), Stat. 2763 (Dec. 21, 2000).

[38] 7 U.S.C. § 19 (a)(1) ("Before promulgating a regulation under this chapter or issuing an order (except as provided in paragraph (3)), the Commission shall consider the costs and benefits of the action of the Commission.").

[39] 7 U.S.C. § 19(a)(2) ("The costs and benefits of the proposed Commission action shall be evaluated in light of—(A) considerations of protection of market participants and the public; (B) considerations of the efficiency, competitiveness, and financial integrity of futures markets; (C) considerations of price discovery; (D) considerations of sound risk management practices; and (E) other public interest considerations.").

from such rule; and (ii) the impact of proposed rules on covered persons . . . and the impact on consumers in rural areas."[40]

Moreover, federal banking agencies—including the Federal Reserve, the FDIC, and the Comptroller of the Currency—are required by statute to "consider, consistent with the principles of safety and soundness and the public interest—(1) any administrative burdens that such regulations would place on depository institutions, including small depository institutions and customers of depository institutions; and (2) the benefits of such regulations."[41] The Federal Reserve further reports that it conducts rulemaking in line with the "philosophy and principles" of Executive Order 12,866, if not with the specific recommendations of Circular A-4.[42]

Congress has recently considered making explicit the president's authority to require cost-benefit analysis of independent agencies. In August 2012, bipartisan sponsors introduced the Independent Agency Regulatory Analysis Act of 2012 in the Senate. The bill would have authorized the president to require independent agencies to perform cost-benefit analysis and regulate only when benefits justify costs.[43] The bill stalled in the Senate Committee on Homeland Security and Governmental Affairs—perhaps due in part to the pressing "fiscal cliff" debates. Similarly, the House passed the SEC Regulatory Accountability Act,[44] which would have broadened the scope of economic analysis performed by the SEC, and Senator Shelby introduced the Financial Regulatory Responsibility Act,[45] which would have similarly enhanced the economic analysis and justification required for SEC rulemaking. It remains to be seen whether, or in what form, these bills will resurface in 2013.

2. Legal Challenges to SEC Rulemaking for Failed Cost-Benefit Analyses

Over the past several years, these financial regulators have come under increasing pressure to improve the quality of their cost-benefit analysis and move closer to the OMB guidelines applicable to other agencies. Some of this pressure has come from litigation, and the SEC's experience in the D.C. Circuit has demonstrated that courts take seriously the agency's statutory responsibilities to consider costs and benefits. In 2004, the SEC published a rule regulating the mutual fund industry under the Investment Company Act. The D.C. Circuit held that the SEC had failed to determine properly whether its regulations would "promote efficiency, competition, and capital formation."[46] In essence, this was a determination that the SEC had not weighed the costs of its rulemaking. Despite arguing before the court that it could not quantify the costs at issue, the SEC on remand proved capable, in a relatively short time, of a reasonably

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[40] 12 U.S.C. § 5512.

[41] 12 U.S.C. § 4802(a); *see also* 12 U.S.C. § 1462(5) (incorporating definition of "Federal banking agency" in 12 U.S.C. § 1813(q)).

[42] BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, RESPONSE TO A CONGRESSIONAL REQUEST REGARDING THE ECONOMIC ANALYSIS ASSOCIATED WITH SPECIFIED RULEMAKINGS 9 (June 2011), *available at* http://www.federalreserve.gov/oig/files/Congressional_Response_web.pdf.

[43] Independent Agency Regulatory Analysis Act of 2012, S. 3468, 112th Cong. § 3(a)(6) (2012).

[44] SEC Regulatory Accountability Act, H.R. 2308, 112th Cong. (2012).

[45] Financial Regulatory Responsibility Act of 2011, S. 1615, 112th Cong. (2012).

[46] Chamber of Commerce v. SEC, 412 F.3d 133, 142 (D.C. Cir. 2005).

thorough analysis of the effects its rulemaking would have on the regulated entities.[47] Again, in 2010, the D.C. Circuit struck down an SEC regulation on the same grounds, that its analysis of the economic effects of the rule was arbitrary and capricious.[48] Finally, in July 2011, the D.C. Circuit struck down a proxy-access rule made pursuant to Dodd-Frank.[49] These adverse rulings have applied new pressure on the SEC to carry out robust cost-benefit analysis.

3. GAO and OIG Reports on Dodd-Frank Rulemaking

Dodd-Frank has brought cost-benefit analysis in financial regulation to the fore by requiring financial regulators to promulgate hundreds of new rules. After Dodd-Frank rulemaking had begun, members of the U.S. Senate Committee on Banking, Housing, and Urban Affairs requested that the Inspectors General of the SEC, CFTC, FDIC, Federal Reserve Board, and Department of Treasury review their agencies' economic analyses in Dodd-Frank regulations. In June 2011, the Office of the Inspector General of the CFTC published its report. In its review of four rulemakings pursuant to Dodd-Frank, the report applauded the agency's recent development of a cost-benefit analysis methodology but faulted it in the first three rulemakings for leaving much of the analysis in the hands of agency lawyers rather than economists.[50] Although the report credited the agency with making progress in the most recent analysis, it still identified room for improvement, such as considering the CFTC's own internal costs of implementation.[51]

The internal audit by the SEC's Inspector General of six Dodd-Frank rulemakings, published in January 2012, uncovered more serious shortcomings.[52] Like the CFTC, the SEC often failed to account for the agency's own internal costs and benefits, and it also solicited too little input from economists. The result was a dearth of quantitative analysis, a failure to compare proposed action to a "no action" baseline, and inconsistent or faulty baseline assumptions that significantly reduced the value of the cost-benefit analysis as a decision-making tool. These findings are consistent with those of the Committee on Capital Markets Regulation, which has reviewed 192 proposed and final rules under Dodd-Frank and found that more than a quarter have no cost-benefit analysis at all, more than a third have entirely nonquantitative cost-benefit analysis, and the majority of the rules that have quantitative analysis limit it to administrative and similar costs (ignoring the broader economic impact).[53]

After reviewing the initial internal audits by the SEC, CFTC, and other financial regulators, the GAO released its own report in November 2011. The GAO found that the agencies' cost-benefit analysis methodologies fell well short of the OMB's guidance in Circular

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[47] Sherwin, *supra* note 30, at 34.

[48] Am. Equity Inv. Life Ins. Co. v. SEC, 613 F.3d 166, 178-79 (D.C. Cir. 2010).

[49] Bus. Roundtable & U.S. Chamber of Commerce v. SEC, 647 F.3d 1144, 1156 (D.C. Cir. 2011).

[50] CFTC IG REPORT, *supra* note 5, at ii.

[51] *Id.* at iii.

[52] OFFICE OF THE INSPECTOR GENERAL OF THE SEC, FOLLOW-UP REVIEW OF COST-BENEFIT ANALYSES IN SELECTED SEC DODD-FRANK RULEMAKINGS (Jan. 27, 2012) [hereinafter SEC IG 2012 REPORT], *available at* http://www.sec-oig.gov/Reports/AuditsInspections/2012/Rpt%20499_FollowUpReviewofD-F_CostBenefitAnalyses_508.pdf. In fact this report was a follow-up to an earlier report on the SEC's cost-benefit analysis process, published in June 2011. *See* SEC IG 2011 REPORT, *supra* note 5.

[53] COMM. CAPITAL MARKETS REG. REPORT, *supra* note 4, at 3.

A-4, despite the agencies' professed intentions to follow its principles. In particular, the GAO faulted the analyses for failing to monetize or quantify costs and benefits: "Without monetized or quantified benefits and costs, or an understanding of the reasons they cannot be monetized or quantified, it is difficult for businesses and consumers to determine if the most cost-beneficial regulatory alternative was selected or to understand the limitations of the analysis performed."[54] The GAO concluded that closer adherence to the OMB's principles would improve both transparency and sound decision-making.

In March 2012, the SEC responded to the criticism from the D.C. Circuit, Congress, and its own Inspector General by issuing a guidance memorandum outlining a new agency approach to cost-benefit analysis. Affirming that "[h]igh-quality economic analysis is an essential part of SEC rulemaking" and that the SEC "has long recognized that a rule's potential benefits and costs should be considered" in its rulemaking, the memorandum provides specific advice for conducting cost-benefit analysis and indicates that it should be performed in every economic analysis of rulemaking.[55] The SEC's 2012 Guidance Memorandum, which is discussed in more detail in Part III.C, draws heavily on the OMB's guidance in Circular A-4, as well as on comments from the D.C. Circuit when that court struck down SEC rules.

In response to the SEC's adoption of more robust cost-benefit analysis, those self-regulatory organizations whose rules must go through the SEC are also working to conduct more thorough economic analyses. Both the Financial Industry Regulatory Authority, which regulates securities firms operating in the United States, and the Municipal Securities Rulemaking Board, which regulates firms involved in the municipal securities industry, have signaled recently that they intend to take a harder look at costs and benefits before submitting rules to the SEC for approval.[56]

The trend seems to be clearly in favor of robust cost-benefit analysis for financial regulators. All branches of government and even financial regulators themselves have expressed acceptance of the importance of justifying the costs of regulatory action with benefits. What remains for these agencies is to put the words into action and duplicate the level of analytical sophistication of executive agencies that have been successfully employing cost-benefit analysis for decades. In December 2012, the GAO released a follow-up report to the November 2011 report on financial regulators' analyses of Dodd-Frank rulemaking. Financial regulators again told GAO auditors that they attempt to follow OMB's Circular A-4 "in principle or spirit," but in an analysis of all final rules in the past 12 months, the GAO concluded that the "CFTC, the Federal Reserve, and SEC did not present benefit-cost information in ways consistent with certain key elements of the OMB's Circular A-4."[57] Notably, the agencies often failed to assess costs and benefits quantitatively, and they rarely assessed costs and benefits of regulatory

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[54] GAO 2011 REPORT, *supra* note 31, at 17-18.

[55] SEC DIVISION OF RISK, STRATEGY, AND FINANCIAL INNOVATION AND SEC OFFICE OF THE GENERAL COUNSEL, CURRENT GUIDANCE ON ECONOMIC ANALYSIS IN SEC RULEMAKINGS 1, 4 (Mar. 16, 2012) [hereinafter 2012 GUIDANCE MEMORANDUM], *available at* http://www.sec.gov/divisions/riskfin/rsfi_guidance_econ_analy_secrulemaking.pdf.

[56] Nick Paraskeva, *U.S. Self-Regulatory Bodies Move Toward Cost-Benefit Analysis*, REUTERS (Oct. 9, 2012), *available at* http://blogs.reuters.com/financial-regulatory-forum/2012/10/09/u-s-self-regulatory-bodies-move-toward-cost-benefit-analysis/.

[57] GAO 2012 REPORT, *supra* note 6, at 16.

alternatives. Accordingly, much progress remains to be made before financial regulators achieve the level of cost-benefit analysis that has become the norm in the executive agency context.

II. POLICY CONSIDERATIONS FOR COST-BENEFIT ANALYSIS

A. General Policies Behind Cost-Benefit Analysis in the Regulatory State

As the history of cost-benefit analysis outlined in Part I suggests, cost-benefit analysis has emerged over the past several decades as a bipartisan methodology for reviewing government regulations on various subjects. The widespread acceptance of cost-benefit analysis in the modern regulatory state reflects the many policy considerations that favor its use. These considerations can be grouped in two main classes. First, cost-benefit analysis promotes more rational decision-making and more efficient regulatory actions. Second, when combined with notice-and-comment requirements, cost-benefit analysis promotes good public governance as a transparent, democratic, and accountable regulatory methodology.

1. Rational Decision-Making and Efficient Regulation

First, and perhaps most obviously, cost-benefit analysis improves the process of agency decision-making. At its core, cost-benefit analysis reflects a venerable, conventional methodology and wisdom on rational decision-making. As expressed, for example, in a 1772 letter that Benjamin Franklin wrote to his friend Joseph Priestley, listing the pros and cons of a solution on a piece of paper and carefully weighing them against one another provides a practical method for solving difficult problems. Franklin's "prudential algebra" resonates today as common sense. Advanced econometric analysis and the accumulated experience of diverse agencies applying cost-benefit analysis for many years have improved this intuitive method into a powerful tool for rational rulemaking.[58] As set forth in the following sections, cost-benefit analysis promotes rational administrative decision-making in several ways.

a. Ensuring Positive Regulatory Outcomes

First, cost-benefit analysis provides a decision-making process that helps to ensure that regulatory efforts produce a net positive effect on society.[59] That society gains enough from the regulation to justify its costs is, after all, a basic goal for all regulation. Regulators facing a problem rarely if ever have the option to choose among solutions that carry no costs. Choosing whether and how to regulate is generally a question of evaluating tradeoffs, and cost-benefit analysis requires an agency to consider the various economic effects of a particular regulation as opposed to alternatives (including the alternative of no regulation at all). Cost-benefit analysis provides a methodology that keeps regulators focused on the critical questions: What are the actual, quantifiable costs and benefits of the proposed regulation? How do these factors weigh against other values that are "difficult or impossible to quantify, including equity, human dignity, fairness, and distributive impacts"?[60] In light of these costs and benefits, how does this regulation compare to other possible solutions? Regulators should be asking all of these questions under

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[58] *See* EUSTON QUAH & RAYMOND TOH, COST-BENEFIT ANALYSIS: CASES AND MATERIALS 3, 8 (2012).

[59] *See* CASS R. SUNSTEIN, RISK AND REASON: SAFETY, LAW, AND THE ENVIRONMENT 22-23 (2002) [hereinafter SUNSTEIN, RISK AND REASON].

[60] Exec. Order 13,563, § 1(b), 76 Fed. Reg. 3821 (Jan. 18, 2011).

any decision-making regime. Cost-benefit analysis provides a structured method for asking and answering these questions.

b. Protecting and Enhancing Agency Rulemaking

Another value of the cost-benefit analysis methodology is that it protects agencies by providing them with a defensible regulatory process that not only is more efficient, but also is more likely to reduce the need for extensive revisions following public comments and will protect the agency against challenges to its regulations. For many regulations, Congress supplies some mandatory factors by statute, requiring agencies to take them into account in the decision-making process. Because agencies have a legal obligation to consider these factors, failure to do so can leave regulations open to challenge in court and can cause agencies to lose considerable time and resources defending or revising their rules. When combined with the notice-and-comment period required of federal agencies, cost-benefit analysis not only aids an agency in avoiding such problems, but also helps the agency to improve its rulemaking by providing a public process that outlines the justifications for favoring a particular regulatory solution.

c. Reducing the Risk of Unintended Consequences

In using the best available evidence and science to consider all relevant factors, agencies also minimize the risks of unintended consequences of regulation.[61] Regulators are often asked to respond to a problem that has recently come to the fore, typically as the result of an event or public debate that has caused Congress to act. Social science evidence suggests that people systematically overestimate the likelihood of events that come easily to mind.[62] Agency regulators are frequently susceptible to this bias. For example, a need for regulatory action may present itself because of recent high-profile events in which it was clear that existing regulation was inadequate, or inadequately or improperly enforced. In such a moment of heightened concern over regulatory inadequacies, cost-benefit analysis provides for a measured response and a healthy dose of rationality. To be sure, regulatory inadequacies may need to be resolved by swift and decisive action. However, when an agency focuses intently on one outcome—preventing a future catastrophe—its urgency may cause it to lose sight of other potential outcomes that could undermine its efforts. By conducting a cost-benefit analysis, the agency forces itself to quantify risks and reduce the likelihood that cognitive biases will negatively affect regulatory efforts. Cost-benefit analysis thus helps bring to light potential unintended consequences that may result from a particular regulatory action.

d. Regulating with Limited Resources

Finally, cost-benefit analysis helps promote rational decision-making by focusing regulators on the need to properly allocate their supervisory and enforcement resources.[63] Regulators must ensure not merely that their regulations provide benefits justify the costs, but that they make the most efficient use of limited resources. In practice, agencies resolve this question by evaluating alternatives and ensuring that the most efficient one is in place, not only

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[61] Cass R. Sunstein, *Congress, Constitutional Moments, and the Cost-Benefit State*, 48 STAN. L. REV. 247, 261-62 (1996) [hereinafter Sunstein, *Constitutional Moments*].

[62] *See* SUNSTEIN, RISK AND REASON *supra*, note 59, ch. 1.

[63] Sunstein, *Constitutional Moments*, *supra* note 61, at 308.

from the standpoint of the rule's impact on societal welfare generally but also from the standpoint of the agency's own supervisory and enforcement capabilities. If an agency can produce comparable outcomes in multiple ways, it should choose the one that does so at the least cost to society and to the agency itself. Without some kind of cost-benefit analysis, the agency has no grounds for making such a judgment. For this reason, the OMB's cost-benefit analysis guidelines require agencies to compare leading alternatives to the agency's chosen solution, including the baseline option of not regulating at all.[64] This process of comparison is critical to efficient resource allocation.

By requiring regulators to account for—and, indeed, attempt to quantify—the anticipated costs and benefits of the rules they promulgate, cost-benefit analysis increases the likelihood that rules will take into account all relevant considerations, produce net positive outcomes, protect and enhance agency legitimacy, avoid unintended consequences, and distribute resources efficiently. All of these considerations relate to the quality of the decision. A different class of considerations, discussed below, relates to a set of equally important values of good governance.

2. Good Governance and Democratic Accountability

Because federal agency officials wield considerable power but acquire their positions by appointment rather than directly through the democratic process, their regulations raise concerns of democratic legitimacy and accountability.[65] Proper cost-benefit analysis can help to alleviate these and other concerns by revealing to the public the decision-making process by which agency regulators make rules that can have enormous impact on the economy, the environment, and individual lives. Indeed, as Eric Posner has argued, "[t]he purpose of requiring agencies to perform cost-benefit analysis is not to ensure that regulations are efficient; it is to ensure that elected officials maintain power over agency regulation."[66] Cost-benefit analysis opens the decision-making process to public comment, and thus encourages the agency to consider the views of experts outside of the agency and helps mitigate the likelihood of agency capture.[67] Although Part II.A.1 noted the value of cost-benefit analysis as a means of protecting and enhancing regulations, cost-benefit analysis also furthers more general goals of enhancing governmental accountability, transparency, and legitimacy.

To appreciate the importance of the value of cost-benefit analysis in promoting good governance, consider the nature of federal regulation: Although Article I of the Constitution provides that "[a]ll legislative powers herein granted shall be vested in a Congress," Congress may delegate some of its policymaking authority to federal agencies.[68] Unlike members of

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[64] *See* OMB Circular A-4, *supra* note 21, at 2-3. As discussed in Part III.C, the SEC has also now embraced the need to define the baseline and consider reasonable alternatives.

[65] *See, e.g.*, Dorit Rubinstein Reiss, *Account Me in: Agencies in Quest of Accountability*, 19 J.L. & POL'Y 611, 615 (2011) ("Accountability of administrative agencies is an ongoing concern in the administrative state.")

[66] Eric A. Posner, *Controlling Agencies with Cost-Benefit Analysis: A Positive Political Theory Perspective*, 68 U. CHI. L. REV. 1137, 1141 (2001) [hereinafter Posner, *Controlling Agencies*].

[67] *See* 5 U.S.C. § 553 (2006); David Fontana, *Reforming the Administrative Procedure Act: Democracy Index Rulemaking*, 74 FORDHAM L. REV. 81, 91 (2005) (explaining that notice and comment "makes it much more difficult for there to be agency capture.").

[68] *See, e.g.*, David Epstein & Sharyn O'Halloran, *The Nondelegation Doctrine and the Separation of Powers: A Political Science Approach*, 20 CARDOZO L. REV. 947, 950 (1998) ("[L]egislators will delegate those issue areas where the normal legislative process is least efficient relative to regulatory policymaking by executive agencies.").

Congress, administrators are not elected. This means that citizens, who are bound by agency regulations, neither directly choose these administrators in the first place nor have the power to directly remove them. If agencies were merely enforcing the law, this system would raise fewer democratic accountability concerns. But agencies, though bound by their statutory authority, wield broad powers that have significant effects on individuals and the national economy. As the federal bureaucracy has grown over time, the president has come to take personal responsibility for much agency regulation. Nonetheless, tension remains between the modern administrative state and our democratic values.[69] Agencies can relieve some of this tension in two key ways. One is transparency, which allows the public to remain informed about agency actions, to reduce the likelihood of agency capture, and to hold Congress and the president accountable to the extent possible. The second is to exercise the technical expertise that at least in part justifies Congress delegating regulatory authority to agencies in the first place.

a. Promoting Transparency

Among the stated goals of Executive Order 12,866 is "to make the [regulatory] process more accessible and open to the public."[70] Cost-benefit analysis helps bring transparency to the regulatory process in several ways. At the most fundamental level it requires an agency to formally present—and attempt to quantify—its reasoning process.[71] This reveals what aspects of a problem the agency has taken into account and how it reckons the significance of the costs and benefits. One can challenge the agency's calculations or even its choices about what factors count in the decision-making process. "Armed with this information, the well-disposed president can scold, threaten, or punish agencies that do not produce welfare-maximizing regulations."[72] The same may be said for the voting public and for Congress, which holds agency purse strings. This ability is particularly important with respect to independent agencies that are otherwise insulated from accountability mechanisms that apply to executive agencies.[73]

Transparency is also critical to counteracting the potentially distorting influence of interest groups in the regulatory process.[74] Regulated parties can and should provide input into the development of regulations. But the possibility exists that private actors—whether the parties who are or will be subject to regulation, or others who stand to gain or lose from particular regulatory action—will gain undue influence over regulators.[75] This phenomenon of "agency capture" can occur for many reasons, including the revolving-door phenomenon whereby

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[69] *See* DAVID SCHOENBROD, POWER WITHOUT RESPONSIBILITY: HOW CONGRESS ABUSES PEOPLE THROUGH DELEGATION 14 (1995).

[70] Exec. Order 12,866 at 51735.

[71] OMB Circular A-4, *supra* note 21, at 11.

[72] MATTHEW D. ADLER & ERIC A. POSNER, NEW FOUNDATIONS OF COST-BENEFIT ANALYSIS 111 (2006).

[73] This is not to argue that certain federal agencies—including most financial regulators—should not be independent agencies. Regardless of the policy utility of their independence, however, independence often reduces the accountability of the regulator. *See* Elena Kagan, *Presidential Administration*, 114 HARV. L. REV. 2245, 2331-32 (2001) (explaining that "presidential leadership enhances transparency, enabling the public to comprehend more accurately the sources and nature of bureaucratic power" and it "establishes an electoral link between the public and the bureaucracy, increasing the latter's responsiveness to the former").

[74] *See* ADLER & POSNER, *supra* note 72, at 117.

[75] *See* Richard B. Stewart, *The Reformation of American Administrative Law*, 88 HARV. L. REV. 1669, 1713-14 (1975).

regulators anticipate taking or returning to jobs in industry and fear alienating the parties they regulate.[76] Cost-benefit analysis does not by itself prevent such influences, but it provides a significant check on them by requiring the agency to reveal the factors that underlie its analysis.[77] If interest-group pressure has distorted the agency's calculations of costs and benefits, the analysis is likely to reflect such influence and provide Congress, the president, the courts, and the public at large with an opportunity to demand corrections.[78]

b. Leveraging Agency Expertise

The second benefit of cost-benefit analysis relative to good governance is that it leverages the technical expertise of the agencies and, ideally, applies it in a neutral fashion to a particular regulatory problem.[79] Agencies do not begin rulemaking on a blank slate, surveying all of the possible solutions to a problem and seeking to choose the best. They begin with a mandate from Congress and often with strong policy preferences from the president. But Congress does not pass rulemaking authority to agencies simply in order to allow the president to shape the details of legislation, especially in the case of independent agencies.[80] Congress does so at least in part on the theory that agencies will bring to bear technical expertise that Congress lacks. Cost-benefit analysis facilitates the exercise of this expertise by providing agencies a framework that insulates the agencies from powerful political pressures. One way it does so is by staying focused on the objective effects of the policy in question; it does not take political or interest-group preferences into account.[81]

Undoubtedly, cost-benefit analysis involves subjective judgments, which raise the potential for manipulation.[82] But the same may be said for any decision-making process.[83] The virtue of cost-benefit is that it brings an agency's assumptions and calculations into the light, where interested parties can raise objections and demand improvements.[84] Furthermore, as markets and their regulations increase in complexity, agency expertise—and cost-benefit

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[76] Rachel E. Barkow, *Insulating Agencies: Avoiding Capture Through Institutional Design*, 89 TEX. L. REV. 15, 23 (2010).

[77] Posner, *Controlling Agencies*, *supra* note 66, at 1198.

[78] *See, e.g.*, Cole, *supra* note 11, at 86-87 (presenting a case study of the Clear Skies Act, in which media and interest groups successfully challenged a politically manipulated cost-benefit analysis); Posner, *Controlling Agencies*, *supra* note 66, at 1199 ("If they are unhappy with regulations that are issued, their real target should not be cost-benefit analysis, which is merely a tool for monitoring the agencies, but the goals of the President and Congress and the public that elects them.").

[79] John F. Manning, *Constitutional Structure and Judicial Deference to Agency Interpretations of Agency Rules*, 96 COLUM. L. REV. 612, 680-81, 686-90 (1996).

[80] Peter H. Aranson et al., *A Theory of Legislative Delegation*, 68 CORNELL L. REV. 1, 7 (1982).

[81] Julie G. Yap, *Just Keep Swimming: Guiding Environmental Stewardship Out of the Riptide of National Security*, 73 FORDHAM L. REV. 1289, 1326 (2004) ("[T]his method subjects the government to greater public accountability because the equation is both objective and easy to understand.").

[82] Frank Ackerman & Lisa Heinzerling, *Pricing the Priceless: Cost-Benefit Analysis of Environmental Protection*, 150 U. PA. L. REV. 1553, 1576 (2002).

[83] Katherine Renshaw, *Leaving the Fox to Guard the Henhouse: Bringing Accountability to Consultation Under the Endangered Species Act*, 32 COLUM. J. ENVTL. L. 161, 170 (2007) ("Agencies also retain the discretion to reject scientific evidence before them, as long as the decision to utilize one set of data rather than another is reasoned.").

[84] *See* ADLER & POSNER, *supra* note 72, at 69-70.

analysis methodologies that facilitate and leverage the exercise of this expertise—takes on commensurately increasing importance.

B. Policy Arguments for Cost-Benefit Analysis in Financial Regulation

Part II.A examined general policy arguments in favor of cost-benefit analysis. This part focuses on specific arguments *against* cost-benefit analysis, and then considers these concerns in the context of financial regulation. Two clear findings flow from this analysis: First, many of the arguments used against cost-benefit analysis in other contexts do not apply in the context of financial regulation. Second, the use of cost-benefit analysis by federal financial regulators is particularly appropriate because of unique regulatory factors, including their status as independent regulators.

1. Responses to Arguments Against Cost-Benefit Analysis

Arguments against cost-benefit analysis typically fall into several categories. Broadly formulated, these categories include scientific criticisms, moral and ethical criticisms, political criticisms, and efficiency criticisms—each of which will be discussed in turn.

a. Scientific Criticisms

Scientific criticisms generally focus on the methods by which cost-benefit analysis is produced.[85] Early in the history of agency use of cost-benefit analysis, Congress and the GAO noted criticisms from affected parties that the underlying assumptions built into particular cost-benefit analyses were not made explicit, that the evidence used in the analyses was not comprehensively presented and communicated so as to be reproducible by independent parties, that the cost-benefit analysis process had been subject to conflicts of interest, and that the analysis lacked precision.[86]

Over time, agencies have developed increased skill and expertise in the use of cost-benefit analysis, which has helped to alleviate these concerns. Agencies have also adopted effective, standardized analytical techniques, aided in great measure by enhanced technological advancements and information systems. Henry Manne notes:

> The techniques and power of so-called cost-benefit analysis have improved remarkably in the last 50 years. This reflects, in part, the huge advancement in the field of econometrics, of which cost-benefit analysis can be said to be a subfield. The quality of the data available for calculations is also much improved, largely as a result of the accessibility that computers have given to new databases and the increased reliability that computerization has added to the regression of data.[87]

This learning is reflected in the SEC's 2012 Guidance Memorandum, which was intended to provide, as the subject line suggests, "Current Guidance on Economic Analysis in SEC

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[85] *See, e.g.*, Thomas O. McGarity, *Professor Sunstein's Fuzzy Math*, 90 GEO. L.J. 2341, 2344 (2002) (discussing "daunting scientific uncertainties" that affect cost-benefit analysis).

[86] *See, e.g.*, Michael S. Baram, *Cost Benefit Analysis: An Inadequate Basis for Health, Safety, and Environmental Regulatory Decision Making*, 8 ECOLOGY L.Q. 473 (1980).

[87] Henry G. Manne, *Will the SEC's New Embrace of Cost-Benefit Analysis Be a Watershed Moment?*, 35 REGULATION 20, 22 (2012).

Rulemakings."[88] Moreover, the Guidance Memorandum relies on earlier efforts by the OMB, the CFTC, and the United Kingdom's Financial Services Authority (UK FSA).[89] The Guidance Memorandum attempts to systematize economic analysis by prescribing the following "basic elements of a good regulatory economic analysis":

> (1) a statement of the need for the proposed action; (2) the definition of a baseline against which to measure the likely economic consequences of the proposed regulation; (3) the identification of alternative regulatory approaches; and (4) an evaluation of the benefits and costs—both quantitative and qualitative—of the proposed action and the main alternatives identified by the analysis.[90]

Although the SEC likely still needs to develop expertise and hire additional personnel (primarily economists) to provide consistently high-quality economic analysis of its regulations, the Guidance Memorandum is a step in the right direction and indicates that the SEC intends to systematically respond to scientific criticisms that have been made of its prior efforts at cost-benefit analysis.

A more specific scientific criticism of cost-benefit analysis in the context of financial regulation is the claim that quantifying costs and benefits is more challenging for financial regulations. The GAO describes the challenge:

> [T]he difficulty of reliably estimating the costs of regulations to the financial services industry and the nation has long been recognized, and the benefits of regulation generally are regarded as even more difficult to measure. This situation presents challenges for regulators attempting to estimate the anticipated costs of regulations and also for industries seeking to substantiate claims about regulatory burdens. For example, while compliance costs of financial regulations can usually be estimated and measured, the economic costs of transactions foregone as the result of regulation can be more difficult to anticipate and measure.[91]

These concerns are not unique to financial regulations, however; indeed, it should be no more difficult to quantify costs and benefits for financial regulations than it is for other areas of regulation, such as environmental impacts or workplace safety regulations.[92]

For example, a workplace safety regulation—just like a regulation imposing additional reporting obligations on firms—may have broad economic consequences, shifting costs from

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[88] 2012 GUIDANCE MEMORANDUM, *supra* note 55, at 1.

[89] The SEC specifically cites as its sources OMB Circular A-4, *supra* note 21; CFTC IG REPORT, *supra* note 5; ISAAC ALFON & PETER ANDREWS, FINANCIAL SERVICES AUTHORITY, COST-BENEFIT ANALYSIS IN FINANCIAL REGULATION: HOW TO DO IT AND HOW IT ADDS VALUE (1999), *available at* http://www.fsa.gov.uk/pubs/occpapers/op03.pdf; FINANCIAL SERVICES AUTHORITY CENTRAL POLICY, PRACTICAL COST-BENEFIT ANALYSIS FOR FINANCIAL REGULATORS VERSION 1.1 (2000), *available at* http://www.fsa.gov.uk/pubs/foi/cba.pdf.

[90] 2012 GUIDANCE MEMORANDUM, *supra* note 55, at 4.

[91] GAO 2011 REPORT, *supra* note 31, at 19 (footnote omitted).

[92] For a recent example of a model to help evaluate costs and benefits in financial regulation, see Eric Posner & E. Glen Weyl, *Benefit-Cost Analysis for Financial Regulation*, 103 AM. ECON. REV. (forthcoming May 2013), *available at* http://ssrn.com/abstract=2188990.

production or research and development to compliance.[93] Because of this cost-shifting, firms may forgo transactions in which they otherwise would have engaged. The benefits of regulations may be difficult to quantify in both instances, as regulators estimate the economic impact of fewer workplace accidents or the effects of disclosure on decreased instances of fraud. Time is on the side of cost-benefit analysis, however, as more and more information is made available on market responses to regulation, consumer behavior, and health outcomes, among other things, and regulators have access to increased computational power to make use of the data.

Indeed, the ability of regulators to produce scientifically robust cost-benefit analysis has increased with technological advances. Some critics have argued that regulators should back away from the challenge of producing cost-benefit analysis because of computational difficulties; to the contrary, recent advances in technology and technique have given regulators new tools that make them more capable than ever in producing cost-benefit analyses.

Furthermore, while regulators face legitimate challenges in producing rigorous cost-benefit analysis, the argument that cost-benefit analysis should be discarded because it is imperfect (e.g., in that it cannot perfectly predict all possible regulatory outcomes) is a rhetorical sleight of hand. The purpose of the argument is to draw attention away from an alternative regulatory model in which financial regulators promulgate rules without regard to their economic effects—a model which for decades has been consistently rejected by both Democratic and Republican administrations in favor of the efficiency, rigor, and transparency afforded by cost-benefit analysis.

b. Moral Criticisms

Aside from increased ability to perform cost-benefit analysis, it may be easier for financial regulators to quantify costs because most of the costs imposed by financial regulation are direct financial costs, rather than costs associated with illness, disability, or death. Cost-benefit analysis has been criticized on moral and ethical grounds for placing a utilitarian value on life and death, raising questions about its use as a policy tool.[94] Furthermore, some have argued that cost-benefit analysis does not account for the noneconomic effects of regulations, such as psychic harms of certain regulations.[95] These arguments raise important questions, but they make assumptions that indicate a misunderstanding of the purpose of cost-benefit analysis. As Adler and Posner have argued, cost-benefit analysis is not designed to serve as a moral standard, but as a decision procedure.[96] In other words, cost-benefit analysis provides a methodology to capture all the costs that can be captured, enabling regulators to determine the best course of action. Where costs cannot be quantified, the agency may include qualitative evaluation that explains the virtues of a particular regulatory action.[97]

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[93] *See, e.g.*, W. Kip Viscusi, *The Impact of Occupational Health and Safety Regulation*, 10 BELL J. ECON. 117, 117 (1979) ("If penalties are too severe, the regulations may be counterproductive.").

[94] *See, e.g.*, Lisa Heinzerling, *Regulatory Costs of Mythic Proportions*, 107 YALE L.J. 1981, 2049 (1998); Martha C. Nussbaum, *The Costs of Tragedy: Some Moral Limits of Cost-Benefit Analysis*, 29 J. LEGAL STUD. 1005 (2000); Amartya Sen, *The Discipline of Cost-Benefit Analysis*, 29 J. LEGAL STUD. 931 (2000).

[95] *See, e.g.*, Jeffrey L. Harrison, *Egoism, Altruism, and Market Illusions: The Limits of Law and Economics*, 33 U.C.L.A. L. REV. 1309, 1317 (1986).

[96] Adler & Posner, *supra* note 12, at 167.

[97] Exec. Order 13,563, 76 Fed. Reg. 3821 (Jan. 18, 2011).

Furthermore, whatever the value of these arguments against the use of cost-benefit analysis in the context of environmental, safety, or other regulations, they rarely apply in the context of financial regulation because financial regulation is less likely to implicate thorny questions of placing a value on human life or comparing tangible economic costs with less tangible environmental costs such as the value of wildlife preserves or endangered species.[98] Instead, while there will still be debates about how to quantify different costs and benefits, generally the costs and benefits at issue in financial regulation are economic and thus quantifiable without having to engage in valuing noneconomic costs or benefits.

c. Political Criticisms

Critics also have objected to cost-benefit analysis on political grounds, arguing that its increased use "closes off opportunities for public debate, and substitutes control by a new breed of 'experts' who subtly manipulate the evaluation so that it conforms to the procedures of the market-place."[99] Compared with other models of regulation, however, cost-benefit analysis as practiced in the modern administrative state enhances the ability of regulatory "experts" to leverage their expertise while limiting the dangers of reliance on such experts by promoting and enhancing opportunities for public debate.

The federal administrative system puts agency regulators in a crucial role in which they translate general statutory imperatives into workable regulations. Cost-benefit analysis regulates this authority by systematizing this process.[100] As Henry Manne recently argued in an article on cost-benefit analysis in SEC rulemaking, cost-benefit analysis provides "an analytical template for the consideration of any new rule."[101] The regulator will thus be forced to "give adequate consideration to a variety of significant economic questions that it now regularly sloughs off or to which it simply assumes the answer," by making "real-world quantitative comparisons."[102] This analysis provides some assurance that the regulator will not adopt economically harmful rules. Importantly, cost-benefit analysis would also serve a democratic function by making "the discussion of new regulations more open to truly informed community comment as opposed to special-interest pleading. Third parties will know that their comments will be examined by sensible and knowledgeable experts and not bureaucrats interested mainly in the political implications of a new proposal."[103]

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[98] Sherwin, *supra* note 30, at 5 ("[T]he cost-benefit issues germane to financial regulation are not so literally matters of life and death.").

[99] Robert C. Zinke, *Cost-Benefit Analysis and Administrative Legitimation*, 16 POL'Y STUD. J. 63, 73 (1987) (citing David Dickson et al., *The Cost-Benefit Swindle Puts Dollar Signs on Human Health*, IN THESE TIMES, May 1981).

[100] Posner, *Controlling Agencies*, *supra* note 66, at 1198.

[101] Manne, *supra* note 87, at 23. In Manne's view, cost-benefit analysis should be expressly required of financial regulators through congressional action. *Id.*

[102] *Id.*

[103] *Id.*

d. Efficiency Criticisms

Finally, cost-benefit analysis has also been criticized on efficiency grounds as being unnecessarily costly and time-consuming.[104] This argument misunderstands the value that cost-benefit analysis brings to regulatory process and makes several problematic assumptions. First, the argument seems to assume that *immediate* regulation is preferable to the *best possible* regulation. This is precisely the problem that cost-benefit analysis was designed to avoid: hasty regulation that fails to achieve its goals and/or imposes costs that outweigh its benefits. Second, the assertion that cost-benefit analysis unreasonably delays regulation is not supported by recent history. As one commentator notes, when the D.C. Circuit ruled that the SEC had not performed an adequate cost-benefit analysis in promulgating rules on investment fund governance,[105] the SEC "reacted quickly to the D.C. Circuit's opinion, re-releasing the final rule in unaltered form—albeit with more and better explanation—less than two weeks later."[106] Importantly, the SEC's initial release stated that "it is difficult to determine the costs associated with electing independent directors"[107] and that the SEC had "no reliable basis for estimating"[108] the costs of requiring an independent chairman; but in the re-release the SEC "came to the conclusion that it did, in fact, have a reliable basis for estimating the costs associated with the new regulation."[109]

2. Justification for Cost-Benefit Analysis in Financial Regulation

As noted in Part II.B.1, the general criticisms against cost-benefit analysis do not provide a firm basis to limit its application to financial regulation. Indeed, several arguments particular to financial regulation suggest it is a singularly appropriate subject for cost-benefit analysis.

a. Financial Regulator Perspectives on Cost-Benefit Analysis

Some of the most compelling arguments for the application of cost-benefit analysis to rulemaking have come from financial regulators themselves. The UK FSA argued more than a decade ago that cost-benefit analysis provides benefits not just to regulated parties, but to the regulators themselves. The UK FSA notes that regulation should addresses causes and not just symptoms:

> Applying economic analysis to financial regulation is the only way of getting to the bottom of these issues. In particular, CBA is a practical and rigorous means of identifying, targeting and checking the impacts of regulatory measures on the underlying

[104] BETTER MARKETS, SETTING THE RECORD STRAIGHT ON COST BENEFIT ANALYSIS AND FINANCIAL REFORM 3 (2012).

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

[106] Sherwin, *supra* note 30, at 32 (citing Investment Company Governance, 70 Fed. Reg. 39390 (July 7, 2005)).

[107] Investment Company Governance, 69 Fed. Reg. 46378, 46387 (Aug. 2, 2004) (to be codified at 17 C.F.R. pt. 270).

[108] *Id.* at n. 81.

[109] Sherwin, *supra* note 30, at 32. Although the SEC was able to expeditiously turn around the cost-benefit analysis on remand, the re-released rule was struck down because the SEC failed to follow the notice-and-comment procedures required by the APA. *See* Chamber of Commerce v. SEC, 443 F.3d 890, 902-903 (D.C. Cir. 2006). The SEC abandoned its rulemaking efforts on remand.

> causes of the ills with which regulators need to deal, those causes being the market failures that in turn may justify regulatory intervention.[110]

Although cost-benefit analysis requires time and effort, the UK FSA notes, "the information gained from a good quality CBA can provide significant pay-backs by improving the quality of regulation and by increasing the confidence of the industry and the public in the regulatory process."[111] Quality cost-benefit analysis also helps ensure that the UK FSA fulfills its obligation "to explain why its proposed rules are compatible with its other general duties,"[112] including duties to facilitating innovation in regulated activities, minimize the adverse effects on competition, and facilitate competition between regulated persons.[113]

In the United States, the SEC's Guidance Memorandum, published in March 2012, states that "[h]igh-quality economic analysis is an essential part of SEC rulemaking."[114] The SEC offered several benefits of such analysis, including that it "ensures that decisions to propose and adopt rules are informed by the best available evidence about a rule's likely consequences,"[115] and that economic analysis "allows the Commission to meaningfully compare the proposed action with reasonable alternatives, including the alternative of not adopting a rule."[116] The SEC specifically notes that "a rule's potential benefits and costs should be considered in making a reasoned determination that adopting a rule is in the public interest."[117] The SEC thus recognizes cost-benefit analysis as an important check on potentially harmful regulation; regulation may have unintended negative consequences, and effective cost-benefit analysis provides a means of protecting against such consequences.

A concern with regulatory hubris also led CFTC Commissioner Scott O'Malia to argue for cost-benefit analysis in a recent statement during an open meeting at which the CFTC considered the Internal Business Conduct Rules. Making reference to a recent article in *The Economist* entitled "Over-regulated America," Commissioner O'Malia warns that "we, as *The Economist* points out, are under the impression that we can anticipate and regulate for every

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[110] Financial Services Authority Central Policy, *supra* note 88, at 5 (quoting Alfon & Andrews, *supra* note 88, at 5).

[111] *Id.* at 6.

[112] *Id.*

[113] *Id.* The Financial Services and Markets Act 2000 gives four primary objectives to the FSA: (1) maintaining market confidence in the UK financial system; (2) promoting public understanding of the financial system; (3) securing the appropriate degree of protection for consumers; and (4) helping reduce financial crime. *See* FINANCIAL SERVICE AUTHORITY, THE ROLES AND RESPONSIBILITIES OF THE FINANCIAL SERVICES AUTHORITY AND THE OFFICE OF FAIR TRADING (2007), *available at* http://www.fsa.gov.uk/pubs/other/rolesOFT.pdf.

The SEC and CFTC have similar missions. The CFTC's stated mission is to "protect market users and the public from fraud, manipulation, and abusive practices related to the sale of commodity and financial futures and options, and to foster open, competitive, and financially sound futures and option markets." *Mission & Responsibilities*, CFTC, *available at* http://www.cftc.gov/about/missionresponsibilities/index.htm. The SEC's mission is to "protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation." *The Investor's Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation*, SEC, *available at* http://www.sec.gov/about/whatwedo.shtml.

[114] 2012 GUIDANCE MEMORANDUM, *supra* note 55, at 1.

[115] *Id.*

[116] *Id.*

[117] *Id.*

eventuality. In our hubris, *The Economist* warns, our overreaching tends to defeat our good intentions and creates loopholes and perhaps unintentional safe-harbors, leaving our rules ineffectual and subject to abuse."[118] One of the principle ways in which the CFTC can improve its rulemaking and protect against potential regulatory abuses, Commissioner O'Malia argues, is through effective cost-benefit analysis.

On the other hand, Commissioner O'Malia notes, the failure to produce a rigorous cost-benefit analysis "hurts the credibility of this Commission and undermines the quality of our rules."[119] Regulatory hubris, then, is one of the ironies that cost-benefit analysis is designed to combat. Detractors argue that careful, rule-by-rule economic analysis makes it difficult for agencies to create rules, but that is precisely the point: it requires regulators to engage in a transparent, rigorous process that, as President Obama has stated, includes "more input from experts, businesses and ordinary citizens."[120] Regulating through a careful, focused process, which includes an analysis of the costs and benefits of a particular regulation, will naturally be more time-consuming than hastily pushing through regulations without making the effort to understand their costs, benefits, and effects. However, as President Obama has argued, the resulting rules will be more affordable, less intrusive, more effective, and the product of a more democratic process.

Indeed, rather than viewing cost-benefit analysis as preventing regulation, rigorous cost-benefit analysis creates confidence in the ability of regulators to craft effective and appropriate solutions to market problems. Cass Sunstein, a leading academic commentator on cost-benefit analysis and the head of OIRA from September 2009 to August 2012, supports this position. He notes that when President Obama was elected, "critics of [cost-benefit analysis] hoped he would jettison it."[121] But rather than doing so, "the administration doubled down on cost-benefit analysis. First, Obama made an unprecedented commitment to quantification of both costs and benefits. Second, he ordered executive agencies to review all significant rules on the books, largely with the goal of eliminating or streamlining excessive requirements."[122]

Because of the Obama Administration's efforts, "it has proved possible to move forward with rules protecting public health, safety and the environment."[123] Sunstein estimates that annual benefits of these rules exceed their costs by "billions of dollars."[124] At the same time, the application of rigorous cost-benefit analysis "deterred agencies from proceeding with rules that promise to impose big economic burdens without corresponding gains."[125] At a time when effective regulation of financial markets is as important and pressing as ever, it is essential not

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[118] Scott D. O'Malia, CFTC Commissioner, Unreasonably Feeble, Opening Statement Regarding Open Meeting on One Final Rule and One Proposed Rule (Feb. 23, 2012), *available at* http://www.cftc.gov/PressRoom/SpeechesTestimony/omaliastatement022312.

[119] *Id.*

[120] Barack Obama, *Toward a 21st-Century Regulatory System*, WALL ST. J., Jan. 18, 2011, at A17.

[121] Cass R. Sunstein, *The Stunning Triumph of Cost-Benefit Analysis*, BLOOMBERG (Sept. 12, 2012, 6:30 PM), *available at* http://www.bloomberg.com/news/2012-09-12/the-stunning-triumph-of-cost-benefit-analysis.html.

[122] *Id.*

[123] *Id.*

[124] *Id.*

[125] *Id.*

only that regulatory efforts are appropriately measured and effective, but also that the public and regulated entities have confidence in the ability of regulators to address market problems.

b. The Particular Importance of Cost-Benefit Analysis to Dodd-Frank Rulemaking

For all the reasons previously discussed, regulators have ample justification to apply cost-benefit analysis to their rulemakings, and particularly to rules that regulate the financial system. This is especially true of regulatory efforts like Dodd-Frank that follow a "boom-bubble-bust-regulate cycle of financial market regulation,"[126] and which Larry Ribstein characterized as "bubble laws." Bubble laws create special risks, as Ribstein explains:

> A boom encourages unwarranted trust in markets, leading to the speculative frenzy of a bubble and then to the inevitable bust. The bust, in turn, leads first to the disclosure of fraud and then to the mirror image of the bubble—a kind of speculative frenzy in regulation. A political context combining long-standing interest group pressures with panic and populism virtually ensures against a careful balancing of the costs and benefits of regulation. Regulators are more likely to react to past market mistakes than to prevent future mistakes. Even worse, post-bust regulators are likely to ignore the benefits of market flexibility and, therefore, to impede the risk-taking and innovation that will bring the next boom.[127]

The need for cost-benefit analysis is thus especially critical when implementing Dodd-Frank to not only ensure a proper balance between costs and benefits, but also to provide an appropriate regulatory platform for long-term economic prosperity.

Additionally, Dodd-Frank rulemaking would benefit from cost-benefit analysis because of the complexity of the statute. The 848-page act will require more than 348 rulemakings, including more than 90 from the SEC[128] and at least 38 from the CFTC.[129] This complexity makes careful rulemaking even more critical. If one can analogize Dodd-Frank to a large and complicated machine, the intended purpose of which is to "promote the financial stability of the United States by improving accountability and transparency in the financial system, to end 'too big to fail,' to protect the American taxpayer by ending bailouts, [and] to protect consumers from abusive financial services practices,"[130] then each part of the machine must function successfully for the whole to function efficiently and to accomplish the tasks for which it was designed. When one part of the machine has not been appropriately calibrated, it may create stresses on the other parts, rendering them less effective or causing them to break down. As a regulatory process, a rigorous cost-benefit analysis helps reduce this risk by asking regulators to consider not only

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[126] *See* Larry E. Ribstein, *Bubble Laws*, 40 HOUS. L. REV. 77, 79 (2003). This cycle has been noted by other scholars as well. *See, e.g.*, Joseph A. Grundfest, *Punctuated Equilibria in the Evolution of United States Securities Regulation*, 8 STAN. J.L. BUS. FIN. 1 (2002); Frank Partnoy, *Why Markets Crash and What Law Can Do About It*, 61 U. PITT. L. REV. 741 (2000).

[127] Ribstein, *supra* note 125, at 78.

[128] Implementing the Dodd-Frank Wall Street Reform and Consumer Protection Act, SEC, available at http://www.sec.gov/spotlight/dodd-frank.shtml.

[129] *Dodd-Frank Act*, CFTC, *available at* http://www.cftc.gov/LawRegulation/DoddFrankAct/index.htm.

[130] Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Pub. L. No. 111-203, 124 Stat. 1376, 1376 (2010) (preamble).

what direct costs and benefits may be associated with compliance with a particular rule, but also to more broadly consider how that particular rule fits in with the regulatory apparatus as a whole.

Finally, the pace of rulemaking required by Dodd-Frank should not be an excuse for imprudent rulemaking. SEC Commissioner Dan Gallagher recently echoed these concerns:

> The result [of Dodd-Frank] has been a dramatic increase in both the volume and pace of SEC rulemaking. As I've said in the past, it's no exaggeration to say that the Commission is handling ten times its normal rulemaking volume, with "normal" being the post Sarbanes-Oxley normal, itself a marked increase from the pace before that law's enactment. As a result, the SEC, like other regulators, is now dealing with the problem of rushed, inadequate rule proposals that were pushed out in a bid to meet arbitrary congressional deadlines.[131]

He notes significant concerns with the increased pace of rulemaking stemming from "the difference between getting rules done and getting them done right."[132] Smart regulation, he argues,

> requires taking the time to understand the problem that needs to be addressed, including not only the proximate cause of the problem but also the often complex and hidden factors underlying that problem. It is at this stage where the peril of false narratives is at its greatest, for incorrectly identifying the causes of a problem—whether outright or by oversimplifying complicated issues—makes finding the right solution far more difficult, if not impossible. And, it should go without saying that we need to ensure that we are performing a rigorous cost-benefit analysis of all rules, whether proposed or final.[133]

Dodd-Frank imposes an unavoidably rapid rulemaking timeline. Cost-benefit analysis provides a regulatory template designed to ensure that, despite the accelerated pace, regulators will not cut corners but will engage in more rational decision-making, will produce better regulations, and will promote good governance.

III. JUDICIAL REVIEW OF FINANCIAL REGULATION

Although the executive orders that require executive agencies to engage in cost-benefit analysis have not been extended to independent agencies such as the SEC and CFTC, these financial regulators have statutory obligations under their respective organic statutes and the Administrative Procedure Act that require the agencies to engage in cost-benefit analysis during the rulemaking process. This part explores these statutory obligations, the trilogy of D.C. Circuit decisions that have reviewed these obligations in the context of SEC rulemaking, and the SEC's response—in the form of its 2012 Guidance Memorandum—to these decisions.

A. Judicial Review Under the Administrative Procedure Act

The Administrative Procedure Act (APA) establishes the default standards for judicial review of agency rulemaking and other agency action.[134] The APA judicial review standards

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[131] Daniel M. Gallagher, Remarks Before the U.S. Chamber Center for Capital Markets Competitiveness (Jan. 16, 2013), *available at* http://www.sec.gov/news/speech/2013/spch011613dmg.htm.

[132] *Id.*

[133] *Id.*

[134] Administrative Procedure Act, 5 U.S.C. § 101 *et seq.*

apply when Congress has made a particular agency action "reviewable by statute" and the action is "final agency action for which there is no other adequate remedy in a court."[135] The statute that authorizes an agency's action, which is commonly referred to as an agency's organic statute, may modify the APA's default review standards or even prohibit judicial review altogether. As is relevant here, under the APA, a reviewing court must "hold unlawful and set aside agency action, findings, and conclusions found to be," *inter alia*, "without observance of procedure required by law."[136] In other words, the reviewing court must ensure that the agency has faithfully followed the procedures Congress has articulated by statute.

Moreover, the reviewing court must set aside agency action that is "arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law."[137] This latter requirement, which is often called arbitrary-and-capricious review, has been interpreted as a reasoned decision-making requirement. Indeed, under Supreme Court precedent—as some scholars have remarked—"'[h]ard look' review has become the name of the game: courts subject an agency's rule to rather rigorous analysis to ensure the rule is the product of reasoned decisionmaking—that the rule is a product of sound reason rather than being 'arbitrary and capricious.'"[138] In *Motor Vehicle Manufacturers Ass'n v. State Farm Mutual Automobile Insurance Co.*,[139] the Court crystalized the breadth of arbitrary-and-capricious review:

> [A]n agency rule would be arbitrary and capricious if the agency has relied on factors which Congress has not intended it to consider, entirely failed to consider an important aspect of the problem, offered an explanation for its decision that runs counter to the evidence before the agency, or is so implausible that it could not be ascribed to a difference in view or the product of agency expertise.[140]

In other words, the focus is on whether the agency addressed and considered the factors set forth by Congress in the agency's organic statute; whether the agency considered all important aspects of the problem it was seeking to address through regulatory action; whether its proposed action is consistent with the evidence gathered; and whether the action otherwise demonstrates reasoned decision-making as evidenced by "the quality and coherence of the agency's reasoning."[141]

Aside from arbitrary-and-capricious review's focus on reasoned decision-making as a general principle for all agency action, *State Farm* makes clear that agency action is arbitrary and capricious if it does not consider factors that Congress intended the agency to consider (or does consider factors that Congress intended the agency *not* to consider). In other words, in reviewing

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[135] *Id.* § 704.

[136] *Id.* § 706(2)(D).

[137] 5 U.S.C. § 706(2)(A). Not relevant here, the APA also requires a court to set aside agency action when it is contrary to the Constitution or exceeds the agency's statutory authority. *See id.* § 706(2)(B), (2)(C). In formal rulemaking or adjudication, the reviewing court also sets aside agency action "unsupported by substantial evidence . . . ." *Id.* § 706(2)(E).

[138] Cox & Baucom, *supra* note 34, at 1825. *See generally* 1 RICHARD J. PIERCE, JR., ADMINISTRATIVE LAW TREATISE §7.4, at 599-600 (5th ed. 2010) (explaining that the Supreme Court's "hard look" doctrine requires agencies to discuss all major issues it considered in formulating a major rule to demonstrate that its rule meets the APA's reasoned decision-making requirement).

[139] 463 U.S. 29 (1983).

[140] *Id.* at 43.

[141] Cox & Baucom, *supra* note 34, at 1825.

agency action, courts must carefully analyze the instructions set forth in the agency's organic statute and ensure that the agency has followed them. The terms of the organic statutes under which the SEC, CFTC, federal banking agencies, and CFPB operate are illustrative of the types of reasoned decision-making constraints Congress has imposed on financial regulators.

1. SEC's Organic Statutes and Cost-Benefit Analysis

In 1996, Congress amended the SEC's organic statutes to expressly require the SEC to consider whether its proposed regulatory action would "promote efficiency, competition, and capital formation."[142] Prior to these amendments, the SEC was charged to regulate as "necessary or appropriate in the public interest" and to consider whether the rule served the aim of "protection of investors," which is the driving purpose behind the statutes.[143] Now, the consideration of "efficiency, competition, and capital formation" is "in addition to the protection of investors." These factors must be "consider[ed]," Congress has commanded, whenever "the Commission is engaged in rulemaking and is required to consider or determine whether an action is necessary or appropriate in the public interest."[144]

The terms "efficiency, competition, and capital formation" are not defined by statute, and the SEC has not attempted to provide a formal definition. The term "efficiency," however, has an ordinary, everyday meaning: an efficient operation is an "effective operation as measured by a comparison of production with cost (as in energy, time, and money)."[145] In other words, considering whether a proposed regulation would promote efficiency necessarily entails comparing the benefits of the regulation against its costs. "Efficiency" is also an economic term of art measuring the net benefits that society gets from its scarce resources.[146]

Recently, some have attempted to argue that the phrase "consider . . . whether the action will promote efficiency, competition, and capital formation" does not entail actually conducting

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[142] 15 U.S.C. § 77b(b) ("Whenever pursuant to this subchapter the Commission is engaged in rulemaking and is required to consider or determine whether an action is necessary or appropriate in the public interest, the Commission shall also consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation."); *accord* 15 U.S.C. § 78c(f) (same); 15 U.S.C. § 80a-2(c) (same); 15 U.S.C. § 80b-2(c) (same).

[143] Cox & Baucom, *supra* note 34, at 1818.

[144] 15 U.S.C. § 77b(b); 15 U.S.C. § 78c(f); 15 U.S.C. § 80a-2(c); 15 U.S.C. § 80b-2(c). The JOBS Act places the same requirement on the SEC's review of PCAOB rules. *See* Jumpstart Our Business Startups Act (JOBS Act), Pub. L. No. 112-106, § 104, 126 Stat. 306 (Apr. 5, 2012).

[145] MERRIAM-WEBSTER'S COLLEGIATE DICTIONARY 397 (11th ed. 2004); *accord* WEBSTER'S THIRD NEW INTERNATIONAL DICTIONARY 725 (2002) (defining "efficiency" as "capacity to produce desired results with a minimum expenditure of energy, time, money, or materials"); THE NEW OXFORD AMERICAN DICTIONARY 544 (2001) (defining "efficient" as "achieving maximum productivity with minimum wasted effort or expense"). It is no surprise that this definition has not materially changed since 1996—the year Congress first amended the SEC's organic statutes to require consideration of efficiency, competition, and capital formation.

[146] *See, e.g.*, N. GREGORY MANKIW, PRINCIPLES OF MICROECONOMICS 5 (6th ed. 2010); Bruce Kraus & Connor Raso, *Rational Boundaries for SEC Cost-Benefit Analysis*, 30 YALE J. ON REG., at 9 (forthcoming 2013) (explaining that "[e]fficiency is also a fundamental concept in economic theory" and exploring how that economic concept aims at obtaining the optimal allocation of resources by evaluating costs and benefits), *available at* http://ssrn.com/abstract=2139010.

a cost-benefit analysis because the term "consider" gives agencies "wide discretion."[147] But this interpretation cannot be squared with arbitrary-and-capricious review under the APA, which requires the agency to provide a reasoned explanation for its action—including, per *State Farm*, the agency's articulation of the factors Congress intended it to consider (or not) as well as its analysis of any important aspect of the problem.[148] Congress has required the agency to "consider . . . efficiency," which necessarily involves comparing costs and benefits. A reasoned explanation of that cost-benefit analysis is thus required by the organic statutes' plain terms.

To the extent there is any ambiguity, the legislative history confirms the ordinary meaning of the provision. Perhaps most telling, the House Committee Report states the following with respect to this provision: "In considering efficiency, competition, and capital formation, the Commission shall analyze the potential costs and benefits of any rulemaking initiative, including, whenever practicable, specific analysis of such costs and benefits. The Committee expects that the Commission will engage in rigorous analysis pursuant to this section."[149] When considering the conference report on the bill, House Commerce Committee Chair Tom Bliley further explained on the floor of the House:

> [T]he National Securities Markets Improvement Act will require the SEC to conduct meaningful cost-benefit analysis of proposed rulemakings that directly affects [sic] all securities issuers. Under this new provision, the SEC must weigh the cost of every rule they propose against the burden those rules would impose on the engine of our economy. This provision is simply common sense: meaningful regulation should not impose unnecessary burdens and costs.[150]

Indeed, even scholars and commentators who have disapproved of the D.C. Circuit's review of the SEC's cost-benefit analyses under these statutes nevertheless agree that the "legislative history makes clear that this enigmatic clause actually commands the SEC to perform a traditional cost-benefit analysis whenever it engages in rulemaking."[151] Cox and Baucom, for instance, expressly refute a narrow interpretation of "consider": "What is stated in the legislative history is that the SEC's 'consideration' is to entail rigorous analysis and evaluation of the potential costs and benefits of the proposed rule."[152]

In sum, the SEC's organic statutes require the agency to "consider" four express factors when engaged in rulemaking: the protection of investors, efficiency, competition, and capital markets. Accordingly, a failure to provide a reasoned explanation of the agency's consideration of efficiency—in other words, its analysis of the costs and benefits of the proposed regulatory action—would be arbitrary and capricious under the APA.[153]

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[147] Brief of Better Markets, Inc. as Amici Curiae Supporting Respondent, Am. Petroleum Inst. v. SEC, No. 12-1398, at 2 (D.C. Cir., filed Jan. 16, 2013) [hereinafter "Better Markets Br."].

[148] Motor Vehicle Manufacturers Ass'n v. State Farm Mutual Auto. Ins. Co., 463 U.S. 29, 43 (1983).

[149] H.R. REP. NO. 104-622, at 39 (1996).

[150] 142 CONG. REC. H12047 (1996).

[151] Mongone, *supra* note 33, at 755; *accord* Cox & Baucom, *supra* note 34, at 1821.

[152] Cox & Baucom, *supra* note 34, at 1821.

[153] Better Markets has also argued that cost-benefit analysis is not required because the "legislative history shows that Congress intended the SEC to place the protection of investors and the public interest above economic considerations." Better Markets Br., *supra* note 146, at 2. This argument suffers from a fundamental misunderstanding

2. CFTC's Organic Statute and Cost-Benefit Analysis

In 2000, Congress amended the CFTC's organic statute to require the CFTC to consider the economic consequences of its rulemaking. The Commodity Exchange Act states that the CFTC "shall consider the costs and benefits of the action of the Commission" and expressly articulates certain costs and benefits that must be considered including effects on "efficiency, competitiveness, and financial integrity of futures markets."[154] Failure to provide a reasoned explanation of its cost-benefit analysis and its consideration of the express costs and benefits articulated by Congress in the CFTC's organic statute would be arbitrary and capricious under the APA and thus grounds for a court to set aside the agency's action.

3. Federal Banking Agencies' Organic Statute and Cost-Benefit Analysis

Similarly, the Federal Reserve, the FDIC, and the Comptroller of the Currency are required by statute to "consider, consistent with the principles of safety and soundness and the public interest—(1) any administrative burdens that such regulations would place on depository institutions, including small depository institutions and customers of depository institutions; and (2) the benefits of such regulations."[155] Whereas this statutory language does not include the mandate to consider "efficiency," Congress does requires these federal banking agencies to consider the administrative burdens that its rules would impose on depository institutions in addition to the expected benefits, so the APA requires some form of cost-benefit analysis.

4. CFPB's Organic Statute and Cost-Benefit Analysis

Finally, Dodd-Frank requires the newly created the CFPB to "consider—(i) the potential benefits and costs to consumers and covered persons, including the potential reduction of access by consumers to consumer financial products or services resulting from such rule; and (ii) the impact of proposed rules on covered persons . . . and the impact on consumers in rural areas."[156] This requirement expressly requires the consideration of costs and benefits of any proposed rules, and thus failure to conduct such a cost-benefit analysis would run afoul of the APA.

B. D.C. Circuit Trilogy on SEC Cost-Benefit Analysis

The SEC's experience in the D.C. Circuit over the past decade demonstrates what can happen when a financial regulator with a statutory mandate to consider the costs and benefits of a particular action fails to take that mandate seriously. Instead of articulating guidelines and boundaries to conduct economic analysis under its organic statutes, such as the OMB and OIRA have done for executive agencies via Circular A-4, the SEC took the back seat and allowed commenters, regulated entities, litigants, and ultimately the D.C. Circuit to define the boundaries

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of how cost-benefit analysis works. In some instances the level of benefit to investor protection may justify the economic costs of a particular proposed regulatory action. But that does not mean that the cost-benefit analysis should not be conducted or that the agency should not explain why the benefits to investor protection outweigh or at least justify the economic costs. Such analysis, for instance, may reveal less costly alternatives that achieve substantially similar levels of investor protection. *See* Part II (discussing the policy rationales for cost-benefit analysis).

[154] 7 U.S.C. § 19(a).

[155] 12 U.S.C. § 4802(a); *see also* 12 U.S.C. § 1462(5) (incorporating definition of "Federal banking agencies" in 12 U.S.C. § 1813(q)).

[156] 12 U.S.C. § 5512(b)(2)(A).

of the economic analysis. Perhaps in response to the SEC's failure to act, in a trio of decisions the D.C. Circuit has aggressively examined the SEC's rulemaking in a way that departs from the court's traditionally more deferential approach to review of agency rulemaking in other administrative law contexts. Each of these cases will be briefly discussed in this part.

1. *Chamber of Commerce v. SEC* (2005)

In 2005, the D.C. Circuit issued its first decision in the trilogy. In *Chamber of Commerce*,[157] the rule at issue required that mutual fund boards have no less than 75% independent directors and be chaired by an independent director. The D.C. Circuit rejected the U.S. Chamber of Commerce's challenge to the SEC's statutory authority to adopt these two requirements as well as the Chamber's principal challenges to the SEC's reasoning for adopting the rule. The D.C. Circuit, however, agreed with the Chamber that "the Commission did violate the APA by failing adequately to consider the costs mutual funds would incur in order to comply with the conditions and by failing adequately to consider a proposed alternative to the independent chairman condition."[158]

Relying on *State Farm*, the D.C. Circuit explained that under the APA's arbitrary-and-capricious standard, the scope of review "'is narrow and a court is not to substitute its judgment for that of the agency,'" but it must "be sure the Commission 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 choice made.'"[159] The court explained that a rule is arbitrary and capricious if the agency fails to consider factors under its organic statute and that the SEC's organic statute requires it to consider costs by stating that the agency should consider "'whether the action will promote efficiency, competition, and capital formation.'"[160] The court held that the SEC need not conduct an independent empirical study to meet the reasoned decision-making mandate and that it need not provide a comprehensive explanation for discounting or rejecting empirical studies. However, it must "apprise itself—and hence the public and the Congress—of the economic consequences of a proposed regulation before it decides whether to adopt the measure"[161] and adequately consider nonfrivolous alternatives to the proposed regulation.[162]

In particular, the D.C. Circuit faulted the SEC for failing to consider the costs of compliance that the mutual funds would suffer and found incredible the SEC's claim that it had no "'reliable basis for determining how funds would choose to satisfy the [condition] and therefore it [was] difficult to determine the costs associated with electing independent

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[157] Chamber of Commerce v. SEC, 412 F.3d 133 (D.C. Cir. 2005). For a more detailed analysis of this case, see Sherwin, *supra* note 30, at 19-53. Sherwin concludes that "the SEC's performance is rather lackluster. Far from being accessible and transparent, its reports rarely explain the sources of information on which its estimates are based or describe the underlying market dynamics that informed its analysis." *Id.* at 53.

[158] *Chamber of Commerce*, 412 F.3d at 136.

[159] *Id.* at 140 (quoting Motor Vehicle Manufacturers Ass'n v. State Farm Mutual Auto. Ins. Co., 463 U.S. 29, 43 (1983)).

[160] *Chamber of Commerce*, 412 F.3d at 140, 142 (quoting 15 U.S.C. § 80a-2(c)).

[161] *Chamber of Commerce*, 412 F.3d at 144.

[162] *Id.* at 144-45. The court made clear that the SEC was free to discard this alternative if it concluded that the alternative "would not sufficiently serve the interests of shareholders, but the Commission—not its counsel or this court—is charged by the Congress with bringing its expertise and its best judgment to bear upon the issue." *Id.* at 145.

directors.'"[163] Although the D.C. Circuit's focus on these costs—which appear to be relatively minor cost considerations in the big picture—has been criticized as micromanaging agency rulemaking, the court's incredulity about the SEC's position that the agency could not determine these costs proved true. On remand, the SEC was able to quantify these costs in a matter of weeks. As one commentator has noted, "[t]his rapid about-face must call into question the Commission's diligence with respect to CBA before *Chamber I* forced it to take such analysis seriously."[164]

2. *American Equity Investment Life Insurance Co. v. SEC* (2010)

In 2010, the D.C. Circuit continued its aggressive review and criticism of the SEC's use of cost-benefit analysis. In *American Equity Investment*,[165] the rule at issue classified fixed indexed annuities as securities and thus subject to federal securities regulation.[166] The D.C. Circuit deferred to the SEC's interpretation of the federal securities law to classify fixed indexed annuities as securities, but it nevertheless vacated the rule because "the SEC failed to properly consider the effect of the rule upon efficiency, competition, and capital formation."[167]

The D.C. Circuit faulted the SEC for a number of errors in its cost-benefit analysis. First, the court found the SEC's consideration of "competition" inadequate, concluding that "[t]he SEC purports to have analyzed the effect of the rule on competition, but does not disclose a reasoned basis for its conclusion that Rule 151A would increase competition."[168] Second, and perhaps more fundamentally, the D.C. Circuit faulted the SEC's cost-benefit analysis for failing to make any "finding on the existing level of competition in the marketplace under the state law regime."[169] It similarly faulted the SEC with respect to its efficiency analysis as "incomplete because it fails to determine whether, under the existing regime, sufficient protections existed to enable investors to make informed investment decisions and sellers to make suitable recommendations to investors."[170]

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[163] *Id.* at 143 (quoting Investment Company Governance, Final Rule, 69 Fed. Reg. 46,378, 46,387 (Aug. 2, 2004)).

[164] Sherwin, *supra* note 30, at 32-33. Sherwin further notes that "[t]he difference between the CBA in the initial release and the post-*Chamber I* re-release could not be more striking." *Id.* at 34. The D.C. Circuit struck down the re-released rule, holding that the SEC violated the APA by relying on materials outside the record and not following the notice-and-comment procedures. *See* Chamber of Commerce v. SEC, 443 F.3d 890, 902-03 (D.C. Cir. 2006).

[165] Am. Equity Inv. Life Ins. Co. v. SEC, 613 F.3d 166 (D.C. Cir. 2010).

[166] Traditional fixed annuities, which are backed by an insurance company's balance sheet and guarantee a fixed return, are not securities under federal law and thus are only regulated by state law. Fixed indexed annuities, by contrast, are a hybrid financial product that combines traditional annuities with investments tied to the stock market indexes. It is for this reason that the SEC determined that they are securities and thus subject to both federal and state regulation. *See Id.* at 167-68.

[167] *Id.* at 167-68.

[168] *Id.* at 177. The SEC rejected as a consideration of "competition" that the rule would bring clarity to the legal question and thus may encourage insurers to enter the market for fixed indexed annuities because "[t]he SEC cannot justify the adoption of a particular rule based solely on the assertion that the existence of a rule provides greater clarity to an area that remained unclear in the absence of any rule." *Id.* at 177-78. That would be equally true, the D.C. Circuit explained, of whatever rule the SEC could pursue "to make the previously unregulated market clearer than it would be without that adoption." *Id.* at 178.

[169] *Id.* at 178.

[170] *Id.* at 179.

These latter two criticisms about failure to evaluate the status quo go to a core principle of cost-benefit analysis: the need to define the baseline. This is the second step of cost-benefit analysis under OMB's Circular A-4, which is preceded only by the requirement to describe the need for regulatory action. Defining the baseline, per Circular A-4, entails providing

> the agency's best assessment of what the world would be like absent the action. To specify the baseline, the agency may need to consider a wide range of factors and should incorporate the agency's best forecast of how the world will change in the future, with particular attention to factors that affect the expected benefits and costs of the rule.[171]

Without an established baseline, an agency cannot truly consider the costs and benefits of the proposed regulation over the status quo, much less compare the proposed regulation with plausible alternative regulatory approaches (or no regulation at all).[172]

The D.C. Circuit's approach in *American Equity Investment* has not received the same amount of criticism as the next case in the trilogy, *Business Roundtable*. Indeed, Cox and Baucom—two of the loudest critics of *Business Roundtable*—conclude that "the *American Equity* panel stood on firm ground, ground sowed by *State Farm*, because the court there assessed the quality of the reasoning the SEC employed in its efficiency, competition, and capital formation analysis."[173] More recently, Kraus and Raso have similarly agreed that the D.C. Circuit was correct in requiring the SEC to define a baseline but warned against requiring too much precision when the agency concludes that quantification is not feasible.[174]

3. *Business Roundtable & U.S. Chamber of Commerce v. SEC* (2011)

The D.C. Circuit's most recent decision on the SEC's use of cost-benefit analysis came down in 2011. In *Business Roundtable*,[175] the rule at issue was the proxy access rule, which "require[d] public companies to provide shareholders with information about, and their ability to vote for, shareholder-nominated candidates for the board of directors" by including in the companies' proxy materials the names of any person nominated by a qualifying shareholder for election to the board of directors.[176] The D.C. Circuit vacated the rule based on a number of criticisms of the agency's cost-benefit analysis.

Similar to its approach in *Chamber of Commerce* and *American Equity Investment*, the D.C. Circuit pointed out steps not taken in the cost-benefit analysis. In particular, the court faulted the SEC for "discount[ing] the costs of Rule 14a-11—but not the benefits—as a mere artifact of the state law right of shareholders to elect directors."[177] This is a fundamental error in cost-benefit analysis: to only discount for the costs of the existing state law but not even attempt

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[171] OMB Circular A-4, *supra* note 21, at 4.

[172] The SEC did not have an opportunity to propose a new rule on remand because Dodd-Frank stripped the SEC of authority to regulate fixed indexed annuities. *See* 15 U.S.C. § 7262. But, as discussed in Part III.C, the SEC did embrace the importance of defining the baseline in its 2012 Guidance Memorandum. *See* 2012 GUIDANCE MEMORANDUM, *supra* note 55, at 6.

[173] Cox & Baucom, *supra* note 34, at 1830.

[174] *See* Kraus & Raso, *supra* note 145, at 15

[175] Bus. Roundtable & U.S. Chamber of Commerce v. SEC, 647 F.3d 1144 (D.C. Cir. 2011).

[176] *Id.* at 1146.

[177] *Id.* at 1151.

to estimate and discount the benefits of the state law. The D.C. Circuit reiterated its discussion in *Chamber of Commerce* that "this type of reasoning, which fails to view a cost at the margin, is illogical and, in an economic analysis, unacceptable."[178] To be sure, the court rejected a number of petitioners' claims that the SEC failed to consider certain costs, but ultimately concluded that the SEC "inconsistently and opportunistically framed the costs and benefits of the rule."[179]

The D.C. Circuit, however, went beyond its approach in *Chamber of Commerce* and *American Equity Investment* to in effect re-do the cost-benefit analysis. The court scrutinized the SEC's extensive review of the empirical evidence and reached its own conclusion that the evidence the SEC had relied on was not enough to justify the rule:

> In view of the admittedly (and at best) "mixed" empirical evidence, we think the Commission has not sufficiently supported its conclusion that increasing the potential for election of directors nominated by shareholders will result in improved board and company performance and shareholder value.[180]

This approach to judicial review of the SEC's rulemaking appears more searching than the D.C. Circuit traditionally applies in other agency contexts. Indeed, in a subsequent decision, the D.C. Circuit rejected an expansive reading of *Business Roundtable* and emphasized that the "evidentiary problem in *Business Roundtable* was not limited to the agency's insufficient treatment of any one study," but "it was the agency's larger failure to deal with the weight of the evidence against it."[181] Ultimately, the court clarified, "[a]n agency's action is arbitrary and capricious if it entirely failed to consider an important aspect of the problem [or] offered an explanation for its decision that runs counter to the evidence before the agency."[182]

Scholars and commentators who have weighed in on *Business Roundtable* have done so with heavy criticism of the D.C. Circuit. For example, Cox and Baucom title their critique "The Emperor Has No Clothes: Confronting the D.C. Circuit's Usurpation of SEC Rulemaking Authority" and conclude that the *Business Roundtable* standard of review "is dramatically inconsistent with the standard enacted by Congress."[183] Mongone calls it a "scathing opinion," concluding that *Business Roundtable* "strictly scrutinized the SEC's methodology and reached all of its drastic conclusions without engaging in a statutory interpretation analysis with respect to the actual level of agency 'consideration' . . . demanded by the" SEC's organic statutes.[184] And Kraus and Raso approve of some of the D.C. Circuit's rulings with respect to failing to consider costs and benefits but conclude that *Business Roundtable* "did not expressly announce a

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[178] *Id.*

[179] *Id.* at 1148-49. Kraus and Raso agree that these criticisms are valid. *See* Kraus & Raso, *supra* note 145, at 23. The D.C. Circuit also addressed the specific costs the SEC did not consider (or consider adequately) about application of the rule to investment companies, such as mutual funds. *See Business Roundtable*, 647 F.3d at 1154-56.

[180] *Id.* at 1151 (internal citations omitted).

[181] Am. Petroleum Inst. v. EPA, 684 F.3d 1342, 1351 (D.C. Cir. 2012).

[182] *Id.* at 1350 (alteration in original; internal quotations omitted).

[183] Cox & Baucom, *supra* note 34, at 1811, 1813.

[184] Mongone, *supra* note 33, at 764, 768.

new standard of review, but a new burden of proof—the opposite of deference—appears to be an implicit holding in the case."[185]

It is difficult to escape the conclusion that the D.C. Circuit's approach to reviewing an agency's cost-benefit analysis in *Business Roundtable* reaches beyond arbitrary-and-capricious review as set forth in the APA and crystalized by the Supreme Court in *State Farm*. That said, it is important to underscore that much of what the D.C. Circuit did in *Business Roundtable*—and the other two cases in the trilogy—does not depart from the traditional approach. Several proper grounds for setting aside an agency's rule under the APA are worth reiterating here:

- Failure to consider certain costs—quantitatively or qualitatively—based on the rationale that the costs are difficult to quantify (*Chamber of Commerce*);
- Failure to provide a reasoned basis for rejecting a nonfrivolous alternative to the proposed rule (*Chamber of Commerce*);
- Failure to provide a reasoned basis for the agency's consideration of a factor set forth by Congress in the agency's organic statute (*American Equity Investment*);
- Failure to attempt to define the baseline as a comparison to the proposed rule as well as its alternatives (*American Equity Investment*); and
- Failure to take into account the benefits of the status quo yet take into account the costs of the status quo (*Business Roundtable*).

Moreover, the D.C. Circuit's more-searching inquiry in *Business Roundtable* must be placed within its proper context—one in which the SEC had failed for years to take seriously its statutory obligation to consider the costs and benefits of its proposed regulatory actions. Indeed, six years had passed between *Chamber of Commerce* and *Business Roundtable*, and one cannot read *Business Roundtable* without sensing the court's frustration with the SEC's continued failure to listen to the court's admonitions to conduct proper cost-benefit analysis. In particular, the D.C. Circuit in *Business Roundtable* noted at the outset of its analysis that it was going to vacate the rule as arbitrary and capricious "for having failed once again—as it did most recently in *American Equity Investment* . . . and before that in *Chamber of Commerce*—adequately to assess the economic effects of a new rule."[186]

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[185] Kraus & Raso, *supra* note 145, at 24. These are not the only criticisms from scholars and commentators, but others reach similar conclusions. *See, e.g.*, Michael E. Murphy, *The SEC and the District of Columbia Circuit: The Emergency of a Distinct Standard of Judicial Review*, 7 VA. L. & BUS. REV. 125, 127 (2012) ("It is now clear that the SEC must follow a steeper, more uncertain, and possibly impassable route to secure judicial approval of rulemaking within the wide ambit of the 1996 statute."); Note, *D.C. Circuit Finds SEC Proxy Access Rule Arbitrary and Capricious for Inadequate Economic Analysis*, 125 HARV. L. REV. 1088, 1088 (2012) ("By parsing in fine detail the methods and results of the SEC's cost-benefit analysis, the panel asserted judicial power in a field that courts struggle to oversee and applied an excessively exhausting standard that all but bars contested reforms."); *see also* Grant M. Hayden & Matthew T. Bodie, *The Bizarre Law and Economics of* Business Roundtable v. SEC, 38 J. CORP. L. 101, 102 (2012) ("[I]ts decision to strike down the regulation rests on a version of law and economics that contravenes the discipline's traditional principles and exacerbates agency costs.").

[186] Bus. Roundtable & U.S. Chamber of Commerce v. SEC, 647 F.3d 1144, 1148 (D.C. Cir. 2011) (internal citations omitted).

C. SEC Response: 2012 Cost-Benefit Analysis Guidance Memorandum

Perhaps most telling, the SEC did not seek rehearing *en banc* before the D.C. Circuit in *Business Roundtable*, nor did it seek *certiorari* review in the Supreme Court. Instead, less than a year after the D.C. Circuit issued its *Business Roundtable* decision, the SEC released its Guidance Memorandum on the use of cost-benefit analysis in its rulemaking.

In its March 16, 2012, Guidance Memorandum, the SEC acknowledges that the D.C. Circuit has essentially held that the SEC must conduct cost-benefit analysis under its organic statutes but reaffirms its position that "[n]o statute expressly requires the Commission to conduct a formal cost-benefit analysis" and that the SEC, as an independent agency, is not bound by the executive orders that require executive agencies to engage in cost-benefit analysis.[187] The SEC proceeds, however, to affirm that "[h]igh-quality economic analysis is an essential part of SEC rulemaking" and then sets forth guidance that "draws on principles set forth in those [executive] orders and in the Office of Management and Budget's Circular A-4 (2003), which provides guidance for implementing Executive Order 12866."[188] Despite not admitting that the D.C. Circuit was correct on a number of fronts in its decisions vacating SEC rulemaking, the SEC's Guidance Memorandum embraces the cost-benefit analysis fundamentals set forth in the D.C. Circuit's trilogy. These half-dozen principles are briefly discussed here.

1. Define the Baseline (*American Equity Investments*)

The SEC proposes that the second step in its cost-benefit analysis—the same second step as in the OMB's guidance[189]—is to "[d]efine the baseline against which to measure the proposed rule's economic impact."[190] The SEC explains that "[t]he baseline serves as a primary point of comparison" because "[a]n economic analysis of a proposed regulatory action compares the current state of the world . . . to the expected state of the world with the proposed regulation (or regulatory alternatives) in effect."[191] In a footnote, the SEC notes the *American Equity Investment* decision and its conclusion that "the SEC's analysis was inadequate because it did not measure the rule's likely effect on efficiency, competition, and capital formation against a baseline that included the existing level of those economic factors . . . ."[192]

2. Identify and Discuss Reasonable Alternatives to the Proposed Rule (*Chamber of Commerce*)

Similarly, as its third step, the SEC proposes that its approach to cost-benefit analysis must "[i]dentify and discuss reasonable alternatives to the proposed rule."[193] This step is substantially the same as the OMB's fourth step to "identify a range of regulatory alternatives."[194] The SEC explains that "[t]he release should identify and discuss reasonable

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[187] 2012 GUIDANCE MEMORANDUM, *supra* note 55, at 3-4.

[188] *Id.* at 1, 4.

[189] OMB Circular A-4, *supra* note 21, at 4.

[190] 2012 GUIDANCE MEMORANDUM, *supra* note 55, at 6.

[191] *Id.*

[192] *Id.* at 7 n.22.

[193] *Id.* at 8.

[194] OMB Circular A-4, *supra* note 21, at 5-6.

potential alternatives to the approach in the proposed rule," and it quotes the D.C. Circuit's decision in *Chamber of Commerce* for the proposition that only reasonable alternatives must be considered: "Such alternatives include those that are 'neither frivolous nor out of bounds.'"[195]

3. Identify Relevant Benefits and Costs (*Chamber of Commerce* and *American Equity Investments*)

The SEC also underscores that the release must "[i]dentify relevant benefits and costs" and then provides a nonexhaustive list of potential benefits and costs.[196] This is analogous to the sixth step under the OMB guidance, which is to "[q]uantify and monetize the benefits and costs."[197] Although the SEC does not cite the D.C. Circuit for this principle, the guidance appears to respond to *Chamber of Commerce* (failure to consider certain costs) and *American Equity Investments* (failure to provide a reasoned basis for consideration of a statutory factor). Indeed, later in the Guidance Memorandum, the SEC expressly references that the release should integrate the cost-benefit analysis section with its analysis of the factors set forth in the statute—efficiency, competition, and capital formation.[198]

4. Attempt to Quantify Costs and Benefits; If Quantification Not Possible, Provide Explanation (*Chamber of Commerce* and *Business Roundtable*)

The SEC underscores that it should "[q]uantify expected benefits and costs to the extent feasible" and that if not reasonably feasible, "the release should include an explanation of the reason(s) why quantification is not practicable and include a qualitative analysis of the likely economic consequences of the proposed rule and reasonable regulatory alternatives."[199] This guidance is wholly consistent with the OMB's guidance in Circular A-4, but the SEC also expressly notes the D.C. Circuit's decisions in *Chamber of Commerce* and *Business Roundtable* for the principle that the SEC must "attempt to quantify anticipated costs and benefits, even where the available data is imperfect and where doing so may require using estimates . . . ."[200]

5. Frame Costs and Benefits Neutrally and Consistently (*Business Roundtable*)

Although not citing *Business Roundtable* for this principle, the SEC directly responds to the D.C. Circuit's criticism in *Business Roundtable* that the SEC had opportunistically framed costs and benefits. The SEC instructs that

> [t]he release should evaluate the costs and benefits even-handedly and candidly, acknowledging any limitations in the data or quantifiable information. To the extent that the release discusses scenarios that might mitigate the costs or enhance the benefits,

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[195] 2012 GUIDANCE MEMORANDUM, *supra* note 55, at 8-9 (quoting Chamber of Commerce v. SEC, 412 F.3d 133, 145 (D.C. Cir. 2005)).

[196] 2012 GUIDANCE MEMORANDUM, *supra* note 55, at 10-11.

[197] OMB Circular A-4, *supra* note 21, at 9-11.

[198] 2012 GUIDANCE MEMORANDUM, *supra* note 55, at 14-15.

[199] *Id.* at 12, 13-14.

[200] *Id.* at 13 & n.34.

> consider and discuss the impact that those scenarios would have on both the costs and the benefits.[201]

The second sentence here specifically addresses the D.C. Circuit's faulting of the SEC in *Business Roundtable* for "discount[ing] the costs of Rule 14a-11—but not the benefits—as a mere artifact of the state law right of shareholders to elect directors."[202] The first sentence, of course, responds to the D.C. Circuit's broader criticism that "the Commission inconsistently and opportunistically framed the costs and benefits of the rule."[203]

6. Shift of Cost-Benefit Analysis from Lawyers to Economists (Overriding Message from the D.C. Circuit Trilogy)

Finally, the SEC also responds to the D.C. Circuit's more general call for the SEC to conduct sound empirical analysis that includes proper cost-benefit analysis. At the end of the Guidance Memorandum, the SEC sets forth a separate section titled "Enhanced integration of economic analysis into the rulemaking process and rule releases."[204] Among other things, this section underscores that economists from the SEC's Division of Risk, Strategy, and Financial Innovation (RSFI) "should be fully integrated members of the rulewriting team, and contribute to all elements of the rulewriting process."[205]

Indeed, at the proposal stage "[t]he economic analysis should be drafted by RSFI economists or in close collaboration with RSFI economists," and during the comment period "RSFI economists . . . should pay particular attention to any comment letters containing economic analysis and data" and should, where appropriate, attend meetings with commenters and third parties.[206] Finally, at the adopting stage, "prepared by or with the assistance of RSFI economists," "the staff should prepare a high-level economic analysis" that incorporates the guiding principles discussed in the Guidance Memorandum.[207] In other words, economists—and not just lawyers—should be heavily involved in all stages of the agency's cost-benefit and other economic analysis in rulemaking.

CONCLUSION

The SEC's experience with cost-benefit analysis, in court and in practice, provides an important lesson for other financial regulators. In sum, not only does the SEC's Guidance Memorandum address each of the D.C. Circuit's specific criticisms in *Chamber of Commerce*, *American Equity Investment*, and *Business Roundtable*, it also addresses the root of many of these problems—the absence of economists in the cost-benefit analysis stage of the rulemaking process. This report does not endeavor to assess whether the Guidance Memorandum is sufficient to address the D.C. Circuit's concerns or fulfill the SEC's obligations under its organic statutes, much less provide a critique of any particular statement in the Guidance

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[201] *Id.* at 14.

[202] Bus. Roundtable & U.S. Chamber of Commerce v. SEC, 647 F.3d 1144, 1151 (D.C. Cir. 2011).

[203] *Id.* at 1148-49.

[204] 2012 GUIDANCE MEMORANDUM, *supra* note 55, at 15.

[205] *Id.*

[206] *Id.* at 16.

[207] *Id.* at 16-17.

Memorandum.[208] Nor does it attempt to predict whether the SEC will actually put these words into practice. Instead, the analysis herein suffices to demonstrate that—instead of challenging the D.C. Circuit's trilogy on the SEC's inadequate cost-benefit analysis—the SEC responded by expressing an intention to correct course and engage in more serious economic analysis that incorporates the core principles of OIRA/OMB cost-benefit analysis.

The SEC's course of action is one that other financial regulators—such as the CFTC, the CFPB, and the federal banking agencies—can learn from and should follow. Such an approach is required by the law and supported by the history and policies that motivate the use of cost-benefit analysis. Especially now that Dodd-Frank has increased the amount of financial rulemaking, financial regulators can and should ground their rulemaking in rigorous cost-benefit analysis to arrive at more rational decision-making and efficient regulatory action as well as to promote good governance and democratic accountability. Financial regulators would be wise to follow the SEC's stated intention in its most recent guidance now before the D.C. Circuit, or Congress, or the Executive forces them to do so.

[208] For a more critical examination of the Guidance Memorandum, see Manne, *supra* note 87, at 23-25.

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U.S. Chamber of Commerce
1615 H Street, NW
Washington, DC 20062-2000
Tel 202.463.3162

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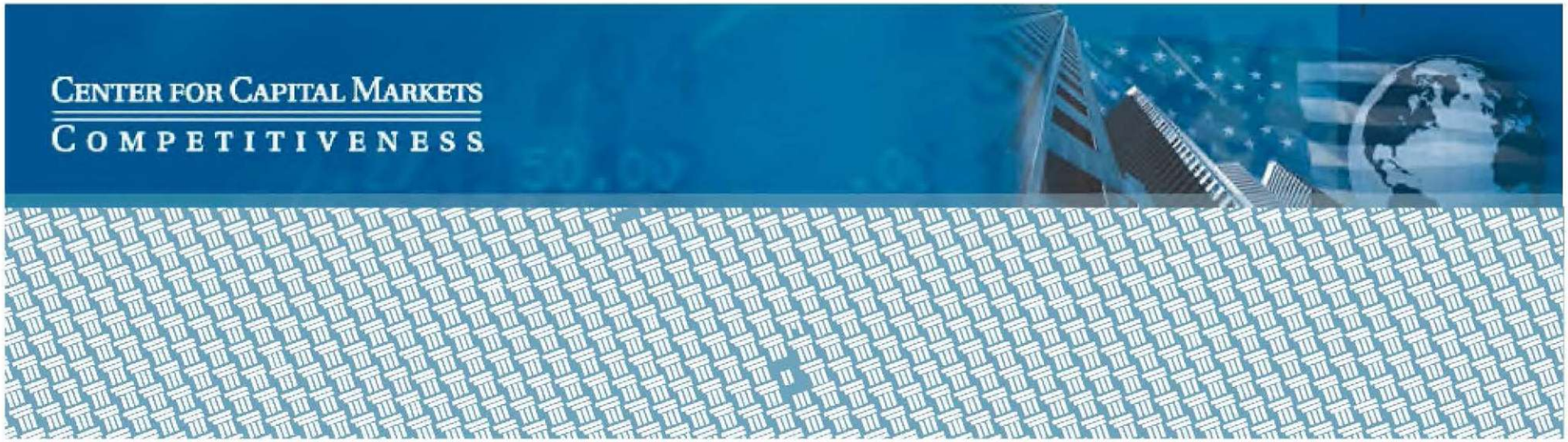


How Main Street Businesses Use Financial Services

Key Survey Findings

April 10, 2013

CENTER FOR CAPITAL MARKETS
COMPETITIVENESS

F T I CONSULTING

Methodology

- On behalf of the U.S. Chamber of Commerce's Center for Capital Markets Competitiveness (CCMC), FTI Consulting conducted a survey among **219 CFOs and Corporate Treasurers**, representing both privately-held and publicly-traded companies.

- The objective of this survey was to understand the financial services needs of mid-sized and large-sized companies and their use of commercial banking and other financial services.

- As such, respondents were screened to ensure they:

  - Worked for companies with at least $75 million in annual revenue.

  - Are very closely involved with at least one significant financial function of their company.

- The survey was conducted online from March 12 – April 1, 2013.

- Additional follow-up interviews were conducted to glean additional, qualitative insights.

FTI CONSULTING

Summary

1. Choice & Diversity Are Paramount

- 95% of Main Street businesses surveyed use 5 or more financial services.
- And, they use multiple institutions to meet their financial services needs. Among Main Street businesses that issue debt, 62% use 5 or more different institutions and 25% use 10 or more institutions.

2. Choice + Diversity = Flexibility

- They use multiple institutions of different sizes to meet their needs. Among Main Street businesses that issue debt, 84% use global institutions, 34% use national institutions, and 21% use a regional/local bank.
- As the economy has improved, Main Street businesses are using more financial vehicles than 2-3 years ago. Specifically, 21% say the number of financial vehicles they use has increased, while only 6% say they use fewer financial vehicles.

Summary

3. Ineffective Regulations = Reduced Choices And Increased Costs

- **More Main Street businesses say Dodd-Frank is reducing choice, rather than creating more choice.**
- **71% rate Dodd-Frank as negatively affecting their ability to access services.**
- **79% of those who say Dodd-Frank is hurting their access to financial services say financial services costs are increasing and causing them to delay investments, make cuts.**

Summary

4. Main Street Businesses Tend To Favor Trends & Policies That Preserve Choice

- They tend to view the preservation of regional and community banks as a positive trend affecting their ability to access services.
- They tend to view consolidation of banks as a negative trend affecting their ability to access services.
- They tend to view the hypothetical breakup of larger banks as a negative trend affecting their ability to access services.
- Main Street businesses favor trends that preserve choice and diversity within the system.

Main Street Businesses Use Many Different Financial Services

Percentages displayed are among those "Very Closely" involved with their company's use of that service.

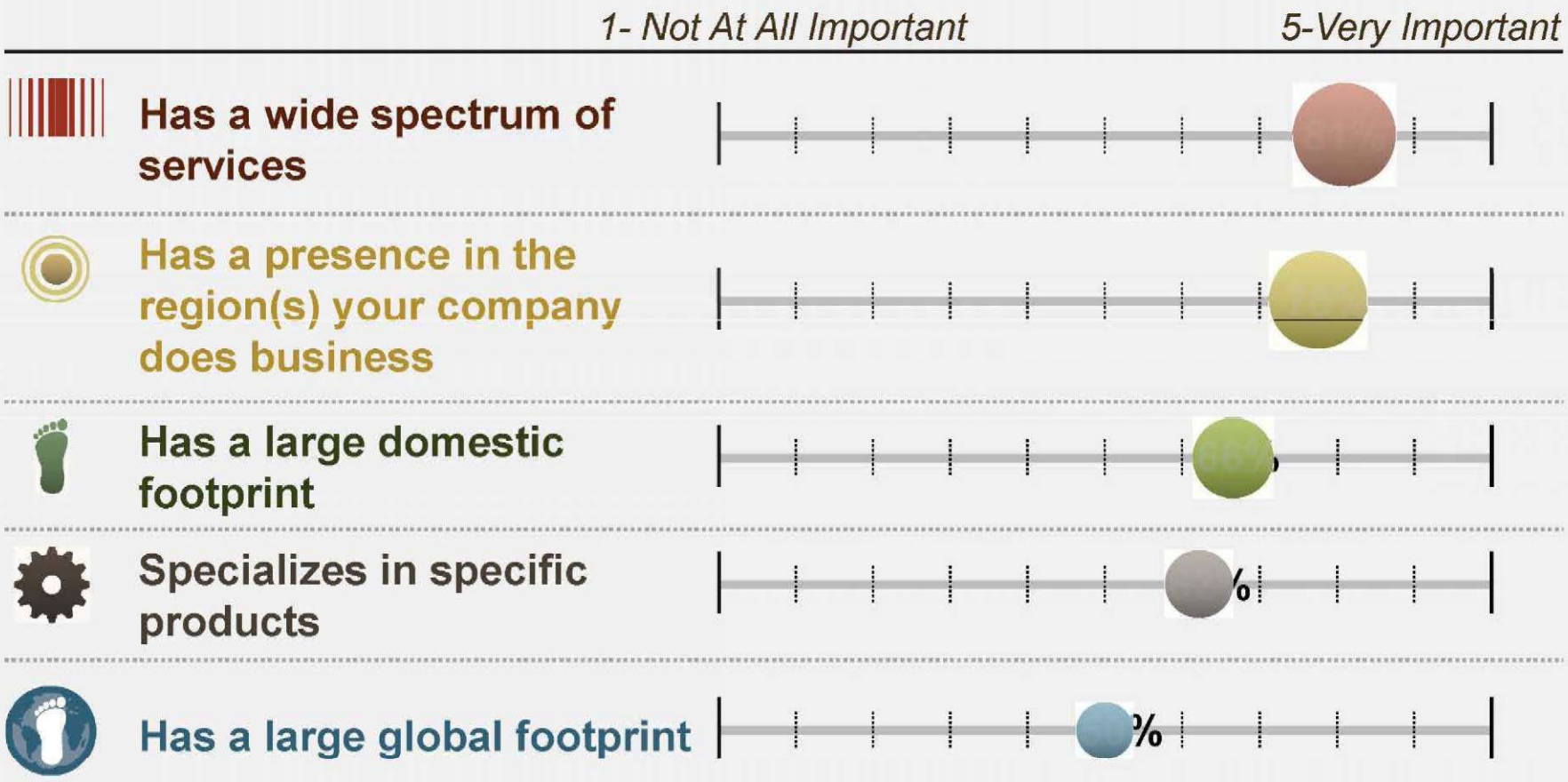
All Types of Financial Institutions Are Needed to Meet Financial Service Needs

	Global	National	Regional	Local
Cash Management	60%	48%	27%	11%
Obtaining Long-Term Loans	66%	43%	27%	6%
Obtaining Short-Term Loans	61%	50%	28%	9%
Issuing Debt	84%	34%	18%	3%
Utilizing Derivatives	74%	40%	13%	2%
Equity Issuances	77%	31%	10%	2%
Trade Financing	63%	35%	27%	10%
Issuing Securitizations	87%	33%	9%	0%
Issuing Commercial Paper	84%	22%	0%	3%

Percentages displayed are among those "Very Closely" involved with their company's use of that service.

Main Street Businesses Value Services, Presence, And Products

How important is it for your company to have a bank that…



Percentages displayed are the percentages who rate each factor a "4" or "5" on a 1-5 Importance Scale.

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As the Economy Has Improved, Main Street Businesses Have Tended to Use More Vehicles & More Global Banks Rather Than Fewer

*Have used **more** rather than fewer financial vehicles…*

Financial Vehicle Use Change
Has the number of financial vehicles your company has used increased or decreased over the past 2-3 years?

Increased

Stayed About The Same

Decreased

Have used Global Financial Institutions more rather than less…

Use of Global Banks
Compared to 2-3 years ago, does your company use global banks more, the same, less, or we never used them?

More

Same

Less

Never Used

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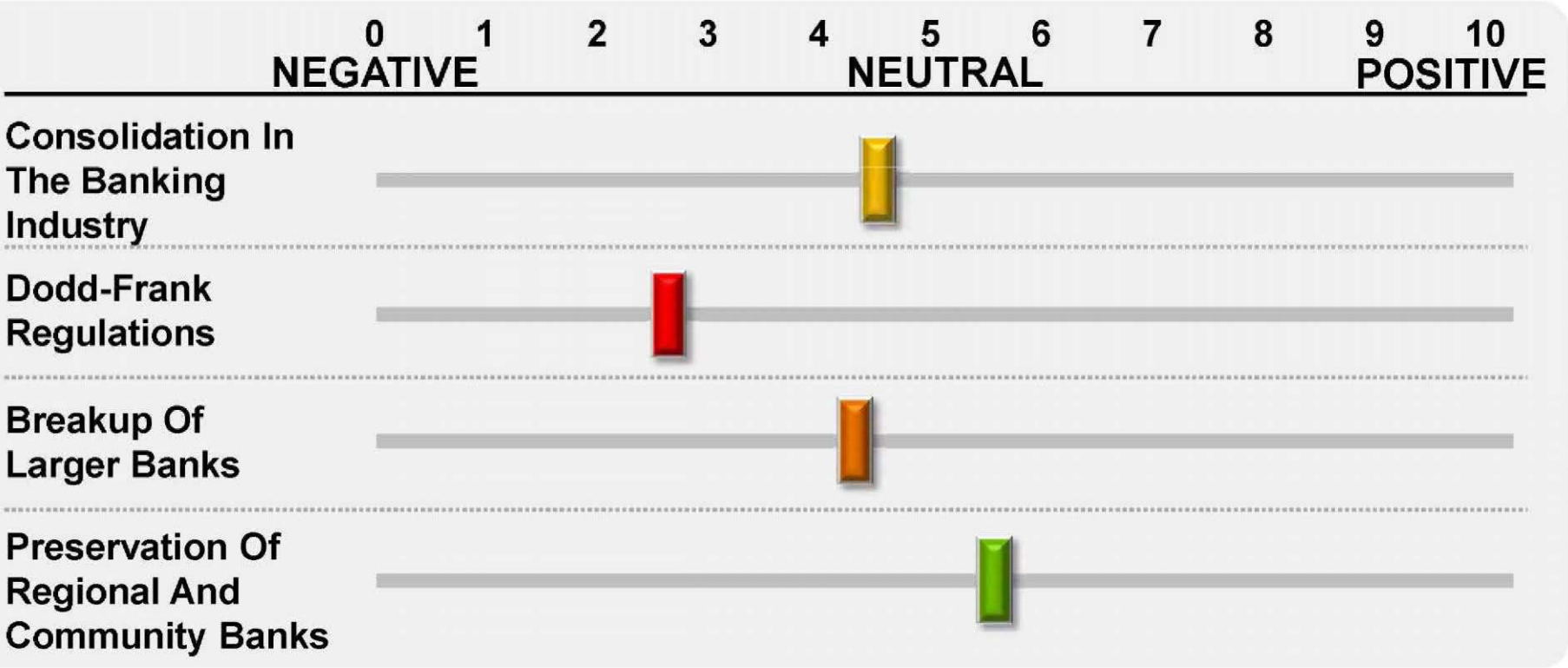
Main Street Businesses Rate Dodd-Frank As The Trend With The Most *(Negative)* Impact

71% rate Dodd-Frank negatively, the strongest rating of any potential trend

Trend Effects

Indicate whether Dodd-Frank has (or would have) a positive or negative impact on your company's ability to access the financial services it needs to operate.



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Main Street Businesses Have Taken Steps to Deal With Increased Financial Services Costs…

Only two and a half years into Dodd-Frank implementation, which of the following actions, if any, has your company had to take as a result of the increased costs of financial services?

Overall, 61% of CFOs have taken an action that negatively impacts consumers, investment, job creation, or services.

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Voices of Choice: Main Street Businesses

*"We had been taking on derivatives in the U.S. that were supporting our overseas entities. As we don't want to face **increased complexity and cost** imposed by Dodd-Frank, we are moving the derivatives back to our overseas entities."*

*"As there is **more regulation**, banks need to add overhead to complete their processes. **We continue to shop the market**."*

Price

*"Our company **competitively bids these services on a more frequent basis** to attempt to curb the pass-through of the [regulatory] administrative burdens."*

Service

*"We are **using more global banks now** that we have an affiliate company in Mexico, suppliers in Europe and Canada."*

"We've diversified banks, local and global for different uses as the company has broadened its activity: derivatives, corporate short-term debt, and project finance."

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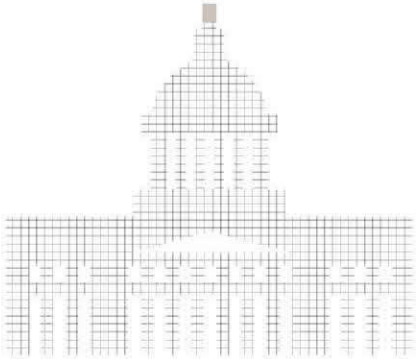
New Regulations Are Hurting Their Business And Borrowing, And Aren't Increasing Choice Or Confidence

Impact of new regulations…

"I'm not certain that our legislators in Washington understand that banks need to earn decent ROEs for their shareholders, with their shareholders being 401k plans, pension plans, etc. In the end, the American public suffers."



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Main Street Businesses See Dodd-Frank As A Big Trend Driving Increases in Financial Services Costs

61 % say that the increased financial services costs have forced them to delay investment or make cuts.

Of the 61%, four out of five said that Dodd-Frank has negatively impacted his company's access to services.

Of the 61%, about 70% say that breaking up the larger banks would negatively impact his company's access to services.

"Increased margin requirements, capital requirements, and regulatory compliance costs are the key cost drivers. We are constantly looking at out of the box ideas to reduce cost."

APPENDIX

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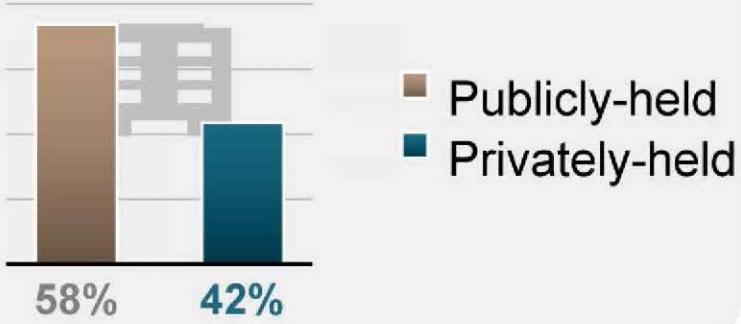
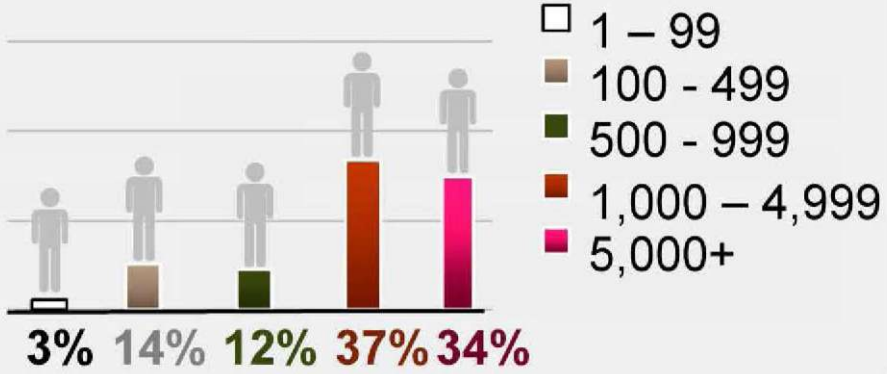
Sample Summary

Public / Private

Is your company...

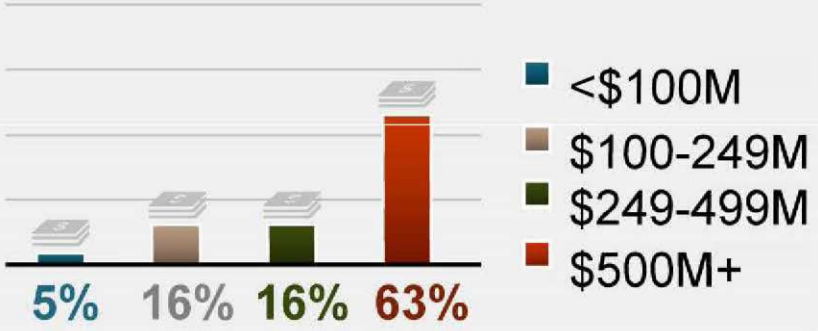


Number of Employees



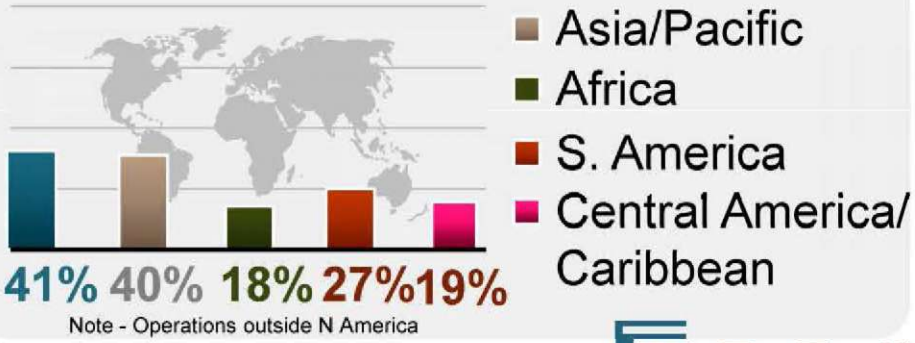
Annual Revenue

And, what is your company's annual revenue?



Overseas Region of Operation

47% Outside North America



Note - Operations outside N America

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